Statement by IMF Mission to the Republic of Kazakhstan

October 28, 2011

An International Monetary Fund (IMF) mission led by Ana Lucia Coronel visited Almaty and Astana during October 21–28, to review economic and financial sector developments since the last Article IV consultation in June 2011, and discuss economic prospects. The mission appreciates the open discussions held with the government and central bank officials, and with representatives of the international, banking, and business communities. At the conclusion of the visit Ms. Coronel issued the following statement:

The economic recovery continues to be strong, supported by favorable oil prices and the rebound in agricultural output from last year's drought. Although construction and real estate remain weak, real GDP growth is projected by staff at 6.5 percent in 2011. Foreign assets are strong, with combined international reserves and oil fund resources at $72.5billion (40 percent of GDP), providing a comfortable buffer to the economy. Driven by rising commodity exports, the current account surplus has increased, and oil-related foreign direct investment and external funding have helped sustain capital inflows. Largely on account of higher international food and fuel prices, but also of increases in incomes (including a 30 percent rise in public sector wages in July), annual inflation stood at 8.75 percent at end-September, and has exceeded the authorities' 6-8 percent objective since January, despite the increased use of price controls. The deposit base (supported by state entities) is growing, and credit growth has slightly picked up, but banks' balance sheets remain vulnerable, reinforcing risk aversion and undermining financial intermediation.

Kazakhstan's fast upturn after the 2007-09 crisis is encouraging. The recovery, however, is taking place against a rapidly deteriorating external environment. Global activity has weakened and become more fragile, confidence is falling, and downside risks are growing. The structural problems facing the crisis-hit advanced economies have proven more intractable than expected, and the process of devising and implementing reforms more uncertain. These complications bring clear downside risks to the global expansion related to possible delays in the resolution of the crisis in the euro area and in the recovery of private demand in the United States. If these risks materialize, commodity prices, global trade, and capital flows would likely decline, dragging down growth in emerging and developing economies. Kazakhstan, like many other countries, is exposed to these shocks, given its dependence on commodity exports and its close links with international markets.

In this environment, the ongoing vulnerabilities in Kazakhstan's banking system are a cause for concern. Despite the foreign debt restructuring and injection of public funds, the quality of bank assets has continued to deteriorate, with nonperforming loans remaining extremely high by international standards. High accrued but not received interest income, a high proportion of restructured loans, and low profitability pose risks to capital adequacy ratios. Targeted subsidized credit, ad-hoc government support, and the accommodative monetary stance are unlikely to encourage robust lending in the near-term, given that banks remain risk averse and large corporations continue to deleverage.

In the absence of significant shocks, banks' health could gradually improve. However, given the uncertain global environment, a proactive approach would be preferable, to fully restore the health of the banking system and improve its resilience to potential shocks and its ability to channel savings to productive activities. A significant deterioration of the global environment, and in particular potential spillovers from large neighboring countries, would negatively impact

Kazakhstan's economy and its banking system. Transmission channels would include lower access to funding and higher borrowing costs (for banks, corporations, and quasi-sovereign entities), and weaker confidence, which would in turn result in additional bank difficulties. Despite the economy's ample financial resources, such a situation would create multiple challenges to policymakers, and could inhibit plans for private-sector-led growth and economic diversification as envisaged under the Development Plan to 2020.

Timely and decisive measures to improve the soundness of Kazakhstan's banking system would help address these difficulties. The authorities have appropriately removed tax impediments to writing off bad loans; strengthened the regulatory framework through measures to discourage foreign currency lending and to increase minimum capital requirements; and introduced the new conceptual plan for the resolution of problem assets. Nevertheless, further critical efforts are needed. As a first priority, forceful action should be taken to ensure proper loan valuation and provisioning in all banks. In addition, concrete actions should be taken to reduce bad loans and to replenish bank capital—with shareholder or public funds— where needed. Contingency plans for such eventualities need to be prepared.

Given the uncertain environment, macroeconomic policies should be flexible. The recent modest increase in reserve requirements is a welcome step in the direction of a less accommodating monetary policy stance. The national bank needs to carefully balance maintaining financial sector support with bringing inflation under control. The planned gradual fiscal consolidation remains appropriate, and should focus on ensuring high-quality expenditure. Monetary and fiscal authorities should stand ready to adjust conditions if external shocks affect the domestic economy. Greater exchange rate flexibility would help the economy to adjust to these shocks.

Looking ahead, fiscal policy should continue to be countercyclical, and budget preparation should be consistent with macroeconomic policy objectives and the optimal use of oil resources. The authorities' plans to reduce the non-oil fiscal deficit in the medium term are welcome. Social spending should be anchored on improved safety nets to avoid the use of administrative measures to control inflation. Moreover, there is considerable scope for more dynamism in private sector activity and further economic diversification, which would make growth more inclusive, bringing benefits to the population as a whole. In this regard, recent improvements in the Doing Business indicators are encouraging, and further gains in governance, transparency, and institution building—in parallel with restoring the soundness of the financial sector—would create new investment and growth opportunities.