Kazakhstan

Country Economic Update
Fall 2018

The Challenge of Economic Diversification amidst Productivity Stagnation

WORLD BANK IN KAZAKHSTAN

Macroeconomics, Trade & Investment Global Practice

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Country Economic Update

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Government fiscal year:	January 1 – December 31
Currency unit:	Kazakhstani tenge (KZT)
Currency equivalents:	Exchange rate effective as of November 20, 2018 US$1 = 367.5 KZT
Weights and measures:	Metric system

Abbreviations and acronyms

EMDEs	Emerging-market and developing economies
FDI	Foreign direct investment
FX	Foreign currency
ICP	International Comparisons Program
MID	Ministry of Investments and Development of Kazakhstan
MNE	Ministry of National Economy of Kazakhstan
NBK	National Bank of Kazakhstan
NPLs	Nonperforming loans
PPP	Purchasing power parity
PPPs	Public-private partnerships
SOEs	State-owned enterprises

Cover photo credit: Shutterstock.com: Asian worker in production plant drilling at machine on the factory floor.

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Foreword

This edition of the Country Economic Update (CEU) for Kazakhstan is part of a semi-annual series designed to monitor socio-economic developments in the country. It presents a concise analysis of economic and social developments, as well as a progress report on structural reform implementation, during the last six to twelve months. This edition includes a special focus section highlighting findings of the World Bank's recently published Country Economic Memorandum for Kazakhstan: Reversing Productivity Stagnation.

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Overview

The economy slowed in the first half of weak consumption despite strong exports.

Real GDP growth in Kazakhstan slowed to an annual rate of 4.1 percent in the first half of 2018 from 4.3 percent in the same period of 2017. Although net exports—supported by increased oil production and improved terms of trade—and investments are driving overall economic growth, and consumption remain weak. As a result of stronger oil exports, the current account deficit narrowed substantially in the first half of 2018 compared with the same period of 2017. On the financing side, foreign direct investment (FDI) rose by 30 percent year-on-year while the primary income deficit widened as a result of higher profit repatriation by mining companies. Higher oil revenues also contributed to an improvement in the fiscal balance. Consolidation efforts to reduce the non-oil fiscal deficit and replenish the National Oil fund (depleted partially during the recent cyclical downturn) are underway, though at a slower pace than initially envisaged.

The economy is expected to perform better thanks to oil sector.

The real GDP growth forecast for 2018 has been revised slightly upward, from 3.7 percent (in our previous Spring 2018 CEU issue) to 3.8 percent, reflecting the better-than-expected oil sector performance. Real GDP growth will maintain a similar rate of growth in 2019 (3.5 percent) before easing thereafter. In 2020-21, a slowdown in both external demand and business investment—owing to cyclical forces and a reversal of fiscal stimulus measures—will crimp overall GDP growth rates. Nonetheless, household consumption is forecast to rise only modestly on the back of recovering real incomes and subdued lending.

Productivity growth is the key determinant of Kazakhstan's growth prospects.

Declining productivity growth, which has fallen during the past two decades, is the main driver of Kazakhstan's poor medium-term GDP growth outlook. Productivity was robust in the early 2000s, contributing about 6 percentage points to annual GDP growth. However, by the early 2010s, annual productivity growth had fallen to an average of less than 2 percent and between 2014 and 2016 the measured productivity growth turned negative, declining by about 2 percentage points per year. The slowdown is mainly the result of falling within-sector productivity growth across all major economic sectors—agriculture, industry, and services. Empirical analysis points to productivity as Kazakhstan's core engine of sustainable long-term growth.

A small private sector, high level of market concentration, and lack of creative destruction are responsible for low productivity growth.

The decline in productivity growth in recent decades is attributable to several factors. Chief among these are the constraints imposed on private sector development, as reflected in low rates of business entry. In Kazakhstan a handful of players—mostly state-owned enterprises, or SOEs—dominate key product markets, including backbone services that support the private sector. Empirical evidence suggests that newer, smaller firms are more productive than older, larger firms. However, because of the continued protection of inefficient, large firms (both SOEs and private firms), the process of creative destruction—whereby less productive firms exit the market—is not taking

place, suggesting that critical elements of Kazakhstan's economic transition remain incomplete.

A. Recent Socio-Economic Developments

Recent political events

The President reshuffled several key political positions in September.

Several powerful political positions were reshuffled in September by President Nursultan Nazarbayev. The Mayor of Astana, Asset Issekeshev, was appointed as the Head of the Executive Office of the President, replacing Adilbek Zhaksybekov. The former Minister of Finance, Bakhyt Sultanov, replaced Mr. Issekeshev as mayor. Alikhan Smailov, Aide to the President, became the Minister of Finance. The government announced that these changes were made to strengthen the implementation of major state programs and ensure close coordination at the regional level.

President Nazarbayev opened the fourth session of the Kazakh Parliament on September 1, 2018. In his speech, he highlighted key areas of social and economic development for attention during the coming parliamentary session, including the formalization of self-employed workers, improvements to the public procurement system, the modernization of housing and utility services, and the development of tourism and agribusiness.

Kazakhstan continues to expand its role as a provider of hosting services for diplomatic mediation. On August 12, Astana hosted the ratification of a territorial treaty between the littoral states of the Caspian Sea. In recent years, Kazakhstan has acted as unofficial mediator in the dispute between the Russian Federation and Ukraine. Kazakhstan has also hosted talks on several occasions between the Syrian Arab Republic and the P5+1 group (the UN Security Council's five permanent members—namely China, France, Russia, the United Kingdom, and the United States—plus Germany).

On October 5, President Nazarbayev issued his second national address this year (the first was in January). The speech covered critical areas such as the provision of liquidity to the banking sector, support to small and medium enterprises (SMEs), a substantial increase in the minimum wage, and reforms in education and law enforcement. The import of this speech and associated high level meetings under the auspices of National Modernization Council might determine the policy thrust for 2019 and beyond as well as the government's agenda for political and economic transition.

Growth and inflation

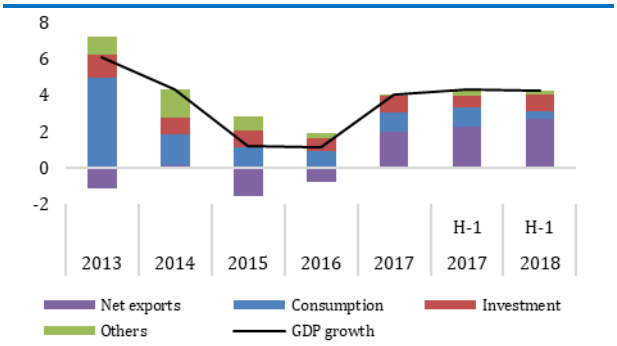
Economic growth remains robust, driven by net exports.

Annual real GDP growth slowed modestly in the first half of 2018, decelerating to 4.1 percent compared to 4.3 percent in the same period of 2017. Preliminary data suggest that real GDP growth slowed to 4.1 percent in the first nine months of 2018, compared to growth of 4.3 percent during the year-earlier period. With export growth accelerating substantially in the first half of 2018 on the back of oil production increases and improved terms of trade, net exports were the main contributor to GDP growth (Figure 1). Stronger private investment, driven mainly by improved investor confidence, underpinned fixed capital investment growth. Consumption growth remained moderate as a result of both weak household real income growth and reduction in public consumption.

Services also contributed positively to GDP growth.

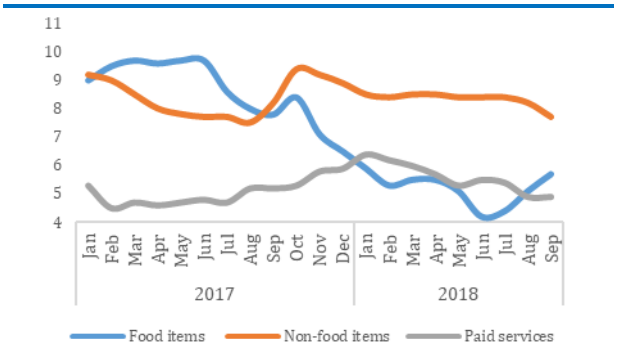
On the supply side, industrial output rose by 5.2 percent year on year in the first half of 2018, due mainly to a 6.2 percent expansion of the oil sector on account of higher-than-expected oil production from the Kashagan oil field. Improved terms of trade spilled over to services (particularly trade and transportation) and non-oil manufacturing. Agricultural output grew at an annual rate of 4 percent in the first half of 2018, marginally higher than a year earlier. Construction growth fell to 3.8 percent, compared to 5.9 percent in the first half of 2017.

