

Republic of Kazakhstan: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Kazakhstan

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Republic of Kazakhstan, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 9, 2003, with the officials of the Republic of Kazakhstan on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on May 7, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 28, 2003 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Kazakhstan.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KAZAKHSTAN

Staff Report for the 2003 Article IV Consultation

Prepared by Staff Representatives for the
2003 Consultation with the Republic of Kazakhstan

Approved by John Odling-Smee and Martin Fetherston

May 7, 2003

- **The 2003 Article IV consultation discussions took place in Astana and Almaty during February 20-March 9, 2003.** The mission met with Deputy Prime-Minister Pavlov, the National Bank of Kazakhstan (NBK) Governor Marchenko, the Ministers of Finance; Economy and Budget Planning; and Industry and Trade, the deputy head of the Presidential Administration, the President's economic advisor, as well as senior officials from the Ministries of Agriculture, Energy, and Labor and Social Protection. The staff also met with representatives from parliament, the trade unions, business, commercial banks, foreign investors, and other members of civil society.
- The staff team consisted of Mr. Keller (Head), Mr. Mathieu, Ms. Bacalu, Mr. Medas (EP) (all EU2), Mr. Yang (PDR), Ms. Marton (interpreter, BLS), and Ms. Boyd (senior administrative assistant, EU2). Mr. Oestreicher, the resident representative, assisted the mission. Mr. Prader, Alternate Executive Director, and Mr. Sazanov, assistant to the Executive Director, participated in some of the discussions.
- **The Extended Fund Facility (EFF) arrangement approved in December 1999 was canceled in February 2002.** No purchases were made under the arrangement. Discussions on a possible precautionary stand-by arrangement took place in spring and summer 2002, but were discontinued because of the absence of a prospective financing need.
- **Kazakhstan accepted the obligations of Article VIII, Sections 2(a), 3, and 4 in 1996 and maintains an exchange system free from restrictions on current international transactions.** Capital account restrictions are administered relatively liberally.
- **The quality and coverage of economic statistics has continued to improve** supported by technical assistance from the Fund and others. Kazakhstan has participated in the General Data Dissemination System (GDDS) since 2000 and in March 2003 subscribed to the Special Data Dissemination Standard (SDDS). Statistical issues are discussed in Appendix V.
- **Significant progress continues to be made in implementing standards and codes.** In 2002-03, both the fiscal (SM/02/317, 10/9/02) and data transparency (SM/03/82, 3/4/03) ROSC modules were completed. The latter was published on March 18, 2003 (Country Report 03/78). Financial sector ROSC modules were undertaken in conjunction with the FSAP in mid-2000. The FSSA report was circulated with the 2000 Article IV consultation report.
- It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

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EXECUTIVE SUMMARY

Kazakhstan continues to reap the benefits from early structural reforms and prudent macroeconomic management. Led by the petroleum sector, the economy continues to grow rapidly, inflation remains moderate, and public sector external debt is declining, while international reserves are rising. Kazakhstan has been attracting large amounts of foreign direct investment mainly in the oil sector.

The principal policy challenge facing Kazakhstan is the management of the rapidly rising petroleum wealth. A rebalancing of the monetary, exchange rate and budgetary policy mix should be considered in favor of greater exchange rate flexibility, and a relaxation of fiscal policy, including through increased spending on social needs, well conceived public sector investment, and selected tax cuts. Structural reforms need to be pursued more vigorously and fiscal and social institutions strengthened.

Kazakhstan has provided revised information on its external position, bringing it into conformity with the requirements of Article VIII, Section 5. No action by the Executive Board is proposed.

I. INTRODUCTION

1. **The 2002 Article IV consultation with Kazakhstan was completed on January 23, 2002¹.** Executive Directors commended the improved macroeconomic performance and the prudent stance of macroeconomic policies. They stressed the need for accelerating structural reforms and promoting private sector development. They thought that the creation of the National Fund of the Republic of Kazakhstan (NFRK) had facilitated the pursuit of prudent fiscal and monetary policies, and increased the transparency of the budget process. While the policy of intervening to moderate an appreciation of the currency was generally appropriate, there was a need to guard against reigniting inflationary pressures. Directors encouraged the authorities to promote free trade, facilitate trade in the region, and pursue accession to the WTO. As described in the following section, the authorities maintained the prudent stance of macroeconomic policies, and made significant gains on transparency, but only moderate progress on structural reforms and trade liberalization was recorded.

II. RECENT ECONOMIC DEVELOPMENTS

Growth and Inflation

2. **Kazakhstan is reaping the benefits from early structural reforms and prudent macroeconomic management.** Led by the petroleum sector, and supported by a favorable external environment, economic growth averaged 11 percent in the three-year period 2000-02. Strong growth has continued in 2003, with an estimated 10.6 percent increase in GDP in the first quarter. The petroleum sector continues to gain in importance with high foreign investment and rising production and export volumes. Including associated services such as transportation and construction, the petroleum sector activity accounts for about one quarter of GDP and half of exports. **The non-oil economy has also grown strongly, at about 8 percent on average in 2000-02.** Services and manufacturing did well, and agriculture has seen significant gains. However, productivity in agriculture remains low.

Selected Macroeconomic and Financial Indicators, 1999-2002

	1999	2000	2001	2002
	Actuals			Preliminary
	(percentage change)			
Real GDP growth	2.7	9.8	13.5	9.5
CPI (end-of-period)	17.8	9.8	6.4	6.6
Reserve money growth	56.9	5.3	30.9	18.1
Broad money growth	84.4	45.9	42.8	34.1
Broad money velocity (annual average)	11.1	7.8	6.6	5.8
	(in percent of GDP)			
General government balance	-5.0	-0.8	2.7	1.5
Revenues and Grants	17.5	21.7	25.7	22.6
Expenditures	22.7	22.5	23.0	21.2
External current account balance	-0.2	4.8	-4.0	-1.9
FDI, net	9.3	7.0	13.6	8.8
	(in millions of U.S. dollars; end-of-period)			
NBK gross reserves	2,003	2,096	2,508	3,136
NFRK			1,240	1,917
Public external debt	4,044	3,979	3,852	3,501
<i>Memorandum items:</i>				
Nominal GDP (average billions)	2,016	2,600	3,251	3,747
World oil Price (WEO; \$/bbl)	18.1	28.2	24.3	24.9

3. **After sharp declines during the 1990s, overall employment has grown in the period 2000-02.** In 2002, unemployment declined from 10½ percent to 9¼ percent, and real wages rose by about 10 percent. In the period 2000-02, real wages have risen about in line with GDP growth. Notwithstanding the sustained strong growth of the economy, poverty remains a serious concern,

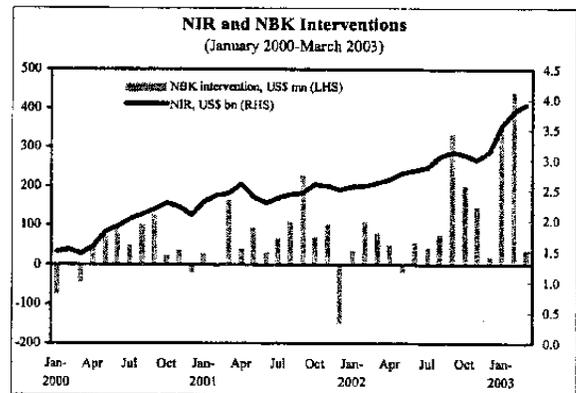
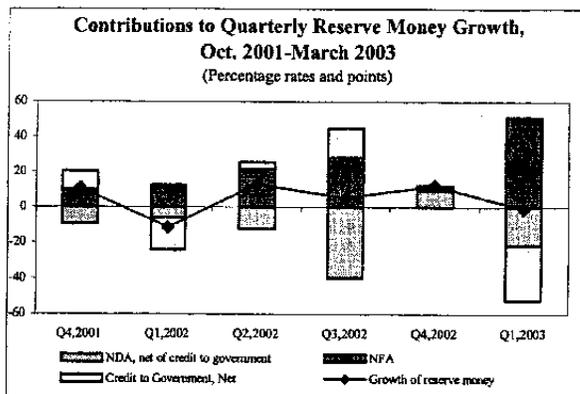
¹ SM/02/5; 1/4/02, and Supplement 1 and Correction 1; and SUR/02/6; 01/28/02. The staff report was published in March 2002 as Country Report 02/63.

especially in the rural areas. More broadly, the rising oil wealth has yet to benefit significantly the majority of the population.

4. **Inflation remained basically unchanged in 2002 at 6½ percent and was broad based.** Impediments to regional trade may have contributed to sharply higher prices of fruits and vegetables. The 12-month inflation rate began to edge-up towards the end of 2002 and reached just over 7 percent by March 2003.

Monetary and Exchange Rate Developments

5. **The growth of the monetary and credit aggregates continued to slow in 2002.** The sterilization of budget surpluses in the NFRK and the partial sterilization of additional large foreign exchange purchases by the NBK were crucial in this regard. Increased monetization continues to facilitate monetary policy, while the level of dollarization of bank assets and liabilities is stabilizing. In the course of 2002, the NBK cut its refinance rate twice to reach 7½ percent.



6. **In 2002, monetary policy was again aimed at the potentially conflicting dual targets of preventing a real appreciation of the tenge and controlling inflation.** The NBK engineered a weakening of the nominal exchange rate against the U.S. dollar through large-scale interventions, and, with moderate inflation, the tenge continued to depreciate in real effective terms. This policy came under increased pressure in the first quarter of 2003, when only part of very large foreign currency purchases were sterilized. Reserve money did not exhibit the usual pronounced seasonal decline and broad money growth accelerated, driven by NFA growth. While there was also a moderate acceleration in the 12-month growth rate of credit to the economy, the rate of credit expansion at end-March 2003 was much lower at 39 percent than in the first quarter of 2001 (84 percent) or 2002 (65 percent). In the first 3 months of 2003, the tenge appreciated by 2½ percent against the dollar and marginally against the Russian ruble, but was steady against the euro. The nominal exchange rate against the ruble has shown only marginal changes in recent years despite a large inflation differential with Russia.

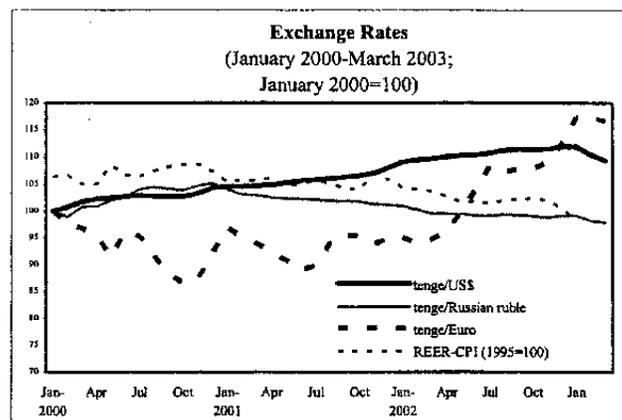
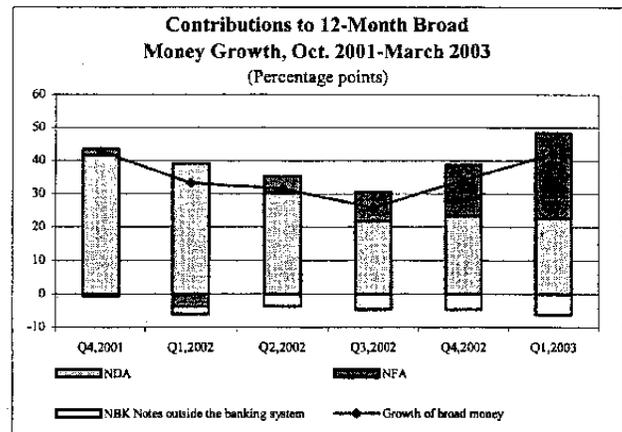
Fiscal developments

7. **Fiscal policy has played a major role in containing aggregate demand and inflationary pressures.** The fiscal stance, as measured by the non-oil budget balance, was significantly tightened in 2002, and the expenditure-to-GDP ratio declined. The overall surplus in 2002 would have been nearly 1 percentage point of GDP higher, had a major oil company not switched to a faster depreciation schedule. In recent years, the revenue-to-GDP ratio has fluctuated broadly with oil prices and large bonus receipts (such as in 2001).

8. **Budget revenues were very strong in the first two months of 2003.** Together with seasonally low expenditures, this resulted in an overall surplus of about 1.6 percent of projected annual GDP.

External sector developments

9. **The external current account deficit declined in 2002 to under 2 percent of GDP, as both petroleum and non-oil export growth recovered and import growth continued to slow for reasons that are not yet fully understood.² Net FDI inflows, largely in the oil sector, have averaged over \$2 billion per year (more than 9 percent of GDP) since 2000.** Gross official reserves rose to over \$3 billion at end 2002, notwithstanding repayment of a \$350 million Eurobond, and further to \$4 billion at end-March 2003 (3.7 months of projected 2003 imports). Moreover, balances in the NFRK reached \$2.2 billion in mid-April 2003. Public external debt dropped to around 14 percent of GDP at end 2002 and Kazakhstan's official sector has



General Government Fiscal Operations, 1999-2002
(In percent of period GDP)

	1999		2000		2001		2002	
	Actual	Budget 2/	Actual	Budget 2/	Actual	Budget 2/	Actual	Est.
Total revenue and grants	17.5	21.7	21.7	25.6	20.4	22.6		
of which: oil revenue 1/	1.0	3.3	6.6	3.6	4.4			
Total expenditure and net lending	22.7	22.5	23.0	22.4	21.2			
Current expenditure	20.2	20.2	19.5	...	17.3			
Capital expenditure	1.4	1.6	2.8	...	3.4			
Overall budget balance (cash)	-5.0	-0.8	2.7	-2.0	1.4			
(Non-oil balance)	(-6.0)	(-4.1)	(-3.9)	(-5.6)	(-3.0)			
Financing	4.7	1.2	-2.9	2.0	-1.4			
Domestic financing (net)	0.4	-0.8	-0.7	1.9	0.9			
Foreign financing (net)	2.6	1.2	0.9	-0.3	-1.5			
Privatization receipts	1.8	0.8	2.5	0.8	0.5			
NFRK	0.0	0.0	-5.6	-0.4	-1.4			
<i>Memorandum items:</i>								
World oil price (WEO; \$/bbl)	18.0	28.2	24.3	19.0	24.9			
Nominal GDP (tenge billions)	2,016	2,609	3,251	3,499	3,747			

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Consists of CIT, royalties, PSA, and bonus payments, and local taxes.

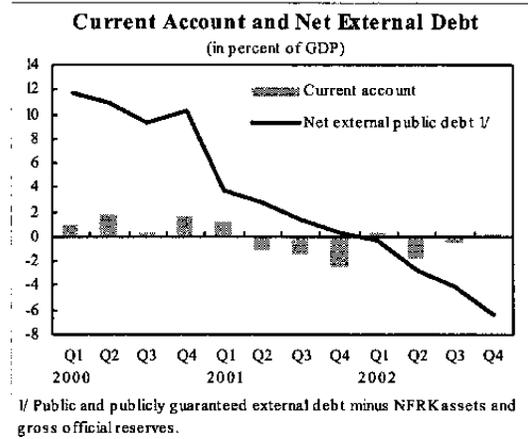
2/ Approved budget for 2002

² The recovery in non-oil exports may have been linked to a rebound in agricultural production and export of metals. Also, the switch of VAT from the origin to the destination principle for non-oil intra-CIS trade lowered the border price for such imports.

become a net creditor to the rest of the world. Kazakhstan's credit rating was upgraded in September 2002 by Moody's to minimum investment grade.

Structural Aspects

10. **After a rapid introduction of market reforms in the early years of transition, the momentum of structural reform has slowed since 2000.** A weak judicial system, entrenched vested interests, "capture" of important sectors, combined with a lack of transparency have resulted in an uneven playing field and a poor investment climate outside the oil and banking sectors, particularly for small and medium-size domestic and foreign investors.



11. **Welcome progress was achieved, however, in 2002 in the areas of treasury modernization, simplification of NFRK funding rules, as well as the introduction of a systematic reform of utility pricing, the latter with EBRD support.**³ The trade regime is generally liberal with relatively low average tariffs. However, reforms to reduce tariff peaks and eliminate specific and combined tariffs have not been implemented. Also, ad hoc restrictions prevail on both imports and exports, including recurring seasonal bans on petroleum product exports and local barriers against imports of fruits and vegetables. Efforts to accede to the WTO were reenergized, but there are no near-term prospects for accession.

12. **Significant progress in strengthening the financial sector is continuing (Box 1).** Also, bank capital has increased significantly as a result of both new share issues and retained earnings. The NBK has energetically fostered domestic capital market development, notably mortgage lending and mortgage-backed securities. Legislative reforms of the bankruptcy code were also an important step forward. Legislation regarding anti-money laundering is still in preparation, and Kazakhstan plans to join the Strasbourg Convention.⁴ In early 2003, a technical MAE mission reassessed the payment system in Kazakhstan and found that it is now functioning according to the best international practices.

³ The reform entails setting utility tariffs based on full cost recovery plus a normal rate of return on investment.

⁴ Kazakhstan is a member of the 1988 drug convention and the 1999 convention on the financing of terrorism, but has yet to ratify the Palermo Convention against organized crime.

Box 1. Kazakhstan: Financial Sector Developments

Kazakhstan's financial system, which is dominated by private commercial banks, has been one of the most rapidly developing sectors of economy, with average growth of 18 percent during 2001-02. The financial services remain small, however, at 3.9 percent of GDP in 2002. Financial deepening has continued with the ratio of broad money to GDP rising from 15.4 percent in 2000 to 20.4 percent in 2002.

