



CWRD Discussion Paper No. 2

THREE DIMENSIONS OF THE BANKING CRISIS IN KAZAKHSTAN

Prepared by JURGEN CONRAD

September 2008

Abstract

The views expressed in this paper are those of the author and do not necessarily reflect the views or policies of the Asian Development Bank. Over 2000-2007, Kazakhstan was one of the best performing emerging markets. Now, it is one of those most affected by global financial turmoil. The paper explains what went wrong and how serious the situation is. The focus is on the banking sector, macroeconomic challenges, and economic development policies. Kazakhstani banks financed an unusually aggressive credit expansion increasingly by foreign borrowing. The credit expansion fueled a real-estate boom that turned into a bust. Banks also got increasingly exposed to risks inherent in small enterprise and consumer lending. The measures taken so far, including liquidity support by the central bank, introduction of a currency-peg, establishment of a construction sector stabilization fund, and presumably interventions by state-owned development organizations and enterprises, have stabilized the situation but not overcome the crisis. Most banking sector risks, including high external debt exposure, remain. There is the risk that necessary adjustments are delayed. This would increase the overall cost of the crisis and undermine the development outlook for the country.

Asian Development Bank

Introduction: A Snow Leopard Catching Up

1. Kazakhstan's economic performance over the past eight years was celebrated as one of the most impressive among emerging markets worldwide. Growth of Kazakhstan's gross domestic product (GDP) averaged 10% per year in 2000-2007 after contracting by 4.5% on average per year in 1992-1999. The external trade balance turned from a deficit of 5% of GDP on average per year in the first eight years of independence into a surplus of 11% on average over the following eight years. The turnaround was equally impressive in the areas of fiscal consolidation and monetary stabilization. Thanks to economic growth and a real appreciation of the local currency Tenge, GDP per capita increased from \$1,000 per year in 1999 to \$6,800 in 2007. Kazakhstan had established itself as a mid-income country at par with countries like Malaysia and Thailand. It was the Snow Leopard catching up with the East Asian Tigers.

2. The factors behind this success story were not only policies that attracted the foreign funds needed to substantially increase the extraction of hydrocarbons and bring them to the market—other resource rich countries in the region have been much less successful here—and the unprecedented increase in global commodity prices. Kazakhstan also stood out through professional macroeconomic management and bold structural and regulatory reforms. Points in case are the establishment of a fully funded pension system in 1998, which is still the most impressive in a transition economy (by 2007 yearly contributions increased to 1.8% of GDP and assets under management to 9.5% of GDP); Kazakhstan's response in 1999 to spillover from the Russian financial crisis; the subsequent cleanup of its banking system, which became the most dynamic in the CIS; the establishment of a national wealth fund named National Fund in 2001 to accumulate excess oil earnings and tax revenues (funds under management increased to \$21 billion or 20.3% of GDP by end-2007); the establishment of the first consolidated financial services regulator in a transition economy in 2004; and the build-up of the new capital Astana, which was a major logistical feat. Meantime, social and political stability were maintained, which was also a major achievement.

3. However, Kazakhstan is among the emerging markets most affected by the global financial turmoil since August 2007. What went wrong? How serious is the situation?

The Crisis Setup

4. In August 2007, the Kazakhstani banking system was hit by liquidity problems in the US-American and European banking systems, which effectively shut down international credit markets. The Kazakhstani banking system had become vulnerable for such an exogenous shock. Since Kazkommertsbank issued its first Eurobond in 1998, all leading Kazakhstani banks had gained access to international capital markets and became increasingly dependent on it. Thanks to favorable company credit ratings and abundant global liquidity, cheap finance from abroad was readily available, mostly in form of Eurobonds and syndicated loans. Since end-2002, Kazakhstani banks increasingly used foreign funds to finance an aggressive credit expansion at home. Foreign liabilities of the banking sector increased from \$1.8 billion (or 2% of GDP) in December 2002 to 43.5 billion (or 20% of GDP) in July 2007 (Chart 1). 58% of these liabilities were short- and medium-term syndicated and bilateral bank loans.

5. Over the same period, private sector credit grew from 19% of GDP to about 56% of GDP (Chart 2). This was still lower than in Thailand (84%) or Malaysia (105%), but almost at par with the USA (60%) and much higher than in most other successful transition economies such as the new European Union member country Czech Republic (41%). About half of the credit expansion in Kazakhstan was funded from abroad. Bank deposits also increased. However, they did not keep pace with the credit expansion. This means that fewer and fewer credits were backed by deposits. The private sector credit to deposit ratio increased from 125% in 2002, which was already high from an

international perspective, to 198% in 2007. For comparison, Thailand had a ratio of 94% in 2007, Malaysia 91%, and developed economies like the USA or Germany of 57% and 115%, respectively.

