

Kazakhstan:

Growth Slows as External Pressures Rise



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Kazakhstan Economic Update
Fall 2014

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Weights and Measures:	Metric System

Abbreviations and Acronyms

CU	Customs Union between Belarus, Kazakhstan and Russia
DB	Doing Business
EaEU	Eurasian Economic Union
ECA	Europe and Central Asia
FDI	Foreign direct investment
FX	Foreign exchange
GCI	Global Competitiveness Index
GDP	Gross domestic product
IFIs	International financial institutions
KASE	Kazakhstan Stock Exchange
NBK	National Bank of Kazakhstan
NOE	Non-observed economy
NPLs	Non-performing loans
PCA	Partnership and Cooperation Agreement (with the EU)
PFA	Partnership Framework Arrangement (with IFIs)
PLF	Problem Loans Fund
SMEs	Small- and medium-sized enterprises
UAPF	Unified Accumulative Pension Fund
VAT	Value-added tax
WTO	World Trade Organization
y-o-y	year-on-year

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Overview

Kazakhstan is experiencing slower economic growth in 2014 due to negative supply- and demand-side effects. Kazakhstan's real GDP growth slowed from 6 percent in 2013 to 4 percent in the first nine months of 2014 due to lower output in the oil industry, weaker external demand by China and Russia for Kazakhstan's metal products, and weaker domestic demand following the tenge devaluation in February 2014. Private consumption, in particular, was hit hard by the negative wealth effect after the devaluation, a tightening of lending conditions for consumer loans, and the delayed impact of the slower growth in real wages in 2013.

The Kazakh authorities are using expansionary fiscal and monetary policies to stimulate domestic demand. Immediately after the tenge devaluation, amid early indications of an economic slowdown, the government launched an economic support program for 2014-15 of one trillion tenge, equivalent to \$5.5 billion. To fund the program, the government tapped the Oil Fund and also plans to issue \$2.5 billion worth of Eurobonds and increase borrowing from international financial institutions (IFIs). To restore trust in the tenge and stimulate lending, the monetary authority has worked to stabilize the exchange rate, increase supply of tenge liquidity, and address scarcity of long-term tenge funding and high dollarization in the banking system.

An uncertain global economic environment and regional geopolitical tensions pose risks to the economic outlook of Kazakhstan. The country's GDP growth is expected to be about 4.1 percent in 2014 before gradually rising to 5.5 percent by 2017, mainly driven by larger oil production. Oil output is projected to increase after off-shore oil production comes on line in 2016/17. Risks to the short-term outlook may emerge from further slowdown of China and Russia that affects metal production and metal processing industries in Kazakhstan, and from investors' sentiment and greater risk-aversion, particularly in response to the Russia-Ukraine crisis. Moreover, a softening of oil prices as global demand for oil slackens may also undermine Kazakh consumer and business sentiments and potentially increase pressures on the tenge.

If the economic slowdown starts to have a negative effect on the labor market, the government has instruments to mitigate its impact on the most vulnerable population. Current social assistance and employment support programs may need to be scaled up if additional funding is available, from the Oil Fund or from reprioritizing budget spending. To improve the efficiency and effectiveness of support programs, the government needs to better target households in need and ensure time-bound assistance. For the economy to become more resilient, the authorities will need to further develop human capital by improving training and educational outcomes.

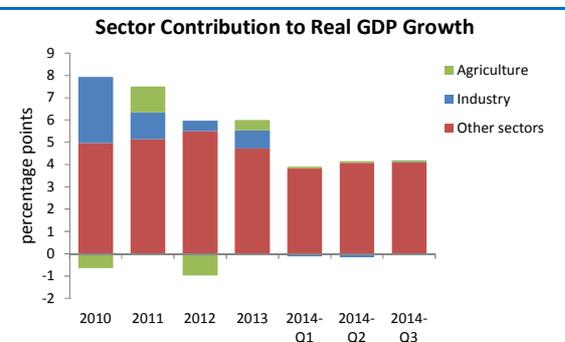
The government has identified a set of reforms that are expected to help diversify the economy and expand the non-oil sector. The authorities have adopted a new package of measures to attract foreign direct investments to the economy, including investment subsidies, tax incentives, and improved visa regime and business services to investors. They have launched a major program of support for the development of small- and medium-sized enterprises, including by addressing the constraints related to access to credit. They are also working to improve the national regulatory and governance framework that would enhance the transparency and efficiency of economic transactions, facilitate private sector participation, and improve service delivery to the population. Ongoing reforms in customs administration and the courts are part of its reform agenda.

A. Experiencing Slower Growth

Economic Growth Has Moderated Due To Supply-Side Constraints and Weaker External and Domestic Demand

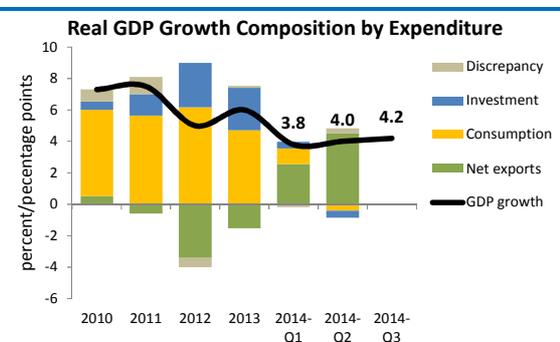
Kazakhstan is experiencing slower economic growth in 2014 due to negative supply- and demand-side effects. In the first nine months of the year, real GDP growth slid to 4 percent year-on-year (y-o-y), from 5.7 percent in same period of 2013, mainly due to a decline in industrial output (Figure 1). The decline was caused by lower oil production and weaker external demand by China and Russia for Kazakhstan metal products. Oil production declined by 0.9 percent y-o-y in the first nine months of 2014, as production by Tengizchevroil, the key driver of oil sector performance for the past decade, went down from the exceptional 27.1 metric tons in 2013 back to 26-26.5 million metric tons expected this year.¹ Meanwhile, Kashagan, the giant off-shore oil field in the Caspian Sea, will not come on line before 2016/2017. This delay has led to substantial adjustments in oil production plans for 2014-16.² Slower growth in China led to lower exports of Kazakh oil, iron ore, and metal products, which together account for 80 percent of China’s imports from Kazakhstan.³ Moreover, depressed industrial activity in Russia saw a drop in exports of Kazakh raw ore and metal products, which account for almost half of Russia’s imports from Kazakhstan, and negatively impacted industrial activity in Kazakhstan.⁴ Official data suggest that industrial output declined by 0.2 percent y-o-y in the first nine months of 2014. Services sector growth has also fallen from 7.6 percent during the first nine months of 2013 to an estimated 5.2 percent in the same period of 2014 as a knock-on effect of lower oil and metal exports on trade and transport services.

Figure 1. Economic growth slowed amid declining industrial output in 2014



Source: Statistical Office of Kazakhstan.

Figure 2. Domestic demand weakened, while the net exports balance improved



Source: Statistical Office of Kazakhstan.

Domestic demand also decreased in 2014 compared to 2013. Higher prices for imports resulting from the tenge devaluation, tighter lending conditions for consumer loans, and weak growth in real wages pushed down domestic demand and led to slower growth of the non-

¹ Oil production at the Tengiz oil field, which accounts for one-third of total oil production in Kazakhstan, reached a record 27.1 million metric tons in 2013, but is expected to normalize to 26-26.5 million metric tons a year in 2014-2015. Ongoing investments to increase capacity may boost annual production at Tengiz to 36-38 million metric tons in five to six years.

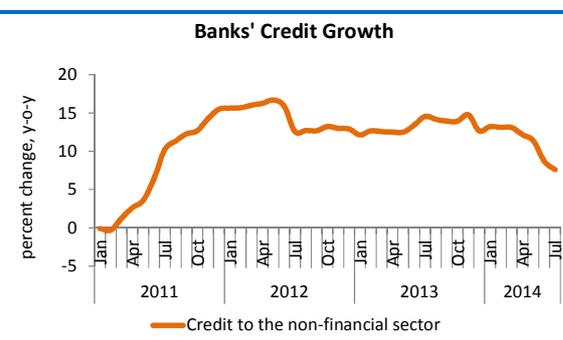
² As a result of another delay in commercial production at Kashagan, Kazakhstan’s GDP growth estimate for 2014 was slashed by about half a percentage point.

³ In the first half of 2014, the volume of oil exported to China dropped by 21 percent y-o-y, iron ore exports by 41 percent, and exports of copper and copper products by 27 percent.

⁴ In the first half of 2014, the volume of rolled metal and steel exports to Russia was down by 16 percent y-o-y, aluminum exports by 26 percent, and copper exports by 93 percent.

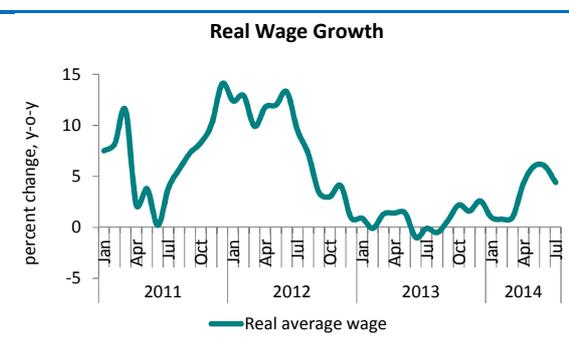
oil economy in 2014.⁵ In the first half of 2014, domestic demand contributed 0.3 percentage points to GDP growth, compared to an average annual contribution of more than 7 percentage points in 2011-13 (Figure 2). Private consumption was affected by lower growth of bank credit to the economy, which slowed from 13 percent y-o-y in December 2013 to 7 percent in August 2014. Credit growth slowed mainly because in the fall of 2013 some big banks froze their mortgage programs and also because in February 2014 the National Bank of Kazakhstan (NBK) introduced a 30 percent cap on consumer lending growth for each bank (Figure 3).⁶ Weak real wage growth in 2013 and in the first quarter of 2014 also depressed consumer spending (Figure 4). Meanwhile, growth in fixed capital investment slowed from 7.1 percent y-o-y in the first half of 2013 to 5.1 percent in the same period of 2014, as the credit slowdown also affected the investment activity. In July-August 2014 growth in fixed capital investment improved slightly to 6.3 percent, partly due to increased government investment.

Figure 3. Growth of banks' lending to the economy moderated in 2014



Source: National Bank of Kazakhstan.

Figure 4. Real wage growth started recovering in the second quarter of 2014



Source: Statistical Office of Kazakhstan.

The Wider Trade Surplus Improved the Balance Of Payments Picture

The February devaluation helped improve the external position reversing its negative impact on GDP growth. As imports plunged when higher prices impacted the purchasing power of consumers, the trade surplus widened from \$15.6 billion in the second half of 2013 to \$22.6 billion in the first half of 2014 (Figure 5). As a result, contributions of net exports to GDP growth improved significantly, to 3.5 percentage points in the first half of 2014 from having been negative in 2011-13 (Figure 2). The larger trade surplus was the main contributor to an improvement in the current account, which amounted to \$6.6 billion in the first half of 2014. Meanwhile, the capital account (excluding investments of the Oil Fund) was in balance in the first half of 2014, with net inflow of foreign direct investment (FDI), portfolio investment, and external loans offset by increased outflows of unidentified capital.⁷

The improved external position helped stop the drawdown of foreign exchange reserves held at the NBK, as official data suggest. Total official foreign exchange (FX) reserves, including FX reserves of the Oil Fund, increased by \$7 billion in the first nine months of 2014, reaching \$97 billion (equivalent to 44 percent of GDP), by the end of September 2014 (Figure 6). While \$5.4 billion of the total increase in official FX reserves has

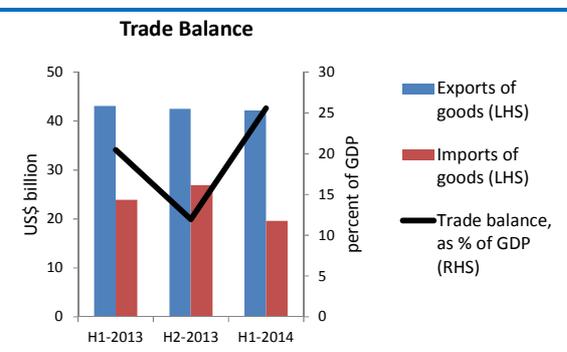
⁵ In February 2014, the tenge was devalued by 19 percent, from an average of 155 KZT/USD in January 2014 to a band of 185±3 KZT/USD. Currently, the exchange rate is being held to 182 KZT/USD, within an asymmetric band of 185+3/-15 KZT/USD.

⁶ Consumer lending growth accelerated from 21 percent y-o-y in 2011 to 40 percent in 2012 and to over 46 percent in 2013, causing concerns about whether the trend was sustainable. As a result of the new regulation (a 30 percent cap), it moderated to 31.4 percent y-o-y in July 2014.

⁷ Official data suggest that unidentified FX outflows, reflected in Errors and omissions, increased from \$3 billion in the second half of 2013 to \$7 billion in the first half of 2014.

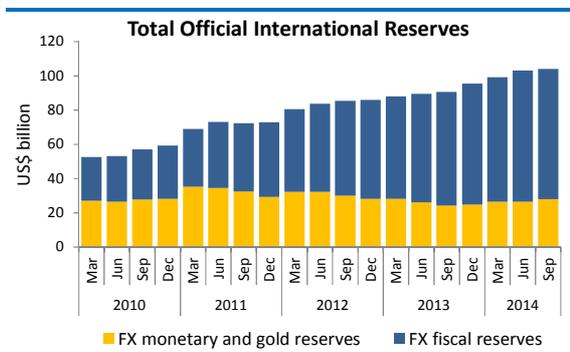
been sterilized (invested by the Oil Fund abroad), the FX reserves held at the NBK show an increase of \$1.6 billion since the beginning of 2014. Official NBK data indicate that after the February devaluation official FX reserves held at the NBK rose from \$19 billion in January 2014 to \$22 billion in April, but fell to about \$20 billion in June-September, following NBK interventions in the FX market to stabilize the exchange rate.

