87855

Kazakhstan:

Short-Term Vulnerabilities, Positive Prospects

THE WORLD BANK

Kazakhstan Economic Update
Spring 2014

Kazakhstan:

Short-Term Vulnerabilities, Positive Prospects

Kazakhstan Economic Update
Spring 2014

THE WORLD BANK
Washington, D.C.

Government fiscal year:	January 1–December 31
Currency equivalents:	Exchange rate effective as of March 31, 2014
	Currency Unit = Kazakhstan Tenge (KZT)
	USD 1.00 = KZT 182.04
	KZT 1.00 = USD 0.0055
Weights and measures:	Metric System

Abbreviations

BRIC	Brazil, Russia, India, China
CES	Common Economic Space
CIS	Commonwealth of Independent States
CPI	Consumer price index
CU	Customs Union between Belarus, Kazakhstan and Russia
EU	European Union
FDI	Foreign direct investment
FX	Foreign exchange
GDP	Gross domestic product
KASE	Kazakhstan Stock Exchange
NBK	National Bank of Kazakhstan
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
PPI	Producer price index
PPP	Purchasing power parity
SMEs	Small- and medium-sized enterprises
SOEs	State-owned enterprises
US	United States of America

Contents

List of Figures

List of Tables

List of Boxes

Acknowledgments

This economic update was prepared by the Kazakhstan country economists, Ilyas Sarsenov and Dorsati Madani. Support and comments were provided by Sebnem Akkaya (Country Manager) and Ivailo Izvorski (Sector Manager). Megumi Kubota (Consultant) provided inputs to the inflationary impact analysis. The formatting of the report was done by Budy Wirasmo.

Overview

In 2013, stronger credit-driven domestic demand from the private sector contributed to higher GDP growth, while external demand remained weak. Kazakhstan's economic growth increased from 5 percent in 2012 to 6 percent in 2013, driven by stronger private consumption and investment. At the same time, weaker external demand led to a deficit in the current account in 2013 and to a sharp devaluation of the local currency in February 2014. The devaluation is expected to put additional pressures on the banking sector, burdened with non-performing loans, and lead to higher inflation in 2014.

Global economic recovery is continuing, but prospects for the Eurasia region are mixed. Economic recovery in high-income countries will have a positive impact on trade with emerging markets, including Kazakhstan. Despite a projected slowdown of economic growth in China, its demand for Kazakhstan's hydrocarbons is expected to remain stable. Economic growth in Russia, however, appears likely to slow in 2014 and—in the event of a further worsening of the geopolitical situation around the Crimea crisis, and possible sanctions applied by the United States and the European Union—may potentially, shift to a contraction, negatively affecting economic developments in Kazakhstan in the short-term.

Despite the short-term vulnerabilities accentuated by an uncertain regional economic outlook, Kazakhstan's medium-term prospects look promising. In 2014, GDP growth of Kazakhstan is estimated to be close to its potential of about 5½ percent, supported by improvements in the external balances. In the medium-term, the economy will continue to grow on the back of the expanding oil sector, while the expansion of the non-oil economy will be lower, due to lower domestic demand. Pro-cyclical expansionary fiscal policy is set to boost economic growth beyond its estimated potential, but is expected to normalize after the EXPO-2017. In the long run, structural reforms envisioned by the development vision Kazakhstan-2050 are set to foster competitiveness of the economy by improving the country's endowments—human capital, infrastructure and institutions.

This economic update is structured as follows: Section A describes the recent economic developments, with a focus on emerged imbalances in the external accounts, which led to growing depreciation expectations and resulted in the one-off tenge devaluation in early 2014. Section B provides an overview of recent macroeconomic policies and the government's forward-looking vision of moving toward a diversified knowledge-based economy by improving the country's endowments. Section C outlines the medium-term economic prospects for Kazakhstan, which is expected to benefit from the global economic recovery, but face risks, both external and domestic. Section D discusses possible short- to medium-term impacts of the devaluation on the economy and suggests a set of policy measures to mitigate inflationary pressures.

This page is intentionally blank.

A. Revealing Imbalances in the External Accounts

Higher credit-driven economic growth was partially offset by weaker external demand

Stronger domestic demand from the private sector was driven by credit and contributed to higher GDP growth, while contribution from external demand remained negative. Kazakhstan's real GDP growth increased from 5 percent in 2012 to 6 percent in 2013, due to much stronger domestic demand from the private sector (Table 1). While the government contribution to GDP growth was negligible, the private sector drove the economy up. Both private consumption and private investment grew much faster in 2013 than in the preceding year. Private consumption growth was supported by a rapid expansion of consumer lending (46 percent increase), while real salaries grew only modestly (1.6 percent increase) in 2013. The boost in investment activity is also explained by an increased availability of credit. According to the official data, the share of credit, as a source for fixed capital investment funding, increased from 12 percent in 2012 to over 20 percent in 2013. At the same time, net exports contributed negatively to real GDP growth. While imports continued growing in 2013, exports decreased slightly due to a weaker external demand for oil, metals, and wheat.

Table 1. Kazakhstan—Contribution to Real GDP Growth by Expenditure, 2008–2013

in percentage points

	2008	2009	2010	2011	2012	2013e
GDP growth	3.3	1.2	7.3	7.5	5.0	6.0
Domestic demand	-1.0	1.1	6.0	7.0	9.0	7.5
Consumption	3.2	0.4	5.5	5.6	6.2	4.8
Government	0.3	0.1	0.3	1.2	1.4	-0.2
Private sector	2.9	0.3	5.2	4.5	4.7	5.0
Investment	-4.2	0.7	0.5	1.3	2.8	2.7
Government	-0.1	0.9	0.5	-0.1	0.4	-0.1
Private sector	-4.1	-0.2	0.1	1.4	2.4	2.8
External demand	5.5	0.7	0.5	-0.6	-3.4	-1.5
Exports of goods and services	0.5	-5.7	1.4	0.2	2.1	-0.1
Imports of goods and services	5.0	6.4	-0.9	-0.8	-5.5	-1.4
Statistical discrepancy	-1.2	-0.6	0.8	1.1	-0.6	0.1

Sources: Statistical Agency of Kazakhstan; World Bank staff calculations and estimates.

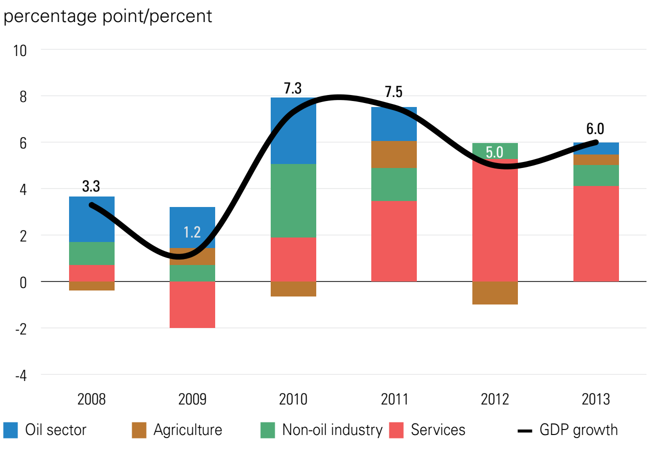
Note: Some sums may not add up exactly due to rounding.

On the production side, despite higher domestic demand, services grew slower in 2013. Slower growth in services is mainly explained by a sharp fall in growth of real estate transactions (from 7.7 percent growth in 2012 to 1.6 percent in 2013), due to lower growth of mortgages. Trade and transportation (especially of oil, metals and wheat) also grew slower in 2013. Real growth of the financial activity, mainly the banking sector, slowed from 11.7 percent in 2012 to 10.1 percent in 2013. As a result, the real growth rate of all services moderated from 10.4 percent in 2012 to 7.1 percent in 2013.

The lower growth in services was more than offset by higher output in agriculture and industry. Better weather conditions in 2013 helped the agricultural sector to partially compensate its negative contribution to economic growth observed in 2012 (Figure 1). Wheat output, in particular, was the main contributor to the 11 percent growth in agriculture, with 14 million tons harvested in 2013, up from 10 million tons harvested in the dry year of 2012. The recovery of industrial growth was characterized mainly by developments in the oil sector. While there was further delay in oil production at the off-shore Kashagan oil field, the on-shore oil sector grew by 3.2 percent in 2013, mainly due to a bumper oil production by Tengizchevroil in 2013 (Figure 2). The restorations made at the second-generation plants at the Tengiz oil field helped Tengizchevroil to boost its production by 12 percent, from 24 million tons in 2012 to 27 million tons in 2013. In the rest of the oil industry, however, oil production remains flat at around 55 million tons a year. Meanwhile, manufacturing growth slowed further (from 3.0 percent in 2012 to 1.8 percent in 2013), due to further declines in the metallurgy sector output, impacted by declining metal prices.

Figure 1. Higher growth in agriculture and the oil sector offset lower growth in services

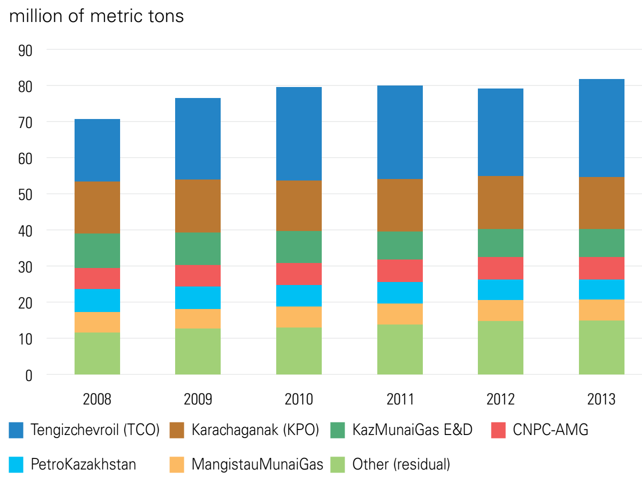
Real GDP growth: Oil and non-oil contribution



Source: Statistical Agency of Kazakhstan.

