Kazakhstan

The growth rate was unchanged in 2018 as a slowdown in industry offset gains elsewhere. Tight monetary policy trimmed inflation, and higher petroleum exports created a small current account surplus. Growth will slow in 2019 with lower petroleum exports and in 2020 under less expansionary fiscal policy. The current account will return to deficit, but continued monetary restraint should contain inflation. Restoring bank sector health depends on reducing nonperforming loans.

Economic performance

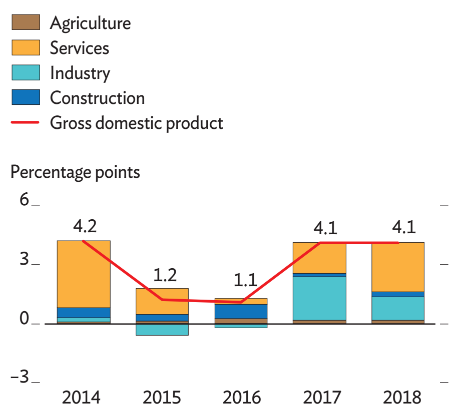
Growth remained at 4.1% in 2018 (Figure 3.4.1). Expansion in industry decelerated from 7.7% in 2017 to 4.2%, however, as manufacturing slowed from 6.1% to 4.0% and mining from 9.5% to 4.6%, though increased output at the major oil fields raised oil production by 4.8%. State support for housing boosted growth in construction from 2.8% in 2017 to 4.1%. Services accelerated by 4.0%, up from 2.4% in 2017 with gains in wholesale and retail trade. Growth in agriculture increased slightly from 3.2% in 2017 to 3.4% on rising livestock and crop production.

On the demand side, comparisons are for the first 9 months of both years. Growth in consumption remained at 1.6% as high consumer lending and lower inflation boosted private consumption growth from 1.4% to 5.1%, offsetting a 13.9% drop in public consumption. Growth in investment accelerated from 2.5% in 2017 to 2.8%, with fixed capital formation, mainly for mining, rising by 4.6%. Net exports also increased as exports of goods and services rose by 8.9% and imports by only 3.7%.

Despite significant local currency depreciation in the second half of 2018 and heightened inflationary expectations, average inflation slowed from 7.4% in 2017 to 6.0% as the National Bank of Kazakhstan, the central bank, issued state-backed securities to absorb liquidity and bring inflation within its target range of 5%–7%. Price increases for food slowed from 8.6% in 2017 to 5.1%, and for other goods from 8.4% to 7.8%, though increases for services edged up from 5.1% to 5.3%. In December 2018, inflation was 5.3% year on year, near the lower bound of the central bank's target range (Figure 3.4.2).

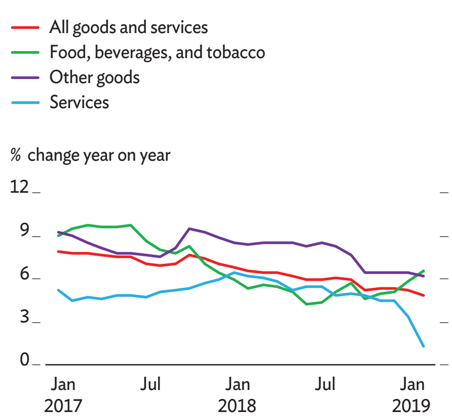
This chapter was written by Genadiy Rau of the Kazakhstan Resident Mission, ADB, Astana.

3.4.1 Supply-side contributions to growth



Source: Republic of Kazakhstan. Ministry of National Economy. Statistics Committee.

3.4.2 Monthly inflation



Source: Republic of Kazakhstan. Ministry of National Economy. Statistics Committee.

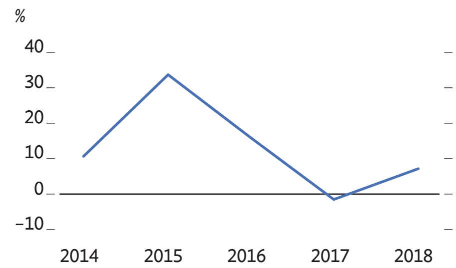
Appreciation of the Kazakh tenge in the first quarter of 2018, however brief, helped slow inflation and enabled the central bank to lower its key policy rate gradually from 9.75% at the start of the year to 9.00% in June. After currency depreciation resumed, however, the central bank sold foreign exchange worth $520.6 million in September, its first intervention since 2017, and increased the policy rate to 9.25% in October. Despite these moves, the tenge depreciated by nearly 16% against the US dollar in 2018 to reach an all-time low of T384.2 per dollar at the end of the year. During this period, the tenge moved in line with the ruble and the currencies of neighboring economies, which depreciated in response to worsening geopolitical tensions and rising US interest rates.

