Republic of Kazakhstan
Concluding Statement of the 2006 IMF Mission[1]

October 20, 2006

An IMF mission team visited Kazakhstan during October 16 - 20, 2006 to conduct discussions on the latest macroeconomic situation and policies.

1. The mission would like to thank the Kazakhstani authorities for their hospitality. The mission's objectives were to review economic and financial developments since the last Article IV consultation discussions, assess the near-term outlook, and discuss the ongoing preparations for the 2007 budget. The mission also discussed monetary, exchange rate, and banking sector policies, as well as key structural reform initiatives.

I. Introduction

2. Kazakhstan's impressive economic performance continues. The authorities' sound management of the economy, which has been underpinned by a favorable external environment, has resulted in major gains. High world oil prices and increasing oil production in Kazakhstan have led to a sharp rise in oil revenue, part of which has been used to meet priority social and infrastructure needs. This has helped achieve a rapid improvement in living standards. Per capita GDP in dollar terms has tripled since the start of the decade. At the same time, a sizable share of the increase in oil revenue has been saved in the National Fund of the Republic of Kazakhstan (NFRK), which now has assets of $12 billion (17 percent of GDP). Buoyant oil and non-oil revenues have boosted the fiscal position, which remains in strong surplus. The external position is also strong, and the National Bank of Kazakhstan's official reserves have almost doubled this year to $12 billion (amounting to 6 months of imports of goods and services).

3. The near-term outlook remains favorable, but macroeconomic policies will need to focus increasingly on mitigating risks in order to sustain the strong economic performance. Real GDP growth exceeded 9 percent in the first half of 2006 and is expected to remain at about that pace in the near term. Unemployment continues to decline, reaching 7 percent in mid-2006. However, inflationary pressures have intensified, with consumer price inflation remaining in or near the 8.5–9 percent range since the start of the year. The planned 30 percent increase in civil service salaries from January, together with the significant fiscal stimulus implied by the preliminary 2007 budget, means that the burden of combating inflation will fall squarely on monetary policy.

II. Evaluation of Economic Policies and Recommendations

[1] This represents the views of the mission team, not of the IMF, and these views may evolve as the staff assessment presented in the staff report on Kazakhstan is produced.

4. A number of welcome measures aimed at tightening the monetary policy stance have been taken in recent months. The reserve requirement was broadened, the policy interest rate (the NBK's deposit interest rate) was raised by 25 basis points, and the NBK stepped up issuance of central bank bills. As a result, banks' average lending interest rates rose by about 100 basis points since early 2006 to over 15 percent. The NBK also allowed the tenge to appreciate significantly, which helped keep inflation from rising further.

5. Further monetary policy tightening will be needed to keep inflation in check. Broad money and bank credit growth remain very high (58 percent and 77 percent, respectively, on a year-on-year basis in August), and banks' external borrowing continues to increase rapidly. Moreover, the significant depreciation of the tenge since late July will likely translate into higher traded goods prices in the coming months. Thus, additional increases in the policy interest rate—which remains well below international rates and is negative in real terms—are needed to slow money and credit growth, and consideration should also be given to raising reserve requirements. A reversal of the recent depreciation of the tenge—which has almost fully unwound the previous appreciation—will be in line with the underlying fundamentals and critical in containing inflation. Resisting nominal appreciation will likely force the inevitable real appreciation to come through higher inflation.

6. It must be recognized that tighter monetary policy and exchange rate appreciation will carry a cost. Higher policy interest rates, along with the greater volume of sterilization, will increase sterilization costs. And a stronger tenge means that the value of the NBK's international reserves will decline in tenge terms, implying sizable (unrealized) revaluation losses. While legislation was passed last year that envisages capital injections for the NBK to offset such costs, its underlying principle needs to be more widely understood. Such losses are an inevitable accompaniment to policy tightening. If they are not compensated on a timely basis by the budget, they will constrain the conduct of monetary and exchange rate policies and result in higher inflation.