The **Financial Sector Assessment Program (FSAP)**, conducted in mid-2000, found that the financial system of Kazakhstan played a minor role in the economy and remained fragile due to uncertainties regarding the adequacy of capitalization and the quality of loans. Noncompliance with several of the Basel Core Principles was due to the lack of supervisors' right to obtain information on the ownership of commercial banks that constituted the core of financial groups in Kazakhstan. Also, courts had the right to overturn banking license revocation by the NBK, but this issue has been addressed. The payment system was found not to be up to the best international practices, in part because of the absence of loss-sharing arrangements to ensure completion of daily settlement.

Considerable progress has been made in strengthening financial system supervision. Supervision of the securities market and pension funds was brought under the responsibility of the NBK, with all financial sector participants to be licensed and supervised by the NBK. **An independent supervisory agency** is to be spun-off from the NBK in 2004. Uniform standards, conforming to IAS, were introduced for accounting, auditing and reporting. New legislation on consolidated supervision has enabled the NBK to obtain information on financial groups ownership. Supervisors concentrate on the downstream activities of the banks to ensure sound and transparent banking practices.

The **banking system** soundness indicators are at satisfactory levels, with capital adequacy ratios well in excess of minimum Basel standards, high liquidity ratios, and good profitability. The share of classified loans appears high at 30 percent during 2001-2002, but classified loans include all lending to new borrowers and loans without collateral. The share of unsatisfactory, doubtful and bad loans increased from 7.0 per cent in 2000 to 9.4 per cent in 2002, but provisioning is reported to be more than adequate and actual loan losses have been small. A new methodology for risk classification was adopted in November 2002, which is expected to contribute to more balanced credit and investment policies by banks. Foreign currency loans account for around 70 percent of the total loan portfolio and banks are increasingly borrowing abroad. Banks are, however, required to ensure that borrowers have an earnings base in foreign currencies before extending loans in foreign currencies. The major challenge is the enhancement of risk management techniques to address the combination of foreign exchange, commercial, and other types of risks. Stress testing and assessment of internal control and risk management systems have been required as a part of 2002 external audit exercise.

Capital markets development has advanced quickly in Kazakhstan. Infrastructure of securities markets has improved along with better regulation and supervision. The Kazakhstan Stock Exchange (KASE) handles primarily Repo transactions backed by government securities, trades in foreign exchange, but also emerging trade in corporate securities and other instruments. KASE turnover has more than doubled since 2000 and reached \$24.6 billion in 2002. The **corporate bonds** market has grown to over \$700 million since its launch in late 1999. It has contributed to increases in maturities and better asset-liability management opportunities for financial system participants. Creation of a **mortgage securities market** and issuance of around \$100 million of mortgage debt instruments in 2002 has contributed to the development of a real estate industry.

Assets in the mandatory **pension fund** system have grown to over \$1.7 billion since its creation in 1998. The **insurance sector** is still in a nascent stage, with a need for establishing proper actuarial systems and securing reinsurance backing.

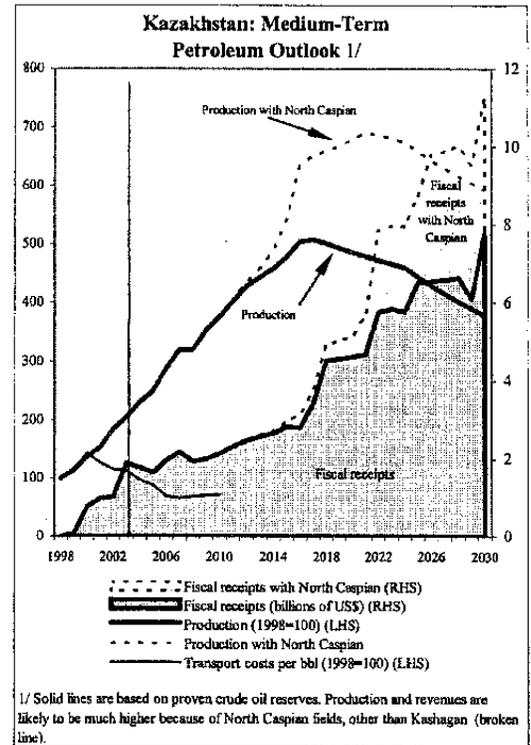
III. POLICY DISCUSSIONS AND OUTLOOK FOR 2003

Overview

13. **Conditions are favorable for strong macroeconomic performance to continue in 2003 and over the medium term.** Large fiscal and external surpluses are expected. While world market prices for oil are expected to decline, significant increases in petroleum production and reductions in transportation costs are expected to more than compensate over time. Growth could easily exceed 7 percent in 2003 and beyond.⁵ Over the medium-term, Kazakhstan can expect very large resource inflows. Export volumes of crude oil and gas condensate almost doubled between 1998 and 2002 and are projected to double again by 2009. The longer term trends are even more impressive.

14. **Macroeconomic policy discussions focused primarily on the foremost issue facing the authorities—the appropriate management of the very large projected increase in petroleum revenues.** The authorities say that they aim at avoiding macroeconomic imbalances, using resources efficiently, and at a more equitable distribution of benefits across society and between current and future generations.

15. **The mission noted that the stance of budgetary policy (as measured by the non-oil deficit) had been tight in 2002, that the authorities had engineered a nominal depreciation against the U.S. dollar, and that the associated large foreign exchange purchases required costly sterilization.** Moreover, the objective of further reducing inflation was in jeopardy. The authorities tended to agree that a rebalancing of the monetary, exchange rate, and budgetary policy mix would be desirable, with a more



Medium-term Macroeconomic Indicators, 2002-06
(Year-on-year percentage change; unless otherwise indicated)

	2002	2003	2004	2005	2006
	Preliminary		Staff Projection		
CPI inflation, end-of-period	6.6	5.5	5.0	5.0	4.5
Real GDP growth	9.5	7.5	7.2	7.0	7.5
Crude oil output	20.3	11.5	12.0	8.5	15.2
Reserve money growth	18.1	14.3	12.5	13.2	13.4
Broad money growth	34.7	20.1	14.7	16.0	16.3
Broad money velocity (annual average)	5.8	5.3	5.0	4.8	4.6
			(In percent of GDP)		
General government balance	1.4	4.1	2.1	0.5	0.5
(non-oil balance)	(-3.0)	(-3.8)	(-4.0)	(-4.7)	(-4.5)
Revenues and Grants	22.6	26.0	24.2	23.4	23.4
o/w oil revenue	4.4	7.8	6.2	5.2	5.0
Expenditures	21.2	21.9	22.1	22.8	22.9
Allocation to NPRK (-)	-1.4	-4.9	-3.1	-0.9	-1.0
External current account balance	-1.8	1.5	0.4	-1.3	-0.4
FDI, net	8.8	7.0	7.5	7.9	5.8
			(End of period in millions of US dollars)		
NBK gross reserves	3,136	4,000	4,500	5,000	5,500
National Fund of the Republic of Kazakhstan	1,917	3,329	4,309	4,629	5,036
Public and publicly guaranteed external debt	3,301	3,495	3,282	3,263	3,354
Memorandum items:					
Nominal GDP (in billions of tenge)	3,747	4,319	4,655	5,143	5,719
World oil Price (WEO: dollars per barrel)	24.9	28.0	23.5	22.0	21.0
Crude oil production (MT millions)	47.3	52.8	59.1	64.1	73.9

Sources: Kazakh authorities; and Fund staff estimates and projections.

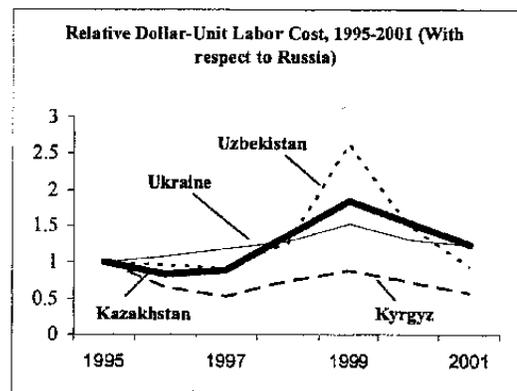
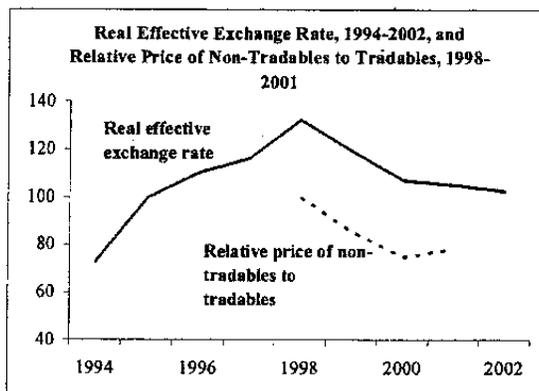
⁵ Based on the outcome for the first quarter of 2003, the authorities revised in April their growth projections from 6.0 percent to 8.3 percent for the year.

flexible exchange rate policy to ease the burden on monetary policy, together with a relaxation of the fiscal stance.

A. Monetary Policy and Exchange Rate Issues

16. **The authorities noted that inflation had been contained well below that recorded in Russia (Box 2) and that their objective was to gradually reduce inflation further in 2003 and beyond.** The mission pointed out that notwithstanding the sterilization of large government surpluses from oil in the NFRK, reserve accumulation has driven reserve money growth in recent years. The authorities said that they recognized the inevitability of a real appreciation of the tenge. They were prepared to limit exchange market interventions and accept a nominal appreciation of the tenge vis-à-vis the U.S. dollar in support of their inflation objective. During the mission, the National Bank went on public record that it projects a 5-6 percent nominal appreciation against the U.S. dollar for 2003. The mission remained, however, concerned that because of the weakening of the U.S. dollar against the Euro, this may not be enough to stem the recent upturn in inflation, and that greater exchange rate flexibility may be called for.

17. **The tenge has depreciated in real effective terms since 1999.** Other indicators also suggest that Kazakhstan remains competitive.⁶ The authorities recognize that the challenge



over the medium term will be how to limit the likely loss of competitiveness in the non-oil sector. The mission stressed that the latter could be substantially reduced, if not eliminated, through increases in productivity, supported by sustained structural reform to improve the business climate and freer trade. The authorities acknowledged that increased attention to education and training, and infrastructure investment to lower costs will be essential for accelerating productivity growth in the non-oil sectors.

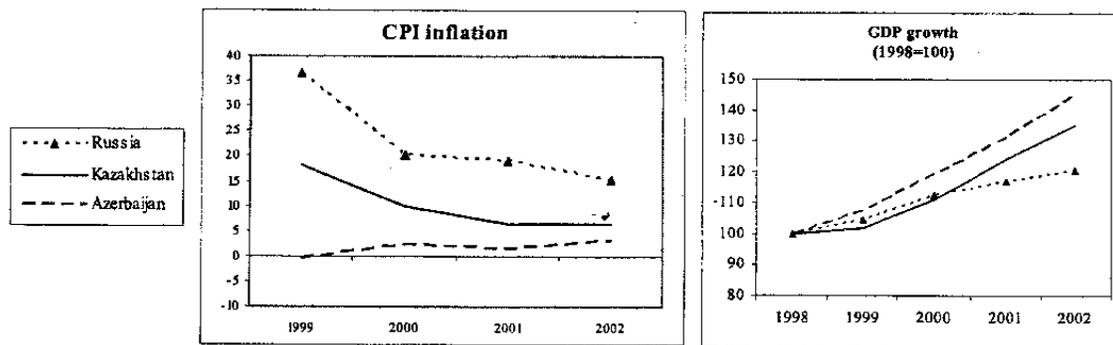
18. **The NBK is planning to move towards direct inflation targeting in the coming years.** The mission noted that this would require giving up on targeting the exchange rate and developing empirical models that reliably link inflation outcomes with monetary policy action, i.e., changes in short-term interest rates. The feasibility of inflation targeting for an economy

⁶ The forthcoming selected issues paper discusses issues of competitiveness in greater detail.

increasingly dependent on exports of a single commodity with large and unpredictable world price fluctuations was also discussed. The mission was concerned that the NFRK sterilization mechanism may not prove sufficient to ensure the required stability of the budget aggregates.

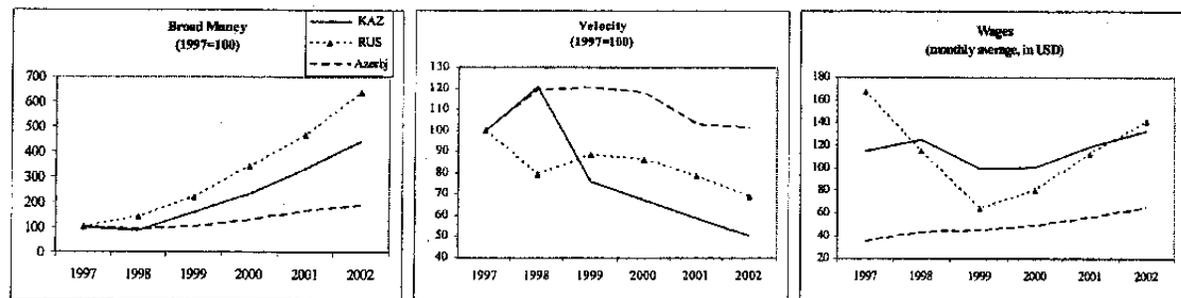
Box 2. Inflation in Three CIS Oil Exporters: Russia, Kazakhstan, and Azerbaijan

A comparison of inflation patterns over the last three years between these oil exporters shows significant differences. These differences are the more notable because the nominal exchange rates of these countries vis-à-vis each other have remained relatively stable. Large increases in Russian administrative prices account for some of the inflation differential, but the main factors seem to be related to macro policy choices and structural differences between the economies.



A high rate of monetization, in part due to the advanced stage of financial sector reforms, and a decreasing non-oil fiscal deficit contributed to keeping prices under control in Kazakhstan. By contrast, because of problems in the banking system, monetization has remained very low in Azerbaijan despite more stable prices, but this was compensated for with very tight monetary policies.

The different impact of rising oil revenues on inflation may also reflect the specificities of the oil industries. In both Kazakhstan and Azerbaijan, the absorption of rising oil revenues is facilitated by oil funds, large investment finance needs and associated imports of capital goods and services, and repatriation of capital by foreign shareholders. In Russia, which has a more mature oil sector, with higher profits and less financing needs, windfalls from oil create stronger pressures for rising private and public wages, pensions, and consumption, fueling higher overall inflation.



Kazakh dollar wages registered only a small dip after the Russia crisis and have grown more gradually than Russia wages since then. Azeri dollar wages registered no decline as a result of the crisis and only very gradual increases thereafter.

B. Budgetary Issues

19. The Republican budget for 2003 projects a deficit of 1.0 percent of GDP, implying a similar deficit for the general government (Box 3). The mission projects substantially higher oil revenues because of a higher oil price assumption and inclusion of a large bonus payment, and a budget surplus of over 4 percent of GDP.⁷ The mission suggested that a small surplus, of between 1 and 2 percent of GDP, would be appropriate in view of the high oil prices, but noted that this still left ample room for more ambitious outlays on health, education, and strengthening the social safety net, where expenditures remain substantially below those in neighboring countries and reforms to better target assistance have lagged. The mission emphasized the need to bolster institutional capacities and expenditure management to ensure the appropriate use of increased outlays. While not necessarily accepting fully the staff's revenue projections, the authorities agreed that there was no need for a large budget surplus. The authorities shared the mission's concern that poverty remains widespread, especially in the south, and that health and education standards remain very low. Public sector wages, especially at higher ranking civil service levels trail significantly wage levels in the private sector. The authorities linked corruption to low public sector wages.

General Government Fiscal Operations; 2002-03
(in percent of period GDP)

	2002		2003		Expected Revised Official Budget 1/	1/
	Preliminary	Staff	Official	Expected		
	Est.	Projection	Budget	Budget		
Total revenue and grants	22.6	26.0	20.9	2/	22.5	2/
of which: oil revenue 3/	4.4	7.8	3.2		...	
Total expenditure and net lending	21.2	21.9	21.9		23.5	
Current expenditure	17.3	17.7	17.6		18.1	
Capital expenditure	3.4	3.6	3.7		3.7	
On lending (net)	0.5	0.6	0.6		1.6	
Overall budget balance (cash)	1.4	4.1	-1.0		-1.0	
(Non-oil balance)	(-3.0)	(-3.7)	(-4.2)		(...)	
Financing	-1.4	-4.1	1.0		1.0	
Domestic financing (net)	0.9	-0.7	1.1		1.1	
Foreign financing (net)	-1.5	0.3	0.2		0.2	
Privatization receipts	0.5	1.2	0.6		0.6	
NFRK	-1.4	-4.9	-0.9		-0.9	
<i>Memorandum items:</i>						
World oil price (WEO/auth.; \$/bbl)	24.9	28.0	21.2		...	

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Based on the presidential speech of April 4, 2003.

2/ Excludes second TCO bonus of \$210 million (0.8 percent of GDP) and NFRK earnings (0.6 percent of GDP).

3/ Consists of CIT, royalties, PSA, local taxes, and bonus payments.

Comparative General Government Social Expenditure, 2000-02
(In percent of GDP)

	2000-2002			2001	
	2000	2001	2002	CIS Avg.	OECD Avg.
Health	2.1	1.9	1.9	2.5	5.6
Education	3.3	3.3	3.2	4.5	5.3
Social security and social assistance	6.6	5.7	5.4	8.1	15.6
<i>Memorandum items:</i>					
Defence, public order, and security	2.6	3.0	3.1	3.2	3.2
Interest	1.4	1.2	1.0	1.7	5.0
Wage bill	...	3.3	3.6	...	...

20. After the mission's departure, the President, in his budget speech, announced a mid-year revision to the 2003 budget. This includes a large increase in pensions, but, contrary to the mission's recommendations, also major outlays for the capitalization of various new and existing industrial policy initiatives (shown under on-lending). While the draft revised budget now discussed in parliamentary committees still aims at a deficit of about 1 percent of GDP, the staff projects that it would result in a surplus of over 3½ percent of GDP for 2003 (before on-lending). For 2004, the budget will feature large increases in public sector wages, but only a modest rise in

⁷ Staff projections do not include what is expected to be a large commercial discovery bonus payment from the consortium developing the Kashagan offshore Caspian field, nor potentially significant fees from the tender of exploration licenses for the blocks in the North Caspian region.

outlays on rural development. Selected tax cuts were also foreshadowed. There were, however, no additional outlays foreseen for health and education.

