Kazakhstan: Constructive Policy Approach

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We believe policymakers are taking a constructive approach

We see that both state and private sector representatives know that Kazakhstan is facing challenging times and they are aware of both the magnitude of what they have to do and how to do it – i.e. We found them all realistic and pragmatic. We think devaluation is largely done, while upcoming reform and privatisation efforts should bring the country longer-term gains. In the current volatile oil price environment, we maintain our scenario approach for Kazakhstan. In Figure 1, we show our 2016E base case, which assumes that Brent oil prices average $45/bl in 2016. Figure 1 also indicates how the base case could change in each of the scenarios listed to the left (higher oil prices) and right (lower oil prices).

Growth remains subdued given weaker oil prices

In 2015, Kazakhstan's GDP growth decelerated to 1.2%, according to preliminary estimates, given significant external headwinds, including a dramatic fall in oil prices, recession in Russia and challenges in the Chinese economy. This compares with 4.1% in 2014 and 5.8% on average since 2005. We still view it as very encouraging that Kazakhstan's GDP growth remained in positive territory despite oil prices halving, while, for instance, Russian growth declined by 3.7%. We consider this as analogous to the 2009 case, when Kazakh growth also remained positive at 1.2%, and attribute this mainly to significant state support, including net National Oil Fund spending of more than 5% of GDP. We expect Kazakhstan's GDP growth to soften to 0.7% in 2016E if oil prices average $45/bl. If oil prices average $40/bl this year, we see growth remaining roughly flat; but if oil prices average only $30/bl, we would expect growth to slip further into negative territory, at -1.0%. However, if the year-average oil price hits $50/bl, we would expect growth to accelerate to 1.4%. In 2017, we would expect growth to accelerate if oil prices simply stop falling.

Exchange rate now flexible, driven by oil and rouble

At the start of 2016, the National Bank of Kazakhstan (NBK) completed the move to a flexible exchange rate, which helps to stabilise external balances (we expect a 0.8% of GDP current account surplus in 2016E), ease budget pressures and defend competitiveness. Future tenge dynamics are likely to be influenced by fluctuations in oil prices and the rouble exchange rate. We estimate the tenge will average KZT330/$ this year at $45/bl oil, while we think it is unlikely to be much stronger than KZT300/$ at a higher oil price and could reach KZT385/$ at $30/bl oil.

Why the tenge and the rouble should be close?

Structure of Kazakh and Russian exports and imports is nearly identical. The main export items in Kazakhstan and Russia include mineral products (68% and 63% of total exports in 2015, respectively) and metals (13% and 10%, respectively), and prices are fully dependent on global commodity market developments. Exports of chemical products (7% in both countries) and food (5% in both countries) are also important. Kazakhstan and Russia import mainly machinery and equipment (41% and 45% of total imports in 2015, respectively) and chemical products (15% and 19%, respectively). Food (11% and 14%, respectively) and metals (13% and 6%, respectively) are also important. Next, GDP structures from both the output and demand side also look similar. Identical economic structures and external balances and the same exchange rate policy mechanisms provide grounds for close rouble and tenge dynamics.

Figure 1: Oil scenarios for Kazakhstan in 2016E

Brent oil, $/bl	80	70	60	50	45 base case	40	30	20
GDP growth	4.5%	3.6%	2.5%	1.4%	**0.7%**	-0.1%	-1.0%	-1.8%
KZT/$, annual avg	270	280	295	310	**330**	350	385	450
Inflation, annual avg	11.1%	11.8%	12.8%	13.3%	**14.3%**	14.5%	15.6%	17.2%
Current account, $bn	14.5	11.0	7.5	3.0	**0.9**	-1.1	-6.6	-11.5
% of GDP	9.5%	7.5%	5.4%	2.3%	**0.8%**	-1.0%	-6.5%	-13.3%
GDP, KZTbn	41.3	40.9	40.5	40.1	**39.8**	39.5	39.1	38.8
GDP, $bn	153	146	137	129	**121**	113	102	86

Source: Renaissance Capital estimates

The absence of trade borders within the Customs Union is also important

Last but not least – the common trade universe within the Customs Union could create significant imbalances if exchange rate dynamics diverge significantly. Anecdotal examples from our recent visit to Kazakhstan suggest tell us that many of Kazakhstan's industries suffered when the tenge was overvalued vs the rouble, especially in Northern Kazakhstan, with many individuals travelling to Russia not only to purchase cars and durable goods, but also for food shopping if possible.

Policy mix is generally similar to Russia, but…

Kazakhstan's policy mix is generally close to Russia's – orthodox monetary policy, flexible exchange rate, prudent fiscal policy – with a few differences. Kazakhstan now has a looser fiscal and a tighter interest rate policy than Russia, while the tenge exchange rate is also influenced by the rouble as well as oil prices.

