October 30, 2008
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 08/61-1

12:30 p.m., July 9, 2008

1. Republic of Kazakhstan—2008 Article IV Consultation

Documents: BUFF/08/97; SM/08/173 and Supplement 1; SM/08/181; SM/08/219

Staff: Callen, MCD, Lohmus, MCM, Boote, PDR

Length: 1 hour, 19 minutes

Executive Board Attendance

T. Kato, Chair

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE), Temporary
	G. Mpatswe (AF), Temporary
	V. De la Barra (AG), Temporary
	S. Na (AU), Temporary
W. Kiekens (BE)	
	R. Perez (BR), Temporary
H. Ge (CC)	
	A. Umaña (CE), Temporary
	M. Morgan (CO), Temporary
	A. Lahreche (FF), Temporary
K. Stein (GR)	
	D. Mohanty (IN), Temporary
	F. Valeri (IT), Temporary
	H.Yamaoka (JA)
	S. Rouai (MD), Temporary
	S. El-Khouri (MI)
	Y. Yakusha (NE)
	J. Hukka (NO), Temporary
A. Mozhin (RU)	L. Palei (RU), Temporary
	S. Alnefaee (SA), Temporary
	A. Eng (ST), Temporary
	A. Raczko (SZ)
	S. Lin (UA), Temporary
	V. Pillai (UK), Temporary

B. Esdar, Acting Secretary
W. Rahman-Garrett, Assistant

Also Present
IBRD: M. Teymourian. Middle East and Central Asian Department: T. Callen, F. Hasanov, A. Husain, N. Ilahi, N. Laframboise, C. Oner, D. Owen, L. Perez, R. van Rooden. Monetary and Capital Markets: P. Lohmus, N. Saker. Office of the Managing Director: P. Gerson. Policy Development and Review Department: A. Boote. Secretary's Department: O. Vongthieres, M. Yslas. Statistics Department: C. Gorter, A. Jimenez de Lucio. Senior Advisors to Executive Directors: F. Yang (CC). Advisors to Executive Directors: H. Caracalla (MI), C. Denk (GR), D. Muradnazarov (SZ), D. Orynbayev (BE), Y. Shinagawa (JA).

1. REPUBLIC OF KAZAKHSTAN—2008 ARTICLE IV CONSULTATION

The staff representative from the from the Middle East and Central Asia Department (Mr. Callen) submitted the following statement:

> The following information has become available since the staff report (SM/08/173, 6/17/08) was issued. These developments do not change the thrust of the staff appraisal.
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> Recent data releases show that:
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> The CPI increased by 1.2 percent (m/m) in June, and by 5.7 percent in the first half of 2008. The year-on-year inflation rate rose to 20 percent in June, from 19.5 percent in May. Food price inflation was a little over 29 percent (y/y) in June, while non-food prices rose by 13.6 percent (y/y).
>
> The current account swung from a deficit of $2 billion in the fourth quarter of 2007 to a surplus of $3.9 billion in the first quarter of 2008 due to a sharp slowdown in imports and higher oil prices. The financial account remained weak in the first quarter as bank access to external financing declined.
>
> Official foreign currency assets have continued to rise. At end-June, foreign exchange reserves stood at $21.2 billion and NFRK foreign currency assets at $25.7 billion.
>
> The National Bank of Kazakhstan (NBK) lowered its refinancing rate from 11 percent to 10.5 percent on July 1. It also announced that minimum reserve requirements would be cut from 6 percent to 5 percent on domestic liabilities and from 8 percent to 7 percent on other liabilities as of July 29. The cut in reserve requirements is expected to free up about T 90 billion ($750 million) in liquidity for the banking system. The NBK cited its desire to support credit expansion and growth and its expectation that inflation will ease in the second half of the year as the reasons for its actions.
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> In the financial sector, non-performing loans on bank balance sheets have continued to rise, reaching 16.4 percent of total loans ("broad" definition) at end-May, up from 15.3 percent at end-March (on the "narrow" definition also shown in the staff report, NPLs increased to 4.4 percent at end-May, from 3.7 percent at end-March).

An investment fund based in the United Arab Emirates has recently announced its intention to increase its stake in Kazkommertsbank, Kazakhstan's second largest bank, from 8 percent to 25 percent (the transaction still requires regulatory approval). Lastly, the Kazakhstan Deposit Insurance Fund (KDIF) has received a capital injection from the NBK of T 14 billion, almost doubling its capital to T 30 billion ($250 million).

Mr. Kiekens and Mr. Orynbayev submitted the following statement:

The Kazakh authorities welcome the Article IV consultation discussion with the Fund and commend the staff for the productive dialogue and helpful recommendations.

General Remarks

Kazakhstan has been integrating smoothly into the global financial system in the last decade. However, the global financial crisis, which originated in August 2007, has also affected Kazakhstan. External financing has significantly declined, thereby dampening GDP growth. Fortunately, these effects have been mitigated by the country's solid public finances.

Short-term Outlook

The short-term outlook remains positive. Oil receipts are projected to rise and the continued high prices for commodities should provide extra budget revenues. The Kazakh authorities are confident that, notwithstanding the ongoing repricing of risk, the economy will weather the ongoing financial market turbulence and that commercial banks will be able to meet their external payments in a timely manner. As global liquidity remains tight, the National Bank of Kazakhstan is committed to provide liquidity to domestic banks.

In the first quarter of 2008, the authorities introduced an export ban on wheat and vegetable oil in order to maintain price stability and protect low and middle-income class families from high food prices. The export bans will be reconsidered by the end of the summer in light of the new harvest. The authorities will continue promoting the country's vast agricultural potential.

Fiscal Policy

In order to promote the diversification of the economy, the authorities intend to adjust taxation by reducing the corporate income tax rate for the non-oil sector. Duties for oil exporters will be increased, while respecting the existing agreements on production sharing concluded in the previous decade. Thus, although those investors benefit tremendously from high crude oil prices, the authorities are committed to maintaining the low tax burden until the expiration of the existing agreements.

Banking Sector

Although the quality of the credit portfolio of banks has been deteriorating, banks remain well capitalized and profitable. The exposure of the Kazakh banks to the real estate sector is a significant source of vulnerability. It is useful to note that in Kazakhstan borrowers are required to pay a down payment of 20 percent of a real estate transaction and remain reliable for the remainder of the entire credit if the market value of real estate drops.

The Kazakh banking sector is relatively highly concentrated. Eight banks out of 35 account for 85 percent of total assets. Last April, the six largest banks signed an agreement with the National Bank of Kazakhstan (NBK) on a short-term liquidity support. The NBK expanded the list of acceptable collateral on which a margin is applied. Acceptable collateral includes debt instruments issued by domestic or foreign private companies, and foreign governments with good credit standing.

During the first quarter of 2008, Kazakh banks repaid about US$ 7 billion external financing. The total amount of external financing falling due in 2008 is US$ 17 billion. The authorities believe that in the second part of the year a more significant part of the external financing will be rolled over. During the same period, domestic deposits remain broadly stable, growing at a modest pace of 1 percent to 2 percent.

Monetary Policy

The authorities are confident that the inflation target of 9 percent can be achieved while broad exchange rate stability can be preserved.

Real Estate and Construction Sectors

The developments in the financial markets have considerably dampened activity in the real estate and construction sectors. Growth in the construction sector dropped from 35 percent on average in the previous years to 15 percent in 2007. Property prices have declined significantly; about 40 percent for all the property built in the 1970s – 1980s, and 5 to 20 percent for more recent constructions. It should be noted that, especially for older properties, prices have risen steeply in the last ten years, in some instances 10 to 15 times.

Although the demand for property remains high, in Almaty, Astana and elsewhere some construction projects have been interrupted because of the lack of available financing. However, with the support of public finances, part of the construction projects could be resumed after an only short interruption. Nevertheless, less well-capitalized construction companies could be going out of business and it will take more time for other construction projects to be resumed.

The authorities are committed to supporting low and middle-income families with low-interest mortgages provided by the Kazakh Mortgage company. This group includes teachers, health care workers, other government employees and young parents.

Structural Reforms

The government is developing a new tax code which will ease the tax burden on the non-oil sector. The authorities are also developing a new budget law to lengthen the budget framework from the current one year to a three year period.

Competition policy will be strengthened to combat the restriction or distortion of competition and to avoid the emergence of new monopolies or the abuse of dominant market positions.

World Trade Organization

The Kazakh authorities are advancing with their agenda for accession to the WTO. Bilateral negotiations with 20 WTO member states have been concluded. Negotiations are ongoing with the United States, the European Union, Australia, India and Mongolia. In early June, another round of negotiations with the U.S. authorities took place in Washington, D.C. Agricultural subsidies and anti-dumping duties against Kazakh steel products were among the main topics and negotiations could be finalized on such issues as the financial and telecommunication sectors and the export regime for U.S. meat products. A hopefully concluding round of negotiations between the United States and Kazakhstan, on WTO access, is scheduled for the fall of this year.

Mr. Alazzaz submitted the following statement:

I thank the staff for the well-written set of papers and Mr. Kiekens and Mr. Orynbayev for their helpful buff statement. Kazakhstan has made impressive economic gains in recent years, supported by prudent macroeconomic policies and structural reforms. Indeed, real per capita income has doubled since 2000 and social indicators have improved. However, the ongoing global financial turmoil has negatively impacted Kazakhstan's economy. Indeed, a sharp decline in external financing has sharply curtailed bank lending, slowed growth, and increased downside risks to the outlook. That said, it is reassuring that Kazakhstan has large financial resources to help withstand the current difficult situation and that the authorities have taken a number of measures to mitigate risks. In this regard, maintaining a prudent macroeconomic stance while strengthening the banking sector and enhancing the climate for private investment by accelerating structural reform is essential.

In the fiscal area, I welcome the plan to take offsetting measures, including freezing of nonpriority spending, to meet the anticipated shortfall in revenues in 2008. I also note that the authorities are preparing new tax and budget codes to promote diversification of the economy and to simplify the tax system. As regards the possibility of a fiscal stimulus package in the event of a sharper-than-expected slowing in growth, I agree with the staff that it is important that such package should be well-targeted. Notably, it is important to ensure that any increased spending goes to areas that will enhance the economy's growth potential. In this connection, the ongoing efforts to strengthen expenditure efficiency with assistance from the World Bank are encouraging.

Turning to monetary and exchange rate policies, the National Bank of Kazakhstan has (NBK) appropriately adjusted its policy rate and minimum reserve requirements to balance a number of policy goals, including preserving financial stability and cushioning downside risks to growth. I also welcome that the NBK is closely monitoring developments in the economy and stands ready to adjust its policy stance. In this regard, it is important to take corrective measures if inflation does not ease in the second half of the year as expected. On exchange rate policy, I agree that exchange rate stability during the current period of uncertainty has helped maintain depositor confidence and limited the risks from the large foreign currency exposure of the corporate sector.

On the financial sector, the recent FSSA update underscores the need to address the increased financial vulnerabilities. In this regard, I welcome the authorities' ongoing efforts to strengthen the banking sector. In particular, I am encouraged to note that the Financial Supervision Agency (FSA) has intensified its supervision of banks and changes are planned to strengthen the regulatory framework. I am also encouraged that a Memorandum of Understanding on Financial Stability has been signed by the government, the NBK, and the FSA that would help manage financial stress.

Finally, I note the progress made in advancing Kazakhstan's accession to the WTO. I also welcome the move to secure the passage of AML/CFT legislation by year-end.

With these remarks, I wish the authorities further success.

Mr. Murray and Mr. Na submitted the following statement:

We thank staff for a well-focused report, and Mr. Kiekens and Mr. Orynbayev for their helpful buff statement.

Although the economy's medium-term growth prospects look favorable, given the extra budget revenues emanating from the rising trend of oil receipts and commodities exports, we point to the downside risks facing the economy, such as prolonged tight situations in global financial markets and the continued loss of confidence in the banking sector. In light of this, we welcome the authorities' recognition that the pace of economic expansion in recent years was faster than warranted, and support the policy packages which focus on managing a smooth transition to a sustainable growth path through pursuing sound macroeconomic policies and restoring banking sector stability.

We note with concern that the current macro-financial risks, partly due to the global financial market turmoil, could not be easily overcome without a well-planned policy mix, including the strengthening of financial supervision and further development of a financial safety net framework. The overheated economy, spurred by a rapid credit growth and the heavy dependence of the banking sector on foreign financing, has contributed to the vulnerability of the financial system. In this regard, we stress that priority should be given to strengthening supervision and regulation in the banking system. In particular, we note the significant exposure of the Kazakh banks to the real estate sector as well as their mortgage lending terms whereby borrowers are held liable for the remainder of the "entire" borrowing if the market value of real estate were to drop. As such lending terms could unduly constrain borrowers' liquidity and thereby aggravate the related financial market, there is a need to have in place a mechanism that would ensure smooth and orderly payment of the real estate borrowing. We would welcome staff's comments.