Broad money (M3) expanded by 7.0% as deposits grew by 16.1% and credit by 3.1%, reversing 1.7% contraction in 2017, when deposits fell by 3.0% and credit by 0.2% (Figure 3.4.3). Credit to households rose by 16.8% in 2018, but loans to firms declined by 4.6%. Currency fluctuation helped raise the share of foreign currency deposits from 47.7% of all deposits in December 2017 to 48.4% a year later, though the share of foreign currency loans dropped from 26.3% of the loan portfolio to 22.9% (Figure 3.4.4).

The state budget recorded a deficit equal to 1.4% of GDP, down from 2.7% in 2017 (Figure 3.4.5). Higher petroleum earnings and improved tax administration boosted tax revenue by 15.8% to equal 13.4% of GDP, and total revenue to 18.4% of GDP, well above projections. Expenditure fell by 9.1% to equal 19.3% of GDP as government outlays for bank recapitalization declined from 4.0% of GDP in 2017 to 1.7%. The non-oil state budget deficit narrowed from 10.4% of GDP in 2017 to 9.0%. Government and government-guaranteed debt rose from 26.3% of GDP at the end of 2017 to 27.3%. Meanwhile, state-owned enterprises cut their debt from 27.0% of GDP in 2017 to an estimated 22.1% as oil and gas enterprises made major debt repayments during the year.

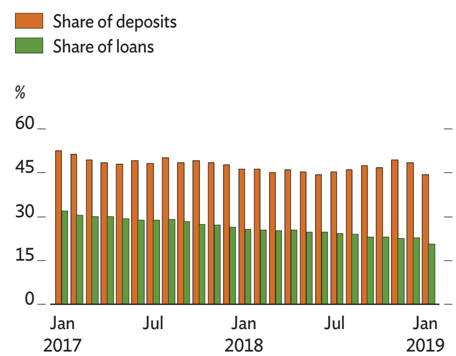
The current account recorded a surplus, equal to 0.5% of GDP, for the first time since 2014, reversing a 3.3% deficit in 2017. Rising oil prices and volumes boosted merchandise exports by 25.2% from the equivalent of 30.3% of GDP in 2017 to 36.3%, while imports rose by 7.5%, climbing from 19.7% of GDP in 2017 to 20.2% as private consumption rose and demand increased for capital goods to supply oil and gas projects and state development programs. The service balance improved slightly, but primary income deteriorated as profit repatriation by foreign investors rose by 29.6% to $20.2 billion. Net foreign direct investment, mainly into oil and mining, rose by 9.8% to $4.1 billion, while net outflows of portfolio investment reached $5.8 billion, reflecting repayment of eurobonds by resident oil and gas companies.

3.4.3 Growth in broad money



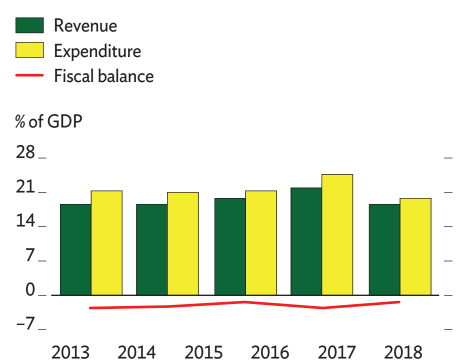
Source: National Bank of the Republic of Kazakhstan.

3.4.4 Dollarization in the banking system



Source: National Bank of the Republic of Kazakhstan.

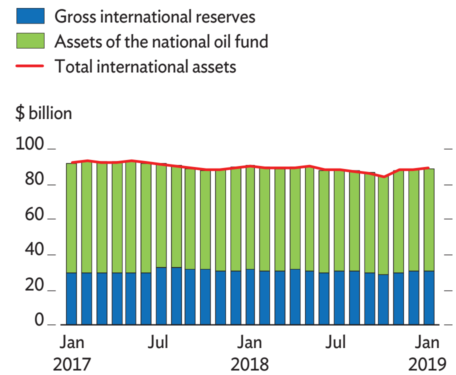
3.4.5 Fiscal indicators



Sources: Ministry of Finance; Ministry of National Economy.

