Republic of Kazakhstan—Concluding Statement of the October 2009 IMF Mission

October 28, 2009

An International Monetary Fund (IMF) mission visited Astana and Almaty during October 21-28, 2009 to review recent economic developments and discuss ongoing policy responses and economic perspectives. The mission met with government officials and representatives of the banking and business communities. The mission would like to thank the authorities for the frank and open discussions. The following statement reflects the views of the mission.

1. **Global economic conditions are beginning to show signs of improvement.** The unprecedented level of public intervention in many advanced and emerging economies has stabilized activity and helped restore market confidence, supporting a rebound in global trade, capital flows, and asset prices. Despite the current progress, the recovery is expected to be slow as financial conditions remain fragile, and household spending is held back by rising saving and high unemployment. Continued recovery is thus dependent upon the maintenance of supportive policies and the restoration of financial sector soundness.

2. **Against this background, the economic recovery in Kazakhstan is also expected to be gradual.** Ongoing difficulties in the banking sector continue to add to the fragile global environment in negatively affecting the economy, which contracted by 2.4 percent year-on-year in the first half of 2009, according to the latest official data. Although the decline in economic activity appears to have bottomed-out and a boost in oil production may help restore growth in the last quarter, credit expansion remains subdued despite ample bank liquidity, activity in key sectors, such as construction and manufacturing, continues to be sluggish, and consumer income and demand will pick up only with a lag. Given this combination of factors, IMF staff still expects the economy to contract for the year as a whole by 2 percent, but risks to this forecast are on the upside. The recent rebound in commodity prices, a record grain harvest in October, and the prospect of additional anti-crisis spending by year-end provide a more optimistic outlook for growth in 2010.

3. **The financial system remains vulnerable and must be placed on a sound and sustainable footing.** With slow economic recovery, non-performing loans have risen significantly and bank asset quality is expected to continue to deteriorate, placing additional pressure on balance sheets. Recent measures to raise bank capital requirements and to discourage lending and borrowing in foreign currency are welcome. Nonetheless, a more comprehensive strategy geared toward restoring confidence in the banking system is necessary. Central to these objectives is the resolution of bank solvency problems. In this regard, crucial steps include finalizing the restructuring of Alliance Bank in line with the term sheet agreement; meeting the December 7 deadline for agreeing with BTA Bank creditors on the term sheet; moving swiftly through the rest of the restructuring process; and taking decisive action should similar circumstances arise in other financial institutions. As these processes move forward, the public sector should continue to play a supportive role in the banking system. This assistance should be provided in a transparent way to ensure that balance sheets reflect their real positions, and that all assets are adequately provisioned.

4. **Strong regulatory and prudential frameworks, and corporate governance are crucial in improving the health of the financial system.** The Financial Supervision Agency (FSA) should be duly empowered with the authority, legal protection, independence, and resources to credibly conduct its mandate—including the ability to enforce regulations and take early corrective actions when required. This encompasses the further development of its supervisory and onsite inspection capabilities. Moreover, the FSA should explore diverging from

a compliance-based approach to supervision and moving to a modern, risk-based methodology, paying greater attention to the need for effective corporate governance, transparency of shareholders, fiduciary duties of directors, and risk management at banks. The envisaged legislative reform is a crucial step in this direction.

5. **Inflation is well contained and the current exchange rate peg to the U.S. dollar remains appropriate until problems in the financial sector are resolved.** Weak domestic demand and international prices will keep inflation low in the near term, but the National Bank of Kazakhstan should ensure that real interest rates remain positive to support depositor confidence. The external position is expected to remain supported by continued foreign direct investment, particularly in the energy sector, the rebound in oil prices, and the new sources of bilateral financing. Notwithstanding these ample sources of foreign exchange, the knock-on effects from the previous decline in oil prices and dampened external demand will result in a current account deficit this year, before moving to a modest surplus next year. The exchange rate peg to the dollar is supported by the strong external position.

6. **Fiscal policy has been correctly centered on providing support to the economy, and will continue to do so in the near future.** Responding to a shortfall in tax revenue, the government has halted the anticipated reduction of corporate income tax rates and postponed some spending measures in 2010. Nonetheless, the scale of committed anti-crisis funds going forward is significant, leading to a sharp increase in expenditure and to a loosening of the budget position. The focus should be on the efficiency of spending and the adequacy of financing—to ensure that the quality of projects is consistent with the growth objectives. Since the start of the crisis, Samruk-Kazyna has been playing a key role in supporting the economy through investments in bank equity, infrastructure projects, and assistance to public companies. The new approach to fiscal policy should incorporate these operations and their corresponding financing into the analysis to ensure accurate assessment of the impact of the fiscal impulse on the economy, timely action at calibrating the stimulus-oriented spending, and proper recognition of potential contingent liabilities.

7. The post-crisis stage leaves Kazakhstan with three main medium-term policy challenges:

· ***Restoring confidence in the financial system while withdrawing public sector support.*** Private domestic savings—rather than external borrowing or public sector resources—should become the primary source of financing of productive activities. This will require efforts to deepen domestic financial markets—including the bond market for non-bank sectors—not only to encourage the demand for holding and transacting in tenge, but also to promote risk diversification and the development of hedging tools. A newer, more stable and sustainable financial system may also have greater foreign participation. External borrowing by banks and non-financial institutions should be carefully managed, and the public sector should start designing a transparent and coordinated exit strategy from its equity positions in banks. Effective communication with domestic and foreign markets during this process is essential.

· ***Gradually withdrawing stimulus-oriented spending and increasing saving of future oil revenues.*** Removing the fiscal support as the economy recovers will allow a healthy return of the non-oil deficit to a sustainable level. Expenditure priorities and sustainability of the fiscal stance should be assessed by using a unified approach that includes all fiscal transactions (including those off-budget) within a medium-term framework. The optimal combination of savings and use of commodity revenues should be determined in this context. While the use of savings in the oil fund for mitigating the crisis was appropriate, the medium-term budget should limit the reliance on oil revenues and allow the issuance of government securities. These securities would offer investment alternatives to market participants and provide a benchmark for the transaction of other domestic assets. Steady saving of oil revenues would help insulate the economy from swings in commodity prices, allow for countercyclical fiscal policy, and encourage a rise of economic diversification.

· ***Allowing greater exchange rate flexibility.*** As confidence is restored and the financial system stabilizes, more exchange rate flexibility would help enhance the effectiveness of monetary policy and the economy's response to external shocks, such as commodity price movements and exchange rate developments in trading partners. In preparation for this move, the authorities will need to further develop monetary policy instruments, improve the interest rate transmission mechanism, encourage deepening of the foreign exchange market, and promote better management of exchange rate risks by developing a futures and forwards market.

Progress in these three areas will strengthen the macroeconomic framework and the financial system's resilience to volatile capital flows, often associated with significant commodity price movements or shifts in market risk appetite. It will also encourage the inflow of more productive capital to support higher levels of sustainable growth.