Box 3. Kazakhstan: Republican and General Government Budgets for 2003-04

Original 2003 Budget

- **Revenue assumptions in the original budget were overly cautious**, in particular as regards revenues from petroleum. No new taxes or changes in existing rates were introduced in 2003 and the intergovernmental distribution of revenue and expenditure responsibility was maintained.
- **On the expenditure side**, the original budget provided for: (i) a wage increase of 6 percent, in line with projected inflation for higher paid government workers, and a 15-20 percent increase for lower paid workers; (ii) a 12 percent average increase in pension benefits; and (iii) a 28 percent increase in capital expenditure. Relative spending increases were allocated for agriculture and national security.
- **Final details on the general government budget** are known from about mid February after all local government budgets are approved by their respective legislatures. However, local budgets are revised frequently during the year in light of revenue outturns. The republican government exerts considerable influence over the expenditure of local governments. Legal prohibitions against local government borrowing will ensure a consolidated fiscal balance very close to that of the republican budget.

Expected Revisions to the Budget

- The presidential speech of April 4, 2003 announced an **increase in outlays for the 2003 and 2004 budgets together with tax cuts for 2004**, in recognition of a much stronger than projected revenue performance.
- **Expenditures:** By mid-year, minimum pensions are to be raised by 10 percent to the equivalent of about \$36/month and other pensions raised by various rates. The average pension would increase by some 28 percent to about \$55/month. The half year cost is estimated at about 0.5 percent of 2003 GDP.
- **Other outlays:** A total of 1.1 percent of annual GDP is to be allocated for capitalization of the new Investment and Innovation funds, the Export Insurance Corporation and a capital increase for the Development Bank. (This will not have any immediate macroeconomic effect).
- **For 2004:** reductions were announced for the VAT rate from 16 to 15 percent; the personal income tax rate from a maximum of 30 to 20 percent, with raised minimum thresholds; and a social tax rate reduction from a flat 21 percent to a scaled regressive rate of 20 to 7 percent (an average rate of about 17 percent) to improve compliance. The tax cuts are estimated to total 1.2 percent of GDP in 2004. On the expenditure side, differentiated wages increases for the public sector are expected, with an estimated cost of 1.2 percent of GDP as well as the full year effect of the increased pensions (0.9 percent of GDP). On these policies, the budget outcome for 2004 is likely to be a small deficit.

21. **Balances accumulated in the NFRK are projected to continue to grow rapidly.** The authorities are aiming at accumulating about \$4 billion in the NFRK to protect future budgets against adverse oil price developments. This goal could be reached as early as 2004. Thereafter, some further, and possibly large, increases in the NFRK were seen as appropriate. The authorities recognized, however, the need to also address large unmet social and developmental needs. The mission noted that the risk of misuse due to weak political institutions argues against an open-ended accumulation of NFRK assets. Further select tax cuts, as subsequently announced in the President's 2004 budget speech, would also be appropriate.

22. **The treasury modernization project, which is supported by the Fund and the World Bank, is nearing completion.** The authorities said that they are experiencing substantial

technical difficulties and that they are reevaluating the design of the project. The mission emphasized the need to preserve a single treasury account and address the ongoing loss of qualified staff. Consideration should also be given to incorporating a wage module into the system at an early stage.

C. External Sector Issues

23. **The external current account is projected to turn into surplus in 2003 because of surging petroleum receipts.** Foreign direct investment is expected to remain strong. The services and income balances are expected to deteriorate further, especially as the profitability of FDI rises. External public debt is expected to decline to near single digit levels as a percentage of GDP. Reflecting high profitability levels in the petroleum sector, the repayment of intra-company debt is expected to rise, and along with flows to the NFRK, offset a large portion of the external inflows.

24. **As liberal trade policies are particularly important to improving the investment climate, the mission encouraged the resumption of tariff reforms either unilaterally or as part of the WTO accession (Box 4).** Improvements in trade facilitation and reductions in non-tariff barriers are also important. The authorities argued that further tariff reform at this stage would undercut their negotiating position for accession to the WTO. They stated that their trade policy compares favorably to that of advanced economies, especially on agriculture. The authorities welcomed the technical assistance on customs reform provided by FAD.

Box 4: WTO Accession

In January 1996, Kazakhstan lodged its application for WTO membership. The fact-finding phase of the accession process is complete, although questions on various trade policies continue to be asked during bilateral negotiations.

Progress in the negotiations during the 5th Working Party meeting in December 2002 was uneven, despite the positive response from a number of WTO members. In recognition of Kazakhstan's progress in legislation, the Working Party requested a detailed written account of all legislative amendments. While negotiations on services seem to have been advanced, little progress was made in resolving the key issues in market access for goods. Negotiations on agriculture (tariffs, export subsidies and domestic support), in particular, seem to be deadlocked at a preliminary stage, as do those on a range of other issues.

The Eurasian Economic Community (EAEC) may have complicated Kazakhstan's WTO accession process and its trade reforms in general. Despite the lack of political commitments to liberalize intra-EAEC trade, there has been a cumbersome process of coordination among member countries (except for Kyrgyzstan which is already a WTO member) in their tariff offers to WTO members. While efforts have been devoted to harmonizing tariffs and coordinating tariff offers, little progress has been made to reduce the tariffs. The average tariff rate in Russia is considerably higher than that in Kazakhstan. The Kazakhstan authorities indicated that Russia's tariff levels were an informal benchmark for Kazakhstan's tariff offers to WTO members. This has tended to reduce the scope of tariff reductions in Kazakhstan's offers.

Although there is some pressure due to advances made in Russia's accession to the WTO, trade policy does not seem to be a priority on the authorities' reform agenda. The industry policy that is being formulated at present could further complicate the accession process as it is likely to result in sector- and/or firm-specific assistance to promote industry diversification and non-oil sector development.

25. **The mission noted the importance of regional cooperation, but participation in various regional trade arrangements has not helped trade liberalization or WTO accession.** The discussion focused on the role regional trade arrangements can play without harming export diversification with non-CIS countries, notably China and Turkey. The authorities broadly agreed with the need to accord priority to a multilateral approach, but indicated that their regional trade policy was part of a broad regional integration process (Box 5). They also noted instances of abuse of liberal transit arrangements.

Box 5. Regional Trade

Kazakhstan has signed a number of regional and bilateral agreements which either deal exclusively with trade or have an important component on trade and investment. These agreements, most of which are among CIS countries, appear to have been largely motivated by geopolitical considerations. Substantial commitments to the implementation of many of these agreements appear to be lacking.

Probably the most important among these agreements is the Eurasian Economic Community (EAEC), which was signed in 2001 to replace the 1995 CIS Customs Union. The aim of the EAEC is to create a customs union and eventually a "Single Economic Space" among the member states, which include Belarus, Kazakhstan, the Kyrgyz Republic, the Russian Federation, and Tajikistan. Under the EAEC agreement, common external tariffs are to be adopted among member countries, thus forming a customs union. However, only about 60 percent of tariff lines (or about 40 percent of the trade value) has so far been harmonized among member countries. Even for these already harmonized tariffs, individual countries may opt for changes twice a year. Meanwhile, trade frictions continue among the member countries. Some countries have imposed contingency protection on imports from other members, and major obstacles remain in the transit shipment of exports for some member countries. The Kyrgyz authorities, for example, have complained about various fees imposed on their transit trucks crossing Kazakhstan. Also, the border with Uzbekistan has de facto been closed by the Uzbek authorities.

In February 2003, Kazakhstan, Russia, Ukraine and Belarus agreed to create a "Single Economic Space" among themselves by September 2003. It is envisaged that a supranational body will be formed to regulate regional trade and tariffs in a newly created free trade area, with an ultimate goal of establishing a "Regional Cooperation Organization" following the EU model. The introduction of a common currency is also a long-term goal. The four countries also agreed to coordinate their efforts to join the WTO. It is not clear at this stage how this new initiative will be different from several earlier agreements which have proved to be ineffective in promoting regional trade. To produce tangible economic benefits, such agreements must first focus on practical issues of regional cooperation, such as concerted efforts in reducing tariff and non-tariff barriers, removing artificial impediments to transit trade, and strengthening cooperation in infrastructure projects.

26. **The strong current external position and outlook supports the authorities' plans for complete capital account liberalization by 2007.** Recently, MAE provided technical assistance on this issue. While the thinking of the authorities is still influenced by fears of capital outflows, the mission noted its concerns about the risk of large capital inflows and the authorities' ability to manage these risks. The building of a sound financial system will be key to safeguarding macroeconomic stability regardless of the pace of liberalization.

D. Structural Reform

27. **The pace of structural transformation remains slow.** The foreign investor's council has criticized the restrictive policies on employment of foreign experts, procurement, transfer pricing regulations, the delivery of government services, corruption, and the high cost of doing business

in general. The authorities intend to improve the investment environment. Recently steps have been taken to reduce overlapping and heavy-handed inspections of small enterprises. The authorities have also begun to implement a much improved tariff methodology with the help of the EBRD.

28. **The discussions revealed an undercurrent in favor of activist industrial and import substitution policies.** The President's recent speech foreshadowed a major capitalization of these initiatives. The authorities stated that they are well aware of the shortcomings of an inward-looking development strategy and the poor performance of institutions such as development banks in other countries. However, they saw a need for state support for the development of new high technology and high value-adding industry to create jobs. The government intends to complement private sector activity, but not to replace or unduly influence private investment. Private sector participation in the new Investment Fund was planned. The mission cautioned against governmental institutions "picking winners" and channeling oil wealth to favored industries. Instead, the government should invest in well-conceived infrastructure projects which would complement, not substitute for, private sector investment.

29. **The authorities are working to extend the progress made on banking supervision to the increasingly important pension and insurance sectors.** They intend to devolve financial sector supervision into an independent agency from 2004. They acknowledged the importance of securing adequate financing for the agency to assure independence and maintenance of professional standards. They welcomed plans for a focused follow-up FSAP in FY 2004.

30. **The proposed revision to the land code, which would introduce private property rights on arable land, is an important step forward.** The authorities recognized the concerns by farmers regarding the fairness of distribution of land and the duration of the process to achieve full private ownership. The mission cautioned against government plans to intensify direct intervention in the supply of inputs and purchase of outputs in agriculture, including through the Food Corporation.

31. **The authorities recognize the importance of reform and capacity building in the health and education sectors as critical for economic development and social stability.** These issues were clearly identified in the authorities' medium-term economic policy and planning documents.⁸ The mission expressed concern that the World Bank and Asian Development Bank were not engaged in the elaboration and implementation of programs in these areas given the expertise they could bring to these important areas. The authorities indicated that this reflected an absence of financing need, rather than a policy of excluding their involvement.

E. Governance and Transparency

32. **The 2002 fiscal ROSC commended the adherence to internationally accepted standards in several areas, in particular treasury operations and development of a medium-**

⁸ "Recommendations on the Indicative Plan for Socio-Economic Development in 2001-06" and "Action Plan" attached to Government Resolution 470.

term budget framework. It also noted the need to deepen reforms, including by; (i) establishing auditing institutions and oversight agencies; (ii) improving transparency in operations of its extrabudgetary funds and intergovernmental fiscal relations; and (iii) further simplification of procedures related to the NFRK.

33. **The 2002 data module ROSC noted that macroeconomic statistics had improved significantly.** Kazakhstan's data dissemination practices more than meet the GDDS recommendations. The quality and coverage of economic statistics continues to improve and are generally adequate for surveillance purposes. Concerns related to the existence of large off-budget accounts (see below), whose operations were not fully recorded, and inconsistencies in data across sectors. Shortly after the mission, Kazakhstan subscribed to the SDDS.

34. **The mission emphasized the importance of continually safeguarding the mounting wealth in the NFRK through strict adherence to budgetary procedures and increased transparency, including by regularly publishing the external audit report.** It encouraged the authorities to consider making public new agreements with oil companies and providing regular information to the public about oil bonuses, privatization proceeds, and other payments. The authorities responded that they would consider this recommendation.

35. **In April 2002, the Prime Minister informed parliament of the existence of previously undisclosed accounts held abroad by the government.** These accounts had received, over time, proceeds linked to the sale of shares in several oil fields to foreign investors in 1996. Balances in these accounts were occasionally drawn on to finance the budget and the construction of the new capital, Astana. The authorities provided the staff in April 2003 with revisions to the international investment position (IIP), ranging up to just over half a billion dollars at times, and the balance of payments data linked to transactions involving these accounts. According to the information provided, a sum of \$321 million from these accounts was transferred to the NFRK in May 2002. The authorities have stated that the revisions to the IIP take account of all government accounts held abroad.

F. Medium-Term Outlook and Vulnerability

36. **The medium- to long-term economic outlook is increasingly favorable.** In addition to the rapid development of existing petroleum fields, Kazakhstan secured in 2002 several strategic agreements with Russia on the Caspian Sea offshore fields and improved access to oil and gas pipelines to western markets. Given the strategic nature and size of Kazakhstan's petroleum reserves, investment in the sector and production are relatively isolated from short-term price fluctuations. Only in the event of investor perceptions of a significant long-term oil price decline (to well below \$15/bbl), or a sharp deterioration in the business climate would there be cause for serious concern and major spillover effects on the non-oil economy.

37. **The medium-term outlook discussed with the authorities cautiously projects sustained growth at above 7 percent.** The assumptions include a gradual nominal appreciation of the tenge, supporting lower inflation and sharply higher imports, in particular of services. Despite the strong growth of petroleum export volumes, the external current account is expected to register small deficits after 2004 as oil prices are assumed to decline, large FDI-related imports continue, and earnings of foreign investors rise. If the revised budget is passed by parliament, somewhat larger current account deficits are likely to materialize. The capital account is expected to remain mostly in surplus despite large projected outflows by domestic private entities (including investment in neighboring countries), the pension funds, the amortization of the remaining public sector Eurobonds, fiscal sterilization flows into the NFRK, and accelerated amortization of intracompany loans in the oil sector. The primary risk to these projections (and financial stability) is that of a much stronger capital account. Also, the projected increases in imports may prove to be too high and the current account may stay in surplus throughout.

38. **The medium-term fiscal profile assumes that, consistent with current policies, the expenditure-to-GDP ratio would remain broadly unchanged, while initially revenues would decline relative to GDP with falling world market prices of oil.** The overall government balance would move close to zero after 2004. The non-oil fiscal deficit would initially rise to close to 5 percent of GDP, but then decline before the end of the projection period, which just precedes the expected huge increases in oil income from 2010 forward. Such non-oil deficits are well below the range suggested by a permanent-income analysis.⁹ With the intended revision to the fiscal stance in 2003 and 2004, the non-oil fiscal deficit would be higher in the early years, but much will depend on policies in the outer years.

39. **Kazakhstan's debt sustainability analysis (tables attached) suggests a comfortable outlook.**¹⁰ While gross total external debt levels are not low, some two-thirds are accounted for by intracompany debt, associated with FDI, which has no definite service profile. Official external debt, net of assets accumulated in the NFRK, is projected to decline to single digit levels in percent of GDP by 2006. As public sector domestic debt amounts to only around 3 percent of GDP, total public sector debt was not subject to a separate stress test.

⁹ See paragraph 37 of the 2001 Article IV consultation report (SM/02/5, 1/4/02) and the analysis in the accompanying Selected Issues paper (SM/02/11, 1/8/02). These calculations were based on lower earnings from oil.

¹⁰ A six-year historical average was used as the 10-year period would be severely distorted by the early years of transition. However, even the six-year historical average is a poor indicator of prospective sustainability, given the major structural changes and oil sector developments in recent years.

Medium-Term Scenarios

	Baseline				Low Case			
	2004	2005	2008	2010	2004	2005	2008	2010
	(Percentage change, unless otherwise indicated)							
Real GDP growth	7.2	7.0	5.5	7.5	4.0	4.0	6.0	6.5
Petroleum production (millions of MT)	59.1	64.2	82.1	96.7	59.1	64.2	73.1	87.7
CPI inflation (eop)	5.0	5.0	4.0	4.0	6.5	8.0	5.0	5.0
	(In percent of GDP)							
Consumption	67.2	68.4	69.0	68.4	76.7	77.1	71.0	69.3
Gross fixed investment	28.5	29.0	30.0	30.0	25.5	24.0	27.0	28.0
General Government balance	2.1	0.5	-0.1	0.2	-1.1	-1.5	-0.7	-0.4
o/w nonoil balance	-4.0	-4.7	-3.6	-3.2	-3.5	-3.5	-2.5	-2.6
Revenue	24.2	23.4	22.4	22.4	21.0	20.4	20.4	21.0
o/w oil revenue	6.2	5.2	3.5	3.5	2.4	2.0	1.8	2.2
Expenditure	22.1	22.8	22.5	22.2	22.1	22.2	21.1	21.4
Allocated to NFRK (- = increase)	-3.1	-0.9	-0.9	-0.8	1.2	0.8	0.1	-0.3
External current account balance	0.4	-1.3	-2.0	-1.1	-4.6	-3.6	-2.1	-1.3
Total external debt	63.7	62.2	53.8	48.0	81.9	85.0	77.9	73.3
o/w excl. intracompany	24.7	23.6	20.2	17.8	32.5	33.5	29.5	26.8
	(In billions of U.S. dollars)							
Exports (G&S)	15.1	16.0	20.1	24.7	10.9	11.8	16.1	19.4
o/w petroleum	6.9	7.0	8.2	10.3	3.1	3.3	5.0	6.5
Gross official reserves	4.5	5.0	6.6	7.9	4.0	4.3	5.5	6.5
NFRK balance	4.3	4.9	5.9	7.0	3.0	2.9	2.6	2.7
(in percent of fiscal expenditure)	60.8	56.8	53.0	50.0	56.8	51.5	37.1	31.0
GDP per capita (in U.S. dollars)	2,015	2,230	3,032	3,738	1,606	1,659	2,227	2,727
World petroleum price (\$/bbl)	23.5	22.0	20.0	20.8	12.0	12.0	15.0	15.6

40. **A more meaningful sustainability test involves a scenario under which oil prices fall to \$12/bbl for 2004-05 before recovering to \$15/bbl.** Petroleum sector investment would be delayed and output would be reduced for several years. Real growth would be severely reduced. The fiscal shock would be cushioned by use of NFRK assets in the period 2004 to 2008, and a nominal depreciation of the tenge while fiscal adjustment takes place. Expenditure outlays, especially investment, would fall initially before recovering gradually. NFRK assets would stabilize after 2008. The drop in export earnings would also be partly compensated by much lower intracompany loan pay downs (as amortization is a function of profits from oil). While overall debt levels would rise modestly compared to the significant decline under the baseline scenario, external public sector debt would remain broadly unchanged.