Figure 5. Trade surplus widened due to a contraction in merchandise imports



Source: National Bank of Kazakhstan.

Figure 6. Monetary reserves stabilized, while fiscal reserves kept rising

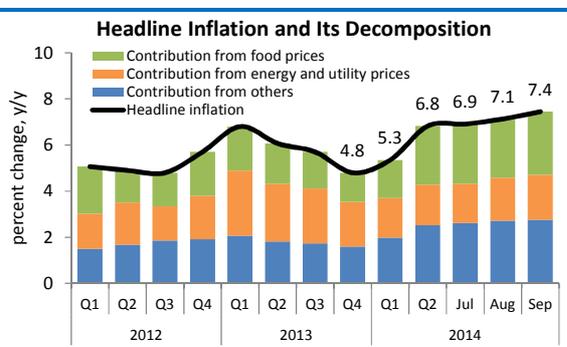


Source: National Bank of Kazakhstan.

The February Devaluation Has Pushed Prices Up

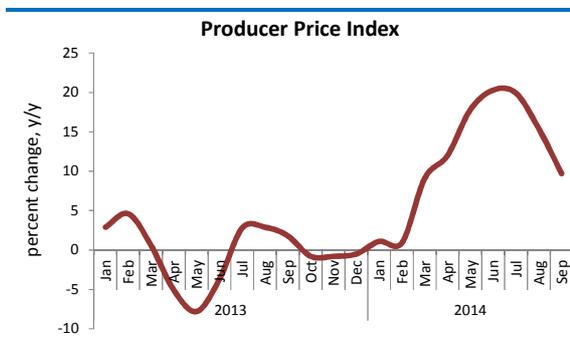
Prices rose steadily in 2014, despite introduction of price controls on basic food, public transport, and utilities after the devaluation. Following the tenge devaluation, consumer price inflation rose steadily from a record low of 4.5 percent y-o-y in January 2014 to an average of 6.9 percent in May-July and then up to 7.4 percent in September (Figure 7). Prices for imported items were the main contributors to the increase. On the other hand, inflation was partially contained by the price controls for basic food and domestically provided utility and public transportation services. Nevertheless, in August 2014, controlled gasoline prices were adjusted upward to address emerging gasoline shortages; that is expected to drive prices of other goods and services higher.⁸ Meanwhile, producer prices increased more dramatically in 2014, than those captured by the consumer price basket. They jumped from about 1 percent y-o-y in January-February 2014 to about 20 percent in June-July before falling back to 9.7 percent in September (Figure 8). Prices for imported inputs were the main reason for higher prices of products made in Kazakhstan. Removal of price controls during the coming months would lead to higher inflation by yearend.

Figure 7. Inflation is on the rise due to increases in prices of imported goods



Source: Statistical Office of Kazakhstan.

Figure 8. Producer prices rose sharply due to higher prices of imported supplies



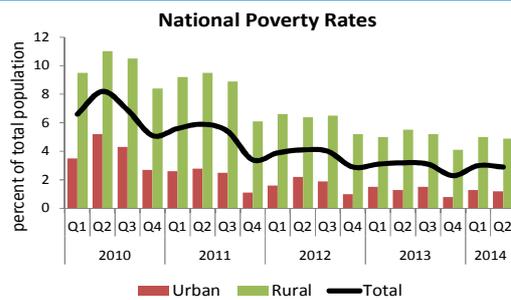
Source: Statistical Office of Kazakhstan.

⁸ Following gasoline shortages in August 2014, prices for AI-92 (regular) were adjusted up by 11.3 percent, from 115 tenge per liter to 128 tenge.

Poverty and Unemployment Remained Low, While Informality and Irregular Migration Are Still High

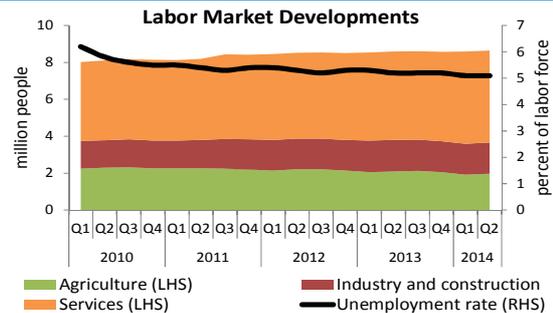
Job creation in services helped keep poverty low in Kazakhstan. As measured by the national poverty line, the incidence of poverty dropped from 3.8 percent of total population in 2012 to 2.9 percent in 2013 and held at about 3 percent during the first half of 2014 (Figure 9). While poverty in cities stayed low at about 1.3 percent of total urban population, in rural areas about 5 percent of the population live below the poverty line, with agriculture-intensive regions being most affected.⁹ The disparity in living standards between rural and urban areas drives domestic migration, which has intensified over the last two years: agriculture lost more than 83,000 (or 5 percent) of its labor force in 2013 and another 78,000 in just the first half of 2014. These migrants filled jobs in the growing services sector in cities, where jobs are better paid than in agriculture. The jobs are mainly in trade-related activities, transportation, and catering. Since job generation in the services sector outpaced losses of jobs in agriculture, the official unemployment rate fell from 5.2 percent of the labor force in 2013 to 5.1 percent in the first half of 2014 (Figure 10). If the economic slowdown starts affecting the labor market negatively, the government should consider mitigating the impact on the population by assisting the most vulnerable (Box 1).

Figure 9. The poverty incidence stabilized in 2013 and in the first half of 2014



Source: Statistical Office of Kazakhstan.

Figure 10. The services sector generates jobs and contributes to higher employment



Source: Statistical Office of Kazakhstan.

While official unemployment rates are low and the labor market is formalizing, informality is still significant. Between 2000 and 2013, the proportion of self-employed fell from 42 percent to 30.5 percent of the employed population, and the percentage of hired/contracted employees rose from 57.7 to 69.4 percent. Nevertheless, a World Bank analysis (2011) placed informality at about 33 percent of the labor force in 2009, with informality heavily concentrated in agriculture but also not uncommon in construction, transport, and trade.

Kazakhstan is also a major destination for migrants from elsewhere in Central Asia; irregular migration is a chronic problem. It is currently estimated that migrant workers in the country, both regular and irregular, may number more than 1 million a year. Most migrants are from Uzbekistan, the Kyrgyz Republic, and Tajikistan; they are young (40 percent are in their 20s and early 30s) and move to major economic centers. Low-skilled migrants respond to demand in agriculture, construction, trade, and services. An estimated 100,000 to 400,000 a year are irregular. Cumbersome processes to obtain work permits appear to be a major obstacle for regularization; the authorities are thinking of revising migration policy to address it.

⁹ The highest rural poverty rate of close to 8 percent was registered in the agriculture-intensive South-Kazakhstan oblast, followed by the oil-rich Atyrau oblast, where over 6 percent of the rural population is poor.

Box 1. Policies that could mitigate the economic slowdown effects on employment

The government has already tapped the Oil Fund since the February 2014 devaluation to support economic activity through loan facilities for the private sector, wage increases in the public sector, and higher social payments to the most vulnerable groups. Additional short-term and reversible policy measures that might become necessary are extension of unemployment benefits, training, and public works to both provide labor income and build human capacity.

In the medium to long run, other measures should be considered:

- ***Make economic support instruments more efficient.*** Review the components of previous economic support programs, including the outcomes of the public works program and labor-saving contracts, to assess the poverty impact of wage increases on the households of public employees. This will provide insight into which elements of the economic support programs were more efficient in mitigating crisis impacts.
- ***Continue refining the social safety net system with instruments that are targeted and time-bound.*** The government is moving to better target social assistance programs and reform the pension system, and plans to improve social insurance. Systematic analysis of the effectiveness and efficiency of social protection programs will help the government hone its policy instruments for future use.
- ***Diversify the economy to strengthen human and institutional endowments to build resilience to shocks.*** To achieve economic resilience, the authorities will need to build on human capacity by improving education and training outcomes. This means both budgeting a larger share for education, which is below the average for Europe and Central Asia (ECA), and ensuring that the allocation is spent efficiently. Reforming migration policy to facilitate immigration of skilled labor Kazakhstan would ease short- and medium-term skills shortages and help build the national pool of skills. Finally, institutions that support the functioning of the market would benefit from further reinforcement, especially those related to the rule of law and transparency, such as those that promote fair competition by addressing public procurement and competition policy, and from upgrading quality and consumer protection. These institutional gains will help keep growth sustainable by diversifying the economy and thus making it more resilient to crises.

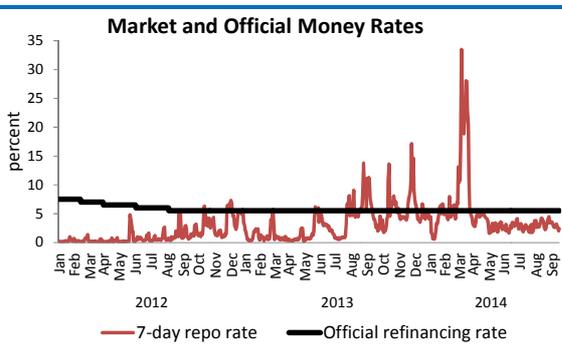
Source: World Bank staff.

B. Stimulating Demand with Expansionary Macroeconomic Policies

The Monetary Authority Is To Revive More Sustainable Lending To the Economy

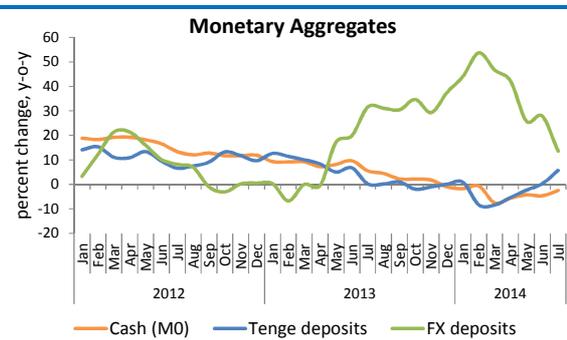
To restore trust in the tenge and stimulate lending activity for growth, the NBK has worked to stabilize the exchange rate and increase supply of tenge liquidity. In the second half of 2013, when depreciation expectations were mounting, the NBK limited provision of tenge liquidity in the repo market to prevent additional pressures on the tenge. A temporary withdrawal of pension funds' money as the funds were being consolidated into a state-run Unified Accumulative Pension Fund (UAPF) also contributed to tighter tenge liquidity in the second half of 2013. Tighter tenge liquidity then led to significant volatility of money market interest rates in the repo market, where depreciation risks were also factored into interest rates (Figure 11). After the February devaluation, the NBK resumed injecting tenge liquidity via the repo market to stabilize expectations and restore trust in the tenge. Moreover, in May 2014, the UAPF adopted a new investment strategy, limiting investments in low-yield government securities (now restricted to 50 percent of total UAPF assets) and increasing placements of deposits in local commercial banks (from below 25 percent to 50 percent of total UAPF assets), on condition that banks use the money for lending to the economy and not for speculative FX operations. As a result of the increased tenge liquidity, money market interest rates stabilized significantly during May-September 2014.¹⁰

Figure 11. Interbank money market interest rates stabilized after the devaluation



Source: National Bank of Kazakhstan; KASE.

Figure 12. Demand for dollars eased after the devaluation



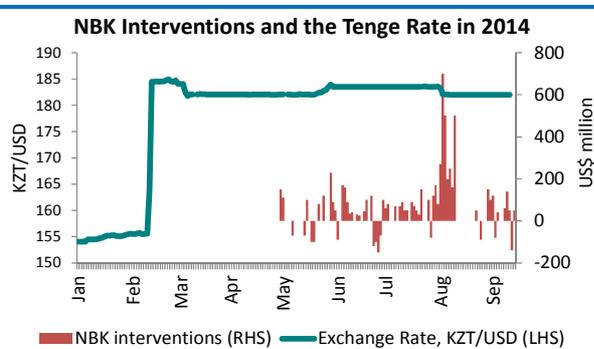
Source: National Bank of Kazakhstan.

In addition, the NBK has launched a currency-swap program to address scarcity of long-term tenge funding and high dollarization of the banking system. The share of FX deposits in the total deposit base stood at about 45 percent in July 2014, even though the pace of deposit dollarization slowed considerably after the devaluation and the liquidity injections, from about 50 percent y-o-y growth for January-March 2014 to 13.5 percent in July (Figure 12). To address the dollarization issue and also provide banks with longer-term funding for a healthier credit revival, the NBK launched a \$10 billion FX-swap program in July 2014, with a fixed interest rate of 3 percent for 1-3-year FX swaps. In addition, the UAPF, which is managed by the NBK, started opening term-deposit accounts in banks for 5-10 years, providing banks with further funds to lend out for longer term. There are also plans to limit FX derivative operations and bank FX asset holdings abroad (a cap of 30 percent of total assets is being considered) to bring bank capital back to the economy. Given that traditional open market instruments, such as

¹⁰ Since May 2014 seven-day repo rates have settled in the range of 1.6-4.5 percent (below an indicative official refinancing rate of 5.5 percent), with the highest rates registered during a tax payment week in August.

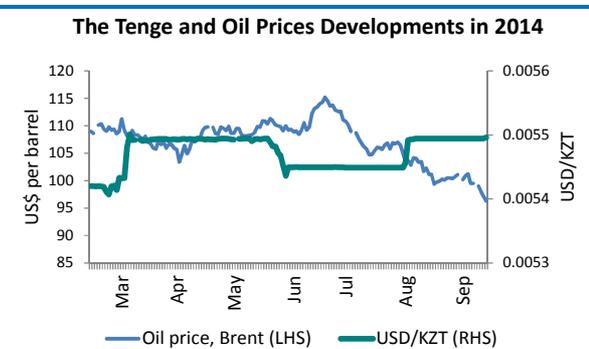
refinancing loans and credit auctions, are of limited use, the NBK considers interventions into the repo market and FX swaps to be the most effective instruments for managing tenge liquidity, stabilizing the exchange rate, and de-dollarizing the deposit base. An analysis of dollarization of the banking system can be found in section D below.