Chart 1: Foreign Debt of Commercial Banks, 1997-2008 (\$ billion)

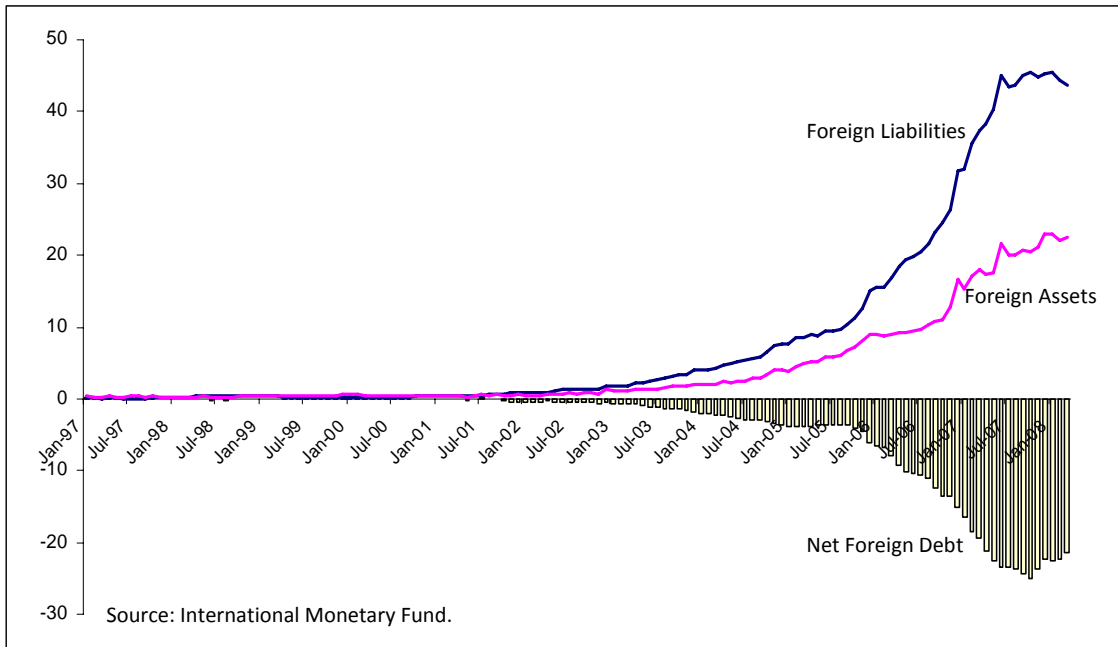
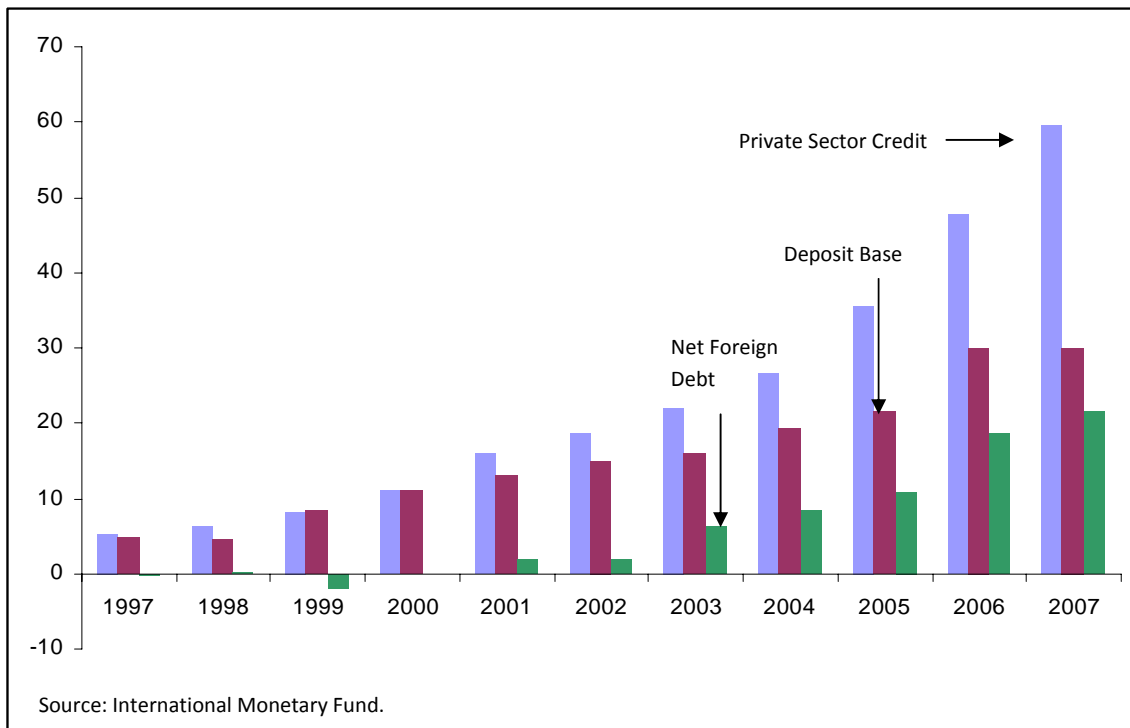