Figure 2. On-shore oil output resumed growing due to a record high production at Tengiz

Oil production in Kazakhstan



Source: Official websites of oil companies.

Meanwhile, it was reported that Kazakhstan's off-shore Kashagan oil and gas project is facing another delay affecting its projected revenue profile. Kashagan is one of the largest oil and gas fields in the world and is expected to bring huge profits to Kazakhstan and the developer companies. It is also considered as one of the most expensive energy projects in the world, with a revised total cost estimate of $136 billion (of which the first phase already cost over $40 billion and is still counting). Moreover, it has experienced several delays since 2005, due to the complicated structure of the field. Oil production at Kashagan off-shore field was launched on September 11, 2013. However, production has been stopped since October 9, 2013, due to pipeline leaks. Some experts believe that if the leaks were provoked by pipelines cracking, the whole pipeline of some 40 km would have to be replaced, delaying the restart of production until 2015 or even 2016.

Weaker external demand led to a deficit in the current account

While the overall external position remained strong, the current account went into deficit. The overall external balance of payments remained strong in 2013 and contributed to a further buildup of total official foreign exchange (FX) reserves, comprising FX reserves in the Oil Fund and FX reserves at the National Bank (Table 2). The total official FX reserves increased by $10 billion and reached $90 billion (41 percent of GDP) by the end of 2013. While the fiscal FX reserves in the Oil Fund continued expanding rapidly due to ample oil revenue inflows ($1 billion a month on average), the FX reserves held by the National Bank of Kazakhstan (NBK) decreased for the second year in a row. The sterilizations of FX inflows by the Oil Fund, accompanied by a sharp decrease of the current account surplus (from $10 billion in 2011 to $1 billion in 2012 and further down to a deficit of $0.1 billion in 2013), were the main reasons for the draw-down of the FX reserves at the NBK during 2012–2013. Over the past two years, the deterioration in the current account balance was driven mainly by developments in the merchandize trade surplus, which narrowed from $44.8 billion in 2011 to $33.7 billion in 2013. Although the terms of trade remained stable in 2012–2013, lower external demand for key commodities and an expansion of imports led to deterioration in the trade surplus.

Table 2. Kazakhstan—Balance of Payments, 2008–2013

in millions of US dollars

	2008	2009	2010	2011	2012	2013e
Current account	**6,250**	**-4,121**	**1,386**	**10,197**	**1,079**	**-118**
Trade of goods	33,612	15,004	28,500	44,844	38,145	33,691
Exports f.o.b.	71,964	43,923	61,392	85,194	86,931	83,407
Imports f.o.b.	38,352	28,919	32,891	40,350	48,786	49,715
Services	-6,927	-5,978	-7,250	-6,635	-7,948	-6,876
Income, *of which:*	-19,375	-12,417	-19,376	-27,746	-28,108	-25,345
Income of direct investors (net)	-17,316	-10,961	-17,997	-25,213	-24,740	-22,722
Current transfers	-1,060	-729	-489	-265	-1,010	-1,589
Capital and financial accounts /1	**2,395**	**3,471**	**9,933**	**2,748**	**8,755**	**10,484**
Direct investments	13,115	10,083	3,665	8,583	11,825	7,790
Portfolio investments /2	-2,898	-25	15,082	-223	-3,247	2,816
Medium and long-term investments	1,084	-4,001	-15,593	27	4,127	5,375
Other investments /1/2	-8,907	-2,586	6,778	-5,639	-3,950	-5,497
Overall balance/Change in reserves /3	**8,645**	**-649**	**11,318**	**12,945**	**9,835**	**10,366**
Change in FX reserves at the NBK	2,165	2,469	4,706	300	-4,306	-2,412
Change in FX reserves in the Oil Fund	6,480	-3,118	6,612	12,645	14,141	12,778
Memorandum items:						
Total official reserves (stock)	45,357	44,958	56,203	68,802	80,048	89,671
NBK FX reserves	17,871	20,590	25,223	25,177	22,121	19,127
Oil Fund FX reserves	27,486	24,368	30,980	43,625	57,927	70,544

Notes: 1/ Including Errors and omissions. 2/ Excluding investments of the Oil Fund. 3/ "+" = reserve accumulation.

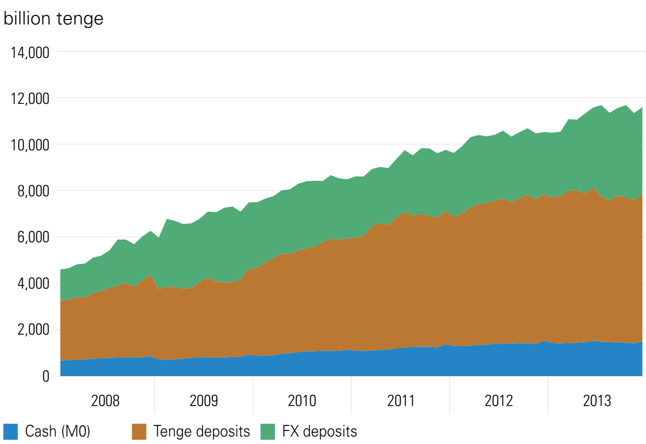
Nevertheless, the financial account surplus more than offset the negative developments in the current account. Although net inflows of foreign direct investment (FDI) decreased from $11.8 billion in 2012 to $7.8 billion in 2013, mainly due to the finalization of the first-phase investments into Kashagan, net external borrowings by the state-owned enterprise (SOE) sector more than compensated the drop in FDI. According to the Kazakhstan Stock Exchange (KASE) data, during the third quarter of 2013, the national oil company KazMunaiGas issued Eurobonds in the amount of $3 billion and the national agricultural holding company KazAgro issued Eurobonds of $1 billion. These Eurobond issuances boosted net portfolio investment inflows (net of amortization) to $2.8 billion in 2013. Disbursements of the Chinese credit line to the national gas transportation company KazTransGas, a subsidiary of KazMunaiGas, for the construction of the Asian Gas Pipeline were reflected in the medium- and long-term investments/loans, where a $5.4 billion net inflow was recorded.[1] Consequently, the financial account balance, net of short-term and other unidentified outflows and excluding investments of the Oil Fund, was estimated at $10 billion in 2013.

Lower tenge liquidity and lower food prices pushed inflation down

Uncertainties associated with US monetary policy created depreciation expectations worldwide and led to lower tenge liquidity in Kazakhstan. The US Federal Reserve indication of its tapering program in May 2013 led to heightened expectation of depreciation of emerging market currencies worldwide. The expected outflow of financial resources from many emerging markets led to exchange rates weakening in countries such as Turkey, Brazil and Russia. The depreciation expectation started mounting in Kazakhstan as well, and FX deposits in Kazakhstan started expanding rapidly during the second half of 2013 (Figure 3). As a result, the share of FX deposits increased from 32 percent of total deposits in April 2013 to over 37 percent by the end of the year. At the same time, although total money supply grew by 10 percent year-on-year in 2013, compared to 8 percent in 2012, cash and tenge deposit virtually stopped growing by the end of 2013. The growth of cash in circulation declined from 8 percent year-on-year in May 2013 to -1 percent in December. The stock of tenge deposits was almost flat in July–September 2013 and started shrinking since October.

Figure 3. Tenge liquidity was affected by transfers of tenge deposits and cash into FX savings

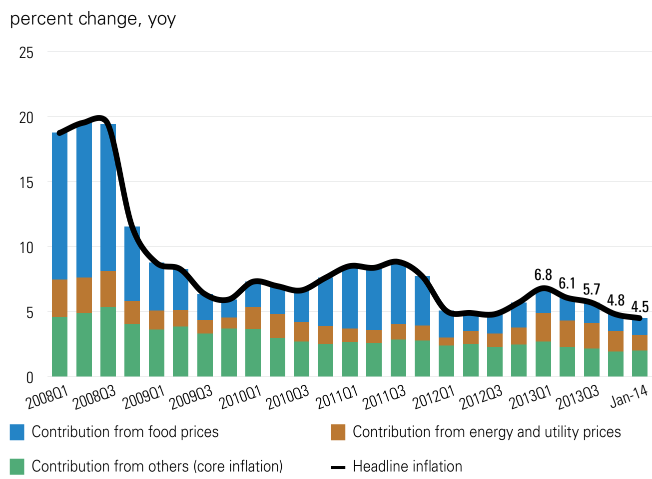
Monetary aggregates



Source: National Bank of Kazakhstan.

Figure 4. Inflation moderated due to lower food prices and a decline in core inflation

Headline inflation and its decomposition



Source: Statistical Agency of Kazakhstan.

1 The Asian Gas Pipeline is a gas pipeline for transporting gas from Turkmenistan and Uzbekistan to China, via the territory of Kazakhstan. The total cost of the first phase of the Asian Gas Pipeline is estimated at $12.1 billion, which makes it one of the most expensive investment projects in the history of Kazakhstan.

Lower international food prices and lower availability of cash in circulation pushed inflation down. Despite the higher consumption growth supported by credit, headline inflation fell from 6.8 percent year-on-year in the first quarter of 2013 to 4.8 percent in the last quarter of the year and further to 4.5 percent in January 2014, mainly due to lower international food and utility prices (Figure 4). Food inflation, in particular, fell from 5.3 percent year-on-year in December 2012 to 3.3 percent on December 2013. Inflation of non-food items also fell slightly from 3.5 to 3.3 percent during the same period. Prices for paid services increased by 13 percent year-on-year during the first quarter of 2013, mainly due to price adjustments for utility services, but their growth rate declined to 8 percent by the end of the year. The contribution of core inflation, excluding food and utilities/energy items, to overall inflation declined from 2.7 percentage points in the first quarter of 2013 to 2.0 percentage points by the end of the year, due to lower availability of cash in circulation.