We welcome the Financial Supervision Agency's (FSA) stepped-up efforts in enhancing its supervision capacity, and call for the authorities to be vigilant in monitoring and to respond quickly to market developments. A Memorandum of Understanding (MOU) on Financial Stability is also commendable, as it sets out the framework for cooperation among the government, the National Bank of Kazakhstan (NBK), and the FSA. Looking ahead, the authorities need to speed up the implementation of the recommendations, set out in the accompanying FSSA update, and consider measures to enhance the authorities' ability to cope with the possible adverse developments in banks' financial positions, including through the revision of the banking law.

In the near term, the main concern is inflation, which rose to 20 percent in June 2008, with food prices rising over 29 percent simultaneously. We view the NBK's December 2007 decision to increase its policy rate to 11 percent as a suitable step in containing inflationary pressures, and encourage the authorities to take preemptive measures, if needed, to cope with further inflation pressures. With regard to the sharp rise in food prices, as in the case of other countries, we support targeted and temporary measures to support the vulnerable groups. We also encourage the authorities to develop agriculture and infrastructure sectors, which would boost local food production, enhance price flexibility, and improve distribution systems.

We note staff's assessment that there is no clear evidence of either overvaluation or undervaluation of Kazakhstan's REER, given its status as an oil exporter and the significant structural changes it has undergone in the past. While exchange rate stability, at the time of distressed external financing conditions, may have contributed to stabilizing inflation, we stress the need to return to a more flexible exchange rate policy if financial market situations improve.

With these remarks, we wish the authorities all the success in their future endeavors.

Mr. Silva-Ruete and Mr. De la Barra submitted the following statement:

Kazakhstan has been hit by the global financial crisis causing a contraction in external funding which has led to a slowdown in growth via credit restrictions. Inflation has also surged due to a rapid expansion of domestic demand and, recently, increasing food prices. In addition, asset quality in the banking system has been affected. However, we are of the view that the economy of Kazakhstan has strengthened in previous years and it is capable of resuming growth and subduing inflation, provided that an adequate policy mix is applied and it continues structural reforms to boost the business environment.

Banking Sector

As the staff report mentions, banks are facing liquidity constraints dealing with repaying loans to foreign debtors and meeting domestic borrowers' needs, while tackling credit rate downgrading. We commend the authorities' awareness of the consequences of a rapid credit expansion and we agree they need to strengthen bank supervision, with measures like close monitoring of the riskier banks, conducting stress tests, and putting in place provision requirements against contingent liabilities, as a proactive approach in light of the potential downside risks. We find the FSAP updated recommendations sound and timely and we hope the Kazak authorities will be able to pay due attention to the higher priority ones.

The Memorandum of Understanding between the Financial Supervision Agency (FSA), the government, and the National Bank of Kazakhstan (NBK) is an important step in dealing with additional financial distress, which may allow providing liquidity in an orderly manner while closely supervising the developments of the banking system operations. Additional capital for the deposit insurance fund is also commendable; in this regard, we would appreciate it if the staff would provide information on the contributions of the secured financial entities to such an insurance fund.

Exchange Rate and Monetary Policy

According to the staff report, the authorities will apply a tighter monetary policy to contain inflationary pressures, which sounds plausible at this time to avoid additional distress in the financial sector, as well as in the rest of the economy. We would appreciate the staff's comments on the net effect on money expansion resulting from the raise in the policy rate and the easiness of the reserve requirement rate on foreign liabilities.

We agree with the staff's position that—at this time—a stable exchange rate is needed to tackle distress in the financial sector, provided that the exchange rate is an important signal for depositors' confidence and there is no clear evidence that the real exchange rate is over or undervalued. We would also like to ask whether the Kazak authorities have succeeded in containing domestic food prices through imposing a ban on wheat and vegetable oil.

Fiscal Policy

The Kazak authorities are going to apply offsetting measures, such as putting a hold on "non priority" spending, for lower fiscal revenue arising from the slowing down of the economy. As a result of these measures, the fiscal stance would show a bigger surplus by the end of 2008 compared to 2007. We believe that this policy is adequate and prudent and would provide room for fiscal stimulus if necessary.

In the very short term this would also help to reduce inflationary pressures. We would appreciate the staff's comments on the coordination of the fiscal and monetary authorities regarding how much of a sharper-than-expected slowdown in growth they envisage to activate stabilizers.

With these comments, we wish the authorities every success in their endeavors

Mr. Kishore and Mr. Mohanty submitted the following statement:

We thank staff for their assessment and Mr. Kiekens and Mr. Orynbayev for their informative buff statement. After a period of remarkable growth, the Kazakh economy is projected to slow largely reflecting the adverse spillover from the financial sector. We broadly agree with the staff assessment and would limit our comments to a few areas.

Inflation

The elevated level of headline inflation is a major concern. In this context, we welcome the authorities' commitment to bring inflation down to a single digit level. While monetary policy has been relaxed to address financial stability considerations, policy tightening may be required if inflation does not revert to its targeted path.

Banking Sector

The reliance of the banking sector on external funds has increased the vulnerability of the financial sector. The problem in the banking sector seems to have been compounded by drop in asset prices. While banks remain well capitalized, deterioration of the credit portfolio could strain the capital base of banks. It is, therefore, important to strengthen supervision along side a close monitoring of banks' loan portfolio.

We welcome the steps taken by the NBK to augment liquidity in the banking sector. However, in view of shrinkage of external funding, banks need to strengthen their domestic deposit base to avoid a credit crunch.

With these comments, we wish the authorities success in their policy endeavors.

Mr. Lushin and Mr. Palei submitted the following statement:

Since the beginning of the financial turmoil in the U.S. and international markets, the performance of the emerging market economies has been generally good, which has led to lively debates on "decoupling". The Kazakh economy, however, has experienced an immediate severe contagion due to a "sudden stop" in capital inflows. According to the staff report, the lack of access to foreign financing led to a speculative attack on the tenge forcing the Central Bank to spend $6 billion (25 percent) of its foreign exchange reserves to prevent the unwarranted depreciation of the currency. The risks of devaluation and uncertainty about the ability of banks to handle the liquidity shock also led to bank runs. Banks had to curtail their credit, which brought several credit-dependent sectors of the economy, including the very important construction industry, to the brink of collapse. A string of credit rating downgrades of the banks and the sovereign followed and, probably, reinforced this violent market reaction, with spreads on credit default swaps widening and remaining elevated for a prolonged period of time.

The ferocity of the market punishment of Kazakhstan was and remains puzzling. While the risks for some commercial entities have certainly increased, creditworthiness of the sovereign should not have been in doubt. The overall fiscal balance was very strong, the authorities had ample foreign exchange reserves, especially if the assets of the NFRK were to be taken into account.

The outlook for Kazakhstan needs to be explained in greater detail. We agree with staff that some indicators raise questions about the quality of assets and credit risks in the banking sector as well as foreign exchange risks in the corporate sector. However, the outlook for the financial sector and the real economy depends on many assumptions, which, in our opinion, are open to debate.

For example, the magnitude of credit risks depends on growth outlook and other key assumptions. We seriously doubt that the ongoing financial distress in Kazakhstan even approaches in its magnitude and likely effects the well-known deep capital account crises in Mexico, Asia, Russia, Turkey or Argentina used as comparators in some of the stress tests. The Kazakhstani authorities have implemented major reforms in the financial sector and tried to follow best practices in this area. The minimum statutory CAR at 12 percent is high compared to many other emerging market economies. Asset classification rules are very strict, hence, the numbers on evolution on NPLs should be treated carefully. Several foreign banks have already expressed strong interest in acquiring shares of commercial banks. Coordination between the NBK and the FSA is being improved on a lasting basis. Relatively high concentration of assets in major banks and the still dominant role of the banking sector make the monitoring and consultations easier. The authorities are in a very strong position to provide additional financing to the sector, if it becomes necessary.

Similarly, the magnitude of foreign exchange risks depends on whether we consider the exchange rate to be overvalued. Last year the authorities and staff agreed that the real exchange rate was undervalued by about 20 percent, although this estimate was subject to caveats. Over the last year, while there has been some real appreciation of the tenge, we have also witnessed a doubling of oil prices. Given oil price developments and in light of Kazakhstan's very favorable oil production and export outlook, one would assume that the equilibrium exchange rate has also changed. We would be interested in staff's comments on the role of oil prices in estimating the equilibrium exchange rate in Kazakhstan.

Last year the current account balance was in deficit of almost 7 percent of GDP. We believe that the outcome was affected by one-off factors, as it had been relatively small in previous years. Moreover, according to table 2, on page 25, for 2008 staff expect a huge improvement in the current account in the amount of 13 percent of GDP, as well as the continuation of large surpluses in subsequent years. What explains this sharp turnaround? We believe that conclusions offered in Box 3 are questionable. Without additional evidence and more in-depth analysis, we remain of the view that the tenge is still very likely to be undervalued, and, accordingly, that foreign exchange risks are relatively minor.

We tend to be more optimistic than staff on the growth outlook for Kazakhstan for 2008. Staff expects a further slowdown in non-oil real GDP growth to 4.7 percent in 2008 and consider the risks to be on the downside. We note in this respect that real non-oil GDP growth has already declined sharply from 11.9 percent in 2006 to 8.7 percent in 2007. In 2005 and 2006 the non-oil sector growth was accompanied by very moderate growth of the oil economy. In 2006-07 the latter has accelerated to 7 percent and, in 2009, it is expected to pick up to 9 percent. What are staff's estimates of real GDP growth sensitivity to oil prices? This fact and the ongoing normalization of the situation in the financial sector, in our opinion, bode well for a more powerful non-oil growth recovery.

We note that staff largely agreed with the authorities' policy actions in the aftermath of the financial turmoil. In the monetary policy area, decisive and active use of foreign exchange reserves to stop the speculative attack against the tenge was entirely appropriate. In this respect, we agree with the authorities that the use of reserves and attention to the exchange rate stability during the period of extraordinary pressures on the balance of payments should not be considered by staff as a change in the exchange rate regime. In this particular case we doubt the need to reclassify the exchange rate regime as a de facto peg, especially given that reclassification should be a judgment call rather than a purely statistical exercise.

We agree with staff that normalization of financial conditions will allow more flexibility in exchange rate movements, in accordance with NBK's focus on inflation objective. We also share the authorities' view that in conducting its monetary policy the NBK will be able to gradually lessen its reliance on exchange rate management in favor of greater emphasis on policy interest rates. The envisaged development of the broader financial markets, including the debt market, will facilitate this transition, and we look forward to staff updates on the progress in this area.

The staff report referred to the initial disagreements on the appropriate fiscal stance under the current circumstances. Our more optimistic view on the nature of current difficulties in Kazakhstan makes it difficult for us to support the use of any major fiscal stimulus aimed at maintaining growth. At the same time, we agree with staff that fiscal policy should not aggravate economic difficulties in a procyclical manner. We are glad that, according to more recent information, the authorities are moving toward a middle ground.

At the same time, we would be interested in staff's views on the authorities' plans to shift the burden of taxation to extractive industries, while lowering the corporate tax rate and the VAT rate (paragraph 17, page 12).

We believe that the jury is still out on whether the international investors and credit rating agencies are excessively pessimistic about the resilience of the Kazakhstani economy. In any case, more work is needed to understand the roots of the turmoil. For example, one may wonder whether additional foreign exchange reserves or NBK's pre-arranged access to additional funds could have lessened the likelihood of a "sudden stop" (Box 2); whether a more forceful communications strategy could have played a role; whether the rules governing the NFRK have been excessively rigid.

We remain concerned about the coverage and depth of surveillance on Kazakhstan. We believe that in the case of Kazakhstan the Fund's bilateral surveillance had to be more comprehensive. Since 2005 Kazakhstan has not had a selected issues paper and, hence, could not benefit from staff's analysis of key policy challenges. As we have stated on previous occasions, Article IV reports on Kazakhstan are too brief to contain an in-depth analysis of the growing vulnerabilities and options to mitigate the associated risks. To be informative and persuasive they have to be supported by additional studies.

We believe that the experience with the Fund's surveillance on Kazakhstan should be an important input to the Board's discussion on the format of reports on Article IV consultations and on the framework for surveillance of vulnerable countries. In this respect, we would also like to ask staff whether during previous several years Kazakhstan has featured prominently on the radar of the Fund's Vulnerability Exercise. And, if it had, whether any additional inter-departmental consultations and enhanced monitoring procedures for this economy had been triggered before the onset of the crisis.

Mr. Sadun and Ms. Valeri submitted the following statement:

We thank the staff for an informative paper and Mr. Kiekens and Mr. Orynbayev for their useful buff statement.

After a period of positive macroeconomic developments, the recent financial turmoil strongly affected the Kazakhstan economy and added to the long-standing domestic vulnerabilities, such as high external debt and inflationary pressures. Market perceptions of Kazakhstani sovereign risk increased sharply in November 2007 and remained elevated until recently. As commercial banks' access to external funding was reduced, domestic liquidity conditions tightened and real GDP and property prices declined. Looking ahead, it is expected that the country's large financial resources would help weather the current difficulties. However, there are some important challenges that the authorities should address to reduce the vulnerabilities of the economy and to manage the current risks. We broadly concur with the staff's assessment and recommendations and would like to offer a few comments for emphasis.