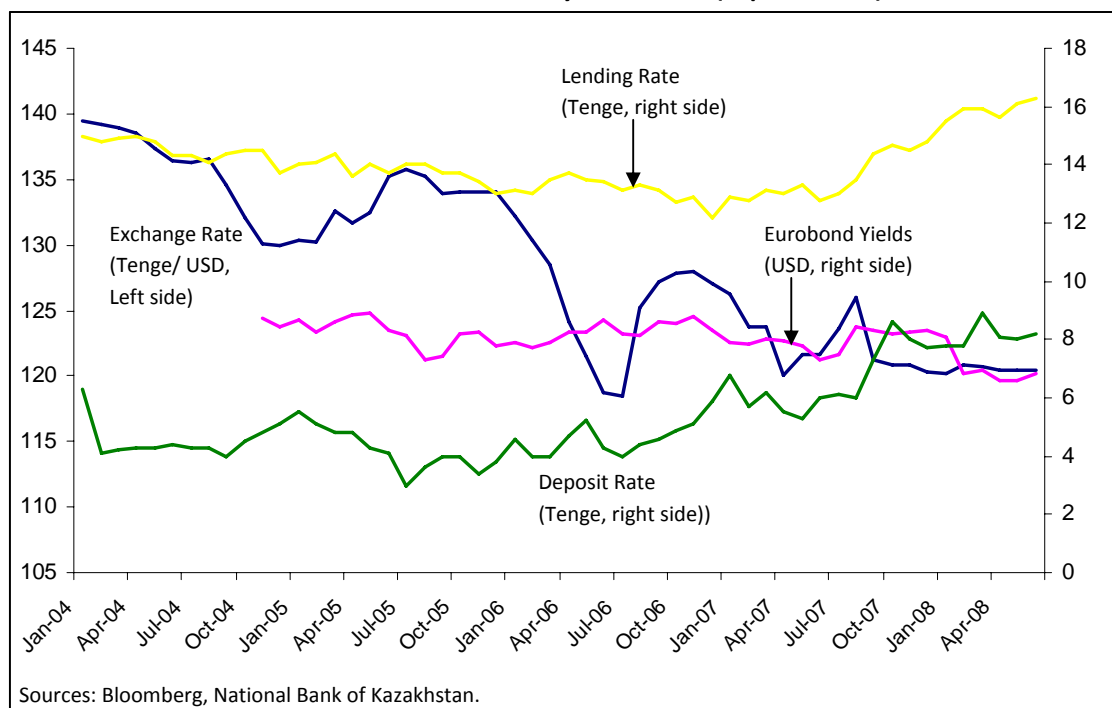
Chart 2: Private Sector Credit and Main Sources of Funding, 1997-2007 (% of GDP)



6. Over the past few years, many other countries also experienced rapid credit growth in excess of GDP growth. This was a global trend.¹ Further, excess liquidity and underestimation of risk bred excesses in many developed and developing economies, which are only now being exposed. Kazakhstan was, as such, not the only one. However, Kazakhstan's credit expansion was clearly among the most aggressive ones, with 70% on average per year over 1999-2007. Further, Kazakhstan relied on foreign financing more than any other country worldwide. Like with bold reforms, Kazakhstan is a country of extremes. Moreover, Kazakhstan's banking system became vulnerable not because of unregulated financial innovation (there was none) or financial instruments that got out of hand (securitization and derivatives were only being introduced) but due to its core banking model.

7. What was the essence of this model? – Rather than more decisively developing their deposit base, which would have been time-consuming and expensive, particularly in a thinly populated country like Kazakhstan, local banks borrowed massively abroad (mostly short- and medium-term) to lend domestically (mostly long-term). This was quite compelling: Foreign funds were available at interest rates between 6-9% depending on borrower and point in time. This was far below domestic lending rates and not much above deposit rates (Chart 3). Meanwhile, the local currency appreciated in nominal terms, which was strongly believed to continue for years to come. In fact, with rapidly rising foreign currency inflows due to commodity exports, foreign direct investment attracted by abundant natural resources, and rapidly rising inflows into the banking system, a continued currency appreciation seemed a safe bet.