Figure 1. Supported by oil, net exports were the main contributor to GDP growth in the first half
(contribution to GDP growth, in percentage points)



Source: World Bank staff calculations based on official data published by the authorities.
Note: Others includes statistical discrepancy and inventory.

Figure 2. Inflation has decelerated in recent months



Source: Statistical Office of Kazakhstan; World Bank staff estimates.

Inflation remains moderate.

Headline inflation eased to 6.1 percent in September 2018, down from 7.1 percent September 2017, despite exchange rate volatility (see next section). Despite some moderation in inflationary pressures, in October the monetary authority increased its base rate by 25 basis points (to 9.25 percent) after keeping it at 9 percent for three consecutive months. A deceleration in food price inflation—which eased from an annual 8.6 percent in 2017 to 5.7 percent in the year ending in September 2018—and moderate

inflation in paid services drove the decline in headline inflation (Figure 2). Despite the increased volatility of the exchange rate in September 2018 and higher fuel prices, non-food price inflation stood at an annual 7.7 percent in September compared to 8.2 percent a year earlier.

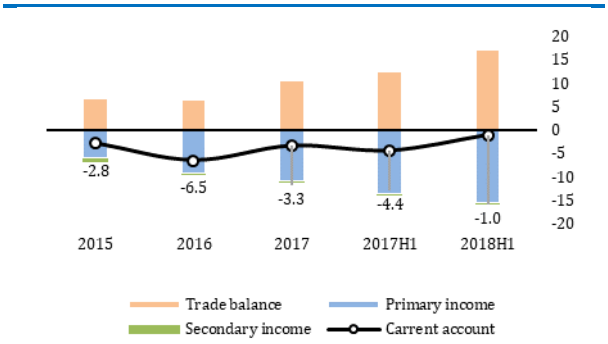
External sector

Benign external conditions supported a narrowing of the current account deficit.

Kazakhstan's external position improved significantly in the first half of 2018 mainly due to more favorable terms of trade. With oil exports rising firmly, the current account deficit narrowed to 1 percent of GDP (US$700 million), from 4.4 percent of GDP in the first half of 2017 (Figure 3). Meanwhile, the widening trade surplus was partially offset by an increase in the primary income deficit, reflecting a rise in mining company profit repatriation. On the financing side, net FDI inflows increased substantially, rising by more than 30 percent year on year to US$4.2 billion; net outflows of portfolio investment and other short-term capital stood at US$2 billion and US$2.7 billion, respectively. Gross international reserves held by the National Bank of Kazakhstan (NBK, the central bank) declined to US$29.1 billion at end-October 2018 (down by 5.4 percent from end-2017).

Figure 3. Current account composition, 2015–18

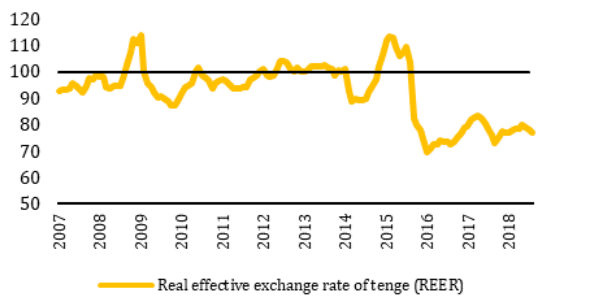
(percent of GDP)



Sources: World Bank Staff calculations based on official data published by authorities.

Figure 4. Real effective exchange rate, 2007–18

(Dec 2013 = 100)



Source: World Bank Staff calculations based on official data published by authorities.

The real effective exchange rate has depreciated slightly.

The real effective exchange rate (REER) has depreciated moderately so far in 2018 (Figure 4). The September 2018 REER shows a depreciation of 5 percent relative to the average for 2017 and remains substantially lower than the levels observed before mid-2015 when the tenge lost almost half of its nominal value. The REER of the first nine months of 2018 is 17 percent lower than the average REER in 2014. Against this backdrop, despite improved exchange rate competitiveness over the past three years, exports of tradable non-mineral goods recorded only modest expansion. Meanwhile, rising interest rates in the United States and Euro area economies, coupled with a forecast moderation of oil prices over the medium-term, are likely to

exert additional pressure on the nominal exchange rate and, potentially, the REER.

Table 1. Balance of Payments and Official Reserves, 2015–18
(In US$ billions)

	2015	2016	2017	2017 H1	2018 H1
Current account balance	**-5.1**	**-8.9**	**-5.4**	**-3.0**	**-0.7**
Merchandise trade	12.7	9.2	17.3	8.5	13.1
Exports f.o.b.	46.5	37.3	49.5	23.6	29.4
Imports f.o.b.	33.8	28.1	32.1	15.1	16.4
Services	-5.1	-4.8	-4.4	-2.0	-1.9
Primary income	-11.1	-12.9	-17.9	-9.2	-11.9
Of which: Income of direct investors	-8.6	-11.0	-15.6	-8.1	-10.7
Secondary income	-1.6	-0.4	-0.5	-0.2	-0.1
Capital and financial account balance /1/2	**-5.4**	**6.6**	**0.9**	**3.0**	**-0.5**
Direct investment	3.1	13.4	3.7	3.2	4.2
Portfolio investment /1	-3.9	-2.9	2.5	3.1	-2.3
Medium- and long-term investment	4.1	4.2	0.4	0.7	0.3
Short-term investment	-3.8	-8.1	-3.2	-3.2	-3.5
Errors and omissions	-5.0	0.0	-2.5	-0.8	0.9
Overall external balance	**-10.6**	**-2.2**	**-4.5**	**0.1**	**-1.3**
Change in FX assets in the Oil Fund	-9.8	-2.2	-2.9	1.0	-0.3
Change in FX reserves at the NBK	-0.8	-0.1	-1.6	-0.9	-1.0
Memorandum items:					
Stock of total official reserves	**91.3**	**90.9**	**89.1**	**92.2**	**88.1**
Stock of FX assets in the Oil Fund	63.4	61.2	58.3	62.2	58.0
Stock of FX reserves at the NBK	20.3	20.1	18.2	18.9	17.2
Gold reserves	7.6	9.6	12.5	11.2	12.9
Terms of trade (2015=100) /3	100.0	98.8	105.1	104.9	116.8
Nominal GDP	184.4	137.3	159.4	67.5	73.3

Source: World Bank staff calculations based on data published by the authorities.
Note: Some sums may not add up exactly due to rounding; 1/ Excluding net investment of the Oil Fund; 2/ Including errors and omissions; 3/ Annual estimates.

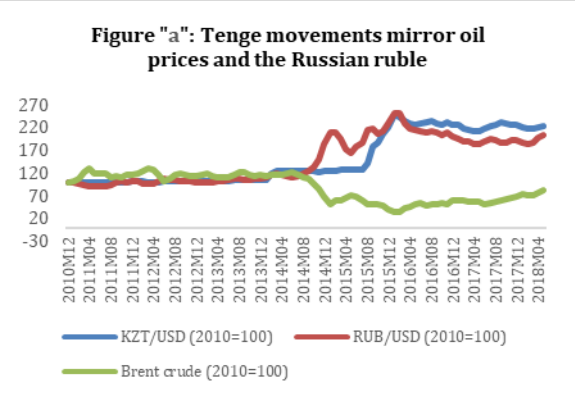
Box 1. Rising interest rates and tightening global financing conditions: The effects on Kazakhstan

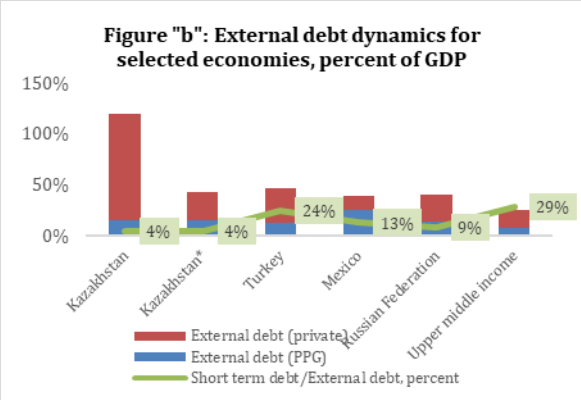
Following an extended period of favorable global financial conditions, interest rates are now on the rise in response to monetary tightening in advanced economies. Financial conditions are expected to tighten at a faster pace in response to the improved outlook of the U.S. economy and the large fiscal stimulus. Consequently, further policy rate hikes by the U.S. Federal Reserve are projected while the Euro area and Japan will opt to scale back asset purchasing programs. US long-term yields are now above 3 percent—their highest level since mid-2014. This trend will lead to major portfolio reallocation out of emerging markets, which will negatively impact debt and FDI flows to emerging markets as well as put pressure on currencies.