After the financial turmoil, authorities reacted appropriately to address inflationary pressures and the sudden reduction of capital inflows. However, inflation still remains a concern: it was close to 20 percent in the first half of the current year, led by increases in food and energy prices. Given that the real interest rate is negative, a monetary tightening will be necessary at this stage. In addition, we concur with the staff that a stable exchange rate will contribute to helping the authorities contain inflationary pressures. Looking ahead, while a slowing economic growth might help to ease inflation, the authorities have to closely monitor and be ready to intervene as needed to bring inflation back to a declining path.

We share the staff's view that the health of the banking sector plays a central role for the outlook of the Kazakhstan economy. We acknowledge from the FSSA that vulnerabilities in the banking sector have increased significantly due to a massive external borrowing, excessive exposure to the property market, and growing liquidity constraints. While authorities are working to strengthen the prudential framework and improve the bank's governance, financial surveillance and risk monitoring need to be further improved. In this regard, the principles of the memorandum of Understanding (MOU) on Financial Stability, which help establish a framework for cooperation between the National Bank of Kazakhstan (NBK) and the Financial Supervision Agency (FSA) on periods of financial stress, is a step in the right direction.

We acknowledge the authorities' intent to address pressing social and infrastructure needs, bringing public finances more in line with development priorities. In light of the sharp deterioration of the non-oil fiscal deficit, the recently announced measures should be well targeted to contribute to cushioning the slowdown without undermining the medium-term stability. Therefore, a prudent fiscal policy will reduce the burden on monetary and exchange rate policy to ease inflationary pressures and prevent second-round effects. Efforts to improve the efficiency of public financial management are welcome and should be continued with the assistance from the World Bank.

Mr. Warjiyo and Mr. Eng submitted the following statement:

The staff report paints a worrisome picture of the Kazakh economy. Risks embedded in the banking sector have been brought to the fore as a result of the fallout from the US subprime crisis. The onset of a domestic liquidity crunch in August 2007 as external funding evaporated has put an abrupt stop to credit growth, sending asset prices on a downward spiral. Meanwhile, spreads have spiked as market perceptions of the economy turned sour. Commendably, the authorities' decisive actions have helped avert a full-blown crisis although the impact on the real economy has been noticeable, with GDP growth slowing sharply since the fourth quarter of 2007. With its huge financial resources, Kazakhstan is in a position of strength to ride out this period of uncertainty. Nevertheless, these are challenging times that call for continued proactive policy responses and added vigilance.

We commend the staff for the excellent report, particularly the assessment of the impact of the recent global financial turmoil to the Kazakh economy, including the regional linkages and spillovers in Box 1. We agree with the thrust of the staff report and offer the following comments for emphasis.

Banking Sector

The FSSA Update points to huge and rising vulnerabilities of the Kazakh banking sector. The banks' aggressive growth strategies in recent years on weakening lending standards have resulted in a significant build-up of credit risks. Additionally, heavy reliance on foreign wholesale funding poses liquidity and funding concerns while over-exposure to the (plummeting) real estate sector raises concentration risks. Against a backdrop of a slowing economy, prolonged uncertainties in global financial markets and volatile commodity prices, the materialization of these risks could severely impair the banking system and with it, the broader economy. Indeed, while financial soundness indicators remain healthy thus far, stress tests indicate that the solvency of the banking system would come under threat under admittedly extreme but nonetheless plausible scenarios. This underscores the need for the FSA to strengthen supervision of the banks, to ensure that they have in place prudent lending standards, sound risk management systems, and adequate capital and provisioning. Contingency planning, crisis management and bank resolution frameworks should also be reinforced. Notwithstanding the considerable progress already made, we encourage the authorities to step up efforts to these ends, including accelerating implementation of the 2004 FSAP Update recommendations. In particular, we take note from the Update that the bank resolution framework is rudimentary and the deposit insurance scheme is likely to be under-funded, and wonder how these issues would be addressed to weather any possible deterioration in the banking sector in the future. Further elaboration from staff is welcome.

Monetary and Exchange Rate Policy

We support the NBK's policy of maintaining a stable exchange rate given the current conjuncture. With depositor confidence still fragile and corporates highly exposed to foreign currency risks, a sharp depreciation of the tenge could translate into severe stresses in the banking sector whilst fanning inflationary pressures. In this regard, we are reassured by the authorities' confidence in preserving broad exchange rate stability and achieving the inflation target of 9 percent, as Messrs. Kiekens and Orynbayev indicate in their helpful buff statement. Nevertheless, we would appreciate further comments from staff on whether they consider the current policy stance to be adequate within the context of high and rising energy and food prices and given that inflationary expectations could have been unmoored with inflation hovering close to 20 percent in recent months. We also note from the staff supplementary statement that the authorities have just lowered the refinancing rate and the minimum reserve requirements; this injection of liquidity into the banking system could further fuel inflationary pressures. In addition, we would be interested in the composition of the foreign currency exposures of corporates. With the tenge tracking the depreciating US dollar, corporates could still face significant foreign currency risks if their exposures were in currencies other than the US dollar.

We note the wide divergence in the assessment of the exchange rate – ranging from 23 percent undervaluation to 16 percent overvaluation – and the subsequent conclusion that the exchange rate is neither under- or overvalued relative to its equilibrium level. This is in sharp contrast to the findings in the Article IV consultation last year when staff found the tenge to be undervalued by some 20 percent. This underscores again the patently clear methodological shortcomings with such assessments, especially for an oil exporting country whose economy is undergoing significant structural changes. We cannot help but question the usefulness of this exercise.

We note the reclassification of the exchange rate regime from the de jure managed float to a conventional peg. We hope that this academic exercise would not have the unintended consequence of attracting speculative attacks on the tenge. Staff recommends that greater flexibility be restored to the exchange rate once financial conditions improve. Presumably, this would result in another round of reclassification to the exchange rate regime. As with the exchange rate assessment, we wonder how useful this exercise is to the authorities.

GFSM 2001 Implementation

We thank the staff for the information note on the pilot study for Kazakhstan's adoption of the GFSM 2001 framework. We are pleased to note that the authorities have found the framework useful and we encourage them to migrate to the new framework at a pace commensurate with their resource availability and capacity.

With these remarks, we wish the authorities success in their endeavors.

Mr. Stein and Mr. Denk submitted the following statement:

We thank the staff for a valuable and well-focused set of papers. The analysis of regional linkages and spillovers in Box 1 was particularly appreciated and constitutes a good example of how the Fund can capitalize on its cross-country expertise. Furthermore, when describing the unfolding of a financial sector crisis, an appendix with a timeline of events might be useful for similar cases in the future. For the next Article IV report on Kazakhstan we would also suggest to include a more extensive sensitivity analysis on the impact of changing oil prices on the economy. Finally, we would like to thank Mr. Kiekens and Mr. Orynbayev for their concise buff statement.

Kazakhstan has been exposed to the full force of global markets since the last Article IV consultations. On the downside, the financial turmoil has reached Kazakhstan quickly, leading to a sudden stop of external financing for Kazakhstani banks. On the upside, surging oil prices created substantial windfall profits for the budget. The latter puts the country in a relatively favorable position to weather the storm in the financial markets. While the current juncture is certainly challenging, it also contains the seeds for building a more stable and sustainable basis for the financial system. We also share the staff's positive medium-term outlook for Kazakhstan's growth prospects.

Since we agree with the thrust of the staff appraisal we limit our comments to the following points:

With inflation rising to 20 percent yoy, we were surprised that the National Bank of Kazakhstan cut its refinancing rate from 11 percent to 10.5 percent last week. We would be interested to learn about the reasons why the authorities believe that inflationary pressures will subside during the remainder of the year and whether the staff shares this view. We would also invite the staff to comment on the authorities' assessment that the inflation target of 9 percent can be achieved.

We agree with both the staff and the authorities that the extraordinary circumstances in the financial sector warrant a temporary shift to a stable exchange rate. Under current conditions in commodity markets, Kazakhstan can credibly pursue such a policy. What would be the staff's advice, however, if oil prices were to drop suddenly?

The banking sector continues to be under significant pressure. In line with the FSAP Update, we are most concerned about credit risk stemming from the real estate sector and about the large external refinancing needs for the remainder of the year. Given the risk that Kazakhstan might lose its investment grade rating, external debt financing might remain challenging for a while. As an immediate measure, encouraging banks to strengthen their capital base seems prudent. Over the longer term, developing a domestic capital market would allow banks to reduce their dependence on external wholesale financing. Finally, we welcome the authorities' steps to strengthen the regulatory framework and financial safety net. We hope that they will become operational soon.

We encourage the authorities to lift the ban on wheat exports as soon as possible. Such a move would bolster agricultural producers' incentive to increase their output. It would also be consistent with the authorities' efforts to strengthen regional cooperation in Central Asia. To cushion the impact of rising food prices for consumers, the authorities could consider targeted subsidies to the most vulnerable parts of the population, as effectively demonstrated by a number of Fund Members.

We welcome the authorities' measures to support good governance and to improve the business climate. The first report under the EITI is particularly appreciated. The passage of the draft bill on AML/CFT would be another important step to secure the integrity of the financial system.

Mr. Yamaoka and Ms. Shinagawa submitted the following statement:

We thank the staff for their well-written report, and Mr. Kiekens and Mr. Orynbayev for their helpful statement.

Inflation

Kazakhstan's annual inflation, which was 7.6 percent in May 2007, has followed an upward trend and has now reached 20 percent (June 2008). The staff expects that the annual inflation rate will decline to 9.7 percent at the end of 2008. Although we could somewhat expect a decline in the annual inflation rate due to the end-2007 surge in the consumer price index, our back-of-envelope calculation, which considers some historical seasonality factors (i.e., inflation has likely increased during the fourth quarter of every year, especially in October), implies difficulty in achieving a single-digit inflation rate by the end of 2008. Moreover, although the staff's assessment states that "there is yet no pressure on wages," the nominal wage is still increasing almost in line with annual inflation, which would continuously cause an upward pressure on prices. In addition, in July, the National Bank of Kazakhstan (NBK) proceeded to ease, not tighten, its monetary policy. Given the above, we would welcome the staff's further elaboration on their inflation projection, if any.

Financial Sector

A high Non-Performing Loan (NPL) ratio and heavy concentration of lending to the construction and real estate sectors are evidence of the banking sector's substantial vulnerability. Moreover, significant volatility in bank loans seems to have generated instability in the real economy, given that the past economic boom was in line with a drastic credit expansion and a decline in bank lending, observed since last August, has been accompanied by weak manufacture and construction indicators.

High volatility in bank credit often stems from a high NPL ratio and limited buffers against possible credit losses, given that the economic slowdown may immediately increase credit risks and impair the risk-taking capacity of banks. Moreover, the experience of many countries (including Japan), suggests that financial system vulnerability substantially increases the difficulties of monetary tightening. In Kazakhstan, credit growth in 2007 was extremely rapid, and the NBK's liquidity provision, which was needed to stabilize the nation's financial system, would have inevitably reduced the effects of monetary tightening that, during that period, should have reduced inflationary pressures.

In view of the above, we encourage the authorities to strengthen their bank supervision and regulations. Banks are required to make realistic assessments regarding NPLs and to take necessary measures to ensure sufficient provisioning and carefully monitor risks that stem from their off-balance sheet transactions. These measures may increase the costs of extending low-rate loans, stabilize the financial system and broaden the maneuver of monetary policy. On the other hand, stimulating bank lending without introducing appropriate supervisory measures would potentially increase the magnitude of future financial sector problems.

It would also be important to strengthen the discipline of the banking sector, and the NBK should not cause any "moral hazard" or "free-rides." Commercial banks, by themselves, should take necessary measures against their own risk-taking activities, without unduly expecting liquidity support from the NBK. In this regard, commercial bank dependence on external funding may imply the possibility that they underestimate exchange-rate risks, due to the authorities' efforts to maintain a stable exchange rate. We reiterate that excessive risk-taking by banks, based on underestimation of exchange rate risks, would increase the difficulty of securing a transition toward a more flexible exchange rate regime.

The currently observed combination of a high NPL ratio, maturity mismatches and exchange-rate risks in bank balance sheets all imply a lack of proper ALM systems, in which ALM committees provide appropriate advice to bank managers concerning risks, stress scenarios and the risk-adjusted profitability of each activity. In this respect, we encourage the authorities to lead banks to establish adequate ALM systems as soon as possible. We welcome the macro stress test, implemented by staff, that analyzes the financial sector's overall risks. Furthermore, we expect each bank to conduct micro-level stress tests so as to examine their own resistance to external shocks. Those micro-level stress tests could reveal and provide useful viewpoints that might be overlooked by macro level stress tests.

Kazakhstan Mortgage Company (KMC)

In general, mortgage financing activities by public entities may present the following risks:

Mortgage financing at lower lending rates may lead to an inefficient allocation of resources. (Particularly, if the access to public mortgage financing is limited to specific groups, the problem of resource allocation may become more intense.)