Chart 3: The Price of Money, 2004-2008 (% per annum)



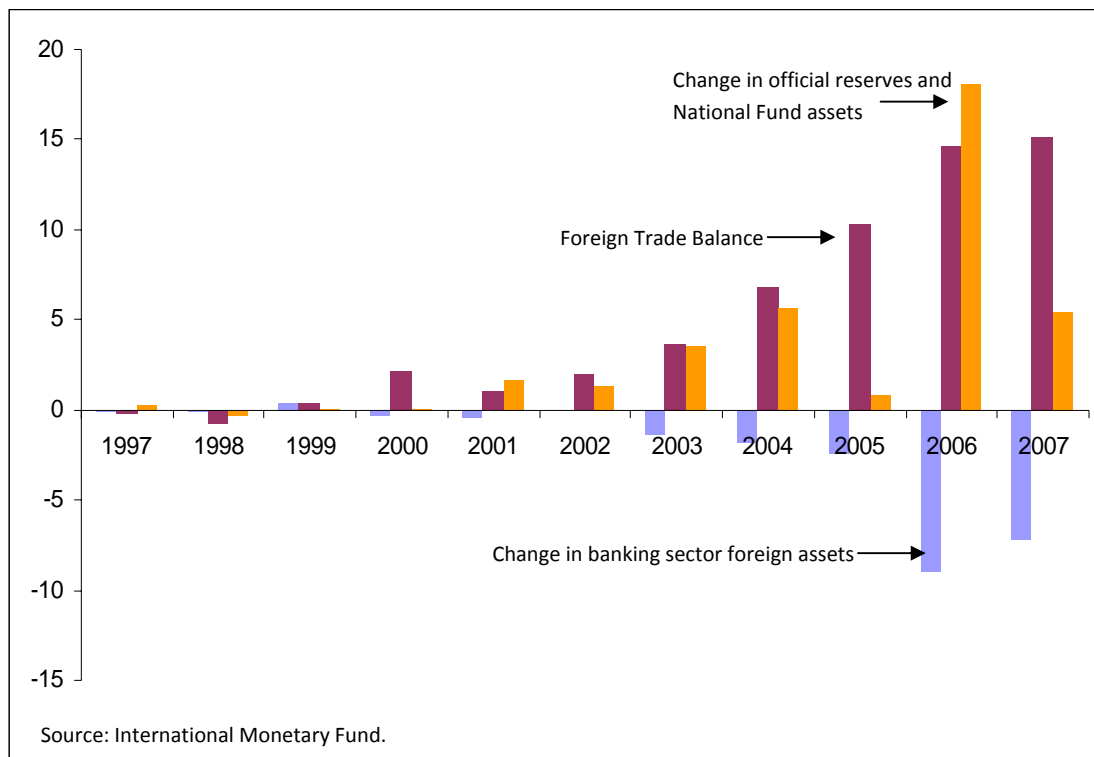
8. Arbitrage between foreign and domestic interest rates in a strengthening currency environment made Kazakhstani banks increasingly profitable. The average return on equity increased from 6% in 2001 to 15% in 2007. This further increased the willingness of foreign investors to lend and banks' to borrow. However, what seemed to be a virtuous circle turned out to be a vicious one.

¹ Joseph Crowley. 2008. *Credit Growth in the Middle East, North Africa, and Central Asia Region*. Washington (IMF Working Paper 08/184).

9. Bank managers were additionally motivated in their credit expansion by fierce competition within the sector over market shares. The Government's desire to accelerate the development and diversification of the economy may also have played a role. In 2004, for instance, the commercial banks came under intense pressure from the previous Government, possibly encouraged by the construction lobby, for not doing enough to finance economic development.

10. However, from a development perspective, the growth patterns of the banking industry, namely its strong reliance on foreign debt, meant that Kazakhstan was not particularly successful in intermediating the increasing profits of export oriented industries—not just crude oil but also copper, various rare metals, and grain—through its own financial system into productive investments. Hard currency piling up in export-oriented sectors and the government's coffers in form of rising official reserves and assets of the National Fund was not reaching the banks (Chart 4).

Chart 4: Balance of Payment – Selected Items, 1997-2007 (\$ billion)



11. Further, bank credit increasingly financed investment in non-tradables, namely residential and commercial property, which prices were substantially growing, and consumption of the middle-class, whose income was rising. Over the 18 months between end-2005 and mid-2007 alone, the share of construction, mortgage, and consumer loans in overall loans increased from 33% to 39%.

