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Document of
The World Bank

Report No: ICR00001738

# IMPLEMENTATION COMPLETION AND RESULTS REPORT
(IBRD-79110)

ON A LOAN

IN THE AMOUNT OF US$1 BILLION

TO THE

REPUBLIC OF KAZAKHSTAN

FOR A

DEVELOPMENT POLICY LOAN

FEBRUARY 14, 2012

Poverty Reduction and Economic Management
South Caucasus and Central Asia
Europe and Central Asia Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective February 5, 2012)

Currency Unit = Tenge
US$ 1.00 = 148.72 Tenge

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| ADB | Asian Development Bank |
| BTA | Bank TuranAlem |
| CAS | Country Assistance Strategy |
| CET | Common External Tariff |
| CFC | Committee of Financial Control |
| CDS | Credit default swap |
| CFCPP | Committee for Financial Control and Public Procurement |
| CPAR | Country Procurement Assessment Report |
| CPS | Country Partnership Strategy |
| DPL | Development Policy Loan |
| FSA | Financial Supervision Agency |
| FSAP | Financial Sector Assessment Program |
| GDP | Gross domestic product |
| IBRD | International Bank for Reconstruction and Development |
| IDA | International Development Association |
| IMF | International Monetary Fund |
| JERP | Joint Economic Research Program |
| KCSL | Countercyclical Support Loan for Kazakhstan |
| KKB | Kazkommertsbank |
| KTZ | Kazakhstan Temir Zholy |
| MOF | Ministry of Finance |
| NBK | National Bank of the Republic of Kazakhstan |
| NPL | Nonperforming loans |
| NF | National Fund |
| PER | Public Expenditure Review |
| PEFA | Public Expenditure and Financial Accountability Assessment |
| SME | Small- and medium-sized enterprises |
| SOE | State-owned enterprises |
| TA | Technical assistance |

| | |
|---|---|
| Vice President: | Philippe H. Le Houerou |
| Country Director: | Motoo Konishi/Saroj Kumar Jha |
| Sector Manager: | Kazi Matin/Ivailo Izvorski |
| Task Team Leader: | John Litwack/Ekaterine Vashakmadze |
| ICR Team Leader | Ekaterine Vashakmadze |

**KAZAKHSTAN**
**DEVELOPMENT POLICY LOAN**

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| A. Basic Information | | | |
|---|---|---|---|
| Country: | Kazakhstan | Program Name: | Kazakhstan Development Policy Loan |
| Program ID: | P119856 | L/C/TF Number(s): | IBRD-79110 |
| ICR Date: | 02/16/2012 | ICR Type: | Core ICR |
| Lending Instrument: | DPL | Borrower: | REPUBLIC OF KAZAKHSTAN |
| Original Total Commitment: | USD 1,000.00M | Disbursed Amount: | USD 1,000.00M |
| Revised Amount: | USD 1,000.00M | | |
| **Implementing Agencies:**<br>Ministry of Finance | | | |
| **Cofinanciers and Other External Partners:** | | | |

| B. Key Dates | | | | |
|---|---|---|---|---|
| **Process** | **Date** | **Process** | **Original Date** | **Revised / Actual Date(s)** |
| Concept Review: | 03/02/2010 | Effectiveness: | 07/09/2010 | 07/23/2010 |
| Appraisal: | 04/09/2010 | Restructuring(s): | | |
| Approval: | 05/25/2010 | Mid-term Review: | | |
| | | Closing: | 01/07/2011 | 01/07/2011 |

| C. Ratings Summary | |
|---|---|
| **C.1 Performance Rating by ICR** | |
| Outcomes: | Moderately Satisfactory |
| Risk to Development Outcome: | Moderate |
| Bank Performance: | Satisfactory |
| Borrower Performance: | Satisfactory |

| C.2 Detailed Ratings of Bank and Borrower Performance (by ICR) | | | |
|---|---|---|---|
| **Bank** | **Ratings** | **Borrower** | **Ratings** |
| Quality at Entry: | Satisfactory | Government: | Not Applicable |
| Quality of Supervision: | Satisfactory | Implementing Agency/Agencies: | Not Applicable |
| **Overall Bank** | Satisfactory | **Overall Borrower** | Satisfactory |

| | | | |
|---|---|---|---|
| **Performance:** | | **Performance:** | |

| C.3 Quality at Entry and Implementation Performance Indicators | | | |
|---|---|---|---|
| **Implementation Performance** | **Indicators** | **QAG Assessments (if any)** | **Rating:** |
| Potential Problem Program at any time (Yes/No): | No | Quality at Entry (QEA): | None |
| Problem Program at any time (Yes/No): | No | Quality of Supervision (QSA): | None |
| DO rating before Closing/Inactive status: | | | |

| **D. Sector and Theme Codes** | | |
|---|---|---|
| | **Original** | **Actual** |
| **Sector Code (as % of total Bank financing)** | | |
| Banking | 44 | 44 |
| Central government administration | 39 | 39 |
| Sub-national government administration | 17 | 17 |
| | | |
| **Theme Code (as % of total Bank financing)** | | |
| Public expenditure, financial management and procurement | 56 | 56 |
| State-owned enterprise restructuring and privatization | 44 | 44 |

| **E. Bank Staff** | | |
|---|---|---|
| **Positions** | **At ICR** | **At Approval** |
| Vice President: | Philippe H. Le Houerou | Philippe H. Le Houerou |
| Country Director: | Saroj Kumar Jha | Motoo Konishi |
| Sector Manager: | Ivailo V. Izvorski | Kazi Mahbub-Al Matin |
| Program Team Leader: | Ekaterine T. Vashakmadze | John Litwack |
| ICR Team Leader: | Ekaterine T. Vashakmadze | |
| ICR Primary Author: | Luis Alvaro Sanchez | |

## F. Results Framework Analysis

**Program Development Objectives (from Project Appraisal Document)**
The operation supports the Government's program of policy measures to foster economic growth and sustain living standards of the population in the aftermath of the economic crisis. The program's objective is to support the Government's efforts in: (i) strengthening public resource management (including oil revenues) through increased efficiency and re-orientation of spending, and (ii) reducing vulnerabilities in the financial sector through restructuring large problem banks, and strengthening the bank supervisory, regulatory and resolution frameworks. The proposed DPL is the major portion of the revised lending program in Kazakhstan, consistent with the CPS objectives presented to the Board in 2004. The proposed DPL is aligned with the first pillar of the CPS, "reducing losses in competitiveness through prudent management of the oil revenues and increased public sector efficiency," and indirectly supports the other three pillars by helping the Government to strengthen public resource management and address vulnerabilities in financial sector.

NOTE: TABLE 6 (PROGRAM OBJECTIVES AND RESULTS) OF THE ICR DOCUMENT PRESENTS THE DETAILED PDO INDICATORS INCLUDING THEIR BASELINE VALUES, ORIGINAL TARGETS AND ACTUAL VALUES AT COMPLETION OF TARGET YEARS.

**Revised Program Development Objectives (if any, as approved by original approving authority)**
NA

**(a) PDO Indicator(s)**

| Indicator | Baseline Value | Original Target Values (from approval documents) | Formally Revised Target Values | Actual Value Achieved at Completion or Target Years |
|---|---|---|---|---|
| **Indicator 1 :** | Indicator 1. Official adoption of new NF rules | | | |
| Value (quantitative or Qualitative) | President requested that new rules be drafted for NF operations by Q1 2010. | Approve, adopt, and implement action by the government of new rules for governing the operation and use of NF. | NA | Met. New rules were adopted and are being implemented. |
| Date achieved | 01/10/2010 | 06/15/2010 | 02/09/2011 | 06/15/2011 |
| Comments (incl. % achievement) | | | | |
| **Indicator 2 :** | Solvency of the system as measured by the capital adequacy ratios (FSA ratio k1-1 and k1-2) | | | |
| Value (quantitative or Qualitative) | Actual capital adequacy ratios as of Jan 1, 2010: k1-1: –0.115 (0.107*) | Capital adequacy ratios for entire system should be | NA | Met.<br>K1-1: .115<br>K2: .181 |

| | | | | |
|---|---|---|---|---|
| | k1-2: –0.116 (0.126*)<br><br>* Without BTA and Alliance | no less than new prudential norms:<br>k1-1: 0.06<br>k1-2: 0.09 as of July 2011 (0.06 currently) | | |
| Date achieved | 01/01/2010 | 06/15/2010 | 06/15/2010 | 07/01/2011 |
| Comments (incl. % achievement) | | | | |

**(b) Intermediate Outcome Indicator(s)**

| Indicator | Baseline Value | Original Target Values (from approval documents) | Formally Revised Target Values | Actual Value Achieved at Completion or Target Years |
|---|---|---|---|---|
| **Indicator 1 :** | NA | | | |
| Value (quantitative or Qualitative) | | | | |
| Date achieved | | | | |
| Comments (incl. % achievement) | | | | |

**G. Ratings of Program Performance in ISRs**

| No. | Date ISR Archived | DO | IP | Actual Disbursements (USD millions) |
|---|---|---|---|---|

**H. Restructuring (if any)**

Not Applicable

## 1. Program Context, Development Objectives and Design

### 1.1 Context at Appraisal

**Before the Crisis**

1. **Kazakhstan grew rapidly from 2000 through 2007 and made considerable progress in reducing poverty.** Growth in output and incomes was supported by sizable revenues from natural resources and market economic reforms. Annual GDP growth averaged 10 percent and average real incomes more than doubled, transforming Kazakhstan into an upper-middle-income economy relatively quickly. The estimated share of the population living below the official poverty line declined from 44.5 percent in 2002 to 12 percent by year-end 2007. Meanwhile, the unemployment rate as defined by the International Labor Organization declined from an estimated 13 percent in 2000 to less than 7 percent by 2007. However, the rapid growth, which was concentrated in large cities and resource-rich western regions, resulted in income disparities. While the poverty headcount dropped below 10 percent in urban areas, in rural locations it remained over 20 percent.

2. **Thanks to responsible fiscal and macroeconomic management, the National Fund of the Republic of Kazakhstan had accumulated substantial resources before the crisis hit.** Total government spending averaged about 22 percent of GDP for most of the pre-crisis period, and the non-oil deficit averaged about 4 percent of GDP even as oil prices and revenues rose. Because the government resisted pressures for major increases in spending, by the end of 2008 the National Fund (NF) had built up savings of US$27 billion (21 percent of GDP) and inflation was relatively low for most of the period. Sterilization of a large part of the oil inflows through the NF and repatriation of a large share of oil profits also reduced pressure on the exchange rate.

3. **By 2008 large capital inflows to the banks, coupled with public and private foreign investment spending, had overheated the economy, which led to currency appreciation and planted the seeds of financial instability.** Encouraged by soaring commodity and real estate prices, international creditors supplied the large commercial banks with abundant unsecured credit. As a result, the external debt of domestic banks rose from US$8 billion in 2005 (14% of GDP) to $45.9 billion in 2007 (43.8 percent) and the nominal value of commercial bank credit to the economy more than doubled, from 25 percent of GDP in 2004 to about 56 percent in 2007. Most of this credit went to construction and real estate, which together accounted for loans amounting to 30 percent of GDP at the end of 2007. Finance and construction had become the major drivers of economic growth.

4. **While at the micro level the prudential position of banks seemed comfortable, macro-prudentially there were signs of building pressures.** The surge in real estate prices supported bank comfort levels, but the heavy exposure to short-term external sources of financing was becoming problematic. Efforts in 2006 to limit the ability of banks to borrow abroad brought heavy resistance from the financial sector and housing lobbies, which prevailed. By the time prudential regulations on foreign borrowing were tightened in early 2007, it was too little too late.

**Responses to the Shocks of the late 2000s**

5. **In 2007 and 2008 Kazakhstan was hit by two external shocks in quick succession.** The first came in August 2007 when a sudden brake on foreign inflows (loans) triggered a banking liquidity crisis, which was exacerbated by a speculative run on deposits and on the national currency. The authorities reacted rapidly, but just as the Kazakh economy was starting to

stabilize in 2008, it was again negatively affected by the plunge in oil prices and the world financial crisis.

