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CONFIDENTIAL

December 20, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Republic of Kazakhstan - Request for Stand-By Arrangement
and Purchase Under the Systemic Transformation Facility -
Letter of Intent

Attached for consideration by the Executive Directors is a letter of intent from the First Deputy Prime Minister of the Republic of Kazakhstan and the Chairman of the National Bank of Kazakhstan requesting a stand-by arrangement in an amount equivalent to SDR 123.75 million and for a request expected to be received from the Republic of Kazakhstan for a second purchase under the systemic transformation facility in an amount equivalent to SDR 61.875 million, together with key macroeconomic tables underlying the program for 1994. The staff paper describing and analyzing the economic program will be issued in the first half of January.

This subject is tentatively scheduled for discussion on Monday, January 24, 1994.

Mr. Kapur (ext. 38732) or Mr. Geadah (ext. 38830) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

Almaty, December 17, 1993

Dear Mr. Camdessus:

1. On July 23, 1993, the Fund approved Kazakhstan's program of economic reforms covering the period July 1993-June 1994 and supported this effort with the first purchase under the Systemic Transformation Facility. Accompanying the move to monetary independence with the introduction of a national currency on November 15, 1993, the Government of Kazakhstan has reinforced its program of economic and structural reforms described in this letter to cover the remaining months of 1993 and all of 1994. This program aims to create the necessary conditions for sustainable growth in the medium term by rapidly stabilizing the macroeconomic situation and accelerating the process of systemic change towards an open and efficient market-based economy. In support of these policies, the Government requests a 12-month stand-by arrangement in an amount equivalent to SDR 123.75 million, or 50 percent of Kazakhstan's quota in the Fund, and will shortly request the second purchase under the Systemic Transformation Facility (STF) in an amount of SDR 61.875 million, 25 percent of Kazakhstan's quota. The Government will also seek financial and technical support for its economic program--in particular, firm commitments of financing to close the projected external financing gap--from the World Bank, and other international agencies, as well as from bilateral donors and creditors through a Consultative Group meeting scheduled for early January 1994.

2. The objectives and policies of the Government's reform package build upon and reinforce the program already approved by the Fund and supported by the first purchase under the STF in July 1993. The key macroeconomic objectives of the 1994 program are to: (a) limit the decline in real output to around 3 percent, (b) sharply reduce monthly inflation rates to single digit levels by the second quarter of the year and further to a 1 percent monthly rate by the end of the year, (c) move toward a sustainable balance of payments position with a level of imports consistent with the need to modernize and transform the economy, (d) strengthen the official external reserve position, and (e) attain a strong national currency with external current account convertibility. On the structural side, the main policy actions envisaged will seek to strengthen those being implemented under the program already approved by the Fund and the World Bank, notably in the areas of privatization of state assets, price liberalization, enterprise and financial sector reforms, and institution building.

Introduction of the national currency

3. As a result of recent economic and financial developments, the Government rapidly introduced a new national currency, the Tenge, in Kazakhstan. The conversion operation, conducted during the period November 15-20, was successfully completed and as of November 18 the Tenge became the sole legal tender. All ruble deposits and claims were converted

at 500 ruble per Tenge. There was no limit on the conversion of noncash deposits, with cash conversion subject to a limit of Rub 100,000 per person; cash deposited after October 1 and deposits in excess of certain limits will be converted upon proof that the source of funds was legal.

4. The new currency is based on a unified, floating exchange rate with current account convertibility based on the measures described below. The exchange rate results from weekly interbank fixing sessions that include around 21 commercial banks and the National Bank. At the initial foreign currency auctions in November, the exchange rate was Tenge 4.68-4.70 per U.S. dollar. It is the policy of the Government and of the National Bank that intervention on the foreign exchange market by the Central Bank will be limited to smoothing out sharp fluctuations in the exchange rate, and there will be no effort to defend a particular level of the exchange rate. In order to deepen the foreign exchange market, limits have been imposed on the open foreign currency position of commercial banks, the establishment of foreign exchange bureaus is being widely authorized, the payment of export taxes in foreign currency has been abolished effective January 1, and measures are being taken to enforce the repatriation of export proceeds. In the week following the conversion, a new auction dealing with the currencies of the FSU states was temporarily set up to encourage transactions in such currencies and provide a vehicle for the settlement of payments; as of November 26, this has been merged with the convertible currency interbank market. To further improve the external payments system, several commercial banks are authorized to open correspondent accounts with banks in other FSU states and in foreign countries.

Price liberalization

5. Following a comprehensive price liberalization, prices of a very limited number of goods and services remained administered and controlled during 1993. 1/ Simultaneously with the introduction of the new currency, these administered prices for energy products, utilities, transport and communications tariffs, were raised by 1.5 times to 4 times their previous wholesale and retail level; in particular, the domestic retail prices for petroleum products now exceed the levels prevailing in the United States. The prices for cereals were increased by a factor of 3 times to over 4 times. In conjunction with the introduction of the Tenge, temporary controls were introduced in mid-November 1993 on a few essential consumer goods (milk products, sugar, salt, meat, soap) to prevent speculation; these price controls will be lifted in December and the price controls on bread will be lifted by March 1. For the remaining controlled commodities and services, the Government will continue to maintain their prices in real terms. The temporary regulation of profit margins for all enterprises regardless of their market position, also introduced in mid-November, will

1/ Bread, flour (partially), baby food, imported medicine, fodder, energy products, housing rents and utility tariffs (both targeted according to income levels), and public transportation fares.

be abolished in December 1993, except for a very limited number of specialized monopolies (such as metallurgy) where these controls will be lifted as soon as antimonopoly measures begin to reduce the present excessively high level of profits. As the Government has already pledged, it will not take any measures which would hinder the move of prices of energy products to world levels. In particular, it intends to raise domestic oil prices to 66 percent of the world price by end-March 1994, 75 percent by end-June, and 100 percent by the end of the third quarter. As an interim step, the domestic price for crude oil was raised to Tenge 100 per ton, equivalent to 18 percent of the world market level on November 15, 1993, and will be raised further to around Tenge 180 per ton as of January 1, 1994. It is expected that the impact of these actions and related adjustments to other prices will result in a relatively high rate of increase in the overall price level during the first quarter of 1994.