IV. STAFF APPRAISAL

41. **Kazakhstan continues to reap the benefits from early structural reforms and prudent macroeconomic management.** Led by the oil sector, and strongly supported by a favorable external environment, real GDP growth continues to be high and broad based. Nevertheless, poverty remains a serious concern, especially in the rural areas.

42. **The maintenance of a strong fiscal position has played a major role in containing aggregate demand and inflationary pressures.** While it was laudable that high oil prices did not lead to a spending boom, the sharp reduction in the non-oil budget deficit in 2002 was unnecessary.

43. **Monetary policy has also supported macroeconomic stability,** but the goals of preventing a real appreciation of the tenge and containing inflation are potentially conflicting

objectives. Despite the sterilization of budget surpluses in the NFRK, monetary policy has recently come under increased pressure and inflation is edging up.

44. **Conditions are favorable for strong macroeconomic performance to continue.** Annual growth of the economy could easily exceed 7 percent in 2003 and beyond. With oil prices at high levels, the fiscal surplus should reach well over 4 percent of GDP in 2003—although the expected supplementary budget may reduce the surplus somewhat—and an external current account surplus is also expected. The intention to reduce inflation to below 6 percent is laudable, but may prove difficult to achieve.

45. **The relaxation of the fiscal stance foreshadowed in the President's recent speech for 2003 and 2004 is welcome.** The increases in pensions and public sector wages are needed to ensure more adequate income levels of retirees and a better qualified civil service. Regrettably, the funding provided for institutions such as the Development Bank and other entities will increase the role of the government in the economy and could distort even more the playing field. The gradual redistribution of oil wealth to the private sector through selected tax cuts as envisaged for 2004 is also appropriate, but further steps in this direction should not be rushed.

46. **A large part of the sustained increases in income from oil should be dedicated to raising education and health standards, developing physical infrastructure, and funding greater targeted social outlays.** There is, however, a need to bolster institutional capacities to ensure the appropriate use of increased expenditures. A well thought-out public sector investment program needs to be established.

47. **It will be important to continue to add the revenues generated by unusually high world market prices for petroleum to the NFRK.** This will ease the burden on monetary policy and build up a protective buffer against unforeseen pressures on the balance of payments and the budget. It will be necessary to safeguard continually the mounting wealth in the NFRK through strict adherence to budgetary procedures and increased transparency, including by publishing regularly the external audit report. Making new agreements with oil companies public and publishing regularly information about oil bonuses, privatization proceeds, and other payments secured, will also be essential.

48. **While the real exchange rate will unavoidably appreciate over the medium-term, the potential loss of competitiveness over the medium term in the non-oil sector can be substantially reduced or avoided through increases in productivity.** Appropriate measures would include further trade liberalization, accelerated structural reform, and improved governance. Cuts in selected tax rates would also boost incomes and private sector profitability and encourage further investment, as would needed improvements in the overall business climate.

49. **Promoting non-oil sector development through an activist industrial policy and import substitution needs to be avoided.** It is worrisome that Kazakhstan is assembling a formidable arsenal for this purpose. There is a high risk that employing these instruments to their full capacity would introduce serious distortions and misallocation of resources.

50. **Improvement to the business climate is a critical precondition for sustained and broad-based development.** The investment climate is particularly harsh for small and medium-

size domestic and foreign investors. Restrictions on the employment of foreign experts, transfer pricing regulations, poor delivery of government services, and corruption contribute to the high cost of doing business in Kazakhstan.

51. **Restructuring and capacity building in the health and education sectors will be of critical importance for economic development and social stability.** It is welcome that the need for action in these areas has been clearly identified in the authorities' plans. However, it is regrettable that there are currently no plans for increased outlays in this area. It would seem advisable to engage more fully international expertise in the development of the health and education sectors.

52. **Continuing efforts to achieve WTO accession are laudable,** but accession should not delay trade reforms such as lowering the level and dispersion of external tariffs, and reducing non-tariff barriers. It will also be important to remove obstacles to regional trade and transport. Attempts to create regional trading blocks should, however, not be at the expense of progress towards joining WTO.

53. **The authorities are encouraged to complete the treasury modernization project in a timely manner and incorporate a wage module into the system at an early stage.** The principle of a single treasury account needs to be preserved.

54. **The reform of the utility tariffs methodology is an important step for improving the performance of the utility sector.**

55. **Significant progress was made in the financial sector as regards the payment system, accounting, auditing, and banking supervision.** The prospective creation of an independent regulatory agency responsible for the entire financial sector, including the increasingly important pension and insurance sectors, is welcome. The increased attention to internal risk management and stress testing by banks is also appropriate as is the requirement for banks to take into account borrowers' foreign currency earning capacity before extending loans in foreign currency. Recent revisions of the bankruptcy code are welcome.

56. **Kazakhstan has made significant progress with respect to governance and transparency in 2002.** The fiscal ROSC has resulted in an agenda for further improving the oversight and transparency of state institutions. The completion of the data ROSC and Kazakhstan's subscription to the SDDS in March 2003 is highly welcome. The data provided to the Fund for the purpose of surveillance are fully adequate. The authorities are encouraged to disseminate key macroeconomic statistics more widely, including through official websites and by again consenting to the publication of the staff report.

57. **The recent corrections provided to the international investment position and to other balance of payments data are welcome.** These corrections bring Kazakhstan into conformity with the requirements of Article VIII, Section 5. No action by the Executive Board is proposed.

58. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Kazakhstan: Selected Macroeconomic and Financial Indicators, 2000-2010
(Percentage change over the same period one year earlier unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Actual 1/		Prelim. Estimate				Projections				
Real GDP (year-on-year)	9.8	13.5	9.5	7.5	7.2	7.0	7.5	7.5	5.5	7.5	7.5
Consumer prices											
End-of-period from end of same period previous year	9.8	6.4	6.6	5.5	5.0	5.0	4.5	4.5	4.0	4.0	4.0
Period average	13.3	8.3	5.9	6.4	5.0	5.0	4.7	4.5	4.2	4.0	4.0
Exchange rate (in tenge per U.S. dollar)											
End-of-period	145.4	150.9	155.9	...	...	...	...	...	...	...	...
Period average	142.3	146.9	153.5	...	...	...	...	...	...	...	...
Real exchange rate (end-of-period from end of previous yr)	1.0	1.0	0.8	...	...	...	...	...	...	...	...
Fiscal accounts (in percent of GDP)											
General government balance	-0.8	2.7	1.4	4.1	2.1	0.5	0.5	0.3	-0.1	0.0	0.2
of which: Non-oil balance	-4.1	-4.0	-3.0	-3.8	-4.0	-4.7	-4.5	-4.1	-3.6	-3.3	-3.2
Revenues and Grants	21.7	25.6	22.6	26.0	24.2	23.4	23.4	23.3	22.4	22.2	22.4
of which: Non-oil revenues	18.4	19.0	18.2	18.1	18.1	18.2	18.4	18.8	18.9	18.9	18.9
Expenditures	22.5	23.0	21.2	21.9	22.1	22.8	22.9	22.9	22.5	22.2	22.2
Financing	1.2	-2.9	-1.5	-4.1	-2.1	-0.5	-0.5	-0.3	0.1	0.0	-0.2
Domestic financing	-0.8	-0.7	0.9	-0.7	1.2	0.1	0.0	1.0	0.5	0.5	0.2
Foreign, net	1.2	0.9	-1.5	0.3	-0.7	-0.1	0.2	-0.6	0.2	0.2	0.2
Privatization receipts	0.8	2.5	0.5	1.2	0.4	0.4	0.3	0.3	0.3	0.3	0.2
Allocation to National Fund	...	-5.6	-1.4	-4.9	-3.1	-0.9	-1.0	-1.0	-0.9	-0.9	-0.8
Monetary accounts											
Reserve money growth, (year-on-year)	5.3	30.9	18.1	...	...	...	...	...	...	...	...
Broad money growth, (year-on-year)	45.9	42.8	34.1	...	...	...	...	...	...	...	...
Broad money velocity (period average)	7.8	6.6	5.8	...	...	...	...	...	...	...	...
NBK Refinancing Rate (end-of-period; percent)	14.0	9.0	7.5	...	...	...	...	...	...	...	...
Interest on 3-Month Treasury Bills (end-of-period; percent)	6.6	5.9	5.8	...	...	...	...	...	...	...	...
External accounts											
Trade											
Exports of Goods and Services (million US dollars)	10,600	10,430	11,774	14,249	15,085	15,950	17,516	19,341	20,088	22,437	24,749
Imports of Goods and Services (million US dollars)	8,852	10,432	11,381	12,658	13,716	15,014	16,306	17,925	19,574	21,547	23,768
Current account balance											
In millions of U.S. dollars	880	-880	-472	442	127	-450	-178	-29	-982	-677	-693
In percent of GDP	4.8	-4.0	-1.9	1.5	0.4	-1.3	-0.4	-0.1	-2.0	-1.2	-1.1
NBK gross reserves											
In millions of U.S. dollars (end-of-period)	2,096	2,508	3,136	4,000	4,500	5,000	5,500	6,000	6,600	7,200	7,900
In months of imports of goods and services	2.8	2.9	3.3	3.7	3.9	3.9	4.0	4.0	4.0	4.0	4.0
In percent of the stock of short-term debt	139.2	112.1	128.4	138.4	162.2	164.9	153.8	163.9	168.4	178.4	185.0
NFRK (end-of-period; US\$ mln) 4/	...	1,240	1,917	3,329	4,300	4,629	5,036	5,504	5,947	6,432	6,949
Debt											
Public and publicly guaranteed total debt (\$ million)	4,580	4,408	4,283	4,082	4,278	4,298	4,404	4,605	4,976	4,838	5,094
In percent of GDP	27.2	20.5	17.6	14.7	13.5	12.2	11.1	10.3	10.1	8.7	8.2
Public and publicly guaranteed external debt (\$ million)	3,979	3,852	3,501	3,495	3,282	3,263	3,354	3,104	3,203	2,797	2,892
In percent of GDP	21.8	17.4	14.3	12.0	10.4	9.2	8.4	6.9	6.5	5.1	4.7
Total public external debt service (percent of G&S exports)	8.5	4.8	7.7	3.6	4.8	2.3	2.1	3.6	1.8	1.6	1.4
Interest payments to exports of goods and services (percent)	2.3	2.3	2.0	1.5	1.4	1.1	1.0	0.7	0.7	0.6	0.6
Amortization to exports of goods and services (percent)	6.2	2.5	5.8	2.0	3.3	1.2	1.1	2.9	1.0	0.9	0.8
Saving-Investment Balance (percent of GDP)											
Final Consumption	73.3	72.1	68.3	66.0	67.2	68.4	68.0	67.8	69.0	68.4	68.4
Net Exports of Goods and Services	8.6	0.0	1.6	5.5	4.3	2.6	3.0	3.2	1.0	1.6	1.6
Gross Capital Formation = Gross Savings	18.1	27.9	30.1	28.5	28.5	29.0	29.0	29.0	30.0	30.0	30.0
Domestic Savings	22.9	23.9	28.2	30.0	28.9	27.7	28.6	28.9	28.0	28.8	28.9
Government	1.5	6.5	5.3	8.3	6.5	6.3	6.8	6.4	6.3	6.3	6.3
Private Sector	21.4	17.4	22.9	21.7	22.4	21.4	21.8	22.6	21.7	22.5	22.6
External Savings	-4.8	4.0	1.9	-1.5	-0.4	1.3	0.4	0.1	2.0	1.2	1.1
Memorandum items:											
Nominal GDP for the period (in billions of tenge)	2,600	3,251	3,747	4,319	4,655	5,143	5,719	6,399	6,963	7,732	8,588
Oil Price (in U.S. dollar per barrel)	28.2	24.3	24.9	28.0	23.5	22.0	21.0	21.0	20.0	20.4	20.8

Sources: Kazakhstani authorities; and Fund staff estimates and projections.

1/ The data for 2000-02 includes adjustments to reflect revisions of the balance of payments by the National Bank and the staff.

2002 values are staff estimates based on preliminary data for GDP by production, balance of payments, and investment from enterprise surveys.

2/ Vis-à-vis U.S. dollar. A positive sign indicates a real appreciation.

3/ NBK notes starting 2001.

4/ Excludes transitory tenge denominated holdings.

Table 2. Kazakhstan: General Government Fiscal Operations, 2002-2010

	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Preliminary	Projections							
(In billions of tenge)									
Total revenue and grants	848	1121	1129	1203	1336	1489	1562	1713	1923
<i>Of which</i> : Oil revenue	165	338	287	269	284	283	246	252	298
Tax	165	307	338	323	354	353	318	328	379
Non-tax	0	31	0	0	0	0	0	0	0
Current revenue	838	1113	1117	1190	1321	1472	1544	1694	1901
Capital revenue	9	9	12	13	14	16	18	20	22
Total expenditure and net lending and transfers	794	946	1029	1175	1309	1468	1568	1713	1904
Total expenditure and net lending	794	946	1029	1175	1309	1468	1568	1713	1904
Total expenditure	776	921	1002	1144	1275	1430	1527	1668	1853
Current expenditure	649	760	828	878	949	1080	1126	1229	1381
Capital expenditure	126	161	174	246	287	316	345	382	427
Net lending	18	25	27	30	34	38	41	46	51
Statistical discrepancy	3								
Overall budget balance	57	175	99	28	26	21	-6	0	19
Financing	-57	-175	-99	-28	-26	-21	6	0	-19
Domestic financing (net)	33	-30	55	4	1	63	36	35	20
Foreign financing, net	-56	14	-31	-4	12	-37	13	13	13
Disbursements	18	35	35	19	34	36	36	36	36
Amortization	74	21	67	23	22	73	24	23	23
Privatization receipts	19	51	20	20	20	20	20	20	20
National Fund of Republic of Kazakhstan (NFRK)	-53	-210	-143	-48	-59	-67	-63	-68	-72
(In percent of GDP)									
Total revenue and grants	22.6	26.0	24.2	23.4	23.4	23.3	22.4	22.2	22.4
<i>Of which</i> : Oil revenue	4.4	7.8	6.2	5.2	5.0	4.4	3.5	3.3	3.5
Tax	4.4	7.1	7.3	6.3	6.2	5.5	4.6	4.2	4.4
Non-tax	0.0	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current revenue	22.4	25.8	24.0	23.1	23.1	23.0	22.2	21.9	22.1
Capital revenue	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Total expenditure and net lending and transfers	21.2	21.9	22.1	22.8	22.9	22.9	22.5	22.2	22.2
Total expenditure and net lending	21.2	21.9	22.1	22.8	22.9	22.9	22.5	22.2	22.2
Total expenditure	20.7	21.3	21.5	22.2	22.3	22.3	21.9	21.6	21.6
Current expenditure	17.3	17.6	17.8	17.1	16.6	16.9	16.2	15.9	16.1
Capital expenditure	3.4	3.7	3.7	4.8	5.0	4.9	5.0	4.9	5.0
Net lending	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Statistical discrepancy	0.1								
Overall budget balance	1.5	4.1	2.1	0.5	0.5	0.3	-0.1	0.0	0.2
Financing	-1.5	-4.1	-2.1	-0.5	-0.5	-0.3	0.1	0.0	-0.2
Domestic financing (net)	0.9	-0.7	1.2	0.1	0.0	1.0	0.5	0.5	0.2
Foreign financing, net	-1.5	0.3	-0.7	-0.1	0.2	-0.6	0.2	0.2	0.2
Disbursements	0.5	0.8	0.8	0.4	0.6	0.6	0.5	0.5	0.4
Amortization	2.0	0.5	1.4	0.4	0.4	1.1	0.3	0.3	0.3
Privatization receipts	0.5	1.2	0.4	0.4	0.3	0.3	0.3	0.3	0.2
National Fund of Republic of Kazakhstan (NFRK)	-1.4	-4.9	-3.1	-0.9	-1.0	-1.0	-0.9	-0.9	-0.8
Memorandum items:									
Nominal GDP (tenge billions)	3,747	4,319	4,655	5,143	5,719	6,399	6,963	7,732	8,588
Non-oil balance (tenge billions)	-112	-163	-188	-241	-257	-262	-252	-252	-279
(In percent of GDP)	-3.0	-3.8	-4.0	-4.7	-4.5	-4.1	-3.6	-3.3	-3.2
Current fiscal balance (tenge billions)	170	328	261	261	298	321	321	363	425
(In percent of GDP)	4.5	7.6	5.6	5.1	5.2	5.0	4.6	4.7	4.9
Balance of NFRK (\$ millions)	1,917	3,329	4,300	4,629	5,036	5,503	5,946	6,431	6,949
Balance of NFRK (tenge billions)	298	490	626	667	719	777	831	890	952
(In percent of expenditure)	37.6	51.7	60.8	56.8	54.9	53.0	53.0	52.0	50.0

Source: Ministry of Finance; and staff estimates and projections.

