Republic of Kazakhstan
Concluding Statement of the 2007 IMF Mission[1]

October 10, 2007

An IMF mission team visited Kazakhstan during October 3 - 10, 2007 to conduct discussions on the latest macroeconomic situation and policies.

1. The mission would like to thank the Kazakhstan authorities. The mission's objectives were to review economic and financial developments since the last Article IV consultation discussions, particularly the impact of the recent turbulence in global financial markets. The mission also assessed the near-term outlook and discussed monetary, exchange rate, and banking sector policies, as well as the ongoing preparations for the 2008 budget and key structural reform initiatives.

I. INTRODUCTION

2. Economic activity remained very strong in the first half of 2007. Real GDP expanded by over 10 percent, exports—both oil and non-oil—remained buoyant, and oil revenue saving continued to accumulate in the National Fund (NFRK). Fiscal revenue exceeded expectations on account of the strong economic growth and further gains in tax administration. At the same time, bank credit growth picked up to over 100 percent in June, financed in large part by a surge in external borrowing by banks. Meanwhile, CPI inflation, after moderating in early 2007, rebounded from mid-year.

3. Global financial turbulence in mid-2007 resulted in a sudden stop in banks' external funding and a sharp tightening of domestic liquidity conditions. External financing for banks dried up and their bond spreads in international markets jumped. Liquidity conditions in the domestic money market tightened correspondingly. The tenge came under pressure, but the National Bank of Kazakhstan (NBK) intervened heavily to support it.

4. The longer-term outlook remains favorable, but with considerably greater uncertainty in the near term. The baseline assumption for now is that access to international markets will remain closed in the coming months, implying sharply slower credit growth and a corresponding slowdown in imports. Consequently, underlying inflationary pressures would ease, although headline inflation—which has been affected by shocks to world grain prices and increases in prices of regulated services—could persist near current levels for some time. Should the closure of international markets become prolonged, however, the slowdown of activity could deepen. On the other hand, an early recovery of international investors' appetite for Kazakhstan exposure, say by early 2008, could push credit growth back to an excessive pace and rekindle inflationary pressures.

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

II. EVALUATION OF ECONOMIC POLICIES AND RECOMMENDATIONS

5. Appropriate measures have been taken to soften the liquidity crunch. The NBK injected liquidity through its refinance window, allowed banks to borrow against their required reserves, and engaged in large-scale purchases of its outstanding notes. In addition, implementation of tighter reserve requirements was deferred until January. The NBK also announced that it stood ready to furnish liquidity, if needed, to help banks meet their external debt amortization payments ($3.8 billion in the fourth quarter of 2007 and $8 billion in 2008).

6. Increasing the cost of borrowing from the NBK, together with greater exchange rate flexibility, will help curb downward pressure on the tenge in the near term. This will also help facilitate resumption of the trend real appreciation of the tenge over the medium term, driven in part by the expected persistence of high world oil prices.

7. Strong supervisory vigilance over the banking sector is needed. The tightening of prudential regulations by the Financial Supervision Agency (FSA) over the past year—including tougher asset classification rules, risk weights, collateral requirements, and liquidity norms—has put banks in a stronger position to weather the more difficult environment they now face. Although financial soundness indicators for the banking system remain adequate, any decline in the quality of loan portfolios would likely not affect the indicators for some time. Thus, intensified supervision efforts are needed to ensure that banks' framework for managing liquidity risk is adequate and they continue to comply with prudential regulations, especially loan classification and provisioning requirements. The mission welcomes plans to require banks having prolonged and/or repeated recourse to liquidity from the NBK to meet strict conditions, possibly including steps to increase capital and provisioning. Enhanced analysis and inspections will also aid in detecting and addressing the emergence of any solvency issues.

8. The mission understands that measures to support the construction sector, which has been hit hard by the liquidity crunch, are under consideration. While steps to facilitate the completion of construction projects already underway would carry clear social benefits, care should be taken to avoid distorting the efficient allocation of bank credit. By the same token, and in order not to reward excessive risk-taking, the measures should ensure that any losses that arise are shared evenly across all parties, including banks, construction companies, as well as the end-purchasers.

9. The fiscal position remains very strong. Impressive gains in tax administration have resulted in strong non-oil revenue performance, while oil revenue has been boosted by strong world oil prices. The preliminary budget for 2008 envisages a moderate increase in spending relative to GDP, and implementation of previously announced cuts in social taxes and the VAT. Even with the marked cooling of economic activity now anticipated, the overall fiscal position should remain comfortably in surplus (5.3 percent of GDP) and—in light of the very strong long-term oil revenue outlook—the non-oil deficit (4.7 percent of GDP) will remain well within the sustainable level. The mission believes that the envisaged increase in spending to meet priority infrastructure and social development needs remains appropriate, but cautions that any further spending increase—beyond the preliminary planned level—could place an excessive burden on

monetary policy to combat inflationary pressures, unless activity slows more rapidly than presently anticipated.

10. An acceleration of structural reform will help sustain Kazakhstan's impressive economic performance over the long term. Early WTO accession and enhancing regional trade will be important steps. The mission welcomes the planned publication this year of the first audited report under the Extractive Industries Transparency Initiative (EITI). The mission notes the recent progress in broadening the coverage of public debt to include debt of state enterprises and development institutions, and in disaggregating imports data across the oil and non-oil sectors of the economy. Expeditious completion of these initiatives will aid in assessing underlying economic conditions. The mission also welcomes the initiation of the project to assess and improve public financial management, with World Bank assistance.