Figure 13. The exchange rate has been tightly managed by the NBK



Source: National Bank of Kazakhstan; Halyk Finance.

Figure 14. Oil prices started softening amid concerns of weakening global demand for oil



Source: National Bank of Kazakhstan; US EIA.

While the NBK considers keeping the exchange rate stable to be paramount for economic growth, pressures from the external terms of trade have recently risen. After the February 2014 devaluation, the exchange rate of the tenge against the US dollar was held tightly at about 182 KZT/USD through May 2014 (Figure 13). At the end of May, the NBK limited interventions in the FX market due to launch of the currency-swap program and kept the exchange rate at about 183.5 KZT/USD during June-July 2014. Nevertheless, the cost of NBK adherence to a tight exchange rate regime rose after oil prices softened in July 2014.¹¹ In early August 2014, despite further softening of oil prices, the NBK re-adjusted the exchange rate back to 182 KZT/USD for August-September 2014, at significant estimated cost to the NBK.¹² Nevertheless, the NBK seems determined to keep the exchange rate stable: in mid-September it announced that the exchange rate will be maintained within a new asymmetric band of 185+3/-15 KZT/USD. However, macroeconomic factors suggest that terms of trade pressures on the tenge have intensified recently due to weakening global demand for oil and thus declining oil prices (Figure 14).¹³ In other words, the increased terms of trade pressures on the tenge may lead to further drawdowns in the FX reserves held at the NBK, unless it allows the tenge to respond to changing market conditions more freely.

Fiscal Policy Is Directed To Alleviating the Impact of the Devaluation and Stimulating the Private Sector

The government has tapped the Oil Fund for an economic support program to stimulate domestic demand. Following the February 2014 devaluation and early indications of slower GDP growth, the government launched an economic support program of one trillion tenge (an equivalent of \$5.5 billion) for 2014-15. In 2014, half of the Oil Fund support package was allocated for stimulating private investment by (i) providing financial support to enterprises in the manufacturing industry via both direct and on-lending operations through a state-owned Baiterek holding; and (ii) addressing non-performing loans (NPLs) in the banking sector via an

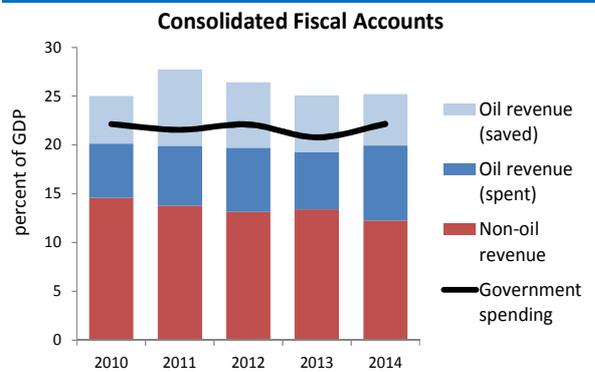
¹¹ According to estimates of Halyk Finance, net NBK interventions amounted to about \$0.4 billion a month during May-June 2014 but shot up to \$1.3 billion in July.

¹² According to estimates of Halyk Finance, re-fixing the exchange rate at 182 KZT/USD cost the NBK about \$2.5 billion during August 2014 and about \$0.75 billion in September.

¹³ In September 2014, Brent crude was trading below \$100 per barrel, down gradually from a one-year high of \$115 per barrel in mid-June.

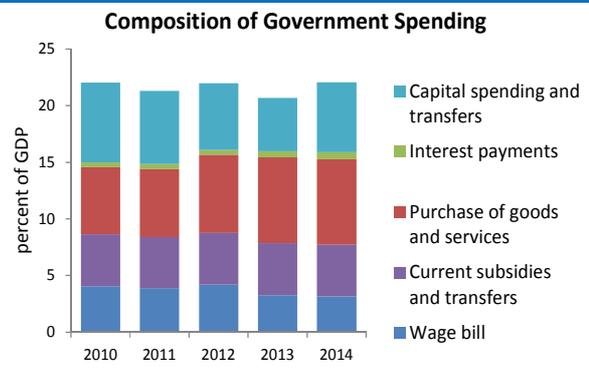
NBK-owned Problem Loans Fund (PLF). The government also announced increases in social transfers, including pensions and student subsidies, and a 10 percent wage increase for the civil and public service that went into effect in April 2014. The government also plans to issue Eurobonds amounting to \$2.5 billion and increase borrowing from IFIs in the medium-term to finance infrastructure and institutional-building projects.

Figure 15. The non-oil deficit widened due to higher spending and lower non-oil revenue



Source: Finance Ministry of Kazakhstan.

Figure 16. The capital budget expanded, while salaries and social transfers were preserved



Source: Finance Ministry of Kazakhstan.

The non-oil deficit widened due to a slowing economy and higher government spending. The non-oil deficit is estimated to widen from about 8 percent of GDP in 2013 to over 10 percent in 2014. About half of the increase can be attributed to the higher capital budget, and the other half due to lower non-oil revenue (Figure 15). The economic support program has raised the 2014 capital budget, compared to 2013, due to capital transfers to the Baiterek holding and the PLF (Figure 16). Disbursements for the support program were low during the first half of 2014 but are expected to pick up towards the end of the year. Current expenditures have already been adjusted to the devaluation impact, as noted above. Meanwhile, depressed profits in the metallurgy sector have reduced non-oil revenue but tax avoidance has not been reduced, as was hoped when the current Tax Code was being introduced in 2009. A detailed discussion on the non-observed economy and its impact on tax avoidance can be found in section E below.

The Recent Government Initiative Demonstrates a New Focus on Structural Reforms

Early in 2014, the government launched a major long-term development strategy, Kazakhstan-2050. The strategy places a focus on accelerating the transformation of the economy into a diversified, private-sector-driven, developed economy by 2050. President Nazarbayev outlined the government's seven strategic priorities in his 2014 Address to the Nation of Kazakhstan: (i) innovative industrialization; (ii) an efficient agri-industrial sector; (iii) improved potential for science; (iv) urban and infrastructure development; (v) development of small- and medium-sized enterprises (SMEs); (vi) an active, educated, and healthy population; and (vii) efficient public institutions.

To achieve the seven objectives outlined in the Kazakhstan-2050 development strategy, the authorities have established eight working groups to design and implement medium-term action plans, jointly with IFIs. The government established a coordination council chaired by the Prime Minister to supervise the work of the working groups.¹⁴ The authorities, in

¹⁴ In early April 2014, Mr. Karim Massimov again became Prime Minister, replacing Mr. Serik Akhmetov. Mr. Massimov had held the premiership in 2007-2012.

collaboration with the IFIs, have developed action plans in the following eight broad thematic areas to ensure inclusive growth outcomes and more sustainable development:

1. Attracting investments and developing public-private partnerships;
2. Facilitating sustainable environmental (greener and energy-efficient) development;
3. Increasing the role of the private sector in the economy by fostering development of SMEs and improving the business climate;
4. Reforming institutions;
5. Building job skills adapted to labor market demands;
6. Promoting regional cooperation and economic integration;
7. Fostering science and innovation; and
8. Building up the financial sector.

Instruments for the implementation of the medium-term action plans will be developed jointly by the government and IFIs under a new Partnership Framework Arrangement (PFA).

To increase effectiveness of the administrative apparatus the government restructured itself to better address short-term challenges and meet long-term objectives. In early August 2014, President Nazarbayev decreed a restructuring of the government to improve its effectiveness in stimulating economic activity and implementing the necessary reforms for structural transformation of the economy. The new government structure consists of 12 ministries and about 30 committees, down from 17 ministries, 9 agencies, and 54 committees previously. All committees are integrated into the newly established/reformatted ministries. The restructuring of the government has led to the creation of five new mega-ministries that combine mandates of various previous ministries and agencies. These include: the Ministry of the National Economy, the Ministry of Health Protection and Social Development, the Ministry of Culture and Sports, the Ministry of Investment and Development, and the Ministry of Energy. The rest of the ministries (the Ministry of Foreign Affairs, the Ministry of Interior, the Ministry of Justice, the Ministry of Defense, the Ministry of Education and Science, the Ministry of Finance, and the Ministry of Agriculture) are to remain the same, with some redefinition of their powers and functions.

The Structural Reforms Are Being Designed To Attract Investment in the Non-Oil Economy

The government is keen to attract more investments into the non-oil economy. In April 2014, the government presented a Framework for Attracting Foreign and Domestic Investment into the Economy of Kazakhstan, comprising (1) a package of new incentives, designed to remove the most critical obstacles for investors; and (2) an action plan that lists priority sectors for investment, interested multinational corporations, and national companies and development institutions assigned responsibility for actualizing the Framework (Box 2).

Box 2. Incentives for investment in Kazakhstan

The incentive package covers five areas of support and corresponding actions:

1. *Investment subsidies, tax preferences, and procurement incentives:* (1) Introduce an investment subsidy from the government budget in the form of a rebate of 30 percent of costs incurred by investors after an investment project is in full operation; (2) exempt investors from paying corporate income tax for 10 years; (3) secure long-term contracts for provision of goods and services to national holdings, national companies, and government institutions.
2. *Stable laws and cost predictability:* (1) Follow a “legislation stability principle” to be applied for 10 years to tax, migration, and environmental legislation; (2) ensure that tariffs and prices of regulated services are predictable.
3. *One-stop service:* Establish a single-window service for investors, to be run by the Investment Committee of the Ministry of Investment and Development.
4. *Energy and transport cost subsidies:* Reconsider budget subsidies for energy and transportation costs.
5. *Waiver of the local content requirement:* Give investors the right to attract foreign labor for the duration of an investment project plus one year after a project begins operation by waiving quota and work permit requirements for foreign labor.

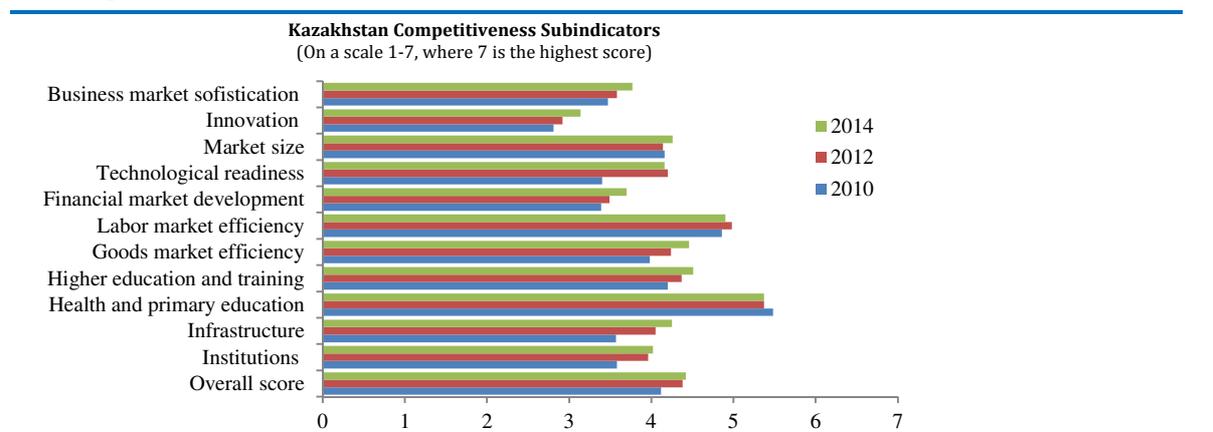
In addition to the main package, Kazakhstan will introduce the following measures:

- *A simpler visa regime:* (1) Set up a visa-free regime for investors from the 10 developed countries that have most investment significance for Kazakhstan; (2) provide investor visas for heads of structural units and affiliates of foreign companies.
- *Duration of agricultural land leases:* Extend the period for which foreigners can rent agricultural land if they invest in agricultural production or processing.
- *Investor protection service:* Establish an institution to protect investor rights, to act as an “investment ombudsman.”

Source: The Government of Kazakhstan.

The business environment for private sector development is improving, though there are still serious constraints to be addressed. The improvements to the business framework are reflected in the Doing Business index (DB) of the World Bank and in the Global Competitiveness Index (GCI) of the World Economic Forum, where Kazakhstan now ranks 50th in the world. Figure 17 captures the country’s progress on various drivers of competitiveness but also underscores that improvements are needed in, e.g., innovation, financial market developments, infrastructure, and institutions.

Figure 17. Global Competitiveness Index shows steady improvement for private sector development



Source: World Economic Forum.

Among the various drivers of competitiveness, improvement in institutions is of special concern. A 2013 enterprise survey of 600 business owners and managers identified corruption as the top business environment obstacle to their firms’ economic activity (World Bank, 2013).

The World Justice Project in 2014 ranked Kazakhstan 71 out of 99 countries on the overall rule of law index and 60 out of 99 on the absence of corruption index.¹⁵ Kazakhstan is characterized as having uneven institutional capacity, low public trust in check-and-balance institutions, such as the courts, and corruption in government procurement and contracting. Institutional reforms are needed to enhance the transparency and efficiency of economic transactions, facilitate private sector participation, and improve service delivery to the population. The government is working on institutional reforms, notably in customs and the courts that are part of its reform agenda (Box 3).

Box 3. Justice and customs administration reforms

In the judicial system, institutional and governance problems have severely limited the state's ability to effectively formulate and implement policies for private sector growth. Trust in courts is low because of concerns about integrity and corruption; dilatory contract enforcement; limited access to justice for the poor and vulnerable; and over-regulation of the private sector. Kazakh policy-makers acknowledge the importance of resolving the problems in order to improve the efficiency of public institutions by promoting fair competition, justice, and the rule of law, and by building up interactions with nongovernmental organizations and the business sector. The strategy for reforming the justice system consists of a three-pronged plan to catalyze private sector growth and better service delivery in order to improve (1) the legal and institutional framework for private sector development, employment generation, and delivery of justice-related services; (2) the delivery of public services critical to private sector functioning and access to justice; and (3) the functioning and professionalism of judges. In recent years Kazakhstan has moved to modernize its justice system to expand institutional capacity, operational efficiency, service quality, and public trust. It has amended criminal and administrative codes, introduced electronic processes, and built up enforcement of judicial decisions by, e.g., introducing private bailiffs in 2010 and building capacity.