7. Important steps to tighten prudential regulations have also been taken to complement the monetary policy measures. These include tighter regulations on related-party lending, real estate exposure, and cross-border loans. In addition, banks' foreign currency liquidity norms have been tightened, open foreign currency position limits have been reduced, and a limit on short-term external liabilities (related to bank capital) has been introduced.

8. The prudential measures are expected to help stem banking sector vulnerabilities, but additional steps may be needed if bank credit growth and external borrowing do not slow markedly in the coming months. In such circumstances, further tightening and/or broadening external borrowing limits—possibly to cover banks' medium- and long-term external debt in addition to their short-term debt—and of foreign currency liquidity norms would reduce banks' vulnerability to a sharp tightening in the availability of external financing. In addition, consideration should also be given to adjusting risk weights for capital adequacy purposes, to help slow credit growth and limit the risk of a rapid deterioration in the quality of loan portfolios. Heightened supervisory vigilance over bank lending—including their foreign lending and

investments—and banks' credit risk management practices will also be critical. In this connection, an expansion in supervisory resources, especially qualified bank examiners, will be critical in ensuring timely bank inspections.

9. Efforts are being undertaken to enhance the monitoring of external debt. External debt statistics have been reconciled with monetary data on banks' external liabilities. Plans to widen the coverage of public debt to include state enterprises' obligations are also welcome. Compilation of private external debt statistics on a remaining maturity basis, and of the maturity profile of external obligations, will be very useful in assessing vulnerabilities and rollover risks. While arbitrary targets for the total external debt to GDP ratio would not be advisable, policies should focus on limiting a further rapid build up of external obligations, especially in the banking sector.

10. The assessment of vulnerabilities will also be aided by progress in disaggregating balance of payments data across the oil and non-oil sectors of the economy. This will help in understanding, for example, how much of the recent increase in imports can be attributed to investment in oil production and transportation. The Fund's Statistics Department has recently provided technical assistance in this area. The mission understands that the necessary information is available and urges expeditious progress in enhancing coordination among the relevant agencies—including the Ministry of Energy—that is needed to prepare the data disaggregration.

11. Kazakhstan's fiscal position remains comfortable, implying significant room to expand spending and reduce taxes without compromising fiscal sustainability, provided further monetary and prudential tightening is undertaken expeditiously. The draft 2007 Republican budget envisages a cut in the VAT rate by one percentage point (to 14 percent) and the introduction of a flat 10 percent personal income tax to replace the existing 5–20 percent progressive rate structure. Capital spending and injections into development institutions will also increase markedly. In addition, the second stage of the civil service wage reform, which includes an increase in wages by 30 percent, will be implemented in January. Plans are being finalized to supplement this with reform of the civil service structure, which will likely include a 30 percent reduction in staff positions, the majority of which are presently vacant, during 2007. As a result, general government spending is expected to increase by about 25 percent, underscoring the need for intensified scrutiny over expenditure efficiency, and the non-oil deficit will widen by about 0.7 percent of GDP. The implied fiscal stance also underscores the need for monetary tightening and exchange rate appreciation to keep inflation from rising further.

12. Decisive action to accelerate structural reform will be key to diversifying the economy. Early WTO accession and further progress in enhancing regional trade will be important in this regard. The newly-formed holding company for the major state enterprises (Samruk) and the Sustainable Development Fund (Kazyna) appropriately seek to improve the performance and focus of state enterprises and development institutions. Progress in achieving these objectives would enhance the provision of infrastructure services, thereby boosting the economy's longer-term growth potential. Improved focus of development institutions' operations should also help

in avoiding distortions to the efficient allocation of resources across the economy. The mission also notes that steps have been taken to implement the Extractive Industries Transparency Initiative (EITI) and urges expeditious completion of the remaining steps to publish the audited reports, which will mark an important gain in transparency.