In general, rising interest rates impact an economy through (i) the exchange rate, (ii) trade, and (iii) financial channels. Higher interest rates in advanced economies, therefore, will lead to the appreciation of their currencies (subsequently impacting exchange rates), trade adjustments as imports from these economies become more expensive, and higher borrowing costs on account of restrained investment flows.

The value of the tenge is mainly influenced by changes in oil prices and the dynamics of the Russian ruble; fluctuations in the value of the U.S. dollar have a limited direct impact. Therefore, the prospects for tenge depreciation in response to U.S. dollar appreciation are relatively weak (see figure "a" below). Even if the tenge depreciates, because of the U.S. dollar-denominated commodity-based structure of Kazakhstan's exports its effect on exports will be insignificant in the short term. The indirect effects, however, will depend on how U.S. dollar appreciation impacts Kazakhstan's REER dynamics, given that Kazakhstan has limited trade with the United States, but a large import bill overall.

The effects from the financial channel are dual. On the one hand, rising interest rates can be beneficial through higher returns on external reserve holdings, which amounted to US$89 billion (56 percent of GDP) at end-2017. On the other hand, rising interest rates make external debt more expensive to service and roll over. Kazakhstan's external debt totaled US$167 billion (105 percent of GDP) in 2017. However, nearly 63 percent of total external debt is intercompany debt (mainly from oil-financed projects in the mining sector). Excluding intercompany debt reduces the external debt to GDP ratio to 39.8 percent of GDP, 70 percent of which is still private debt. Excluding intercompany debt—which is particularly large in Kazakhstan's case due to the large leverage of the foreign oil companies—the country is on par with several major emerging market economies in terms of its external (private and public) debt to GDP ratio (see figures "a" and "b" below).





Source: World Bank staff calculations.
Note: *- Excluding intercompany debt.

Also, both the term and interest composition of corporate debt are favorable—85 percent of outstanding debt is long term and nearly 70 percent of debt is at fixed rate. However, almost 75 percent of corporate debt is denominated in foreign currency, leaving it vulnerable to tenge depreciation.

Financial sector

The banking sector clean-up continues.

The merger of Kazakhstan's two largest banks, Halyk and Kazkommertsbank (Kazkom), was finalized in July, establishing a new institution accounting for about one-third of total financial system assets (Table 2). The banks were merged to address serious financial issues at Kazkom, whose takeover of BTA Bank in 2013 proved ruinous. Under the merger, the Problem Loan Fund (PLF) purchased Kazkom's stressed assets (totaling 2.4 trillion tenge, or US$7.3 billion) and Halyk paid a symbolic amount for the remaining Kazkom assets and injected about US$750 million in capital.

Meanwhile, Kazakh banks continue to show signs of stress. Three small banks had their licenses revoked in mid-2018. In September, Kazakh authorities bought 450 billion tenge (US$1.2 billion) of agricultural sector loans from Tsesnabank, the second-largest lender, to strengthen its balance sheet; state holding KazAgro is restructuring part of Tsesnabank's agricultural portfolio. Although the NBK issued 3 trillion tenge worth of securities (US$8 billion), the treasury was not involved but the securities were acquired by the National Pension Fund.

Table 2. Key Exposure Indicators of the Top 10 Banks, as of October 2018

Top 10 banks by assets	Percent of system assets	Percent of system lending	Share of problem loans /1	Share of NPLs past 90 days
Halyk Bank of Kazakhstan 2/	33.2	29.3	17.5	12.1
Tsesnabank	8.8	10.5	11.2	6.7
Sberbank of Russia	7.3	9.2	8.0	6.0
ForteBank	6.6	4.7	13.4	8.0
KASPI BANK	6.5	8.6	13.8	7.7
Bank 'CenterCredit'	6.1	7.8	15.5	7.0
ATFBank	5.8	7.2	12.9	8.9
Eurasian Bank	4.5	4.9	26.1	8.8
Zhilstroysberbank	3.6	4.5	1.8	0.2
Bank RBK	2.4	1.7	45.7	25.4

Source: National Bank of Kazakhstan.
Note: 1/ Loans with overdue payments (principal and/or interest; 2/ Halyk Bank acquired Kazkommertsbank in July 2017.

Credit growth remains stagnant due to banking and corporate sector weaknesses.

The public sector has repeatedly provided funding to the banking sector at subsidized market rates to support credit growth. President Nazarbayev ordered the NBK to provide another 600 billion tenge (nearly US$2 billion) in long-term liquidity support to the banks in his annual address in October. However, rather than extending credit, banks are accumulating liquid assets (nearly 41 percent of total assets), reflecting weaknesses in banks' solvency and corporate balance sheets. As a result, despite double-digit credit growth to individuals, total credit growth has remained flat in 2018. Meanwhile, the de-dollarization trend continues, with foreign currency loans falling from

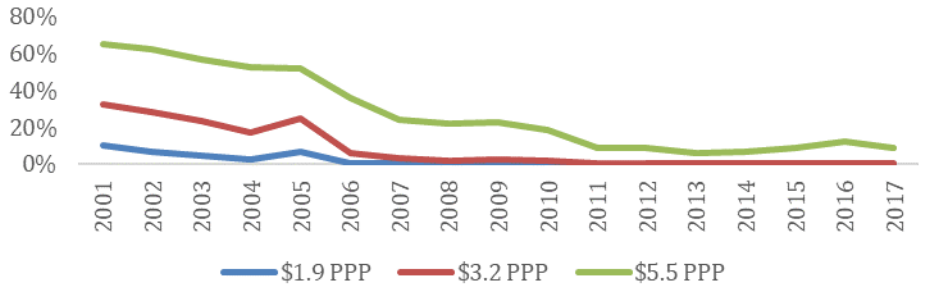
28 percent of total loans in September 2017 to 23 percent in September 2018, driven by a real appreciation of the tenge. Reported financial indicators show strong bank capitalization (20.7 percent at end-July 2018) and declining nonperforming loans (NPLs) (8.2 percent of total loans), largely reflecting loan purchases by the PLF. However, the central bank has recognized publicly that the actual figure of NPLs is likely closer to 30 percent.

Social sector

Kazakhstan is reducing poverty at a steady pace

The most recent data available suggest that the poverty rate in Kazakhstan declined between 2016 and 2017 (Figure 5). Measured against the highest poverty line used by the World Bank—typically reserved for upper-middle-income economies like Kazakhstan—poverty fell from about 65 percent in 2001 to about 8.5 percent in 2017. But many challenges remain, and Kazakhstan is vulnerable to economic shocks that periodically reverse the country's progress on poverty reduction. During periods of low economic growth or recession—as in 2005 and 2013–16, for example—many people fell into poverty (though not often extreme poverty); the poverty rate only improved after a subsequent return to growth in the following years. Indeed, measured at the highest poverty line, Kazakhstan has yet to return to the levels achieved in 2013.

Figure 5. Poverty Rates in Kazakhstan (US$ per day, PPP)



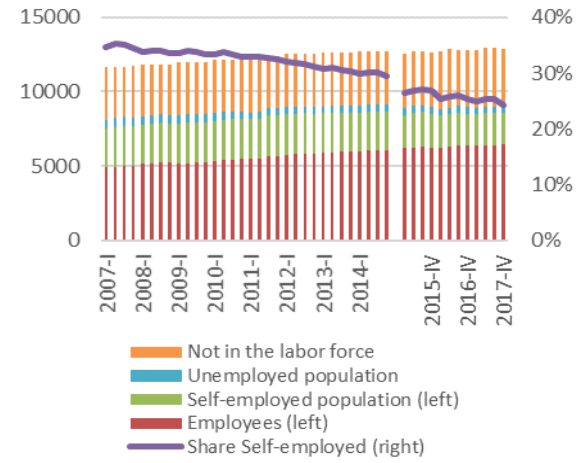
Sources: World Development Indicators, World Bank.