Table 3. Kazakhstan: Monetary Survey, 2000-March 2003 1/
(In billions of tenge, end period stocks unless otherwise indicated)

	2000		2001				2002			2003
	December	March	June	September	December	March	June	September	December	March
National Bank of Kazakhstan										
Net Foreign Assets	302.0	356.4	336.1	362.5	377.9	400.0	434.0	483.9	488.5	595.3
Net domestic assets	-167.4	-225.1	-192.2	-203.4	-201.6	-244.2	-258.0	-298.3	-280.2	-388.9
Domestic credit	-47.0	-120.1	-81.5	-78.0	-71.9	-111.0	-115.9	-91.0	-113.4	-231.4
Credit to Government	-14.1	-94.1	-73.0	-76.6	-59.5	-91.6	-86.1	-56.7	-56.0	-120.3
Credit to banks 2/	-38.8	-20.5	-3.8	-3.1	-5.4	-4.6	-7.8	-11.4	-24.6	-62.3
Credit to the rest of the economy 2/	6.0	-5.5	-4.6	1.7	-7.0	-14.8	-22.0	-22.9	-32.7	-48.9
Other items (net)	-120.4	-105.0	-110.7	-125.4	-129.7	-133.1	-142.1	-207.4	-166.8	-157.5
Reserve Money	134.7	131.4	143.8	159.0	176.3	155.8	176.0	185.5	208.3	206.4
Currency outside NBK	116.3	110.8	119.3	133.9	145.5	135.9	146.9	155.4	177.9	175.8
Deposits	18.3	20.6	24.5	25.1	30.8	19.9	29.1	30.1	30.4	30.6
Banking System										
Net Foreign Assets	306.0	348.5	322.5	352.7	313.8	332.8	346.2	399.8	402.1	476.7
Net domestic assets	101.1	79.4	153.8	182.9	267.1	243.2	295.0	298.3	399.6	369.2
Domestic credit	346.7	302.8	396.5	449.2	560.1	544.9	616.8	692.2	778.9	756.4
Net credit to Government	40.6	-32.4	-11.8	-11.4	8.8	-13.2	13.0	44.7	38.5	-15.2
Credit to the economy	306.1	335.1	408.4	460.5	547.6	552.2	599.6	643.9	738.6	767.2
Claims on Local Government	...	...	...	...	3.8	6.0	4.3	3.6	1.8	4.4
Capital Accounts and Other Items Net	-245.6	-223.4	-242.7	-266.2	-293.0	-301.7	-321.8	-393.9	-379.4	-387.2
NBK Notes outside the banking system 2/	7.6	9.1	8.2	1.8	10.6	18.4	25.5	26.4	36.8	53.0
Broad Money	399.5	418.7	468.1	533.8	570.4	557.7	615.7	671.7	764.9	793.0
Currency in circulation	106.4	102.0	110.5	124.2	131.2	123.9	135.0	141.4	161.7	159.2
Deposits	293.0	316.7	357.5	409.6	439.2	433.8	480.7	530.4	603.2	633.8
Tenge deposits	143.6	153.7	177.8	174.5	173.4	168.6	188.3	223.8	241.6	283.6
Foreign exchange deposits	149.4	163.1	179.7	235.1	265.9	265.2	292.4	306.6	361.6	350.1
Memorandum Items:										
Net International Reserves (in \$ millions)	2,093.7	2,453.8	2,297.6	2,456.7	2,506.2	2,625.4	2,831.0	3,132.0	3,135.7	3,923.3
NFRK (in \$ millions) 3/		660.0	956.6	1182.3	1,240.4	1,306.3	1,655.6	1,669.6	1,917.3	1999.0
Annual Growth Rates (in percent)										
Broad money	45.9	60.8	47.1	48.4	42.8	33.2	31.5	25.8	34.1	42.2
Reserve money	5.3	28.6	19.3	15.4	30.9	18.6	22.4	16.7	18.1	32.5
Credit to the economy	81.0	83.7	93.1	87.5	78.9	64.8	46.8	39.8	34.9	38.9

Sources: Data provided by the Kazakhstani authorities; and staff estimates.

1/ The Development Bank of Kazakhstan (DBK) has been removed from the monetary survey as it is not a deposit taking money bank. Nevertheless, some claims on, and liabilities to, the DBK (since September 2001) remain to be reclassified.

2/ NBK notes holdings by non-banks are staff estimates for December 2000 and March 2001.

3/ Transitory deposits in tenge not included.

Table 4. Kazakhstan: Balance of Payments, 2000-2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Actual		Prelim.				Projections				
Current Account	880	-880	-472	442	127	-450	-178	-29	-982	-677	-693
Trade balance	2620	1516	2540	3817	3689	3395	3802	4145	3534	4069	4322
Exports (f.o.b.)	9468	9124	10186	12467	13133	13816	15170	16762	17249	19316	21319
Oil and gas condensate	4429	4463	5157	7015	6949	7045	7831	8801	8239	9399	10322
Non-oil exports 1/	5039	4661	5029	5452	6184	6771	7340	7961	9010	9917	10996
Imports (f.o.b.) 2/	-6848	-7607	-7646	-8651	-9444	-10421	-11368	-12618	-13715	-15248	-16996
Services and income balance	-1989	-2628	-3126	-3495	-3682	-3965	-4100	-4293	-4636	-4866	-5135
Services, net	-872	-1518	-2147	-2226	-2319	-2459	-2592	-2729	-3021	-3179	-3341
Income, net	-1117	-1110	-979	-1269	-1362	-1506	-1508	-1564	-1615	-1687	-1794
of which: income to direct investors	-934	-1033	-916	-1196	-1398	-1652	-1681	-1802	-1878	-1979	-2095
Current transfers	249	232	113	120	120	120	120	120	120	120	120
Capital and Financial Account	811	2249	1232	422	373	950	678	529	1582	1277	1393
Capital transfers, net	-291	-197	-107	-200	-200	-200	-200	-200	-200	-200	-200
Foreign direct investment	1278	3006	2138	2025	2391	2806	2296	2533	2308	2518	2739
Amortization of intra-company liabilities	-1411	-1792	-1514	-1800	-1900	-1800	-2100	-2000	-1900	-1900	-1900
Portfolio investment, net	-55	-1323	-927	-1522	-1330	-651	-969	-1170	-677	-673	-834
of which: National Fund 3/	...	-1270	-327	-1412	-971	-329	-407	-467	-443	-485	-518
Public sector Eurobonds, net	11	-103	-449	0	-300	0	0	-350	0	0	0
Other investment											
Medium- and long-term loans and credits, net	243	641	786	479	497	406	545	583	615	651	690
Short-term and other capital, net	-364	122	-657	-359	-985	-1411	-994	-1218	-464	-1019	-1001
Errors and omissions	-1106	-939	-132	0	0	0	0	0	0	0	0
Overall Balance	585	431	628	864	500	500	500	500	600	600	700
Financing	-585	-431	-628	-864	-500	-500	-500	-500	-600	-600	-700
Net international reserves of the NBK (increase -)	-585	-431	-628	-864	-500	-500	-500	-500	-600	-600	-700
Memorandum Items:											
Current account (in percent of annual GDP)	4.8	-4.0	-1.9	1.5	0.4	-1.3	-0.4	-0.1	-2.0	-1.2	-1.1
Exports in percent of GDP	51.8	41.2	41.7	42.9	41.5	39.1	38.2	37.4	35.0	34.9	34.4
of which: oil exports	24.2	20.2	21.1	24.1	21.9	19.9	19.7	19.6	16.7	17.0	16.6
Imports in percent of GDP	37.4	34.4	31.3	29.7	29.8	29.5	28.6	28.1	27.8	27.6	27.4
Annual growth rate (in percent)											
exports	54.6	-3.6	11.6	22.4	5.3	5.2	9.8	10.5	2.9	12.0	10.4
non-oil exports	27.6	-7.5	7.9	8.4	13.4	9.5	8.4	8.5	13.2	10.1	10.9
imports	21.3	11.1	0.5	13.1	9.2	10.3	9.1	11.0	8.7	11.2	11.5
Exports of crude oil and gas condensate, million tons	27.7	32.4	39.3	44.2	50.1	54.6	63.8	71.3	70.7	78.4	83.8
NBK gross international reserves (in millions of U.S. dollars)	2096	2508	3136	4000	4500	5000	5500	6000	6600	7200	7900
in months of imports of goods and non-factor services	2.8	2.9	3.3	3.8	3.9	4.0	4.0	4.0	4.0	4.0	4.0
National Fund (incl. interest), end of period stock	...	1270	1917	3329	4300	4629	5036	5503	5946	6431	6949
External debt in percent of GDP	69.0	68.4	71.2	64.8	63.7	62.2	59.1	55.5	53.8	50.3	48.0
excluding intra-company loans	31.2	29.5	29.1	26.3	24.7	23.6	22.3	20.5	20.2	18.5	17.8
Public external debt service in percent of exports of gnfs	8.5	4.8	7.7	3.6	4.8	2.3	2.1	3.6	1.8	1.6	1.4
World oil price (U.S. dollars per barrel)	28.2	24.3	24.9	28.0	23.5	22.0	21.0	21.0	20.0	20.4	20.8

Sources: The Kazakh authorities and the Fund staff estimates.

1/ Agriculture and metals account for the main part of projected non-oil export growth.

2/ Numbers for 2001 and 2002 are Fund staff estimates.

3/ For 2001 and 2002 the numbers also reflect the effect of market valuation.

Table 5. Kazakhstan: External Debt Sustainability Assessment, 1997-2010
(percent of GDP unless otherwise indicated)

	Actuals					Prelim. 2002	Staff Projections							
	1997	1998	1999	2000	2001		2003	2004	2005	2006	2007	2008	2009	2010
A. Total external debt outstanding at year-end														
Baseline														
Stress tests:	40.8	44.8	71.0	69.0	68.4	71.2	64.8	63.7	62.2	59.1	55.5	53.8	50.3	48.0
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2010							78.2	83.5	88.4	91.8	95.1	96.2	96.9	98.4
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							66.6	67.2	65.5	62.2	58.3	56.5	52.8	50.3
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							73.8	82.2	79.6	75.2	70.3	67.8	63.3	60.0
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							95.2	126.1	120.6	113.3	105.3	100.9	94.0	88.4
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004							77.3	87.0	84.0	79.3	74.1	71.4	66.6	63.1
6. Combination of 2-5 using one standard deviation shocks							98.0	128.9	123.3	115.7	107.6	103.1	95.9	90.2
7. One time 30 percent nominal depreciation in 2003							94.6	92.2	88.9	83.9	78.3	75.4	70.3	66.5
B. External debt, excluding intra-company debt														
Baseline														
Stress tests:	29.5	29.5	34.6	31.2	29.5	29.1	26.3	24.7	23.6	22.3	20.5	20.2	18.5	17.8
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2010							33.6	36.1	37.9	39.6	41.0	40.8	40.3	40.6
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							27.0	26.3	25.1	23.6	21.8	21.3	19.6	18.8
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							30.8	32.3	30.7	28.9	26.6	25.9	23.8	22.7
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							38.8	50.4	47.7	44.6	41.0	39.5	36.4	34.3
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004							37.5	45.6	43.1	40.4	37.1	35.8	33.0	31.2
6. Combination of 2-5 using one standard deviation shocks							43.7	59.4	56.1	52.4	48.2	46.3	42.6	40.1
7. One time 30 percent nominal depreciation in 2003							38.6	36.6	34.7	32.6	29.9	29.1	26.7	25.4
C. External debt, net of NFRK														
Baseline														
Stress tests:	40.8	44.8	71.0	69.0	62.6	63.3	53.4	50.1	49.1	46.4	43.2	41.8	38.7	36.8
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2010							65.4	67.6	71.5	73.8	75.9	75.9	75.6	76.2
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							54.7	52.5	51.4	48.5	45.2	43.7	40.5	38.5
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							61.4	66.2	64.4	60.7	56.5	54.5	50.6	47.9
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							80.6	104.8	100.9	95.0	88.4	84.9	79.1	74.6
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004							65.8	73.5	71.3	67.2	62.5	60.2	56.0	53.0
6. Combination of 2-5 using one standard deviation shocks							83.5	108.1	104.1	97.9	91.1	87.5	81.5	76.9
7. One time 30 percent nominal depreciation in 2003							80.0	75.8	73.5	69.3	64.5	62.1	57.7	54.6
D. External debt, excluding intra-company debt and net of NFRK														
Baseline														
Stress tests:	29.5	29.5	34.6	31.2	23.7	21.3	14.8	11.1	10.5	9.6	8.2	8.1	6.8	6.6
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2010							20.9	20.2	21.0	21.6	21.9	20.7	19.2	18.5
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							15.2	11.5	10.9	10.0	8.6	8.5	7.2	6.9
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							17.6	16.4	15.6	14.6	13.1	12.9	11.5	11.2
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							24.2	29.3	28.3	27.0	25.0	24.8	23.0	22.4
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004							26.1	32.4	31.4	30.0	27.9	27.6	25.8	25.2
6. Combination of 2-5 using one standard deviation shocks							29.3	38.7	37.6	36.0	33.7	33.4	31.5	30.7
7. One time 30 percent nominal depreciation in 2003							24.0	20.3	19.5	18.4	16.7	16.5	15.0	14.6
Key macroeconomic and external assumptions:														
Real GDP growth (in percent)	1.6	-1.9	2.7	9.8	13.5	9.5	7.5	7.2	7.0	7.5	7.5	5.5	7.5	7.5
Exchange rate appreciation (US dollar value of local currency, change in percent)	-10.3	-3.8	-34.0	-16.3	-3.2	-4.3	3.4	1.0	1.0	1.0	1.0	1.0	1.0	1.0
GDP deflator (change in domestic currency)	16.9	5.7	13.2	17.4	10.2	5.3	7.2	0.5	3.2	3.4	4.1	3.1	3.3	3.3
QDP deflator in US dollars (change in percent)	4.9	1.7	-25.2	-1.7	6.6	0.7	10.8	1.5	4.3	4.5	5.1	4.2	4.3	4.4
Growth of exports (US dollar terms, in percent)	11.1	-12.5	4.1	50.2	-1.6	12.9	21.0	5.9	5.7	9.8	10.4	3.9	11.7	10.3
Growth of imports (US dollar terms, in percent)	9.9	-5.7	-13.8	31.2	17.8	9.1	11.2	8.4	9.5	8.6	9.9	9.2	10.1	10.3

Source: Data provided by the Kazakhstani authorities; and staff estimates.

Table 6. Kazakhstan: Indicators of Vulnerability, 1998-2002
(In percent of GDP unless otherwise indicated)

	1998	1999	2000	2001	2002 Prelim.
Financial Indicators					
Broad money (12-month percent change)	-13.3	82.7	45.9	42.8	34.1
Private sector credit (12-month percent change)	29.9	65.7	81.0	78.9	34.9
Refinance rate (period average, in percent)	20.1	22.3	15.2	11.7	8.1
Average yield on 3-month T-bill (in percent)	19.6	22.2	12.2	5.5	5.3
External Indicators					
Competitiveness-related					
Merchandise exports (nominal percent change, 12-month basis in US\$)	-14.9	4.3	54.6	-3.6	11.6
o/w Non-oil exports (percent change, 12-month basis)	-19.3	-6.4	27.6	-7.5	7.9
Imports (nominal percent change, 12-month basis in US\$)	-7.0	-15.4	21.3	11.1	0.5
Terms of trade (12-month percent change)	-11.2	11.6	31.7	-7.1	-0.1
Current account balance	-5.4	-0.1	4.8	-4.0	-1.9
Capital and financial account balance	8.3	5.3	4.4	10.2	5.0
o/w Foreign direct investment (in millions of US\$)	1324	1583	1278	3006	2138
Exchange rate (per US\$, period average)	78.5	118.9	142.1	146.3	153.5
REER appreciation (+) (12-month basis, CPI-based)	13.6	-8.5	-8.1	-1.6	-2.8
Annual REER appreciation (+) (CPI-based, c.o.p.)	21.1	-26.8	-0.5	-3.3	-1.4
Reserves-related					
Gross official reserves					
- in millions of US\$	1964	2003	2096	2508	3136
- in months of imports	3.0	3.6	2.8	2.9	3.3
- in percent of short-term external debt 1/	84.6	111.0	148.7	109.2	119.9
- in percent of total external debt	19.9	16.6	16.6	16.6	18.0
- excluding intra-company loans	30.2	34.1	36.7	38.5	44.1
Gross official reserves/Broad money (M2)	1.1	1.0	0.8	0.7	0.6
Gross official reserves/Reserve money	2.0	2.2	2.3	2.1	2.3
Debt-related					
Central bank short-term foreign liabilities (in millions of US\$)	651.6	462.5	2.1	1.8	0.6
Short-term foreign liabilities of commercial banks (in millions of US\$)	260.2	96.8	164.4	434.6	434.6
Short-term external debt 1/					
- in millions of US\$	2320.9	1804.6	1409.2	2297.2	2615.5
- in percent of GDP	10.5	10.6	7.7	10.4	7
- in percent of total external debt	23.5	15.0	11.2	15.2	15.1
Total external debt					
- in millions of US\$	9878	12034	12616	15130	17377
- excluding intra-company loans	6506	5872	5703	6522	7113
- in percent of GDP	44.8	71.0	69.0	68.4	71.2
- excluding intra-company loans	29.5	34.6	31.2	29.5	29.1
- in percent of exports of goods and services	145.8	170.6	119.0	145.1	147.6
- excluding intra-company loans	96.0	83.2	53.8	62.5	60.4
Public external interest payments (in percent of exports of g&s)	3.0	2.9	2.3	2.3	2.0
Public external amortization payments (in percent of exports of g&s)	4.7	9.0	6.2	2.5	5.8
Net public external debt (in millions of US\$) 2/	1994.5	2040.5	1883.5	74.2	-1552.6
National Fund (NFRK) assets (in millions of US\$) 4/	...	...	...	1269.8	1917.3
Financial Market Indicators					
Foreign currency debt rating					
Moody's	Ba3	B1	B1	Ba2	Baa3
Standard and Poor's	B+	B+	BB-	BB	BB
Spread over benchmark bonds (basis points, period average) 3/	903	567	326	235	93

Source: The Kazakhstan authorities, and Fund staff estimates.