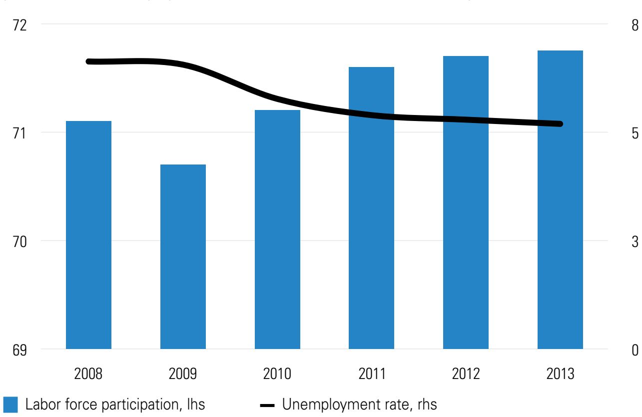
Unemployment and poverty ratios continue to decline

Unemployment in Kazakhstan declined slightly due to the creation of jobs in the services sector. The unemployment rate declined from 5.3 percent of total labor force in 2012 to 5.2 percent in 2013 (Figure 5). An increase in officially employed labor was the main contributor to higher labor force participation in 2013. While the number of unemployed remained almost flat at about 0.47 million and the number of self-employed decreased from 2.69 million people in 2012 to 2.63 million in 2013, the number of hired/contracted employees increased from 5.81 million to 5.95 million, respectively. Additional jobs were created in the services sector, especially in retail trade and car sales, as well as in education and healthcare. Meanwhile, the agricultural sector saw a continued outflow of workers of 0.1 million in 2013, leading to higher urbanization.

Figure 5. Unemployment rate declined, as labor force participation increased further

Labor force indicators

percent of active population | percent of labor force

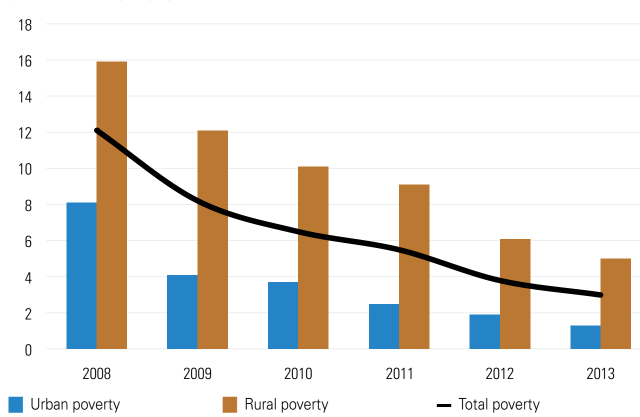


Source: Statistical Agency of Kazakhstan.

Figure 6. Poverty incidence has improved, but the urban-rural gap has widened

Poverty headcount ratios

percent change, yoy



Source: Statistical Agency of Kazakhstan.

Poverty incidence has improved dramatically overall, but the poverty gap between urban and rural areas has widened. The poverty headcount ratio, as measured by the national poverty line, declined from 3.8 percent of total population in 2012 to about 3 percent in 2013.[2] Meanwhile, the gap in poverty incidence between urban and rural areas almost doubled during 2009–2013, compared to the period before the economic crisis of 2008. While the poverty ratio was below 1.5 percent in cities, it was about 5 percent in rural areas in 2013 (Figure 6). This can be explained by the expanding services sector in cities, which attracts the abundant labor force from rural areas. The highest poverty is recorded in rural areas of the densely-populated South-Kazakhstan Oblast, where the poverty ratio is about 9 percent, and in the oil-rich western regions with a poverty ratio in rural areas ranging from 5 percent in Western-Kazakhstan and Mangistau Oblasts to 7 percent in Atyrau Oblast. The lowest poverty ratios of less than 1 percent were registered in Astana and Almaty.

2 Although the national poverty line roughly corresponds to the international poverty line at $2.5 a day, an upper-middle income country like Kazakhstan should apply a higher poverty line at international $5. The latest available poverty estimate for Kazakhstan shows that the poverty headcount ratio at $5 a day was about 35 percent of total population in 2010.

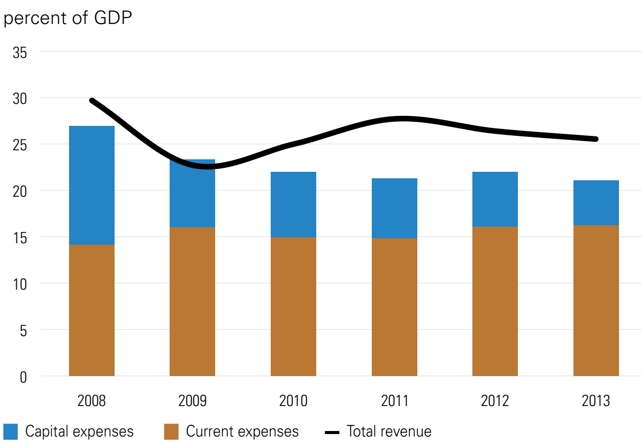
B. Maintaining Prudent Macroeconomic and Structural Policies

Fiscal policy remained conservative and neutral to inflation

The government continued following a conservative fiscal policy by controlling budget spending and accumulating oil revenue savings in the Oil Fund. As total government revenue leveled off at around 26 percent of GDP and total budget spending was maintained at around 21½ percent of GDP, the overall fiscal surplus stabilized at around 4½ percent of GDP in 2012–2013 (Figure 7). Recent changes to the rules of disbursements from the Oil Fund increased the amount of oil revenue transfer to the budget by 15 percent, from $8.0 billion a year in 2010–2011 to $9.2 billion a year in 2012–2013. Despite these changes, the Oil Fund accumulated around $1 billion a month during 2013 to reach a stock of 32 percent of GDP (Figure 8). Net of government debt of 13½ percent of GDP, the government's net financial assets increased to 18½ percent of GDP, the largest fiscal buffer in recent history.

Figure 7. The government has kept its total spending under a strict control

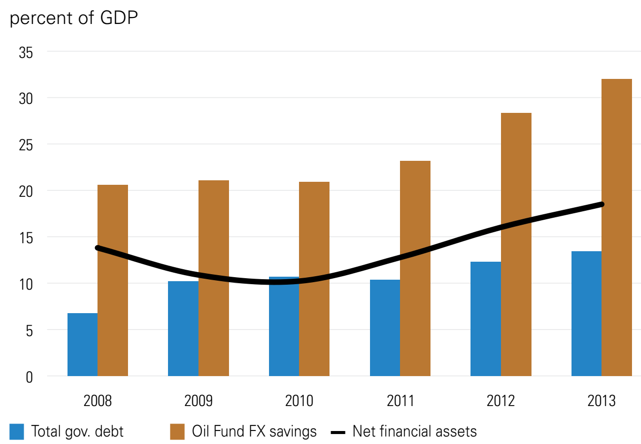
Consolidated fiscal accounts



Source: Finance Ministry of Kazakhstan.

Figure 8. Government's FX savings are almost twice as large as its total debt

Government debt and savings



Source: Finance Ministry of Kazakhstan.

Conservative fiscal policy has had a neutral impact on inflation. Empirical analysis shows that lagged government spending to GDP ratio is positively and significantly related to inflation; therefore, larger government spending may induce inflationary pressure in the overall CPI inflation the following year (Kubota, 2013).[3] Nevertheless, during 2010–2013 fiscal policy was neutral to inflation, as government spending has been growing less than or on par with GDP. In 2013 in particular, the government's contribution to domestic demand and inflation was negligible, due to substantial under-execution of the capital budget.

3 Kubota, Megumi, 2013, "Notes on inflation in Kazakhstan: The impact of fiscal policy on inflation," Note #3 (Washington: World Bank).

To maintain macroeconomic stability and fiscal sustainability, the authorities set ambitious fiscal targets. The government recently approved a new Concept of budget/fiscal policy. According to the Concept, the non-oil deficit is to be cut significantly from 8 percent of GDP in 2013 to 2.8 percent by 2020. The envisioned measures cover both (a) increases in non-oil tax proceeds, and (b) cuts in current spending. The government has plans to improve equity and neutrality of the tax system (by increasing tax burden on wealthier segments of the population) and strengthen tax administration. The government also plans to streamline current expenditures and finance them exclusively from non-oil revenue (from 2018 onwards).

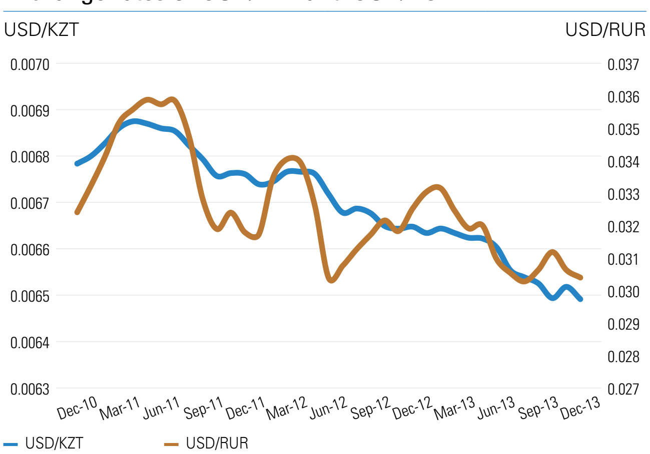
Exchange rate policy remains the main monetary policy instrument

As economic performance was solid in 2013, the NBK kept its refinancing rate unchanged throughout 2013, but tightly controlled the short-term tenge liquidity. The refinancing rate was lowered from 6.0 to 5.5 percent in 2012—when economic growth slowed—and has remained unchanged since then. Nevertheless, given that banks' liquidity was impacted by the depreciation expectations, key money market/interbank rates experienced periodic spikes throughout 2013, reflecting adherence of the NBK to keeping the exchange rate stable. To support stability of the exchange rate, the NBK had to control supply of short-term liquidity, leading to volatility in interbank rates. According to the KASE data, there was a significant variation in interbank repo rates, ranging from 3 to 25 percent during 2013.