Formal wage employment is steadily overtaking self-employment in Kazakhstan, with self-employment accounting for less than one-quarter of the labor force for the first time in 2017. Real wages, which rose by about 2 percent year on year in the first half of 2018, are expected to push the poverty rate lower in the coming year. Formal wages rose most rapidly in administrative and service support, followed by construction and mining. In the first half of 2018, those areas recording the fastest pace of formal wage growth were Atyrau, Karaganda, and East Kazakhstan regions.

In his October speech, President Nazarbayev announced a significant increase to the national minimum wage. From January 1, 2019, the minimum monthly

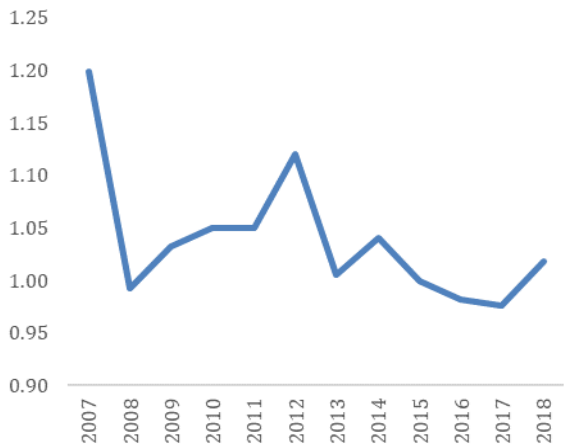
wage will rise to 42,000 tenge (US$115) from 28,000 tenge (US$80) currently. More than 96 billion tenge (US$260 million) will be allocated annually from the republican budget for 2019–21 to fund the increase. According to government estimates, 1.3 million people across economic sectors will be impacted by the minimum wage increase. While higher wages may lead to a slight reduction in labor demand, the positive impact on poverty levels and inequality throughout the country (excluding Almaty and Astana) could be substantial.

Figure 6. Key Indicators of Employment (in '000 of people, LHS and % RHS)



Sources: United States Energy Information Agency (EIA); National Bank of Kazakhstan.

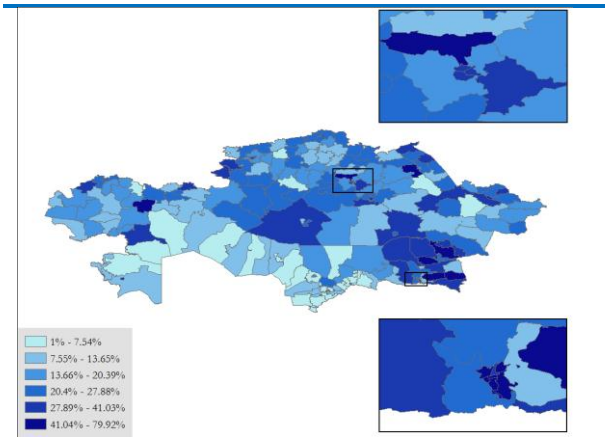
Figure 7. Real Wage Index (January-June) (January-June 2015 = 1,)



Source: World Bank staff calculations based on official data published by the National Bank of Kazakhstan.

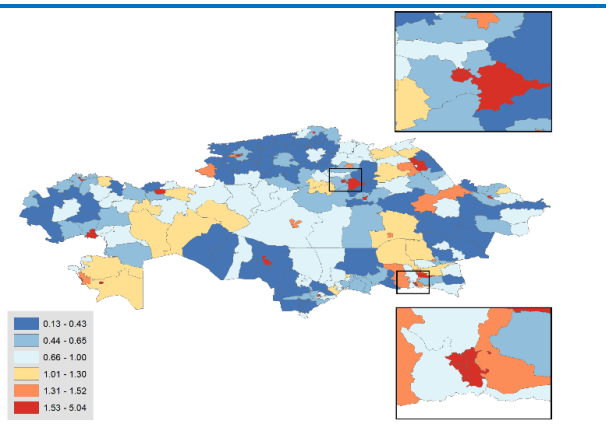
Spatial inequality represents a significant challenge for Kazakhstan. Although most districts in Kyzylorda, Atyrau, Aktobe, and South Kazakhstan do not have extremely high poverty rates, the size of the middle class in these areas lags the districts around Almaty, Akmola, North and East regions, and Pavlodar (figure 8). The rising cost of housing in the country's most prosperous cities risks a further widening of wealth inequality by impeding the mobility of people from lower-income areas (figure 9). Addressing the growing shortage of affordable urban housing will be vital in fostering geographic and economic mobility in the coming years.

Figure 8. Distribution of the Middle Class in 2015



Sources: United States Energy Information Agency (EIA); National Bank of Kazakhstan.
Note: Middle class is defined as households with income per capita of between US$14-52 PPP per day.

Figure 9. Index of Housing Costs in 2015



Source: World Bank staff calculations based on official data published by the National Bank of Kazakhstan.

B. Macroeconomic Policies and Structural Reforms

Assessment of fiscal and debt policies

Expenditure adjustment and non-oil deficit reduction are in line with the fiscal consolidation plan

The authorities continue consolidation efforts to reduce the non-oil fiscal deficit and replenish the National Oil Fund (partially depleted during the recent cyclical downturn). Following substantial one-off budgetary support to the banking sector in 2017, in 2018 fiscal expenditure returned to a more sustainable level (table 3). Public spending is projected to drop to 20.8 percent of GDP in 2018, from a past three-year average of 25.9 percent of GDP, while the non-oil deficit is projected to fall to 6.9 percent of GDP (from a year-earlier level of 12.8 percent of GDP). Although reducing budget outlays is consistent with the government's medium-term fiscal consolidation strategy, and an appropriate action given the cyclical recovery of the economy, an additional push will be needed to improve the efficiency of public expenditure.

Table 3. General Government Fiscal Accounts, 2016–20
(In percent of GDP, unless otherwise indicated)

	2016	2017	2018 e	2019	2020	2021
				Projections		
Total revenue and grants	**19.6**	**23.2**	**22.8**	**23.4**	**22.9**	**22.4**
Oil revenue	4.5	8.4	6.9	7.4	6.9	6.4
Oil Fund gross revenue /1	3.0	6.7	5.4	5.3	5.0	4.6
Customs duty on oil exports	1.5	1.7	1.5	2.1	1.9	1.8
Nonoil revenue	15.2	14.8	15.9	16.0	16.0	16.0
State Budget revenue /2	12.2	11.7	12.9	13.0	13.0	13.0
Other extra-budgetary funds' revenue /3	3.0	3.1	3.0	3.0	3.0	3.0
Expenditure and net lending	**24.1**	**25.4**	**20.8**	**19.8**	**19.3**	**19.2**
State Budget spending, excluding Oil Fund flows	15.3	16.2	15.4	15.3	15.3	15.9
Oil Fund consumption	6.8	8.3	4.5	3.9	3.4	2.7
Other extra-budgetary funds' spending /3	1.9	0.8	1.0	0.6	0.6	0.6
Overall fiscal balance	**-4.4**	**-2.2**	**2.0**	**3.6**	**3.6**	**3.2**
State Budget deficit /2	-1.7	-2.9	-0.9	-0.2	-0.4	-1.1
Oil Fund fiscal savings, net	-3.8	-1.6	0.9	1.5	1.6	1.9
Other extra-budgetary funds' balance /3	1.1	2.3	2.0	2.4	2.4	2.4
Nonoil deficit of the Consolidated Budget /4	**-10.0**	**-12.8**	**-6.9**	**-6.2**	**-5.7**	**-5.6**
One-off expenditure /5		3.9	0.8			
Nonoil deficit, excluding one-off expenditure	**-10.0**	**-8.9**	**-6.1**	**-6.2**	**-5.7**	**-5.6**
Memorandum items:						
Stock of net financial assets	25.0	15.7	16.0	16.2	16.4	16.3
Stock of FX assets in the Oil Fund	44.6	35.8	35.4	34.3	33.4	32.9
Stock of total government debt /6	19.6	20.1	19.4	18.0	17.0	16.6
Stock of net financial assets (US$ billion)	33.6	26.1	27.1	29.8	32.5	34.8

	2016	2017	2018 e	2019	2020	2021
				Projections		
Stock of FX assets in the Oil Fund (US$ billion)	61.2	58.3	60.2	62.9	66.1	70.3
Stock of total government debt (US$ billion) /6	27.6	32.2	33.0	33.1	33.6	35.5

Source: World Bank staff calculations based on data published by the authorities.

