Republic of Kazakhstan

Concluding Statement of the 2008 IMF Mission[1]

September, 26, 2008

An IMF mission visited Kazakhstan during September 22 - 26, 2008 to review developments since the last Article IV consultation in April 2008. The mission would like to thank the authorities for the informative and open discussions during its stay. Against the background of the recent turbulence in global financial and commodity markets, the mission discussed economic developments and policy responses in Kazakhstan with the authorities and private sector representatives. The following statement reflects the views of the mission.

Global financial markets have been under considerable pressure in recent weeks. With evidence mounting of a slowdown in the world economy and significant stresses emerging in the U.S. financial sector, world equity prices have been very volatile, lending spreads have widened, and oil and commodity prices have fallen from their mid-year highs. While the direct impact on Kazakhstan from this financial turmoil has been much more limited than in August-September 2007—interbank interest rates and the exchange rate have been little affected this time—CDS spreads on the sovereign and banks have risen and the local stock market has fallen sharply.

Against this background, we expect real GDP growth to remain relatively weak in the period ahead. Banks will likely be more constrained in their ability to replace maturing external borrowing in the current market environment, which means real credit growth will continue to decline, and the drop in oil prices will weaken a key support that the economy enjoyed during the first half of 2008. All-in-all, we project real GDP growth of 4.5 percent this year and 5.3 percent in 2009. There is considerable uncertainty around these projections given the rapidly evolving global economic and financial situation, but, on balance, risks are on the downside.

Kazakhstan has large financial resources to help it weather the current situation, and medium-term economic prospects remain favorable. Official foreign currency assets, comprising central bank (NBK) reserves and oil fund (NFRK) assets, reached $48 billion at end-September, well above the mid-2007 level. The current account balance has strengthened significantly this year, and oil production is set to increase substantially in the years ahead.

As at the time of the Article IV consultation discussions in April, we believe that in the short-term policies should remain focused on managing risks to the outlook and setting the stage for the resumption of strong and sustained growth. Since our last visit, the authorities have continued to skillfully handle the difficulties the economy has faced, and we welcome the policy steps that are being taken in the monetary, fiscal, and supervisory areas to strengthen the resilience of the Kazakhstani economy. Nevertheless, considerable challenges remain, and these have been heightened by the renewed bout of global financial market volatility. Our views on the key policy issues are set out below.

Kazakhstan's banks remain under considerable pressure, and strong supervisory vigilance needs to continue. While reported capital adequacy and liquidity ratios of the banks remain healthy, profitability is declining, further large foreign currency debt repayments are due over the next year, and asset quality is deteriorating. In this environment, it is important that the authorities continue to closely monitor developments, particularly ensuring that banks provision adequately to cover rising NPLs and declining collateral values, and appropriately assess risks from their overseas operations which could be adversely affected by the recent turmoil in Russia. Further, a timely and consistent picture of upcoming external debt maturities needs to be developed to aid the policy process.

The authorities are further improving the regulatory and supervisory framework. The FSA has already taken a number of welcome steps to strengthen its supervision of banks over the past year, including working to establish early warning indicators of financial stress and improving the efficiency of off-site supervision, including data collection. We also welcome plans to increase the minimum amount of capital a bank will be required to have. Operational aspects of the Memorandum of Understanding signed last year are being developed. The tools for central bank liquidity provision have been broadened, the capital of the deposit insurance fund has been bolstered, and changes to the banking law to strengthen the ability of the supervisory authorities to intervene in a distressed bank have been presented to parliament.

A plan to establish an Asset Stabilization Fund (ASF) to handle some of the distressed assets of the banking sector is currently under discussion. We believe that the creation of an ASF could be a useful tool for helping deal with ongoing difficulties in the banking sector. To ensure its effectiveness, it is important that the goals of the Fund are clearly established upfront and that it is part of a broad package to strengthen bank balance sheets that includes bank owners raising additional capital where needed. The ASF should not be used as a vehicle to provide short-term liquidity to the banks—this job should be left to the central bank. Experiences with similar funds in other countries suggest that to be most effective the ASF should be run with commercial goals in mind, rather than aimed at subsidizing banks. This means that assets should be purchased at a price close to the estimated market value rather than book value, although the bank disposing of the asset could be offered a share of any gains made on the eventual sale. The Fund should also be transparent and accountable, and should be established with a clear termination date to ensure there are appropriate incentives in place for the prompt workout of the distressed assets it acquires. It is also important that the ASF is staffed with experts in managing and restructuring distressed assets and is free from political interference. To support the effective operation of the ASF, it may also be necessary to consider other supporting reforms such as to the bankruptcy law.

Turning to monetary policy, the NBK continues to need to strike a balance between supporting growth, maintaining financial stability, and ensuring that inflation is on a firm downward path. Inflation appears to have peaked, and we anticipate that it will decline to around 11? percent by year-end as food price inflation eases and slower growth affects the pricing power of companies. It will be important that inflation is brought down further during 2009, and we therefore support the decision of the NBK at its September Board meeting to leave the monetary policy stance unchanged. Indeed, we believe that as inflation comes down, positive real interest rates should be restored to support domestic deposit growth and help banks move to a more sustainable funding base. To this end, we would suggest that while there may be scope to consider an easing of monetary policy once inflation is more firmly contained, a cautious approach should be taken.

The stability of the exchange rate over the past year has been a key factor in maintaining depositor confidence and supporting the corporate and banking sectors as they deal with their large maturing foreign currency liabilities. Since July, the tenge has appreciated modestly, and going forward the mission supports further flexibility in the rate as long as conditions in domestic financial markets remain relatively stable. Nevertheless, if the tenge were to come under significant downward pressure, the mission believes that the central bank should support the exchange rate, as it did last year, though with clear operational rules limiting the amount of reserves that are committed to its defense.

The strong budget position in Kazakhstan has provided scope for the government to use fiscal policy to support the economy as growth has slowed. We believe that the increase in spending in the recent supplementary budget is appropriate, and that the automatic fiscal stabilizers should be allowed to work, with any revenue shortfalls due to a weakening economy being accommodated in the near future rather than offset with expenditure cuts to meet budget targets. Going forward, the government's recently announced three-year budget plan maps out a transparent path for fiscal policy over the medium-term. We believe, however, that it is important that the government not commit to further large increases in public sector wages and pensions in future years given uncertainties about budget revenues—particularly from the oil sector—and the stage of the macroeconomic cycle in two or three years time.

The proposed reforms to the tax code in the non-extractive sector are a welcome step to help increase competitiveness in the sector and aid the government's goal of economic diversification. The proposals seek to broaden the tax base, lower most tax rates, and bring the rates applying to the corporate sector to competitive levels with key trading partners. In the subsoil sector, it is important that the reforms strike a balance between the government's desire to raise more revenues and promoting investment and production incentives in the sector.

The government's decision not to renew the export ban on wheat, which expired September 1, is a very welcome step. The mission urges the government to remove the remaining export restrictions on food and fuel items and refrain from imposing any duties on wheat exports. In order to help alleviate the impact of still high domestic food and energy prices, we believe that well-targeted temporary assistance programs to vulnerable social groups, which have been implemented with success in a number of countries, could be considered.

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[1] This represents the views of the mission team, and not necessarily those of the IMF.