Republic of Kazakhstan—2012 Article IV Consultation Concluding Statement of the IMF Mission

May 8, 2012

The following statement reflects the views of an International Monetary Fund (IMF) mission, led by Ana Lucía Coronel, which visited Almaty and Astana during April 26-May 8, 2012 to conduct discussions for the 2012 Article IV consultation. The mission reviewed economic and financial sector developments, and discussed ongoing and envisaged policy responses as well as economic prospects. The mission met with government and central bank officials, and representatives of the international, banking, and business communities. The mission would like to thank all counterparts for the useful discussions.

Led by high commodity prices, economic performance continues to be strong. The rebound from the crisis in 2007-09 has been impressive, with real GDP growth reaching 7.5 percent in 2011. Notably, growth has become more broad-based, as high commodity prices helped spur activity in transport and communications and domestic demand. At the same time, slowing international food prices and a record high harvest, aided by administrative measures to limit price increases for fuel and staple food items, brought inflation below 5 percent. The external position strengthened further, with the current account surplus increasing to 7.75 percent of GDP, the highest level in recent history. Combined oil fund resources and National Bank of Kazakhstan's (NBK) international reserves provide an ample external buffer of $80.5 billion, equivalent to 17 months of imports. After having remained subdued for three years and reflecting the recovery in domestic demand, bank credit to the economy is now growing by 15 percent year-on-year—partly funded by deposits of state-owned companies and special lending programs. For 2012 IMF staff projects robust growth of 6 percent with a continued rebound of nonoil activity, and a modest pick-up of inflation from the current level to 6-7 percent.

Fiscal and monetary policies have adapted to the economic recovery. An expansion of nonoil revenues from improved tax collection combined with a small decrease in the expenditure-to-GDP ratio resulted in a welcome decline in the nonoil fiscal deficit. The transfer from the oil fund to the budget remained capped at $8 billion in 2011, and the government borrowing requirements were fully covered in the domestic market. Key monetary indicators continued to grow at a slower rate than nominal GDP, and as inflation pressures subsided, the NBK signaled a more accommodative monetary policy stance, cutting its policy rate by 100 bps in early 2012. The tenge has started to show more flexibility, with the NBK intervening on both sides of the market to avoid undue exchange rate volatility in either direction.

Against the background of strong growth, the banking sector has still not fully recovered from the severe shock in 2007. Foreign liabilities have fallen drastically, aggregate liquidity is ample, and provisioning of overdue loans is still relatively high. Nevertheless, domestic banks' burden of nonperforming loans has further increased, and BTA bank has embarked on a second debt restructuring with external creditors after a default earlier this year. While banks' reported capital adequacy ratios are strong, accrued but not received interest income has continued to expand, raising doubts about recovery of restructured loans and signaling possible recapitalization needs for some banks. So far, hopes that economic growth and government ad-hoc support to distressed borrowers in the construction, real estate and SME sectors would help to improve the quality of the loan portfolio have not been justified, as activity in construction and real estate, the sectors subject to highest bank exposure, remains flat. Moreover, low asset quality is leading to increased risk aversion and undermining banks' preparedness to finance productive projects.

Favorable commodity prices underpin an auspicious economic outlook, albeit one subject to risks. Over the medium term, staff expects growth to converge to 6-6.5 percent, and inflation to remain within the objective of 6-8 percent. A protracted global slowdown, in particular if it affects China and Russia, is the main external risk, as it could affect Kazakhstan through trade, finance, and investment channels. If these developments are combined with a decline in commodity prices, the adverse impact on Kazakhstan's economy and its banking system will be even stronger. Conversely, if world oil prices remain high, the economy will continue to benefit from positive spillovers. Overall, while Kazakhstan's strong net foreign asset position and its good track record of fiscal management are critical shock absorbers, healthier banks would be an essential complement to the existing buffers to protect the economy against possible deterioration in global conditions.

In this context, restoring the health of the banking system remains a key short-term policy priority. The authorities have adopted regulations to contain banks' risks, including by discouraging foreign currency lending, increasing minimum capital requirements, requiring better governance and transparency practices, and temporarily removing tax impediments to writing off bad loans. The NBK has enabled banks to set up asset management companies to handle bad debts, and established a centralized problem loans fund, albeit limited in size. This new mechanism could allow more efficient management of troubled assets and collateral, but represents only a partial solution to the problem. Ultimately, successful resolution of problem loans will depend critically on the willingness of banks to accept realistic asset valuation and recognize losses, and on the readiness of the NBK to enforce proper provisioning and adequate bank capitalization. New capital should come in the first instance from existing shareholders, and the public sector should stand ready to inject funds to support viable banks. In addition, the NBK, as the banks' regulator, should strictly enforce existing regulations, refrain from forbearance, and ensure that banks adopt and implement better practices in governance, accountability, and risk management. A quick and definitive solution to the BTA problem is a key priority to minimize further risks.

6. The authorities intend to pursue countercyclical fiscal and monetary policies. This is important for ensuring macroeconomic stability and would entail loosening policies only when, on average over the cycle, the economy is growing below the estimated potential of 6-6.5 percent. After two years of very strong expansion, the projected return to potential growth calls for continuation of the ongoing fiscal adjustment and close control of inflation. Therefore, the authorities' plans to deal with the ongoing uncertainty in the global environment by expanding policies should be treated as contingent. This approach would guard against premature or excessive reaction that could unnecessarily invigorate demand and result in overheating. At the same time, policies should ensure that the necessary adjustment in the financial sector is not delayed. Exchange rate flexibility will need to be a key tool in helping the economy to adjust to external shocks.

7. Looking ahead, macroeconomic policymaking would benefit from improved medium-term frameworks. To increase transparency, the use of oil revenues as well as all expenditure plans should be accommodated within clear medium-term targets aimed at gradually reducing the nonoil deficit to its sustainable level. Full integration of the oil fund into the medium-term fiscal framework would facilitate this task. At the same time, broadening the tax base and further improving tax collection would help reduce dependence on oil revenues. Given the large role of public enterprises in the economy, incorporation of their operations in a consolidated balance sheet would be also essential for the authorities' fiscal planning and analysis. On the monetary front, it is important to strengthen the currently weak transmission mechanism while gradually unwinding the use of administrative measures to control inflation. This would require deepening financial markets in both foreign and domestic currencies.

8. In the medium-term, the authorities' plans rightly focus on economic diversification. Successful implementation of the diversification strategy would require further enhancements in competitiveness and the business environment. Recent improvements should be complemented by additional efforts to enhance governance and the quality of institutions. This would enable greater private sector participation, in particular in nonoil activities. The authorities' plans to use some of the oil fund savings to finance medium-term productive nonoil investments are consistent with the objectives of ensuring that the oil wealth benefits the whole economy and promoting job-creating and inclusive growth. These steps, along with reducing trade barriers (in coordination with other members of the customs union) and further integrating Kazakhstan into the global economy, would help to fully realize the country's significant economic potential.