12. From a financial soundness and risk-management perspective, the growth model of many banks was unsustainable, and this is not only from hindsight.² Obvious and easily quantifiable risks indicators were:

- (i) The rapid pace of credit expansion (para. 6), which is always risky because it strains the capacity of a banking system to ensure sound loan quality, and increases the share of new and untested loans in banks' portfolios;

² See, for instance: International Monetary Fund (IMF). April 2006. *Article IV Consultations – Preliminary Conclusions of the IMF Mission*. Washington.

- (ii) a high and increasing exposure to small enterprise and consumer loans, which are both riskier than traditional markets with the risk amplified in Kazakhstan, because banks were relatively unfamiliar with these types of credit; the share of consumer credits in total credits was 17% at end-2006; the share of credits to small enterprises was 18%, which was higher than their contribution to GDP; this is unusual, given their higher risk profile; most of SME credits were long-term (73% at end-2006);
- (iii) low real interest rates, including for consumer and small enterprise loans (6% at end-2006 for long-term loans to small enterprises);
- (iv) a high exposure to mortgage lending that involved risks, although mortgage loans are normally considered safer as the collateral is secure, because Kazakhstani banks were unfamiliar with mortgage lending, there were concerns about a real estate bubble, and collateral recovery procedures were believed to be weak; the direct exposure to mortgage lending and the construction sector was 22% of the loan portfolio at end-2006 and many other borrowers were believed to invest in real estate; further, most loans were collateralized by real estate; directly or indirectly, 70% of the loan portfolio was reportedly linked to real estate;
- (v) rapidly increasing gross and net foreign liabilities of the banking sector (para. 4);
- (vi) high and increasing private sector credit to deposit ratios (para. 5);
- (vii) in context with (v) and (vi) above, the unfavorable funding structure of the banking system; at end-2006, foreign liabilities already accounted for 48% of total liabilities and customer funds for merely 36%; and
- (viii) a maturity mismatch between mostly short- and medium-term foreign liabilities and mostly long-term domestic assets; at end-2006, 73% of bank loans had maturity periods above one year and frequently much more.

13. These issues were compounded by shortcomings in the regulatory environment for the banking sector, namely in the areas of related-party lending, single borrower exposure, risk-management, and classification of non-performing loans (NPLs). These shortcomings were well documented through a comprehensive financial sector assessment, which was undertaken in 2004 and fully disclosed.³

14. Over time, the authorities got increasingly concerned, particularly about external borrowing. In January 2007, the regulator made an effort to limit the sector's exposure to foreign debt by introducing, effective 1 March 2007, a cap on bank's international borrowing based on their capital levels. Nevertheless, foreign debts skyrocketed by another \$13 billion or 41% in the first half of 2007. In June 2007, the central bank announced an increase in reserve requirements on bank's foreign liabilities for 29 August 2007. However, even before that date the crisis stopped the excess (Chart 1).

The Sector Dimension

15. Credit growth naturally varies across the 35 Kazakhstani banks, so does exposure to foreign borrowing and other risk-factors. However, there was not much room for differentiation initially, since foreign creditors' country limits were reduced almost overnight. That triggered a liquidity crisis at the interbank money market that put all banks under stress. As a response, banks tried to shore up liquidity and stopped lending. That had a direct negative impact on enterprises in the construction sector and real estate prices, which went steeply down.

³ IMF. 2004. *Republic of Kazakhstan—Financial Sector Assessment Program Update*. Washington (IMF Country Report No. 4/338). Unfortunately, the establishment of an integrated financial services regulatory agency absorbed a lot of managerial and staff capacity, which could otherwise be spend on addressing remaining regulatory weaknesses more vigorously. Moreover, in follow up discussion on these weaknesses undertaken in mid-2004 and yearly 2005 management of the agency made it clear that it was quite content with the existing regulatory framework and industry practices, particularly in the area of risk-management.

16. Like central banks in many other countries, National Bank of Kazakhstan (NBK) tried to mitigate the crisis by providing short-term liquidity support to commercial banks totaling over \$10 billion.⁴ NBK also effectively pegged the Tenge to the US Dollar. More controversial was the establishment of a stabilization fund of \$4 billion to provide support to the largest builders to ensure delivery of paid-for but unfinished properties, which would, in turn, also prevent real estate loans from going bad. This amount, which came from the National Fund, was equivalent to 25% of banks' exposure to mortgage and construction loans (totaling \$16 billion at end-2007). The establishment of the fund was obviously intended to stabilize the construction sector and encourage banks to continue construction and mortgage lending. However, critics saw the danger that a failing sector could be indiscriminately bailed out without dealing with the underlying problems. This would lead to moral hazard and potentially breed another, bigger crisis. There was a similar controversy related to the idea to use funds of government organizations or state-owned enterprises (SOEs) to buy-up banks' shares to stem the allegedly unjustified fall in their market value.⁵

17. Behind these controversies were divergent views about the role of the state in the economy, and about the nature and extend of the crisis. Most Kazakhstani stakeholders saw the reasons for the crisis, if any, outside the country and expected the situation to improve shortly.⁶ Downgrades of international rating agencies were, thus, not well received. Kazakhstan's long-term foreign currency rating was downgraded to the lowest investment grade by end-2007. All but one commercial bank, Halyk Bank, were downgraded below investment grade.

