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Statement by Mr. Mozhin and Mr. Palei on Republic of Kazakhstan
(Preliminary)
Executive Board Meeting 07/55
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1. We welcome the continuing fast GDP growth mostly driven by the non-oil economy of Kazakhstan. Many years of very high growth were accompanied by a trend toward more equitable distribution of income, with the Gini index declining from about 35, in 1999, to 28, in 2005. In turn, high growth and favorable distribution of income led to a significant poverty reduction. While the economic outlook for Kazakhstan remains bright, the authorities are facing a number of challenges.

2. Last year staff called for a more restrictive monetary policy to contain the risks of rising inflation. From an informative BUFF by Mr. Kiekens and Mr. Saudabaev we note that inflation did decline from a high rate of about 9 percent in February-April of last year to about 7.6 percent in May of this year. However, the data presented in the staff report painted a controversial picture of the conduct of monetary policy. On the one hand, in 2006, with broad money growing by 80 percent, much faster than in 2005, changes in the monetary aggregates pointed to a significant easing of monetary policy. On the other hand, the authorities have increased the reserve requirements and imposed additional prudential safeguards to slow down the private credit growth and limit the risks to the banking sector; the NBK has stepped up the issuance of its notes; and the real exchange rate has appreciated by almost 8 percent, faster than in 2005.

3. While the stance of the monetary policy in 2006 remains open to questioning, fiscal policy certainly played a prominent anti-inflationary role. At the time of the previous Article IV Consultations both the authorities and staff expected the non-oil fiscal deficit to remain close to the level of 2005, at about 4.8 percent of GDP. However, the outcome of 2.8 percent of GDP was much more favorable. At the same time, against the background of limited increase in oil production and the decline in fiscal oil revenues, the overall fiscal surplus has increased from 5.8 to 7.5 percent of GDP. It appears that inflation has been contained largely due to more restrictive fiscal policy rather than to monetary policy, and the policy mix in 2006 was quite different from the one expected a year ago.

4. In 2007 the authorities aim at significant fiscal loosening compared to the previous year. It seems to us that a much more restrictive monetary policy would be required to compensate for a weaker support from the fiscal side, and we are not sure whether such tightening would be feasible. We note that staff forecast CPI to remain at a level of 8.5 at the end of 2007. Assuming that capital inflows do not abate this year and taking into account larger non-oil deficit, how large, in staff's opinion, should the main adjustments be in the key parameters of the monetary policy stance to ensure that inflation remains in check in Kazakhstan?

5. Current macroeconomic challenges in Kazakhstan illustrate the difficult trade-off faced by many energy exporters when they are trying to balance the need to preserve medium-term macroeconomic stability with the pressing demands for social and infrastructure development. We believe that more cross-country comparative analysis in this area would be very useful for many Fund members, and the MCD is well-placed to shed light on how this trade-off is being addressed in various countries.

6. Over the last year large capital inflows, especially external borrowing by the banks, were among the main factors complicating macroeconomic management. While it is difficult to predict the scale of additional capital inflows in the future, we agree with staff that the authorities should be prepared for a continuation of this worrisome trend. We welcome the measures introduced by the NBK aimed at slowing down the rapid growth of domestic credit, including higher reserve requirements and policy interest rates. Tighter prudential controls imposed by the FSA may also lead to at least temporary moderation of credit growth largely financed by external borrowing. However, the main goal of prudential measures is to ensure the stability of the banking sector, not to deliver low inflation. After a period of adjustment, including increases in bank capital, banks may be able to resume active foreign borrowing. At the same time, large corporations may step in to compensate for the "shortfalls" in foreign borrowing stemming from the banks.

7. For Kazakhstan, it would be important to distinguish between the healthy increase in access to international capital markets observed in many emerging market economies and excessive inflows related to other reasons. In this respect, we note that the authorities and staff are concerned about the role of "one-way bet" on the tenge appreciation. While recognizing the role of the incentives based on perceptions of a significant undervaluation of the currency, the authorities are also wary of the risks associated with the rapidly appreciating tenge and/or higher domestic interest rates, which may compromise the exporters' competitiveness and invite additional speculative inflows. Implementation of staff's advice on monetary policy would move the Kazakhstani authorities much closer to inflation targeting, and it is not clear whether they are ready for such a move. Also, we would be cautious in interpreting the existing evidence on the negligible, if any, effects of the real exchange rate appreciation on competitiveness, because, since the devaluation of 1999, the real exchange rate appreciation in Kazakhstan has been relatively small when compared to several other countries. There is also a significant uncertainty regarding what may happen

to capital inflows in case the authorities embark on a more aggressive monetary tightening, including nominal appreciation of the tenge. Over the last several years many commodity exporters relying on inflation targeting and flexible exchange rates, including Canada, Australia and New Zealand, had to deal with significant nominal and real exchange rates appreciation. The experience of these countries shows that the ability of an economy with significant dependence on commodity exports to adjust to possible large swings in nominal exchange rates to a great extent depends on the depth of its financial sector, and, unfortunately, we know little about this sector in Kazakhstan.

