Statement by IMF Mission to Kazakhstan

December 9, 2010

An International Monetary Fund (IMF) mission led by Ana Lucia Coronel visited Astana and Almaty during December 1-9, to review economic and financial sector developments since the last Article IV consultation in July 2010, and discuss economic prospects. The mission appreciates the open discussions held with the government, parliamentarians 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:

"In line with global economic trends, Kazakhstan's economy has begun to improve, but the recovery needs to become more broad-based to be sustainable. Aided by public sector support and favorable global commodity market developments, real GDP has continued to rebound, and IMF staff projects an expansion of about 5^{1}/г percent in 2010. Growth is being driven mainly by oil and mineral-related industries and associated services sectors, including transportation and communications. While some improvement in retail trade—largely reflecting the rebound from the crisis-induced contraction in consumption—is helping the recovery, activity in construction and real estate remains subdued. IMF staff projects the economy to expand by about 5 percent in 2011, still led by oil and minerals, as ongoing difficulties in the banking and corporate sectors will continue to limit the scope of the recovery of domestic demand.

"There is a clear need, therefore, to reinvigorate domestic demand by spurring economic diversification and promoting efficient financial intermediation. The challenge is to ensure that natural resource wealth supports the development of the domestic economy and financial system. The authorities have begun to implement the Development Plan 2020, which envisages an increased share of manufacturing and small and medium-sized enterprises in GDP, improved productivity in agriculture, and health and education reforms. These efforts are likely to produce economic benefits in the medium term, particularly if accompanied by structural reforms to further enhance the business environment, promote competition, enhance labor productivity, and strengthen governance. Equally important, a healthy, adequately capitalized, and well regulated financial system is essential to facilitating an efficient allocation of resources under the Development Plan, boosting external confidence, and sustaining economic diversification.

"While the acute phase of the crisis has passed, the banking and corporate sectors have not fully recovered, and restoring their health is a key priority. Notwithstanding ample bank liquidity and some recovery in deposits—with an increasing share denominated in tenge—high nonperforming loans (NPLs) represent ongoing risks to banks' capital. Aggregate provisioning for problem loans is declining and its coverage, albeit still high, is likely to be affected by doubtful recoveries of restructured loans. Uncertainties surrounding the stability of funding sources, provisioning needs, and implications of pending regulatory enhancements have increased banks' incentives to maintain cash reserves and restrain lending activity. Against this, the non-oil corporate sector remains highly leveraged from the heavy borrowing in the years preceding the crisis, further reducing the pool of potential borrowers and impeding the resolution of NPLs. This underscores that the recovery of the non-oil sector and the resolution of NPLs will need a more concerted policy effort to improve balance sheets of banks and corporations and thus unclog credit channels.

"Within a government-led, harmonized, and transparent strategy, banks and corporations should reinforce efforts to restore their financial health. The current fragmented approach to resolving NPLs by targeting specific economic sectors with subsidized lending has proven to be insufficient to address the difficulties, and could lead to further market distortions. This calls for intensified efforts to achieve restructuring of nonperforming assets through actions to ensure that both the financial system and corporate sector, including quasi-sovereign entities, are placed on a sound footing, including by:

- *Assessing banks'* capital needs and resolving NPLs in a transparent way. The recent regulatory and supervisory enhancements introduced by the Financial Supervision Agency (FSA) should be complemented by a forward-looking diagnostic assessment of systemic banks' asset quality. Rapid action should be taken to attract new capital, if needed, ideally from existing shareholders and other private investors, but contingency plans for the use of public sector resources should be in place. Bank-led measures to facilitate NPL resolution should be supported by a centralized scheme to manage problem assets at an aggregate level. This should be done before corporate sector restructuring can be undertaken, as viable banks must have both the necessary capital and incentives to participate in the restructuring of the corporate sector.

- Facilitating an orderly and transparent deleveraging of the non-oil corporate sector. Given the close relation between corporate sector stress and banking sector difficulties, there is a need for an encompassing resolution approach. Successfully deleveraging corporations and attracting capital from strategic investors will require legal and governance reforms, as well as sequencing and harmonization with the resolution of the banking system. A fragmented approach, including by the public sector providing direct support to selected entities, should be avoided in favor of a more transparent and comprehensive strategy.

- Addressing legal shortcomings. The resolution of the financial and corporate sectors should be supported by efforts to strengthen bankruptcy, foreclosure and insolvency regimes, as well as reforms to the tax code. Ongoing efforts to remove tax impediments to the recognition and writing-off of nonperforming assets are therefore welcome. Progress in these directions will complement recent measures to boost transparency among banks' large shareholders, resulting in an improved business environment.

- Coordinating actions among the different government agencies. There is a need to coordinate government actions, perhaps through the Council for Financial Stability, to address balance sheet difficulties. Against this, the FSA should balance the need to tighten regulatory measures against that to support the recovery of banks and corporations, while ensuring that the health of the financial system takes priority over the resumption of credit growth.

"Although monetary policy remains accommodative, inflation should be closely monitored. The moderate recovery in the non-tradable sector has helped to keep inflation relatively contained, albeit close to the upper bound of the objective range of 6-8 percent. Given that rising food prices and planned government expenditure pose risks to the outlook, inflation should be monitored, real interest rates kept positive, and administrative measures for price determination phased out. Against an improved financial sector backdrop, the economy would benefit from greater exchange rate flexibility and lower central bank intervention, which would enhance the economy's responsiveness to external shocks and provide additional monetary policy leverage.

"Kazakhstan's external position will continue to be strong and the authorities should be prepared to manage a potential increase in foreign inflows. Driven by rising commodity exports, the external current account has returned to surplus, and international reserves and oil fund assets are increasing. Oil-related foreign direct investment, and external funding—including increased use of public private partnerships for the planned development projects—are expected to sustain capital inflows. Against the backdrop of ample international liquidity, the monetary and supervisory authorities should stand ready to manage a potential resumption of short-term inflows.

"The authorities appropriately target fiscal consolidation over the medium term, but the efficiency of public spending should be ensured. Fiscal policy continues to support the economic recovery. Nevertheless, the overall fiscal stance has tightened in 2010 given the one-off nature of the 2008-09 anti-crisis measures, while there is an increased proportion of oil revenue being saved. The budget for 2011, however, provides for continued rises in public sector wages and social expenditures. Such hard-to-reverse outlays should be carefully balanced with the need to avoid excessive increases in the tax burden on the non-oil economy. Additionally, contingent fiscal risks, including those arising from increasingly indebted quasi-sovereign entities, should be closely monitored and incorporated into an aggregate approach to assessing fiscal sustainability".