Budgetary policy and the social safety net

6. The target for the budget deficit for 1993 had been set at the equivalent of 6 percent of GDP under the program supported by the first STF purchase. Despite some shortfalls in revenues, the firm control exercised by the Government over expenditures resulted in a small overall surplus during the first ten months of the year; however, in part as a consequence of the wage increase awarded in October and sizable purchases of grain, the budgetary position will be under pressure before the end of the year and an overall deficit equivalent to 3 percent of GDP is now expected for 1993, well within the program targets, with domestic bank financing equivalent to around 2.6 percent of GDP. This performance has been made possible by severe cuts in various categories of expenditures, notably capital outlays, purchases of goods and services, and subsidies and transfers.

7. In 1994, to meet the inflation targets, the Government intends to limit the overall budget deficit to Tenge 7.8 billion, or 4 percent of GDP, enabling limited domestic bank borrowing of around Tenge 2.9 billion, or 1.5 percent of GDP, with the remainder being financed through the sales of Treasury Bills of Tenge 1.2 billion and net foreign financing of Tenge 3.6 billion. To achieve this objective, revenue-enhancing measures and a tight expenditure program have been introduced with the 1994 budget which will be adopted by Parliament in December. In view of the present difficult financial situation of enterprises, notably a very high level of interenterprise arrears, total revenue is projected to decline modestly to 21 percent of GDP, while expenditures would remain stable at around 25 percent of GDP in 1994. Taking account of seasonality, budgetary operations are expected to be in balance during the first half of 1994 with a deficit in the second half.

8. On the revenue side, the coverage of the VAT will be expanded to all imports from non-CIS countries, with deductions of the VAT paid on purchases of capital goods, and the rate structure will be simplified to 10 percent and to 20 percent. In trade negotiations with CIS countries, the Government will adopt the reciprocity principle and only apply the VAT on imports from

CIS countries that apply the VAT on imports from Kazakhstan. Regarding excises, tax rates on alcoholic beverages and tobacco products will be increased and the tax base extended to include gasoline, fuel and other oil products, natural gas, cars, soft drinks, luxury items, and household appliances; an airport tax of Tenge 60 for travel outside Kazakhstan, other than to CIS states, will be introduced. Export taxes, which are payable in domestic currency as of January 1, 1994, will be revised by January 1 to drastically reduce the number of products subject to such taxation, increase the tax rates on petroleum products and minerals, and abolish the requirement to prepay such taxes; comprehensive taxation of selected natural resources will be put in place with technical assistance from the World Bank by January 1995. A minimum customs duty rate of 15 percent will be introduced, effective January 1, 1994, on all imports from non-CIS countries, excluding a limited number of critical necessities (medicines and baby food); all barter trade transactions will be subject to the same import duties and taxes. Corporate income tax rates will be unified at 30 percent, except for the banking sector. The personal income tax schedule will be simplified to three rates (15, 20 and 30 percent) to eliminate unnecessary complications in tax administration and increase tax revenue. In addition, severance payments and bonuses paid by enterprises, and the receipts from sale of personal capital assets, above a certain level, will be made taxable.

9. A major effort is being made, in the context of the 1994 budget, to reduce or eliminate exemptions to all taxes (or special treatment for certain enterprises or sectors on an ad hoc basis). The Government will continue strengthening the Central State Tax Inspectorate (CSTI) and customs administration along the lines recommended by Fund technical assistance. The Tax Inspectorate will strengthen enforcement by the first quarter of 1994; specific plans include the reinforcement of laws and regulations that grant CSTI the legal authority to improve taxpayer compliance. The Customs Committee will broaden its responsibilities and will introduce legislation to consolidate and update customs and excise laws; specific programs for 1994 include the preparation and development of a computerized customs clearance system.

10. With regard to expenditures, the Government is sharply cutting generalized subsidies, both implicit and explicit, and replacing them with a well-targeted social safety net, as suggested by recent Fund technical assistance. Total budgetary subsidies are expected to decline from the equivalent of 4.4 percent of GDP in 1993 to 3.1 percent in 1994. The Government will not extend loans at preferential interest rates, and will eliminate compensation for inflation on Savings Bank deposits effective January 1 following the settlement of the frozen deposits and the payment of a one-time bonus. With the liberalization of prices, state subsidies for bread, fodder, and flour will be cut by half, and housing, community, and heating subsidies cut by one-third. To mitigate the effect of these policies on vulnerable groups, cash compensations targeted to low-income pensioners, families with numerous children, and recipients of unemployment benefits will increase by Tenge 470 million or 0.24 percent of GDP. The

Government will continue to improve targeting of welfare payments through identification of the needy. A plan along the lines recommended by Fund technical assistance will be prepared by March 1, 1994, to standardize Pension Fund eligibility criteria and restructure current benefits for working recipients and pensioners. In addition, a major effort is underway to reduce the number of employees in the civil service.

11. The Government will continue to maintain the cash management principle and extend this system to local governments. The Treasury will be developed into a fully operational department responsible for preparing annual and monthly forecast of revenue and expenditures of the state budget and extrabudgetary funds by June 1994. By late-1994, the functions of the Treasury will be broadened to include expenditure control in addition to improving the cash and debt management functions of the Government. The Government will ensure that the Pension Fund, Employment Fund, and the Social Insurance Fund have a modest level of reserves in 1994. As a general policy, the automatic indexation of benefits will be replaced with periodic reviews of the adequacy of minimum benefits. The Government will undertake a comprehensive review of the Pension system and the Employment Fund drawing on technical assistance from the Fund and the World Bank. Based on the recommendations of this assistance, the Government will formulate a program of reforms, for phased implementation beginning in July 1994, that would convert the pension and employment funds into a guaranteed minimum benefit scheme to be complemented by a modest earnings-related benefit.