1/ The National Bank of Kazakhstan does not compile short-term debt statistics on a remaining maturity basis. Before 2000, the short-term debt data are on an "original maturity" basis. From 2000 onwards, the short-term debt is estimated by Fund staff on a remaining maturity basis.

2/ Total external public debt minus gross official reserves, and minus National Fund assets.

3/ Kazakhstan eurobonds are mostly held by domestic investors who have limited investment opportunities abroad.

Therefore, bond spreads of Kazakhstan are not comparable to those of other countries and do not fully reflect country risks.

4/ Includes transitory domestic currency deposits.

Kazakhstan—Relations with the Fund
(As of March 31, 2003)

I. Membership Status: Joined: 07/15/92; Article VIII					
II. General Resources Account:					
			SDR million	Percent of quota	
	Quota		365.70	100.0	
	Fund holdings of currency		365.70	100.0	
	Reserve position in the Fund		0.01	0.0	
III. SDR Department:					
			SDR million	Percent of Allocation	
	Holdings		0.77	N/A	
IV. Outstanding Purchases and Loans:					
			None		
V. Financial Arrangements:					
	Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
	EFF	12/13/99	3/19/02	329.10	0.00
	EFF	7/17/96	7/16/99	309.40	154.70
	Stand-by	6/05/95	6/04/96	185.60	185.60
VI. Projected Obligations to the Fund:					
			None		
VII. Safeguards Assessments:					

The safeguards assessment procedures are not applicable to the National Bank of Kazakhstan (NBK) at this time.

VIII. Exchange Rate Arrangements:

The currency of Kazakhstan is the tenge, which was introduced in November 1993. The official exchange rate is determined on the basis of foreign exchange auctions that are held daily. Auctions are held for U.S. dollars, euros, and Russian rubles, and official rates are quoted for over thirty other currencies on the basis of cross-rates. On April 4, 1999 the tenge was allowed to float freely but in practice has been kept relatively stable since the latter part of 1999. On March 31, 2003, the rate was T 151.93 per U.S. dollar. Nearly 2,000 exchange bureaus have been established throughout Kazakhstan; the rates at these bureaus are very close to the auction

IX. Article IV Consultation:

Kazakhstan is on the standard 12-month consultation cycle. The last consultation was concluded on January 23, 2002 (see SM/02/5 (1/4/02)).

X. FSAP Participation and ROSCS:

Kazakhstan participated in the Financial Sector Assessment Program (FSAP) in 2000. The Staff Report on the Financial Sector Stability Assessment (FSSA) was issued on November 27, 2000 (FO/DIS/00/142). The FSSA included the following ROSC modules: Basel Core Principles for Effective Banking Supervision, Core Principles for Systemically Important Payment Systems, Code of Good Practices on Transparency in Monetary and Financial Policies, IOSCO Objectives and Principles of Securities Regulation, IAIS Insurance Core Principles. The fiscal transparency module was completed and issued to the board in October. A data module mission took place in April/May 2002, and its final report was published in March 2003.

XI. Technical Assistance:

Kazakhstan has received considerable technical assistance and training by the Fund in virtually every area of economic policy, including through about 75 technical assistance missions provided during 1993–2002 by FAD, MAE, STA, LEG, and the IMF Institute. In addition to short-term missions, the Fund has provided resident advisors to the National Bank of Kazakhstan, to the Agency of Statistics of the Republic of Kazakhstan, and to the Ministry of Finance. Other international agencies and governments, including the World Bank, EU TACIS, EBRD, UNDP, OECD, also are providing a wide variety of technical assistance.

The following list summarizes the technical assistance provided by the Fund to Kazakhstan since 1996.

Monetary and Exchange Affairs

Technical assistance has enabled steady progress to be made in a number of arrears related to monetary and exchange affairs, including banking legislation, central bank accounting, payments system reform, central bank organization and management, foreign operations and reserve management, banking supervision, monetary statistics, currency issuance, monetary operations and money-market development. Since 1996 missions to Kazakhstan by the Monetary and Exchange Affairs Department of the Fund have included:

1. February/March 2000: FSAP mission.
2. Fall 2001: Multi-topic mission—Financial sector consolidated supervision and capital account liberalization.
3. December 2002: Sequencing of capital account liberalization and financial sector supervision.
4. January 2003: Assessment of the CPSS Core Principles for Systemically Important Payment Systems and Transparency of Payment System Oversight.

Fiscal Affairs

The Fiscal Affairs Department of the IMF has given comprehensive advice to Kazakhstan in the areas of tax and expenditure administration, the establishment of a Treasury system, and the introduction of a social safety net. Technical assistance missions to Kazakhstan since 1999 have included:

1. January 2000: Tax Code.
2. February 2000: Customs Administration reform.
3. August 2000: Tax Code.
4. Treasury Modernization (1997–present).

Statistics

The Fund's technical assistance program in statistics has focused on the development of the institutional framework appropriate to the needs of a market economy. The assistance has concentrated on establishing procedures for collecting and compiling monetary, government finance, balance of payments (including external trade), national accounts, producer price statistics, and consumer price statistics in accordance with international standards. Since 1999, missions by the IMF's Statistics Department to Kazakhstan have included the following:

1. March 1999: National Accounts.
2. July 1999: GDDS pilot country study.
3. February 2000: National Accounts.
4. February 2000: Balance of Payments.
5. March-April 2000: Money and Banking.
6. November-December 2000: National Accounts.
7. November 2002: International reserves.

IMF Institute

Kazakh officials have participated in courses in Washington and at the Vienna Institute in the areas of macroeconomic management, expenditure control, financial programming, taxation, statistics and other areas. In addition, the Fund's Institute has conducted courses in the region. Seminars and training sessions have also been conducted by MAE and STA technical assistance missions.

VIII. Resident Representatives:

Mr. Geoffrey Oestreicher replaced Mr. Ross on August 14, 2001.

Kazakhstan—Relations with the World Bank Group
(As of February 28, 2003)

Kazakhstan became a member of the World Bank and IDA in July 1992 and of the IFC in September 1993. The Bank's lending program has been curtailed in recent years because of an absence of a need for balance of payments support and the authorities' decision to cease borrowing for technical assistance.

The accents in IBRD's relationship with Kazakhstan are changing from major adjustment operations towards more focused investment loans and policy dialogue. For the next three years the program will be focused on the environment, forestry, water sector and rural development with an average new commitments of \$100 million a year. A \$3 million three-year program of joint economic research will be cofinanced by the republican budget in support of knowledge transfer. The first year of the program focused on non-extractive growth, expenditure management, natural resource management, pension reform and health sector. There are now 7 active projects, representing a total commitment of US\$525 million, of which \$255 million has been disbursed.

The IFC has 19 active operations, totaling \$330 million, including syndications, of which 8 are in the financial sector, 2 in general manufacturing, 1 in agribusiness, 5 in oil and gas, and 3 in the Extending IFC's Reach Program. To date, \$121 million has been disbursed.

In addition, the Bank is assisting the government in attracting grants from the Global Environmental Facility (GEF) and the International Fund for Agricultural Development (IFAD) in support for a Dry Land Management Project costing an estimated US\$10 million. The Bank, together with UNAIDS, has also provided assistance for a Government grant proposal to the Global Fund to Fight AIDS, TB and Malaria (GFATM).

Kazakhstan—Relations with the EBRD

(As of February 28, 2003)

1. The EBRD has focused its assistance on the financial sector and sovereign infrastructure operations. As at the end of February 2003, the EBRD's net cumulative commitments in Kazakhstan were at €825 million financing 26 projects with a total value of €1,776 million. The EBRD's gross cumulative disbursements stood at €429 million.

2. The experience of the Bank in Kazakhstan has been satisfactory and all loans have been performing. A €363.4 million financing from the EBRD and the IFC helped in the restructuring of operations of the major steel producer Ispat Karmet. However, because of a dramatic fall in commodity prices, Ispat Karmet postponed part of the planned investment and the undisbursed portion of the EBRD and IFC A Loans and full amount of B Loans were cancelled.

In 2002, the EBRD signed its first industrial domestic corporate loan for €24.9 million to Kazakhmys Corporation, the largest copper producer in Kazakhstan. It is an environmental enhancement loan for the Balkhash Smelter. In infrastructure, the Bank has contributed to the renovation and modernization of the Caspian Sea port of Aktau, Kazakhstan's main shipping gateway through a €67.1 million loan and is involved in two projects in the power sector, including renovation of the national grid (KEGOC) under a joint €237.4 million loan with the World Bank.

In 1999 the EBRD signed a €60.4 million loan in favor of Kazakhstan Temir Zholy (KTZ-Kazakhstan Railways), guaranteed by the Republic of Kazakhstan. The operation supports the ongoing restructuring and increased commercialization of the railways and contributes to reduce transport costs in Kazakhstan. Also, in 2000 the Bank provided €26.5 million to the RK Government under the syndicated with Asian Development Bank loan of a €112.1 million to the rehabilitation of the Almaty-Bishkek road. The project promotes regional economic cooperation in Central Asia, and will assist the RK Government to improve the administration of the road sector.

The Kazakhstan Small Business Program is now active in 29 towns and cities with 116 lending outlets across the country. The Program has already disbursed on a revolving basis 46,500 micro and small loans, totaling more than US\$272 million. The EBRD approved in 2002 an additional €85 million for the Program to be disbursed in early 2003. As in other SME programs of EBRD, the repayment rate of SME credits stands above 99 percent.

EBRD's acquisition of 15 percent stake in Kazkommertsbank will be finalized in April-May following ratification of the decision during the next KKB shareholders' meeting.

3. EBRD priorities for Kazakhstan in 2002-2004:

- Promote economic diversification through support for domestic and foreign investors, SMEs, trade facilitation and a further expansion of structured finance and increasing activities in agribusiness.
- Support financial sector to increase capital, enhance stability, encourage prudent expansion of lending to the real economy and facilitate diversification of domestic financial assets.
- Promote commercial principles and competitive access in infrastructure including through non sovereign lending.

Kazakhstan—Relations with the Asian Development Bank
(As of March 31, 2003)

Kazakhstan became a member of the Asian Development Bank (AsDB) in 1994. As of December 31, 2002, total loan commitments by AsDB consisted of 11 loans amounting to \$467 million covering investment projects in agriculture, transport, and education, as well as policy-based program lending for special assistance, agriculture and pension reforms. Total loan disbursements stood at \$104 million as of December 31, 2002. With the exception of 2000 there was no lending in 1998–2002. The AsDB hopes to have two projects in 2003 and a further 1-2 projects in 2004. A new country strategy and program (CSP) is currently under preparation. Kazakhstan is no longer eligible for concessional resources from the Asian Development Fund.

The AsDB has provided Kazakhstan with TA grants in most sectors, including agriculture, education, finance, pension reform, transport, energy, water supply and sanitation, aid coordination and management, public investment programming, and poverty reduction planning. As of 1 December 2002, total TA commitments consisted of 49 projects—16 of which were in preparation for loans—for a total of \$23.2 million

Kazakhstan—Statistical Issues

The data ROSC conducted in April/May 2002 found that the quality of Kazakhstan's macroeconomic statistics has improved in recent years. Nevertheless, there are shortcomings in some statistical practices that have the potential for detracting from the accurate and timely analysis of economic and financial developments and the formulation of appropriate policies. The public disclosure of the existence of a large off-budget fund, the operations of which may not be fully recorded, indicates an urgent area for improving transparency. Also, agencies compiling national accounts, fiscal, monetary, and balance of payments statistics in Kazakhstan could better coordinate investigation of data discrepancies that exist across data sets.

Sector specific issues

1. In the area of **national accounts**, several weaknesses in data compilation remain in both the quality of GDP estimates by sectoral branches produced by the National Statistical Agency (NSA) and the quality and timeliness of the production of GDP estimates by expenditures. First, the quality of **GDP estimates by industry** is affected by the poor coverage of production and financial statistics, particularly concerning small enterprises and informal activities. Second, while some progress has been made in making **GDP estimates by final expenditure** consistent with output-based measures, there remain substantial shortcomings particularly in the estimation of fixed capital formation.
2. Data on **prices** conform to international standards. **The consumer price index** is calculated on a basket comprising 329 items using a weighing system based on an annually revised Household Budget Survey. The index covers 19 regions (oblasts) and is calculated on a monthly basis. In addition, a provisional index is compiled weekly, based on a smaller basket of consumer goods. **The producer price index** is based on the Laspeyres formula. However, the quality of the underlying price information received from enterprises needs improvement. Also, the weights need to be updated to account for shifts in the structure of production.
3. The coverage and quality of data on **wages and employment** has improved. In addition to agriculture, industry, and services, collective farms and joint ventures have been included to the survey used for the wage data. Two sets of unemployment data are provided by the Ministry of Labor: the monthly data on unemployment covers only those who are officially unemployed and receive benefits; in addition, the Ministry of Labor is collecting data on hidden unemployment, comprising workers on compulsory leave or on enforced part-time status.
4. Most real sector data are published in a **monthly statistical bulletin** issued by the NSA, which is made available to other government authorities.
5. As a result of extensive technical assistance, the quality of **fiscal data has improved**, in particular on the **consolidation, in 1999, of most extrabudgetary and social security**

funds into the fiscal accounts and on the provision of more **detailed expenditure data** on a quarterly basis. However, the coverage of oil revenues, particularly royalties, is not transparent and may be underrepresented to a significant degree. The coverage and classification of the operations of the National Fund of the Republic of Kazakhstan (NFRK), which has been operating as a stabilization fund since May 18, 2001, needs to be clarified. Progress also has been made in the establishment of a **classification of the fiscal accounts** consistent with the Fund's government finance statistics (GFS) methodology. However, as a result of the reorganization of the public sector, including the re-definition of budgetary units, difficulties have arisen with regard to the **recording and reporting of expenditure arrears**. Since 1997, the authorities have reported detailed data for publication in the *GFS Yearbook* on central government and on local government operations. The latest published data are for 2001. The Ministry of Finance also provides monthly consolidated general government data for publication in *International Financial Statistics (IFS)*.

6. The existing framework for compiling monetary statistics generally conforms with the Fund's methodology, and data are compiled on a timely basis. Several steps are being taken by the NBK to further improve the quality and coverage of data. In particular, **the chart of accounts for commercial banks** has been revised to enable the NBK to distinguish sectors and financial instruments in accordance with the *Monetary and Financial Statistics Manual*. The NBK intends to extend **institutional coverage** to compile a financial sector survey, which is important in light of the exclusion of the Development Bank from the monetary survey beginning August 2002. However, the authorities have not implemented recommendations of past money and banking statistics missions regarding the use of residency criteria as defined in the *Balance of Payments Manual*, fifth edition (*BPM5*). Not all financial assets held by commercial banks are valued at **current market prices**, and there are inconsistencies among banks in recording **syndicated lending and Eurobond holdings**. These factors can distort the measure of net foreign assets and credit to the domestic economy. Also, **data revisions** in the monetary statistics are not synchronized with those for the International Investment Position and balance of payments statistics.

7. EU2 and STA staff are working with the authorities to harmonize the presentation of monetary statistics for both the area department and *IFS* purposes.

8. **In the area of balance of payments**, the overall quality and timeliness of data is satisfactory and considerable progress has been made in implementing the Fund staff's recommendation to address two major deficiencies. First, the coverage of **trade data** has been improved through a survey to determine the volume of shuttle trade and travel expenses. The NBK has also worked closely with relevant agencies to update the ratios used for adjusting c.i.f. imports to an f.o.b. basis. Nevertheless, the timeliness of trade data remains an issue; improvements can be expected with the continuing computerization of customs administration. Second, the NBK has initiated changes and additions to the Law of the Republic of Kazakhstan "On State Statistics" to improve the coverage of international operations of branch offices of foreign companies and thus bring **foreign direct investment statistics** in line with the standards set forth in the fifth edition of the *BPM5*. In particular, work is continuing to ensure the correct treatment of construction services provided by

foreign companies that operate local branch offices. The data module ROSC mission in April/May 2002 also noted other shortcomings in the compilation of balance of payments statistics. They include (i) commercial banks define nonresidents based on a legal basis rather than the *BPM5* principle, which affects data reporting by these banks for balance of payments purposes, and (ii) discrepancies exist between balance of payments data and other macroeconomic statistics.

9. The authorities successfully completed subscription to the Special Data Dissemination Standard (SDDS) in March 2003. Kazakhstan is the second Commonwealth of Independent States (CIS) country to subscribe to the SDDS. Also, Kazakhstan is the first General Data Dissemination System (GDDS) participant to become an SDDS subscriber.

10. Kazakhstan has published statistical data in *IFS* since September 1996. Balance of payments data were published for the first time in the March 1998 issue.

KAZAKHSTAN: CORE STATISTICAL INDICATORS

(As of April 25, 2003)

	Exchange rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern't Balance	GDP 2/	External Debt
Date of Latest Observation	Mar. 2003	Jan. 31, 2003	Feb 2003	Feb. 2003	Feb. 2003	Mar.2003	Jan. 2003 Mar. 2003	Q4 2002	Q4 2002	Sep. 2002	Q3_2002	Sept. 30, 2002
Date received	Apr. 7, 2003	Feb. 3, 2003	Mar. 4, 2003	Mar. 4, 2003	Mar. 4, 2003	Apr. 7, 2003	Apr. 16, 2003	Apr. 16, 2003	Apr. 16, 2003	Oct. 30, 2002	Nov. 14, 2002	Nov. 2002
Frequency of Data	M	W	M	M	M	M	M	Q	Q	Q	Q	Q
Frequency of Reporting	M	W	M	M	M	M	M	Q	Q	Q	Q	Q
Source of Updating	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting	E	C	E	E	E	E	I	C	C	C	C	C
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	B
Frequency of Publication 1/	M	M	M	M	M	M	M	M	Q	N/A	A	Q

1/ Some data are partially published by the authorities but cannot be used in the format in which they are being published.