With net central bank sales of $520.6 million in foreign exchange in September 2018 to support the tenge, gross international reserves declined by $70 million during the year to $30.9 billion, or cover for 8.1 months of imports (Figure 3.4.6). Assets in the National Fund of the Republic of Kazakhstan (NFRK), the sovereign wealth fund, declined by 1.1% to $57.7 billion, and external debt—63.4% of which is private intercompany debt—eased from the equivalent of 102.7% of GDP at the end of 2017 to an estimated 94.7% a year later (Figure 3.4.7). In November, investors bought €1.05 billion in euro-denominated Kazakh bonds, half paying 1.550% over 5 years and half paying 2.375% over 10 years. Demand for the bonds was three times the amount offered.

3.4.6 Foreign currency reserves and oil fund assets



Source: National Bank of the Republic of Kazakhstan.

Economic prospects

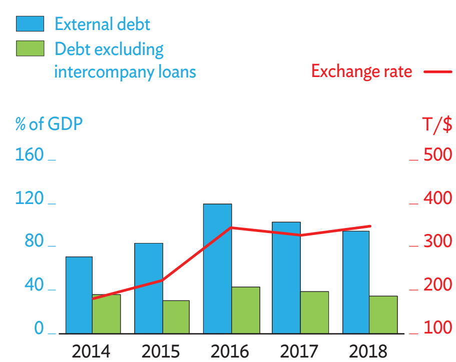
Growth is forecast to slow to 3.5% in 2019 and 3.3% in 2020, reflecting mainly lower oil prices and slower growth in the People's Republic of China and the Russian Federation (Figure 3.4.8). State investment is expected to become a key source of growth aside from oil in the coming years.

On the supply side, industry is forecast to expand by 4.3% in 2019 and 4.4% in 2020 as state-led investment in manufacturing and utilities partly offsets slower gains in oil production. Oil production will likely decline in the first half of 2019 to meet Kazakhstan's commitments under production constraints agreed with the Organization of the Petroleum Exporting Countries, and to accommodate planned maintenance on the country's three major oilfields, then recover in the second half and expand in 2020 despite lower average oil prices.

Government housing and infrastructure modernization programs will support construction, which is forecast to expand by 3.4% in 2019 and 3.5% in 2020. Services are projected to grow by 3.2% and then 2.7%, buoyed by a 50% rise in the minimum wage in January 2019 that should boost household income in 2019 but have limited effect in 2020. Agriculture is forecast to expand by 3.0% in 2019 and 2.5% in 2020 on strong state support for livestock expansion, crop diversification, and measures to boost agricultural productivity and exports, with substantial nonperforming loans (NPLs) in agriculture limiting further expansion. In 2018, Kazakhstan's Unified Pension Savings Fund bought $1.2 billion in NPLs from KazAgro, the state agency that promotes agricultural development.

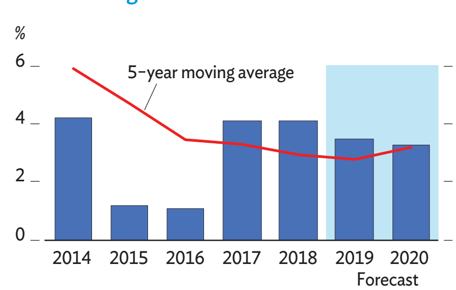
On the demand side, growth in consumption is projected to slow to 1.3% this year and 1.0% next as continued declines in public consumption more than offset gains in private consumption spurred by higher household income.

3.4.7 External debt



Sources: National Bank of Kazakhstan; ADB estimates.

3.4.8 GDP growth



Source: *Asian Development Outlook* database.

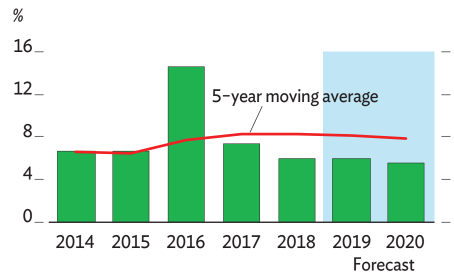
Expansion in investment is similarly projected to slow, to 1.8% in 2019 and 1.6% in 2020, as further reductions in transfers from the NFRK constrain government capital spending. Net exports are forecast to rise gradually, by 1.0% in 2019 and 2.0% in 2020, as moderate increases in oil production beginning in the second half of 2019 outpace rising imports for industrialization programs and higher household purchases of imported services.