What remains to be done: The new draft Code of Civil Procedure is expected to simplify judicial processes and promote alternative dispute resolution mechanisms to facilitate mediation and conciliation (through, for instance, a type of small claims court). The government intends to examine international practices for the design and administration of legal aid programs. Also the Ministry of Justice will be drafting a responsive Commercial Code and related regulations to address the fact that business activities and relations between the state and the private sector and between business entities are regulated by numerous fragmented and sometimes contradictory laws.

Reform of the customs administration and its practices has already had positive results. The objectives of the reforms are to improve transparency and efficiency in customs operations, thus enhancing both revenues and service quality. The time it takes to clear the border has fallen from 129 hours in 2011 to 114 hours in 2013. The number of documents traders must submit for customs clearance has fallen from 14 in 2009 to 3 in 2014. The percentage of consignments selected for physical inspection has also fallen from the baseline of 70 percent in 2006 to 23.4 percent in 2013. Revenue collection, as a ratio of total salary bill, has shown a steady increase, from 204 percent in 2009 to 235 percent in 2013. As a result, traders' perceptions of customs professionalism and integrity have risen from 60 percent in 2011 to 68 percent in 2013. The recent merger of the tax and customs administrations, to be headed by the chairman of the new State Revenue Committee, is expected to increase synergy in public revenue management. To further reduce in-person contacts and processing, the government is preparing to introduce electronic import and export declarations in January 2015.

Source: World Bank staff.

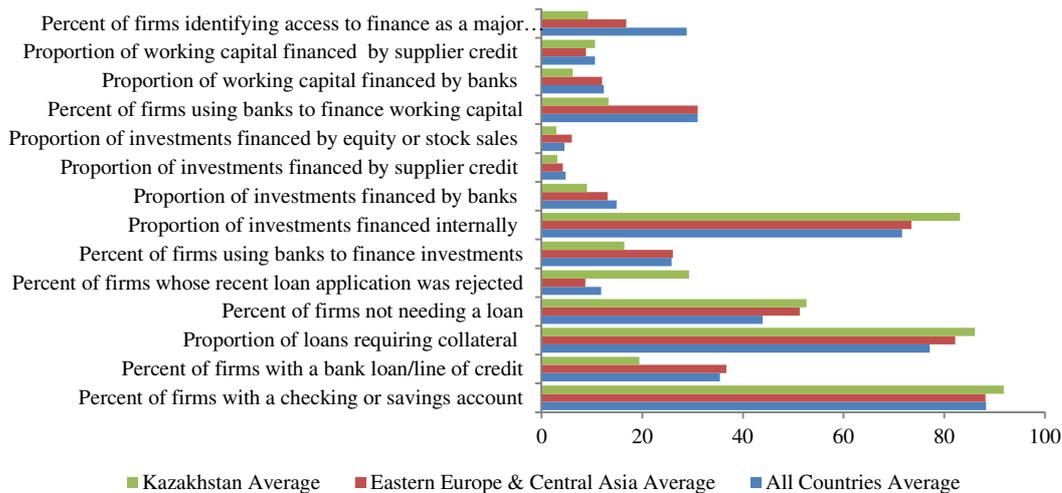
¹⁵ <http://www.enterprisesurveys.org/data/exploreeconomies/2013/kazakhstan>

Kazakhstan will need to make sustained efforts to build up its financial markets, which can be important drivers of economic activity. Developed financial markets provide payment services, mobilize deposits, and ease investment financing. Efficient financial markets reduce reliance on internal funds and money from informal sources, such as family and friends, by connecting firms to a broad range of lenders and investors (Box 4). The authorities are taking action. For instance, addressing the NPL issue is expected to ensure the health of the banking sector, which in turn should ease lending to small and medium enterprises. Furthermore, the one trillion tenge economic support program launched in February 2014 provides loans to these enterprises on more attractive terms.

Box 4. Constraints on access to finance

Kazakhstan's financial market does not compare well with those of other ECA countries and other countries surveyed (World Bank 2013). Only about 9 percent of the firms surveyed considered access to finance a major constraint to their business activities because a majority had made alternative financing arrangements, primarily using internal funds for investment and working capital. However, excessive reliance on internal funds suggests inefficient financial intermediation, and indeed, about 82 percent of Kazakh firms surveyed use internal funds for financing investment, compared to about 67 percent of firms in upper-middle-income countries. Only about 18 percent of Kazakh firms secure working capital from banks, compared to 34 percent in upper-middle-income economies. Also, only about 19 percent of Kazakh firms have bank loans or a line of credit, compared to 36.7 percent in other ECA countries, 35.4 percent in all countries surveyed, and 40 percent in upper-middle-income economies.

Figure 18. Kazakhstan compared to other countries surveyed



Source: World Bank, Enterprise Survey 2013.

Regional and Global Integration Initiatives Remain a Priority Instrument to Support Development of the Non-Oil Economy

The Kazakhstan authorities consider regional integration a priority to increase access to larger markets. In May 2014, Belarus, Kazakhstan, and Russia signed an establishment agreement to move from the Customs Union (CU) to a more integrated Eurasian Economic Union (EaEU). The CU came into effect on January 1, 2010. The EaEU is to become active on January 1, 2015. Meanwhile, Armenia is planning to join the CU in 2015, and the Kyrgyz Republic is still negotiating membership. This could well be one of the fastest regional

integration efforts on record.¹⁶ The Kazakhstan authorities are working to coordinate their economic policy more closely with Russia and Belarus in light of the upcoming EaEU.

The government is also pursuing integration into global markets. In parallel with the creation of the EaEU, the authorities are finalizing a Partnership and Cooperation Agreement (PCA) with the European Union (EU) and pursuing membership in the World Trade Organization (WTO). September 2014 saw a final round of negotiations on the PCA, which specifies 29 areas of cooperation, among them education, innovation, science and technology, and trade and investments, that take into account both the EaEU and Kazakhstan's future membership in the WTO. The PCA is expected to deepen trade and investment relations between Kazakhstan and the EU, with an eye to diversifying Kazakhstani exports to the EU.¹⁷ The PCA is expected to be signed in late 2014 or early 2015. The authorities have also put great emphasis on finalizing negotiations to join the WTO, with Kazakhstan is now expected to join by the end of 2014 or early 2015.

¹⁶ The European Union took decades to work out creation of a common economic space, and other long-standing groupings, such as the ASEAN group, have not attempted full economic union.

¹⁷ The EU remains one of Kazakhstan's most important trade partner, with trade turnover between the partners amounting to \$53.4 billion in 2013 and to \$28.4 billion in the first half of 2014, or 54.7 percent of the total foreign trade turnover of the country.

C. Revisiting Medium-Term Prospects, Due to Downside Risks

A World in Flux Means Slower Growth for the Kazakhstan Economy

Overall, global recovery is expected to pick up pace in the second half of 2014 and continue in 2015, but risks to Kazakhstan economy remain. The global economy is expected to grow 2.6 percent in 2014 and 3.2 percent in 2015, compared to 2.4 percent in 2013. Global growth picked up in the second quarter of 2014 after a weak start of the year, partly due to strengthening of the US economy. The US economy grew 4.2 percent (seasonally adjusted) in the second quarter, after a weather-related 2.1 percent contraction in the first quarter. It is projected to grow 2.1 percent in 2014 and move above trend – at around 3 percent – in 2015, supported by rising employment and investment growth, still accommodative monetary policy, and easing fiscal consolidation. On the other hand, in the Eurozone, Kazakhstan's largest client, the second quarter GDP growth was flat at 0.2 percent after a 1.1 percent expansion in the first quarter, due to a continued weakness in France and Italy and a contraction in Germany. Eurozone growth is projected to reach 0.8 percent in 2014 due to slow improvements in the credit and labor markets but improved exports prospects due to a strengthening US economy and a weakening Euro. The Eurozone growth is projected to recover to 1.4 percent in 2015. The slow pace of recovery could translate into lower demand for oil from Kazakhstan. China's second quarter GDP growth was steady at 7.5 percent y-o-y supported by a rebound in exports and earlier stimulus measures. It is projected to grow at 7.4 percent in 2014 but slow to a more sustainable growth rate of 7.1 percent in the two years following. China is Kazakhstan's second largest client after the Eurozone countries, and its slowdown from annual GDP growth rates of over 9 percent as recently as 2011 to 7.5 percent in 2014 has already reduced its imports of oil and metals from Kazakhstan.¹⁸ In the medium term, China's demand for Kazakhstani oil, iron ore, and metal products are expected to be sustained, though at a lower level.

Accommodative monetary policies and gradual recovery in high-income countries are expected to support the revival of global trade and growth in developing countries. In the three months to June 2014, global trade increased by 4.2 percent. Advanced economy imports of investment goods and consumer durables posted strong gains, benefiting trade partners in emerging markets, especially in East Asia. However, global trade remains on a weak post-crisis trend. Looking ahead, gradually improving labor markets, accommodative monetary policy, and easing fiscal consolidation are expected to support growth in high-income countries, which, in turn, will benefit activity in developing countries through stronger trade, investment, and capital flows. Developing countries are expected to grow 4.4 percent in 2014 and 5.0 percent in 2015. Kazakhstan is expected to benefit from this global recovery, with GDP growth firming up from 4.1 percent in 2014 to 4.5 percent in 2015. However, global risks remain. The end of US quantitative easing is expected to translate into a rise in policy rates in mid-2015, which carries the risk of bouts of financial market volatility that could affect middle-income economies like Kazakhstan. In the Euro areas, there is increased risk of stagnation that could affect demand for Kazakhstan's petroleum. A rapid unwinding of the Chinese debt may affect investor sentiments and lead to a sharp deleveraging, affecting the Chinese economy and by extension Kazakhstan's export prospects.

Regional economic developments are also affecting the Kazakhstan economy. Integration into the CU has made Kazakhstan more vulnerable to economic developments in Russia. The Russia-Ukraine crisis and related sanctions on Russia have already affected the growth of

¹⁸ In the first half of 2014, the volume of oil exported to China dropped by 21 percent year-on-year, iron ore by 41 percent, and copper and copper products by 27 percent.

the Kazakhstan economy. Russian GDP growth slowed from 1.3 percent in 2013 to an estimated 0.5 percent for 2014 and 0.3 percent for 2015 and 2016 (baseline scenario).¹⁹ It is estimated that the Russian economic slowdown is shaving 0.5–1.0 percentage points from Kazakh GDP growth in 2014 because it has negatively affected not only Kazakhstani industrial exports to Russia but also domestic and international sentiments about investing in Kazakhstan (Box 5). Kazakhstan's exports to Russia fell by about 22 percent in value during January–July 2014 compared to the same period in 2013. Gross inflow of FDI to Kazakhstan had amounted to \$28.9 billion in 2012 but dipped to \$24.1 billion in 2013 and \$5.8 billion in the first quarter of 2014. If aversion to risk rises with heightened frictions and economic sanctions applied by Russia and the West, FDI flows into Kazakhstan may fall further, affecting the country's economic diversification efforts. Projected anemic growth for Russia in 2015 and 2016 are expected to continue to affect Kazakhstan's growth in the medium term. If the geopolitical situation worsens, a possible contraction of the Russian economy is projected in a high-risk scenario for 2015 that would produce a more severe shock to economic and investment activities in Kazakhstan as well.

Box 5. How the Russia's slowdown could have costs and benefits for the Kazakhstan economy

Slower growth in Russia is expected to affect Kazakhstan negatively through two main channels: (1) the trade channel, through lower exports of Kazakh raw materials to Russia, and (2) the investment channel, through lower inflows of new FDI into Kazakhstan. The trade channel could have significant impact, since about half of Kazakhstan's exports to Russia are mineral ores and concentrates and aluminum, which began to decline in the first half of 2014. The investment channel is likely to be affected to a lesser extent, and not immediately. Most FDI into Kazakhstan originate from the European Union, and about 60 percent goes to the extractive sector, for longer-term contracts, though new FDI into non-extractive sectors might be affected. The aggregate negative impact of both channels on Kazakhstan is estimated to be in the range of 0.5–1.0 percentage point of GDP growth.

On the other hand, Kazakhstan may also have opportunities to gain from recent geopolitical developments. For instance, Russia's counter-sanctions against the West in the form of a ban on import of certain food items may offer Kazakhstan an export opportunity. Moreover, protracted sanctions may give firms in Russia's partners in the Customs Union an opportunity to re-export goods from countries sanctioned by Russia. If international investors were to consider withdrawing from or not investing in Russia, Kazakhstan could also benefit as substitute destination. Finally, a worsening of the situation in the region may offer Kazakhstan higher oil prices and terms of trade gains.

Source: World Bank staff.

Mixed global recovery and new technology are expected to moderate oil and metal prices, despite short-term surges spurred by geopolitical developments in some oil-producing countries. Geopolitical concerns in Iraq, Ukraine, and Russia earlier in the year pushed up oil prices in the second quarter of 2014, with crude oil (Brent mix) reaching \$115 per barrel in mid-June. However, in August, energy prices fell by 4.5 percent, metals and minerals by 0.2 percent, and precious metals by 2.1 percent, signaling that markets have internalized the risk factors. In September, spot prices of crude oil dropped below \$100 per barrel.²⁰ Over the medium term, the growing supply of unconventional oil (shale oil), efficiency gains, and substitution away from oil into new energy sources will affect oil prices. Softening oil prices will limit revenue gains for Kazakhstan, which is already producing at close to its on-shore production capacity and does not expect the Kashagan off-shore oil field to contribute to the national coffers before 2016 at the earliest. Moderating metal prices will further affect the already soft activities in the industrial sector, possibly leading to further restructuring in the metallurgy subsector.