6. **In 2008 sinking commodity prices and intensification of the global crisis hit the Kazakh economy hard.** First, exports dropped. Monthly exports fell from US$3–5 billion in the first 11 months of 2008 to less than US$1.5 billion in December and the first quarter of 2009. Correspondingly, the current account moved from a surplus of US$3.7 billion in the first half of 2008 to a deficit of US$3.5 billion in the first half of 2009. Meanwhile, Kazakh banks lost virtually all access to rollover opportunities in global financial markets, weakening the capital account and putting excessive pressure on the tenge.

7. **As the financial crisis deepened and the economy fell into recession in late 2008, the Government tapped into its National Fund to finance an Anti-Crisis package of US$ 10 billion.** US$4 billion was spent on the recapitalization of the four largest commercial banks through the purchase of ordinary (up to 25 percent ownership) and preferred shares. A small share of this sum was placed as deposits in the two relatively less distressed banks to facilitate lending to the economy. The remaining US$6 billion financed economic stimulus programs for construction, agriculture, real estate, small business, and key infrastructure projects. A large share of this Anti-Crisis spending package was financed off-budget from National Fund resources through the State holdings Samruk-Kazyna and Kazagro, and was administered through larger Kazakhstani banks.

8. **The Government also introduced measures to alleviate the social consequences of the crisis**. The Government protected social expenditures from budgetary sequestration, insured all pension payments (including those from private pension funds) indexed to inflation, extended unemployment benefits from four to six months, and promoted the signing of memoranda between regional authorities and larger enterprises on preserving jobs. As of mid-2009, memoranda with 5,215 enterprises employing 813,000 workers were reportedly signed. Special shops selling subsidized food products and medicines to the poor which were set up during the rapid food price increases in 2007-2008 continued to operate. In the spring of 2009, an additional public works program of US$1.5 billion (1.5 percent of GDP) called the "Road Map" was set up for the creation of jobs, training, and the provision of temporary wage subsidies to vulnerable groups at the regional level through special budgetary transfers to local authorities. Public salaries were increased significantly. The share of social spending in the consolidated Government budget increased from 52 percent in 2008 to 60 percent in 2009.

9. **The National Bank stepped up its liquidity support for commercial banks in late 2008 and 2009, while deposit insurance was increased seven-fold.** By March 2009, reserve requirements for commercial banks had been progressively decreased from 6 percent to 1.5 percent for internal liabilities, and from 8 percent to 2.5 percent for external liabilities. Reverse REP0 operations were used for liquidity support (US$2.9 billion by the end of the third quarter of 2009). The accounts of a number of state-owned organizations were also shifted from the National Bank to commercial banks. As a measure to support depositor confidence, household deposit insurance was increased seven-fold from 700 thousand tenge to *5* million tenge (from US$5,833 to US$41,667).

10. **Instead of the initial plan to recapitalize the four largest banks by buying minority shares, the Government decided to seize control of BTA and Alliance on February 2, 2009, while going ahead with the minority equity injection into the other two banks.** The downward spiral in real estate prices and the imminent devaluation of the tenge implied that the approved recapitalization package for BTA and Alliance of October 2008 would be insufficient. Consequently, the authorities feared that the remaining assets of these banks might be in

jeopardy. BTA had severe liquidity problems and, being the biggest bank in Kazakhstan at the time, its failure had systemic implications. On February 2, 2009, the Government decided to acquire control of BTA through a share issue, purchased by the state holding.

11. **The period August 2007 - December 2009 is associated with US$21 billion dollars of anti-crisis support.** The majority of this came from the Republican budget or the large state corporate conglomerate Samruk-Kazyna). Table 1 summarizes the primary sequence of events and programs of 2007-2009, as well as estimated costs to the Government and foreign creditors. Approximately half of this money (US$11 billion) was devoted to direct assistance to struggling commercial banks (primarily BTA), while the other half (over US$10 billion) financed anti-crisis stimulus measures in various sectors of the economy. In addition to public works programs, the Government increased other social spending significantly during this period, mainly through a structural reallocation of budgetary spending.

**Core Issues before Loan Approval**

12. **Kazakhstan's fiscal position deteriorated and the non-oil fiscal deficit widened to 10.5 percent of GDP in 2008 and hit 13.8 percent in 2009.** Consolidated state budgetary revenues dropped by about 4 percent of GDP in 2008 due to the recession, low commodity prices, a lowered corporate income tax rate, and the granting of uniform investment credits. Outlays increased from 23 percent of GDP in pre-crisis years to 27.9 percent in 2009 to finance higher social commitments and off-budget stimulus spending. The guaranteed transfer from the NF financed half of the deficit; the rest was financed by an additional transfer (1.5% of GDP), a loan amounting to 0.5% of GDP from the Asian Development Bank, and local borrowing (2.4% of GDP). It was decided to resist populist pressures to fully finance the deficit with NF resources.

13. **The fiscal difficulties highlighted the need for more budget flexibility and more effective targeting of countercyclical fiscal policies.** The immediate priority became to make public spending more efficient so as to make budgets more strategic and budget execution more flexible. The government undertook a major revision of the 2004 Budget Code and Parliament approved its first three-year national budget for 2009–11 based on the strategic plans of government ministries in 2008. Those reforms were in line with a Public Expenditure and Financial Accountability Assessment (PEFA) published in early 2009, which reflected how public finances were managed in 2006 and 2007, highlighted progress in expenditure management, and identified areas that needed attention.

14. **How to protect the poor was a major challenge.** The government had to quickly re-prioritize spending toward social outlays and keeping social spending adequate despite the deteriorating fiscal position. Kazakhstan had traditionally allocated fewer resources to social expenditures than other countries with similar levels of per capita income. To maintain social spending, the government cut administrative expenditures and phased out production subsidies for construction, agriculture, and financing of loans to small and medium enterprises (SMEs), which were channeled through the state-owned Samruk-Kazyna and Kazagro. To speed the responses to the crisis, the authorities introduced a number of ad hoc measures: The US$1.5 billion (1.5 percent of GDP) public "Road Map" was set up in the spring of 2009 to create jobs, offer training, and provide temporary wage subsidies to vulnerable groups at the regional level through special transfers to local authorities. The government also protected social expenditures from budgetary sequestration, ensured that all pension payments (including those from private pension funds) were indexed to inflation, extended unemployment benefits from four to six months, and promoted the signing of memoranda between regional authorities and larger enterprises on preserving jobs.

## Table 1. Timeline of Major Crisis Events, Programs, and Costs: 2007–2009

| Date | Event | Policy Response | Fiscal or Other Cost |
|---|---|---|---|
| | | **2007-mid 2008** | |
| Aug-07 | Sudden stop in capital inflows (foreign loans) to Kazakhstan banks | Commitment to defend exchange rate | |
| | | Liquidity (mostly REPO) provided to banks | See below |
| | | Program to complete frozen housing construction | US$ 1.5 billion |
| | | SME loan refinancing at subsidized interest | US$ 1.3 billion |
| | | **US$ 10 billion Anti-Crisis Program for late 2008-2009** | |
| Oct-08 | World economic crisis further trightens external constraints, commodity and real estate prices fall | Recapitalization program for 4 largest banks | US$ 4 billion |
| | | *US$ 6 billion Anti-crisis spending package for 2008-2009* | |
| | | For completion of frozen construction projects[1] | US$ 2 billion |
| | | Refinance of mortages at lower interest rates[2] | US$ 1 billion |
| | | Refinance and new loans for SMEs[2] | US$ 1 billion |
| | | Agriculture: investment, loans to farmers, etc.[3] | US$ 1 bilion |
| | | Priority infrastructure projects[2] | US$ 1 billion |
| | | Household deposit insurance inreased 7X to 5 million tenge (US$ 42,000) | |
| Feb-09 | Low commodity prices, real estate price crash, and recession creates large external imbalance and further distress for banks | One-off 20 percent devaluation of the tenge | |
| | | Government takes control (ownership) of highly distressed BTA and Alliance banks | No additional immediate costs (financed from US$ 4 billion recapitalization program) |
| Mar-09 | Pressure on tenge continues, as many expect further depreciation | National Bank pledges to defend exchange rate | |
| | | Government secures commitments of inflows from China, other countries, and IFIs of over US$ 15 billion | |
| | | ***Debt swaps and other unsecurred support for banks*** | |
| Spring-09 | Government keeps BTA and Alliance current on debt service, but declares need for debt restructuring | Samruk-Kazyna conducts bond swaps with BTA bank (US$ 4.3 billion) and Alliance (US$ 700 million), giving these banks securities to pledge for refinance | US$ 5 billion |
| | | Unsecured deposits or refinance | US$ 2 billion |
| Apr-09 | Two foreign creditors call acceleration clauses in debt contracts: BTA and Alliance default | Government insists that unsecured foreign debts of these banks must be restructured | |
| Apr-09 | BoP position strengthens, but continuing recession fuels worries about unemployment | Government introduces Road Map public works program | US$ 1.5 billion |
| Summer-09 | Impasse in debt restructuring negotiations | Government passes new Bank Resolution Law that allows alternative resolution procedure (good bank-bad bank) for large insolvent banks | |
| Oct-09 | Non-binding agreement reached on debt restructuring for Alliance bank that writes down roughly 75 percent of foreign debt | | |
| Dec-09 | Non-binding agreement reached on debt Restructruing for BTA Bank that writes down roughly 60 percent of foreign debt | | Projected US$ 7 billion in costs to foreign creditors (Costs to Government already counted above) |
| 10-Mar | Restructuring deal of Alliance completed and implemented | | US$ 3 billion in costs to foreign creditors (Costs to Government already counted above) |

[1]Channeled half through the budget and half through S-K ($1 billion).
[2] Channeled half through S-K.
[3] Channeled through KazAgro.

15. **Another challenge was to complete restructuring of the debt of the troubled banks.** The Government actively pursued the recapitalization of BTA and Alliance through substantial foreign debt restructuring**.** The government kept the two banks it acquired current on their foreign debt obligations rather than go immediately for debt restructuring. However, two international creditors, who had more than hedged their exposure to the banks using credit default swaps (CDSs) called an acceleration clause in their contracts, citing change of ownership. Because the government did not wish to accelerate the debt or give preferential treatment to individual creditors, BTA and Alliance fell into default, pending negotiations to restructure their foreign debts. The government position was that foreign creditors who made unsecured private loans to BTA and Alliance did so at their own risk and should bear a significant share of the losses. This strong signal to financial markets was deemed necessary to avoid future speculative capital inflows. Through Samruk-Kazyna the government finally achieved agreements on general terms with committees of foreign creditors for Alliance (October 2009) and BTA (December 2009). Because these general memoranda did not bind individual creditors, in December Alliance reached binding agreements with a qualified majority of creditors that confirmed the terms of the October memorandum. Similar agreements for BTA were concluded in 2010. These agreements prescribed average haircuts of about 75 percent for foreign creditors of Alliance and 60 percent for those of BTA and gave some preferential treatment to trade credits. It is estimated that the write downs of foreign debts for BTA and Alliance amounted to around US$10 billion. The challenge then became how to implement these agreements.

16. **The government also had to deal with reinforcing regulation of the financial sector.** The absence of a sound legal framework for resolving weak and troubled banks, insufficient independent monitoring of the conditions of banks to generate early warning signs, and the perception that the government might be willing to bail banks out meant that the banks had few incentives to manage their risks. Also, the porous regulatory framework could not restrain excessive external borrowing or domestic real estate lending, and supervision capacity was inadequate.

17. **The interventions that helped stabilize both the financial sector and credit to the private sector also increased fiscal risks and the cost of restoring the sector to health.** The US$11 billion (10 percent of GDP) that the authorities provided in direct equity and debt financing helped stabilize credit to the private sector, and CDS spreads came down to 550–800 bps for the two largest banks (now Halyk Bank and KKB) from more than 3,000 in the summer of 2009. The interventions were successful in maintaining depositor confidence in the rest of the system, although depositors did leave BTA and Alliance. However, fiscal risks remained as liquidity injections continued after nationalization, most notably as facilitated by a bond swap between Samruk-Kazyna and BTA.[1]

[1] Samruk-Kazyna received BTA bonds in exchange for its own bonds, which for liquidity the banks could then pledge to the National Bank. Because the BTA and Alliance bonds that Samruk-Kazyna received were converted into equity as part of the restructuring, the true fiscal costs will remain uncertain until the market value of the banks can be established.