Monetary and credit policy

12. With the introduction of the Tenge, the Government of Kazakhstan and the National Bank have adopted tight monetary and credit policies for the period ahead to reduce inflation in line with the targets under the program and the broad objective of attaining a strong currency. As indicated in the attached table, the quarterly expansion in broad money will be kept in line with the targeted path of inflation. To achieve this, limits have been established on the stock of net domestic assets of the National Bank of Kazakhstan (NBK), so as not to exceed Tenge 2,915 million by March 31, 1994; Tenge 3,320 million by June 30, 1994; Tenge 3,435 million by September 30, 1994; and Tenge 3,484 million by December 31, 1994. ^{1/} The net credit position of the Government with the banking system will be no less than Tenge 787 million at March 31, 1994, Tenge 1,620 million at June 30, 1994; and Tenge 1,693 million at September 30, 1994; there will be a net debit position not exceeding Tenge 3,653 million at December 31, 1994.

^{1/} Net domestic assets of the National Bank of Kazakhstan are defined as the difference between base money (including currency, required and excess reserves) minus net foreign assets. Thus defined, NBK's NDA would comprise: credit to all levels of government minus deposits of the government, credit to domestic banks, credit to domestic enterprises, and all other net assets. End-of-quarter performance criteria for domestic credit and the NBK's net foreign assets will be based on data for the following day.

The limits for end-March and end-June are performance criteria under the stand-by arrangement. These limits will be adjusted for differences between actual external financing and program assumptions, as explained in Appendix I. As of early December 1993, the NBK has also tightened its credit policies to achieve the targeted credit expansion by the banking system; these measures included a substantial increase in the refinance rate to market levels and an upward adjustment in the statutory reserve requirement to 30 percent which will be kept under close review in collaboration with the Fund staff. Indicative quantitative targets on credit have been established for end-September and end-December 1994, which will be converted to performance criteria at the time of the first program review.

13. In line with the move to reduce directed credits and encourage the role of interest rates, the NBK will increase the proportion of credit auctioned to banks from 35 percent of total credit to banks in the first quarter of 1994 (agreed to under the STF program) to 50 percent in the second quarter, and 75 percent in the fourth quarter of 1994. The NBK's refinance mechanism will be used for meeting short-term liquidity needs, and not as a primary source of credit to banks. The maximum maturity of new refinance credits will be reduced from one year to nine months by March 31, 1994, and further to six months by December 31, 1994; the practice of automatic rollover of refinance credits will be eliminated, by June 1, 1994. In the interim, the NBK will set a timetable to reduce dependence on refinance credits on a bank-by-bank basis. The interest rate applicable to rolled-over credits will be the official NBK refinance rate prevailing at the time of the roll-over.

14. Effective December 3, the refinance rate of the NBK has been aligned with the market rates resulting from the weekly credit auctions; on December 2, at the first credit auction since the introduction of the Tenge, interest rates were in the range of 247-254 percent on an annual simple basis. The NBK does not provide credit at interest rates below its official refinance rate. The credit auctions will be held weekly starting on January 1, 1994. The Savings Bank will raise deposit interest rates closer to market levels following the settlement, through budgetary transfers in January 1994, of the assets which have been frozen by the former Soviet Union Savings Bank; in the initial step these rates will be raised from the present 20-100 percent to 60-200 percent and will be adjusted further during the course of the year depending upon the financial position of the Savings Bank and developments in inflation. The interest rate charged on new lending to the Government--as well as the rate paid on Government deposits--will be raised to market levels as of January 1, 1994 to serve as a basis for the creation of a government securities market; this will be accompanied by the establishment, in December 1993, of a transparent mechanism to transfer, quarterly, a proportion of NBK profits to the budget on the basis of the agreement between the Government and the NBK. The Government intends to rapidly develop arrangements for the sale of treasury bills, with the National Bank acting as its agent, by the first quarter of 1994, with technical assistance from the Fund. Initially, treasury bills of 30-days

and 60-days maturities will be auctioned at monthly intervals starting in March 1994.

15. The banking supervision operations of the National Bank will be urgently strengthened. Audits of the NBK and ten largest banks will be initiated before March 31, 1994 and completed no later than September 30, 1994. On this basis, an initial assessment of nonperforming assets of these banks will be made and measures to deal with these assets will be decided upon no later than December 31, 1994. The Government is formulating a strategy to resolve interenterprise arrears and the nonperforming assets of the commercial banks such as not to undermine the objectives of the stabilization program; among actions under consideration are the establishment of a clearing house for the cross-compensation of arrears, the possible transformation of debts into securities, and the strict enforcement of bankruptcy procedures. The National Bank and the Government intend to move rapidly with a comprehensive reform of the financial sector, for which technical and financial assistance is urgently being sought from the World Bank and other international agencies. The auditing of banks and formulation of policies which address the problems of nonperforming assets are structural benchmarks under the stand-by arrangement. Regulations will be put into effect in early January 1994 to strictly limit the proportion of credit that commercial banks can grant to their employees or shareholders, or to any other single borrower. To make improvements to the payments system, the NBK will impose an effective penalty rate on banks for delays in crediting customer accounts. In order to generate confidence in the new currency, controls or limits on the use of cash have been removed and will not be re-established.

External sector policies

16. Following the introduction of the Tenge, with effect from January 1, 1994, the Government has introduced regulations requiring immediate and full repatriation of all export proceeds, abolished the payment of export taxes in foreign currency, and imposed a uniform surrender requirement equivalent to 50 percent of these receipts; export proceeds will be surrendered through sales on the foreign currency auction market at the prevailing exchange rate. As the foreign exchange availability improves, the Government intends to reduce the surrender requirement with a view to its eventual abolition. In order to ensure that all foreign exchange receipts are appropriately surrendered and accounted for, the Government will select by March 1, 1994 internationally recognized firms or agencies to audit the foreign exchange transactions of the key foreign exchange earners. It is expected that the investigation will be completed by September 30, 1994.

17. Several measures are being taken to broaden the interbank foreign exchange market. In addition to the decision already taken to limit the open foreign exchange position of commercial banks, amended foreign exchange regulations consistent with the principles of convertibility for current international transactions for residents have been introduced in early

December 1993 with importers having free access to foreign exchange for all bona fide current international transactions. During the arrangement period, the Government will not impose or intensify restrictions on payments and transfers for current international transactions, introduce or modify any multiple currency practices, conclude any bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or impose or intensify any import restrictions for balance of payments purposes.

