Republic of Kazakhstan–Concluding Statement of the 2012 IMF Staff Visit

December 5, 2012

An International Monetary Fund (IMF) mission led by Hossein Samiei visited Almaty and Astana during November 28–December 5 to review economic and financial sector developments and policies in preparation for the upcoming May 2013 Article IV consultations. The mission thanks the authorities and other counterparts for the productive discussions. At the conclusion of the visit Mr. Samiei issued the following statement:

Growth is decelerating but is expected to remain solid this year. The deceleration is mostly due to subdued external demand and a sharp decline in agricultural output from last year's high levels. The authorities expect to lower their 2012 growth projection form 5½ to 5 percent. Inflationary pressures have eased, and end-2012 inflation is expected to be slightly over 6 percent. While economic fundamentals remain relatively strong—as echoed by rating agencies' recent assessments—risks are mainly on the downside. These reflect possible further deterioration in the global economy—with implications for oil prices and growth in Kazakhstan's major trading partners—as well as weaknesses in the domestic banking sector.

The banking sector remains vulnerable and credit growth is moderate. While liquidity and capitalization are high and profitability is showing signs of improvement, non-performing loans (NPLs), at over 30 percent of total loans, remain extremely elevated. Credit growth is constrained by limited lending opportunities against the backdrop of stricter prudential regulations. Moreover, credit is concentrated in selected small- and medium-sized banks, while large banks continue to deleverage. BTA's second proposed debt restructuring has been agreed by the creditors. The restructuring will need to be complemented by a viable business plan, including measures to strengthen the bank's risk management and to minimize contingent liabilities to the state.

Efforts to address the stock of NPLs are progressing, but with limited impact so far. Currently, the policies comprise of three instruments: sale of some non real-estate bad loans to the National Bank of Kazakhstan's (NBK) problem loans fund (PLF), transfer of loans to bank-run Special Purpose Vehicles (SPVs), and writing off loans without tax consequences (currently applied through December 2013). The PLF has started to buy loans on a pilot basis and some banks have begun to set up SPVs. The package of measures is a step in the right direction. However, many obstacles remain and progress has been slow: according to the authorities the measures will take at least 2-3 years to fully resolve the problem. Obstacles reflect difficulties in implementing the required legal and tax reforms, banks' unwillingness to sell some of their assets in the expectation of a price recovery, and the complexity of the loan restructuring process. In view of the risks to financial stability and economic growth, the authorities should: (i) do their utmost to expedite the process by addressing remaining constraints and encouraging banks to take speedy action; (ii) ensure realistic valuation of assets transferred to SPVs and prevent circumvention of prudential regulations; and (iii) re-assess the PLF's design depending on its performance.

Looking ahead, it is essential to avoid a recurrence of the problem. In this context, the authorities have introduced several prudential regulations and plan to adopt elements of Basel III in 2013, while banks report a strengthening in their risk management and lending practices. Nevertheless, further work is urgently needed to strengthen bank supervision, in particular to bolster on-site inspection and ensure that banks have viable business plans. Moreover, macro prudential surveillance and the infrastructure for minimizing credit risk need to be enhanced, in particular by strengthening banking sector liquidity and indirect credit risk assessments, the

Early Warning System, and the credit registry. The IMF stands ready to provide technical assistance in these areas, including through an already-assigned long-term expert on NPLs within the NBK.

Monetary policy objectives and instruments can be further aligned and clarified. In response to declining inflation, the NBK has cut its official policy rate, while continuing to intervene to smooth exchange rate fluctuations. However, the transmission from the policy rate to market interest rates is hampered by the lack of a fully functioning interbank market and monetary conditions have thus been slow to ease. The economy's dollarization complicates the operations of monetary policy, and adopting formal inflation targeting may not be appropriate at this point. However, building on the framework's existing strengths, there is scope to take preparatory steps, including by enhancing the transparency of monetary policy operations, reviewing and clarifying the role of exchange rate policy, and putting stronger emphasis on anchoring core inflation expectations. In this context, the NBK should consider strengthening its public communication by elaborating on the factors guiding its interest rate decisions in the post-meeting communiqués and quarterly inflation reports.

Lowering the non-oil deficit in 2013 and over the medium term is a key priority. Lower-than-budgeted revenues in 2012, related mostly to the oil sector, have been partially offset by downward revisions in spending. Furthermore, legislation has been amended to make certain future budgeted expenditures contingent on revenue performance. In light of the shortfall in 2012, the 2013 budget envisages a reduction in the non-oil deficit of over 1 percent of GDP on a consolidated basis—an objective that should be strictly adhered to. Over the medium term, the authorities remain committed to reducing the non-oil deficit toward sustainable levels by limiting expenditure growth. To enhance the credibility of these plans, the authorities should continue with their efforts to limit the use of preferential tax regimes; broaden the non-oil tax base (including by reducing tax loopholes in the special economic zones); and consider revisions in some tax rates. It is also essential to improve fiscal planning by increasing the transparency of Samruk Kazyna's (SK) activities. In this context, recent amendments in legislations to separate the commercial functions of SK as a manager of state assets from its role as a vehicle for government development programs is a welcome step.

Reducing the economy's dependence on oil remains a primary long-term objective. To this end, the authorities are developing plans to diversify the economy by using a portion of oil revenues for investment in the non-oil sector and infrastructure development, including possibly through Public Private Partnerships (PPPs). Such partnerships can play an important role in promoting diversification, but it is essential to ensure transparent contracts to control contingent liabilities. Furthermore, chosen projects should be of high return, and consistent with fiscal sustainability and macroeconomic and implementation capacity. Successful diversification also requires continued improvements in the business environment.