18. **The banking sector was still vulnerable to external shocks and the growth in nonperforming loans.** Beyond continuing uncertainty in the international environment, an emerging threat to the financial system was a rise in nonperforming loans (NPLs). Loans 90 days in arrears as a percentage of total credit increased from 5.1 percent on January 1, 2009, to 21.2 percent on January 1, 2010. Fortunately, Halyk Bank, the former state savings bank that held a large share of consumer deposits, and KKB, now the largest bank in Kazakhstan, had kept current on their foreign debt obligations. However, given the difficulties on the asset side of bank portfolios and their limited opportunities to attract resources.

### 1.2 Original Program Development Objectives (PDO) and Key Indicators (as approved)

19. **The World Bank development policy loan (DPL) supported the government's post-crisis policies of fostering economic growth and sustaining Kazakh living standards.** The objective was to support the government's efforts to (i) strengthen management of public resources, particularly oil revenues, through increased efficiency and re-orientation of spending; and (ii) reduce financial sector vulnerabilities by restructuring large problem banks and building up the bank supervisory, regulatory, and resolution frameworks. Intended outcomes of the program were (i) continued economic growth and improved social indicators; (ii) more effective, strategic, and flexible public resource management; (iii) successful debt restructuring for the large problem banks; and (iv) more effective bank regulation and resolution.

20. **The DPL was intended to finance part of the non-oil deficit in 2010 as markets recovered and to signal the government's intention to harden the budget constraint.** In 2008 and 2009, large exceptional transfers from the NF financed both budget and off-budget expenditures. The government moved quickly to restore discipline in the use of oil revenues and to sustain it in a structured and transparent manner. The higher-profile engagement with the World Bank through the DPL also accelerated technical work and deeper dialogue on management of the NF and enhanced the effectiveness of government efforts to maintain fiscal discipline and strengthen NF governance over the medium term. DPL-supported reforms were directed to increasing the confidence in Kazakhstan of both domestic and foreign investors by signaling that the government was willing to hold the line against domestic pressures, thereby accumulating reserves in the NF despite an uncertain domestic and external environment.

21. **In the financial sector the DPL supported government efforts to stabilize the banking system by intervening fast and effectively when the financial crisis broke.** The loan supported the government decision to resist the pressure to bail out private banks entirely and force shareholders and private creditors to bear a large share of the cost. This was an important signal from the government about the need to establish better discipline in the banking sector to avoid moral hazard.

22. **Although the DPL had not been foreseen in the World Bank 2004 Country Partnership Strategy (CPS), the policy areas it supported were fully aligned with the CPS goals.** The CPS, presented to the Bank Board on September 8, 2004, and updated in early 2008, focused on assistance and support for achieving the government's four main goals:

- Reduce losses in competitiveness through prudent management of oil revenues and increased public sector efficiency.
- Promote competitiveness by building government capacity to reduce barriers to businesses and private investors.
- Lay the foundation for future competitiveness by investing in human capital and basic infrastructure.
- Ensure environmentally friendly growth and mitigate past ecological liabilities.

23. **The DPL was directly aligned with the first pillar of the CPS: Reduce losses in competitiveness through prudent management of oil revenues and increased public sector efficiency.** The loan also indirectly supported the other three pillars of the CPS by helping the government to better manage public resources and address financial sector vulnerabilities. It also supported the government priority to address the crisis and set the course for its aftermath. In 2009 the government approved an ambitious *Concept for the Development of the Financial Sector* that outlined a medium-term strategy for improving incentives, including improvements to corporate governance.

### 1.3 Revised PDO (as approved by original approving authority) and Key Indicators, and Reasons/Justification

24. Because the DPL was a single-tranche operation, neither the program development objectives nor the major indicators were revised.

### 1.4 Original Policy Areas Supported by the Program (as approved)

**Pillar 1. Strengthening Public Resource Management**

***Fiscal Management of Oil Wealth***

25. **The DPL supported the government's central objective of imposing discipline on the use of oil revenues.** In April 2010 use of NF resources was restricted. The program thereafter envisaged an engagement with the Bank through technical work and dialogue on use and management of the NF. The accelerated technical work was to examine best practices in governance and management of sovereign wealth funds elsewhere, adapt them to Kazakhstan, and analyze what might be done in the medium term to refine the new rules. With the DPL, the government committed to limiting to US$8 billion the annual guaranteed transfer from the NF to the budget and mandating that the NF acquire only assets traded on international markets.

***Budgetary Reform***

26. **The DPL supported the government's commitment to addressing the weaknesses in budget management identified in the PEFA.** DPL-supported actions included three initiatives launched by the revised Budget Code at both national and local levels: medium-term budgeting, expansion and regularization of internal controls, and execution flexibility for local budgets. Prior actions were to "(a) develop and approve three-year rolling budgets at the republican and local level based on three-year strategic plans; (b) delegate powers to administrators of budgetary programs at the republican (national) and local levels for redistribution of funds between specifics and subprograms within one budgetary program in the process of budget execution; and (c) adopt

regulations for creation of internal control services in budgetary organizations to perform internal state financial controls."

***Reorient Budgetary Outlays***

27. **The DPL supported efforts to increase social spending to mitigate the impact of the crisis,** especially efforts to streamline public expenditures while maintaining the share of public outlays that went to social sectors. Specifically, it foresaw a decrease in the share of nonpriority spending and transfers to SOEs. The increased allocations for social spending were to be accompanied over the medium to long term with institutional reforms to improve the quality and efficacy of social assistance programs and the delivery of health and education services. It was also expected that the lessons of the temporary employment programs would be incorporated into policies for generating employment, especially in rural areas. Because technical analysis was limited, reviews of social spending were planned for FY 12–13 so that the impact of these programs could be better assessed. The government program sought to decrease the share of nonpriority administrative expenditures and transfers to SOEs in the budget and increase the share of social spending.

**Pillar 2. Addressing Financial Sector Vulnerabilities**

28. **The DPL supported the reform agenda that the government, the National Bank, and the Financial Supervision Agency (FSA) adopted to address the banking crisis and restore domestic credit to firms.** The core of the strategy was to overhaul incentives for commercial banks. The immediate agenda had three priorities: (i) reinforce the bank resolution framework; (ii) restructure large problem banks, with shareholders and creditors sharing the cost; and (iii) improve regulation and supervision.

***Bank Resolution and Problem Bank Restructuring***

29. **Upgrading the resolution framework was fundamental to sorting out the crisis and enabling the authorities to respond to future shocks.** The new resolution framework was drafted to give the regulators options for effectively addressing the challenges posed by weak and troubled banks (see next paragraph). The resultant law, "On Improving Legislation on Banking Activity and Activity of the National Bank of Kazakhstan," enacted on July 11, 2009, set out mechanisms for the orderly restructuring of obligations, which filled a serious institutional void in Kazakhstan's banking regulation. It also improved the government's bargaining position in debt restructuring negotiations because it ensures that the costs of bailout are borne by shareholders and creditors rather than taxpayers.

30. **The government also needed to signal to shareholders and creditors of troubled banks that they would have to bear a significant share of the costs of bank restructuring and to build on the restructuring to stimulate recovery of the banking sector.** Agreements with international creditors achieved a significant write-down, alleviated the burden of the crisis on Kazakhstan's taxpayers, and signaled that the government is not implicitly insuring private unsecured foreign loans. Resolution of BTA and Alliance also helped relieve the debt overhang, clarify the value of claims on these banks, and re-establish the international reputation of the Kazakhstan financial sector. Restructuring the two large problem banks initiated the recovery of the banking sector. The DPL prior actions were that (a) BTA and Alliance each enter into a terms-sheet agreement with their credit committees on a restructuring plan that would restore their financial viability and would write down the majority of foreign debts; and (b) a law would

be passed that would ease bank resolution through creation of stabilization banks, execution of purchase/assumption agreements, and restructuring of banks by a specialized financial court."

***Bank Regulation***

31. **Strengthening supervision, especially through use of an early warning system, and enhancing government capacity to intervene were also part of the reform agenda.** Limitations on the ability of the FSA to monitor banks and intervene when necessary was a primary weakness that had made it impossible to avoid the financial instability that emerged in 2007. Government efforts to remedy these shortcomings included major increases in personnel, number of inspections, and types of inspections, and placement of permanent FSA representatives in systemically important banks. The Law on Financial Stability of October 2008 authorized the early warning system but the system did not reach its current effectiveness until the FSA in August 2009 revised its Resolution 200, which establishes concrete conditions for implementing the system. The early warning system gives regulators power to monitor closely a series of basic indicators of the financial health of a bank. If the indicators evidence a deterioration in performance, the FSA can intervene in a number of ways to restrict the bank's activities or force managerial changes, even if the bank is not yet in explicit violation of any prudential norms.

32. **Improving prudential regulations to prevent excessive foreign borrowing and credit expansion by banks was also part of the reform agenda.** With the crisis, bank capital had become negative. The plan was for banks to build capital and reduce foreign exposure gradually. Increased capital adequacy requirements and tighter limits on foreign borrowings by banks as a share of equity was scheduled to become effective in 2011. As the banking sector recovers over the medium term, other prudential norms are due to be tightened, such as limiting foreign loans to 30 percent of liabilities. The DPL prior action required enactment of a law establishing an early warning system to empower the FSA to (i) monitor indicators of bank performance; (ii) require banks to submit to a contingency plan if the indicators deteriorated; and (iii) take additional measures as needed to provide for financial stability, even if there had not been an explicit violation of prudential norms. The second prior action called on the government to issue decrees to (i) increase the capital adequacy requirements for commercial banks, starting in July 1, 2011; and (ii) limit their total liabilities to nonresidents relative to their equity.

## 2. Key Factors Affecting Implementation and Outcomes

### 2.1 Program Performance

33. **Table 2 presents the triggers the authorities met before Board approval.** As noted, the DPL supported only part of the government program to help ameliorate the impact of the crisis. The Bank contributed to the design of complementary measures and has monitored their implementation, sometimes providing advice. The government created an Inter-Ministerial Working Group to be responsible for coordinating DPL preparation and implementation. The authorities and the Bank team have maintained an active dialog throughout, with the Bank providing technical assistance (TA) through the Joint Economic Research Program (JERP). This dialogue has been more active on fiscal than on financial sector issues; for the latter the Bank has concentrated on presenting alternatives for resolving the high level of NPLs and reinforcing the insolvency framework.

## Table 2. Status of DPL Prior Actions

| **First Programmatic Reform: DPL Implementation** | |
|---|---|
| **Prior Actions** | **Status** |
| **I.** ***Strengthen public resource management.*** | |
| Issued a decree limiting the amount of the annual guaranteed transfer from the National Fund to the budget to the equivalent of US$8 billion and obligating the NF to acquire only assets traded on international markets. | The decree was issued in April 2010. Efforts are underway to strengthen the rules for using countercyclical fiscal policy to deal with shocks. |
| Implemented a revised Budget Code to develop and approve three-year rolling budgets at the national and local levels based on three-year strategic plans. | Mid-term budgeting is in place at the central and regional levels. Current efforts are directed to better aligning sector strategies with budgetary allocations using a results-based approach. |
| Implemented the revised Budget Code to delegate powers to administrators of budgetary programs at the national and local levels for redistribution of funds between specifics and subprograms within a single budgetary program when budgets are being executed. | Powers have been provided for redistribution of resources between specifics and subprograms within one budgetary program when budgets are executed; measures are being taken to strengthen the finances of oblast and local executive bodies. |
| Implemented the revised Budget Code to create the internal control services of central government bodies and executive bodies funded from budgets of oblasts, national cities, and the capital to perform regular internal control related to areas of the body's activities to improve the quality and productivity of its operations. | Internal control services were created, but further analysis identified weaknesses in related legislation. The regulatory framework is now being reviewed. |
| Enacted a law to decrease the share of nonpriority administrative expenditures and capital transfers to state-owned enterprises in the budget and increase the share of social spending. | The law is in place. The government has removed the fiscal stimulus provided during the crisis and has kept social spending higher than before the crisis. |
| **II.** ***Address financial sector vulnerabilities.*** | |
| BTA and Alliance banks each entered into an agreement with their credit committees on a restructuring plan that restores their financial viability and writes down the majority of outstanding foreign credits. | The agreements are being implemented satisfactorily. |
| Enacted a law to strengthen the bank resolution framework through, e.g., the creation of stabilization banks, execution of purchase/assumption agreements, and restructuring of banks by a specialized financial court. | The law is in place and has helped the government intervene at the two large banks that were insolvent. The government is preparing to present to Parliament legislation to fine-tune banking regulatory powers; |
| Enacted a law that established an early warning system to empower the FSA to (i) monitor indicators of bank performance; (ii) require banks to submit to a contingency plan if the indicators deteriorate; and (iii) take additional measures as needed to sustain financial stability, even before there is an explicit violation of prudential norms. | The law is in place and covers all the banks in the system. |
| Issued a decree to (i) increase the capital requirements for commercial banks, starting in July 1, 2011; and (ii) limit the total liabilities of commercial banks to nonresidents relative to their equity. | This decree has been fully implemented. |

## 2.2 Major Factors Affecting Implementation:

34. **Government ownership of the program has been high.** The government put in place the DPL-supported policies and actions necessary to address the challenges of the crisis and the institutional weaknesses that emerged. The DPL program also sought to help maintain the pace of reform throughout the crisis. The authorities had full control of the process that led to design of the program; its ownership then translated into prompt and flexible implementation. That is, to meet program objectives the authorities could adjust it as needed to respond to emerging events. The high degree of ownership also meant that the government was able to withstand internal and external pressures working against the strategy.