Average inflation is projected to remain in 2019 at 6.0%, the upper end of the central bank's target range for the year, then moderate to 5.5% in 2020 (Figure 3.4.9). The central bank will likely raise the policy rate and maintain measures to absorb excess liquidity to counter inflationary pressures imposed by higher import prices as the tenge depreciates. Food price inflation is projected to slow from 5.2% in 2019 to 5.0% in 2020 as the government promotes domestic food production, institutes stabilization funds for critical foodstuffs, and imposes selective price controls. A review of utility prices ordered by the President in November 2018 prompted considerable reductions in 2019 utility charges. Further government intervention in utilities, and in the gasoline market, should trim inflation for goods other than food to 7.3% in 2019 and 6.5% in 2020. Price rises for services will slow from 5.8% in 2019 to 5.2% in 2020.

Fiscal policy is expected to remain slightly expansionary in the next 2 years. State budget deficits are projected to equal 1.5% of GDP in 2019 and 1.3% in 2020, with the non-oil deficit narrowing to 7.0% of GDP in 2019 and 6.5% in 2020 (Figure 3.4.10). Revenue is projected to fall to 17.0% of GDP in 2019 and 17.7% in 2020. This reflects a policy to reduce NFRK transfers to the budget to $6.7 billion in 2019 and $6.0 billion in 2020, as well as a tax amnesty for small and medium-sized enterprises (SMEs) intended to get more firms to start reporting income. A separate effort aims to improve tax administration. Expenditure is forecast to fall to 18.5% of GDP in 2019 and then recover to 19.0% in 2020 on modest civil service pay increases as programs continue to support industrialization, infrastructure, housing, and agriculture. Economic growth will trim government and government-guaranteed debt to 26.0% of GDP in 2019 and 25.0% in 2020.

Broad money is projected to increase by only 5.0% annually in 2019 and 2020 as the central bank continues to drain excess liquidity. A relatively high NPL rate, officially 7.9% at the end of 2018 but possibly higher because of underreporting, will constrain credit growth despite efforts to resolve NPLs through mergers and closures of problem banks. Although Kazakhstan has a floating exchange rate, the central bank may intervene in the market to smooth exchange rate volatility and limit opportunities for cross-currency arbitrage with the ruble, which historically has been closely linked with the tenge.

3.4.9 Inflation



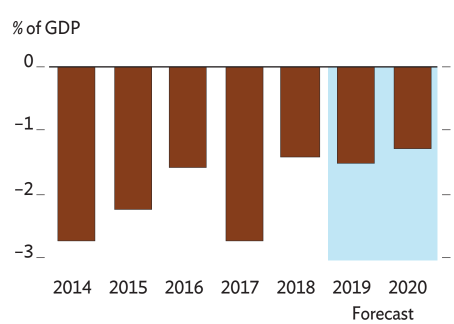
Source: *Asian Development Outlook* database.

3.4.1 Selected economic indicators (%)

	2019	2020
GDP growth	3.5	3.3
Inflation	6.0	5.5
Current account balance (share of GDP)	−0.8	−1.2

Source: ADB estimates.

3.4.10 Fiscal balance

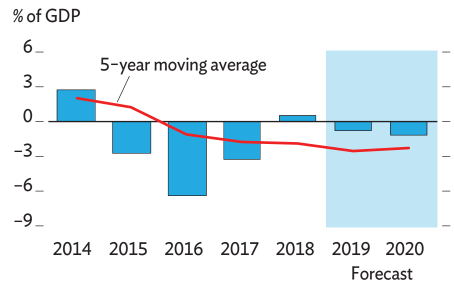


Source: *Asian Development Outlook* database.

The current account is forecast to revert to a deficit in 2019, equal to 0.8% of GDP and then 1.2% in 2020, with lower global petroleum prices and higher profit repatriation by foreign investors (Figure 3.4.11). Despite a slowdown in the first half of the year, exports are projected to grow by 6.0% in 2019 and 7.0% in 2020 after oilfield modernization boosts production. Growth in imports will slow to 5.0% in 2019 and 2020, reflecting measures to promote import substitution and, as the tenge depreciates, weaker domestic purchasing power. Currency depreciation will also trim the service deficit in 2019 and 2020 by reducing demand for imported services and facilitating service exports, especially after the completion of major road construction projects intended to strengthen Kazakhstan's position as a transport and logistics hub.

International reserves are projected to turn around and reach $31.5 billion this year and then $32.4 billion, or cover for 10 months of imports. With smaller transfers to the budget and a reasonable projection for commodity exports, NFRK assets are forecast to rise to $59.5 billion at the end of 2019 and $60.7 billion a year later, with external debt at the equivalent of 98.0% of GDP at the end of 2019 and 95.0% a year later.

3.4.11 Current account balance



Source: *Asian Development Outlook* database.