¹⁹ World Bank, 2014, *Russian Economic Report 32: Policy Uncertainty Clouds Medium-Term Prospects* (Moscow).

²⁰ http://www.eia.gov/dnav/pet/pet_pri_spt_s1_d.htm

Kazakhstan's Growth Will Remain Below Its Potential Until Off-Shore Oil Production Starts

The Kazakhstan economy is not expected to reach its potential GDP growth rate until 2017. According to the World Bank's Global Economic Prospects (January 2014), potential GDP growth of Kazakhstan is estimated at about 5.5 percent a year. Our baseline scenario postulates that Kazakhstan's GDP growth will recover gradually over the next three years. GDP growth of 4.1 percent in 2014 and 4.5 percent in 2015 will continue to be influenced heavily by global economic flux and developments in China and Russia (Table 1). Private domestic demand will grow lower in the short term due to continued effects of the devaluation and a restraint on consumer credit. If geopolitical frictions over Ukraine are not resolved, business and consumer sentiments will continue to be affected in 2015. On the other hand, the \$5.5 billion economic support program launched in 2014 and infrastructure investment related to EXPO-2017 will be reflected in higher private and public investments, contributing to GDP growth in 2015.²¹ As private sector investment benefits from the support program, private consumption will be gradually recovering from the effects of the devaluation. Continued higher public investments and the start of oil production at Kashagan in mid-2016 are expected to boost GDP growth to 5.0 percent in 2016 and 5.5 percent in 2017. Meanwhile, contributions from the non-oil economy to GDP growth are estimated to be about 4.5 percentage points a year, indicating that non-oil services will be driving growth in the medium term. Nonetheless, risks remain, in that export growth will continue to depend on how the oil sector performs and on global economic recovery.

Table 1. Kazakhstan: GDP Growth and Inflation, 2010-15

(Percent change; unless otherwise indicated)

	2010	2011	2012	2013	2014e	2015p
Real GDP	7.3	7.5	5.0	6.0	4.1	4.5
Oil sector (percentage contribution)	2.9	1.5	0.0	0.9	-0.1	0.0
Non-oil sector (percentage contribution)	4.4	6.0	5.0	5.1	4.2	4.5
Prices						
Consumer price inflation, period average	7.1	8.3	5.1	5.8	6.8	7.6
Consumer price inflation, end of period	7.8	7.4	6.0	4.8	7.8	7.9

Source: Statistical Office of Kazakhstan; World Bank staff estimates

Meanwhile, inflation will remain within the 6-8 percent band targeted by the monetary authorities. The expected spike in inflation associated with the February 2014 devaluation did not materialize fully due to price controls on basic goods, transports, and utilities and the weakening domestic demand. Given a delayed impact from removing price controls, average annual inflation is expected to reach 6.8 percent in 2014 and about 7.6 percent in 2015. From 2016 on, it is expected to pick up slightly but remain within the policy band, because GDP growth is projected to be close to potential.

Though Solid, the External Position is Vulnerable to External Shocks

The tenge devaluation helped improve the external position, but deterioration in the terms of trade is still a risk. The recent tenge devaluation has had a positive impact on the trade balance and the current account as imports declined in 2014 (Table 2). But these gains are expected to fade away in 2015-17, since import growth is expected to resume as domestic

²¹ As part of the Oil Fund support program, government plans to support private investment growth by facilitating lending to the manufacturing industry and SMEs, via state-owned and private banks.

demand picks up. If global recovery stays weak and lower petroleum prices prevail, the current account may come under pressure, at least until revenues from Kashagan start flowing in late-2016. On the other hand, the authorities are actively seeking FDI and are expected to borrow about \$10 billion from IFIs during 2015-17. This may alleviate pressures on the balance of payment. In the absence of such inflows to the capital/financial account, and if the NBK adheres to the same strict management of the exchange rate, the pressures on the balance of payment may lead to additional drawdowns of FX reserves held at the NBK. Kashagan production coming on line will alleviate some of the pressure on the current account and contribute to additional international savings by the public sector.

Table 2. Kazakhstan: Balance of Payments, 2010-15

(US\$ billions)

	2010	2011	2012	2013	2014e	2015p
Current account	1.4	10.2	1.0	1.1	5.7	1.9
Merchandise trade	28.5	44.8	38.1	34.8	37.5	32.6
Exports f.o.b.	61.4	85.2	86.9	85.6	80.8	77.3
Imports f.o.b.	-32.9	-40.3	-48.8	-50.8	-43.3	-44.7
Services	-7.2	-6.6	-7.9	-6.9	-6.7	-6.4
Income, of which:	-19.4	-27.7	-28.1	-25.2	-23.3	-22.3
Income of direct investors (net)	-18.0	-25.2	-24.8	-22.5	-22.1	-21.2
Current transfers	-0.5	-0.3	-1.0	-1.6	-1.8	-1.9
Capital and financial accounts *, **	9.9	2.7	8.9	9.3	3.7	6.1
Direct investments	3.7	8.6	11.9	8.1	8.2	8.0
Portfolio investments *	15.1	-0.2	-3.1	2.8	0.0	0.0
Medium and long-term investments	-15.6	0.0	4.1	5.3	1.5	4.0
Other investments **	6.8	-5.6	-4.0	-6.9	-6.0	-6.0
Overall balance/Change in reserves ***	11.3	12.9	10.0	10.5	9.4	8.0
Change in FX reserves at the NBK	4.7	0.3	-4.3	-2.4	0.1	-2.2
Change in FX reserves in the Oil Fund	6.6	12.6	14.3	12.9	9.3	10.2
<i>Memorandum items:</i>						
Total official reserves (stock)	56.2	68.8	80.0	90.0	99.4	107.4
FX reserves held at the NBK	25.2	25.2	22.1	19.2	19.2	17.1
FX reserves in the Oil Fund	31.0	43.6	57.9	70.8	80.1	90.3

Source: National Bank of Kazakhstan; World Bank staff estimates.

Notes: * Excluding investments of the Oil Fund. ** Including Errors and omissions. *** "+" = reserve accumulation.

The Fiscal Position Will Remain Strong Despite Higher Spending

Expansionary fiscal policy will erode the fiscal surpluses saved in the Oil Fund. The economic support program is likely to push up government spending in 2014 and 2015. The program aims to stimulate private sector growth by providing the financial support to the manufacturing industry, SMEs, and infrastructure projects envisaged in the second five-year industrial and innovation development plan and those for EXPO-2017. Current expenditures are also expected to grow, because of planned increases in the salaries of teachers and doctors and more spending on goods and services for EXPO-2017 over the next three years. Consequently, the non-oil deficit is expected to rise from 8 percent of GDP in 2013 to over 10 percent a year in 2014 and thereafter (Table 3). The overall fiscal balance will remain in surplus but will narrow, given the widening non-oil state budget deficit.

Table 3. Kazakhstan: General Government Fiscal Accounts, 2010-15

(Percent of GDP)

	2010	2011	2012	2013	2014e	2015p
Total revenue	25.0	27.7	26.4	25.1	25.0	24.1
Oil revenue	10.9	14.4	13.8	12.2	13.2	12.0
Oil revenue saved in the Oil Fund	5.3	8.2	7.3	6.4	5.4	5.1
Oil revenue spent in the State Budget	5.6	6.1	6.6	5.8	7.7	6.9
Non-oil revenue of the State Budget	14.1	13.3	12.6	12.9	11.8	12.1
Total expenditure and net lending	22.1	21.5	22.1	20.8	22.3	23.2
Current expenditure	15.0	14.9	16.1	16.0	16.0	16.9
Capital expenditure and net lending	7.1	6.7	6.0	4.8	6.3	6.3
Overall fiscal balance	2.9	6.2	4.3	4.3	2.6	0.8
State Budget deficit	-2.4	-2.1	-2.9	-2.1	-2.8	-4.3
Non-oil deficit	-8.0	-8.2	-9.5	-7.9	-10.6	-11.2
Oil revenue spent in the State Budget	5.6	6.1	6.6	5.8	7.7	6.9
Oil revenue saved in the Oil Fund	5.3	8.2	7.3	6.4	5.4	5.1
<i>Memorandum items:</i>						
Net government financial assets	10.2	12.8	16.1	18.3	22.3	21.9
Oil Fund FX reserves	20.9	23.2	28.5	31.5	37.2	39.8
Total government debt	10.7	10.4	12.3	13.2	14.9	18.0

Source: Kazakhstan Ministry of Finance; World Bank staff estimates.

Notes: Some sums may not add up exactly due to rounding.

Nevertheless, the net financial asset position of the government will remain solid. The widening non-oil deficit will be financed by increased use of oil revenue from the Oil Fund, but the state budget deficit is also expected to widen. This will require the government to borrow more, raising the stock of government debt. Nevertheless, when oil production at Kashagan begins, projected oil revenue (net of transfers to the budget) flowing into the Oil Fund is expected to grow faster and to offset net borrowings by the government. In other words, the net financial asset position of the government will keep expanding despite higher government spending and softening oil prices. The government's fiscal and net financial/debt positions are thus expected to remain sustainable for the medium term.

Total government debt is set to increase over the medium term but remain within stable bounds. External debt of the government is expected to remain flat at about 2.5 percent of GDP as the government will borrow about \$10 billion from IFIs in the context of the PFA implementation to support the Kazakhstan-2050 development strategy. Government domestic indebtedness will increase given its widening non-oil fiscal deficits that will be kept high over the medium term. The upward shift in the ratio of total external debt to GDP from 66 percent in 2013 to about 72 percent in 2014 is mainly attributed to a lower GDP denominated in dollars following the tenge devaluation. Otherwise, the ratio of total external debt to GDP and the debt service ratio are anticipated to remain stable for the medium term.

D. In Focus 1: Dollarization in Kazakhstan

After the February 2014 devaluation of the tenge, Kazakhstan saw a rise in dollarization. Dollarization is defined here as the share of foreign currency denominated deposits (loans) in the total deposits base (loan portfolio).²² Dollarization can occur because of currency substitution (i.e. using a foreign currency as a medium or exchange) or asset substitution (using it as store of value). There can be different types of dollarization depending on assets or liabilities that are dollarized.

In principle, dollarization can bring both benefits and policy challenges. It can bring benefits in terms of providing additional assets which can protect against exchange rate and inflation movements or by facilitating domestic or international transactions. However, it can also pose policy challenges. For example, the conduct of monetary policy can become more complex, given that the interest rates for dollarized consumption and investment decisions are no longer influenced by the rate the central bank rate sets. However, dollarization is not necessarily a binding constraint on effective monetary policy. Dollarization could carry risks for financial stability through raising balance sheet risks for the private sector and consequent credit risks for banks and through foreign currency liquidity risks and associated policy responses (for example, requiring the central bank to have adequate foreign currency as lender of last resort).²³ Also, dollarization can complicate exchange rate policy if financial stability concerns limit the scope for using currency adjustment as an economic shock absorber, which would increase the burden for fiscal and monetary policy adjustments.

This section, which provides an initial assessment of dollarization and its drivers in Kazakhstan, concludes with indicative policy suggestions. Further assessment would be necessary to inform specific policy responses to the current degree of dollarization in the country, either in terms of ensuring that measures put in place take into consideration the implications of dollarization, promote de-dollarization, or combine these two objectives.

The Extent of Dollarization in Kazakhstan

➤ Liability and asset dollarization - the international perspective

In international terms, dollarization in Kazakhstan is significant. Dollarization is measured by the share of foreign currency deposits and loans in the banking sector. Foreign currency liabilities account for 44 percent of total global liabilities of deposit-taking institutions.²⁴ The extent of loan dollarization is somewhat lower in Kazakhstan at 37 percent. The financial sectors of larger emerging economies, such as Russia, Indonesia, Brazil, Turkey, and Mexico

²² Usually, the usage of foreign currency in circulation is also reviewed as part of the dollarization analysis. However, due to lack of data we do not focus on this component of dollarization in the economy at this stage. We do note that over 2013, exchange offices made a net-sale of foreign exchange of USD 14.4 billion with a total turnover of USD 33.4 billion. The significant inflows of FDI and export proceeds, and presence of large number of migrants, could be contributing to the large amount of foreign currency in circulation. Furthermore, a sizeable informal sector could be fueling demand for cash transactions, including in foreign currency.

²³ The credit risks associated with sharp devaluations of the tenge, such as in February 2014, are highlighted in the World Bank's Spring 2014 Kazakhstan Economic Update - Kazakhstan: Short-Term Vulnerabilities, Positive Prospects. See <http://documents.worldbank.org/curated/en/2014/03/19456558/kazakhstan-short-term-vulnerabilities-positive-prospects-spring-2014#>.

²⁴ As of Q1 2014, based on IMF data.

tend to have less dollarization. However, compared with most countries in the region, dollarization does not seem to be unduly high in Kazakhstan (Table 4).