… monetary policy is tighter …

Monetary policy in Kazakhstan in now tighter than in Russia, given Kazakhstan's later devaluation. The policy rate in Kazakhstan is currently at 17%, while Russia has already brought down the 17% rate introduced in late 2014 to 11%. Another possible difference is that Kazakhstan's interest rate policy transmission mechanism could be less developed than that in Russia, given its later shift to an orthodox monetary policy framework (which Russia started to introduce in 2009) and the banking sector's higher rate of dollarisation. Other priorities for the NBK, apart from bringing down inflation and dollarisation, could therefore include developing domestic financial markets and the interest rate channel of its monetary policy transmission mechanism. We expect the NBK to start easing rates in 2H16, bringing the base rate from 17% currently to 12% at end-2016E. We still consider this as a tight monetary policy.

… while budget policy is less strict.

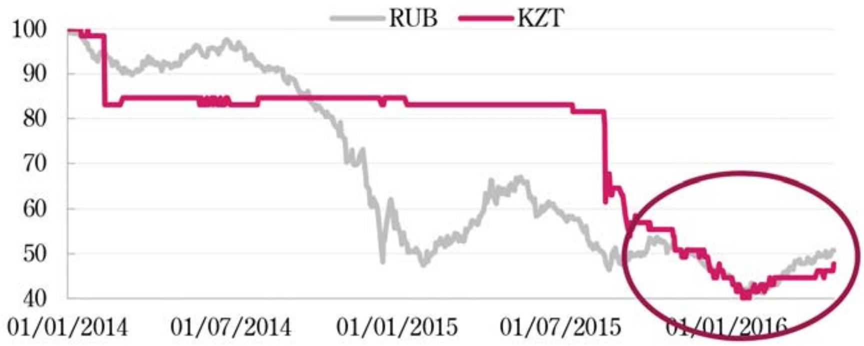
The budget has been adjusted for weaker oil prices by cutting all types of what the government sees as unnecessary spending and any new infrastructure spending, while big projects such as Expo 2017 (of which the overall cost stood at c. $3bn, according to mid-2015 estimates) and the Nurly Zhol (Bright Path) public spending programme aimed at infrastructure development (which is to receive a KZT808bn direct transfer from the National Oil Fund in 2016) are still running at full speed. Nevertheless, we think Kazakhstan could afford a slightly looser fiscal policy than Russia, as its government has relatively more reserves ($64bn in the National Oil Fund and, in addition, $15bn in the state-owned Pension Fund – nearly $80bn or 67% of GDP, while the Russian government has nearly $120bn or just 9% of GDP).

Unlike Russia, we see higher chances for reforms

We were impressed by Kazakhstan's reform and privatisation agenda. What has been achieved since its launch? Although the current challenging environment complicates the reform process and diverts resources towards measures aimed at ensuring overall economic sustainability, we see progress in a number of key areas. In particular, we highlight the following.

- Development of NBK policies: introduction of a floating exchange rate and an orthodox interest rate corridor (done).

Figure 2. RUB/$ and KZT/$, 1 January 2014 = 100



Source: Bloomberg

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- The start of a new property legalisation programme, whereby individuals pay a small fee to legalise funds, placing them under their own name in a bank account. This has so far appeared to work well domestically, with nearly KZT1trn ($3bn) legalised to date, although less well for external assets. Nevertheless, we view the results of the domestic legalisation programme as remarkable within the CIS. By comparison, for example, state pension funds contain around KZT5.2trn of assets.
- Various measure aimed at improving the investment climate, including the launch of a 'one window' service for investors and the creation of the positions of minister of investments and investment ombudsmen (under way).
- Easing of specific tax/customs procedures (done) and development a new customs and tax code (under way).
- A new law on state servants, aimed at improving the quality of public services and reducing corruption (completed in 2015; official numbers suggest that instances of corruption declined).

The privatisation agenda is gradually making progress

The privatisation agenda is gradually making progress, although we think the sales of some major companies could be delayed until 2017-2018, given their current valuations and the need to prepare for sale. We recall that the government plans to privatise 65 of the largest companies owned by the National Welfare Fund, Samruk-Kazyna, the joint stock companies Baiterek and KazAgro and 173 subsidiaries and affiliates of Samruk-Kazyna. According to the Ministry of National Economy, companies from this list could include seven companies to be sold at IPO: Temir Zholy (KazakhRail; transportation); KazMunaiGaz EP (energy); Kazatomprom (nuclear fuel); Samruk-Energo (utility); Tau-Ken Samruk (mining); Kazpost (post); and Air Astana (airline).