2/ Data on GDP is calculated on an annual basis; monthly data are available on production.

Explanation of abbreviations:

Frequency of data, reporting and publication: D—daily, W—weekly, M—monthly, Q—quarterly, V—irregularly in conjunction with staff visits.

Source of data: A—direct reporting by National Bank, Ministry of Finance, Ministry of Statistics and Analysis or other official agency.

Mode of reporting: C—cable or facsimile; E—e-mail; I—available in official web site. Most data are provided to the Resident Representative's office and then forwarded to headquarters.

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IMF Concludes 2003 Article IV Consultation with the Republic of Kazakhstan

On May 28, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Kazakhstan.¹

Background

Kazakhstan is reaping the benefits from early structural reforms and prudent macroeconomic management. Led by the petroleum sector, and supported by a favorable external environment, economic growth averaged 11 percent in the period 2000-02. Strong growth has continued in 2003, at an estimated 10.6 percent in the first quarter. The petroleum sector continues to gain in importance with high foreign investment and rising production and export volumes. The non-oil economy has also grown strongly, at about 8 percent on average in 2000-02. After sharp declines during the 1990s, overall employment has grown since 2000. Unemployment declined to 9¼ percent in 2002, and real wages rose by about 10 percent. Notwithstanding the sustained strong growth of the economy, poverty remains a serious concern, especially in the rural areas and the rising oil wealth has yet to benefit significantly the majority of the population.

Inflation remained basically unchanged in 2002 at 6½ percent and was broad based, although relatively stronger in the services sector. Impediments to regional trade may have contributed

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the 2003 Executive Board discussion based on the staff report.

to sharply higher prices of fruits and vegetables. The 12-month inflation rate began to edge-up towards the end of 2002 and reached just over 7 percent by March 2003.

Monetary Policy

The growth of the monetary and credit aggregates continued to slow in 2002. The sterilization of budget surpluses in the National Fund for the Republic of Kazakhstan (NFRK) and the partial sterilization of additional large foreign exchange purchases by the National Bank of Kazakhstan (NBK) were crucial in this regard. Increased monetization continues to facilitate monetary policy, while the level of dollarization of bank assets and liabilities is stabilizing.

In 2002, monetary policy resulted in keeping inflation stable. The nominal exchange rate weakened against the U.S. dollar because of large-scale interventions, and, with moderate inflation, the tenge continued to depreciate in real effective terms. In the first quarter of 2003, reserve money did not exhibit the usual pronounced seasonal decline and broad money growth accelerated, driven by net foreign assets growth. Also, in the first quarter of 2003, the tenge appreciated against the dollar and marginally against the Russian ruble, but was steady against the euro. The nominal exchange rate against the ruble has shown only marginal changes in recent years despite a large inflation differential with Russia.

Fiscal Policy

Fiscal policy has played a major role in containing aggregate demand and inflationary pressures. The fiscal stance, as measured by the non-oil budget balance, was severely tightened in 2002. There was considerable underspending on investment programs and the expenditure to GDP ratio declined. Budget revenues were very strong in the first two months of 2003. Together with seasonally low expenditures, this resulted in an overall surplus of about 1.6 percent of projected annual GDP.

The external current account deficit declined in 2002 to under 2 percent of GDP, as both petroleum and non-oil export growth recovered and import growth continued to slow. Net Foreign Direct Investment inflows, largely in the oil sector, have averaged over \$2 billion per year (more than 9 percent of GDP) since 2000. Gross official reserves rose to over \$3 billion at end 2002 and further to \$4 billion at end-March 2003 (3.7 months of projected 2003 imports) and balances in the NFRK reached \$2.2 billion in mid-April 2003. Public external debt dropped to around 14 percent of GDP at end 2002 and Kazakhstan's official sector became a net creditor to the rest of the world. Kazakhstan's credit rating was upgraded in September 2002 by Moody's to minimum investment grade.

Structural Reforms

After a rapid introduction of market reforms in the early years of transition, the momentum of structural reform has slowed since 2000. A weak judicial system, entrenched vested interests, "capture" of important sectors, combined with a lack of transparency have resulted in an uneven playing field and a poor investment climate outside the oil and financial sectors, particularly for small and medium-size domestic and foreign investors.

Welcome progress was achieved, however, in 2002 in the areas of treasury modernization, simplification of NFRK funding rules, as well as the introduction of a systematic reform of utility pricing. The trade regime is generally liberal with relatively low average tariffs. However, reforms to reduce tariff peaks and eliminate specific and combined tariffs have not been implemented. Also, ad hoc restrictions prevail on both imports and exports. Efforts to accede to the World Trade Organization were reenergized, but there are no near-term prospects for accession.

Significant progress in strengthening the financial sector has continued. Bank capital has increased significantly as a result of both new share issues and retained earnings. The NBK has energetically fostered domestic capital market development, notably mortgage lending and mortgage-backed securities. Legislative reforms of the bankruptcy code were also an important step forward. Legislation regarding anti-money laundering is still in preparation, and Kazakhstan has yet to join the Strasbourg Convention. A reassessment of the payment system in early 2003 found it to be functioning according to the best international practices.

Executive Board Assessment

Executive Directors commended the authorities for Kazakhstan's strong macroeconomic performance, which has been marked by fast and broad-based GDP growth, rapidly mounting international reserves and assets in the NFRK, and reductions in public sector external and internal debt. Market confidence has improved, with an attendant upgrade in Kazakhstan's credit rating. While high world energy prices have contributed to these results, Kazakhstan was reaping the benefits of early implementation of first-generation structural reforms and continued sound macroeconomic policies.

Looking ahead, Directors considered that the key challenge facing Kazakhstan's policymakers is the continued effective management of rapidly rising oil production and revenues. Directors generally agreed that, while considerations regarding intergenerational savings should guide such efforts, the widespread poverty poses an immediate demand on these resources. Directors agreed that a rebalancing of policies should be considered. Some relaxation of the fiscal stance at this stage would be appropriate to accommodate important outlays, together with a more flexible exchange rate policy and a monetary policy consistent with a further lowering of inflation. Equally, a reinvigoration of second-generation structural reforms is essential for building a sound investment climate and fostering sustained broad-based growth outside the energy sector.

Directors discussed the tension between the recent trend of the real exchange rate and the authorities' objective of lowering inflation. While taking note of the clarification of the authorities' single policy objective—securing price stability—they observed that high budget surpluses, strong productivity gains, sterilization of oil proceeds in the NFRK, and rapid financial deepening, have contributed to keeping inflation low. Directors judged that some real appreciation of the currency may become unavoidable because of Kazakhstan's strong balance of payments position. In this regard, they noted that the tenge has continued to

depreciate in real effective terms because of large foreign exchange purchases by the National Bank. They called for the NBK to limit its interventions in the foreign exchange market so as to exercise firmer control over the growth of the monetary and credit aggregates. Directors considered that achieving the aimed-for reduction in inflation would be difficult without a more substantial appreciation of the tenge against the U.S. dollar.

Directors welcomed the intention to ease the stance of fiscal policy through increases in priority outlays, and judged that the proposed reductions in the rates of the value added tax, income tax, and social security tax are also steps in the right direction. To ensure the appropriate use of budgetary resources, they encouraged the authorities to strengthen their institutional capacity and the targeting of social assistance, and to proceed, with help from the international community, to develop and execute more ambitious and well-thought-out public sector investment programs. They welcomed, in this connection, the progress being made in strengthening capacity and increasing allocations in the health and education sectors, and Directors encouraged further increases in well-targeted outlays in these areas. Directors also urged the government to focus on infrastructure investments that are complementary to, rather than in competition with, private sector investment. In this connection, they considered that more transparent budgetary procedures would facilitate open and comprehensive discussion of how best to ensure efficient allocation of public resources. Directors cautioned against relying on import substitution policies and using the Development Bank and other recently created institutions to “pick winners” among firms.

Directors noted the important role the NFRK has played in easing the burden on monetary policy, moderating pressures for an appreciation of the exchange rate, and building a protective buffer against unforeseen pressures on the budget and the balance of payments. The rapidly mounting wealth in the NFRK will need to be carefully safeguarded through strict adherence to budgetary procedures, further simplification of its operating rules, and greater transparency. Directors called on the authorities to release complete and timely information about oil bonuses, tax payments, and other oil-related payments.

Directors expressed concern about the relatively slow progress in structural reforms in recent years, after a very impressive start. They called for an improvement of the investment climate so as to diversify the economy and raise productivity, particularly in the non-oil sector. Key areas needing further reform include public administration and the judiciary, and, more broadly, fighting corruption and providing a less difficult environment for small and medium enterprises. Directors emphasized that Kazakhstan’s strong external position has created an important opportunity for trade liberalization and that substantial progress in this area should not be delayed but proceed in parallel with the negotiations on the World Trade Organization accession. Directors also welcomed the revision of the land code and introduction of private property rights, which should contribute to efforts to develop the non-oil sector and combat rural poverty. They supported the authorities’ plans for complete capital account liberalization by 2007, but underscored the need for appropriate sequencing with financial sector reforms to safeguard macroeconomic stability.

Directors welcomed the considerable progress made in strengthening the financial sector and its supervision, and endorsed Kazakhstan's request for a focused Financial Sector Assessment Program update. They encouraged the authorities to monitor closely the still rapid growth of bank credit and emphasized that the fast growth of the economy could mask incipient problems with the quality of banks' assets. Directors commended the progress made toward creating a unified financial sector supervisory agency and endorsed the intention to separate this agency from the NBK. Directors commended the authorities for their efforts at countering money laundering and the financing of terrorism, and were encouraged by the authorities' intention to usher quick passage of the legislation aimed at fully implementing the UN Security Council Resolution and Conventions on terrorism financing.

Directors welcomed Kazakhstan's subscription to the Special Data Dissemination Standard and the completion and publication of fiscal and data Reports on the Observance of Standards and Codes. They noted that the corrections provided to the international investment position and the balance of payments have brought Kazakhstan into conformity with the requirements of Article VIII, Section 5.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Kazakhstan: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002 Prel. Est.
	(Changes in percent)					
Real economy						
Real GDP	1.7	-1.9	2.7	9.8	13.5	9.5
CPI (end-of-period)	11.2	1.9	17.8	9.8	6.4	6.6
	(In percent of GDP)					
Public finance						
Government revenue and grants	13.3	18.3	17.5	21.7	25.6	22.6
Government expenditures	20.1	26.1	22.7	22.5	23.0	21.2
General government balance 1/	-6.9	-7.8	-5.0	-0.8	2.7	1.5
General government debt (end-of-period) 2/	...	22.7	30.6	27.2	20.5	17.6
	(Changes in percent)					
Money and Credit						
Base money	42.0	-29.0	56.9	5.3	30.9	18.1
Broad money	29.2	-14.1	84.4	45.9	42.8	34.1
Banking sector credit to the economy	23.4	39.9	50.9	81.0	78.9	34.9
Interest rate on three-month treasury bill, percent per annum (end-period) 3/	16.1	25.8	16.6	6.6	5.9	5.8
	(In percent of GDP)					
Balance of Payments						
Trade balance	-1.2	-3.6	2.8	14.3	6.9	10.4
Current account balance 4/	-3.5	-5.6	-0.2	4.8	-4.0	-1.9
External public debt	20.6	17.9	23.8	21.8	17.4	14.3
Gross international reserves						
In millions of US\$, end of period	2,252	1,964	2,003	2,096	2,508	3,136
In months of imports of goods and nonfactor Services	3.3	3.0	3.6	2.8	2.9	3.3
Exchange Rate						
End-of-period level (Tenge/US\$)	75.9	84.0	138.3	145.4	150.9	155.9
Real exchange rate vis-à-vis U.S. dollar 5/	6.7	-9.4	-30.1	1.0	1.0	0.8
Real exchange rate vis-à-vis Russian Ruble 5/	4.8	72.9	-31.4	-9.4	-7.5	-5.4

Sources: Kazakhstan authorities; and IMF staff estimates.

1/ This definition of the general government balance treats revenue from privatization as a financing item and is measured from below-the-line financing which includes the statistical discrepancy.

2/ Gross domestic and external debt, including government guaranteed debt.

3/ Starting in 2001, yields refer to NBK notes.

4/ Reported figures for the 1999–2002 current account have been adjusted for staff estimates of the under invoicing of exports.

5/ End-of-period from end of previous year. A negative sign indicates a depreciation.

**Statement by Johann Prader, Alternate Executive Director
for the Republic of Kazakhstan and
Kuanyshbek Sazanov, Assistant to Executive Director
May 28, 2003**

Our authorities wish to express their appreciation for the staff's work and for the consistently high quality of their advice. They broadly share the staff appraisal, with the exception of some nuances on fiscal and monetary policy, education, poverty reduction, rural development, and investment policy.

The authorities are grateful for their continuing collaboration with Fund technical assistance missions, which has helped immensely in areas where Kazakhstan is actively pursuing changes, such as establishing inflation targeting, creating a unified authority to supervise the financial markets, modernization of the treasury, and capital account liberalization. The Fund has advised Kazakhstan that the office of resident representative for Kazakhstan is to be closed, which is a signal of the Fund's confidence in the stability of Kazakhstan's balance of payments and the prudent macroeconomic management of the authorities.

1. Recent Economic Developments and Prospects

Kazakhstan's growth is one of the strongest among CIS countries, averaging 11 percent for the last three years. This has increased per capita GDP and gradually altered the distribution of income among the population. Prudent macroeconomic policies, the stable exchange rate, prudent fiscal policy, and the de-monopolization of the economy have enabled Kazakhstan's per capita GDP, which was 40 percent of Russia's ten years ago, to nearly equal the Russian level today. In 2002, GDP grew by 9.5 percent, mainly driven by high domestic demand and strong export receipts from the oil price increase in the third quarter of 2002.

Kazakhstan's economic growth has been broadly based for the last three years, with non-oil sector growth reaching about 7 percent in 2002. The oil sector's share in the Kazakh economy constitutes only 18 percent of GDP as of 2002, with oil receipts share constituting only 32 percent of total fiscal revenues and the rest being made up by transportation, communication and agriculture. In the last three years the industrial sector grew by 43 percent, construction grew by 73 percent, and transportation grew by 37 percent. In 2002, industrial output grew by 9.8 percent and the processing industry by 7.7 percent, compared with 13.5 percent in 2001. Transportation increased by 8.5 percent over the previous year. Kazakhstan has a full-fledged market economy, in which 75 percent of GDP and about 85 percent of industrial production came from the private sector.

Kazakhstan's inflation rate is one of the lowest in the CIS area. The monetary policies of the National Bank of Kazakhstan have pushed the year-on-year inflation rate down to 5.9 percent, in turn permitting the refinance rate to be lowered to 7.5 percent. At the end of 2002, year-on-year inflation edged up to 6.6 percent, and inflation for 2003 is projected to average about 6 percent.

Exports of goods increased by 13.5 percent in 2002, to a total of \$10.2 billion. At the same time imports decreased by 4.5 percent, to the level of \$7.5 billion. In the third quarter of 2002, a sharp increase in the world oil price pushed up total export revenues to \$2.9 billion.

In the year 2002 for the first time Kazakhstan achieved positive balance in energy exchanges with neighboring countries, thus becoming an energy independent state.

Kazakhstan has managed to change from a net official debtor to a net creditor country in only 10 years, and is now the only creditor country in the CIS, with a positive external position of \$2 billion. By the end of 2002, Kazakhstan's gold and foreign currency reserves had grown by 9 percent to reach \$5.5 billion.

The development of the financial sector has also been remarkable. The overall capitalization of the banking system increased by 32 percent in 2002. Household deposits also grew very rapidly to a per capita level of \$112, again the highest among CIS countries. Bank credits to the economy grew by 2.8 percent to reach 17.9 percent of GDP. The share in these of medium- and long-term credits increased by 7 percent to reach 57 percent of total bank credits. In this environment both commercial and private loan rates declined by another 3 or 4 percent.

Strong economic growth and prompt implementation of socioeconomic and structural reforms has reduced the number of people living in poverty by 250,000, while the unemployment rate fell steadily from 10.4 percent to 9.4 percent.

In April, the Kazakh authorities raised their GDP growth forecast for 2003 to 8.3 percent, to take account of the higher oil prices in the first quarter of the year.

2. Fiscal Policy

After the experience of the stabilization crises of the 1990s, fiscal policy has been rather cautious. The authorities have been following the time-honored Fund advice to err on the side of cautiousness. The staff's conclusion that cutting the non-oil deficit in 2002 was not necessary was, in the Kazakh authorities' view, unexpected. However, the authorities appreciate the staff's view that there is room for easing fiscal policy, and the Government's priorities for 2003 and beyond are moving in that direction.

Both prudent fiscal management, and the tax cuts, were major contributors to last year's GDP growth. The Government is making the additional tax cuts called for in the President's speech: the VAT will fall from 16 percent to 15 percent, the social tax from 21 percent to a range between 7 and 20 percent, and a maximum income tax for individuals from 30 percent to 20 percent, with effect from January 1, 2004 (the present effective income tax rate is 9 percent). The lower tax rates are intended to increase private investment in Kazakhstan's economy, in anticipation of expected lower oil prices in the near future. The authorities do not entirely agree with the staff's assessment regarding the status of the health, education, and rural sectors and of poverty reduction. As a matter of fact, significant advances have been made in all these areas.