Table 4. Dollarization Rates in Selected Economies

(Foreign currency share)

	Date	Loans Percent	Rank	Liabilities Percent	Rank	Memo: FSU?	Resource rich?	Income level
Argentina	2014 Q1	5.4	24	11.1	22			UMI
Austria	2014 Q1	19.0	18	11.2	21			HI-OECD
Belarus	2014 Q1	52.2	10	63.1	6	X		UMI
Brazil	2014 Q1	15.2	21	14.7	19			UMI
Chile	2014 Mar	18.8	19	25.4	16		X	HI-OECD
Colombia	2014 Jun	7.1	23	5.5	24			UMI
Czech Rep.	2014 Q1	28.6	14	22.5	17			HI-OECD
Georgia	2014 Q2	59.6	8	65.4	3	X		LMI
Indonesia	2014 Q1	16.0	20	21.9	18		X	LMI
Kazakhstan	2014 Q1	36.8	13	43.8	13	X	X	UMI
Latvia	2013 Q4	88.5	1	71.8	1	X		HI-other
Lithuania	2014 Q1	69.1	3	48.2	11	X		HI-other
Mexico	2014 May	27.5	15	11.4	20		X	UMI
Russian Fed.	2014 Q1	23.9	17	29.2	15	X	X	HI-other
South Africa	2013 Jun	10.2	22	6.1	23			UMI
Tajikistan	2013 Q4	61.5	6	60.2	7	X		LI
Turkey	2014 Q1	26.8	16	48.7	10			UMI
Ukraine	2014 Q1	43.2	12	46.4	12	X	X	LMI

Source: IMF Financial Soundness Indicators <http://fsi.imf.org/>; IMF; World Bank

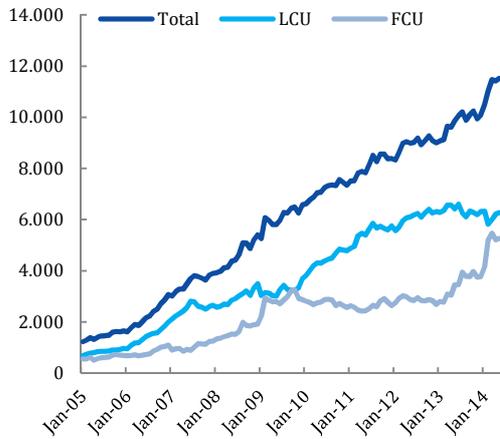
Notes: Data for deposit-taking institutions. FSU: Former Soviet Union. Resource rich based on non-renewable natural resources assessment included in Annex 1 of IMF (2012). Income levels (2014)– UMI: Upper middle income; LMI: Lower middle income; LI: Low income; HI-OECD: High income OECD; HI-other: High income non-OECD

➤ Deposit and asset dollarization in Kazakhstan – trends over time

The extent of deposit dollarization in Kazakhstan has fluctuated since 2007, rising during periods of currency weakness and higher inflation. The share of foreign currency deposits had fallen to 24 percent by mid-2007, but then shot up in the wake of the banking crisis and rising inflation. This trend accelerated through the 2008/2009 global financial crisis which had a significant impact on the Kazakhstan economy and the stability of its financial sector, including when the tenge was devalued against the US dollar by close to 19 percent in February 2009. By October 2009, the share of foreign currency deposits rose above 50 percent of total deposits with some evidence of currency substitution. The period that followed was characterized by gradual de-dollarization of deposits as the government worked to restore confidence in the tenge, and by early 2013 the share of foreign currency deposits had retreated to just above 30 percent of total deposits. It appears that during this period there was some conversion from foreign currency deposits to tenge deposits, since when converted into US dollars, the former remained fairly stable in nominal terms in local currency. The ratio of foreign currency deposits increased again to about 45 percent of all deposits in response to the February 2014 devaluation, clearly a flight to safer assets.

Figure 19. Deposits in banks, 2005-14

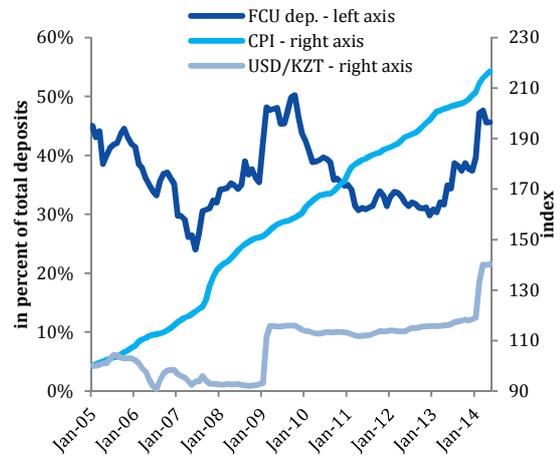
(Tenge billion)



Source: National Bank of Kazakhstan.

Figure 20. Deposit dollarization, inflation, and the exchange rate

(FCU deposits as % of total deposits, CPI and KZT/USD rate as January 2005 =100 index)

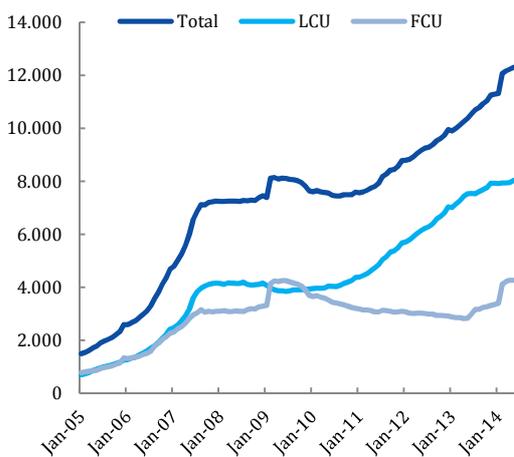


Source: National Bank of Kazakhstan.

Loan dollarization in Kazakhstan is lower than deposit dollarization, having fallen after the 2009 devaluation. The share of foreign currency loans to total loans fell from 53 percent in early 2005 to 42 percent by early 2008 as the tenge appreciated and banks channeled large external wholesale borrowings into higher-interest rate earning tenge loans. As a short-term impact of the devaluation in early 2009, the foreign currency share of loans rose, largely reflecting valuation effects. However, de-dollarization resumed in 2010 as access to foreign funding for Kazakh banks collapsed. Consequently, the dollar value of foreign currency loans declined from \$28 billion at end-2009 to \$19 billion in mid-2013. Since tenge loans have since leveled-off and foreign currency loans increased. A valuation effect after the 2014 devaluation increased the share of foreign currency loans to about 35 percent.

Figure 21. Loans extended by banks

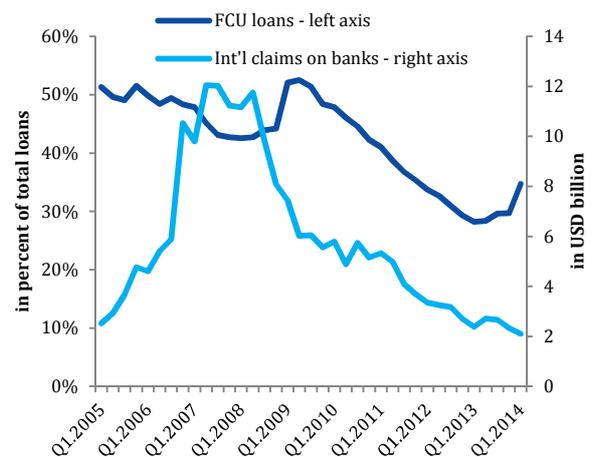
(In tenge billion)



Source: National Bank of Kazakhstan.

Figure 22. Loan dollarization and international claims on Kazakh banks

(FC loans as % of total loans, claims in USD)



Source: National Bank of Kazakhstan; BIS.

Drivers of Dollarization

In recent years dollarization seem to have been driven by both near-term macroeconomic factors (inflation, currency volatility and interest rates) and longer-term structural and institutional factors. These factors include relatively low level of financial inclusion and development of domestic financial markets. Kazakhstan's high level of informal international trade is also likely to be a major structural factor behind the degree of dollarization. In this light, dollarization in Kazakhstan appears to be motivated by both asset substitutions (as a store of value) and currency substitution (as a unit of account and payment).

A widely accepted finding is that dollarization is more significant in countries with past episodes of severe economic crisis, such as exchange rate volatility, and high and uncertain inflation. During periods of high inflation and instability, economic agents convert their assets into currencies that are considered more stable (Cartes, 2010).²⁵ The Kazakhstan experience appears to fit this profile well, with periods of higher domestic inflation and currency instability coinciding with an increased share of foreign currency deposits. For example, using quarterly data on deposits from 2000 to 2014, the IMF (2014) found that inflation volatility, particularly in 2008 and 2009, and the asymmetry of exchange rate policy toward depreciation while resisting appreciation was a driver of deposit dollarization in Kazakhstan.

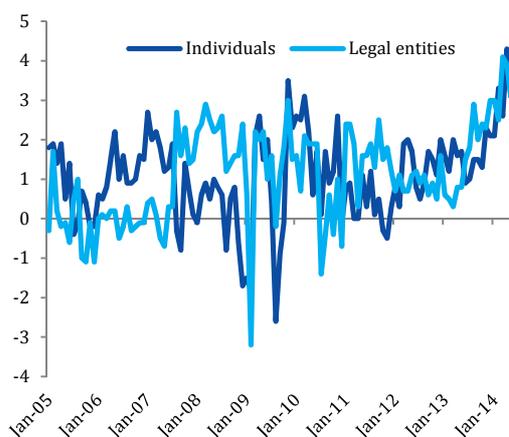
Interest rate differentials between local and foreign currency also affect dollarization, and again this appears to be true in Kazakhstan. A wider interest rate differential (local currency rate minus foreign currency rate) on deposits is expected to support de-dollarization while a wider interest rate differential on loans is expected to support dollarization.²⁶ However, exchange rate and inflation expectations should be added to this comparison to get the differential in expected cost for loans or expected returns on deposits. In Kazakhstan, interest rates on domestic deposits did not significantly exceed rates on foreign currency deposits over the last decade, and exchange rate expectations are likely to have been particularly important factors in determining expected relative returns. The appreciation of the tenge over 2005-08 may have increased the expected return on the tenge relative to the US dollar and contributed to the process of de-dollarization. However, in recent years, interest rates differentials on deposits may have been too limited, or offset by concerns over expectations of further exchange rate weakness, to promote de-dollarization. Wider interest rate differentials on loans do not seem to have contributed to dollarization in Kazakhstan, because banks took on the exchange rate risk rather than passing it on to customers. Further analysis is needed to look at these drivers and split by the structure of deposits and loans and differences in rates by maturity.

²⁵ The "minimum variance portfolio approach" goes further to relate dollarization to the real return of financial assets denominated in local versus foreign currency and suggests that dollarization is higher in cases when inflation volatility remains high relative to real exchange rate volatility.

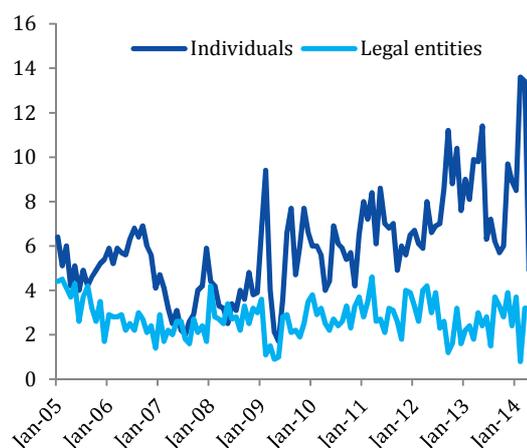
²⁶ Basso, Calvo-Gonzales and Jurgilas (2010) find that a wider interest rate differential on loans increases dollarization. Hake, Lopez-Vicente and Molina (2014) find similar evidence for the countries of Central and Eastern Europe.

Figure 23. Interest rates differential on deposits and loans

(On deposits, in percentage points)



(On loans, in percentage points)



Source: National Bank of Kazakhstan.

Structural features also matter: openness of the economy tends to increase dollarization, especially in the corporate sector. The more economic entities engage in international transactions, the higher the demand for foreign exchange. This may be further fueled by the fact that a significant part of foreign trade in Kazakhstan, and Central Asia generally, is informal and intermediated through large bazaars. Most of the goods that are traded are light manufactures and consumption goods brought in through nonstandard channels.²⁷ Most of the trade is in cash, fueling demand for foreign currency.

Preference for foreign currency may also be due to insufficient availability of banking services (including for hedging purposes), low financial literacy and the low perceived safety of deposits. Certain aspects of financial inclusion in Kazakhstan are relatively low given its income level. Total deposits are less than 30 percent of GDP and as of 2011 only 42 percent of the population over the age of 15 had an account with a formal financial institution, compared to 47 percent on average in upper-middle income countries.²⁸

There is also growing evidence that broader institutional factors influence dollarization. Scheiber and Stix (2009) find a strong negative correlation between the quality of governance and level of dollarization. Given the institutional weaknesses identified in Kazakhstan, this channel may also explain dollarization there.²⁹

Policy Suggestions

To the extent that dollarization gives rise to macro or financial stability challenges, the policy response can be guided by a combination of two objectives: (i) mitigating the impact of the challenges and (ii) supporting a process of de-dollarization. As outlined below a number of policies may be able to support both these objectives simultaneously. On the other hand, experience from countries such as Venezuela and Nigeria suggests that forced de-

²⁷ Usually individual traders clearing goods using the simplified customs clearance procedures or people living in vicinity of border areas taking advantage of provision to bring in certain quantity of goods customs-free.

²⁸ World Bank's Global Financial Inclusion database (FINDEX)

²⁹ See World Bank (2013), *Kazakhstan - Beyond oil: Kazakhstan's path to greater prosperity through diversifying* available at <http://documents.worldbank.org/curated/en/docsearch/report/78206>.

dollarization - such as outlawing use of foreign currency, forced conversion of deposits into local currency- is ineffective. To the contrary, financial repression and capital controls lead to dollarization.

➤ **Living with dollarization**

Policies can be adopted to address some of the financial stability risks associated with dollarization. These policies might include limiting associated credit risks (for example, through prudential limits on direct foreign currency exposures of financial institutions, loan-to-value limits for foreign currency lending, differential provisioning for foreign currency lending and limiting liquidity risks (for example, higher reserve requirements on foreign currency deposits).³⁰ The appropriateness and the effectiveness of such measures depend on the degree and the nature of the dollarization in the economy, the structure of the financial sector and local supervisory and regulatory institutions.