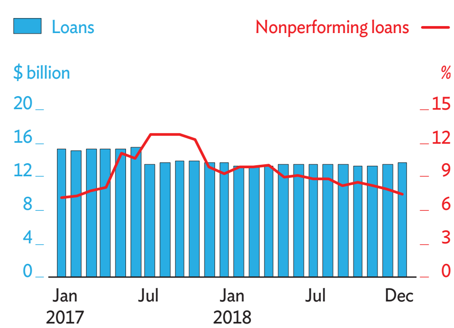
Policy challenge—addressing nonperforming loans

A healthy banking system is a prerequisite for expanding private enterprise and ensuring sustainable economic development in Kazakhstan. Before the global financial crisis, when the economy was expanding rapidly, the bank sector was considered an engine of dynamism, innovation, and economic growth. A decade later, numerous bank failures and a proliferation of mainly underreported NPLs have left the sector's survival dependent on state support and continuous injections of liquidity.

Kazakhstan's massive NPL problem stems largely from fraud and loans to connected parties. The leading case in the past decade saw the prosecution of senior and middle management at Bank Turan Alem, then the largest domestic bank. It was nationalized in 2009 and sold to Kazkommertsbank in 2014, with net government support estimated at $10 billion. In mid-2018, that bank was merged with Halyk Bank, a deal made possible by additional government capitalization of $7 billion. In addition, the Problem Loans Fund purchased $1.3 billion in troubled assets from Tsesnabank in September 2018 and an additional $1.6 billion in agricultural loans in February 2019.

A policy to limit NPLs to 10% of the commercial banks' total loan portfolios may have contributed to underreporting.

3.4.12 Lending portfolio and share of nonperforming loans



Source: National Bank of Kazakhstan.

In May 2018, the central bank acknowledged that NPLs in 2017 were actually 23% of the loan total, two and a half times the officially reported 9.3% (Figure 3.4.12). The underreporting of NPLs appears to have continued in 2018. For example, the central bank reported Eximbank NPLs at 3.6% in April 2018, but only 5 months later determined that they were 53.7% and revoked Eximbank's license.

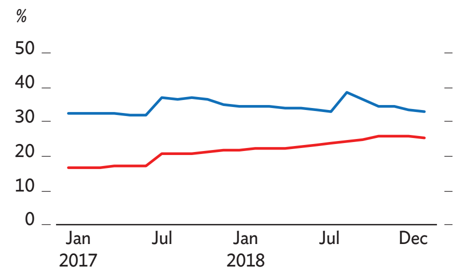
Extensive NPLs, along with the restructuring of loan portfolios and the closure of several banks, have severely limited lending to firms, especially SMEs, despite substantial state support to banks, hindering private investment. Loans to SMEs fell by 12.2% in 2018, following a 1.1% decline in 2017, while the share of loans to SMEs declined to 33.6% in December 2018, well below the average of 44.0% in member countries of the Organisation for Economic Co-operation and Development (Figure 3.4.13). This happened despite government subsidies of up to 50% on interest for business loans made within the framework of the Business Road Map approved in 2010. The central bank's tight monetary policy, which kept average rates for business loans at 12.5% in 2018, has also hindered new lending. The National Chamber of Entrepreneurs (Atameken) estimates that only 20% of the country's 1.2 million or more entrepreneurs use credit.

In January 2019, the government acknowledged that the lack of an efficient bankruptcy procedure and lax supervision have exacerbated difficulties among commercial banks. The central bank and the government aim to streamline the bankruptcy law, and the central bank to adopt a risk-based approach to bank regulation. However, inadequate transparency, accountability, and integrity remain fundamental problems that need to be addressed. Resolving them will require a comprehensive overhaul of the regulatory framework, not least to limit the influence of insiders and connected interests, and a rethinking of loan subsidies. Further, constraints impeding the work of the Problem Loans Fund should be addressed.

Independent portfolio reviews and bank stress tests are also critical. In April 2018, a deputy central bank chairman declared that large discrepancies had been identified between audited statements and central bank assessments of bank assets for fiscal year 2017. Because the underreporting of NPLs undermines the credibility of official statistics and confidence in bank regulation, the central bank needs to strengthen macroprudential policies to ensure that commercial banks comply with rules and standards. In addition, it needs to take steps to level the playing field for SME access to credit.

3.4.13 Shares of SME and consumer credit in the lending portfolio

Small and medium-sized enterprises
Consumer credit



SMEs = small and medium-sized enterprises.
Source: National Bank of Kazakhstan.