18. The Government is making a major effort to encourage exports with a view to arresting the decline in output and improving the balance of payments position. Export quotas, which have been applied to a significantly shorter list of around 34 types of goods since November 1993, will be further liberalized; the coverage of export quotas will be reduced to 25 types of goods by January 1 and further to 12 types of goods by June 30, 1994. Trade in all goods, whether or not covered by export quotas, is conducted at market prices. Moreover, the amounts available for export outside the quotas will be increased on average by 25 percent as of March 1. All quotas applying to goods that are not produced by state monopolies will be auctioned as soon as feasible but not later than end-June 1994. Export licenses, which presently cover 61 types of goods, will be limited to no more than 50 types of goods by January 1, 1994 and 30 types of goods by June 30, 1994. By the end of 1994, licensing of exports will be carried out solely with the aim of complying with foreign exchange regulations, avoiding the dumping of exports, ensuring the timely payment of taxes (including export taxes), meeting health protection standards, for purposes of national and international security, and for reasons of cultural and artistic heritage. In order to allow domestic producers to take full advantage of world market prices and to ensure the repatriation of export receipts, agencies (which are producer-owned cooperative structures) act as intermediaries for trade in key products, such as petroleum, rare metals, gold and silver, ferrous and nonferrous metals, chemicals, grain, and caviar; the remaining limited regulatory role of these agencies is seen as temporary, pending the development of competitive market structures in the area of external trade in key products. The Government replaced the state order system (Goszakaz)--governing the distribution of enterprise output between domestic and interstate or foreign sales--with a system which will have completely voluntary forms of transactions--at market prices--with the state. The Government will take steps to avoid new barriers to all foreign and interstate trade, and supports the creation of a mechanism for resolving trade conflicts; it stands ready to coordinate the liberalization of trade prices with other states; and it intends to join with other states to make improvements in the mechanisms for payments clearing and settlement in interstate trade. In 1994, the Government is committed to reviewing the coverage of import licenses with a view to eliminating as many of them as feasible.

19. The new law on foreign direct investment clarifying the treatment of foreign capital and profits was submitted to Parliament in December 1993. All foreign investment transactions will take place at the unified exchange

rate, and there will be no special coefficient or rate for the revaluation of assets being sold to foreign investors or restrictions on the repatriation of dividends or profits. Enterprises with foreign participation will be subject to the same tax treatment as national enterprises, and registration procedures will be simple, uniform and transparent. Steps will be taken to conclude double taxation agreements with foreign countries, initially focusing on those whose residents are likely to be among the major investors in the republic. The National Agency for Foreign Investments will become, by January 1, 1994 a "one-stop" information center on investment regulations and investment opportunities. Laws which establish the protection of intellectual property and meet international standards will be adopted by June 30, 1994, by which time Kazakhstan will also have joined ICSID and entered into international agreements for the enforcement of investment disputes.

20. On the basis of revised estimates, prepared in collaboration with the Fund staff, Kazakhstan's balance of payments situation is expected to remain difficult in 1994. Total exports are anticipated to increase during 1994, but this will be offset by higher imports--reflecting new oil and gas sector projects, the expected recovery of interstate trade following the serious difficulties this year, and the requirements for essential medical supplies. Overall, the consolidated current account, both interstate as well as foreign transactions, is expected to show a deficit of around US\$940 million in 1994, compared to an estimated US\$540 million in 1993; in particular, there will continue to be a substantial trade deficit with the other republics of the former U.S.S.R. The financing of this deficit, despite sizable inflows of direct investment, will require additional external financial assistance in the short term, beyond the amounts already committed. On the basis of current projections, the financing gap for 1994 is estimated to be around US\$450 million, after including disbursements of credits from the World Bank (US\$240 million), bilateral trade credits (US\$270 million), Fund credit (US\$247 million), and a build-up in official foreign currency reserves. As already noted, the Government has requested a meeting of the Consultative Group in early January 1994 in order to seek commitments of financial support to close this gap.

21. In line with the overall balance of payments situation, and the need to strengthen the external asset position, the National Bank has established the following quarterly targets for the accumulation of official net international reserves (foreign currency and gold holdings): compared to the position as of end-December 1993, such reserves will increase by no less than US\$80 million by March 31, 1994, US\$160 million by June 30, 1994, US\$240 million by September 30, 1994, and US\$320 million by December 31, 1994. The National Bank's net holdings of convertible currencies, compared to their level of end-December 1993, will increase by no less than US\$40 million by March 31, 1994, US\$80 million by June 30, 1994, US\$120 million by September 30, 1994, and US\$160 million by December 31, 1994. For both categories, the minimum amounts for March and June 1994 are performance criteria under the stand-by arrangement while the amounts for September and December are indicative targets that will be

converted into performance criteria during the first review of the program (Appendix I). These limits will be adjusted for deviations in external financing from the program assumptions, as explained in Appendix I.

22. The Government of Kazakhstan intends to undertake a prudent external debt management policy and meet its debt service commitments on a timely basis. The level of total external debt outstanding undertaken by the Government or the National Bank (or guaranteed by them), as of end-October 1993, is estimated at US\$1,671 million. In view of the weak external position, we have established institutional mechanisms to monitor closely the contracting and guaranteeing of external debt by the Government and its agencies as well as state enterprises and to ensure that debt service payments are made on a timely basis; 1/ the sole authority to undertake foreign borrowing by the Government or accord guarantees has been assigned to the Minister of Finance effective January 1, 1994. The net interstate interenterprise arrears of Kazakhstan, as of October 1993, are estimated at Russian rubles 323 billion; there are no arrears to non-FSU countries. Cumulative quarterly ceilings have been established for end-March, end-June, end-September, and end-December 1994 on the amounts of nonconcessional loans contracted or guaranteed by the Republic, including the Government and the National Bank of Kazakhstan (as specified in Appendix I); limits have also been established on the amounts of external payments arrears. The limits for end-March and end-June are performance criteria under the stand-by arrangement; indicative targets for end-September and end-December 1994 will be converted to performance criteria at the time of the first program review.