Publicly-operated mortgage financing may crowd-out private business. If a public mortgage company targets households with relatively high-credit scores, private banks would be forced to extend their loans to riskier borrowers.

If a public mortgage company were to purchase mortgage assets originated by private banks, since some private banks might try to sell portfolios with relatively bad loans while maintaining good portfolios, this might bring about an accumulation of risks due to an "asymmetry of information."

We understand the need for Kazakhstan to build housing infrastructure. Having said that, we would not encourage the country to maintain a big public mortgage company.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Raczko and Mr. Muradnazarov submitted the following statement:

We thank the staff for their well-written report, and Mr. Kiekens and Mr. Orynbayev for their helpful buff statement. We concur with the staff appraisal and will focus our comments on the following points.

In the last seven years, the real growth of Kazakhstan's GDP oscillated around the 10 percent level. Rapid economic growth was supported by favorable oil prices and fueled by heavy external borrowing by Kazakhstan's banks. Until mid-2007, Kazakhstan maintained the strong economic performance although some signs of growing overheating risks were visible. However, very high credit growth, mainly in foreign currency, and a real estate sector boom undermined the confidence of the financial sector. The global financial market turmoil that begun last summer has sparked a sudden stop of foreign capital inflow into the financial sector triggering a liquidity squeeze of domestic banks. The credit crunch will have a substantial negative impact on Kazakhstan's economy, especially on the non-oil sector. We agree with the staff's opinion that the restoration of the banking sector's confidence is essential. Strengthening the banking system is a sine qua non condition to reinvigorate strong and sustained growth in the future.

We commend the authorities for reacting decisively and taking strong measures to restore banking sector liquidity. The authorities' interventions through the enhanced refinance window and adjustment of the reserve requirements system were timely and so far have been appropriate. We also support the National Bank of Kazakhstan's (NBK) interventions in the foreign exchange market to stabilize the exchange rate. In this respect, we concur with the staff that maintaining a stable exchange rate during the current period of uncertainty is essential to secure depositor confidence, to limit the risks from the large currency exposure of the corporate sector and to help reduce inflation.

Looking forward, the authorities need to implement a set of measures to protect the integrity of the banking system and to prevent the credit crunch from deepening further. As the staff highlighted in the timely and useful FSSA update, the banking sector continues to be under stress as loan quality worsens and liquidity ratios decline. In addition, Kazakhstan's banks are heavily exposed to the deteriorating real estate market, face indirect exchange rate risk from lending in foreign currency and have large external debt repayments (about USD17 billion) coming due. In the face of these challenges, we agree with the staff that a clear picture of the vulnerabilities facing the banks needs to be developed. Steps need to be taken to mitigate risks, including by bolstering capital bases, strengthening bank supervision and further developing the financial safety net framework. In this regard, we welcome the authorities' efforts to strengthen bank supervision and regulation and to develop the crisis management framework. However, much more needs to be done, especially to operationalize a recent interagency Memorandum of Understanding on Financial stability as well as to strengthen the FSA.

Although we support the FSSA recommendations, we need clarification about the staff's position on the authorities' initiative to support financing of some investment projects. The government placed large earmarked deposits in the banking sector to assure continuous lending for construction of unfinished projects. A similar solution was offered to continue the financing of small and medium size enterprises. However, such a state intervention may distort the process of reducing lending activity as the burden of proper asset/liabilities management is shifted from the banks to the government. We note that an alternative system, in which the resolution of non-performing loans was co-financed by the public sector participation by increasing the banks' capital has been successfully implemented in some Central European countries. The staff's comment on the appropriateness of such a solution for Kazakhstan will be welcomed.

On the fiscal front, we commend the authorities for maintaining a strong fiscal position, with a large budget surplus and low public debt. While we note the authorities' intention to take the measures to adjust tax rates and lower expenditures in order to meet the 2008 budget targets, we agree with the staff that allowing the automatic fiscal stabilizers to operate would be the more preferable policy alternative to offset any revenue shortfalls due to the slowing economy. Going forward, we urge the authorities to use the available fiscal space to introduce well-targeted government subsidies to low income households to help offset the rising food prices.

Mr. Ge and Ms. Yang Jiehan submitted the following statement:

We thank staff for the well-written report and Mr. Kiekens and Mr. Orynbayev for their helpful buff statement.

Having enjoyed rapid growth for almost a decade, Kazakhstan has been greatly affected by the recent global financial turmoil. Commercial banks' access to external financing has declined significantly and banking credit has been sharply curtailed, leading to a significant drop in property prices and a slowdown in GDP growth. As an important player in central Asia, recent developments in Kazakhstan have spread to other countries in the region, clouding the regional outlook. Nevertheless, in view of Kazakhstan's considerable public financial resources and development potential, underpinned by its rich natural resources and prudent macroeconomic policies, we are confident the economic outlook will remain favorable as we believe the authorities can manage the risks involved and bring the economy back to sustained growth if an appropriate policy mix is followed.

In the financial sector, it is vital to mitigate risks and maintain stability. While a deterioration in asset quality resulting from the sharp decline in property prices is regrettable, a reassessment of Kazakhstan's banks is much needed to ensure that they are adequately capitalized to cover potential losses. Furthermore, with the ongoing financial turmoil and external financing of the banking sector not able, in the short run, to rebound to its previous levels, we urge the authorities to monitor the global and domestic markets closely and provide banks with timely and much needed liquidity. We applaud the NBK's measures to inject capital into the Kazakhstan Deposit Insurance Fund and in signing an agreement with large banks on short-term liquidity support. However, the banking sector's heavy reliance on external financing remains a source of vulnerability. We welcome staff's recommendation on how to resolve this problem in the long run.

Monetary policy needs to strike a balance between containing inflation and preventing the higher-than-expected slowdown in growth. Recently, the NBK cut refinancing rates by 50 bps while lowering the reserve requirement ratio by 1 percent. Despite the NBK citing its desire to support credit expansion as reasons for the action while expecting inflation to ease in the second half of the year, we note that inflation continued to rise in June and might not be on a declining cycle in the next few months. How will the NBK's recent action affect future inflation movement in Kazakhstan? Staff's comments are welcome. The difficulty facing the NBK in balancing its policy targets also raises the future problem that central banks in major economies might have to face if the global economy continues to slow down and inflation to rise, leading the world into stagnation.

On exchange rate policy, we concur with staff that exchange rate stability is essential in maintaining market confidence and limiting exchange rate risks for Kazakhstan's corporate sector. We appreciate staff's recognition of the uncertainties and difficulty in using the exchange rate evaluation models to assess the equilibrium exchange rate for Kazakhstan—a country rich in resources with a dynamic economy. The vast deviation in the results from different models, ranging from an undervaluation of 23 percent to an overvaluation of 16 percent, once again displays the implausibility of a model-based exchange rate evaluation. As before, we caution against the mechanical use of less-trusted models in Fund surveillance.

Fiscal policy can play an active role if the growth slowdown is sharper than expected, facilitating monetary policy to focus on price stability. With a large budget surplus and low public debt, the government has ample room to allow the automatic fiscal stabilizers to operate. We welcome the authorities' plan to adjust taxation to promote non-oil sector growth and develop a new budget law.

Enhancing structural reforms without delay even under the current difficult situation is necessary to sustain the growth momentum. We welcome the authorities' efforts to boost competition and advance negotiations for WTO accession.

With these remarks, we wish the authorities all the best in their future endeavors.

Mr. Rutayisire submitted the following statement:

We thank Staff for the set of papers and Mr. Kiekens and Mr. Orynbayev for their informative buff statement. Kazakhstan economic performance over recent years have been impressive thanks to the favorable developments in the oil sector, the authorities' prudent macroeconomic policies and structural reforms, and increased access to global financial market, which fuelled credit growth to the households, trade and construction sectors.

We note however that as Kazakhstan was increasingly integrating into the global financial system, its vulnerabilities to global shocks have also been on rising as reflected by the toll the recent global financial market turmoil has caused on the country's economic outlook – notwithstanding the authorities' proactive policies which helped to contain the impact from totally unfolding. We are encouraged by the authorities' recognition that the situation remains challenging and by their commitment to maintain prudent macroeconomic policies going forward with the view of further containing the remaining risks and set stage for the transition to sustainable growth and low inflation. Since we broadly agree with the thrust of the staff appraisal, we will limit ourselves to few comments for emphasis.

The continuing rise in food prices (to a little over 29 percent y/y in June 2008) and in overall inflation (to 20 percent y/y in June 2008 from 19.5 percent in May) poses a major challenge to the monetary policy, at time when the authorities have also to balance with the goals of preserving financial stability and cushion downside risks to growth. We note from staff's updating buff that the National Bank of Kazakhstan (NBK) has recently lowered its policy rate to 10.5 percent in July 2008 after its increase last December, and plan to further cut the minimum reserve requirement rates – citing its desire to support credit expansion and growth, and its expectations that inflation will ease in the second half of the year as reasons for these actions. We wonder whether the NBK's priorities are changing away from reducing inflation. Following these new developments, we see no indication from staff whether the likely reduction in inflation pressures stemming from weaker growth and summer harvest would be sufficient to offset the impacts from this monetary policy loosening in addition to helping achieve the targeted inflation rate of 9 percent. Staff comments are welcome.

We agree with the view that foreign exchange stability will remain a central policy objective to help maintain depositor confidence in banks, and limit the risks from the large foreign currency exposure. We support the staff's suggested measures to prevent downward pressures on exchange rate from resuming, which advocate a number of steps to lower forex demand and limiting the level of NBK intervention to defend the tenge.

Albeit the impact from the slowing economy, the authorities' fiscal position remains very strong with large budget surplus and low public debt. We welcome the authorities' commitment to maintain a prudent fiscal stance going forward. Their intention to take offsetting measures, including freezing non-priority spending, goes in this direction. As in Mr. Alazzaz's statement, we agree with the staff that any possible fiscal stimulus package in the event of a sharper-than-expected slowing in growth should be well-targeted to ensure increased spending goes to areas that will enhance the economy's growth potential, whilst avoiding overheating further the economy. The development of a new budget law to lengthen the budget framework from the current one year to a three-year period, as stated by Messrs. Kiekens and Orynbayev, goes in this direction. We also commend the authorities for the continued prudent management of the National Oil Fund (NFRK) and welcome their commitment to continue using the Fund's assets cautiously.

The authorities have made impressive progress in developing financial safety net framework, particularly the signing between the government, the NBK, and the FSA of the Memorandum of Understanding on Financial Stability, which will help manage financial stress. Also encouraging are the steps taken by the Financial Supervision Agency (FSA) to strengthening its supervision of banks and the government's commitment to increase resources available to the FSA. Building on the sound and timely recommendations of the recent FSSA update, authorities are encouraged to make further efforts so as to address the remaining financial vulnerabilities.

As regards structural reforms, we take positive note of the authorities' continued determination to diversify the economy away from the oil sector. To this end, we see merit in the authorities' plan to develop a new tax codes so as to simplify the tax system. We welcome progress made with the process toward WTO accession and the authorities' plan to strengthen the competition policy, particularly with the aim to remove remaining distortions in the market and to avoid the emergence of new monopolies or the abuse of dominant market positions. We once again commend the authorities for their decision to make participation in the EITI mandatory to all new contracts in extractive sectors, and for the strong progress already made in this direction, including the publishing of the first national report in February and the achieved level of participation. The steps taken to enact AML/CFT legislation are a further testimony of the authorities' commitment to good economic governance.

With these remarks, we wish the Kazakh authorities every success in their endeavors.

Mr. Rojas and Mr. Umaña submitted the following statement:

We thank the staff for the clear and concise papers and Messrs. Kiekens and Orynbayev for the insightful buff statement. Kazakhstan has experienced very strong economic growth since the year 2000, averaging 10 percent per year, leading to a doubling of real per capita income in the last 7 years, as well as to improvement in social indicators. The financial turmoil that has affected the global economy in the last year has had a significant impact on the country's economy, with reduction in the levels of external financing for the banking sector and a tightening of liquidity resulting in sharp curtailing of lending. The financial crisis has also affected construction and real estate prices, which have experienced a large drop. Under these conditions, it is inevitable that growth will be affected, decreasing to around 5 percent this year and slightly over 6 percent next year.

Development of the oil sector has been an important strength and Kazakhstan has considerable public financial resources to face the present situation. The country is benefiting from present high levels of oil and commodity prices and the medium-term prospects are favorable. Official foreign currency assets of $46 billion are made up of NBK reserves of $21 billion and the oil fund (NFRK) assets of $25 billion. However, the health of the banking sector is critical to this outlook thus banking supervision and regulation need to be strengthened. NPLs are expected to continue rising and the banks' credit portfolio has been deteriorating, although they remain well capitalized and profitable. They face external debt repayments of $17 billion this year, which will continue pressures on liquidity. Bank exposure to the real estate sector is a significant source of vulnerability.