The rigid exchange rate regime in Kazakhstan did not allow the external balances to adjust to changing external environment and led to depreciation pressures on the tenge. Despite the announced move to a managed float regime in March 2011, the exchange rate policy in Kazakhstan remained relatively rigid and resulted in NBK interventions that led to a draw-down of the FX reserves held by the NBK (Figure 9). Over the past two years, the FX reserves held by the NBK decreased by $6 billion, from $25 billion at the end of 2011 to $19 billion by the end of 2013. The exchange rate regime came under an increased pressure in the second half of 2013, following further deterioration in the external current account, depreciation of the Russian ruble,

Figure 9. The managed float regime in Kazakhstan was more rigid than in Russia

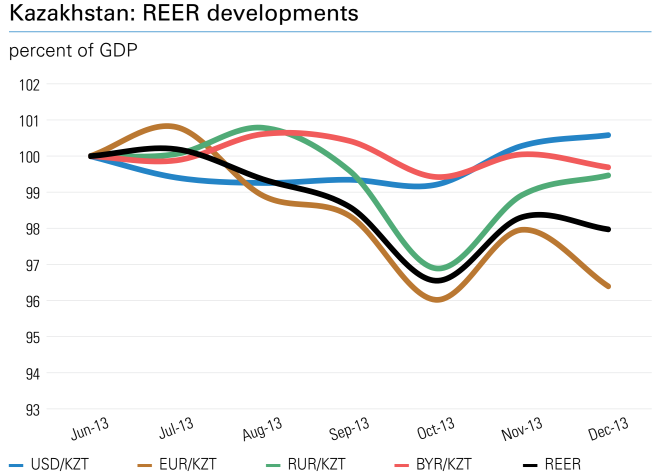
Exchange rates of USD/KZT and USD/RUR



Sources: Central banks of Kazakhstan and Russia.

Figure 10. The ER policy rigidity did not help the tenge to adjust to the changing environment

Kazakhstan: REER developments



Source: National Bank of Kazakhstan.

and uncertainties related to the US Federal Reserve monetary policy (Figure 10). The unsustainability of the exchange rate policy led to growing devaluation expectations and further draw-downs of the FX reserves held by the NBK during the second half of 2013.

The NBK eventually reacted to the situation by announcing a one-off 19 percent devaluation of the tenge against the US dollar. The exchange rate of the tenge to the US dollar was adjusted from 155 to 185 in February 2014. Currently, the exchange rate has stabilized around 182 tenge per one dollar. A more detailed discussion on reasons and implications of the devaluation can be found in section D.

Imbalances in banks' lending portfolios are being addressed by new prudential norms

Given the limited access of banks to long-term external funding, domestic deposits became the main source of funding credit. Following the recent external debt restructuring and deleveraging in the banking sector of Kazakhstan, domestic deposits became the main source of funding credit to the economy. Consequently, the loan-to-deposit ratio declined substantially from 187 percent in 2007 to 111 percent in 2012 and 2013 (Table 3). The lending activity resumed in 2012 when credit to the economy expanded by 8.2 percent year-on-year in real terms and continued to grow by an estimated 8.8 percent in 2013. The main driver of this credit growth was a higher rate of lending to households, while lending to small- and medium-sized enterprises (SMEs) has not recovered yet.

Table 3. Kazakhstan—Selected Indicators of the Banking Sector, 2007–2013

	End-2007	End-2008	End-2009	End-2010	End-2011	End-2012	End-2013
Deposits (in billion tenge)	3,890	5,409	6,574	7,334	8,387	8,994	10,089
Credit to the economy (in billion tenge)	7,258	7,460	7,644	7,592	8,781	9,958	11,292
Credit to the economy (percent change)	54.7	2.8	-6.8	-0.7	15.7	13.4	13.4
Credit to firms, *of which:*	48.3	9.4	-4.5	1.1	17.5	10.4	7.9
Loans to SMEs	74.8	4.3	-0.9	-18.9	-3.1	5.2	-9.1
Credit to households, *of which:*	68.0	-9.3	-11.7	-4.9	10.9	21.7	27.0
Consumer loans	55.4	-11.9	-12.7	-4.3	21.7	39.6	46.4
Mortgages	72.3	-4.7	-3.2	-0.8	7.2	9.8	7.2
Loan-to-deposit ratio (percent)	186.6	137.9	116.3	103.5	104.7	110.7	111.9
NPLs (percent of credit portfolio)	4.6	10.6	36.5	32.6	35.1	36.7	35.0*
Provisions (percent of credit portfolio)	5.9	11.1	37.7	30.9	32.0	34.4	34.5*
Capital adequacy ratio (percent)	14.2	14.9	-8.0	17.9	17.4	18.1	18.7
Liquidity (share of highly liquid assets in all assets)	13.9	13.6	19.2	21.2	21.0	17.5	17.3
Profitability - return on assets (percent)	1.9	0.1	-24.5	11.8	-0.3	1.6	1.7

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

Note: * Data as of May 2013; since the NBK has stopped publishing these data since June 2013.

The shorter-term nature of deposits led commercial banks to issue more uncollateralized consumer loans. The volume of consumer loans grew by 40 percent year-on-year (in nominal terms) in 2012 and by more than 46 percent in 2013, driven by higher consumption. Mortgages, on the other hand, grew moderately due to a lack of long-term funding. As a result, the share of consumer loans increased from 46 percent of total loans to households in 2011 to 61 percent in 2013, whereas the share of mortgages dropped from 31 to 24 percent, respectively. The rapid expansion of consumer lending created some concerns over further escalation of non-performing loans (NPLs), which already account for 35 percent of the total credit portfolio of the banking sector.[4]

To prevent a possible overheating of the consumer lending market and an escalation of NPLs, the regulator introduced a number of additional prudential norms. First, as of February 1, 2014, each bank has to maintain the rate of growth of collateral-free consumer loans at less than 30 percent. Additionally, the debt servicing ratio for each borrower should not exceed 50 percent of their income, to ensure that borrowers have sufficient funds to service their debt. Finally, the NBK increased the capital adequacy ratio for consumer loans from 75 to 100 percent, to prevent perverse incentives for banks to make risky decisions. All of these measures are supposed to bring growth of consumer lending back to a more sustainable path.

Structural reforms are focusing on improving the quality of the country's endowments

The authorities continue with the formulation and implementation of policies that are to help the country become one of the top 30 developed nations by 2050. The January 2014 President Nazarbayev's address to the nation, *Kazakhstan's Path—2050: Common Goal, Common Interests, Common Future*, elaborated on the government's long-term vision for Kazakhstan. The president laid out a two-phased approach for implementing the longer-term development strategy 'Kazakhstan-2050'. The first phase is up to 2030, when Kazakhstan is to benefit from the growth of its traditional extractive sectors and the expansion of its manufacturing industry, while transitioning to a knowledge-based economic model. During the second phase, covering 2030–2050, the knowledge-based economy will ensure sustainable development of the country.

The long-term development vision highlights seven priority areas for action by the government. These seven priority areas cover (i) innovative industrialization; (ii) efficient agri-industrial sector; (iii) improved potential of science; (iv) urban and infrastructure development; (v) SME development; (vi) an active, educated, and healthy population; and (vii) efficient public institutions. Each priority area is defined with objectives, outcome goals, and implementation guidance (Annex 1). Seven consecutive five-year industrial-innovation plans are to be the integrative implementation tool to achieve objectives of the Kazakhstan-2050 strategy.

The emphasis placed by Kazakhstan on improved infrastructure, human capital, and public institutions is well supported by the findings of the World Bank's new diversification report. The diversification report studies economic development in twelve countries of Eurasia, where six countries, including Kazakhstan, are rich in natural resources and the other six countries are not.[5] The main observation of the report is that a diversified economy is the result of successful development and not the cause of successful development. The report suggests that better economic institutions in all Eurasian countries, including Kazakhstan, could

4 According to the NBK classification, non-performing loans amount is calculated as the sum of loans, classified as doubtful 5th category, bad loans and actual provisions for homogenous loans.

5 World Bank, 2014, *Diversified Development: Making the Most of Natural Resources in Eurasia* (Washington: World Bank).

enhance the stability and reduce the volatility of public finances, improve education and infrastructure to make workers more productive, and strengthen the competition regimes to encourage private enterprise and entrepreneurship. Macroeconomic stabilization, better education, and greater competition are identified as three priorities for the Eurasian countries for the next decade. On the other hand, the report argues that forced diversification (for example by subsidizing new industries), if it is not consistent with the country's endowments, will almost always fail, as it usually results in economic inefficiency.

C. Benefiting from Positive Medium-Term Prospects

Global economic recovery is continuing, but regional prospects are mixed

Both high-income and developing economies are expected to resume a steadier growth path after several years of crisis and uncertainty, which will strengthen demand for Kazakhstan's main exports. Growth in high-income economies is expected to strengthen from 1.3 percent in 2013 to 2.2 percent in 2014 and 2.4 percent in 2015 and 2016.[6] This growth will translate into higher imports from developing countries and act as tailwind for them. Demand for Kazakhstan's main exports—oil and mineral products—should firm up going forward. In the meantime, China, the other main client for Kazakhstan's oil exports, is projected to grow slower at 7.5 percent per year for the next three years, but will continue providing sustained demand for Kazakhstan's oil. The end of the quantitative easing in the United States of America (US) is expected to follow an orderly trajectory, and the consequent higher interest rates and capital flow rebalancing are not expected to continue affecting strongly middle-income economies, including Kazakhstan.

The strengthening economic activity in the Euro area will lead to a firming up of GDP growth in the Commonwealth of Independent States, especially those countries endowed with natural resources. The Commonwealth of Independent States (CIS) transition countries' GDP growth will firm up from 3.5 percent in 2013 to 4.1 percent in 2016.[7] The resource-rich countries who have undertaken major investments to expand their production capacity—such as Kazakhstan with the Kashagan oil field—will be able to respond to the increased external demand. While volumes may increase, improved technology is expected to dampen the price responses, so that oil prices in nominal terms will remain at about $104 a barrel in 2014 before dipping slightly in 2015 and 2016.