Systemic Reforms

23. The Government is determined to keep on track its three-tier privatization program as described in the Statement on Systemic and Macroeconomic Policies of the STF program. First, all enterprises engaged in wholesale and retail trade, and related transport, storage and distribution, will be privatized by the end of 1994. Second, the distribution of investment coupons for the privatization of medium and large enterprises will be completed by the end of the first quarter of 1994 and 30 percent of the assets of nonagricultural medium and large enterprises will be privatized by the end of the second quarter. Third, by end-June 1994, 10 special enterprises, to be privatized on a case by case basis, will have been offered for sale; privatization will be done at the lowest organization unit practicable. The proceeds from sales from these state assets have been included in the Government's budget for 1994.

1/ All external credits including escrow or gold secured credits, credits contracted and/or guaranteed by the Government or the National Bank will be compulsorily registered at the Ministry of Finance, which will also compile complete debt service tables.

24. As agreed with the World Bank, the State needs system is considered to be transitory and will not be used as an instrument to direct domestic output nor control trade with other countries (except to cover the bilateral trading agreements within the FSU at market prices). Significant improvements were made in reducing the role of the state needs system in the allocation of resources in 1993. However, the Government recognizes that the system still affects the contractual freedom of enterprises and that it includes more goods and services than required for the operation of the public sector, in particular goods obtained for bilateral interstate agreements. As contained in the program with the World Bank, the Government will introduce a market-oriented state procurement system based upon the principles of contractual freedom and covering strict Government needs only--for example, hospitals, public administration, education, and defense--by the end of 1994.

25. A new anti-monopoly law will be submitted to Parliament during the Spring 1994 session and administrative guidelines for the implementation of the new law, including a revision of the role of the Anti-Monopoly Committee will be prepared by June 1994. The anti-monopoly committee's control of prices will be replaced by ex post notification of prices. The Government will pay particular attention to the break-up of monopolies in wholesale trade, and in related transport and distribution activities, as well as in external trade. Legislation will be submitted to Parliament at its first session in 1994 to strengthen enterprise management structures and to establish clear ownership rights. State enterprise access to government financial assistance will be conditional on the implementation of a restructuring plan, with all such assistance included in the budget.

Incomes policy

26. Parallel with the more precise targeting of the social safety net, the level of the minimum wage will be reviewed, in particular after the removal of the remaining price controls on basic consumer goods and services. Specifically, the present level of the monthly minimum wage (Tenge 30) will be increased in February 1994 to Tenge 40--in light of the sharp increases in administered prices during the coming months--and in July 1994 to Tenge 60, but any additional increases during the year will depend upon the success in reducing inflation; in any case, it is the policy of the Government to delink any increases in the minimum wage from inflation. In general, in early 1994 the Government will introduce a broad incomes policy that will seek to contain increases in the average nominal wage level in the economy; in particular, the Government is considering penalizing the granting of wage increases in excess of a specific proportion of the inflation rate of the previous three months, by making that part of the wage bill per worker nondeductible for the purposes of calculating corporate income taxes.

Monitoring program implementation

27. The Government has delegated to the Ministry of Economy the overall task of coordination and monitoring of progress in implementation of the

program. The Ministry of the Economy, will prepare a set of economic, financial, and structural indicators to report the status of program implementation to the Presidency and the Cabinet of Ministers on a monthly basis. The various measures to improve the use, coordination, and implementation of technical assistance that were described in the Statement of Systemic and Macroeconomic Policies for the STF program are being undertaken; in the same manner, the actions included in the policy statement regarding improvements in the collection, analysis, and use of statistics (including those related to the accounting system of the National Bank and the introduction of the UN System of National Accounts) will be implemented.

28. The Government will remain in close consultation with the Fund, in accordance with the Fund's policies on such consultations, and will provide the Fund with such information as it requests for monitoring progress in program implementation. There will be two reviews with the Fund on policies and developments under the program before end-May and end-November 1994. Special emphasis will be placed on the development of the necessary policy instruments required for the attainment of the program's objectives. In addition, completion of the first review will be contingent upon assessment of monetary and external developments, notably progress with regard to the foreign exchange system and exchange rate developments, and disbursements of external financing; the quantitative performance criteria and structural benchmarks for end-September and end-December 1994 will also be established. The second review will focus on the implementation of price liberalization and key systemic reforms, including progress made in the privatization program.

29. The economic program described in this letter has been formulated amidst great uncertainties. Nevertheless, the Government stands ready to strengthen its adjustment effort, should circumstances call for such action, in order to ensure the fulfillment of the program's objectives.

Sincerely,

/s/
D. K. Sembayev
First Deputy Prime Minister
Government of Kazakhstan

/s/
G. Bainazarov
Chairman
National Bank of Kazakhstan

Attachment

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Table 1. Kazakhstan: Main Economic Indicators