The NBK provided large-scale liquidity support to banks last year and it will continue to do so as liquidity remains tight. NBK has also intervened heavily in the foreign exchange market, using 25 percent of its reserves during August-October of 2007 and has since effectively pegged the tenge to the US dollar, although the official exchange rate regime is still considered a managed float. Intervention by the central bank has scaled back substantially in recent months, but NBK stands ready to intervene if downward pressures on the exchange rate re-emerge. Exchange rate stability is a priority in this period and staff agrees that the current position is justified by the circumstances now facing the country. When conditions in financial markets improve, a return to a more-flexible exchange rate regime would be desirable.

Inflation has been high and the central bank raised its policy rate from 9 to 11 percent to help contain inflationary pressures, but food price increases continue to be a concern. It is necessary to mitigate the impact of these increases on the lowest-income sectors of the population. Well-targeted subsidies to low-income groups could be an important measure instead of trade restrictions or across-the-board subsidies. Weaker growth is likely to reduce inflation pressures and authorities will closely monitor the situation and adjust the policy stance as needed. The fiscal position is very strong, with a large budget surplus and low public debt. There is space for a fiscal stimulus package in case the economic downturn is sharper than expected.

Progress in developing their financial safety net is encouraging. The liquidity support framework proved effective during the recent turbulent period, but reforms to give the authorities more flexibility to react to adverse changes in a bank's financial position need to be implemented. The publication of Kazakhstan's first report under the Extractive Industries Transparency Initiative (EITI) is encouraging. We wish the authorities well in the implementation of reforms and strengthening supervision in the financial system.

Mr. Fayolle submitted the following statement:

At the outset, we would like to thank staff for an interesting set of papers, as well as Messrs. Kiekens and Orynbayev for their helpful buff statement.

The recent financial turmoil has seriously hit Kazakhstan's economy. Fortunately, the fiscal position of the country has been strong enough to mitigate the effects of the banking crisis, even though the latter has taken its toll on economic growth. Moreover, the strong external position of the public sector was helpful in cushioning the impact of the crisis on the exchange rate. As highlighted in Messrs. Kiekens and Orynbayev statement, the short-term outlook remains positive, as the oil sector will continue to support the economy, while commercial banks should be able to meet their external commitments. However, as pointed out by the staff, risks are on the downside since the credit crunch is still ongoing. Moreover, like other countries in the region, Kazakhstan is experiencing large inflationary pressures as a consequence of the increase in food prices.

We particularly welcome the extremely timely FSAP update, and agree with the focus of the staff report, which rightly emphasizes the consequences of the banking crisis and the policies designed to address them. The authorities have correctly reacted to the crisis by enhancing banking supervision and strengthening their operating framework during periods of financial stress. In the current juncture, and even if the financing needs of the banking sector are expected to increase in order to meet external repayment obligations, the balanced aggregate net external position of the banking sector substantiates the notion that external debt is not the immediate risk. A larger source of concern, however, is the rising number of non-performing loans, as well as the exposure of the banking sector to the now poorly performing construction sector. In this vein, we urge the authorities to strengthen the monitoring of the banking sector, in line with the recommendations of the FSAP report, as fluctuations in the price of collaterals might have a lasting impact on the real sector and the macro-economy. In doing so, it will be important that the efforts undertaken by the authorities to mitigate the impact of the downturn in the construction sector do not lead to a moral hazard situation. Staff's comments would be welcome.

While the direct foreign exchange exposure of banks seems to be manageable, the indirect risks highlighted in the FSAP update are a source of concern. For this reason, we find merit in the staff's recommendation to keep the exchange rate relatively stable while the adjustment to the financial shock is still ongoing. This will be crucial to restore confidence in the banking system as well as to avoid a worsening of the balance sheets in the economy. We would, however, recommend that the authorities stand ready to allow for some increased volatility in the exchange rate as soon as the situation allows it. In a highly dollarized environment, this will be instrumental to install a sense of currency risk and provide incentives for currency hedging.

Moreover, while we note that the staff considers the real exchange rate to display no clear sign of under or overvaluation, we would be slightly more cautious. The macro-economic balanced approach is not particularly well fitted to the case of oil-exporting countries, while the two other approaches point to undervaluation. Moreover, in the longer run, real appreciation is to be expected as a result of growth, and some flexibility would be helpful to accommodate this foreseeable equilibrium appreciation. This would have the additional benefit of providing an incentive to dedollarization, while avoiding that relative prices adjust to equilibrium through inflation.

We are a bit puzzled by the very limited elaboration in the staff report on inflation issues in Kazakhstan. With y-o-y price surges reaching 20 percent in June, inflation is no less an important issue for the country than it is for the countries of the region. We would have appreciated further insights on the sources of this inflationary breakout. Can it be explained mainly by food import prices, credit growth, or public expenditure growth? To what extent is the apparent relaxing of the monetary stance decided in July consistent with the inflationary environment? We also note in the staff's forecast that inflation should be decreasing in 2009 and returning to single-digit levels. In light of the reduction in interest rates and in reserve requirements, we wonder whether such a projection is realistic.

Finally, while we can understand the authorities' concerns about inflation in food prices, which primarily affects the poor, we urge them not to rely on quantitative measures to contain this inflation, as such measures can only fuel expectations of further price increases on the world markets and therefore have a strongly negative externality.

We welcome the analysis of regional linkages and spillovers in central Asia in relation to the critical role of Kazakhstan in the region. However, in light of the Fund's refocusing presently under way, we consider that such an analysis could be extended further to article IV reports dealing with regionally macro-critical countries. In particular, since Kazakhstan is a major emitter of remittances, we would appreciate staff's view on the impact of the current macro-economic situation on remittances from Kazakhstan to the countries of the region.

Mr. Bergo and Mr. Hukka submitted the following statement:

We thank staff for their set of reports, including the informative FSSA update, and Messrs. Kiekens and Orynbayev for their concise buff. We broadly share staff's analysis. Relative to previous credit booms in emerging markets, Kazakhstan's non-oil output remains at reasonable levels and the abundant natural resources provide a useful buffer against a broader slowdown in growth. With its sizable financial resources Kazakhstan is also reasonably placed to weather the recent storm in the banking sector. This said, the developments in the construction and retail sectors, and their likely impact on the economy on the whole may protract the troubles in the banking sector. More worryingly, despite some progress by the authorities, notable vulnerabilities in the banking sector remain to be addressed. In particular, the system currently seems ill-equipped to deal with the possibility of bank failures in the event the recent trouble turns into a systemic crisis.

The impact of the credit crunch on the non-oil economy's growth prospects has been notable. While recognizing that the outlook for the economy primarily hinges on the health of the banking sector, the sizable correction in the Kazahkstani housing prices after years of credit-driven gains also raises concerns. Besides the risks that continued house price declines would impose on the heavily exposed Kazahkstani banks, the slowed down construction and retail sector activity is likely to contribute to the weaknesses elsewhere in the real sector and a recovery may take time.

While the spillovers from the oil sector partially mitigate the slowdown, they have also increased Kazakhstan's vulnerability to a fall in oil prices. We welcome the authorities' intention to promote diversification of the economy through new tax and budget codes. However, we agree with staff that seeking to offset shortfalls in tax revenues may be inappropriate at the current stage of the economic cycle. While being mindful of the deteriorating non-oil fiscal balance, there is room to allow automatic stabilizers to operate.

We also agree that there is scope for developing a well-targeted transfer mechanism to mitigate the impact of the higher food and fuel prices. As noted recently in the related Board discussion, export restrictions tend to have unintended negative consequences both at the domestic and global levels. The reduced supply incentives may hamper the authorities' efforts to boost agricultural production.

Facing high and rising inflation, slowdown in growth and financial market instability, the NBK is in the middle of an unenviable balancing act. Not least due to the relative importance of the banking sector, we agree that its emphasis on financial stability has up until recently been appropriate. However, while wage pressures have so far been contained, inflation standing at 20 percent highlights the need to stand ready to adjust this policy. Like Messrs. Stein and Denk, we would be interested to hear staff's views on whether the authorities' inflation target of 9 percent is reachable. In the longer term, the underdeveloped money market warrants close attention. The NBK currently has an excessive role in providing liquidity to the system and the banks' tendency to resort to foreign exchange markets for liquidity adjustment is an additional source of risk.

We agree that for the time being, stable exchange rate is necessary to maintain confidence in the banking sector and to limit the risks from the large foreign currency exposure.

The vulnerabilities in the Kazakhstani banking sector remain notable, and we encourage the authorities to speed up the implementation of the 2004 FSAP recommendations. With the rising NPL ratios and continued difficulties in external debt financing, it needs to be ensured that the banks continue to meet solvency standards. It is also important to ensure that bank failures, while still unlikely, can be resolved swiftly to minimize any destabilizing effects to the sector on the whole. As it stands, the authorities are rather ill-equipped in this regard and establishing functioning contingency planning and bank resolution frameworks is a priority. The recent Memorandum of Understanding on Financial Stability is a positive step and its eventual completion will hopefully pave the way for further measures. A requirement for the banks to prepare their own contingency plans would also be helpful.

Beyond the more immediate measures, the aggressive growth strategy of the banking sector and the consequent turmoil has highlighted the need for the FSA to move toward a risk-based approach to financial supervision. Such change should be supported by appropriate institutional arrangements that would enhance the operational autonomy of the FSA. We also note that despite the FSA's proactive approach to dealing with banks with stress, the weak capacity and high staff turnover have hampered efforts to refocus bank supervision on systemic stability. In view of this, we welcome the authorities' intention to allocate more resources to the FSA.

Ms. Agudelo and Mr. Perez submitted the following statement:

We thank the staff for a concise report and selected issues paper and Messrs. Kiekens and Orynbayev for their informative buff statement.

We commend the authorities on their sustained strong economic performance over the past years. Economic growth has averaged around 10 percent annually between 2001 and 2007 with high growth in the oil and the non oil sectors. This performance has resulted in better social indicators and in doubling real per capita income in seven years. The banking sector had been a key element in the impressive growth of Kazakhstan.

The prudent and consistent macroeconomic policies during the last decade and the high commodities prices give enough room to manage the global financial crisis and its effects into the local banking system. We agree with staff's assessment in the sense that policies should be focused on managing risks to the outlook and maintaining the stability of the financial system.

The banking sector remains capitalized and profitable despite the deterioration of the credit portfolio but given the external environment, we encourage the authorities to strength bank supervision and increase supervisory capacities. As we learned from Messrs. Kiekens and Orynbayev's buff statement, the prudent credit policy that required a 20 percent down payment for home borrowers gives some room to manage the real estate drop.

We commend the authorities for the timely progress in developing the financial safety net framework and also the improvement in the liquidity management of the National Bank of Kazakhstan (NBK). In that sense, we welcome that six of the largest banks have signed the Memorandum of Understanding (MOU) to access the exceptional liquidity support –as foreign swaps– with new instruments and flexible collaterals.

We welcome the decision of the authorities to maintain –at this time– the stability of the exchange rate to preserve the confidence of the depositors in the banking system, reduce the risk of exposure of local loans in foreign currency and contain inflation. We concur with staff that an improvement of the situation of the financial market will set conditions to return to a flexible exchange rate policy.

On the fiscal side, we welcome the decision of the authorities to reduce the corporate income tax rate for the non oil sector, given the strong fiscal position of Kazakhstan. We also encourage the stimulus given to increase production of food products and the possibility to adopt targeted cash transfers to vulnerable households.

The authorities are to be commended for the publication of the first report under the Extractive Industries Transparency Initiative (EITI), an important effort to development a competition policy that focuses on market abuse practices.

With these remarks, we wish the authorities success in dealing with the challenges that lie ahead.

Mr. Larsen and Mr. Pillai submitted the following statement:

We thank staff and Messrs Kiekens and Orynbayev for their helpful information and analysis for today's meeting. We broadly concur with staff and make some comments for emphasis.

It is clear that Kazakhstan has been exposed to the full effects of the global financial crisis, but on the other hand is benefiting from the increases in oil prices. It is a critical period for the country, and we appreciate the focus of the authorities on managing a smooth transition to sustainable growth path, strengthening the banking sector and maintaining fiscal discipline. We welcome the update on FSAP, and share the concern of other Directors on the credit risks associated with the real estate sector, and agree with staff on the need to develop a clearer picture of the vulnerabilities facing the banks. We look forward to updates on this in the next staff report.

We note that despite the authorities' intention to maintain fiscal discipline in light of the revenue shortfalls, there have been recent increases in allocations for wages and pension. We welcome the measures being planned to align public finances with development priorities. maintain fiscal discipline in light of the revenue shortfalls.

We note from Box 1 the likely wider regional impacts of the current macro-economic situation in Kazakhstan – these are significant and would need to be continuously monitored. We would welcome an update on the role being played by the Fund in encouraging ongoing discussions between the respective authorities in the region.

We welcome Kazakhstan becoming a candidate country for EITI implementation, and the ongoing efforts to obtain the participation of all subsoil companies in this initiative. We look forward to the passage of the AML/CFT legislation which conforms to international standards, and would appreciate staff engagement on this important agenda.