Note: Some sums may not add up due to rounding; 1/ Including FX gains/losses; 2/ Excluding sale of state property and land; 3/ Excluding the Oil Fund; 4/ The Consolidated Budget comprises the State Budget and the Oil Fund consumption; 5/ One-off expenditure covers a US$6.5 billion transfer to the Problem Loans Fund in 2017 and a US$1.2 billion transfer to buy distressed loans from Tsesnabank in 2018; 6/ Including state guarantees.

Increasing the efficiency of public spending is crucial. The authorities should act more decisively to prioritize public expenditure toward growth-stimulating measures. Such an approach will be critical in the medium term, particularly considering the falling contribution of capital investment (at just 13.6 percent of total spending in 2017 compared with an average of 20 percent in 2010–15). Along with measures to promote efficiency, there is also a rising need to boost non-oil revenue to strengthen the public finances and meet the fiscal costs of the President's recent announcements, which included raising the minimum wage (for public sector employees) and initiatives supporting SMEs, agriculture, and manufacturing.[1]

Authorities should plan to reduce the reliance of budget spending on Oil Fund transfers. A decline in oil prices or deceleration of economic activity could place additional pressure on the government's medium-term goal of reducing guaranteed transfers from the National Oil Fund. This challenge is underscored in the recently-adopted 2019–21 budget, which includes an increase in annual transfers from the Oil Fund of an additional 150 and 300 billion tenge (the equivalent of US$430 and US$860 million, respectively) to compensate for a projected shortfall in budget revenue. Consequently, the original target to cut transfers from the Oil Fund to 2 trillion tenge by 2020 (as included in a new Oil Fund Rule) has been deferred to a later date. Despite higher oil prices and production, supplemental withdrawals are projected to result in a decrease in foreign reserves of the National Fund of the Republic of Kazakhstan (NFRK) from 35 percent of GDP in 2018 to 32 percent in 2021. Government debt, however, will stabilize near 20 percent of GDP.

[1] In addition to covering the cost of raising the minimum wage by 50 percent for public sector employees, over the next three years the authorities will need to raise an additional 30 billion tenge (to be allocated annually) to support SMEs, at least 100 billion tenge to support the agricultural processing industry and 500 billion tenge to support the manufacturing industry.

Box 2. Rising trade protectionism: What does it mean for Kazakhstan?

Rising trade tensions between major economies pose significant risks to the global economy and cloud the medium-term outlook. In the past several months, the United States has imposed tariffs on a variety of imports; these were then countered with retaliatory measures by the respective economies. The ongoing trade tensions between the world's two largest economies, the United States and China, is particularly worrisome—the consequences for the rest of the world's economies include rising uncertainty, disruption of value chains, commodity market volatility, and depressed investment flows. Trade protectionism has risen in the wake of the 2008-09 global financial crisis. Global Trade Alert data indicate that the number of harmful measures has increased in recent decades (see figure) and these have been concentrated in select sectors (table 2).

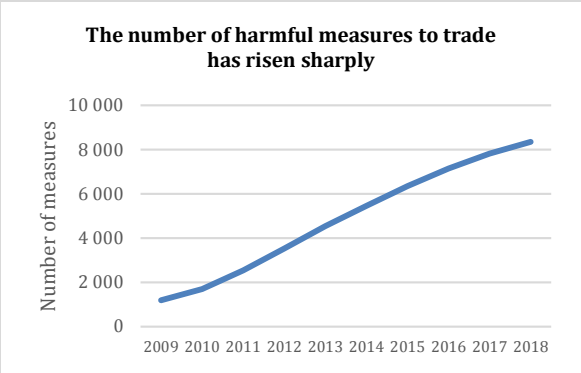


Table 2. Sectors affected by protectionist measures globally

Sector	Measures
Products of iron or steel	1089
Other fabricated metal products	830
Motor vehicles, trailers and semi-trailers; parts and accessories	658
Basic iron and steel	518
Basic organic chemicals	511

Source: Global Trade Alert (https://www.globaltradealert.org/).

The direct impact on Kazakhstan of protectionist measures is expected to be minimal. Kazakhstan's exports consist mainly of globally-traded commodities such as crude oil, gas, and copper, reducing the likelihood of protectionist measures impacting the country's exports. Although the export base includes products that were recently exposed to heavy protectionist measures (see table 3), the value of these product categories is insignificant as a share of Kazakhstan's total exports. Growing trade tensions among the world's major economies pose only a limited threat to Kazakhstan's exports; protectionist measures by individual economies would have a marginal direct effect.

Table 3. Sectors affected by protectionist measures in Kazakhstan

Sector	Measures
Products of iron or steel	146
Basic iron and steel	61
Copper, nickel, aluminum, alumina, lead, zinc and tin, unwrought	58
Basic inorganic chemicals n.e.c.	43
Cereals	37

Indirect effects—in the form of a slowdown of growth in major trading partners and rising uncertainty in global commodity markets—could have a greater impact. *Trade tensions have adversely—but moderately, so far—affected the economic performance of Kazakhstan's major trading partners, including China.* Trade tensions between China and the United States can disrupt value chains between the two economies, stoke inflation, and worsen investment-inhibiting uncertainty. These forces are likely to curtail economic performance in both China and the United States. China is Kazakhstan's biggest export destination, accounting for 13 percent of total exports—a slowdown in China will negatively impact demand for Kazakhstan's exports. The composition of Kazakhstan's exports to China is dominated by commodities, including crude oil, copper, and radioactive chemicals. While demand for commodities may not be immediately impacted, export volumes may eventually fall if tensions persist for an extended period.

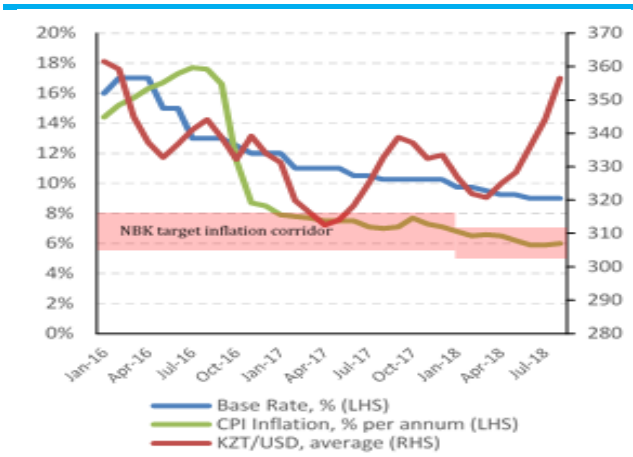
Trade tensions may also trigger volatility in global commodity markets over the medium term. The economies involved in trade tensions are major economic power centers, and the ongoing tensions are fueling global market uncertainty. Global commodity markets will also be affected by higher uncertainty, leading to increased volatility in commodity prices over the medium term. For oil-exporting countries like Kazakhstan, volatile oil prices complicate the macroeconomic framework. Ultimately, there may be a push for a return of sub-optimal pro-cyclical fiscal policies in response to temporary oil price increases.

Assessment of monetary and exchange rate policies

The NBK is taking a cautious approach to monetary easing.

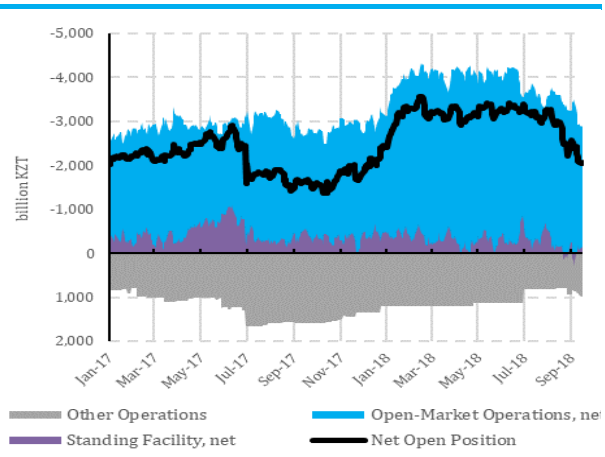
The monetary authorities increased the base rate by 25 basis points in October, to 9.25 percent (figure 10). The NBK had kept the base rate at 9 percent since cutting rates in June, when the authorities also adjusted its forward guidance to include limited easing measures for the remainder of 2018 on account of rising inflationary risks. Further decisions on the base rate will be conditional on price developments; inflation may accelerate in the coming months following a notable depreciation of the tenge recorded in August and September, when it lost nearly 7 percent of its value against the U.S. dollar. The authorities will remain cautious on further monetary easing and stick to anchoring inflation expectations to mitigate negative spillovers. After its peak at 17.7 percent in mid-2016, inflation stood at 6.1 percent in September, within the NBK's 5-7 percent target range for 2018, but above the revised 4-6 percent target range for 2019–20.