The Government's allocation for health care rose to 2.2 percent of GDP in 2002, while spending for education increased to 3.7 percent of GDP in 2002. The Government plans to

increase health spending by 42 percent in 2003, and education spending by 40 percent. Kazakhstan's outlays for health are determined by the Strategic Plan for Kazakhstan's Development, which runs until the year 2010, and by the guidelines contained in the 2000 decree on health care.

Last year the Government adopted a List of Investment Projects for 2003-05 to be financed by the budget, which essentially corresponds to the former Program of Investment Projects. It includes projects related to education, health care, roads, transportation, water supply, public infrastructure, and emergencies. Altogether \$2.3 billion (almost 10% of the 2002 GDP) has been budgeted for the next three or four years.

3. Monetary Policy and Exchange Rate Developments

So far in 2003, the Kazakh tenge (KZT) has appreciated against the US dollar by 3.3 percent in nominal terms. But since US dollar has depreciated sharply against most world currencies, Kazakhstan's competitiveness has not been affected by the US\$/KZT exchange rate. The index of the real effective exchange rate relative to the currencies of its main trading partners has depreciated by 9 percent since 2001, which has increased the competitiveness of Kazakh goods.

Gold and currency reserves grew by 34.8 percent to a total of \$5.054 billion, of which \$1.917 billion were NFRK (oil fund) assets. In 2002, the central bank's gold and currency reserves grew by 25.1 percent to \$3.134 billion. Inflation averaged 5.9 percent during 2002, allowing the refinance rate to stay at the low level of 7.5 percent, before rising to 6.6 percent at the year's end. The NBK projects that inflation will fall again to 5 percent, which is closer to the European standard.

The authorities do not agree with the staff's description of NBK's monetary policy. Kazakhstan's monetary authorities recognize that it is not possible to pursue two goals at the same time. Their first concern has always been to keep inflation low, although they have not yet moved to inflation targeting. They have not and will not attempt to control or target the exchange rate.

Sound macroeconomic policies, prudent fiscal expenditures, and the exchange rate stability achieved by promptly sterilizing foreign currency inflows, all are contributing to the continued lowering of the inflation rate. The year-on-year for end May 2003 is expected to decline to 6.4 percent, in view of expected May monthly inflation rate of 0.3%. This is lower than the 6.6 percent year-on-year rate for 2002. The first quarter sterilization by NBK caused a seasonal decrease in reserve money of 1 percent. More than half of the foreign currency purchased in the first quarter was sterilized by the issuance of NBK bonds.

To conform more closely to best international practice, the NBK will discontinue the practice of setting an "official" KZT exchange rate in favor of a market rate. All transactions will be made using an average weighted rate determined in the Kazakh Stock exchange.

4. Financial Sector Development

Kazakhstan has developed an independent and transparent financial system. Financial sector reforms in Kazakhstan have been broad in extent, covering the banking system, the securities and insurance markets, and the pension system.

The positive trends of past years continued in 2002. For the first time in 2002 Kazakhstan received an investment class rating from Moodys agency, becoming the only country in the CIS to have investment class rating. The most important developments during 2002 were the lowering of the annual inflation rate, the depreciation of the KZT, and the increase in gold and currency reserves. The banking system saw a rapid increase in general assets and household deposits. The development of the insurance market was accomplished by the state insurance development program for 2002. Timely redemption of the sovereign Eurobonds issued in 1997 gave another boost to market confidence.

The financial sector has grown remarkably in the last three years. Credits have expanded more than fourfold, to 17.9 percent of GDP in 2002. Share of medium- and long-term credits rose from 50.5 percent to 55.3 percent of GDP, enabling borrowers to strengthen their potential capacity.

The development of a transparent and stable financial sector is a prerequisite for effectively financing an economy's real sector. The real sector is also financed by the accumulated assets of the pension system. Kazakhstan established a well functioning pension system five years ago. Pension assets invested in securities issued by domestic companies now account for 37 percent of all pension fund assets. Total pension fund assets now amount to 7 percent of GDP, having increased by 48 percent over the previous year.

Kazakhstan is the first CIS country to adopt an adjustment program for banks based on international standards. Starting in 2003, all financial reporting by Kazakh banks will conform to international standards. Since 2001, financial supervision has been conducted on a consolidated basis. Kazakhstan is presently developing a model for unified supervision of the financial markets. A separate supervisory agency will be established in 2004. Kazakhstan also aims to continue developing its financial sector during the next four years and bringing it into conformity with all EU standards and directives. Kazakhstan also has a functioning system of deposit insurance, with 21 major banks as its participants. The combined assets of the insurance companies grew by 36.3 percent to reach KZT 20.8 billion.

Kazakhstan also has a reliable payments system which almost fully conformed to international standards and fulfills all requirements of a payments system. More than 20 percent of the economically active population uses plastic payment cards. In 2002, the gross number of transactions accomplished through the payment system exceeded GDP by a factor of 4.1.

Kazakhstan is also the first CIS country to offer gradual compensation for individual deposits lost during the hyperinflation of 1992-1993. This action echoes earlier Government initiatives to compensate the deposits lost by war veterans and pensioners in 1996-1997.

5. Investment Policy

The authorities are continuously working to improve Kazakhstan's investment climate. The Government is approving a program consisting of a package of measures designed to stimulate inflows of foreign direct investment between now and 2005.

The Government has also adopted the "Strategy for Innovative Industrial Development in Kazakhstan for the Period 2003-2015." This strategy aims at promoting projects whose initial phases are too risky or too drawn out for Kazakhstan's private sector to launch unaided.

The institutions that will take part in this strategy--the Development Bank, the Investment Fund, and the Fund for Innovation--will not replace the private sector, but will become its partners. Private sector participation will be required for any project, and only the private sector participants will be allowed to own a controlling interest in any project. The main reason for these institutions' involvement is to lessen the risks for the private sector participants in a strictly competitive environment. The private sector participants will receive no subsidies, and residents and nonresidents will receive equal treatment.

The overall capitalization of these new development institutions is small compared with other precautionary balances, such as that of Kazakhstan's Oil Fund (NFRK), whose assets now total more than \$2 billion and could easily reach \$4 billion by the end of this year. For example, the Development Bank's authorized capital stock was less than \$200 million on January 1, 2003. A planned increase will raise its capital stock to \$270 million by July 1, 2003. Prudent management of these funds resulted in the approval during 2002, by the Board of Directors, of projects requiring only \$147 million of the \$2 billion originally proposed. In order to limit possible risks, the Government has set up 1:1 gearing ratio of loan to capital for the Development Bank. The Development Bank's net profit in 2002 was \$13 million.

The authorized capital of the Investment Fund to be established in July 2003 has been set at about \$148 million. For the Fund for Innovation, the figure is less than \$20 million, and for the Export Insurance Corporation, less than \$50 million. By the time all of the listed institutions have been launched and capitalized, their total capitalization will not exceed 20 percent of the NFRK's assets in July 2003, and far less than 10 percent Kazakhstan's gold and currency reserves.

There are no plans to add more capital in the near future. With oil revenues increasing, the Government did not want to invest all of the extra money from the oil sector and other sectors abroad, which would be the result if all the money went to NFRK. In order to distribute the oil wealth better by improving the economic situation of the whole population and creating business opportunities for Kazakh companies, the Government has decided that a relatively small share of this growing wealth will be invested in Kazakhstan itself and its close neighbors as a part of its socioeconomic programs. The enabling institutions were created as instruments for diversifying the economy and creating more employment opportunities for the Kazakh people. This is not only fair but accords with the staff's advice to increase social outlays, creating more jobs, diversifying investment opportunities, and redistributing some income in favor of ordinary people.

6. Agriculture Sector Development and Unemployment

The agricultural output in 2002 was 2.7 percent greater than in 2001. The grain harvest was 16.2 million tons, up from 15.9 million tons in 2001. Kazakhstan is the world's sixth largest exporter of grain.

Kazakhstan has launched a three-year plan called the "Socioeconomic Program of Rural Development," based on the agriculture/food program launched last year, which included new codes for Water Resources, Forestry, and Land Use. The Government of Kazakhstan has also established two budgetary programs for improving the regulation of water resources, and has made structural changes in ownership in order to promote more effective management of water resources and forestry.

In 2003, the Government earmarked \$260 million for rural and agricultural development, aimed at creating rural sector employment and increasing productivity. Altogether the Government has allocated more than \$1 billion to support its three-year program of restoration and development of the agriculture sector.

General unemployment fell from 10.4 percent of the economically active population in 2001 to 9.4 percent in 2002. The Government has also adopted an Anti-Poverty Program 2003-05, which aims at sharply reducing the poverty level by increasing economic growth, improving employment efficiency, raising living standards, and upgrading the system of targeted social security.

7. Other Structural Reforms

The authorities are actively pursuing other structural reforms. The Parliament recently approved a simplified, more effective Customs Code and a law establishing a transportation insurance system, approved new amendments which further liberalize foreign exchange regulations, and adopted a set of laws aimed at creating an information infrastructure. Parliament also recently adopted a Land Code that complements the rural structural reforms, and is considering a revised Budget Code.

As to privatization, Kazakhstan will privatize Kazakhtelecom in 2004 by the planned sale of 50 percent stake as a part of the liberalization of Kazakhstan's telecom market.

Kazakhstan is actively seeking admission to the World Trade Organization. As a member of the "Single Economic Space" along with Russia, Ukraine, and Belarus, and of the economic and customs union of the Eurasian Economic Community (EAEC), Kazakhstan will seek WTO membership jointly with the other members of these bodies.

**Introductory, Intermittent, and Concluding Remarks by Johann Prader
on the Republic of Kazakhstan—2003 Article IV Consultation
May 28, 2003**

Additional Statement

I would like to add three remarks. First, the authorities plan to publish the staff report, as they have done in the past, and I would like to blow the horn a little for our chair by mentioning that all ten members of our constituency have published their Article IV staff reports.

Second, as noted in the staff report, the authorities have provided the Fund with all the information needed to settle an earlier problem related to information transparency. The authorities have asked me to inform the Board that Kazakhstan will release revised balance-of-payments statistics and a revision of the international investment position as soon as possible.

Third, I can announce the good news that the monthly inflation increase for May was only 0.1 percent, confirming the authorities' view that they are on the way to reaching an inflation rate of 6.1 percent for 2003.

Also, I have sensed from Directors' buff statements a desire for some clarification of Kazakhstan's monetary policy. There is the perception that there are dual targets and possible contradictions, but the central bank would like me to convey to the Board that the National Bank of Kazakhstan has only one goal, and that is to ensure price stability. The national bank has never set an exchange rate target, nor does it pursue the goal of preventing a real appreciation of the tenge. Even looking at the index of real effective exchange rates, which shows a real depreciation, no one should be misled. The ultimate goal of the central bank's policy is to lower inflation, and obviously the record is quite good. As we know, the governor of the central bank is both pragmatic and visionary, and I am sure that in spite of a problem like the huge inflows, he will find a way to reach the inflation target, and I would like Board members to take account of this reassurance when reviewing Kazakhstan's monetary policy that there is only one goal, and that is to ensure price stability.

Additional Statement

I appreciate Mr. Keller's explanations, and generally agree with them. I have only a few remarks. The first is on fiscal policy. I think that Mr. Luzhin is correct in pointing out that the authorities' policy is wholly in line with the recommendations of last year's staff report. It is not a deliberate overtightening. Indeed, I find it striking that the Minister of Finance and the Budget Minister are very conservative men, just the kind of people the Fund would like to see as their counterparts. I think they are following the traditions of many Western European countries, who are deliberately cautious in their budgetary assumptions. Mr. Keller has pointed out that the situation resulted from a wrong forecast which they failed to correct in their own forecast. But I think their forecast was deliberately conservative,

because they didn't want to receive a negative surprise as they had did in the 1990s. There is a tradition behind this prudent forecasting that one has to understand. I do not disagree with Mr. Keller's explanation. My point is that the wording in the staff appraisal concerning the non-oil budget deficit in 2002 could be read as meaning a deliberate, unnecessary tightening, but the real story is more complex than that.

My second comment is on social outlays. I tend to agree with the points made by Mr. Luzhin, both because he displays a knowledge of what is going on in the CIS countries, and because the policy on social outlays is based on a strategic plan unveiled in 2000 and which runs to 2010. Basically the policy is to promote the private sector so as to reduce reliance on the government, and to privatize functions such as health care and education. Together with the pension reform, these policies aim at improving the social situation of people. I think the strategy is to keep health care and other social outlays in a constant ratio to GDP, so that the very strong economic growth will ensure a strong increase in social spending or at least guarantee a minimum, enabling the authorities to deal with many of the concerns that have been raised here today.

On monetary policy, I think I should convey to my authorities Mr. Keller's remarks about the growth of reserve money. But I still maintain that even though the index of real effective exchange rates indicates a depreciation, and even if it could be inferred from this that there is a policy of allowing a real depreciation--as mentioned in the staff report--the authorities recognize that they must accept some appreciation of the exchange rate, and that they are willing to subordinate everything else to the one single overriding goal of price stability.

Finally, on Mr. Zurbrügg's confusion about nuances, disagreements, and unclear language, let me say that he and I share the German language tradition of speaking very directly. But I have learned, slowly and painfully, that here in the Fund we follow the British tradition of indirect speaking, meaning participation in a very polite, civilized culture for discussion in which we still manage to disagree, to reflect on the pros and cons, and to give credit where it is due.

Concluding Statement

I would like to thank all my colleagues for their valuable comments and recommendations, as well as for their understanding, and I will pass on all these comments to my authorities. On their behalf I would also like to convey special thanks to Mr. Keller and his team for their hard work and strong interest in the Kazakh economy. The Kazakh authorities recognize that their years of cooperation with the Fund have been important for the success of the Kazakh economic policy, and they also greatly appreciated the good work done by successive resident representatives in Kazakhstan.

Everyone agrees that overall, Kazakhstan's situation is very positive. The economy is one of the fastest growing in the world. Inflation is among the lowest among the CIS countries, and Kazakhstan has crossed the line from net debtor to net creditor. I can only

hope that the Fund's Treasurer will not too soon discover that Kazakhstan is now a net creditor, and will not too soon include Kazakhstan in the Fund's Financial Transactions Plan.

The authorities have also been very active and timely reformers, carrying out, among other things, the pension reform, and establishing the National Oil Fund. The economy has reaped great benefits not only from Kazakhstan's wealth of national resources but also from the prudent management of the proceeds. This management will remain prudent, even though the budgetary guidelines for 2003 and later show a trend towards careful relaxation. As mentioned in our buff, fiscal and monetary policies have been very prudent because of the lessons of the shocks of the stabilization crisis of the 1990s.

On the divergence of views with respect to social and education spending, I have already stated my views. I think the issue is more whether the glass is half full or half empty. I think simply that the strategy of making social spending a ratio of GDP, so that high growth over time can take care of the issue, is quite straightforward. The rising tide will lift all the boats. Mr. Keller, as a sailor, will understand this.

I would also like to say that the authorities have expressed strong interest in discussing medium-term budget plans and perspectives with the Fund. They think the Fund could play a useful role in developing a medium-term framework, particularly one which can cope with the main issue facing the country--namely, the expectation of huge new revenues from oil, and the question of how to distribute the oil wealth, how to divide the oil income between saving and investing and spending.

On structural policy, the staff's warnings together with the Board's warnings about an activist industrial policy and a policy of promoting import substitution should be heeded. We have tried to show in our buff statement that the policy initiatives involved are rather small in magnitude. We might also have pointed out that in virtually every country there are efforts to involve the government in diversifying the economy. In any case, I think it is important to convey the message that Kazakhstan would be well advised to limit such policies to keep them from conflicting with their own objective of strengthening the private sector.

On monetary policy, I think the overriding message of today's meeting is that Directors have given credit to some of the staff's doubts about the conduct of policy, but at the same time have also believed the assurance of the authorities that there is really only one goal, and that is to lower inflation. While comparing the figures on real effective exchange rate, one should also compare the effects of NBK's policy on inflation, and I think the latter comparison is the one that counts. I hope the summing up of today's meeting will mention the point made by almost all Directors, acknowledging the reassurance that there is only one goal for monetary policy. Also important is Mr. Zurbrugg's view that the issue is not how or whether to paper over differences, but to give more weight to the views of the authorities, who have, I think, a good case. They are rightly proud, and because they have an economy with a huge potential, because they have managed to stabilize this economy, and because they have reformed it in many respects, they are not only proud but also assertive, and therefore they want to see their views reflected. If you include in the summing up their

clarification on monetary policy, I think it would greatly help, and would also convey that there is a sense of respect for the authorities' achievements.

Further on monetary policy, let me add that the authorities have expressed interest in obtaining technical assistance from the Fund to study the possibility of inflation targeting. This is something that the governor has expressed in talks with the Fund management here.

On investment policy, I understand that some Directors are concerned about the investment climate. Let me stress that the new law gives the same rights to both domestic and foreign investors, and does not propose a revision of old contracts. I should also mention that yesterday, Standard and Poors followed Moody's in upgrading the rating of Kazakhstan. To me this is a sign that the external rating agencies recognize that Kazakhstan's investment climate is quite good.

Finally, on the complaints about insufficient action on AML legislation, I can report that the legislation is in the final stage, and will soon be enacted.

I have also taken note of some concerns about trade policy. We discussed this in Kazakhstan, and I think it is important that the discussion be fully reflected.

Ultimately my authorities think the Fund and the World Bank should and could play a significant role in the Central Asian region by promoting economic integration and promoting reforms in the economic, social, and environmental policies of every country there. My authorities would like to see real economic reforms throughout the region. The situation has become very serious. Kazakhstan is increasingly besieged by huge inflows of illegal labor. Its neighbors have closed their economies to Kazakh investment in both the financial and real sectors. Protectionism is rising, and environmental problems are proliferating. We hope that the Fund and the World Bank can play a useful role here.