18. To a degree, this dichotomy of views persists. However, a consensus has evolved that home-grown issues are part of the overall problem. Further, it is well understood that Kazakhstan has strong external and financial buffers, and that the Government is willing and has the resources to prevent a meltdown. Still, it is also clear that the availability of funds overall does not necessarily mean (and should not mean) that they are available to each and every distressed company and bank.

Table 1: External Debt Service Structure of Kazakhstani Banks, March 2008 (\$ billion)^a

2008		2009				2010			
QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	Later
4.6	6.1	3.8	3.5	3.2	1.8	1.7	2.5	0.8	26.3

^a The table does not include \$0.3 billion debt on correspondence accounts and \$0.4 debt with unknown maturity.

Source: National Bank of Kazakhstan

19. The measures taken over the past 12 months were sufficient to stabilize the sector but not overcome the crisis. With regard to foreign debt, banks have done well so far. Kazkommertsbank, which had been the most aggressive foreign borrower among the top-three banks, was able to pay off syndicated loans totaling \$1.2 billion in December 2007 and February 2008; it faces another \$600 million payment in September. Second-tier Bank CenterCredit redeemed its \$250 million debut Eurobond in February 2008. Top-tier Bank TuranAlem redeemed \$550 million in March 2008; this represented almost half of all its 2008 external debt payment. Commercial banks' foreign debt service in 2008 amounts to \$17 billion overall (as of end-December 2007). All payments due in the first half of 2008, which were \$9.7 billion, have been made. Foreign debt services in the second half of 2008 amounts to \$7.3 billion and in 2009 to \$9.2 billion (Table 1).

⁴ This was done through repo and currency swap transactions, the purchase of a significant amount of government securities from banks, and the early redemption of most short-term notes issued by National Bank of Kazakhstan (NBK).

⁵ The proposal produced acid comments on the part of foreign media and rating agencies, since senior Government figures and their relatives own significant shareholdings in leading banks. Nevertheless, the discussion may have actually helped to stabilize expectations since some banks are now believed to be both, too big and too well connected to fail. The credit rating of Halyk Bank, for instance, is two notches higher than fundamentals justify due to a very high probability of external support from the authorities. See: Moody's Investor Service. 2008. *Halyk Savings Bank of Kazakhstan – Credit Analysis*. London.

⁶ The crisis was indeed triggered by an external shock. Foreign borrowers, which were all too willing to provide funds before the crisis due to excess liquidity and an underestimation of risks cut their credit lines almost overnight.

20. However, only Halyk Bank, another top-three bank, has managed to sell a new \$500 million five-year bond through an international issue in April 2008. Halyk Bank, the former state-owned savings bank, has traditionally the largest deposit base and is least dependent on foreign loans. Nevertheless, gross foreign debt of the banking system has not declined since August 2007 (Chart 1). This means that the broadly expected downward adjustment of foreign debts has not materialized so far, at least not at the sector level. Little is known about how the roll-over has been taking place. To what extent have affiliated companies provided funds? Have Government controlled organizations or SOEs participated? In Russia, such entities have reportedly been very active since August 2007 in investing in company debt to fill the gap left by foreigners. Further, it is not clear whether Kazakhstani banks have been successful in lengthening the maturity structure of their liabilities? Is maturing external debt being replaced by higher-cost, short-maturity loans? This would increase vulnerabilities in the future.⁷ Such questions have kept investors and rating agencies on their toes.

21. Growth of private sector credit has slowed substantially from an annualized 70% before July 2007 to around 4% thereafter. However, it is surprising to see the credit portfolio growing at all. The expected contraction of an obviously inflated credit portfolio has not taken place, although banks should have strong incentives to shore up liquidity and decrease their exposure to various credit risks. The explanation may be a combination of factors, including moral suasion from the authorities, strong relations with customers (which are frequently shareholders, staff, or otherwise related), and the desire on the part of individual banks to prevent a rapid increase of NPLs. No bank wants to be recognized as the one with the most serious asset quality problems.