However, the increased integration of Kazakhstan within the Customs Union will leave it more vulnerable to economic developments in Russia. As noted in section D, the Customs Union (CU) members are increasingly coordinating their economic policies and some experts view the February 2014 tenge devaluation as an attempt at re-aligning trade prices between Russia and Kazakhstan. By extension, the size and health of the Russian economy, as well as any shocks that affect it, will affect Kazakhstan's economy, as its exports to Russia may suffer. Additionally, the Ukrainian crisis has led to disturbances in the Russian financial and exchange rate markets and its projected GDP growth for 2014 has been lowered substantially, with a projected 1.1 percent growth in a low-risk scenario, assuming a limited and short-lived effect of the Crimea crisis. If the geopolitical situation worsens, a possible 1.8 percent contraction of the Russian economy is projected in a high-risk scenario, assuming a more severe shock to economic and investment activities from the Crimea crisis.[8] Political and economic sanctions by the US and the European Union (EU), related to the Crimea situation, may lead to a possible recession in Russia and may impact negatively on investment flows into the other CU countries, including Kazakhstan and Belarus.

6 World Bank, 2014, *Global Economic Prospects: Copying with policy normalization in high-income countries* (Washington: World Bank).

7 The CIS transition countries include Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, and exclude high-income Russia.

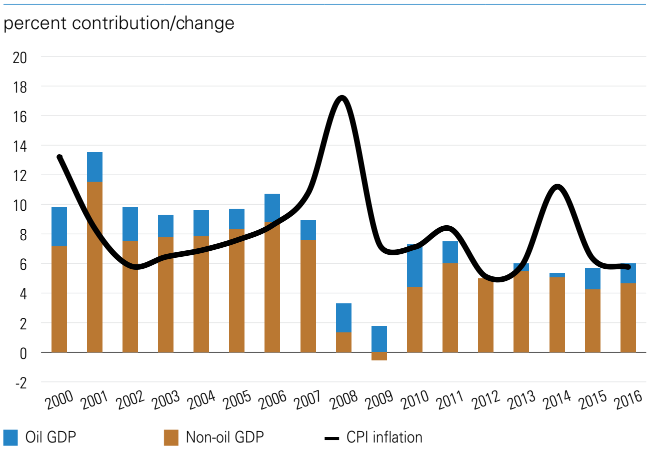
8 World Bank, 2014, *Russian Economic Report 31: Confidence Crisis Exposes Economic Weakness* (Washington: World Bank).

Kazakhstan's economy will grow on the back of the oil sector

In the medium-term, the Kazakhstan's economy is expected to grow close to its potential, on the back of the oil sector. According to the World Bank's Global Economic Prospects (January 2014), the potential GDP growth of Kazakhstan is estimated at about 5½ percent a year. Our baseline scenario also assumes GDP growth to be around this estimate in the medium-term (Figure 11). Recent prudential limits placed on consumer credits and the devaluation induced inflation are expected to constrain short-term consumption, both of domestic and imported products, affecting overall demand and the growth of the non-oil economy. Government investments, on the other hand, are expected to partially offset slower growth in private consumption, due to an additional Oil Fund support program of 1 trillion tenge (equivalent of $5.5 billion) and the EXPO-2017 investment plans. 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. Net exports growth will continue to depend on the oil sector and the global economic recovery. If Kashagan finally comes on stream in 2015, it will contribute to a rapid expansion of the oil sector (Figure 12).[9] Based, on these assumptions, GDP growth is expected to slow to 5.4 percent in 2014 and then increase to 5.7 percent in 2015 and about 6 percent in 2016. Meanwhile, the February devaluation will led to an inflation spike of around 10 percent in 2014, as discussed in section D, and then return to the range of 6–8 percent targeted by the NBK, barring any other external shocks.

Figure 11. Lower non-oil growth will be offset by higher oil supply in the medium-term

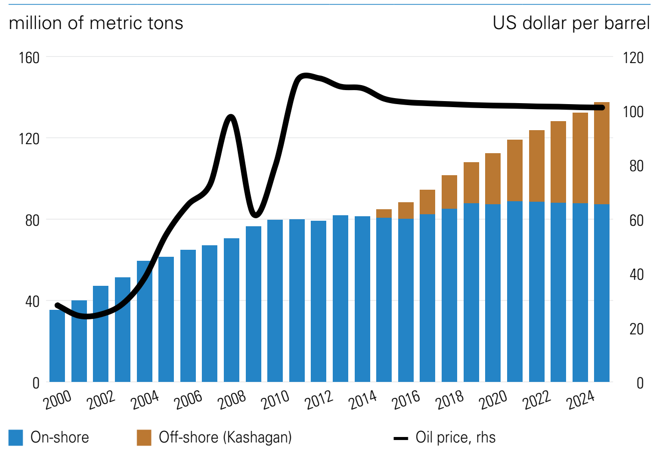
Real GDP growth and inflation



Source: World Bank staff estimates.

Figure 12. The oil sector will be expanding on the back of Kashagan oil from 2015 onwards

Oil production and oil price prospects



Source: World Bank staff estimates.

The external position will remain strong

International savings by the public sector are expected to rise further. The recent tenge devaluation will positively impact the trade balance and the current account, as imports are expected to decline slightly in 2014

9 The most recent government's optimistic scenario assumes Kashagan to come on stream in the second half of 2014.

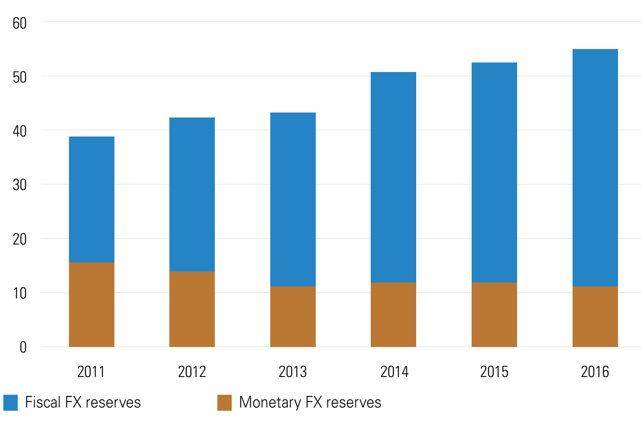
and then resume growing moderately in the years after. As a result, no further significant draw-downs of the FX reserves at the NBK are anticipated. As a percent of GDP, the NBK FX reserves, including gold reserves, are projected to be in the range of 11–12 percent during 2014–2016 (Figure 13). At the same time, the FX savings in the Oil Fund are expected to continue growing, but less rapidly than before, due to the planned additional disbursement of $5.5 billion from the Oil Fund for financing the manufacturing industry and SMEs and investing into infrastructure projects during 2014–2015. Nevertheless, the stock of the Oil Fund is expected to increase from 32 percent of GDP in 2013 to 43 percent in 2016, maintaining a very solid external position of the government. Consequently, the total official FX reserves are expected to rise from 43 percent of GDP in 2013 to 55 percent in 2016.

External debt of the public sector will decline, while external debt of the private sector will continue to grow slowly. External debt of the public sector, including SOEs, is expected to go down, due to availability of additional funding from the Oil Fund and planned privatization of problem banks and some SOE assets. As a percent of GDP, external debt of the enlarged public sector (including the SOEs) will decline from 16 percent in 2014 to 14 percent in 2016, the majority (83 percent) of which belongs to the SOE sector (Figure 14). The external indebtedness of the banking sector has declined considerably after two debt restructuring programs initiated by the government in 2010 and 2013, and will remain low. Meanwhile, the corporate sector is expected to continue expanding its balance sheet by borrowing externally, mainly for financing big infrastructure projects in the oil and gas sector (e.g. oil and gas pipelines financed by China). Although there will be an upward shift in the ratio of total external debt to GDP from 67 percent in 2013 to about 74 percent in 2014–2016, this shift is attributed to a lower GDP denominated in dollars, due to the tenge devaluation in February 2014. Otherwise, total external debt is anticipated to remain stable, as a share of GDP, in the medium-term.

Figure 13. The overall external position will become stronger

Total official international reserves

percent of GDP

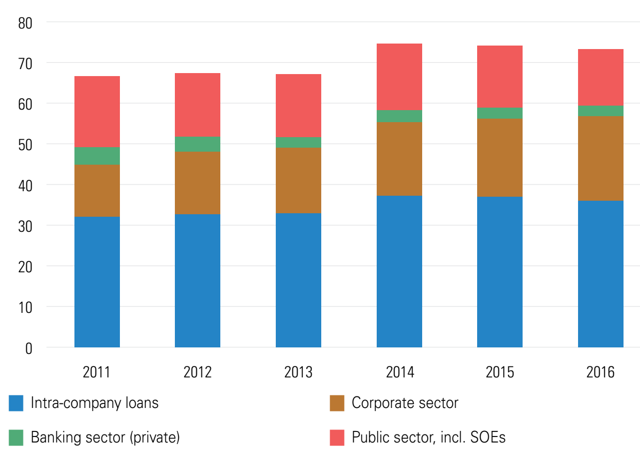


Source: World Bank staff estimates.

Figure 14. The external debt to GDP ratio will increase due to lower denominator in dollars

Total external debt

percent of GDP



Source: World Bank staff estimates.

Fiscal policy is set to be more expansionary and pro-cyclical

The overall fiscal surplus is anticipated to narrow as fiscal policy is set to expand pro-cyclically in the medium-term. Government spending will increase during 2014–2015 by appropriating an additional transfer from the Oil Fund of about $5.5 billion. These additional funds will be allocated to finance the manufacturing industry, SMEs, and infrastructure projects envisaged by the second five-year industrial and innovation development plan, including the needs of the EXPO-2017 project. Current expenditures are also expected to grow. While in 2014, current expenditures will be adjusted to alleviate the impact of the devaluation on civil and public servants and vulnerable groups of the society, there will be real increases in the wage bill in 2015 and 2016, as well as more goods and services to be procured for the EXPO-2017 needs during the next three years.[10] Consequently, the non-oil deficit is anticipated to increase from 8 percent of GDP in 2013 to about 10 percent a year in 2014–2016 (Table 4). Nevertheless, ample oil revenue proceeds, including the announced $20 increase in oil exports duty (from $60 to $80 per barrel), will keep the overall fiscal balance in surplus, though it is projected to narrow from 4 percent of GDP in 2014 to about 2 percent in 2015–2016.