| | 1991 | 1992 | 1993 STF target | 1993 Est. | 1994 Program |
|--|---------|--------|--------------------|--------------|-----------------|
| (Percent change, unless otherwise specified) | | | | | |
| GDP, prices and wages | | | | | |
| Nominal GDP <u>1/</u> | 94 | 1,213 | 17,285 | 16,686 | 195 |
| Real GDP | -13.0 | -14.0 | -7.5 | -10.0 | -3.0 |
| Consumer prices | | | | | |
| Average | 91 | 1381 | 926 | 1506 | 463 |
| End-of-period | 147 | 2567 | 625 | 2005 | 109 |
| Wages <u>2/</u> (monthly, end-of-period) | | | | | |
| Average | 452 | 13,359 | 60,573 | 198,530 | 820 |
| Minimum | 342 | 900 | 10,000 | 15,000 | 60 |
| Domestic crude oil prices | | | | | |
| End-of-period <u>2/</u> | 70 | 8,400 | 92,000 | 90,000 | 1,304 |
| As percent of international prices | 44 | 20 | 65 | 33 | 100 |
| (In percent of GDP) | | | | | |
| General government | | | | | |
| Revenue and grants | 25.0 | 18.7 | 19.1 | 22.7 | 21.3 |
| Expenditure | 32.9 | 24.3 | 25.2 | 25.6 | 25.3 |
| Overall balance | -7.9 | -5.6 | -6.0 | -2.9 | -4.0 |
| Domestic financing | 7.4 | 1.1 | 3.9 | 2.6 | 2.1 |
| Foreign financing | -- | 1.2 | 2.1 | 0.4 | 1.8 |
| (In percent change in relation to beginning period M2) | | | | | |
| Money and credit | | | | | |
| Base money <u>3/</u> | ... | 564 | 639 | 526 | 82 |
| Broad money | ... | 389 | 380 | 583 | 102 |
| Credit to the economy | ... | 1,067 | 506 | 1,059 | 206 |
| Credit to government | ... | -40 | 94 | 91 | 51 |
| (In millions of U.S. dollars) | | | | | |
| Balance of payments | | | | | |
| Exports | 10,211 | 3,562 | 5,080 | 4,771 | 6,700 |
| Imports | -13,368 | -4,683 | -6,190 | -5,238 | -7,360 |
| Current account | -1,295 | -1,479 | -1,150 | -540 | -941 |
| Financing gap | -- | -- | 325 | -- | 447 |

Source: Kazakh authorities; and staff estimates.

- 1/ Data through 1993 is in billions of Kazakh rubles, while 1994 is in billions of Tenge; rubles were converted at 500 rubles per Tenge in November 1993.
2/ In rubles for 1991-93, and in Tenge for 1994; oil prices per ton.
3/ Percentage change.

Table 2. Kazakhstan: Government Finances, 1992-94

| | 1992 | 1993 | 1994 |
|---|-------------------------|-------|---------------------------|
| | (In billions of rubles) | | (In millions of Tenge) 1/ |
| <u>Total revenue and grants</u> | 298 | 3,788 | 41,576 |
| Direct taxes | 92 | 1,054 | 12,962 |
| Of which: | | | |
| Corporate income tax | 62 | 686 | 8,286 |
| Indirect taxes | 169 | 1,687 | 25,213 |
| Of which: | | | |
| VAT | 72 | 695 | 8,787 |
| Taxes on international trade | 28 | 258 | 3,538 |
| Nontax revenue | 16 | 864 | 3,376 |
| Other revenue | 1 | 171 | 25 |
| Grants | 21 | 12 | -- |
| <u>Total expenditure</u> | 387 | 4,280 | 49,352 |
| Current expenditure | 306 | 3,546 | 41,644 |
| Wage bill | 39 | 584 | 6,871 |
| Goods and services | 173 | 1,665 | 21,306 |
| Subsidies | 18 | 717 | 6,054 |
| Transfers | 44 | 546 | 6,699 |
| Interest payments | 33 | 34 | 714 |
| Capital expenditure | 81 | 734 | 7,708 |
| <u>Overall balance (commitment basis, including grants)</u> | -89 | -492 | -7,776 |
| <u>Financing</u> | 89 | 492 | 7,776 |
| External | 19 | 70 | 3,602 |
| Domestic | 18 | 432 | 4,174 |
| Arrears | 53 | -10 | -- |
| <u>Memorandum item</u> | | | |
| Primary deficit | -56 | -459 | -7,062 |
| | (In percent of GDP) | | |
| Overall balance, including grants | -7.3 | -2.9 | -4.0 |
| Revenue (excluding grants) | 22.9 | 22.6 | 21.3 |
| Grants | 1.7 | 0.1 | -- |
| Total expenditure | 31.9 | 25.6 | 25.3 |
| Current expenditure | 25.3 | 21.3 | 21.3 |
| Capital expenditure | 6.7 | 4.4 | 3.9 |
| Primary deficit | -4.6 | -2.7 | -3.6 |

Source: Kazakh authorities and staff estimates.

1/ Rubles were converted at 500 rubles per Tenge in November 1993.