35. **Tight alignment of the DPL agenda with government priorities facilitated design and implementation.** The DPL agenda was aligned with short-term stabilization priorities: It supported the government on use of NF resources, giving priority to social spending, and prompt resolution of the banking crisis. It also supported continued attention to improving budgetary and banking institutions. This alignment and the high degree of government ownership meant that substantive actions could be undertaken quickly, before the operation went to the Bank Board.

36. **A history of effective dialogue between the authorities and the World Bank Group facilitated design and implementation of the program.** The design of the World Bank Country Partnership Strategy (CPS) for Kazakhstan was innovative and flexible; it recognized that Kazakhstan is an upper-middle-income country. The cornerstone of the CPS has been the JERP, which began in 2002. JERP is a demand-driven AAA program cofinanced by the Bank and the government that comprises ESW and TA, including periodic day-long brainstorming, on topics identified by the government. Bank engagement had been particularly intensive in fiscal, public financial management, financial, infrastructure, private sector development, agriculture, and social areas (health and education). The CPS strategy also envisioned flexible lending with room for additional borrowing should that be necessary. This approach meant that is was not necessary to reshuffle the lending program to accommodate the DPL. *No follow-up DPL is foreseen.*

37. **The CPS now being prepared will support the government's 2020 Vision, which gives priority to the efficiency of the state, sound macroeconomic management, and strong financial institutions.** In these areas, the fourth cycle of JERP-4, also now being prepared, will be the main instrument for dialog and support. Support will continue to be demand-driven; but, building on the lessons of the previous JERP cycles, programmatic work will facilitate implementation of the multiyear reform agenda.

# 3. Assessment of Outcomes

## 3.1 The Structure of the Program

38. **The DPL design was appropriate given the needs and the priorities of the Kazakh government.** The DPL provided resources the government needed to implement its strategy of sound fiscal management in a difficult external environment where access to international finance had virtually come to an end. Moreover, the DPL was aligned with the government strategy of softening the impact of the crisis, preparing for a strong recovery, and advancing the process of strengthening fiscal and banking institution. The policy design combined support for short-term priorities, such as protecting the NF and dealing with the troubled banks, while at the same time advancing financial sector and public expenditure agendas that needed a longer-term perspective. The decision to opt for a single tranche and standalone DPL avoided committing the incoming administration to an inherited policy.

39. **The focus on the financial sector helped the country protect against risks from the global crisis and thus avoid a lasting blow to Kazakhstan's competitive position.** The DPL focused on building up the powers of the authorities to intervene in insolvent banks and implementing agreements with creditors of the two banks that had come under government control. The Bank advised the government on its negotiations with creditors and helped implement a solution where the financial costs of saving the two banks were shared by the country and the creditors. This solution set an important precedent.

40. **The focus on public sector efficiency was relevant to Kazakhstan maintaining a small, agile, and effective state capable of delivering priority services to its people**. Protecting the integrity of the NF was central to the preservation of a reliable national savings mechanism that was also an instrument of countercyclical policy. The emphasis on social spending was needed in the short term to mitigate the impact of the crisis and over the long haul to redress gaps in social service delivery.

41. **The focus was on the year after the crisis in order to frontload actions that could have medium-term impact.** Phasing out the fiscal support provided during the crisis was a priority, as was improving the quality of public expenditure to ensure that the efforts made during the crisis were followed up.

### 3.2 Achievement of Program Development Objectives

42. This implementation Completion and Results Report rates the achievement of development outcomes as being moderately successful in terms of the two pillars of the DPL, (a) strengthening public resource management and (b) addressing financial sector vulnerabilities.

#### Fiscal and Macroeconomic Developments

43. **Economic recovery is well underway.** Although the economy slowed to 1.2 percent growth in 2009, in 2010 growth was 7.3 percent and it is estimated to have been 6.5 percent in 2011. In the medium term the expectation is that the economy will continue growing at over 6 percent annually.[2] The recovery has been driven by rising revenues from oil, minerals, and related services, such as transport and trade. In 2010 agriculture contracted due to a severe drought, and real estate and construction were stagnant. The expectation is that the economy will prove to have been more broad-based in 2011, with agriculture and construction again growing. Inflation pressures have increased mostly because of external factors, such as international food prices.

44. **The fiscal position has improved considerably since the crisis** (see Table 3)**.** The non-oil balance went from over 10 percent of GDP in 2008 and 2009 to less than 8 percent in 2011, although it is still higher than the pre-crisis level of about 4 percent. The state budget deficit that determines central government borrowing has improved notably,[3] to an estimated 1 percent of GDP in 2011.

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[2] See IMF Article IV 2011.

[3] The "state budget deficit" is that part of the total non-oil deficit not covered by oil revenue; it is therefore equal to net government borrowing.

**Table 3. Kazakhstan: Government Fiscal Accounts (Percent of GDP)**

| | Actual | | | Estimate |
|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 |
| **Fiscal accounts** | | | | |
| Non-oil revenues | 16.8 | 14.1 | 14.1 | 14.2 |
| Expenditures (on- and off-budget) | 27.2 | 27.9 | 22.1 | 21.5 |
| **Non-oil balance** | **-10.5** | **-13.8** | **-8.0** | **-7.4** |
| Oil revenues spent | 8.4 | 10.9 | 5.6 | 6.4 |
| **State budget balance** | **-2.1** | **-2.9** | **-2.4** | **-1.0** |
| Foreign financing | 0.0 | 0.5 | 1.0 | 0.6 |
| Domestic financing | 2.1 | 2.4 | 1.5 | 0.4 |
| NF assets (stock) | 20.6 | 26.5 | 26.1 | 28.6 |
| Government debt (stock) | 6.7 | 9.9 | 10.4 | 9.7 |

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

45. **The size of the state grew, however, and the measures to stem the impact of the crisis increased fiscal risks.** The government bailout of two systemically important commercial banks, BTA Bank, the largest in Kazakhstan, and the mid-sized Alliance Bank, and its acquisition of stakes in two other banks, Kazkommertsbank and Halyk Bank, drove the balance sheet of SOE conglomerate Samruk-Kazyna from 46 percent of GDP in 2008 to 65 percent in 2009. Not only is the size of the state larger, but the external debt of SOEs as a percent of GDP exceeds that of the national government. The government has moved to increase oversight of SOEs, emphasizing the use of strategic planning, and tightened monitoring of performance. As part of a broad effort to improve governance, in March 2011 a new law on state property was enacted. It requires enterprises to both formulate strategies and introduce performance indicators. Informational requirements have also been tightened to monitor debt and quasi-fiscal activities.

**Pillar 1. Strengthening Public Resource Management**

***Management of Kazakhstan's Oil Wealth***

46. **The role of the NF has been clarified and reinforced.** The World Bank supported government efforts (a) to successfully fend off political pressures to increase transfers out of the NF and (b) to adopt countercyclical fiscal policy. An important instrument to shield the NF from political pressure was the April 2010 presidential decree that capped annual transfers from the NF to the budget at US$8 billion (calculated in domestic currency at a fixed exchange rate for the US dollar and the tenge over a three-year period), and forbade off-budget transfers to SOEs. There is compliance with both provisions. Together with increases in the value of oil exports, the decree has meant continued increases in the NF balance, which is expected to have reached US$40 billion by the end of 2011, up from US$27.5 billion at the end of 2008.

47. **NF governance compares well with similar institutions in other countries, and the new rule for transfers from the NF to the budget is consistent with current long-term goals.** A recent Bank review[4] comparing the design of the NF and of similar funds in other countries

[4] World Bank-JERP (2010), *Comparative Review of Global Experiences in the Management of Natural Resource Related Sovereign Wealth Funds*.

confirmed sound practices and outlined options for better aligning NF design with government objectives (stabilization, savings, etc.). The review pointed out, however, that the fixed transfer rule of April 2010 could lead to procyclical behavior and called for a design that integrates NF operation with the general fiscal framework. A follow-up Note[5] found the US$8 billion transfer rule consistent with a permanent income approach, given expectations at the time; it also found that other approaches, such as moving to a 3 percent non-oil fiscal deficit by 2020 as the government had proposed, would be harder to implement. Given the problematic global economy, thought should be given to designing a mechanism that embeds a countercyclical approach into fiscal management. The issue is currently being debated in Kazakhstan.

***Reorienting Budgetary Outlays***

48. **Crisis support, budgeted and off-budget, has ended.** In 2008 and 2009, government spending increased by 5 percent of GDP due to both an anti-crisis budget and off-budget transfers; ultimately it reached 27 percent of GDP. A conservative estimate for the DPL put the share of budgeted spending on anti-crisis measures from government reserves plus transfers to SOEs at 17 percent of total expenditures in 2008. By other accounts, if off-budget liquidity support to the financial sector that year is added, the share could have been as high as 31 percent. In 2010 the corresponding share was down to 7.9 percent and consisted only of transfers to SOEs, mostly for targeted public investments; budget and off-budget outlays returned to about 22 percent of GDP as off-budget expenditures disappeared.

49. **The share of the budget allocated to social expenditures was higher in 2010 than in 2008.** Allocations to social sectors increased from 52 percent in 2008 to 58 percent in 2010–11. Spending on social security and welfare has contributed most to the shift in spending, mainly because there were three consecutive increases in pensions over 2009–11, each in the range of 25 –30 percent a year. Spending on healthcare rose gradually. The shares of spending on education and on housing and utilities were lower in 2010 than in 2009 because the temporary training and public works program (the Road Map) were phased out. Still, in 2010 the shares in spending on education and on housing and utilities were both higher than pre-crisis (see Table 4).

[5] World Bank (2011), *The Fiscal Management of Kazakhstan Oil Revenues*,

**Table 4. Kazakhstan: Composition of Budget Expenditure**

| | Actual | | | Estimate |
|---|---|---|---|---|
| | **2008** | **2009** | **2010** | **2011** |
| Budget outlays (billions of tenge) | **3,761** | **3,999** | **4,827** | **5,705** |
| Composition of budget outlays (% of total) | **100.0** | **100.0** | **100.0** | **100.0** |
| *Of which:* | | | | |
| Budgeted expenses | 90.2 | 93.7 | 92.3 | 96.2 |
| Government administration & national security | 18.1 | 16.8 | 16.9 | 17.9 |
| Social sectors | 52.0 | 58.7 | 57.5 | 58.7 |
| Education | 15.2 | 16.5 | 15.6 | 17.3 |
| Healthcare | 9.7 | 11.3 | 11.4 | 11.1 |
| Social security and welfare | 16.5 | 19.0 | 18.8 | 19.9 |
| *Of which:* Pensions | 9.7 | 11.4 | 11.5 | 12.3 |
| Housing and utilities | 6.2 | 7.6 | 6.9 | 6.9 |
| Culture, sports, tourism | 4.4 | 4.3 | 4.7 | 3.4 |
| Economic services [1] | 18.6 | 16.5 | 16.0 | 17.5 |
| Interest payments | 1.5 | 1.7 | 2.0 | 2.2 |
| Capital transfers to SOEs [2] | 8.6 | 5.6 | 7.2 | 7.8 |
| Net lending | 1.1 | 0.7 | 0.5 | 1.2 |

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

[1] Includes other sectors, such as agriculture, transport and communication, industry, etc.