Mr. Heath and Mr. Lin submitted the following statement:

Kazakhstan's primary challenge is to emerge from the current global credit market turmoil with a structurally stronger economy. The rapid credit growth of recent years contributed greatly to high growth rates and overheating. As foreign financing abruptly receded last year, the domestic liquidity squeeze sharply curtailed growth. Combined with favorable terms of trade and sound public finances (as highlighted in the statement by Messrs. Kiekens and Orynbayev), the authorities' extension of the financial safety net prevented even more severe financial stresses. However, the situation remains fragile. Intensive exchange rate management, attractive as a temporary measure, is likely to prove costlier in the future. The key to restoring financial stability and strengthening growth of the real economy is to reform the financial sector as quickly as possible. We agree with the thrust of the staff's appraisal, and we make the following comments for emphasis.

Financial Sector

Kazakhstani authorities must act to restore investor and depositor confidence. We urge the authorities to bring about a direct and prompt resolution of banking sector stresses. Strengthening bank risk management, financial sector supervision, and contingency planning are urgent tasks. The staff appropriately highlights the importance of strengthening the independence and influence of the FSA, as well as its operational capacity and human capital.

We share the staff's concerns about the reliability of bank reporting, as discussed in the FSSA update. Greater transparency is crucial for restoring confidence and normal credit market conditions. Banks should be encouraged to make full disclosures and, if necessary, to raise additional capital. To that end, allowing greater foreign investment in the sector will broaden potential sources of capital.

Monetary Policy and the Exchange Rate

Given banks' indirect exposure to foreign exchange risk, we acknowledge short-term benefits of the central bank's intensified focus on exchange rate stability. However, this should be a temporary objective, as it could come into sharp conflict with the central bank's growth objectives. Moreover, combined with the expanded financial safety net, market perceptions of asymmetric foreign exchange risk could stimulate further accumulation of balance sheet vulnerabilities. Therefore, we encourage the authorities to return to a more flexible exchange rate when financial market conditions improve. Over time, stronger risk management by banks and stronger supervision of banks will mitigate balance sheet risks more directly and effectively.

While the staff appropriately considers country-specific factors in its exchange rate assessment, we would have preferred a fuller explanation of these factors, and how they influence the assessment. For example, the staff argues that the estimated MB and ERER models may not accurately represent Kazakhstan's current account or exchange rate dynamics. To assess this statement, it would have been helpful to have additional information. What economies were included in the sample, and how similar are their dynamics (over the relevant time period) to those of Kazakhstan? Are the potential biases amenable to standard econometric remedies? Further comment by the staff would be appreciated.

Fiscal Policy

We commend the authorities for their plans to ease the tax burden on the non-oil sector, which will mitigate potential Dutch disease problems and contribute to longer-term growth. In view of Kazakhstan's large budget surplus, low public debt, and the risk of aggravating the slowdown, we endorse the staff's cautions against increases in tax rates or cuts in expenditures to meet previously set fiscal targets.

Mr. Rouai made the following statement:

We thank staff for a well–written set of papers, including the analysis on regional linkages and spillovers, and Mr. Kiekens and Mr. Orynbayev for their focused and candid statement. We broadly concur with the staff analysis and policy recommendations, and would like to make some comments for emphasis.

Like other Directors, we note with concern the rapid increase in macrofinancial risks associated with the sudden stop in capital inflows as a result of spillover from the current financial turmoil. We are, however, comforted by the authorities' policy reaction and by the availability of large financial resources which could help Kazakhstan weather the current difficulty.

We associate ourselves with the recommendations by the staff and other Directors to address financial sector vulnerabilities, in particular through strengthening banking supervision and regulations, and to remain vigilant and take corrective action if inflation does not ease in the second half of the year, as projected by the staff.

We note that this is the second update to the FSAP. While we consider that this is a timely and helpful initiative, we appreciate the staff's assessment of the effectiveness of prior FSAP advices in reducing banking sector vulnerabilities and in preventing rapid credit growth and the high dependence of the banking sector on foreign financing.

While still on the financial sector, we note the complex scoring system adopted in nonclassification. While we agree with the staff assessment that the rules are relatively strict, we wonder if the use of two indicators for NPLs—broad and narrow—does not introduce some complacency and confuse banking supervision. We would appreciate the staff's clarification of the policy.

Also important for financial soundness is the provisioning policy. We note in this regard that the FSSA does not include much detail on this policy. Staff comments are welcome.

We also look forward to the staff's answers to the comments made by Mr. Murray and Mr. Na on bank exposure to the real estate sector. We also look forward to hearing from the staff about the impact of the regulation which holds borrowers liable for the remainder of the entire borrowing if the market value of real estate were to drop.

Finally, we join Mr. Stein and Mr. Denk in urging the authorities to lift the restrictions on wheat exports. Like Mr. Warjiyo and Mr. Eng, we fail to see the usefulness of Box 4 on the assessment of the real exchange rate in view of staff's own conclusions regarding the considerable uncertainty surrounding the assessment, given methodological shortcomings and the variation in results.

With these comments, we wish the authorities all the success.

Mr. Yakusha made the following statement:

I thank staff for the well–written—though unexpectedly concise—Article IV report, and Mr. Kiekens and Mr. Orynbayev for the informative buff.

It is rather staggering to see in one year such dramatic changes in the set of policy challenges. Only a year ago, the major challenge was to mop up excessive liquidity, while now it is to provide liquidity for the struggling banking system. Given the fact that Kazakhstan is a major case of an emerging market economy seriously affected by global financial turmoil, the Article IV report could have been less concise and, as mentioned by the Russian chair, the selected issues report would also be appreciated in such circumstances, probably by the authorities as well.

Similar contagion cases obviously could not be ruled out elsewhere, and it may be the right time to start distilling some preliminary lessons from the relatively hard landing of the Kazakh economy caused by the abrupt change in investor sentiment. The FSAP update is very helpful in that respect, though it probably also describes the issues and challenges as of at least a quarter or two quarters ago, and as such may already be outdated.

Before going into the possible lessons, I would like to agree with other Directors who commended the authorities for the appropriate handling thus far of increased vulnerabilities of the banking sector. Most of the staff's policy recommendations for the period of normalization of financial conditions also seem quite reasonable and they can be supported.

Like several other Directors, I would caution against the mechanical application of exchange rate regime reclassification rules for Kazakhstan. I would suggest that staff at least explain that regime reclassification to a de facto peg is based on performance during the last six months, and also that the staff's current exchange rate policy recommendations favoring stability now do not mean that the authorities are committed to defending any particular level of the exchange rate.

At the current juncture, it would be unfortunate if we contribute to instability in any way. In this light, like some other Directors, I am not convinced that the staff's relatively pessimistic near–term growth projections are correct, not to mention that they seemed to be based on rather low oil price forecasts.

We have learned recently in other regions that financial sector problems do not immediately translate into real sector problems if they are handled properly. However, if they are not handled properly, they will obviously affect growth, but in our opinion there is no evidence of improper handling in the case of Kazakhstan.

Like some Directors, we do not see many additional inflationary risks, given the contraction of credit and overall fiscal problems. The staff's inflation projections for Kazakhstan also look rather benign compared to what is happening elsewhere among emerging market economies. The absence of wage pressures and changes in the current account, in particular lower demand for imports, also point to possibly limited risks to continued overheating.

Food price inflation is, of course, a continuous challenge for Kazakhstan and many other economies. In that context, we do not see export restrictions imposed by the authorities as an appropriate response. In terms of supply response, such restrictions obviously are not helpful for incentives to increase production. They also aggravate global problems, as Kazakhstan is a major producer of grains. They are also not well-targeted for the protection of the most vulnerable inside the country.

Where we see more risks is in the area of domestic market confidence that may suffer more blows if credit delinquencies go unaddressed or if there is an outflow of deposits. To this end, I am not sure whether increasing deposit rates are helpful. It would be more helpful to further boost the Deposit Insurance Fund, intensify supervision, and have better policy coordination between the central bank, the FSA, and the government.

The authorities should stand ready to intervene aggressively and early on in case any systemic risks re-emerge. They have the necessary resources for such an intervention. Of course, better disclosure of risks and prompt recapitalizations are necessary to maintain confidence.

I also appreciate staff efforts to show Kazakhstan's increased interlinkages with other economies in the immediate neighborhood. I would also urge the staff to continue to look into those interlinkages as well as into possible interlinkages with other economies in Europe, including Russia and countries where Kazakhstan has sizable investments.

Regarding the preliminary lessons we may start to distill from the recent experience of Kazakhstan, first and foremost is that markets behave in an unexpected manner, often acting on perceptions that are not necessarily correct. Kazakhstan, given its resources and prospects for further oil revenues, was not the most obvious candidate for a change in investor sentiment or a speculative attack. The recent one–off worsening of the current account should have been better explained and was probably in the end misinterpreted by markets.

The high speed of credit expansion and associated asset price boom were, of course, major factors for investor worries, but more so the unprecedented increase in external borrowing to finance such a credit expansion, as this Chair mentioned last year.

The second lesson, therefore, is that underdeveloped financial markets pushed economic agents, and the banking sector in particular, in the direction of excessive reliance on foreign borrowing for financing. Loose global monetary policy was also part of the problem. Therefore, the Fund may have a role in providing advice to the authorities as to whether their corporate and banking sectors' reliance on foreign financing is becoming excessive or not. This is a separate question from whether the credit boom in general is excessive and inflationary, or not.

Third, credit discipline problems start everywhere, not only in Kazakhstan, with the lowering of criteria for extending loans. Loan quality worsened at this stage when over half of mortgage loans in Kazakhstan were approved with self–certification of income, as mentioned in the FSSA. The real problem emerged at that stage, as opposed to after the erosion of external investor confidence or the real estate price correction, as one may occasionally read from market analysis.

In last year's Article IV report on page 12 it was mentioned that prudential indicators, including solvency risks, deteriorated in Kazakhstan to a lesser extent than among its peers with similar rates of credit expansion. In this light, I think we may want to look again at the indicators we are using. The credit quality problem is again a relatively separate problem from the speed and financing sources of credit expansion.

The staff representative from the Middle East and Central Asia Department (Mr. Callen), in response to comments and questions from Executive Directors, made the following statement:

Let me start in an area where Directors clearly had many questions, the inflation-monetary policy nexus.

In terms of explaining the surge in inflation over the past year, the primary factor has been the large increase in food prices. Food in the Kazakhstan CPI accounts for slightly less than 50 percent of the basket. Year–on–year, food price inflation went from 8 percent to 25 percent between September and December last year. Currently, food price inflation accounts for about two thirds of the current year-on-year inflation rate. Non-food price inflation has also risen, but to a much lesser extent.

We still expect inflation to ease in the second half of this year, but it has to be admitted that the inflation data from May and June has been on the disappointing side. We now believe that bringing inflation below 10 percent by the end of the year will be difficult.

The NBK has a target range. Mr. Kiekens' and Mr. Orynbayev's statement said the midpoint was 9 percent. The range around that is 7.9 percent to 9.9 percent by the end of the year.

There are three reasons why inflation should ease. First, according to the Agricultural Department of Kazakhstan, the expectations are that there will be another very good harvest this year. That is expected to begin to put some downward pressure on food price inflation. Second, clearly there is an economic slowdown underway which, with a lag, will begin to affect prices and companies' pricing power. Third, there are going to be positive base effects toward the end of the year. Between September and November last year, there were some very large month-to-month inflation increases which will drop out of the year-on-year calculations as we move toward the end of the year.

Thus, incorporating the latest data we have, our forecast is now that inflation by the end of the year will be in the 10.5 percent to 11 percent range rather than below 10 percent as we had stated in the staff report. However, that is clearly still well below the 20 percent year-on-year rate we had in June.

In terms of the impact of export bans on prices, export bans were imposed on wheat in mid-April, and on vegetable oil in mid-March. It is still too early to be able to pick up whether there has been an impact or not. There is clearly a great deal of month-to-month variability in the components of the CPI, and that volatility is obscuring any attempt to see an impact.

In terms of the effect of the monetary policy easing on inflation, we have tried to look at the impact of central bank interest rate changes on the CPI. As we noted in the staff report, we cannot find any direct statistical link. But clearly, at the margin, we would expect the easing of monetary policy to have some impact on inflation relative to the no-change monetary policy scenario.

In terms of the appropriate monetary policy stance, we said in the staff report that we saw keeping monetary policy on hold as appropriate to balance risks to inflation growth and financial stability. We would still stick with that view and would see the recent easing by the NBK as possibly being a little premature. We would have preferred them to wait for evidence that the inflation scenario is playing out before easing monetary policy.

Turning to questions on the fiscal side, Mr. Silva-Ruete asked about both the coordination of monetary and fiscal policy, and about how much of a growth slowdown would be needed before the authorities have a fiscal policy response. Our view is that monetary and fiscal policies are actually fairly closely coordinated in Kazakhstan. The Ministry of Economy and Budget sits on the Board of the National Bank of Kazakhstan, and the Governor is actively involved in policy meetings in Astana with government officials.

In terms of the slowdown and the fiscal response, ultimately the authorities will make that call on the ground if it happens based on incoming information. I do not think they have any growth target or triggers in mind for when another fiscal policy response may be needed.