Table 4. Kazakhstan—General Government Fiscal Accounts, 2011–2016

in percent of GDP

	2011	2012	2013	2014p	2015p	2016p
Total revenue	**27.7**	**26.4**	**25.5**	**26.5**	**25.4**	**24.8**
Oil revenue	14.4	13.8	12.4	13.9	12.5	11.8
Oil revenue saved in the Oil Fund	8.2	7.3	6.5	5.9	5.4	5.8
Oil revenue spent by the State Budget	6.1	6.6	5.9	7.9	7.1	6.0
Non-oil revenue of the State Budget	13.3	12.6	13.1	12.6	12.9	13.1
Total expenditure and net lending	**21.5**	**22.1**	**21.2**	**22.5**	**23.5**	**23.1**
Current expenditure	14.9	16.1	16.3	16.3	17.3	17.8
Capital expenditure and net lending	6.7	6.0	4.9	6.2	6.2	5.4
Overall fiscal balance	**6.2**	**4.3**	**4.4**	**4.0**	**1.9**	**1.7**
State Budget deficit	-2.1	-2.9	-2.1	-2.0	-3.5	-4.1
Non-oil deficit	-8.2	-9.5	-8.0	-9.9	-10.6	-10.0
Oil revenue spent by the State Budget	6.1	6.6	5.9	7.9	7.1	6.0
Oil revenue saved in the Oil Fund	8.2	7.3	6.5	5.9	5.4	5.8
Memorandum items:						
Net government financial assets	**12.8**	**16.1**	**18.5**	**24.5**	**24.0**	**24.2**
Oil Fund FX reserves	23.2	28.5	32.0	38.7	40.5	43.2
Total government debt	10.4	12.3	13.5	14.2	16.5	19.0

Sources: Kazakhstan Ministry of Finance; World Bank staff calculations.

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

Meanwhile, the net financial asset position of the government will remain strong, despite the pro-cyclical expansionary fiscal policy. Although total government debt is projected to grow (from 13½ percent of GDP in 2013 to about 19 percent in 2016), due to a growing deficit of the state budget, it will be more than offset by fiscal savings in the Oil Fund (expected to expand from 32 percent of GDP in 2013 to 43 percent in 2016), as external demand for oil firms up and the Kashagan oil field comes on line. Consequently, the net financial asset position of the government will increase from 18½ percent of GDP in 2013 to about 24 percent during 2014–2016, including an exchange rate gain (of about 6 percent of GDP) occurred in 2014, due to the tenge

10 The government has already announced a 10 percent increase of salaries of civil and public servants from April 1, 2014 and an additional 5 percent increase of pay-as-you-go pensions from April 2, on top of the 9 percent increase implemented from January 1, 2014. Additional increases to the government's wage bill are expected during 2015–2016 (see Annex 1).

devaluation. This means that higher government spending envisaged during the next three years will neither harm the medium-term fiscal sustainability nor the net debt position of the government. Nevertheless, the pro-cyclical fiscal policy may create additional inflationary pressures, if the economy is pushed to grow beyond its estimated potential in the medium-term.

D. Special Focus—Coping with the Devaluation Impact on the Economy

The devaluation was a response to new regional and global economic realities

The authorities announced that the tenge devaluation was partly undertaken to improve the competitiveness of the economy. "Competitive devaluation"—as this policy practice is known—is believed to help the competitiveness of national products directed to domestic and export markets in the short-term. The devaluation is expected to lead to an increase in import prices, thus curbing imports, helping the competitiveness of domestic products, and improving the trade balance of the country. However, to the extent that each industry is dependent on imports of intermediate and raw products, the rise in import prices will affect their production costs, making their gains in competitiveness short-lived. In fact, the producer price index (PPI) rate already increased sharply from 0.9 percent year-on-year in February 2014 to 9.1 percent in March. Moreover, following recent salary increases for civil and public servants (as of April 1, 2014), wages in the private sector were adjusted upwards and will partially erode some of gains in competitiveness, unless labor productivity gains outstrip these additional production costs.

The suggestion that Kazakhstan needs to improve its competitiveness is also associated with the creation of the Customs Union between Belarus, Kazakhstan, and Russia. The CU led to trade diversion, with CU exports to Kazakhstan rising from 32.5 percent of total imports in 2009 to about 39.9 percent of total imports in 2012. In comparison, imports from EU fell from 27.4 percent of total exports in 2009 to 16.9 percent in 2012. However, Kazakhstan's exports to Russia and Belarus fell from 8.3 percent of total exports in 2009 to about 7.4 percent in 2012.[11] The private sector has faced costly non-tariff barriers when trying to export to Russia.[12] The devaluation is expected to help domestic producers compete against CU imports, while helping Kazakhstani exporters who face the cost of the CU non-tariff barriers.

The deepening regional economic integration initiative has most likely played a role in the devaluation of the tenge. While Kazakhstan has retained its international trade and investment relationships, the authorities are working to coordinate their economic policy more closely with Russia and Belarus in light of their joint regional integration efforts. As of February 2014, the Common Economic Space (CES) negotiations package includes trade policy, technical regulations, natural monopolies, and cooperation in the field of transport, energy, industry, and agriculture, as well as currency policies. These policy alignments are translating into closer alignment of the Kazakhstani and Russian economies, including closer ties between the ruble and the tenge in the past year. Russia remains one of the largest trade partners for Kazakhstan, and is facing subdued growth prospects, worsening external and fiscal balances, and a sharply weaker ruble. As of February 2014, the ruble depreciated by 17 percent against the dollar from a year earlier. Of this 17 percent, 7 percent happened during 2013 and almost 10 percent during the first two months of 2014, following the political tensions with Ukraine.

11 COMTRADE data, World Bank staff calculations.

12 Analysis by the World Bank suggests that unless trade facilitation and trade related regulatory reforms are undertaken within the CU, Kazakhstan would experience a welfare loss of -0.1 percent of GDP per year as a result of joining the CU.

Finally, global economic realities appear to have influenced the decision to devaluate the tenge. First, the gradual withdrawal of quantitative easing in the US has caused an outflow of financial resources from many emerging markets, with exchange rates weakening in countries such as Turkey, Brazil and Russia. Second, the uncertainties related to the global economic recovery and softening petroleum and metal prices appear also to have been major contributors to this devaluation. For instance, prices are down almost 9 percent from a year earlier, pulling down natural gas prices in Eurasia. As reported earlier, softer international metal prices in the past two years have already impacted the metallurgy industry and will continue to do so in 2014.

The devaluation can impact the banking sector and inflation

The devaluation could increase the risk associated with NPL situation in the banking sector. The banking sector has experienced a slow recovery from the 2007–2009 crisis and remains vulnerable. Furthermore, about 30 percent of bank loans in 2013 were in foreign currency. The devaluation may lead to further increases in NPLs and to an overall pressure on the banking system through its retail loan portfolio. Preliminary reports show that NPLs (of over 90 days overdue) increased from 31.2 percent of total loans at the end of 2013 to 33.6 percent in February 2014. Even before the devaluation, the quality of retail loans appeared to be deteriorating.

The devaluation also shift demand for tenge holdings. The last three quarters of 2013 saw a 24 percent growth of bank deposits denominated in foreign currency while tenge-denominated accounts declined by 4 percent, indicating increased devaluation expectations. As of end-February 2014, the dollarization of deposits increased further, with FX deposits accounting for 47 percent of total deposits, compared to 30 percent a year ago. To lower incentives for holding FX deposits, in March 2014 the authorities increased the maximum ceilings for interest rates on tenge-denominated deposits from 9 to 10 percent and decreased them for dollar-denominated deposits from 4½ to 4 percent (within the deposit guarantee scheme).

Inflation in Kazakhstan will rise in the short run. The actual data on inflation indicate that the consumer price index (CPI) rate increased from 4.5 percent year-on-year in January 2014 to 5.4 percent in February and 6.2 percent in March. For the short run, our estimates suggest a higher inflation rate than the government has announced:

- The authorities estimate that the exchange rate devaluation will increase inflation by about 3.3 percentage points, and that the overall inflation rate for 2014 is expected to remain within the 6–8 percent range targeted by the NBK.[13] To help control the inflationary impact of the devaluation, the government has announced price controls over food and energy prices affecting the majority of citizens (Box 1).

- We estimate that the inflation rate to reach about 10 percent in 2014, based on our assumption of a pass-through of about 36 percent from nominal exchange rate to inflation by the end of 2014. Consequently,

13 This means that a pass-through (the percent change in inflation due to percent change in the exchange rate) will be about 17 percent. The low inflation estimate is based on the 2009 devaluation experience. The government estimate of additional impact should be considered a lower bound estimate of the impact of the devaluation. First, the 2009 devaluation occurred in a recession, so its inflationary effects would have been dampened by the lack of demand. In contrast, the economy in 2013 was growing at close to its potential growth rate (assessed at about 6 percent), where inputs and factors are supposed to be close to fully used. The impact of a large devaluation on such an economy should be higher. Secondly, while the new government policy measures may keep prices of specific items in check in the next few months, these measures will eventually run out and the prices of food, transport, and energy will adjust up.

Box 1. Government measures to mitigate the impact of the devaluation

In the aftermath of the devaluation the government has announced a number of broad based measures to counter the impact of the devaluation:

Price controls. Prices for 33 essential food products have been capped. Gas prices are also to be held fixed in the short run. The national air company Air Astana and the national railways operator Kazakhstan Temir Zholy have committed not to increase their rates for domestic transport for the time being. In addition, all utility tariffs will be frozen until May 1, 2014.