[2] Expenditures in 2008 on recapitalizing the four largest banks were removed for comparability.

### *Budgetary Reform*

50. **The institutional basis for a more effective, efficient, and strategic allocation of public resources has improved.** A 2009 PEFA, based on findings from 2006 and 2007, noted that Kazakhstan had made significant progress on managing public spending since 2000. It also considered the 2004 Budget Code to give solid ground for institutional development and highlighted the single treasury system as a major achievement, though it identified some institutional gaps. The DPL was directed to areas the PEFA had identified as lagging, mainly (a) consolidation of mid-term expenditure frameworks around strategic objectives; (b) deepening internal controls; and (c) flexible use of resources, especially at the local level. The legal basis for addressing some of these gaps was the 2008 revision of the Budget Code. Although follow-up PEFA exercises that the DPL expected did not happen, the JERP work with the government made it possible to track progress in the areas the DPL identified as priorities.

51. **The alignment of mid-term budget programming and strategic planning foreseen in the 2008 Budget Code revision code is making satisfactory progress.** The code revision in December 2008 mandated (Art. 32) linking budgeted programs with strategic decisions, goals, tasks, and results indicators defined for each agency. In July 2009 the government introduced a system of strategic planning. The central administration has already drafted a first round of strategies, and medium-term budget frameworks for the national government and sectors are in place. Government efforts are now centered on merging strategic planning with budget preparation. The Ministry of Finance (MOF) is leading the effort to align program budgets to strategic objectives, while the Ministry of Economic Development and Trade is helping ministries perfect their strategic plans. Sector strategies are being aligned with the goals of the Country Vision 2020. The challenge now is to continue perfecting sector strategies so that they are not only aligned with national goals but also properly programmed and costed so that they are more consistent with mid-term budgeting.

52. **Local authorities now have more flexibility in allocating budgetary resources.** In 2008 Parliament adopted the Budget Code, which has elements of results-oriented strategic planning and budgeting. In 2010 results-oriented budgeting was implemented at the local level, with three-year budgeting and use of strategic results-oriented plans. The 2008 Budget Code delegated to program administrators the flexibility to adjust to uncertainty by reallocating resources between specifics and subprograms within one budgetary program while budgets are being implemented; lack of this authority had been a major source of inefficiency in the past. A recent JERP review[6] found that introducing flexibility has had an impact because budgetary organizations can now freely allocate their utilities budgets and change allocations within programs with permission of the local oblast administrator. The review notes, however, that the flexibility granted is limited and is handicapped by too narrow a definition of budget programs. As the resources transferred to local governments increase, the central government is turning its attention to designing a system of intergovernmental financing that will ensure the quality of services throughout the country. The Bank will support these efforts through JERP IV.

53. **Decisions have been made about how internal audits can be institutionalized.** The 2009 PEFA (Article 21) had reported that, although there was no consolidated internal audit legislation, the legal framework for internal controls was adequate. Internal control services were therefore created in central and local government agencies. However, reviews in 2009 and 2010 found that the current arrangements do not meet the major criterion for an effective internal control system, which is to help management attain ethical, economical, efficiency, and effective operations. The current internal control arrangement does not provide the heads of public bodies with independent and impartial opinions and advice to help them improve performance and use resources efficiently. Hence, the current recommendation is to give first priority to establishing a solid legal foundation that takes into account the decision of the government to opt for decentralized internal control, which requires a strong coordinating body (Central Harmonization Unit) to guide internal control services.[7] With hindsight, the PEFA assessment that the laws supporting internal control were adequate proved incorrect. Progress made in setting up an internal control system in Kazakhstan must now be backed by supporting legislation and development of control institutions that meet international standards. To transform internal control services into internal audit services, the government plans to make changes in the Budget Code and in subordinate legislation in 2012.

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[6] World Bank (2011**),** *Review of the System of Inter-budgetary Relations and Management of Local Budget Expenditures for Education and Social Protection*.

[7] This would be accompanied by development of internal control tools, such as manuals and methodology, standards to be followed by the internal control fraternity, internal control charter, etc. A capacity development strategy and plan will be necessary to guide all capacity-building activities, including training and retraining to equip the internal control staff with modern audit skills. Also planned is training for managers to sensitize them to their role in setting and maintaining effective systems of internal control as part of their accountability. A number of workshops, seminars, and other events will be necessary to create awareness among stakeholders about the role of internal controls in the management of public resources.

**Pillar 2. Addressing Financial Sector Vulnerabilities**

54. **The regulatory changes supported by the DPL allowed the government to implement solutions tailored to the weaknesses and risks of each bank.** The powers to intervene in banks in trouble and the creation of an early warning system filled serious gaps that had contributed to the crisis. These changes enabled the supervisory authorities to effectively collect the information required from the banks and to intervene when needed.[8] It also allowed the authorities to follow a differentiated approach tailored to each bank. Alliance and BTA, as noted, were acquired and their debt reprogrammed. The next largest banks, KKB and Halyk Bank, had fewer solvency problems; for them the government strategy was mainly injecting capital (US$300 million for KKB, US$500 million for Halyk) without taking control; the government took less than 25 percent of the voting stock. The fifth and sixth largest banks were also offered injections of capital but declined in favor of capital support from their parents, Unicredito of Italy and Kookmin Bank of Korea. Smaller foreign banks like RBS, Citibank, and HSBC, which were in the market mainly to serve local units of global clients, were less exposed to the crisis and did not require government support. Small domestic banks tend to be systemically unimportant and would be liquidated should the need arise.

55. **The government's successful handling of the debt obligations of troubled banks signaled to the financial community that it does not implicitly insure unsecured private credit.** Kazakhstan faced a difficult choice during the crisis about how to deal with bank debt. Although the troubled banks had incurred debts before the crisis, some debtors chose to threaten the government with acceleration clauses in the loan documents. World Bank advice was instrumental in finding an equitable solution that signaled that resources lent without a government guarantee are not government obligations. The agreements with creditors reflected this advice, represented major savings for the country, and must be considered one of the most successful results of the DPL.[9]

56. **Although the agreements between troubled banks and their creditors are being acted on satisfactorily, high levels of NPLs loans are again raising concerns about bank solvency.** BTA and Alliance Bank have achieved the solvency targets set by the DPL, but both are insolvent by International Financial Reporting Standards (IFRS). According to the FSA, BTA's NPLs constitute 66 percent of all its loans and Alliance NPLs are 60 percent. Thus, restructuring has not yet been able to ensure solvent and viable banks. BTA's problems are particularly deep because income from its assets is lower than interest expenses, generating losses. On November 14, Fitch downgraded BTA paper to CCC because of the bank's negative equity under IFRS, core poor profitability, and uncertain asset quality. In December 2011, BTA called for a second reprogramming of its debt. As part of the reprogramming proposal, it withheld payment of a US$160 million coupon on a US$2 billion Eurobond. With the grace period on the

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[8] The 2011 folding of the regulatory agency (FSA) into the Central Bank (following similar practices in other countries) further increases the power of the regulator and enhances its independence.

[9] BTA was the nation's biggest lender before it taken over by the state in 2009 when credit markets froze and Kazakhstan's property bubble burst. The bank restructured US$16.7 billion of debt; creditors agreed to reduce the bank's debt to US$4.2 billion in exchange for cash and a stake in the company. Bondholders also received 10-year "recovery notes" under which they will receive 50 percent of anything BTA recovers from impaired assets, including any award in a lawsuit against the previous management. BTA Bank and Alliance Bank successfully emerged from a debt restructuring in which creditors accepted haircuts totaling about US$11 billion on their claims.

debt payment over, Fitch downgraded the BTA from C to RD, a default status. S-K has announced that it will contribute towards finding a solution in the context of an eventual restructuring. Alliance is currently rated by Fitch B-. Alliance is smaller and has a more manageable (retail oriented) loan book, but it remains insolvent under IFRS and some action is likely to be needed.

57. **The current financial difficulties of BTA and Alliance are of concern but they not pose a systemic threat to the banking sector.** [10]Systemic risks are moderated by the influence of government ownership in the sector and a lack of traditional systemic risk transmission mechanisms. There is little interbank market activity and almost no reliance on money market funding, deposit insurance is generous and credible because the fiscal position of the government is strong, and a large part of the domestic funding is from SOEs, which reduces the risk of a run on deposits. However, given the global economic problems, the financial sector will remain vulnerable if the NPL problem is not addressed forcefully now (see Table 5).

58. **Despite progress in improving banking sector prudential indicators, the high NPLs are limiting the sector's capacity to finance productive activities.** The DPL development outcome indicators have been met: specifically, the average capital asset ratios are above the floor that was set and exposure to foreign liabilities related to equity has been brought far below the DPL target. Debt restructuring has substantially reduced the external indebtedness of banks, from US$30 billion a year ago to about US$20 billion. But the sector has yet to fully recover, mainly because the real sectors are not yet doing well. As of July 1, 2011, 34 percent of all bank loans were nonperforming. Loans classified as doubtful amounted to another 40 percent of total loans, reflecting deep distress in the non-resource economy. The NPLs are concentrated by bank and by sector (trade and real estate). Loan provisioning as of March 31, 2011, was inadequate given the reported and expected NPLs, but the rapid increase in provisioning (now at about 30 percent of assets) has tied up resources and prevented new lending. For firms not in default this limits financing for investment and possibly also working capital; for firms in default it may hinder normal operations. Indeed, new lending has been minimal since the beginning of 2009, and most banks now have substantial liquidity.

59. **The government has a strategy to reduce the NPL burden on the banking system, but it is off to a slow start.** The Council for Financial Stability has approved a strategy to improve the quality of bank assets by removing NPLs with an approximate face value of US$6 billion (about 37 percent of the total) from bank balance sheets so that lending can resume, costs can be limited, and moral hazard mitigated. If successful, the plan would be expanded, drawing participation from both domestic and foreign investors. The strategy proposes creation of a national asset management company (the Second Distressed Asset Fund, DAF-2) and private (bank-specific) asset management companies that would operate as special purpose vehicles into which banks would separate nonperforming assets. Though a law to allow individual debts to be written off has been passed, it has not yet taken effect, World Bank comments[11] on this strategy presented options based on global experiences. The Bank has called for a concerted, proactive

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[10] The Bank has been following the potential sources of systemic risks and has informed the authorities of its findings. A recent Note ("Systemic Risks in the Financial sector") and has advised on the need to establish a framework for regular assessment of systemic risks in Kazakhstan.

[11] World Bank in June 2011 provided advice on NPLs in *Enhancing Distressed Asset Management in Kazakhstan*. A revised version of the note was published in September 2011.

effort of the fiscal and the monetary authorities and for training on debt work-outs to avoid moral hazard problems and reduce the potential fiscal impact. The recent Report on the Observance of Standard and Codes (ROSC) on Insolvency and Creditor Rights noted weaknesses in credit enforcement. The World Bank is currently helping the authorities to draft an insolvency law.[12] It has also recommended a detailed audit of all banks; so far only TA and Alliance have had full reviews.

**Table 5. Kazakhstan: Selected Indicators of the Banking Sector**

| | **Jan, 1, 2008** | **Jan. 1, 2009** | **Jan. 1, 2010** | **Jan. 1, 2011** | **Mar. 1, 2011** |
|---|---|---|---|---|---|
| Assets (billion tenge) | 11,683 | 11,890 | 11,557 | 12,031 | 12,360 |
| Credit to the economy (billion tenge) [1] | 8,033 | 8,285 | 7,644 | 7,597 | 7,666 |
| Household deposits (billion tenge) [1] | 1,565 | 1,625 | 1,893 | 2,195 | 2,277 |
| Corporate deposits (billion tenge) [1] | 2,637 | 4,264 | 4,680 | 5,203 | 5,550 |
| External indebtedness (US$ billions) | 45.9 | 39.2 | 30.1 | 20.0 | .. |
| Capital (billion tenge) | 1,782 | 1,948 | -914 | 1,832 | 1,786 |
| Capital adequacy ratio (%) | 14.2 | 14.9 | -8.2 | 17.9 | 17.8 |
| NPLs-90 days in arrears (% of total credit portfolio) | 1.8 | 5.2 | 21.2 | 23.8 | 25.3 |
| NPLs-category 5 doubtful and loss loans (% of total) | .. | 8.1 | 36.5 | 32.6 | 32.8 |
| Provisions (% of total credit portfolio) | 5.9 | 11.1 | 37.7 | 30.9 | 31.1 |
| Liquidity (% share of liquid assets in all assets) | 13.9 | 13.6 | 19.2 | 21.2 | 22.6 |
| Profits - net income after taxes (billion tenge) | 217 | 11 | -2,834 | 1,420 | 0 |

*Sources:* National Bank of Kazakhstan; World Bank calculations.