Mr. Lushin asked about our views on the proposed tax reforms. We are certainly very supportive of reducing the tax burden on the non-extractive sectors of the economy. Lowering the corporate tax rate would bring that rate more in line with rates in neighboring countries and within Europe, and would also help with the overriding goals of economic diversification that the government has in mind.

A very detailed World Bank report looking at tax reforms in the nonoil sector was recently released. One of the points that was made in that report is that it is not only the overall tax rate that is important, but also the complexity of the tax system. There are a lot of exemptions in the system.

The World Bank report called for reforms to simplify the tax system, particularly to ease administrative and compliance costs, and reduce incentives for corruption within the system. We would support those goals of simplifying the system at the same time as lowering the overall tax rates.

Regarding the taxes on the oil sector that the government is going to be raising, we support this move as long as they do not favor domestic consumption over exports.

Turning to the current account and exchange rate issues, there was a question about the sharp turnaround in the current account that we are seeing between 2007 and 2008. Two factors are clearly driving this trend. One is that oil prices are much higher and that is giving a significant boost to export revenues, but also imports have slowed very sharply as domestic credit growth has stalled.

In our statement we gave the outcome for the first quarter current account balance of a surplus of US$4 billion, which already accounts for half of the annual projected surplus we have in our projection. We therefore feel we are well on track for seeing the turnaround that we have projected. Over the medium term, clearly the current account position is much better because of the higher oil price assumptions that we are now using relative to what we had at the time of the staff report last year.

Mr. Stein asked about our exchange rate advice if oil prices were to fall. I think the advice would remain the same as we have in the staff report, namely to defend the exchange rate but with a clear stop-loss operation rule in place that would limit upfront the reserve losses that the authorities are willing to tolerate. If oil prices were to fall sharply, it probably makes it more likely that the stop-loss rule would actually kick in in that environment.

There was also a question about the currency composition of the corporate foreign borrowing. That borrowing is almost all in U.S. dollars, so we believe that the dollar-tenge exchange rate is the one that matters from the corporate balance sheet point of view.

Mr. Lushin asked about the role of oil prices in estimating the equilibrium exchange rate, and Mr. Heath and Mr. Lin asked about the potential remedies to the estimation difficulties that we are facing on the equilibrium exchange rate side. Oil prices directly affect both the macro balance and the equilibrium exchange rate calculations. For the equilibrium exchange rate, the terms of trade is one of the explanatory variables in the regression, and for the macro balance approach the oil price both affects the staff medium-term projections and also affects the estimated current account norm over the medium term.

The exchange rate is less undervalued now than it was assessed to be in the staff report last year. The macro balance approach suggests that there is less overvaluation this year than last year. The biggest difference is that this year we did not include the external sustainability approach, because we have increasingly felt, both on the Kazakhstan desk but, more broadly within MCD, that this approach is not suitable for an oil-exporting country because it does not account for the oil wealth that these countries have in the ground.

On Mr. Lin's question on the estimation difficulties, the equations we are using at the moment are based on a group of advanced and emerging market countries so there are certainly questions about applying these to an oil-exporting country.

Within MCD there is an ongoing departmental exercise to look at estimating or applying all of these approaches both to oil-exporting countries and oil-importing countries in the department, and looking at different specifications for each of these groups of countries. That work is still ongoing. However, for Kazakhstan, while certainly the methodologies make one feel much more comfortable, the range of estimates that we have obtained is currently still very broad. Clearly, going forward, this is an issue we need to continue to work on, and we will try to refine these estimates for Kazakhstan as we go forward over the next year.

Mr. Lushin raised the issue of the impact of higher oil prices on GDP growth. The simple econometric equation, where we looked at real GDP growth with, on the right-hand side, oil prices and a number of other explanatory variables, suggests that a 20 percent increase in oil prices raises growth by about three quarters of a percentage point after one year. In the staff report, we see higher oil prices as partly mitigating the impact of the fallout from the credit crunch that the economy is experiencing at the moment.

Mr. Fayolle asked about remittances. This is an area where there is very limited information, and what we know is included in Box 1 of the staff report. Anecdotally, the stories one hears are that foreign workers in Kazakhstan are being affected by the slowdown.

Many of them work in the construction sector, which has been particularly badly hit. We expect that remittance flows out of Kazakhstan—and they are particularly important for both the Kyrgyz Republic and Tajikistan—will slow, and that is one of the reasons why we expect growth to slow down in both the Kyrgyz Republic and Tajikistan this year.

Mr. Lushin asked about Kazakhstan and the Vulnerability Exercise. Kazakhstan has been on the radar screen of the Vulnerability Exercise for quite a while. The assessment of the underlying vulnerabilities was raised in March 2006. This triggered interdepartmental consultations which have been ongoing in various forms since that time, and led to enhanced monitoring by the desk as well at that time.

Mr. Larsen asked about the role of the Fund in encouraging discussions between country authorities in the region. I believe we are quite active in this regard. The Fund is an active participant in the Central Asian Regional Economic Cooperation (CAREC) Initiative, which brings the regional countries together. We have also brought groups of countries into the Joint Vienna Institute for courses and seminars. We held a conference on capital flows in the Central Asia region in Kazakhstan last year.

Last, and although this is at this stage still work in progress, we are hoping to be able to establish a Regional Technical Assistance Center in Central Asia. Currently, we are working with a number of countries in the region and looking at the possibility of moving this forward over the next few months.

The staff representative from the Monetary and Capital Markets Department (Mr. Lohmus), in response to comments and questions from Executive Directors, made the following statement:

Let me start with the question on how the weak Bank Resolution Framework and underfunded Deposit Insurance Scheme would play out and whether the banking system situation will deteriorate further. The weak Bank Resolution Framework would be a concern. However, we must give some credit to the government, as they are well aware of the shortcomings and are working hard to improve the legal framework, including bank resolution. Their efforts will be hopefully supported by the Fund as we are planning to send over two long-term advisors to work on those issues.

As for the Deposit Insurance Fund, the authorities have recently gradually injected capital to the fund. In addition, the fund has a formal line of support from the budget in case the Deposit Insurance Fund falls short in the event of a crisis.

There were questions related to the steps taken by the government to support some sectors of the economy; namely, whether those measures create moral hazard, and whether direct government injections in banks' capital to address NPL issues would have been a better solution. These steps taken by the Kazakh authorities—namely, placing deposits with the banks for on-lending those funds to SMEs and the construction sector—were really designed to serve as a first line of defense, to avoid a complete credit freeze and also provide some social protection for people who had made down payments for apartments that had not yet been finished.

I agree that, as with every government intervention, there is a risk of moral hazard. However, in this particular case, those risks were partly addressed by leaving the credit risk with the banks and not with the government. Also, the funds placed with the banks were not really subsidized, and the banks choose very carefully whom to finance and whom not to. As we can see now, the banks have not fully used up those government funds which, again, indicates that moral hazard risks have been, at least for the time being, somewhat mitigated.

Indeed, in principle, it would have been cleaner to adopt a somewhat different approach, leaving the borrowers and lenders to deal with market forces, and only then, and if needed, injecting capital into the banks that were still viable. Nevertheless we think that, as a second best solution, the approach taken by the government was reasonable.

There was also a question about the contribution the banks have to make to the Deposit Insurance Fund, given that this is underfunded. Those contributions made by banks are risk–based and are determined by banks' risk profiles based on different financial and prudential criteria. The contributions range from about 0.2 percent to 1.5 percent of insured deposits annually, which is within the range of international practices, although we do not have a best international practice for contributions.

Some Directors asked about measures which would reduce banks' heavy reliance on external financing. Indeed, we fully agree that reliance on foreign borrowing has remained a concern for quite some time. Unfortunately, there are no short-term solutions available. A combination of factors would be necessary—for example, risk-based prudential measures to make external borrowing more expensive, higher real interest rates on deposits, higher domestic savings rates and, of course, last but not least, improved confidence in the banking sector.

Mr. Murray inquired whether the lending standards are too rigid in Kazakhstan and could thereby aggravate the credit squeeze. As far as we are aware, the lending policies in Kazakhstan in general are not very different from other countries. However, as Kazakhstan has not really faced a similar credit squeeze before in its history, and as written and unwritten practices are still developing, we would expect some adjustment in the way the banks handle problem borrowers in the periods ahead by introducing some flexibility and allowing loan renegotiations where appropriate. We indeed recognize that the lack of a personal bankruptcy law and procedures may be a constraint, but we do not see a big problem there.

Addressing the questions by Mr. Rouai here on the different NPL definitions, let me stress that the FSA supervisors have one definition, and they are working based on this one definition. The reason why we introduced two in our report was to bring the definition in use closer to what we know as international best practice, because the Kazakh definition is much more stringent.

There was a question about provisioning policies. As with loan classification rules, the provisioning policies are also rather strict in Kazakhstan. However, we agree that the actual practices may be a bit different. In recent months we have been concerned that, for example, the provisions probably do not fully reflect the decline in real estate prices. Provisioning may become a concern even if the policies themselves are stringent.

Because Kazakhstan was the first country to have a second FSAP update, there was a question as to whether these updates have been useful. I think that they have, although the results, if one looks at the last FSAP update, were quite mixed. There were areas where the authorities have done well, for example, in improving the regulatory framework. There were, however, areas where we would have liked to see more progress. For example, in the last FSAP update, we warned them about the liquidity risks and their reliance on foreign borrowing. Even if the authorities did take some steps, they were clearly not enough to mitigate those risks. Overall, however, I think the FSAPs have been very useful, and the authorities appreciate the recommendations we have come up with.

Mr. Palei made the following statement:

First of all, I would like to thank the staff for their answers to the many questions we had in our gray and the questions asked by other Directors. I know that I wrote a relatively long gray, but I still would like to make two points, because I think Kazakhstan deserves the attention of the Fund and the situation is very serious in this country.

Today in the morning Mr. Lipsky told us that Tolstoy would not write Anna Karenina about a happy family, and it is difficult to disagree with his point. For some happy countries, we could have Article IV consultation reports every two years, perhaps, or the reports could be brief and streamlined.

The staff reminded us this morning that there are various ways to streamline surveillance, and one of them is to prepare a selected issues paper every other year. This practice is usually followed, first when there are no major changes in the country's economy, and second when a country has a program.

However, Kazakhstan is not a happy country. According to Mr. Callen, it has not been considered as such since 2006. Mr. Callen told us today Kazakhstan was on the radar of the Vulnerability Exercise of the Fund in 2006 already. In this respect we fail to understand why not a single selected issues paper has been issued since 2005.

We welcome the FSAP update, and we wish the follow–up had taken place earlier than the beginning of 2008—perhaps in the beginning of 2007, or even before that in 2006, so it could have had more of an impact in mitigating the consequences of the devastating crisis that has taken place now in Kazakhstan.

We also know that Kazakhstan had received technical assistance, and relations between the country authorities and the Fund are good in this respect. We welcome the intention to create a Regional Technical Assistance Center. However, we still believe that Article IV reports have to be supported by analytical studies, and three years without a selected issues paper for Kazakhstan is not acceptable.

Second, in our gray we have tried to argue that Kazakhstan is not as dysfunctional as international investors and the rating agencies seem to believe. We looked at the strong fundamentals in Kazakhstan, including high GDP growth and excellent prospects for additional oil production, a large current account surplus with an undervalued currency, and large foreign exchange reserves. But the markets are extremely pessimistic, and it is dangerous to ignore them.

In the staff update, we noted that one more foreign investor has decided to increase its equity stake from 8 percent to 25 percent in Kazkommertsbank, the largest bank in the country. We considered this as good news and as another sign of normalization.

However, yesterday I found out that Fitch has again lowered the rating of one Kazakhstani bank and said that other banks were candidates for further downgrades. Over the last two weeks, the spread on CDS for Kazkommertsbank increased by more than 100 basis points, to reach 716 basis points. This is a very large spread for the main bank in the country.

I do not want to read too much into these short–term changes, but I have to say that I remain confused whether the situation in Kazakhstan is improving or deteriorating, particularly in the financial sector and the banking sector, and how dangerous it is. The question for me is whether in the short– to medium–term the authorities should do anything else to stabilize the situation, or whether they should merely persevere with the ongoing work.

I would be happy to hear staff's comments on recent developments in Kazakhstan and their views. Again, to me it is puzzling that the rating agencies and international investors are so pessimistic on Kazakhstan. I hope that the staff can shed some light on the apparent disconnect between the strong fundamentals of the country as we saw them from reading the staff report, and the views of the markets.

Mr. Raczko commented on the authorities' plans to lower the tax burden, noting that it was supported by the staff with the caveat that taxation of the extractive industries was not lowered. However, a tight fiscal policy was clearly required, and, taking into account the rapid credit expansion, it would be a good idea to tax consumption. What were the staff's views on cutting the VAT rate?

Mr. Rouai made the following statement:

I join Mr. Yakusha and other Directors in expressing some concern about the reclassification of the exchange rate arrangements for the country. I think what the staff did is to reclassify within the current policy, and I would like to have their confirmation.