8. The Kazakhstani authorities face a choice between the continuation of their current monetary policy and following the staff advice on allowing significantly more exchange rate flexibility. While staff seem to imply that there would be little difference between the two approaches in terms of real exchange rate appreciation, such an outcome is not predetermined and requires further analysis. At least from the authorities' perspective it may be safer to tolerate high single-digit inflation rather than risk triggering speculative capital inflows and possible large swings in the exchange rate, which may have negative consequences for growth. In light of the above, we believe that in order to make staff's policy recommendations more persuasive, more analysis is needed on the role of the fiscal policy in containing inflation, on the likely effects of further real exchange rate appreciation on competitiveness, on the authorities' readiness to move faster toward inflation targeting, and on the structure of the broader financial sector in Kazakhstan.

9. In the area of structural reforms, the authorities have already achieved commendable progress, reflected in their fast improving rating in 2006 Global Competitiveness Index as well as in their movement from the 82nd to the 63rd place in Doing Business database. The latter improvement was almost entirely due to better ranking in the area of "Getting Credit". We note that the authorities are in the process of streamlining their licensing procedures, plan to improve regulation and enforce competition in the infrastructural and other key sectors, and intend to step up their privatization efforts. One area where they still have to tackle many challenges is international trade, which is important not only for the Kazakhstani economy, but for other countries in the region as well. We would like to hear staff's comments on any changes in this area.

10. We welcome the progress achieved in implementation of the EITA, including the broadening of the list of participating companies. We would also like to know more about the incorporation of the NFRK activities into the budget and about the authorities' plans for structural changes in taxation. We also recall that staff and the authorities had previously discussed the possibility of updating the ROSC on fiscal transparency, and we would appreciate more information on this matter.

The format of Article IV Consultations Report on Kazakhstan

11. The Kazakhstani economy is going through an extremely rapid and very deep economic transformation. As it is well described in the staff report, the authorities are facing major challenges in macroeconomic management. The country plays an increasingly important economic role as one of the major energy suppliers, and the developments in Kazakhstan already affect in a major way many neighboring countries. In addition, Kazakhstan is one of the leading reformers in the CIS region, and dissemination of the lessons from its experience is a primary responsibility of the Fund. All of the above certainly calls for more, not less surveillance by the Fund.

12. In this respect we are having difficulties in understanding the rationale for the preparation of a very short Article IV report. Similar to last year, staff have not prepared the Selected Issues Paper. We did not find any recent working papers on Kazakhstan either. While we broadly agree with the key policy recommendations contained in the staff report, we were disappointed by somewhat sketchy analysis to support them. The main text of the staff report appeared to us overly descriptive, primarily focusing on the authorities' views, at the expense of the analysis by staff. Sometimes it was difficult to understand from the report whether staff did carry out an additional analysis to support their views and policy advice, but decided not to provide it to the Board. For example, in paragraph 14 devoted to vulnerabilities of the banking system and the stress-testing exercise there was a reference to "illustrative scenarios analyzed by staff", but we did not find this analysis in the paper. The material in Box 3 invites similar questions.

13. We are not sure to what extent the choice of the format of the Article IV report on Kazakhstan was driven by the MCD and to what extent it was defined by the Fund-wide rules. If the sketchy analysis/description was the result of the MCD's decisions, we would like to understand the reasoning behind such a treatment of Kazakhstan. If it was rather the result of the Fund's policy decisions in the area of streamlining, these rules, in our opinion, should be reconsidered as soon as possible, as we find them to be detrimental to the quality of the reports. We believe that the abridged Article IV reports are an impediment to the Fund's efforts to make its surveillance more effective and its advice to the authorities more persuasive. We would like to hear staff comments on these issues.

Treatment of broader financial sector

14. After reading the report we realized that Kazakhstan was not among the 10 lucky countries chosen by the Fund for an in-depth surveillance of the financial sector, but we would like to reiterate our call for close attention to this sector in Kazakhstan. One of the few relevant facts presented in the report was about the very large amounts of primary Eurobond issues by the Kazakhstani banks. What is the situation with non-financial entities? Do staff have information about the Kazakhstani entities' plans for bond placements abroad? What is the size and the role of the offshore IPOs?

15. Information on the size and liquidity of domestic financial markets is also essential for evaluation of the macroeconomic policies as well as for vulnerability analysis. According to the media, capitalization of the stock market in Kazakhstan has tripled since 2005 and now amounts to about 60 percent of GDP. It would be useful to understand to what extent it was the result of additional listings on the stock exchange and to what extent this growth could be attributed to changes of asset prices. Furthermore, was there any evidence of excess liquidity affecting equity prices? Similarly, what are the developments in the property market? The analysis of the domestic bond market, including corporate bonds, and a look at the role of foreign investors may provide useful information on the prominence of "one-way bets" on the tenge. And having a grasp on the liquidity and depth of the foreign exchange market may highlight the risks of abrupt reversals in the direction of capital flows.

16. We realize that the Fund still does not have a well-articulated approach to financial sector surveillance, and we look forward to the results of the ongoing experiment in this area. We also hope that information on the broader financial sector and the associated analysis will be incorporated in the future reports on Kazakhstan.