Note: [1] Jan-2008 and Jan-2009 data are adjusted to account for the February 2009 devaluation.

### 3.3 Justification of Overall Outcome Rating

Rating: Moderately Satisfactory

60. **The majority of objectives were achieved (see Table 6), and some were surpassed.** Eight of ten development impact indicators have been fully met. The recovery is well underway, with growth in all sectors of the economy. Kazakhstan's fiscal position is stronger. NF management rules are clearer and have helped ease out the fiscal stimulus provided during the crisis. Post-crisis the DPL supported a fiscal consolidation that has set the country on a stable

[12] The government has also prepared draft legislation that will move forward the comprehensive revision of the laws regulating the activities of financial organizations. The draft legislation takes into account the supervision experience and recommendations received by the authorities during the crisis and also international standards, which would offset the shortcomings and in general make the activities of financial organizations more transparent. The draft legislation provides for, among other measures, (a) strengthening consolidated supervision of banking; (b) improving transparency; (c) reinforcing the early warning system, and (d) setting clear governance criteria. Over the long term, the government seeks to harmonize its regulatory standards with best international practice and the Basel III framework by, e.g., strengthening core capital and reducing systemic risks through dynamic provisioning and enhanced capital buffers.

mid-term growth path. The government has set ambitious non-oil deficit goals for 2020. Current work, with the support of the Bank, focuses on building up fiscal institutions to manage fluctuations in the prices of oil and other natural resources and on implementing a countercyclical fiscal policy. The government is also working to reduce fiscal risks, mostly through closer oversight of the SOEs.

61. **Public spending is increasingly aligned with national priorities; as a result, budgetary allocations to social sectors have increased.** The government is implementing an active employment policy, with special attention to isolated regions. The authorities continue to perfect results-oriented budgeting with a view to ensuring that budgetary programs are linked to the strategic directions and goals of government bodies. Local government has been given more flexibility in the use of resources that amount to almost half of public expenditures.

62. **However, the share budgeted for transfers to SOEs was slightly higher than the targets.** Moreover, although as foreseen internal control services were expanded throughout the government ministries and agencies, reviews of current audit practices show that inadequate regulation undermines the effectiveness of these initiatives and the framework needs to be amended. This evaluation differs here from the 2009 PEFA, which was the basis for the design of the DPL.

63. **Government actions, supported by the DPL, helped to stabilize the financial sector and provided tools for addressing vulnerabilities.** A major achievement during the crisis was the approach toward settlement of bank external debt: debtors and creditors shared the burden of adjustment, which sent the signal that the government does not guarantee private debt. All banking indicators have improved in terms of domestic accounting standards. Systemic risk has been reduced.

64. **The NPLs that are keeping the banking sector vulnerable are concentrated in the banks the government acquired**. Given the worrisome international context, the unfinished rescue of BTA and the insufficiently addressed NPL problem are retarding the development of the financial sector in both the short and medium term. The government has yet to field a credible strategy to address the NPLs. The NPL problem mostly materialized after the DPL was designed as a second-round effect of the crisis. The government is working to facilitate debt resolution through insolvency and out-of-court restructuring, but it must move more proactively on NPL management to reduce sector vulnerability.

## Table 6. Program Objectives and Results

| **First Programmatic Reform Implementation Development Policy Loan P083927 and Second DPL, Loan P106724** | | | | |
|---|---|---|---|---|
| **Indicator** | **Baseline Value** | **Original Target** | **Formally Revised Target (Target Years)** | **Actual Value at Completion of Target Years** |
| Indicator 1. Official adoption of new NF rules | | | | |
| Values (qualitative and quantitative) | January 2010: President requested that new rules be drafted for NF operations by Q1 2010. | 2010, 2011: Approve, adopt, and implement action by the government of new rules for governing the operation and use of NF. | No change. | Met. New rules were adopted and are being implemented. |
| Comments: | | | | |
| Indicator 2. Annual transfers from the NF to the national budget and other uses of NF resources. | | | | |
| Values (qualitative and quantitative) | 2009: Total use of NF resources = US$11.3 billion. Annual guaranteed transfer of US$5.6 billion, additional targeted transfer of US$1.7 billion, and NF purchase of domestic bonds worth the equivalent of US$4 billion. | 2010, 2011: Annual transfer to the national budget from NF not more than US$8 billion and no additional use of NF resources. | No change. | Met. In 2010 and 2011 transfers to the budget did not exceed U$ 8 billion. |
| Comments: | | | | |
| Indicator 3. Approval of three-year rolling budgets at national and oblast levels, 2009–12<br>PEFA: PI-12 | | | | |

| | | | | |
|---|---|---|---|---|
| Values (qualitative and quantitative) | 2009: Three-year budgeting does not exist at the oblast level.<br><br>PEFA: PI-12=C | 2010, 2011: Three-year budgeting being done in all oblasts.<br><br>PEFA: PI-12=B | No change. | Met. |
| Comments: There has been no follow-up PEFA, but JERP reviews confirm that all oblasts have three-year budgets. | | | | |
| Indicator 4. Increased authority in budgetary organizations at the local level to adjust budgetary allocations within subprograms during execution. | | | | |
| Values (qualitative and quantitative) | 2009: Local budget administrators had no authority to reallocate resources across subprograms. | 2010, 2011: Authority to reallocate across sub-programs during execution delegated to the local level. | No change. | Met. |
| Comments: JERP reviews confirm increased authority to reallocate resources within subprograms. They also confirm that they are being used their effectively. | | | | |
| Indicator 5. Establishment of internal audit units. PEFA: PI-21 | | | | |
| Values (qualitative and quantitative) | 2009: Internal audit units in most central government entities.<br>PEFA: PI-21=C | 2010, 2011: Internal audit units in most central and oblast government entities.<br>PEFA: PI-21=C+ | No change. | Partially met. |
| Comments: There has been no follow-up PEFA. Internal audit units have been extended, but recent reviews have found the enabling environment inadequate for effective internal audit; although at the time of DPL design the PEFA analysis suggested otherwise. | | | | |
| Indicator 6. Share of budgetary spending on anti-crisis measures from the Government Reserve and transfers to SOEs in consolidated budget spending. | | | | |
| Values (qualitative and quantitative) | Share of such spending, 2008: 17%. | Share of such spending, 2009–2010: < 7% , | No change. | Partially met. |
| Comments: In 2010 transfers to SOEs amounted to 7.9 percent of GDP, slightly above the target. | | | | |

| | | | | |
|---|---|---|---|---|
| Indicator 7. Indicators of financial health of BTA and Alliance improve due to implementation of these agreements (FSA capital adequacy ratios k1-1, k1-2, k2). | | | | |
| Values (qualitative and quantitative) | Capital adequacy ratios as of January 1, 2010:<br><br>BTA:<br>k1-1: –0.97<br>k1-2: –0.67<br>k2: –0.67<br><br>Alliance:<br>k1-1: –0.85<br>k1-2: –0.45<br>k2: –0.45 | Implied capital adequacy ratios of BTA and Alliance after agreement on restructuring<br>are no less than prudential norms:<br>k1-1: 0.05<br>k1-2: 0.05 (0.08 as of July 1, 2011)<br>k2: 0.1 | No change | Met.<br><br>BTA<br><br>K1-1 .123<br><br>K1-2 .117<br><br>K2 .157<br><br>Alliance<br><br>K1-1 .082<br><br>K1-2 .104<br>K2: .135 |
| Comments: Status on compliance with prudential requirements on January 5, 2011. | | | | |
| Indicator 8. Bank resolution procedures in Law 185-IV available to FSA and government. | | | | |
| Values (qualitative | Insufficient procedures | Procedures authorized by | No change. | Met. |

| | | | | |
|---|---|---|---|---|
| and quantitative) | available to the authorities for restructuring and resolving problem banks. | Law 185-IV increase government capacity to deal with problem banks. | | |
| Comments: | | | | |
| Indicator 9. Number of banks monitored in the early warning system. | | | | |
| Values (qualitative and quantitative) | In 2009: 37 banks | For 2010: all banks (currently 38) | No change. | Met. |
| Comments: Information provided by the National Bank. | | | | |
| Indicator 10 . Solvency of the system as measured by the capital adequacy ratios (FSA ratio k1-1 and k1-2) | | | | |
| Values (qualitative and quantitative) | Actual capital adequacy ratios as of Jan 1, 2010:<br>k1-1: –0.115 (0.107*)<br>k1-2: –0.116 (0.126*)<br><br>* Without BTA and Alliance | Capital adequacy ratios for entire system should be no less than new prudential norms:<br>k1-1: 0.06<br>k1-2: 0.09 as of July 2011 (0.06 currently) | | Met.<br>K1-1: .115<br>K2: .181 |
| Comments: Status on compliance with prudential requirements on January 5, 2011 | | | | |
| Indicator 11. Foreign liabilities of the banking system relative to equity (FSA ratios k8 and k9). | | | | |
| Values (qualitative and quantitative) | Actual ratios for entire system as of Jan 1, 2010:<br>k8: –2.114 (0.686*)<br>k9: –4.391 (1.504*)<br><br>*Without BTA and Alliance | Ratios for entire system should not be more than new prudential norms as of July 2009:<br>k8: 2 (previously 2.5)<br>k9: 3 (previously 5) | | Met.<br><br>K8: .383<br>K9: .1271 |
| Comments: As expected, the k8 and k9 indicators have foreign liabilities in the numerator and capital in the denominator.<br>Status on compliance with prudential requirements on January 5. 2011. | | | | |

### 3.4 Overarching Themes, Other Outcomes and Impacts

#### (a) Poverty Impacts, Gender Aspects, and Social Development

65. **The government put in place special employment programs to address possible impacts of the crisis.** The authorities believe these interventions have been successful, especially in rural areas. Government efforts to create temporary jobs during the crisis probably helped bring official unemployment down to 5.5 percent recently. Youth unemployment especially fell significantly, from 13.5 percent in 2005 to 5.25 percent at the end of 2010. The authorities now are seeking to apply the lessons learned from these programs in medium-term strategies to expand employment opportunities, especially in remote areas. This work was discussed in a brainstorming session with the Prime Minister of Kazakhstan in February 2011 and provided inputs for the government Employment Strategy 2020 unveiled then. These special programs and the rapid economic recovery are further reducing poverty. Official information put the poverty rate at 6.5 percent in 2010, compared to as much as 50 percent in the 1990s. The government is also revising the system of social assistance to make it more efficient and effective by better matching beneficiaries to jobs and auxiliary services (education, child care, etc.) so they can graduate from the Social Security Network.

#### (b) Institutional Change/Strengthening

66. DPL support for building up banking and finance institutions and streamlining public spending contributed to the following achievements:

- New laws have expanded the powers of the banking regulators. For instance, one law has established procedures for resolving problem banks by, e.g., creating stabilization banks, executing purchase/assumption agreements, and restructuring banks through a specialized financial court. The law that established the early warning system empowers the regulator to (i) monitor indicators of bank performance; (ii) require banks to submit to a contingency plan if the indicators deteriorate; and (iii) take other measures as required to ensure financial stability, even if there has been no explicit violation of prudential norms.
- The rules for operation of the National Fund were clarified by an April 2010 presidential decree limiting transfers to the national budget and forbidding off-budget transfers. All NF resources are to be invested in securities traded on international markets.
- The 2008 revision to the Budget Code made possible the widespread introduction of mid-term budgeting and strategic approach to planning and budgeting. This has been complemented by follow-up decrees.
- Guidelines for social spending are now in place.
- A law on state property (2011) tightens and improves management SOEs.