Table 3. Kazakhstan: Summary Monetary Accounts, 1992-94

| | 1992 | 1993 | 1993 | 1994 | 1994 | | | |
|-------------------------------|---|--------|--------|---------|------------------|---------|---------|---------|
| | | | | | I | II | III | IV |
| | (Rubles billions) | | | | (Tenge millions) | | | |
| <u>National Bank</u> | | | | | | | | |
| Net foreign assets | -230 | 1,035 | 2,070 | 3,346 | 2,389 | 2,708 | 3,027 | 3,346 |
| Net international reserves | 0 | 1,474 | 2,949 | 4,224 | 3,268 | 3,586 | 3,905 | 4,224 |
| Other | -230 | -439 | -878 | -878 | -878 | -878 | -878 | -878 |
| Net domestic assets | 529 | 836 | 1,672 | 3,484 | 2,915 | 3,320 | 3,435 | 3,484 |
| Credit to Government (net) 1/ | 2 | 412 | 825 | 3,759 | -681 | -1,514 | -1,587 | 3,759 |
| Credit to banks | 652 | 2,872 | 5,743 | 15,453 | 9,967 | 15,370 | 18,509 | 15,453 |
| Credit to the economy | 38 | 69 | 139 | 139 | 139 | 139 | 139 | 139 |
| Other items (net) | -163 | -2,517 | -5,034 | -15,866 | -6,509 | -10,674 | -13,626 | -15,866 |
| Liabilities | 299 | 1,871 | 3,743 | 6,830 | 5,304 | 6,028 | 6,462 | 6,830 |
| Currency outside NBK | 148 | 1,000 | 2,000 | 4,053 | 3,052 | 3,494 | 3,777 | 4,053 |
| Reserves | 46 | 307 | 614 | 1,878 | 1,467 | 1,687 | 1,805 | 1,878 |
| Excess reserves | 70 | 246 | 492 | 0 | 0 | 0 | 0 | 0 |
| Other deposits | 35 | 160 | 320 | 582 | 468 | 529 | 562 | 582 |
| <u>Banking System</u> | | | | | | | | |
| Net foreign assets | -78 | -206 | -412 | 1,219 | -5 | 403 | 811 | 1,219 |
| Net domestic assets | 504 | 3,110 | 6,219 | 10,503 | 9,049 | 9,982 | 10,340 | 10,503 |
| Credit to Government (net)1/ | -25 | 360 | 719 | 3,653 | -787 | -1,620 | -1,693 | 3,653 |
| Credit to the economy | 986 | 5,487 | 10,973 | 22,944 | 16,207 | 22,335 | 25,822 | 22,944 |
| Other items (net) | -457 | -2,737 | -5,474 | -16,095 | -6,372 | -10,733 | -13,790 | -16,095 |
| Liabilities | 425 | 2,903 | 5,807 | 11,722 | 9,044 | 10,385 | 11,151 | 11,722 |
| Currency in circulation | 147 | 995 | 1,990 | 4,053 | 3,052 | 3,494 | 3,777 | 4,053 |
| Deposits | 279 | 1,908 | 3,817 | 7,669 | 5,992 | 6,891 | 7,374 | 7,669 |
| <u>National Bank</u> | | | | | | | | |
| | (In percent change in relation of beginning period Base Money 2/) | | | | | | | |
| Net foreign assets | -544 | 423 | 423 | 34 | 9 | 6 | 5 | 5 |
| Net international reserves | -- | 493 | 493 | 34 | 9 | 6 | 5 | 5 |
| Net domestic assets | 1,109 | 103 | 103 | 48 | 33 | 8 | 2 | 1 |
| Domestic credit | 1,380 | 880 | 880 | 338 | 73 | 86 | 51 | 35 |
| Net credit to Government | -- | 137 | 137 | 78 | -40 | -16 | -1 | 83 |
| Credit to banks | 1,380 | 742 | 742 | 259 | 113 | 102 | 52 | -47 |
| Base money | 564 | 526 | 526 | 82 | 42 | 14 | 7 | 6 |
| <u>Banking System</u> | | | | | | | | |
| | (In percent change in relation to beginning period M2) 2/ | | | | | | | |
| Net foreign assets | -107 | -67 | -67 | 28 | 7 | 5 | 4 | 4 |
| Net domestic assets | 498 | 613 | 613 | 74 | 49 | 10 | 3 | 1 |
| Domestic credit | 1,026 | 1,150 | 1,150 | 257 | 64 | 59 | 33 | 22 |
| Net credit to Government | -40 | 91 | 91 | 51 | -26 | -9 | -1 | 48 |
| Credit to the economy | 1,067 | 1,059 | 1,059 | 206 | 90 | 68 | 34 | -26 |
| Broad money | 389 | 583 | 583 | 102 | 56 | 15 | 7 | 5 |

Source: NBK, and IMF staff estimates.

1/ Includes official entities.

2/ Percent change relative to the end of the previous quarter for 1994 quarterly data.

Table 4. Kazakhstan: Balance of Payments, 1992-94

| | Non-FSU Balance | | | FSU Balance | | | Consolidated Balance 1/ | | |
|------------------------------------|-------------------------|--------|--------|---------------------------|--------|---------|-------------------------|--------|--------|
| | 1992 | 1993 | 1994 | 1992 | 1993 | 1994 | 1992 | 1993 | 1994 |
| | (U.S. dollars millions) | | | (Russian rubles billions) | | | (U.S. dollars millions) | | |
| <u>Current account balance</u> | -294 | -127 | -489 | -185 | -434 | -943 | -1,479 | -540 | -941 |
| Trade balance | -33 | -37 | -195 | -170 | -445 | -976 | -1,121 | -467 | -661 |
| Exports | 1,489 | 1,566 | 1,770 | 324 | 3,371 | 10,779 | 3,562 | 4,771 | 6,700 |
| Imports | -1,523 | -1,603 | -1,965 | -494 | -3,816 | -11,756 | -4,683 | -5,238 | -7,360 |
| Services and transfers, | -312 | -155 | -374 | -15 | -39 | -86 | -410 | -193 | -415 |
| of which | | | | | | | | | |
| Interest | -175 | -12 | -80 | -- | -- | -- | -175 | -12 | -80 |
| <u>Capital account balance</u> | -105 | 450 | 699 | -- | 262 | -- | -105 | 802 | 699 |
| Medium- and long-term credits, net | -275 | -67 | 70 | -- | -51 | -- | -275 | -123 | 70 |
| Trade credits | 70 | 302 | 269 | -- | 313 | -- | 70 | 710 | 269 |
| Direct private invest. | 100 | 295 | 330 | -- | -- | -- | 100 | 295 | 330 |
| Short term Capital | -- | -80 | 30 | -- | -- | -- | -- | -- | -- |
| Errors and omissions | 44 | -- | -- | 116 | -50 | -- | 785 | -55 | -- |
| <u>Overall balance</u> | -355 | 323 | 209 | -70 | -222 | -943 | -799 | 207 | -242 |
| <u>Financing</u> | 355 | -323 | -209 | 70 | 222 | 943 | 799 | -207 | 242 |
| Net international reserve | -253 | -547 | -449 | -- | -- | -- | -253 | -547 | -449 |
| increase (-) | | | | | | | | | |
| Exceptional financing | 608 | -- | -- | 70 | 105 | -105 | 1,052 | 86 | -49 |
| Arrears reduction (-) | 335 | -- | -- | -169 | 105 | -105 | -743 | 86 | -49 |
| Financing gap (+) 2/ | -- | -30 | -53 | -- | 117 | 1,048 | -- | -- | 447 |
| <u>Memorandum items</u> | | | | | | | | | |
| Net reserves | 83 | 630 | 1,003 | -- | -- | -- | 83 | 630 | 1,003 |
| Net reserves (months of imports) | ... | ... | ... | ... | ... | ... | 0.2 | 1.4 | 1.6 |

Sources: Goskomstat, Ministry of Economics, Ministry of Foreign Economic Relations, NBK, and staff estimates.

1/ Russian ruble figures converted into U.S. dollars using quarterly exchange rates.

2/ Financing gap after use of Fund credit not put into reserves; excludes gold reserve buildup, which is from domestic sources.