Figure 10. The NBK paused monetary easing amid slower disinflation and tenge depreciation.



Source: National Bank of Kazakhstan, Statistical Committee of the Republic of Kazakhstan

Figure 11. The NBK reduced its open market operations back to 2017 levels.



Source: National Bank of Kazakhstan

NBK's efforts still having limited effect on bank lending.

Although the NBK has curtailed its use of open market operations since July following currency depreciation (figure 11), banks have continued to increase their liquid assets at correspondent accounts. Bank liquidity rose by 2.6 percent between end-2017 and July 2018, to 9.9 trillion tenge (US$8.9 billion) or roughly 41 percent of total banking sector assets. This

liquidity is not being circulated through the economy by the banks as it was intended to by the NBK. Instead, the high level of bank liquidity reflects the banks' allocation of riskless income at the NBK base rate or the interest income from other financial institutions.

The effectiveness of monetary policy will depend on the NBK's (i) ability to respond to external factors, (ii) ability to facilitate lending activity, and, perhaps most importantly, (iii) credibility. The structure of the Kazakh economy means that external factors—such as economic sanctions on Russia and volatility in commodity prices—strongly impact the exchange rate and price stability. Weak monetary policy transmission mechanisms hinder the effect of interest rate decisions on the real economy. The policy decisions and the forward guidance from the NBK are key to the effectiveness of monetary policy. The regulator should, therefore, use the monetary policy instruments at its disposal—including inflation targeting and the flexible exchange rate regime—to facilitate real activity.

Ongoing structural reforms

Reform is underway, but there is a risk of over-regulation.

The authorities report that much of the government's "100 Concrete Steps" initiative, announced by President Nazarbayev in early 2015, has been implemented. Many of the more than 50 laws and regulations that have been adopted include provisions for the strengthening of governance, which is critical to Kazakhstan's structural transformation. However, while important, legislative changes should be viewed only as a means to an end; Kazakhstan should be cautious of becoming over-regulated while losing sight of the original goals of reform.

Kazakhstan requires a more significant transformation and change management agenda that targets results rather than processes, encourages initiative rather than hierarchical decision-making, and provides budget flexibility within established limits. Kazakh authorities increasingly are demonstrating their support to institutional transformation. Acknowledging deficiencies in legal drafting, the Ministry of Justice initiated a discussion on streamlining legal drafting processes to increase the quality and stability of legislation, and to encourage self-regulation. The Supreme Court embarked upon an extensive transformation program built on "Seven Stones of Justice" which targets changes in business processes and internal procedures under existing legislation. The Civil Service and Anti-Corruption Agency runs an information campaign on corruption prevention, while increased criminal prosecution of corruption cases simultaneously sends a strong message to society.

Improvements in the business

The government is also implementing measures to ease the regulatory burden on businesses—such as cutting the number of inspections and

environment have been reflected in the latest WB Doing Business report.

reducing administrative reporting requirements. Services provided by natural monopolies and quasi-state organizations are also being streamlined and regulated to improve the protection of entrepreneurs' interests.

Government's efforts are reflected in the World Bank's recently updated Doing Business-2019 ranking, in which Kazakhstan is listed 28th (out of 190 countries) in the overall ease of doing business (up from 36th position a year before). Kazakhstan has improved in 6 out of 10 ranking items; particularly in enforcing contracts, dealing with construction permits, starting a business, resolving insolvency, getting credit, and trading across borders. Notably, the country remained in the top in protecting minority investors.

Government measures are supported by the "Unified Business Roadmap 2020" program, which aims to foster entrepreneurship and create jobs in the regions. The program includes partial credit guarantees, infrastructure development, the creation of industrial zones, long-term lease financing, specialized support to exporters, interest rate subsidies, and non-financial capacity building support.

These and other major state-supported initiatives aim to stimulate the economy by increasing investment using public money. In effect, the government is the main driver of private sector investment, increasing the private sector's dependence on public support. The share of bank credit in corporate capital structures fell from 16.5 percent in 2013 to 7.4 percent in 2017, while the share of public support increased.

Furthermore, public employment as a share of total employment has been rising since 2013, underscoring a lack of private sector employment opportunities.

Excessive government financial support acts as a disincentive to firms to operate under normal market conditions (thereby making them less competitive). Furthermore, public funds do not flow to the most productive sectors. As a result, improving domestic market efficiency and the business operating environment are key to counteracting the negative side effects of government intervention and boosting private investment.

In this context, the strategic attraction of knowledge-intensive, export-oriented FDI is critical to relieving mounting pressure on the public finances. As such, effective implementation of the recently-adopted National Foreign Direct Investment Strategy, which focuses on raising Kazakhstan's investment attractiveness for non-resource seeking investments, will be critical.

C. Economic Outlook and Risks

Global economy and drivers

Global growth will peak in 2018 before decelerating slightly in 2019–20.

The global economy is projected to expand at a rate of 3.1 percent in 2018, unchanged from 2017, before slowing to 3 percent in 2019 and 2.9 percent in 2020. Following firm growth in the first half of 2018, economic performance has become more heterogenous, reflecting country-specific challenges and vulnerabilities. Economic growth is accelerating in the United States, supported by fiscal and monetary stimulus, but is expected to slow in 2019–20 as these factors fade and start to reverse. Euro area activity is expected to slow from 2.4 percent in 2018 to 2.1 percent in 2019, reflecting a moderation in trade. A reduction in monetary stimulus in 2019–20 will contribute to a further deceleration in 2020, to 1.5 percent.

In China, economic performance was robust in the first half of 2018, but recent data indicate a deceleration of growth momentum in the third quarter. Continued domestic rebalancing and higher tariffs will weigh on growth, which is expected to slow in 2019–20. In emerging market and developing economies (EMDEs), the pace of recovery of commodity-exporting economies has moderated, reflecting a softening of agricultural and industrial commodity prices. However, growth is projected to pick up in 2019–20. While growth in commodity importers remains robust—supported by buoyant domestic demand—signs of softening momentum are evident, reflecting capacity constraints and slowing export growth.

Risks to financial conditions and trade are intensifying.

Increasingly, the risks to the global economy are weighted to the downside. Escalating trade tensions and a broadening of financial market turbulence could result in weaker-than-expected growth in many EMDEs. Tight regional and global value chains mean that rising trade tariffs could have a significant impact on economic activity. Economies with external vulnerabilities—such as Argentina and Turkey, for example—have experienced significant currency depreciation and financial turmoil in 2018. The depreciation of the Turkish lira in August was quickly followed by currency depreciation in several economies in Europe and Central Asia, including Georgia, Kazakhstan, and Russia. Sharper-than-expected monetary tightening in developed economies and rising risk aversion could exert further pressure on EMDEs with vulnerabilities, especially those with elevated levels of government and/or private sector debt or large external financing requirements.

Oil prices are expected to decline slightly, with upside risks.

Energy prices have remained elevated since mid-2018. Oil prices, which are projected to average US$70 per barrel (bbl) in full-year 2018 (up 32 percent from 2017), were volatile throughout the year. Upward price pressures reflected continuing declines in production in República Bolivariana de Venezuela and the reintroduction of sanctions on the Islamic Republic of Iran by the United States. Oil prices are expected to decline slightly, averaging

US$69/bbl both in 2019 and 2020, unchanged from previous projections. Increased supply from the United States is expected to accompany the anticipated increase in global demand. Upside price risks remain high given low levels of spare capacity and ongoing uncertainty about Venezuelan production.

Kazakhstan's baseline scenario, risks and challenges

The economy will grow steadily, but the pace of expansion will slow.