Wage increases. A 10 percent wage increase will go into effects as of April 1, 2014 for all civil and public servants. Major state-owned enterprises and private sector employers were encouraged to follow suit with wage increases for their blue color workers.

Pension, social assistance and student stipends increases. Starting April 2, 2014 the authorities were to increase pensions for the year to 14 percent (pensions were increased by 9 percent in January 2014, so the new measures are to add another 5 percent increase). Starting from April 2014, targeted social assistance was to be boosted by a total of 12 percent for the year, student allowances by a total of 10 percent.

The Oil Fund to support the economy. The authorities plan to use the Oil Fund to support SMEs, the manufacturing industry, and the banking sector. Out of $5.5 billion allocated from the Oil Fund for 2014–2015, $2.7 billion of the amount will be allocated in 2014. The 2014 support package will comprise of $552 million being spent to support SMEs, another $1.3 billion will be directed to the Problem Loans Fund to help deal with NPLs in the banking sector, and $828 million is to support the Industrial Development Program. Additionally, over $535 million will be earmarked in the 2014 budget to finance the Employment Roadmap Program to support the current employment rate.

Source: World Bank staff notes, based on government announcements.

the 19 percent increase in the nominal exchange rate could lead to a 6.8 percentage point jump in inflation, and cause overall inflation to rise above the 6–8 percent range targeted by the NBK.[14]

Higher inflation can affect household consumption and savings patterns

The medium-term impact of the devaluation on consumption will depend on how households react to higher inflation. Those who held bank accounts in tenge have experienced a negative wealth effect, and their consumption is expected to be affected. Moreover, increased prices will affect consumption. Price increases for food and non-food items were the main contributors to the CPI increase in March 2014, while price controls for paid services somewhat offset the increase in overall consumer prices. Consumption changes will depend on how much households can substitute away from more expensive imports into cheaper imported or domestic products, and, otherwise, how much they can reduce consumption. Poorer households will be more vulnerable

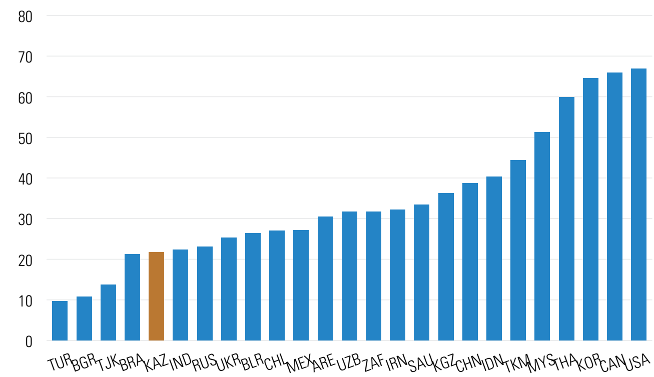
14 From a preliminary VAR analysis, we also did a basic calculation to identify an impact range, based on a 25 percent and a 37.5 percent pass-through ratio. A 2012 IMF study found that a one percent change in exchange rates can on average lead to an increase of 0.63 percent in import prices among emerging economies in the first three months; for countries rich in natural resources (such as Chile) this pass-through is estimated to be 0.85 percent. Applying the average pass-through 0.63 estimate to the 19 percent devaluation by Kazakhstan would translate into potential jump of a 12 percentage point change in import prices. Kazakhstani economy is dependent on imports— goods imports constituted 22.5 percent of GDP in 2013 while overall imports stood at 27.9 percent of GDP for the same year. Assuming a pass through from import prices to domestic prices of 0.4 to 0.6 percent will translate into an impact of 4.8 and 7.2 percent, respectively. So in the short run the overall inflation could range from 10.6 to 13 percent.

to the price increases, especially as only about 30 percent of the population receives some form of social assistance. This low coverage is related to the low value of the income-eligibility threshold, which is set per person at about $1 per day.

The devaluation can affect domestic savings and investment. Private savings matter as they provide funds for future investments and consumption. Already, Kazakhstani private savings are estimated to have fallen from 24 percent of GDP in 2008 to 20 percent in 2012–2013 (Annex 2). A 2011 World Bank survey also shows that only about 22 percent of Kazakhstani respondents (15 years and older) had saved in 2010.[15] This is a relatively low ratio of savers compared to regional comparators, selected resource-rich and developed countries (Figure 15). If the devaluation erodes savings and savings incentives, the authorities should consider policies to counteract it, such as higher deposit rates and insurance against risks.

Figure 15. Adults who saved money in 2010

percent of 15 years+



Source: World Bank staff calculations, based on the FINDEX survey data, 2011.

Some domestic policies can help mitigate inflationary pressures

These domestic policies are:

- **Adhere to macroeconomic policies that are neutral to inflation.** An increase in economic activity beyond potential output can lead to higher inflation. In the case of Kazakhstan, the growth potential is assessed at about 5½ percent.[16] The economy is already growing at close to its potential. Therefore, both monetary and fiscal policies should remain neutral to avoid creating additional pressures on inflation (Box 2). A further increase in domestic demand may push up the price of non-traded goods. This, in turn, could create inflationary pressures and possibly also adversely impact the non-resource tradable sector, leading to Dutch disease.

- **Move to a more flexible exchange rate regime in the medium-term.** A more flexible exchange rate regime helps mitigate the effects of external shocks on domestic inflation. There is, in fact, strong empirical evidence from case studies that in open economies a pass-through from exchange rate changes to inflation is weak and declining. In the case of Hong Kong, Saudi Arabia and Kuwait, which share similarly open economies and exchange rate regimes, the pass-through from exchange rate changes to domestic

15 2011 World Bank FINDEX survey.

16 World Bank, 2014, *Global Economic Prospects: Coping with policy normalization in high-income countries* (Washington: World Bank).

Box 2. Determinants of inflation in Kazakhstan

Recent inflationary episodes in Kazakhstan have been driven by external shocks. Higher international energy and food prices led to short-run inflationary shocks. As Kazakhstan is dependent on imports of food and intermediate goods, higher international food prices, in particular, are likely to increase inflation, as was the case in 2008 and to a lesser extent in 2011. This high correlation is mainly explained by a significant weight of food items in the CPI basket (38 percent). Energy and related utility prices also have a material weight (17 percent) in the CPI basket and are usually excluded in the calculation of core inflation in Kazakhstan.

Macroeconomic fundamentals and policies affect inflation. Our analysis uses Kazakhstan's quarterly macroeconomic data from 1994 to the third quarter of 2013. The analysis finds that inflation increases are associated with (i) an increase in the previous year of economic activity beyond potential output; (ii) depreciation of the Kazakhstani tenge, and (iii) a significant extent of inflationary inertia in the country (as lagged CPI inflation is positive and statistically significant).[17] Also, lagged government spending to GDP ratio is positively and significantly related to the inflation. Therefore, larger government spending may induce inflationary pressure in the overall CPI inflation next year. The (lagged) primary fiscal balance to GDP ratio is negatively and significantly related with inflation. Consequently, our findings show that larger primary government deficits are correlated with greater inflationary pressures on the overall CPI in the next year. Lagged current spending to GDP ratio shows positive but insignificant while both current and capital spending show an unexpected significant and positive coefficient estimate (Kubota, 2014).[18]

The findings above support the macroeconomic prudence shown by the authorities in the past few years. During the crisis years, higher government spending and more liquidity provided by the central bank to stimulate economic activity where shadowed by higher core inflation. These fiscal and monetary stimuli were phased out during the post-crisis period. In fact, lately fiscal policy has been neutral to inflation, as government spending has been growing less or on par with GDP. The phasing out of these fiscal and monetary stimuli is mirrored by a gradual fall of the core inflation in recent years. Based on our calculations, contribution of core inflation to headline inflation in Kazakhstan was almost halved from about 4 percentage points in 2008–2009 to about 2 percentage points in 2012–2013.

Source: World Bank staff notes, 2014.

prices is about 20 percent. A move towards more flexible arrangements requires reducing the extent of dollarization of the economy and deepening local currency debt markets.

- **In the longer-term, gains in productivity in the non-commodity sector will counter the inflationary pressures of labor costs increases.** Kazakhstan has experienced high labor productivity between 2000 and 2010 compared to the members of the Organisation for Economic Co-operation and Development (OECD) and the BRIC countries (Brazil, Russia, India and China). However productivity growth was highest in oil producing regions, driven by large investments in the sector. As Kazakhstan seeks to diversify into a knowledge-based economy, the non-oil economy needs to become and remain competitive in the regional and global markets. For such a competitiveness to be achieved, wage increases should match or be outstripped by labor productivity gains. This can be achieved through investment in physical capital, but also through market oriented human capacity building, such as demand driven technical training.[19]

17 A one percent increase in output beyond it GDP sustainable potential leads on average to 0.9 percent increase in inflation the following period; a one percent depreciation of nominal exchange rate leads to a 0.20 percent increase in inflation and, 0.33 percent of last period's inflation will be transferred to the current period (inflation inertia).

18 Kubota, Megumi, 2013, Notes on inflation in Kazakhstan: *The impact of fiscal policy on inflation*, short note #3 (Washington: World Bank).

19 World Bank, 2013, *Beyond oil: Kazakhstan's path to greater prosperity through diversifying* (Washington: World Bank).