Quantitative Targets and Structural Benchmarks

I. Performance Criteria 1/

1. The National Bank of Kazakhstan's net domestic assets will not exceed T 2,915 million by March 31, 1994, T 3,320 million as of June 30, 1994, T 3,435 million as of September 30, 1994, and T 3,484 million as of December 31, 1994. 2/
2. The net credit position of the Government with the NBK, commercial banks, and the Savings Bank will be no less than T 787 million at March 31, 1994, T 1,620 million at June 30, 1994, and T 1,693 million at September 30, 1994; there will be a net debit position not exceeding T 3,653 million at December 31, 1994. 3/ The limits for the NBK's net domestic assets and net credit to Government will be increased for shortfalls (and reduced for excesses) in external financing from the amounts assumed in the program up to a maximum of Tenge equivalent of US\$15 million by March 31, 1994, US\$30 million by June 30, 1994, US\$45 million by September 30, 1994, and US\$60 million by December 31, 1994.
3. Compared to their end-December 1993 level, NBK holdings of net official international reserves (including gold valued at US\$350 per ounce) will increase by no less than US\$80 million by end-March, US\$160 million by end-June, US\$240 million by end-September, and US\$320 million by end-December 1994. 4/ Compared to their end-December 1993 level, NBK net

1/ The end-September and end-December 1994 limits are indicative targets, which will be converted to performance criteria at the time of the first review of the program.

2/ Net domestic assets of the NBK are defined as the difference between base money (including currency, required and excess reserves) minus net foreign assets including the net position of the NBK correspondent account with FSU central banks. Thus defined, the NBK's net domestic assets would comprise: credit to all levels of government (including the Pension Fund and the Employment Fund) minus deposits of the Government, credit to domestic banks, credit to domestic enterprises, and all other net assets.

3/ The General Government is defined as comprising the republican and local budgets of Kazakhstan, and all Government extrabudgetary funds. Net credit of the banking system to the General Government is defined as the consolidated gross credit given to the Government by the institutions listed above minus the consolidated liabilities of those institutions to the General Government.

4/ Net official international reserves consist of the NBK's net asset position in nonconvertible currencies (including its correspondent accounts with central banks of the former Soviet Union) plus NBK's net international reserves in gold and convertible currencies (calculated as the difference between the gross reserves of the NBK and the reserve liabilities of the NBK).

(continued...)

holdings of convertible currencies will increase by no less than US\$40 million by end-March, US\$80 million by end-June, US\$120 million by end-September, and US\$160 million by end-December 1994. These targets will be reduced for shortfalls and increased for excesses in external financing relative to the amounts assumed in the program up to a maximum of US\$15 million at end-March, US\$30 million at end-June, US\$40 million at end-September, and US\$50 million at end-December 1994.

4. The following ceilings will apply to external debt contracted or guaranteed by the General Government and the NBK from December 31, 1993. The stock of contracted and guaranteed short-term external debt by the Government and the NBK will not increase by more than US\$15 million at the end of the first quarter of 1994; US\$25 million at the end of the second quarter of 1994; US\$35 million at the end of the third quarter of 1994; and US\$50 million at the end of the fourth quarter of 1994. The contracting and guaranteeing of new medium- and long-term non-concessional external debt (1-12 year maturities) will not exceed US\$300 million by the end of the first quarter, US\$500 million by the end of the second quarter, US\$650 million by the end of the third quarter, and US\$800 million by the end of the fourth quarter of 1994. The contracting and guaranteeing of new medium- and long-term nonconcessional external debt of the Government or the NBK with an original maturity of one year to 5 years will not exceed US\$250 million by the end of the first quarter, US\$400 million by the end of the second quarter, US\$500 million by the end of the third quarter, and US\$600 million by the end of the fourth quarter of 1994.

5. No new foreign payments arrears will be incurred during 1994; net FSU interstate arrears will be reduced through negotiation or payment by Russian ruble 105 billion by December 31, 1994.

4/ (...continued)

Gross official international reserves in convertible currencies shall be defined as official monetary gold of the NBK (excluding gold which has been swapped against foreign exchange), holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the NBK including any held with domestic banks. Excluded are capital subscriptions in foreign financial institutions, long-term (beyond one year of original maturity) illiquid assets of either the NBK or the Government (excluding monetary gold), any assets in nonconvertible currencies, and the NBK credit balances in any bilateral clearing accounts or correspondent accounts with other FSU central banks.

For the purposes of the program, official reserve liabilities in convertible currencies shall be defined as IMF purchases, and convertible currency liabilities of the NBK and the Government to nonresidents, with an original maturity of up to and including one year.

II. Indicative Quantitative Targets

Broad Money will not exceed T 9,044 million by end-March 1994, T 10,385 million by end-June 1994, T 11,151 million by end-September 1994, and T 11,722 million by end-December 1994.

Structural Benchmarks

| | |
|---|-----------------------------|
| Start monthly Treasury-bill auctions. | March 1994 |
| Distribute coupons for mass privatization. | January 1994 |
| Complete specific action plan to deal with domestic interenterprise arrears. | March 1994 |
| Adjust domestic oil prices to 66 percent of world market levels by March 1994, 75 percent of world market levels by June 1994, and world market levels by September 1994. ^{1/} | March, June, September 1994 |
| Privatize 30 percent of the assets of the non-agricultural medium and large enterprises. | June 1994 |
| Increase amounts available for export outside quotas by 25 percent by March, reduce number of products subject to export quotas to 12 types of goods by June, those subject to export licenses to 30 types of goods by June, and begin auctioning quotas. | March, June 1994 |
| Complete audits of NBK and ten largest banks. | September 1994 |
| Increase proportion of credit auctioned to 35 percent of NBK credit to banks in the first quarter, 50 percent in the second quarter, and 75 percent in the fourth quarter of 1994. | March, June, December 1994 |
| Reduce the maturity of new refinance credits from the NBK. | March 1994 |
| Privatize all enterprises engaged in wholesale and retail trade, and related transport, storage and distribution. | December 1994 |

^{1/} World level of oil prices is computed as the border price for imports from Russia plus all domestic processing and distribution costs.