Kazakhstan's economy will continue to grow modestly in 2019, expanding by 3.5 percent. In 2020–21, real GDP growth is projected to decelerate due to easing external demand as well as a slowdown in business investment as cyclical forces wane and fiscal stimulus measures likely turn to decline. Household consumption is expected to rise moderately on the back of recovering real incomes and subdued lending. The government's decision to raise the minimum wage from 2019 will give impetus to household consumption, but it will also pose a challenge for SMEs as they attempt to adjust and remain competitive. On the production side, economic activity will be mainly supported by growth in the non-oil industrial sectors and services; the contribution to growth from construction will moderate, tied to receding momentum in investment. Overall, GDP growth rates are forecast to remain below recent averages (table 4) due to subdued labor supply and weak productivity growth (see the focus section).

Table 4. Baseline Scenario: Selected Macro-Fiscal Indicators, 2015–20
(In percent, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021
				Projections		
Real GDP growth	1.1	4.1	3.8	3.5	3.2	3.2
Oil sector	2.3	7.4	4.1	3.5	1.7	1.7
Nonoil economy	0.9	3.2	3.8	3.4	3.5	3.5
Consumer price inflation, period average	14.6	7.4	5.6	6.1	5.8	5.7
Current account balance (percent of GDP)	-6.5	-3.3	-0.2	-0.2	-0.2	-0.1
Overall fiscal balance (percent of GDP)	-4.4	-2.2	2.0	3.6	3.6	3.2
Nonoil fiscal balance (percent of GDP)	-10.0	-12.8	-6.9	-6.2	-5.7	-5.6
Net financial assets (percent of GDP)	25.0	15.7	16.0	16.2	16.4	16.3
Poverty rate (US$5.5 per day at PPP terms)	7.9	6.9	6.2	5.6	5.0	5.0

Source: World Bank staff calculations and estimates.

A favorable external environment will support improvements in both the current and fiscal accounts.

Consumer price inflation is expected to continue to follow its current declining trajectory. However, further ahead, upward price pressures could stem from both external factors (rising prices for imported goods due to exchange rate volatility, for example) and domestic factors (rising wages and a further tightening of the labor market). Benign external conditions—including relatively high commodity prices and firm external demand—will lead to a balanced current account in 2019 and thereafter. The fiscal balance is also projected to improve over the forecast period with the non-oil deficit

falling to 5.6 percent of GDP by 2021, although the potential for oil price volatility and external demand shocks will remain a risk to the government budget. On the back of recovering household incomes, the poverty rate is projected to follow a declining trajectory, reaching 5 percent by 2020, significantly below previous levels.

Risks to the outlook are broadly balanced, although drags on growth will persist.

The balance of risks to the growth outlook remain broadly unchanged from our Spring 2018 update. In the next two years, several factors could intensify downside pressures, however. A further escalation of geopolitical tensions and greater trade protectionism, for example, could slow global economic activity, reducing reduce demand for oil and other commodities.

These factors, together with the tightening of interest rates in advanced economies, could lead to a reduction in oil prices and, subsequently, a deterioration in Kazakhstan's balance of payments and the overall rate of economic growth. On the domestic side, exchange rate volatility would heighten inflation expectations, leading to a tighter monetary stance from the NBK. These developments would ultimately feed through to higher borrowing costs for firms and households, further dampening lending activity. Furthermore, the recovery and growth momentum observed since 2016 could be short-lived if the authorities delay the implementation of structural reforms to improve the business environment and raise productivity. The latter is discussed in more detail in the next section, which provides a summary of the World Bank Group's recent Kazakhstan Country Economic Memorandum (CEM).

D. Focus Section: Reversing Productivity Stagnation[2]

The time has come for Kazakhstan to implement the reforms necessary to raise productivity growth—the foundation of sustainable growth and higher living standards—and foster new sources of economic growth. Until recently, high commodity prices favored an economy dominated by oil and, to a lesser extent, mining. The high rate of return on commodities discouraged the development of alternative and more sophisticated economic sectors. Structural constraints discouraged private investment, resulting in a slowdown in income growth. The authorities should deepen structural reforms to promote private sector development and investment to bridge Kazakhstan’s productivity gap.

After experiencing exceptional economic growth in the 2000s, Kazakhstan’s economy has slowed sharply since the global financial crisis, putting development achievements at risk. Strong growth—boosted by rising oil and gas prices, and rapid domestic demand, including soaring investment—drove significant welfare gains, as real wages surged, and inequality and poverty levels declined. Since the global economic downturn, however, Kazakhstan's economic growth has slowed

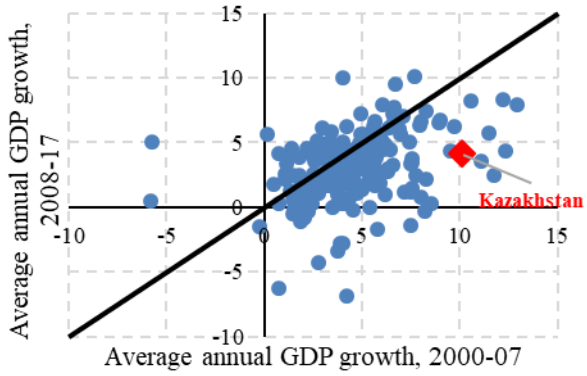
[2] This is based on the recent World Bank Country Economic Memorandum for Kazakhstan: Reversing Productivity Stagnation (2018).

markedly. While the decline in growth mirrors a broader global phenomenon, on a percentage basis Kazakhstan's deceleration has been among the most severe in the world (Figure 12).

The economic slowdown has been caused by sharply lower commodity prices, and structural degradation of the economy. Kazakhstan's growth model has not developed sufficient engines outside of hydrocarbons to buffer against commodity price fluctuations. Accordingly, investment and employment patterns have tended to follow oil price swings, resulting in a shift in resources away from their most productive use during periods of high oil prices. This contributed to a gradual, but cumulatively sizable, weakening of potential output and productivity growth. Policies have also favored the development of non-tradable services over tradable goods, where the scope for productivity gains can be higher.

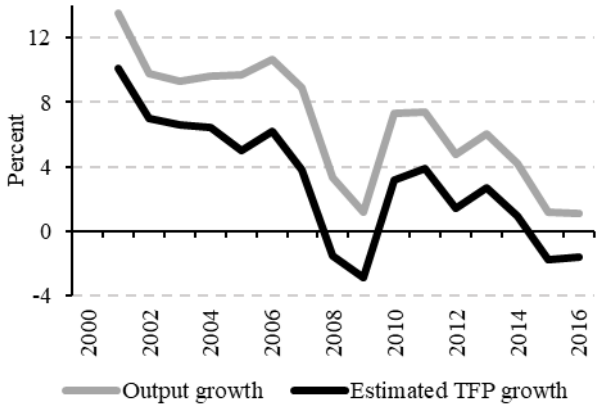
Kazakhstan's productivity growth has steadily fallen over the past two decades (Figure 13). Productivity was robust in the early 2000s, contributing about 6 percentage points to annual GDP growth. However, by the early 2010s, annual productivity growth had fallen to an average of less than 2 percent; between 2014 and 2016 measured productivity growth turned negative, falling by 2-3 percentage points per year.

Figure 12. Kazakhstan's growth slide has been more severe than most other economies



Source: World Development Indicators, World Bank.

Figure 13. The output fall-off has been driven by declining productivity



Source: World Bank staff estimates using country data.

Falling within-sector productivity improvements are the driving force behind Kazakhstan's productivity slowdown (Figure 14). Empirical analysis points to *productivity* as the core engine of sustainable long-term growth for Kazakhstan. The sectors most affected by declining within-sector productivity are agriculture, industry and services.