## 4. Assessment of Risk to Development Outcome

Rating: Moderate

67. **In its 2020 Vision, the government has committed to keeping fiscal policy prudent over the medium term.** Management of NF resources will continue to be prudent even if the current rules are revised. The government is also committed to making public spending more efficient in order to assure quality services throughout the country.

68. **However, leisurely implementation of the strategy to address the NPLs is a source of risk.** With the global environment still uncertain, to improve the health of the banks the government needs to move proactively to apply the new insolvency framework to facilitate debt resolution. Already there has been progress in stabilizing the situation since the crisis, when banking sector capital was negative. At present, the NPL problem presents a moderate risk, but that could escalate if the government's failure to act promptly is exacerbated by a further global slowdown and perhaps a drop in natural resources prices—financial difficulties could engender fiscal risks.

69. **In November 2011 S&P upgraded Kazakh government paper to BBB primarily because it considered the fiscal and foreign exchange conditions to be strong,** although international observers do recognize the risks in the banking sector. The upgrade notes the reduction of foreign liabilities (from 50 percent before the crisis to 20 percent now) and the critical role of state-influenced deposits in assuring sustainable liquidity. High oil prices and high growth may make it possible to muddle through with the high level of NPLs, but prompt government action is needed to reduce vulnerability to any further global economic slowdown. The forthcoming political transition raises concerns about how it will affect the speed of structural transformation, though not about the direction of the development program supported by the DPL.

## 5. Assessment of Bank and Borrower Performance

### 5.1 Bank Performance

#### (a) Bank Performance in Ensuring Quality at Entry

Rating: Satisfactory

70. **Preparation of the DPL operation was a prompt and timely response to the client request for support during the crisis.** Slightly more than six months separated the Concept Note discussion from presentation to the Board. Despite the speed, the operation was thoroughly scrutinized within the Bank; however, the team was able to address reviewer concerns satisfactorily. DPL design responded to both Kazakhstan's short-term challenges and its need to lay a solid foundation for recovery over the medium term. At the same time, the operation was selective: It did not formally incorporate some areas that might be relevant, such as programs to generate employment. However, the Bank did engage with these other areas. Sound JERP analytical work supported DPL design and the policy dialogue. The Bank had also been involved with the analysis of financial sector conditions, especially through brainstorming sessions with the Prime Minister, the heads of FSA and the National Bank, and numerous associated analytical notes as well as through the Financial Sector Assessment Program and updates produced with the IMF. Contribution to development outcomes began before the Board approved the DPL through the advice provided to the government on negotiations with the creditors of BTA and Alliance.

With hindsight, there should have been more emphasis in the original design on confronting the NPL issue directly; this shortcoming could not be fully remedied in a single DPL operation, and experience shows that after a crisis, resolving debt overhangs takes a long time.

**(b) Quality of Supervision**

Rating: Satisfactory

71. **The operation was supervised in the context of a continued dialogue about areas of Bank engagement.** JERP studies and reviews have been the main instrument, notably the discussions for the new JERP (Cycle IV). The JERP dialogue included a review of the National Fund in response to government queries about medium-term options for fine-tuning the transfer rule. Through JERP the Bank has also prepared a review of local financing that has made it possible to determine the impact of recent measures to increase flexibility in budget execution and social expenditures. The Bank likewise has been helping build the capacity of government to prepare sector strategies and move toward program budgeting, which will be a feature of the new JERP. The Bank is still engaged on insolvency issues and has advised the Kazakh government on options for dealing with the NPLs. However, dialogue with the government on broader issues fell back during the program.

**(c) Justification of Rating for Overall Bank Performance**

Rating: Satisfactory

**5.2 Borrower Performance**

**(a) Government Performance**

Rating: Satisfactory

72. **The government preferred to borrow rather than continue drawing resources from the NF.** However, because international financial markets were tight and access limited, the authorities borrowed from the World Bank, where Kazakhstan's borrowing capacity had not been fully committed. The Bank resources made it possible to extend the maturity of the country's debt profile.

73. **The authorities moved quickly to respond to shocks and recognized the internal weaknesses that magnified their impact.** The Letter of Development Policy clearly states not only the request for support but also government plans to address the crisis and its post-crisis strategy. The government created an Inter-Ministerial Working Group to take responsibility for coordinating DPL preparation and implementation. The government also has a strategy to reduce NPLs, but given the international environment the slow pace of implementation is raising concerns about the fragility of the system.

**(c) Justification of Rating for Overall Borrower Performance**

Rating: Satisfactory

## 6. Lessons Learned

74. **A selective one-tranche DPL operation can be adequate to respond to an external shock.** Such an operation is particularly effective when the design of the program is aligned with government priorities, ownership by the client is high, sufficient knowledge is available, and the short-term actions adequately address the main concerns. A large operation in a country with limited previous engagement with budget support in an uncertain global environment presented considerable risks that were highlighted during the review process. Rather than seeking an all-encompassing and multi-tranche design, the DPL opted for a selective single-tranche focus. The DPL document argued that government ownership of the program, the level and areas of Bank engagement, and the program design mitigated the main risks. A posteriori this judgment seems partially correct. The government indeed carried out the program, including actions in complementary areas that were not explicitly part of the DPL. The knowledge that the Bank acquired during a relationship anchored in solid analytical work allowed it to provide guidance and judge relevancy. However, with hindsight, full stabilization of the banking sector required a clearer strategy for addressing the NPLs. Arguably, without a second DPL operation, the engagement that characterized the Bank-government relationship at the height of the crisis was not sustained.

75. **A well-designed DPL can send a powerful signal to the international community about the capacity and commitment of the authorities to mitigate the impact of a crisis.** The DPL came at a point critical for Kazakhstan, which had been hit by successive crises that required considerable expenditures. The operation translated the trust of the Bank in the commitment and capacity of the authorities into a clear statement to the international community that Kazakhstan could surmount the crises and look forward to renewed growth and stability over the medium term.

76. **The effectiveness of the single-tranche operations is enhanced by a design that balances addressing short-term challenges with concern for mid-term sustainability.** The debt restructuring made it possible for banks to write down foreign debts by about US$11 billion. The financial community considers these deals to be a fair distribution of losses between unsecured foreign creditors and the government, which spent US$10 billion to support the banking sector in 2008–2009. The debt restructuring also reduced banking sector external indebtedness by about a third, from US$30 billion at the end of 2009 to about US$20 billion currently.

77. **The DPL design also helped address internal political economy concerns.** The most immediate concerns were the pressures to use more NF resources. The timeliness and size of the operation allowed the authorities to protect NF resources.

## Annex 1: Bank Lending and Implementation Support/Supervision Processes

### Task Team members

| Names | Title | Unit | Responsibility/ Specialty |
|---|---|---|---|
| John Litwack | Lead Economist | AFTP3 | Task Team Leader |
| Ekaterine Vashakmadze | Senior Country Economist | ECSP1 | Task Team Leader |
| Ilyas Sarsenov | Economist | ECSP1 | Economist, Macroeconomics |
| Salamat Kussainova | Consultant | ECSP4 | Economist |
| Yulia Mironova | Consultant | ECSPE | Poverty Reduction/Econ Management |
| Liberty Reposar | Senior Executive Assistant | ECSOQ | Operational support |
| Zakia Nekaien-Nowrouz | Program Assistant | ECSP1 | ECS-ECA Sector Units, Macroeconomics 1 |
| Elena Glinskaya | Country Sector Coordinator | ECSH3 | Country Sector Coordinator, Social Protection |
| Chris Uregian | Consultant | ECSPF | Private and Financial Sector Development |
| Andrea Mario Dall'Olio | Senior Economist | ECSPF | Economist |
| Steen Byskov | Senior Financial Sector Specialist | ECSF1 | Financial Sector Specialist |
| Yeraly Beksultan | Consultant | ECCKZ | Financial Sector Specialist |
| Sophie Sirtaine | Sector Manager | ECSF2 | Private and Financial Sector Development |
| Claire McGuire | Senior Financial Sector Specialist | FFSBK | Financial Sector Specialist |
| Krishnamurti Damodaran | Senior Financial Sector Specialist | FFSBK | Financial Sector Specialist |
| Adolfo Rouillon | Consultant | LEGPS | Legal Consultant |
| Christophe Bosch | Sector Leader | AFTUW | Urban & Water |
| Mirlan Aldayarov | Energy Specialist | ECSS2 | Energy Specialist |
| Cordula Rastogi | Senior Transport Economist | ECSS5 | Transport Economist |
| Danielle Malek Roosa | Senior Counsel | LEGEM | Legal Vice Presidency |
| Katelijn Van den Berg | Senior Environmental Economist | ECSS3 | Environmental Economist |
| Irina Galimova | Country Program Assistant | ECCKZ | Operational support |
| Yuling Zhou | Lead Procurement Specialist | EAPPR | Procurement Specialist |
| John Otiono Ogallo | Senior Specialist | ECSO3 | Financial Management Specialist |
| Aksulu Kushanova | Team Assistant | ECCKZ | Operational support |
| Gulmira Akshatyrova | Program Assistant | ECCKZ | Operational support |
| Tatiana Sedova | Consultant | SEGOM | Transport, Gas and Mining |
| Alexandra Pugachevsky | Senior Energy Specialist, Mining | SEGOM | Energy Specialist, Mining |
| Victor Zafra | Consultant | ECSPE | Budget Policy |
| David Shand | Consultant | EAPFM | Financial Management |
| Oxana Shmidt | Team assistant | ECCKA | Operational Support |
| Luis Alvaro Sanchez | Consultant | LCSPR | Poverty Reduction, Economic Management |
| Irina Rubashina | Consultant | ECSPE | Budget Policy |

**(b) Staff Time and Cost**

| Stage | Staff Time and Cost (Bank Budget Only) | |
|---|---|---|
| | No. of staff weeks | USD Thousands (including travel and consultant costs) |
| **Lending** | 91.2 | 456,205.90 |
| **Total:** | | |
| **Supervision/ICR** | 5.6 | 28,000.00 |
| **Total:** | 96.8 | 484,205.90 |

## Annex 2. Stakeholder Workshop Report and Results

### Astana, September 11, 2010

**Rationale**: The Government of Kazakhstan is concerned about the fiscal risks associated with the debt of state-owned enterprises (SOEs) and seeks to strengthen its systems for monitoring SOE debt in order to manage and mitigate these risks effectively.

**Content:** The workshop presented international experience in monitoring and managing SOE debt and discussed its relevance and application for Kazakhstan and international principles that guide good practice for SOE fiscal oversight, using approaches used in Korea, Turkey, New Zealand, Malaysia, and France. It also featured a presentation by Marat Kussainov, vice-minister of economic development, on a proposed new approach to SOE fiscal oversight and debt management by the Kazakh authorities.

The discussion centered on two questions raised in the government's presentation: (a) appropriate institutional arrangements for effective management of the fiscal risks associated with SOE debt in Kazakhstan, and (b) principles of SOE debt regulation in Kazakhstan. International speakers offered their comments from the perspective of good international practices.

### Major Points and Preliminary Recommendations

***Importance of General Principles for Monitoring SOE Debt***

- Monitoring SOE debt should be integrated into fiscal policy analysis and budgeting. SOE debt is a source of fiscal risks because it can lead to implicit contingent liabilities for the State, even though SOEs are an important revenue stream for the state in terms of dividends and taxes.
- Since there is an international consensus that SOEs should be operationally and financially autonomous, governments must find and maintain a balance between exercising reasonable oversight of SOE finances and respecting the operational and financial autonomy of SOEs in their business decisions.
- International experience with SOE fiscal oversight shows that countries tend to use three primary tools to manage the risks associated with SOE debt:

  (i) *A robust reporting and disclosure system* that allows the government and stakeholders to monitor SOE economic performance and financial health effectively in real time. This means SOEs must observe high standards of financial reporting, publish financial statements regularly, and hire skilled and reputable external auditors. Transparency is essential if governments are to effectively manage fiscal risk. This requires that government and the public have access to timely and complete information about SOE operations and finances.