Annex

Annex 1. Government's Longer-Term Development Priorities

Development Priorities	Objectives	Outcome Goals	Implementation Actions
Innovative Industrialization	• Increase efficiency of traditional extractive industries (oil and gas, metals); • Develop new industries (mobile, multimedia, nano-tech, space, robotics, genetic engineering, energy of the future).	• GDP growth of not less than 4% on average; • GDP per capita at $60,000 (by 2050); • Increase investment share in GDP from 18% to 30%; • Increase share of non-resource produce in total exports to 70%; • 15% of crop area to apply water-saving technology (by 2030).	• Develop the second (out of 7) five-year Plan of Accelerated Industrial and Innovative Development for 2014–2019.
Efficient Agri-Industrial Sector	• Increase efficiency of the agri-industrial sector by applying new technology and best international standards; improving efficiency of the land market; improving access to finance.		• Update the Development Plan for the Agri-Industrial Sector.
Improved Potential of Science	• Increase scientific capacity by improving the legislative base; attracting FDIs; facilitating transfer of knowledge and new technology; activating operation of technological parks.	• Science financing of not less than 3% of GDP.	• Submit to the Parliament legislation on venture capital, protection of intellectual property, R&D support, and technology commercialization (by September 1, 2014).
Urban and Infrastructure Development	• Develop agglomerations with urban centers in Astana, Almaty, Shymkent and Aktobe; • Improve connectivity by building modern high-ways and high-speed railways; and developing logistical services; • Improve energy-efficiency by developing the power sector (power stations, a new oil refinery, a nuclear power station).	• Increase urban population from 55% to 70%; • Improve connectivity and streamline customs clearance procedures; • Halve the power intensity of production.	• Draft strategies for developing agglomerations in Astana and Almaty until 2030 (by the end of 2014); • Complete construction of high-ways (Astana-Karaganda-Almaty, Astana-Pavlodar-Ust-Kamenogorsk, Almaty-Kapchagai-Ust-Kamenogorsk), railways (Zheskazgan-Shalkar-Beineu); • Conduct feasibility studies for building a new oil refinery and a nuclear power station.
SME Development	• Support SMEs by improving business environment; ensuring property rights; and developing effective mechanisms of support.	• Increase SME share in GDP from 20% to 50%.	• Harmonize the Road Map Business-2020 with the Plan of Accelerated Industrial and Innovative Development for 2014–2019.

Development Priorities	Objectives	Outcome Goals	Implementation Actions
Active, Educated, and Healthy Population	• Improve quality of education by introducing modern teaching methods; developing professional cadres; promoting cognitive thinking; • Improve primary healthcare by considering introduction of a mandatory health insurance system; • Develop Kazakhstani culture by forming competitive cultural mentality and developing modern cultural clusters; • Improve incentives in the public sector by reconsidering social packages for public servants in education, healthcare, and social protection; • Improve life of disabled people by removing physical barriers and providing employment.	• Ensure 100% enrollment in pre-school (by 2020); a two-shift education in schools (by 2017); access to technical and vocational education; academic and management autonomy of universities; • Increase life expectancy to 80 years and more; • Further reduce poverty and unemployment.	• Develop proposals for technical and vocational education (by June 1, 2014); • Increase stipend by 25% (from January 1, 2016); • Consider introducing a mandatory health insurance system; • Develop a long-term Concept of Cultural Policy; • Develop and introduce a new pay system for the public service and increase salaries of medical staff by 28%, educational staff by 29%, public servants in the social support area by 40% (from July 1, 2015); • Increase social support to disabled people and families that lost a breadwinner by 25% (from July 1, 2015) and improve legislation for associations of disabled people.
Efficient Public Institutions	• Improve efficiency of public institutions by promoting fair competition, justice, and the rule of law; and enhancing link with NGOs and businesses.	• Ensure rule of law and access to justice; • Develop and implement a new anti-corruption strategy.	• Develop proposals for administrative reforms (by July 1, 2014); • Increase salaries of civil servants of corps 'B' by 15% (from July 1, 2015) and provide another 15% increase a year after (from July 1, 2016).

Source: World Bank staff notes, based on the President's speech of January 17, 2014.

Annex 2. Selected Economic and Social Indicators

	2008	2009	2010	2011	2012	2013	2014	2015
Income and Economic Growth								
GDP growth (percent)	3.3	1.2	7.3	7.5	5.0	6.0	5.4	5.7
GDP per capita (in US dollars)	8,514	7,165	9,071	11,358	12,121	12,933	12,134	12,987
Private consumption (percent change)	6.8	0.7	11.8	10.8	11.0	12.5	7.0	8.5
Gross fixed investment (in percent of GDP)	27.5	29.4	25.4	22.5	24.8	26.2	27.1	27.5
Public	4.4	5.5	5.1	4.2	4.6	4.1	4.5	4.6
Private	23.1	23.9	20.3	18.3	20.2	22.1	22.6	22.9
Savings (in percent of GDP)	32.3	25.7	26.3	27.9	25.3	26.1	27.2	26.9
Public	8.2	6.8	6.4	5.4	5.4	4.8	5.3	5.5
Private	24.1	18.9	20.0	22.5	19.9	21.3	21.9	21.5
Money and Prices								
Consumer price inflation (percent change, year-end)	9.5	6.2	7.8	7.4	6.0	4.8	10.1	8.9
Consumer price inflation (percent change, annual average)	17.2	7.3	7.1	8.3	5.1	5.8	8.3	8.6
Refinancing rate (percent, annual average)	10.8	8.4	7.0	7.4	6.2	5.5	..	..
Nominal exchange rate (tenge per dollar, end-year)	121	148	147	148	150	154	..	..
Real exchange rate (2008=100)	100	114	108	102	100	98	..	..
Fiscal Accounts	*(In percent of GDP, unless indicated otherwise)*							
Revenues	29.7	22.7	25.0	27.7	26.4	25.5	26.5	25.4
Oil revenues	12.9	8.6	10.9	14.4	13.8	12.4	13.9	12.5
Non-oil revenues	16.8	14.1	14.1	13.3	12.6	13.1	12.6	12.9
Expenditures	27.2	23.5	22.1	21.5	22.1	21.2	22.5	23.5
Current	14.2	16.1	15.0	14.9	16.1	16.3	16.3	17.3
Capital and net lending	13.1	7.4	7.1	6.7	6.0	4.9	6.2	6.2
Overall fiscal balance	2.5	-0.8	2.9	6.2	4.3	4.4	4.0	1.9
Non-oil state budget balance	-10.5	-9.4	-8.0	-8.2	-9.5	-8.0	-9.9	-10.6
Total government debt	6.8	10.2	10.7	10.4	12.3	13.5	14.2	16.5
External	1.6	2.4	2.7	2.6	2.6	2.6	2.9	2.7
Domestic	5.2	7.9	7.9	7.8	9.7	10.9	11.3	13.8
Oil Fund FX reserves	20.6	21.1	20.9	23.2	28.4	32.0	38.7	40.5
Oil Fund FX reserves (in billions of US dollars)	27.5	24.4	31.0	43.6	57.8	70.5	81.1	92.0

	2008	2009	2010	2011	2012	2013	2014	2015
External Accounts	*(In billions of US dollars, unless indicated otherwise)*							
Export growth (percent, constant prices)	0.9	-11.9	3.1	0.4	4.7	-0.2	0.7	4.8
Import growth (percent, constant prices)	-11.5	-15.7	2.9	2.8	20.9	5.2	0.0	3.0
Merchandise exports	72.0	43.9	61.4	85.2	86.9	83.4	83.1	84.3
of which: Fuel and oil products	48.9	30.0	42.5	65.3	64.5	63.1	62.7	63.9
Merchandise imports	38.4	28.9	32.9	40.3	48.8	49.7	50.5	52.6
Net services	-6.9	-6.0	-7.2	-6.6	-8.0	-6.9	-6.6	-6.5
Net workers' remittances	-2.5	-2.4	-1.9	-1.7	-1.8	-1.6	-1.5	-1.4
Current account balance	6.3	-4.1	1.4	10.2	1.1	-0.1	0.5	-1.0
as percent of GDP	4.7	-3.6	0.9	5.4	0.5	-0.1	0.2	-0.5
Net foreign direct investment	13.1	10.1	3.7	8.6	11.8	7.8	8.2	8.1
Total external debt	107.9	112.9	118.2	125.3	136.9	148.8	157.0	166.7
Public	2.2	3.7	5.1	5.5	5.9	6.1	6.5	6.6
Private	105.8	109.1	113.1	119.8	131.0	142.6	150.4	160.1
of which: Intra-company loans	40.2	49.6	52.3	62.6	67.6	72.7	78.0	83.2
Population, Employment and Poverty								
Population (million people)	15.7	16.1	16.3	16.6	16.8	17.0	17.3	17.5
Population growth (percent)	1.2	2.7	1.4	1.4	1.4	1.5	1.4	1.3
Unemployment rate (percent of labor force)	6.6	6.6	5.8	5.4	5.3	5.2	..	..
Poverty headcount ratio (percent of the population)								
at national poverty line	12.1	8.2	6.5	5.3	3.8	2.9	..	..
at US$ 1.25 a day (PPP)	0.1	0.1	0.1	..	..	..	..	..
at US$ 2.50 a day (PPP)	3.3	4.2	2.4	..	..	..	..	..
at US$ 5.00 a day (PPP)	41.3	42.3	34.7	..	..	..	..	..
Gini coefficient (income)	0.288	0.267	0.278	0.290	0.284	0.276	..	..
Life expectancy (years)	67.1	68.4	68.5	69.0	69.6	70.3	..	..
Other								
GDP (in billions of tenge)	16,053	17,008	21,816	27,572	30,347	33,521	38,134	42,025
GDP (in billions of US dollars)	133.4	115.3	148.1	188.0	203.5	220.3	209.5	227.2
Doing Business rank /1	..	74	58	56	53	50	..	..
Human Development Index rank /2	..	..	69	68	69	..	..	..
CPIA (overall rating)	3.6	3.7	3.7	3.8	3.8	3.8	..	..
Economic management	4.0	4.2	4.3	4.3	4.3	4.5	..	..
Structural policies	3.5	3.5	3.5	3.7	3.7	3.7	..	..
Social inclusion and equity policies	3.6	3.6	3.6	3.7	3.7	3.8	..	..
Public sector management and institutions	3.4	3.4	3.4	3.5	3.5	3.4	..	..

1/ The DB indicator is ranked out of 181 countries in 2009; 183 in 2010; 185 in 2011–2012; and 189 in 2013.

2/ The Human Development Index is ranked out of 169 countries in 2010,187 in 2011 and 186 in 2012.

This page is intentionally blank.

THE WORLD BANK