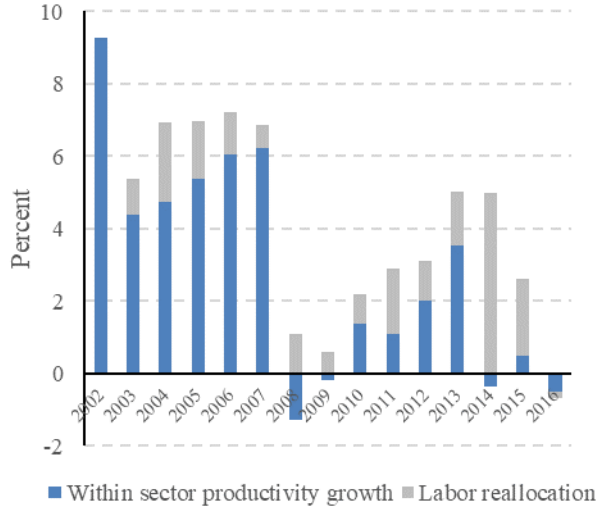
Kazakhstan has not moved toward new, *higher-value* products. As measured through the Economic Complexity Index (ECI), Kazakhstan has not increased the knowledge value of its export base relative to other economies which is found to be a strong predictor of income, since economies grow as they develop deeper knowledge (which is embedded in their products). Kazakhstan's ECI fell between 2009 and 2016, both in absolute and relative terms, from being in the 38th percentile to fall to the 25th percentile. Cross-country benchmarking also suggests that Kazakhstan performs poorly in terms of overall goods market efficiency, intensity of local competition, extent of market

dominance, and prevalence of foreign ownership, ranking 72, 114, 91 and 110 out of 137 countries, respectively.[3]

The private sector is significantly constrained and does not exhibit many important features of healthy private sectors worldwide. Empirical evidence suggests that business entry rates are relatively low in Kazakhstan (Figure 15), even controlling for the structure of economy. A few players (mostly SOEs) dominate key product markets, including in backbone services that support the private sector.

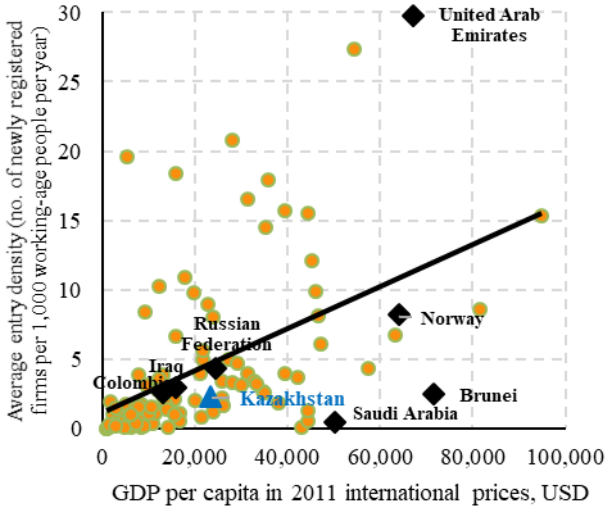
The evidence shows that new (and small) firms are more productive than older (and larger) firms. Because of continued protection of inefficient large firms (both SOEs and private firms), the heavy presence of older (and larger) firms in operation suggests that the process of creative destruction, by which less productive firms exit the market, is not fully effective and that many important elements of Kazakhstan's economic transition have not been completed.

Figure 14. Within- and Between-sector Contributions to Annual Productivity Growth



Source: Statistical Committee of the Republic of Kazakhstan, World Bank staff estimates.

Figure 15. New Business Entry and GDP per Capita, 2016

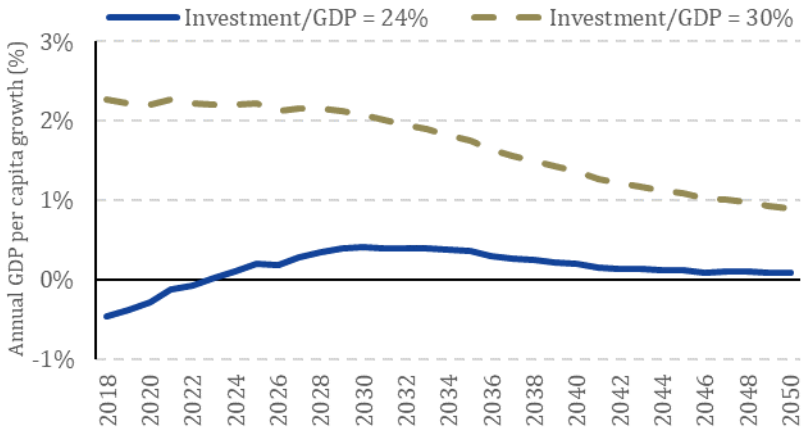


Source: World Bank staff estimates using country data.

Without higher productivity growth, Kazakhstan will find it difficult to meet its long-term aspirations. In the absence of a strong productivity growth, diversification and support of the private sector, investment rates would need to increase to infeasible levels (more than 50 percent of GDP in order to reach even 2.5 percent of annual growth in 15 years!) and even then, they will be insufficient to achieve Kazakhstan's long-term growth goal of becoming one of the world's top-30 economies by 2050 (Figure 16).

[3] 2018 Global Competitiveness Report.

Figure 16. GDP growth will slide further without TFP improvements



Source: World Bank staff estimates using country data.

The corrosive patterns must be corrected to revive productivity growth, which is essential for higher economic growth—since higher investment cannot substitute for productivity growth in the long run. Prior analytical work confirms that there are significant opportunities for scale economies and productive activity in services, including logistics, finance, communications, and health and education.

Faster productivity growth will require a significant boost to efficiency gains within sectors. Cross-sectoral labor shifts alone will not be sufficient to drive productivity growth since productivity differentials among major sectors are diminishing. Acceleration of productivity growth instead has to come from technological innovation and enhanced within-sector efficiency.

Spurring within-sector productivity calls for economic diversification (less reliance on oil) and removal of fundamental constraints to private sector development. Analysis of enterprise data points to market dominance by large SOEs and a few state-connected private firms. They also describe a private sector where entry of small firms outside low-value services is very limited (even compared to other commodity-exporting countries), where large productive private firms do not exit, and where SMEs face significant operating constraints. The government's unequal regulatory treatment of public and connected private sectors, the extreme level of bureaucracy, excessive control of financial markets, and limited dissemination of technology are among the factors that constrain private sector development.

The first policy imperative is to level the playing field for all firms—well-connected or otherwise. This means reforming long-standing structures that protect state-owned and other well-connected firms and handicap new ones. The fact that older, less productive firms are able to stay in business shows that the process of creative destruction—whereby less productive firms exit the market, making room for newer and more productive ones—is not happening. The government needs

to revisit the competition policy program to strengthen competition-supporting institutions and fully decentralize the decision-making process to allow for free flow of resources and technology.

The second policy is to strengthen the rule of law and to deal more aggressively and comprehensively with corruption. The judicial system, perceived as a source of negative outcomes due to institutional fragility and instances of corruption, is seen as one of the biggest barriers to an efficient and highly productive economic system. Also, firms are being severely constrained by the prevalence of corruption.[4] While the government has a strategy for combatting corruption, the activities associated with the plan do not align with the objectives.[5] The inadequate reporting of corrupt practices also hinders authorities' ability to respond. Within the anti-corruption policy program, the government should consider reforming toward transparent public procurement procedures and revise the burdensome and costly trading procedures and a border administration to improve transparency in customs.[6]

Third, the governments will need to introduce structural changes in the economy to boost private investment and reduce a disproportionately large role of the state in the economy. The strong presence of SOEs results in inefficient prices, quota-based production, and a number of other market distortions that serve to suppress the domestic private sector. Reducing the role of the state requires the elimination of private sector distortions and favorable treatment of SOEs. Kazakhstan's productivity dilemma demands it attracts and grow investments outside of oil and extractives, and outside of low-value (non-tradeable) services tied to oil wealth.

To ensure a successful implementation of the above policy options, the government of Kazakhstan may start by focusing on the following policy actions: (i) develop a framework to establish a regulatory environment that enables SMEs to emerge, grow, and attract FDI, and substantially reduce the state's presence in the economy, (ii) introduce reforms to modernize and transform Kazakhstan's institutions to make them open, adaptable, and effective by applying world's best practices in reducing corruption, strengthening justice institutions, bolstering rule of law, among others, and (iii) implement competition and regulatory frameworks in parallel to international standards (such as OECD) to ensure that privatization processes will reduce concentration of market power rather than simply transfer rents from the public sector to the private sector.

[4] World Bank Enterprise Survey data identify corruption as the top obstacle to doing business in Kazakhstan across all sectors.

[5] With resolution No.234 of 14 April 2015, the government approved its Plan of Activities for 2015-17, which includes, apart from the 64 proper anti-corruption activities, another 65 aiming to counter "shadow economy."

[6] Official data show that two of the four most corrupt spheres in Kazakhstan are customs control and tax collection (the others are roads and public procurement), OECD 2014.