I remember we had a preliminary discussion on the issue of exchange rate classification, and there was an agreement that we would continue the discussion, and that this issue would form part of the Work Program of the Board. However, recently I saw a follow–up by the Secretary that indicated that the paper on exchange rate reclassification would only be sent to the Board for information. I think many Directors expressed concern about this issue, and feel that it should be put on the Board agenda.

This is confirmed by the interest of the Board on exchange rate issues in general. Particularly since the last discussion was inconclusive, I do not see why is the paper will be sent only for information. When we discussed the Work Program, there was a call for postponing some policy issues until after the Annual Meetings, but I do not remember Directors calling for a postponement specifically on this issue of classification of exchange rate arrangements.

The staff representative from the Middle East and Central Asia Department (Mr. Callen), in response to comments and questions from Executive Directors, made the following additional statement:

Let me start with Mr. Palei's question about the assessment of the overall economic situation in Kazakhstan.

I feel that the way to think about this is that we have two competing forces going against each other. Clearly, there is an oil sector which is benefiting hugely from higher oil prices. As I explained this morning, we think that that is having positive spillover effects into the rest of the economy. On the other hand, clearly the financial sector is still under considerable stress.

As we pointed out in the staff report, nonperforming loans are continuing to rise. Our expectation is they have further to go. Deposit growth has recovered from the declines we saw late last year, but it remains quite weak. Access to new external financing for the banks is still almost nonexistent. They are able to largely replace the financing that is maturing, but that is on short-term maturity and higher-cost grounds.

Certainly, the situation has stabilized in terms of increasing central bank reserves. Again, clearly the National Oil Fund is seeing a large increase in its assets, as money is filtered into the fund from the government. It is certainly far too early to say that there has been a stabilization of the situation in the banking sector, and we still think that has further to run. There are positive signs in terms of the foreign investor interest in Kazkommertsbank. There have also been rumors that foreign investors are interested in Alliance Bank, the fourth largest bank.

What do we think the authorities should be doing in this situation? Well, as hopefully the staff report indicates, we think that they have been following the right policies, but there is further to go, particularly on the financial supervision side. In this respect, it is very important that they stay on top of the situation, make sure banks are provisioning appropriately, strengthen their supervisory mechanisms, and make sure the markets are open to foreign capital coming in.

One of the most important things the banks can do is to strengthen their capital positions to offset the likely loan losses that they will have going forward. In sum, the situation is better than it was late last year, but Kazakhstan is not completely out of the woods yet. That is reflected in the growth forecast we have going forward, that while growth in the first quarter was 6 percent year-on-year, we are expecting it to weaken on a quarterly basis over the next couple of quarters before we see some recovery toward the end of the year.

Regarding the question on the VAT tax rate decline, if the proposed tax cuts had been happening during the midst of the consumption boom, we would have been more concerned. That consumption boom has come quite rapidly to a halt in the last few months. The government views the VAT tax rate cut as a way of trying to help the general population, in particular the lower-income groups. One of the goals of the government is equitable growth in the economy. The VAT tax rate cut is only 1 percent, which is not as big as the cut in the corporate income tax rate.

On the exchange rate reclassification, the stability of the tenge against the dollar started in October 2007 and we are now in the beginning of July 2008. We have seen virtually no movement in the exchange rate over that period against the dollar. I think the reclassification is consistent with existing Fund policies on this. It is a de facto classification system. Clearly, the authorities still view this system as being a managed float in what they would expect the system to be like in the longer term, but on the basis of actual behavior over the last ten months I think it is hard to argue that it is anything else apart from an effective peg against the U.S. dollar.

Mr. Kiekens made the following concluding statement:

This Board meeting and the entire consultation process were very helpful and constructive. The high quality of the staff papers, with well-articulated policy advice, was instrumental in having a focused Board discussion in which the Directors concentrated on the key challenges for the Kazakh economy and the appropriate policy responses.

I thank all my colleagues for their constructive interventions. In particular, I would like to thank Mr. Lushin and Mr. Palei for their candid statement, as well as Mr. Raczko, Mr. Yakusha, and Mr. Rouai, four colleagues representing countries in the region. Those Directors elaborated, inter alia, on the regional effects of the Kazakh economy, and how this affects the countries they represent in the Board.

There was broad consensus between Directors and staff on the analysis of the economic situation and in the policy recommendations. Obviously, there are some nuances on different topics by a number of Directors. I will only touch on a few of them.

On fiscal policy, a good number of Directors basically agreed with the staff that the stabilizers should work, and that, in a somewhat less benign situation, there is space for discretionary fiscal policy. However, a number of Directors were more in line with the authorities' stance of a somewhat stricter fiscal policy than the staff's recommendation. This is a matter of nuance, Mr. Chairman. I do not think there are substantial differences.

On the inflation outlook, the Board by and large agrees with the outlook of the staff that there is a good chance for a gradual decline in inflation. However, some Directors were less sanguine. There was a broad consensus on monetary policy. At the same time, I observed that a few Directors were skeptical about the recent interest rate reduction of the central bank, though, by and large, there is good support for the monetary policy strategy.

In relation to the exchange rate, I would like to focus on substance. Staff has shown flexibility, good analysis, and judgment in changing its advice to the government and the central bank. In the past, staff advised the authorities to allow more exchange rate flexibility. Today, given the situation in the financial sector, and the exchange rate exposure of the corporate sector, staff recommends to stabilize the exchange rate given the potentially serious negative consequences of significant exchange rate volatility.

Mr. Palei had an intriguing question. He asked why it is that the markets seem to be wrong. The fundamentals of the Kazakh economy are good, even very good, and yet we see extreme nervousness in the markets. As explained in my written statement, the outlook for the Kazakh economy is indeed encouraging. Kazakhstan has high oil reserves and the prospects for increased production are very good. Commodities are abundant. All this is positive. However, having a claim on a private Kazakh bank is different from having a claim on the Kazakh government. There is no state guarantee for creditors when a private bank is in financial difficulties. So far, banks have managed well. As it is written in the staff report and in my statement, this is to some extent due to strong public finances. But there is constructive ambiguity. There is no outright state guarantee; and, to my knowledge, not an implicit one either. In any case, creditors of private Kazakh banks, in their behavior, make a clear difference between a claim on a private financial entity and on the Kazakh Treasury.

This brings me to another reason why, in comparison with other emerging market economies, especially Central European countries, Kazakhstan was affected more severely. Until the crisis happened, almost all private banks were Kazakh banks. Although there is some foreign participation, the situation is by comparable with that in Central Europe, where the large majority of banks are solid, reputable international banks. This feature explains to an extent why the solvency ratings of Kazakh banks were considered lower than that of major European banks that are active in Central Europe.

Mr. Yakusha, in particular, was candid in observing that the situation in Kazakhstan is a clear example of how markets can turn around rapidly. Only last year, the main issue the Board focused on was how to mop up excess liquidity flowing into the country. This year it is just the opposite.

Commenting on a question what could have been done to avoid the present situation, Mr. Lohum of the staff, agreed that this was a difficult issue. In my opinion, prudential authorities need to make sound judgment on the level of risk they allow a bank to assume. The key instrument for that is to make risk-taking by banks more expensive by raising the capital adequacy requirements for banks. In retrospect, this might not have been done forcefully enough. We now must observe that the most critically needed measure is to recapitalize banks. As the staff rightly points out, if the balance sheet is impaired and solvency is not repaired, the situation will go from bad to worse.

If the Kazakh banks - and the same situation can happen in other countries - need to refinance external debt by more expensive credit, the problem would not be solved, but only postponed. The solution is to adequately and timely repair the balance sheet by recapitalization, which will allow to refinance the outstanding liabilities at an acceptable rate, rather than a prohibitive rate.

The taxation of the oil sector is an important issue, not only in Kazakhstan, but for many poor and middle income countries in the world that have natural resources. How are profits related to oil and other natural resources shared in an equitable manner? What is a fair, effective taxation regime of the benefits of national resources? Many countries have binding contracts on royalties to be paid by the extractive industries. In Kazakhstan, at this point in time, some of these contracts may not be very equitable. This is why Kazakhstan is working on a new taxation policy in this respect. I would like to ask staff to update the documentation on taxation practices for the extractive industries.

Mr. Palei expressed his disappointment about the depth of the analysis of Kazakhstan's economic situation. I would agree that more is always possible. It is a matter of managing limited resources. I leave it to the staff and to management whether more resources in terms of analytical research can be provided for Kazakhstan. I would certainly welcome that. However, let me repeat what Mr. Callen has said. There is more activity and interaction between the staff and the Kazakh authorities than what appears in today's staff papers. MCD has actively participated in a number of seminars that took place in Kazakhstan, which were organized for the region on the topic of abundant capital inflows. In the area of technical assistance, there is good cooperation, as Mr. Palei rightly pointed out. I am grateful that two technical resident advisors will be posted in Kazakhstan, and that a Regional Technical Assistance Center will be established. In addition to the Article IV consultation, there have been useful interim staff visits.

In conclusion, Mr. Chairman, I would like to thank Tim Callen for his work, and also Mr. Lohmus, who lead the second update of the Financial Stability Assessment. Kazakhstan is the first country of the region to receive such an update. This demonstrates in yet another aspect the intense cooperation between the staff of the Fund and the Kazakh authorities.

I should not close without mentioning the very good work done by Ms. Nicole Laframboise, who had to take over as Acting Mission Chief in the last and most difficult days of the mission. She was very effective in presenting the conclusions of the mission to the Prime Minister, to the Governor, and to the Deputy Minister of Finance. I was happy to be present at these meetings, and can testify that the Fund has an excellent staff.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They observed that the economic situation has been affected significantly by the recent global financial turmoil, with growth slowing down and liquidity conditions tightening. The authorities' prompt policy responses have been instrumental in helping the country weather the current difficulties. Directors noted that, while risks to the outlook remain on the downside, growth prospects in the medium term are still favorable, and the Republic of Kazakhstan has considerable financial resources at its disposal, including comfortable levels of the oil fund and international reserves. Directors stressed that policies should continue to focus on managing risks and promoting a return to strong, sustainable growth, supported by a sound banking system and ongoing reforms aimed at diversifying the economy and boosting competition.

Directors welcomed the considerable progress made in developing a financial safety net framework, which has proven effective in supporting the banking sector in response to the dry-up of external financing over the past year. They looked forward to the operationalization of a Memorandum of Understanding on Financial Stability, which sets out the framework for cooperation among relevant bodies during periods of financial distress. In this context, they underscored the importance of enhancing the authorities' flexibility to react to adverse developments in banks without compromising the central bank's financial position or creating moral hazard.

Directors noted with concern the deteriorating loan quality at the banks, linked to their high exposures to the weakening property market and rapid credit growth in recent years. Further efforts will be needed to strengthen banking supervision and regulations, and to fully implement the FSAP Update recommendations. Immediate priorities are to improve both onsite and offsite supervision, and to strengthen capacity for stress testing and risk analysis. Steps should also be taken to ensure that banks have sufficient capital and provisioning, and to strengthen the operational autonomy of the Financial Supervision Agency.

Directors agreed that, in current circumstances, preserving a stable exchange rate is key to boosting depositor confidence, limiting the risks from the large foreign currency exposure of the corporate sector, and helping reduce inflation. Any intervention in the foreign exchange market to ease downward pressures on the exchange rate should be carried out under clear operational rules that limit reserve losses. Directors encouraged the authorities to return to a more flexible exchange rate policy when financial market conditions improve. They noted the staff's assessment that there is currently no clear evidence of undervaluation or overvaluation of the real exchange rate relative to its equilibrium.

Directors emphasized the importance of pursuing monetary policy that strikes an appropriate balance between preserving financial stability, cushioning downside risks to growth, and ensuring a downward path of inflation. They encouraged the authorities to monitor headline inflation closely, given the possibility of further food and oil price increases, and to stand ready to tighten monetary policy as needed to bring down inflation to the targeted level.

Directors commended the authorities for their prudent fiscal management, which has resulted in large budget surpluses and low public debt, and created ample room for automatic stabilizers to operate. With the economy weakening, Directors supported the recently announced measures to increase spending in priority areas. They saw room for a further well-targeted fiscal stimulus should growth slow more sharply than expected, while being mindful of its inflationary impact. At the same time, efforts should continue to improve public financial management, with the assistance of the World Bank. Directors looked forward to the finalization of a new tax code, which should help ease the tax burden on the nonoil sector.

Directors emphasized the need for a well-crafted response to the sharp rise in food prices, including well-targeted transfer programs for low-income households. Efforts should be strengthened to improve agricultural production and distribution systems, while avoiding trade restrictions that affect prices in international markets.

Directors welcomed the publication of the Republic of Kazakhstan's first report under the Extractive Industries Transparency Initiative. They encouraged the prompt passage of the draft bill to help bring the Republic of Kazakhstan's AML/CFT legislation in line with international best practice.

It is expected that the next Article IV consultation with the Republic of Kazakhstan will be held on the standard 12-month cycle.

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SHAILENDRA J. ANJARIA
Secretary