➤ **Supporting de-dollarization**

De-dollarization is often a gradual process that in addition to keeping the economy stable requires anchoring future expectations for low and stable inflation, an appropriate exchange rate regime, institutional changes, and micro-prudential measures to support incentives to hold the local currency. These policy measures relate to the longer-term structural determinants of dollarization. For example, the cross-country empirical analysis and case studies of Kokenyne et al (2010) found that durable de-dollarization requires both a credible plan for bringing down inflation (for example, associating it with an inflation targeting regime) and specific microeconomic measures to support use of the local currency. Despite the persistence of dollarization, Poland, Chile, Egypt, and Israel, among other countries, have been able to de-dollarize. The following is a brief overview of some policies that appear to have shown results.

Greater confidence in economic and financial policies is critical to promoting greater reliance on the tenge. Prudent, predictable, and accountable monetary and fiscal policies (broadly defined so as to cover Kazakhstan's large quasi-fiscal sector) will be central to this confidence building, as will low and steady inflation. Reinforcing the independence of the monetary authority and its resolve to ensure stability will be critical to promoting greater use of the tenge.

A more flexible exchange rate regime for the tenge, one that allows for both appreciation and depreciation, could help promote de-dollarization. There is evidence that exchange-rate-based stabilization could actually be leading to dollarization (Duma, 2010), a revealing finding for Kazakhstan which has relied on the exchange rate to maintain stability with episodes of large devaluations followed by relatively tight management of the exchange rate. Further, implicit government guarantees of the exchange rate value may generate mispricing of risks and excess dollarization (Bacha, Holland and Goncalves, 2008).

Deepening financial markets can provide local currency-denominated alternatives that provide a more-credible store-of-value function. Capital markets in Kazakhstan are underdeveloped; promoting issuance of tenge-denominated bonds or greater availability of stocks to invest in could make the tenge a more desirable currency for savings. Some countries have also supported issuance of inflation-indexed domestic bonds to make holding local currency bonds more attractive.³¹

³⁰ Licandro and Licandro (2003) and Galindo and Leiderman (2005)

³¹ IMF(2014) notes the examples of indexed local currency securities in Chile, Mexico in the 1980s and in Bolivia, Israel and Turkey in 2000s. Other macro policies that have been adopted include widening

Changes to the regulatory framework can also help de-dollarizing, as well as limiting the risks to financial stability risks associated with dollarization. Currency-sensitive reserve requirements and prudential regulations (allowing foreign currency lending only to hedged borrowers, higher risk-weights for foreign currency loans, caps on loan-deposit ratios by currency etc.) may help to incentivize economic agents to rely increasingly on the tenge. A robust deposit insurance scheme can help increase confidence in banking and facilitate channeling of cash transactions through the banking sector.

exchange rate bonds and measures to increase the differential between local and foreign currency interest rates for deposits.

E. In Focus 2: The Non-Observed Economy in Kazakhstan

What is the Non-Observed Economy?

The literature uses various definitions for the non-observed economy. The terms “gray market” and “shadow”, “informal”, “illegal”, “underground”, “uncovered”, and “unrecorded” economy are usually used interchangeably. The actual definitions of these terms depend on the specific aspect of the non-observed economy (NOE) that is being analyzed.³²

In effect, the non-observed economy encompasses a variety of economic activities, legal and illegal, formal and informal. Legal activities are those sanctioned by the national authorities, whether they are undertaken formally (through registered economic entities) or informally (Table 5). Formal activities can be reported and accounted for to the authorities for purposes of taxation and payment of social benefits, or they can be unreported (or shadow) to avoid costly administrative procedures, taxation or payment of social benefits or because it is statistically difficult to assess them. Unreported formal activity (shadow economy) may consist of selling products without receipts or hiring workers without a contract or benefits. Informal economic activities are undertaken by companies and individuals that are not registered with state or local authorities and that may or may not pay taxes and benefits on their activities. Home production is usually categorized as legal informal activity. In contrast, illegal economic activities encompass activities such as production and sale of illicit drugs, crimes, prostitution, and smuggling. Informal employment can be undertaken throughout the NOE.

Table 5. The Non-Observed Economy

Non-Observed Economy		
Legal Economic Activities		Illegal Economic Activities
Shadow economy		Informal economy
Activities that are productive and legal but deliberately concealed from public authorities to evade tax legislative rules or due to difficulty in collecting required statistics.		
Activities unreported for statistical reasons	Activities Unreported for economic reasons	
such as failure to obtain statements from respondents included in the data collection program for specified activities	such as evasion of indirect or direct taxes; violation of labor laws or immigration orders, informal hiring of labor; or operating without a permit to avoid lengthy and costly bureaucratic procedures	Production carried out by household unincorporated enterprises, that are not registered and / or size by number of employees is less than a certain threshold, and that have some market production. Also, household production for own final use; hired domestic workers; domestic and personal services
Producing goods and services that are prohibited by law or that are illegal if made by manufacturers without a permit		
such as drug trafficking, prostitution, and other crimes		
Informal Employment		

Source: OECD methodology, Statistical Office of Kazakhstan.

³² For a discussion, see Perry et al., 2007, Chapter 1

Why Be Concerned About the Non-Observed Economy?

Many activities of the non-observed economy have social and economic consequences for a country's development. The NOE affects economic growth by lowering productivity levels and failure to achieve economies of scales; informal firms stay small to avoid detection or formalization. Government finances are affected because potential revenues are not collected. Formal firms that carry the burden of tax payments and meeting regulatory requirements are placed at a competitive disadvantage. Workers employed in the NOE are usually paid less and are more vulnerable to labor law violations than those in the formal economy. Overall, informality distorts the playing field and may feed into social distrust and further disregard of laws and regulations.

There are benefits and costs in being a part of the non-observed economy. The economic incentives for its existence are rooted in socioeconomic structure and political history of each country. Many participate in the NOE to avoid taxes or heavy administrative burdens to register their business, or heavy regulatory framework of the labor or product market. On the other hand, participating in the NOE has a number of drawbacks. For instance, it may constrain the access of economic agents to such facilities as formal financing or deprive workers of legal protection in case of abuse.

There are also benefits and costs associated with implementing policies to measure, register, regulate, and tax the non-observed economy. Ensuring that economic actors report their activities and transactions helps authorities to better estimate the size of various sectors, their pace of activity and their contribution to the economy as a whole. The authorities can then include these more accurate assessments of economic activities into their service delivery, infrastructure or urban development plans. If the economic actors engaged in the NOE also pay their taxes, the additional revenues will provide additional fiscal space for the national budget. International experience also suggests that ensuring that workers are hired under contract and with related social benefits is associated with better paying and better quality jobs. If such workers then become unemployed, they would be able to rely on the social safety net until they secure new jobs. However, there are costs to attempting to measure, register, regulate, and tax the NOE. For instance, to reduce tax evasion, the authorities may need to bring on board more tax auditors or invest in electronic infrastructure to encourage cash-less transactions. It may also be counterproductive to pursue household based economic activities unless they are intended for the market and sufficiently large (for example as measured by the number of employees who are not members of the household). It is therefore important to take a *measured approach* that would help account for and regulate the most important categories of activities in the NOE, but still allow flexibility for a percent of economic activities to remain non-observed.

Kazakhstan Has a Relatively Large Non-Observed Economy

Kazakhstan has a relatively large non-observed economy. Official estimates place the NOE at 28.6 percent of GDP in 2013, of which 10.9 percent of GDP is categorized as shadow economy, 15.3 percent of GDP is informal economy, and the remaining 2.4 percent of GDP are illegal activities. The official estimates do not fully match recent analyses by international sources. According to Schneider (2010), the informal sector accounted for 38.4 percent of GDP in Kazakhstan in 2007, somewhat above the ECA average of 36.5 percent (Figure 24). An IMF assessment (2013) of the informal economy in Central Asia and Caucuses also found that the NOE in Kazakhstan is 33 percent of GDP compared to 26.3 percent in the Kyrgyz Republic, 30 percent in Georgia, and 35 percent in Armenia. A World Bank analysis (2011), which studied the size and profile of informal employment in Kazakhstan, finds that the size of the informal sector – one element of the NOE, is higher than would be predicted be given its level of GDP per capita

procedures, creating a large taxpayer unit and facilitating electronic tax filing; the 2013 DB ranked it 17th ease of paying taxes. A 2013 survey of 600 registered firms finds that only 12.4 percent of firms identified tax rates as a major constraint, compared to 30.2 percent of firms in Eastern Europe and Central Asian countries as a group and 30.9 percent for all countries participating in these surveys. Furthermore, only 5.4 percent of firms surveyed identified tax administration as a major constraint, compared to 16.2 percent of firms in Eastern Europe and Central Asian countries as a group and 21.9 percent of firms in all participating countries (The survey did not cover informal firms or identify informal activities by the firms).

Still, the authorities report noted informal or unreported economic activity in trade, agriculture, real estate and construction. The 2009 tax reform that was intended to reduce tax rates while increasing tax compliance and broadening the tax base has not fully succeeded, as evidenced by the shortfall it created in the non-oil revenue in the government budget. There is widespread informality in retail trade (bazaars) both in hiring workers and cash transactions to avoid VAT and business taxes. There is also a large informal international trade that needs to be brought under control through better customs management. In agriculture and construction informality stems mostly from informal, often seasonal work, which is often supplied by irregular migrants from other Central Asian countries. In real estate, many landowners do not register their units as rentals to circumvent taxes due on rental earnings.

Labor Market Regulations

Heavy labor market regulation is often associated with higher informal employment in an economy. Employers may avoid hiring workers formally to reduce the burden of social and health benefit payments or avoid providing exit packages if they need to fire a worker. At the same time, the bigger the difference between total labor cost in the formal economy and the after-tax earnings from work, the greater the incentive for workers to function in the NOE.

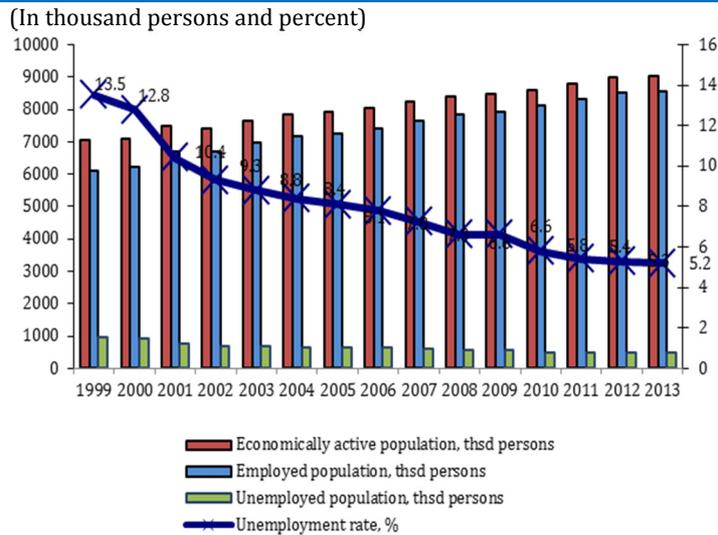
Labor regulations do not appear to be a major reason to be a part of the non-observed economy in Kazakhstan. DB indicators for 2013 suggest that in Kazakhstan labor regulations – difficulty of hiring, rigidity of hours, difficulty in firing and cost of firing – are not unduly burdensome. For instance, there are no limits to the maximum length of a fixed term contract and the costs of firing an employee are only 4.3 months of the employee’s salary. Furthermore, a 2013 survey of 600 registered firms reveals that only 2.1 percent of the firms identified labor regulations as a major constraint in Kazakhstan compared to 6.4 percent of firms in Eastern Europe and Central Asia as a group and 11.4 percent in all countries.³⁴ However, in 2014, the government of Kazakhstan increased the contributions of firms to social and environmental protection, which could make it more expensive to hire workers formally.

Also, between 2004 and 2014 jobs increased steadily through creation of salaried, formal employment; self-employment, where informality is most dominant; has stagnated. This shift toward salaried employment matches the ongoing structural shift of the economy from agriculture to services and increased urbanization – which reached 55 percent in 2013.³⁵ In 2013, services employed over 58 percent of the active population, including the public sector. In 2011, the public sector accounted for 31 percent of nonagricultural employment, and 34 percent of wage employment.

³⁴ <http://www.enterprisesurveys.org/data/exploreconomies/2013/kazakhstan#workforce>

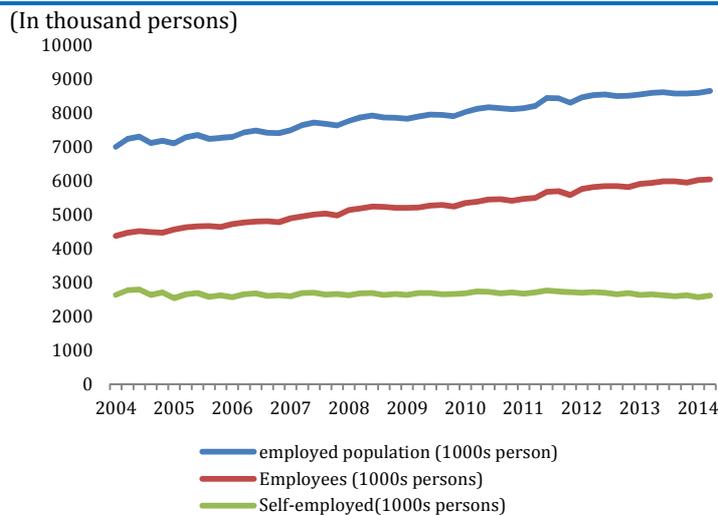
³⁵ According to the Statistical Office of Kazakhstan, in the first five months of 2014, preliminary official statistics indicate there were 138 thousand new jobs created in the services sector (mainly in transportation and catering), while the agriculture sector lost 135 thousand jobs.

Figure 26. Labor market participation has increased and official unemployment has steadily fallen



Source: Statistical Office of Kazakhstan.

Figure 27. Steady employment growth has been through salaried employment while self-employment has stagnated



Source: Statistical Office of Kazakhstan.