22. To keep NPL ratios low, credits could be re-written or rolled over, with or without consent from the regulator. Official ratios of NPLs, which are defined as 60 days overdue or loss in Kazakhstan, had been low during the boom years (1.6% at end-2006). This is typical. While rapid credit growth trends to breed poor loan quality, particularly in a low interest rate environment, quality problems are frequently only exposed during downswings. Since mid-2007, NPL ratios have increased, but not dramatically (to 2.7 in June 2008). This is another surprise. Classified loans ratios, which are all loans with payments areas if only for a day, had been high and rising for years (46% at end-2006) and increased further to very high levels (57% in June 2008). However, something or someone is preventing classified loans from really turning sour. There is apparently some differentiation by sectors: NPL ratios for the construction sector, for instance, reportedly increased from 4.7% in June 2007 to 8.6% in January 2008. However, the overall picture reflected in official figures is that the Kazakhstani banking sector does not have serious loan quality problems. In line with that, not a single bank in Kazakhstan has collapsed.

23. In light of this, the relatively low NPL levels, the successful roll-over of foreign debt, and the growing credit portfolio one may want to ask whether the Kazakhstani banking sector was in crisis at all?—In our view, it was at least under intense pressure. Exceptional measures had to be taken by the authorities and individual banks to prevent a breakdown. More importantly, most risk factors, with the exception of high credit growth, remain (Table 2). Banks are still exposed to risks involved in small enterprise and consumer lending. The same applies to maturity risk. In June 2008, 81% of credits were long-term, which was certainly more than the share of long-term liabilities in overall liabilities; figures for June 2008 are not available, but the share of long term liabilities at end-2007 was 50%. To a degree, there is also a currency mismatch. At end-2007, 62% of the banking sector liabilities (mainly foreign debt and deposits) were in foreign currency but only 55% of its assets. Further, foreign currency loans, which accounted for 43% of the total loan portfolio in June 2008, are exposed to exchange rate risks because borrowers have their revenues mostly in local currency.

24. After a decline in August-October 2007, bank deposits increased again; in March 2008, they were 10% above July 2007 levels. However, the ratio of private sector credit to deposits has

⁷ The share of long term Eurobonds in overall external debt, which was 42.1% at end-June 2007, has certainly declined.

remained very high. Further, the increase in overall bank deposits was due to rising deposits of bank subsidiaries rather than customer deposits. The share of customer deposits in overall liabilities of banks fell from 36% at end-2006 to 33% at end-2007. Over the same period, the share of deposits of banks' subsidiaries increased from 18% to 22%. To strengthen its deposit base, Alliance bank, which' credit portfolio increased with triple-digit annual rates before the crisis, broke ranks in early 2008 and offered 15% rates for three year time retail deposits. While this was then already several percentage points below consumer price inflation, it still raised concerns about a possible deposit war and related moral hazard. For a while, the introduction of a 13% cap on interest rates was under discussion; the idea was apparently supported by NBK and a number of other leading banks. With rising inflation, deposit rates are now highly negative. That, together with worries about banks' stability, explains why customer deposits still do not play a bigger role than before August 2007.

Table 2: Banking Sector Risk Indicators, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	June 2008
Banking sector assets, % of GDP	20.3	25.1	30.3	36.4	45.8	59.5	86.9	91.8	
Private sector credit, % of GDP	11.2	16.0	18.6	21.9	26.5	35.7	47.8	59.5	
Private sector credit to deposits, %	101.7	122.8	125.3	138.3	136.4	165.5	159.9	198.0	188.6 ^a
Banks' net foreign assets, percent of GDP	0.0	-1.9	-1.9	-6.2	-8.5	-10.8	-18.6	-21.5	
Private sector credit growth, % (year end)	75.1	78.5	35.4	43.9	53.7	74.2	80.2	55.2	4.0 ^{a b}
Small enterprise loans, % of total	26.9	24.9	21.8	20.1	19.4	18.1	18.4	20.7	20.4
of which long term, %	46.0	50.7	57.0	58.9	66.2	69.9	72.3	80.3	80.1
Loans to construction sector, % of total	4.3	4.7	6.4	7.7	10.7	12.1	14.0	17.2	17.9
Mortgage loans, % of total	0.0	0.5	1.1	3.0	6.7	8.5	8.4	9.4	9.1
Consumer loan loans, % of total	1.1	1.5	4.7	6.5	9.7	12.4	16.6	16.6	16.5
Capital adequacy ratio (risk weighted)	25.7	18.6	17.2	16.9	15.9	15.0	14.4	14.2	15.0
Nonperforming loans, % of total	2.0	2.1	2.0	2.1	2.9	2.2	1.6	1.5	2.7
Classified loans, % of total	21.8	28.9	26.7	36.8	40.9	39.5	45.8	58.7	56.8
Total number of banks ^c	48	44	38	35	36	34	33	35	35

^a March 2008

^b Annualized

^c Includes Development Bank of Kazakhstan

Sources: Agency on Regulation and Supervision of Financial Markets and Financial Institutions in Kazakhstan, International Monetary Fund, National Bank of Kazakhstan.