  (ii) *Sound internal governance* that relies on an active and competent board of directors with the government acting as a responsible shareholder. Many countries have established specialized ownership entities to monitor SOEs and act as focal points for SOE directors within the government.

  (iii) *Marked-based mechanisms to impose financial discipline* on SOEs, such as regular reviews by credit rating agencies and the listing of SOE debt or shares. These provide external, independent indicators of the SOE's performance and financial condition.

- Some countries also have in place mechanisms to limit SOE borrowing or control it more directly; however, limits and direct controls tend to be used only when the risk is considered very high (for instance, when the state has given explicit guarantees, when borrowing is predominantly in foreign currency, or it involves unusually high amounts).
- The previous principles form the basis for a system in which the state acts as a responsible shareholder, respecting an SOE's operational autonomy while ensuring that its management and board of directors are accountable to the government and other stakeholders.

***State Control over SOE Debt***

- In general, direct state control of SOE debt in the form of borrowing ceilings should be reserved only for those SOEs that expose the government to excessive fiscal risk, and ceilings should then be tailored to the specific circumstances (e.g., the industry) in which the SOEs operate.
- Explicit no-bailout clauses (a guarantee waiver) is a good practice to mitigate the risk of moral hazard even if they do not necessarily eliminate the perception that there is an implicit guarantee.

***Institutional Arrangements and Reporting Mechanisms***

- Clearly defined institutional arrangements, backed by law, for monitoring SOE debt are critical.
- Legislation and government regulations need to define the primary data sources and specific indicators to be used in monitoring contingent liabilities originating in SOEs.
- Coordination mechanisms and information flow need to be streamlined and transparent (and preferably specified in the law), to ensure efficiency and protect data confidentiality. Duplicative lines of reporting should be avoided to reduce the administrative burden on both SOEs and government agencies.
- Laws and regulations should stipulate which agency is responsible for collecting SOE debt data from primary sources, consolidating the data, and maintaining the debt database (this should be the National Bank for foreign debt), and for analyzing the debt data (the Ministry of Economic Development and Trade [MEDT] or, preferably, the Ministry of Finance [MOF]) Alternatively, a reinforced MOF unit might combine the functions of data collection, consolidation, and analysis. The institutional set-up must be discussed by the agencies involved and a consensus reached before the final decision assigning responsibility for data collection.
- Effective fiscal oversight depends on designing appropriate financial monitoring tools and conceiving financial monitoring as a proactive process rather than just gathering numbers for statistical purposes.

***SOE Governance***

- SOEs should have freedom to make business decisions. Government should avoid requiring approval for SOE commercial decisions except through government representation on SOE boards. It is widely accepted that requiring that SOE boards have adequate authority and are thoroughly professional and making them responsible for financial performance diverts central governmental interventions in SOE day-to-day operations.

- SOEs should operate on a for-profit basis and make commercial returns. Loss-making SOEs and those with excessive borrowing or unproductive investments should be restructured to minimize government obligations and avoid bailouts.
- SOEs should operate in competitive markets on a competitively neutral basis and should be regulated just as private firms are; there should be no preferred procurement or preferential market access.
- Any non-commercial activities the government asks SOEs to undertake should have a clear public-policy purpose, and SOEs should be fully compensated for the costs.

**Conclusion and Next Steps:**

In his concluding remarks, Prime Minister Massimov expressed his satisfaction with the workshop and indicated that the government would use the discussions as a basis for finalizing its proposed approach to the fiscal oversight of SOEs, with inputs from the MOF, the MEDT, the National Statistics Office, and the National Bank.

**Annex 3. Summary of Borrower's ICR and/or Comments on Draft ICR**

ҚАЗАҚСТАН РЕСПУБЛИКАСЫ ҚАРЖЫ МИНИСТРЛІГІ

МИНИСТЕРСТВО ФИНАНСОВ РЕСПУБЛИКИ КАЗАХСТАН

010000, Астана қаласы, Жеңіс даңғылы, 11, тел.(7172)71-77-64, 71-77-65, факс: 71-77-85 e-mail: administrator@minfin/kz

010000, город Астана, проспект Победы, 11, тел.: (7172) 71-77-65, 71-77-64, 71-77-65, факс: 71-77-85 e-mail: administrator@minfin/kz

№

**World Bank**
Country Office in Kazakhstan
12 Samal
010000 Astana

*Re: Loan* 7911-KZ *"Development Program Loan"*

Ministry of Finance of RK (hereinafter referred to as the Ministry), having reviewed the draft Implementation Completion and Results Report on Development Program Loan that was submitted with your Letter # 12/002 dated January 4, 2012, notifies of the following.

According to Article 85 of the Budget Code of RK (hereinafter referred to as BC RK), administrators of budgetary programs can independently make adjustments in plans of financing for liabilities and payments, which are related to specifics of the economic classification of expenditures and subprograms of budgetary programs and do not modify annual and monthly volumes of expenditures of a budgetary program, i.e. redistribution of funds between specifics and subprograms is done within one budgetary program.

Therefore, the Ministry suggests the following:

- use the following version of Sub-paragraph (b) Paragraph 25: "delegation of powers to administrators of budgetary programs at the national and local levels for redistribution of funds between specifics and subprograms within one budgetary program in the process of budget execution";

- in Line 5 Column 1 Table 1. "DPL Prior Actions and their Status" (hereinafter referred to as the Table) use the following version: "Implementation of the revised Budget Code for delegation of powers to administrators of budgetary programs at the republican (national) and local levels for redistribution of funds between specifics and subprograms within one budgetary program in the process of budget execution";

- in Line 5 Column 2 of the Table use the following version: "Powers for redistribution of resources between specifics and subprograms within one budgetary program in the process of budget execution have been provided; measures are taken for further strengthening of finances of oblast and local executive bodies".

Also, in Line 5 Column 1 of the Table replace words “budget allocations” with words “budget expenditures”, because there is no notion “budget allocations” in BC RK.

Article 136 BC RK provides for creation of internal control services (hereinafter referred to as ICS) by central government bodies and executive bodies funded from budgets of oblasts, national cities and the capital to perform internal state financial control at national and local levels. Planning of ICS transformation into internal audit services occurs this year.

Therefore, we suggest the following:

- in Paragraph 25 replace words “internal audit” with words “internal control”;

- use the following version of Sub-paragraph (c) Paragraph 25: *“adopt regulations for creation of internal control services in budgetary organizations to perform internal state financial control”.*

- in Line 6 Column 1 Table 1. “DPL Prior Actions and their Status” use the following version: “Implementation of the revised Budget Code for creation of internal control services by central government bodies and executive bodies funded from budgets of oblasts, national cities and the capital to perform regular internal control related to areas of the government body’s activities in order to improve quality and productivity of its operations”;

- in Line 6 Column 2 Table 1. “DPL Prior Actions and their Status” use the following version: “Internal control services were created, but further analysis identified weaknesses in subordinate legislation; measures are taken to review the regulatory framework”;

In Paragraph 49:

- replace words “internal audit” with words “internal control”;

In Paragraph 52:

- replace words “internal audit” with words “internal control” throughout the paragraph;

- instead of “internal control units” use the following version: “internal control services”;

We also suggest considering the following in this paragraph: “To transform internal control services into internal audit services, it’s planned to make corresponding changes in the Budget Code and then in subordinate legislation in 2012”.

- In Paragraph 61 instead of “internal control units” use the following version: “internal control services”.

Since in accordance with BC RK, results-oriented strategic planning and budgeting, as well as the norm of Article 85, were implemented in RK in 2009 at the national level and in 2010 at the local level, we suggest the following:

In Paragraph 51 replace words: “The 2008 Decree decentralized budgetary implementation and introduced elements of strategic results-oriented budgeting at all levels of government. Local (oblast) level administrations have began to adopt reforms that mirror those taken at the central level, including three-year budgeting and the adoption of strategic results-oriented plans. The 2008 Decree also delegated to administrators of budgetary programs the flexibility to adjust to uncertainty by reallocating resources between subprograms during the period of budgetary implementation, a major source of inefficiency in the past” with words: “In 2008, the Budget Code of RK, which included elements of results-oriented strategic planning and budgeting, was adopted. In 2010, results-oriented budgeting was implemented at the local level, including three-year budgeting and the adoption of strategic results-oriented plans. The Budget Code of 2008 delegated to administrators of budgetary programs the flexibility to adjust to uncertainty by reallocating resources between specifics and subprograms within one budgetary

program during the period of budgetary implementation, a major source of inefficiency in the past".

In Paragraph 60 instead of words "The authorities continue perfecting the institutions of public expenditure with a view to improving the alignment between strategic objectives and budgetary allocations and put in place the institutions needed to track and evaluate impact", we suggest using the following version: "The authorities continue perfecting results-oriented budgeting with a view to ensure the link between budgetary programs and strategic directions and goals of government bodies".

Sincerely,

**Vice-Minister** **R. Dalenov**

## Annex 4. List of Supporting Documents


IMF (June 2011). Republic of Kazakhstan: 2011 Article IV Consultation—Staff Report; Supplement; and Public Information Notice.

IMF /World Bank (June 2009). Republic of Kazakhstan Financial Sector Assessment: Enhancing Distressed Asset Management in Kazakhstan.

World Bank (June 2011). Public Finance Management Review in the Republic of Kazakhstan: Review of the System of Interbudgetary Relations and Management of Local Budget Expenditures for Education and Social Protection.

World Bank (June 2011). Public Finance Management Review in the Republic of Kazakhstan: Review of Administrative Sector Expenditures and Creation of a System Promoting Outcome-Based Activities.

World Bank (June 2011). Kazakhstan Economic Report.

World Bank (June 2011). Kazakhstan: Issues in SOE's Debt and Management.

World Bank (June 2010). Improvement of the System of Accumulation, Use and Management of the National Fund of the Republic of Kazakhstan.

World Bank (April 2010). Comparative Review of Global Experiences in the Management of Natural Resource–Related Sovereign Wealth Funds.


KAZAKHSTAN
SELECTED CITIES AND TOWNS
OBLAST CAPITALS
GALASY (CITIES WITH REGIONAL STATUS)
NATIONAL CAPITAL
RIVERS
MAIN ROADS
RAILROADS
OBLAST BOUNDARIES
INTERNATIONAL BOUNDARIES
RUSSIAN FEDERATION
CHINA
KYRGYZ REP.
TAJIKISTAN
UZBEKISTAN
TURKMENISTAN
AFGHANISTAN
AZERBAIJAN
Caspian Sea
Aral Sea
2001 LEVEL OF ARAL SEA
1990 LEVEL OF ARAL SEA
1960 LEVEL OF ARAL SEA
NORTH KAZAKHSTAN
AKMOLA
PAVLODAR
KOSTANAI
WEST KAZAKHSTAN
ATYRAU
AKTOBE
MANGYSTAU
Ustyurt Plateau
Torghay Plateau
Kazakh Uplands
KARAGHANDY
EAST KAZAKHSTAN
KYZYLORDA
ZHAMBYL
ALMATY
SOUTH KAZAKHSTAN
Petropavlovsk
Kostanai
Kokshetau
Pavlodar
Ekibastuz
ASTANA
Ural'sk
Chapaevo
Aktobe
Arkalyk
Turgay
Karagandy
Semipalatinsk
Öskemen (Ust-Kamenogorsk)
Ayakos
Embi
Shalkar
Atyrau
Zhezkazgan
Balkhash
Aral
Saryshaghan
Lake Balkash
Lake Alakol
Lake Zaisan
Beineu
Baikonur
Kyzyl-Orda
Taldykorgan
Aktau
Turkistan
Shu
Almaty
Taraz
Shymkent
Pik Khan-Tengri (6995 m)
To Chelyabinsk
To Kurgan
To Tyumen'
To Novosibirsk
To Barnaul
To Saratov
To Samara
To Orenburg
To Ufa
To Astrakhan'
To Nukus
To Urumqi
To Korla
To Naryn
To Bukhoro
To Dushanbe
Volga
Ural
Tobol
Ertis (Irtysh)
Ob'
Esil (Ishim)
Zhaiyk (Ural)
Yrghyz
Torghai
Zhem
Sarysu
Syrdariya
Shu (Chu)
Talas
Ile
Karatal
Lepsi
0 100 200 300 Kilometers
0 100 200 Miles
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JANUARY 2007
IBRD 33425R1