Weak institutions and high regulatory burden

Weak institutions that affect the rule of law and the effectiveness of regulations also affect people's decisions to operate in the non-observed economy. Countries with better rule of law, less regulation and less bribery have smaller shadow economies (Johnson et al., 1998a, 1998b). Also, a higher per-capita GDP is associated with a larger informal sector size in countries where institutional quality is low; the opposite is true in countries with good institutions (Elgin and Oztunal, 2013). In Kazakhstan, the 2013 survey of 600 firms found that 19.6 percent considered corruption to be the most constraining factor in the business environment, highlighting the need for reform.³⁶

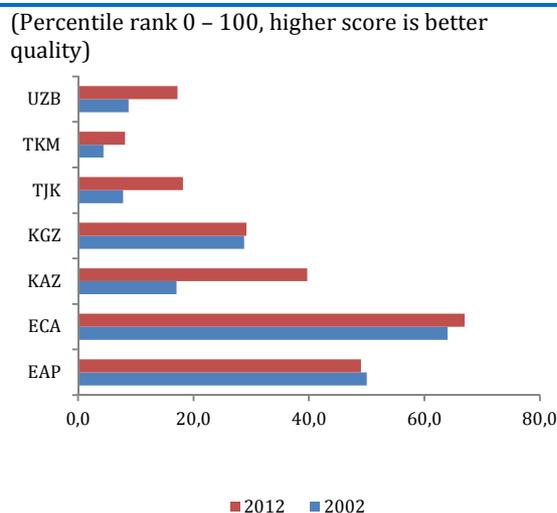
Kazakhstan is making progress in reinforcing its institutional and regulatory framework. The 2012 Worldwide Governance Indicators on rule of law and regulatory quality show a slight improvement over the early 2000s. Agencies have been established to regulate competition policy, procurement and consumer protection. Substantial reform is underway to professionalize the civil service. The e-government initiative, which has an e-procurement element, is an example of the successful effort to build-up institutions.

However, there are gaps to overcome in implementing regulations effectively and without discrimination. A comparison with the OECD reveals that for Kazakhstan, the gap between legislation and practice is the lowest on effective enforcement of regulations, but is strikingly high for due process in administrative proceedings, which suggests that respect for the rule of the law is not guaranteed. Fifty percent of respondents in a recent survey on Kazakhstan (Ernst & Young, 2012) felt that the level of legal and regulatory transparency and predictability is insufficient. The main areas of concern were inconsistency in the interpretation of laws and its selective application; over-regulation and onerous local content requirements; perceived corruption and an insufficiently independent court system. According to the

³⁶ <http://www.enterprisesurveys.org/data/exploreeconomies/2013/kazakhstan#regulations-and-taxes>

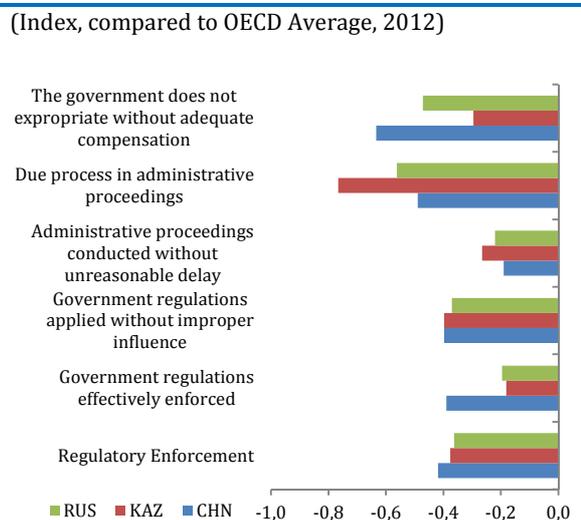
European Bank for Reconstruction and Development (EBRD), Kazakhstan scores above 60 (out of 100) on extensiveness of the commercial legal framework (i.e. quality of the laws in place); but scores only 40 on effectiveness (the actual application of the laws).³⁷

Figure 28. Regulatory quality is improving



Source: World Bank's Worldwide Governance Indicators, Staff calculations

Figure 29. ...but there is still a gap in regulatory enforcement



Source: World Justice Project: Corruption and transparency.

Policy Suggestions

This brief assessment suggests that not all the typical causes of being part of the non-observed economy apply in Kazakhstan. Taxes and labor regulations do not seem to be as powerful factors as expected; instead, institutional quality appears to be a driving factor of NOE activities.

It would be useful to better assess the size, nature and drivers of the non-observed economy in Kazakhstan at the aggregate and for select sectors before suggesting specific policies to deal with it. In fact, other factors beyond those reviewed here may influence people to become active in the NOE. For instance, age and gender can affect informality: in Turkey, where those at the two ends of the age profile tend to be more prone to work informally as are women (World Bank, 2010). Also, factors like the overall tax structure or how the national pension plan is defined may affect informal or shadow activities. The lack of tax morale (unwillingness to pay taxes for public services received due to perceived corruption or waste of public resources) and personal preference can explain becoming active in the NOE. The role of exclusion from vs. choice to participate in the formal economy could be a guiding framework.³⁸ Finally, it would be important to analyze how the NOE affects government revenues, growth, job creation, labor productivity, labor income, and worker protection.

It is also useful to develop a *measured approach* to accounting for and regulating the non-observed economy. Such an approach should help account for and regulate the most important categories of activities in the non-observed economies, but allow flexibility for a percent of economic activities to remain in the non-observed sphere. This is because there are benefits and

³⁷ EBRD – Commercial legal framework assessment – Kazakhstan, available at: <http://www.ebrd.com/pages/sector/legal/what/Country.shtml>

³⁸ As done in the World Bank Latin America Region Informality Flagship.

costs associated with implementing policies to measure, register, regulate, and tax the non-observed economy.

Global experiences can guide the development of appropriate policy responses to measure, register, regulate, and tax the NOE in Kazakhstan. For example:

Tax evasion can be reduced in a variety of ways. These measures include ensuring better recording, reporting and cross-checking of transactions, reducing cash transactions and expanding contactless transactions such as electronic payments. For instance, to control tax evasion and NOE, Portugal is now mandating issuance of invoices for all transactions. Turkey has introduced a system for cross-checking VAT declarations with bank credit card transaction documentation from the banks; as a result, in 2012 about 360,000 tax payers were added to the tax rosters.³⁹ A more systemic approach would be to review the entire national tax structure to ensure that it incentivizes formal activities. Efficient tax administration is also crucial to discouraging tax evasion.

- **To reduce the non-observed economy, many countries use controls, sanctions and penalties to curb undeclared work.** For instance, Spain places high penalties on businesses that do not monitor labor contracts (up to €185,000); it can deprive them of labor market subsidies and forbid them from bidding on public contracts for two years. In the Czech Republic a 2012 amendment to the Act on Employment sets large fines for persons or companies using commercial contracts, which do not provide social and health benefits to workers, instead of employment contracts (Schneider, 2013). A more structural approach would be to review the entire social protection package with a view to optimizing labor protection while encouraging formal employment.
- **Many countries are working to improve their institutional and regulatory framework.** Revising legislation, improving regulations and building institutional capacity help improve the efficiency of public services, control corruption, and help reduce the attractiveness of NOE. Kazakhstan is already engaged on this path, through e.g., its reform of the civil service and the creation of agencies for competition and for consumer protection. Simplifying administrative procedures and processes that affect economic activities through no-contact licensing and propagation of e-services and e-payments also reduces the draw of the NOE. Encouraging an active role for the public to demand accountability and improved governance reinforces the government drive for reform.

³⁹ Ibid.

Statistical Appendix

Kazakhstan: Economic and Social Indicators, 2010-17

Selected Indicators	2010	2011	2012	2013	Projections			
					2014	2015	2016	2017
Income and Economic Growth								
GDP growth (percent)	7.3	7.5	5.0	6.0	4.1	4.5	5.0	5.5
GDP per capita growth (percent)	5.8	6.0	3.5	4.5	2.7	3.1	3.8	4.3
GDP per capita (US\$)	9,071	11,358	12,120	13,172	12,480	12,963	14,100	15,544
GDP per capita, PPP (current international dollars)	19,224	20,772	21,882	23,206	21,986	22,837	24,841	27,385
Private consumption (percent change)	11.8	10.8	11.0	10.1	-2.0	8.5	6.0	6.0
Gross fixed investment (percent of GDP)	25.4	22.5	24.8	26.2	26.1	26.4	26.4	26.2
Public	5.1	4.2	4.6	4.1	4.4	4.6	4.6	4.6
Private	20.3	18.3	20.2	22.1	21.7	21.9	21.8	21.6
Money and Prices								
Consumer price inflation (percent change, yearend)	7.8	7.4	6.0	4.8	7.8	7.9	7.8	8.5
Consumer price inflation (percent change, annual average)	7.1	8.3	5.1	5.8	6.8	7.6	7.5	8.2
Treasury bill rate, 12-months (percent, annual average)	2.2	1.6	2.1	2.9				
Nominal exchange rate (tenge per US\$, yearend)	147.4	148.0	150.3	153.6				
Real effective exchange rate (2000=100)	107.7	107.1	112.7	112.7				
M0 (percent of GDP)	5.3	5.0	5.0	4.4	7.1	7.0	7.1	7.5
M2 (percent of GDP)	38.9	35.4	34.7	34.0	30.8	30.0	29.6	30.4
Fiscal Accounts								
	(In percent of GDP, unless otherwise indicated)							
Revenues	25.0	27.7	26.4	25.1	25.0	24.1	23.6	23.4
Oil revenue (saved)	5.3	8.2	7.3	6.4	5.4	5.1	5.7	5.9
Oil revenue (spent)	5.6	6.1	6.6	5.8	7.7	6.9	5.7	5.0
Non-oil revenue	14.1	13.3	12.6	12.9	11.8	12.1	12.2	12.5
Expenditures	22.1	21.5	22.1	20.8	22.3	23.2	22.7	22.9
Current	15.0	14.9	16.1	16.0	16.0	16.9	17.5	17.8
Capital	7.0	6.4	5.9	4.7	6.2	6.2	5.1	5.1
Net lending	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Overall fiscal balance, before grants	2.9	6.2	4.3	4.3	2.6	0.8	1.0	0.4
Overall fiscal balance, after grants	2.9	6.2	4.3	4.3	2.6	0.8	1.0	0.4
Primary fiscal balance	3.3	6.6	4.8	4.8	3.3	1.7	2.2	1.8
Non-oil state budget deficit	-8.0	-8.2	-9.5	-7.9	-10.6	-11.2	-10.4	-10.5
Oil Fund FX reserves	20.9	23.2	28.5	31.5	37.2	39.8	41.9	43.6
Total government debt	10.7	10.4	12.3	13.2	14.9	18.0	20.7	24.0
External	2.7	2.6	2.6	2.5	2.5	2.4	2.4	2.2
Domestic	7.9	7.8	9.7	10.7	12.4	15.5	18.4	21.8
Debt service ratio (percent of revenues)	7.1	5.2	5.1	5.9	7.5	9.2	11.7	13.7
External Accounts								
	(In billions of US dollars, unless otherwise indicated)							
Real export growth (percent)	3.1	0.4	4.7	-0.2	-2.3	0.4	5.2	7.2
Real import growth (percent)	2.9	2.8	20.9	5.2	-15.0	3.0	3.9	4.1
Merchandise exports	61.4	85.2	86.9	85.6	80.8	77.3	81.8	88.2
Merchandise imports	-32.9	-40.3	-48.8	-50.8	-43.3	-44.7	-47.1	-49.8
Net services	-7.2	-6.6	-7.9	-6.9	-6.7	-6.4	-6.3	-6.1
Net workers' remittances	-1.4	-1.5	-1.7	-1.8	-1.6	-1.5	-1.5	-1.5
Current account balance	1.4	10.2	1.0	1.1	5.7	1.9	2.3	3.7
as percent of GDP	0.9	5.4	0.5	0.5	2.7	0.9	0.9	1.3
Net foreign direct investment	3.7	8.6	11.8	8.1	8.2	8.0	8.7	7.1

Kazakhstan: Growth Slows as External Pressures Rise

Selected Indicators	Projections							
	2010	2011	2012	2013	2014	2015	2016	2017
Total official FX reserves	56.2	68.8	80.0	90.0	99.4	107.4	119.5	136.9
FX reserves at the NBK	25.2	25.2	22.1	19.2	19.2	17.1	14.9	15.6
FX reserves in the Oil Fund	31.0	43.6	57.9	70.8	80.1	90.3	104.7	121.3
Total external debt	118.2	125.3	136.9	148.8	156.2	166.1	177.6	188.8
as percent of GDP	79.9	66.6	67.3	66.3	71.9	72.5	71.1	67.9
Multilateral debt (percent of total external debt)	2.2	2.6	2.7	2.8	2.4	2.3	2.6	2.9
Debt service ratio (percent of exports of goods and services)	23.9	18.1	19.6	21.2	23.3	23.9	22.9	21.6
Population, Employment, and Poverty								
Population (million people)	16.3	16.6	16.8	17.0	17.3	17.5	17.7	17.9
Population growth (percent)	1.4	1.4	1.4	1.5	1.4	1.3	1.2	1.1
Unemployment rate (percent of labor force)	5.8	5.4	5.3	5.2	5.1	5.0	5.0	5.0
Poverty headcount ratio, national line (% of the population)	6.5	5.5	3.8	2.9				
Gini coefficient (income)	27.8	29.0	28.4	27.6				
Life expectancy (years)	68.3	69.0	69.6	70.3				
Other								
Doing Business (rank) *	58	56	53	50				
Human Development (rank) **	69	68	69	70				
CPIA (overall rating)	3.7	3.8	3.8	3.8				
Economic management	4.3	4.3	4.3	4.5				
Structural policies	3.5	3.7	3.7	3.7				
Social inclusion and equity policies	3.6	3.7	3.7	3.8				
Public sector management and institutions	3.4	3.5	3.5	3.4				

* The DB ranked 183 countries in 2010; 185 in 2011 and 2012; and 189 in 2013.

** The HDI ranked 169 countries in 2010, 187 in 2011, 186 in 2012, and 187 in 2013.



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