25. Banks also remain exposed to the real estate sector, which saw a construction boom and excessive price increases before the crisis. With the introduction of mortgages in the early 2000s, the real estate industry began expanding quickly, especially in the more affluent urban areas. Residents of Almaty and Astana have been particularly active: They held 34% and 16% of the total outstanding mortgages in June 2008. The boom was also fueled by commercial and infrastructure development. Rising real estate prices gave way to unregulated speculation. By June 2007, real estate prices in Almaty and Astana were reportedly nearly \$4,000 per square meter. This was equal to, or more expensive than those in major cities in the USA.

26. The financial shock in August 2007 resulted in a dramatic fall in the demand for real estate and a supply glut as many speculators were forced to sell to meet mortgage payments. This sent prices deeply down. The situation was further exacerbated by the construction sector's dependence on bank credit. Sudden lack of financing left construction companies without resources to finish projects.⁸ The establishment of the \$4 billion stabilization fund in late 2007 (para. 16) has partly

⁸ That has left a significant number of hopeful home-owners and would-be investors, which frequently bought their properties before the foundation was laid, without a home and often with little hope to receive what they paid for. Furthermore, many construction companies have saturated the market with luxury housing developments, which appeared most profitable.

addressed this problem and somewhat mitigated the risks associated with construction and mortgage loans. In June 2008, the direct exposure of the banking sector to the construction and mortgage sector was equivalent to \$16.3 billion. One quarter of the stabilization fund had reportedly been disbursed by March 2008. The remaining \$3 billion are equivalent to 18% of the banks' direct exposure to mortgage and construction lending. The Government promised to add another \$3 billion to the fund, if needed. The fund would then be equivalent to 36% of bank's direct exposure. However, the stabilization fund provides state financial support to the construction sector and not to the banking system, although the funds are channeled through participating banks into selected projects. However, they do not refinance banks or remove credit risks from the loan portfolios of banks. Further, banks also have exposure to borrowers outside the construction sector that have invested funds in real-estate. Finally, most bank loans are collateralized with real estate, which prices have declined substantially and apparently not yet bottomed out. Similarly, the Government has launched an additional scheme to support SME lending by providing a credit line to banks. Here again, credit risks remain with the banks.

27. Having stabilized the banking sector so far is certainly no small achievement. However, to overcome the critical situation differentiation is needed. There need to be winners and losers. Financial institutions with better strategy and management, particularly in the area of risk, and with better underwriting practices must come out as winners. Only then can a constructive process take place that ultimately leads to a sounder and more competitive banking sector. In other words, the sector challenge for Kazakhstan is to repeat what was successfully done after the Russian crisis.

28. The reforms that followed the Russian crisis resulted in a consolidation of the Kazakhstani banking sector. This time, it may be cross-boarder consolidation. While the banking sector is highly concentrated, with the top three banks accounting for 62% of credits and 63% of deposit (June 2008), few banks had a strategic partner abroad before the crisis and foreign banks were underrepresented. At end-2007, foreign banks accounted for only 3.4% of banking assets. This was radically different from successful transition economies in Eastern Europe, where typically more than two thirds of the banking systems are foreign-owned.⁹ Foreign participation tends to facilitate know-how transfer and access to funds. Before summer 2007, neither Kazakhstani banks nor the Government were keen on changing the status quo. Banks felt they have the know-how they needed. Many of them were able to easily raise funds on foreign debt markets or by issuing shares on foreign exchanges.¹⁰ Since summer 2007, however, a number of Kazakhstani banks have been looking for strategic buyers. This has been actively encouraged by the Government.

29. In January 2008, Italian Bank Unicredito completed its acquisition of 92% of the shares of ATF Bank, the sixth largest bank in Kazakhstan, for \$2.1 billion. For ATF bank, the benefit of partnering with a major foreign bank with strong balance sheet has already shown. The credit agencies have positively adjusted their views of the bank and its short and long-term outlook, and ATF Bank was able to attract structured funding from abroad. In early February 2008, Korean Kookmin Bank announced its intention to buy a controlling stake in the mid-sized Bank CenterCredit. Kookmin Bank is expected to sign an agreement to buy a 30% stake in CenterCredit for \$630 million. It could exercise an option to raise its ownership to 50.1 per cent in three years for an additional \$400 million. Several less high-profile deals by medium-sized Kazakhstani banks with private equity funds and the acquisition of Kazakh Teksaka Bank by Russian Sberbank and Kazakh Demir Bank by Israeli Hapoalim Bank confirm the trend towards cross-border consolidation. The focus has been on mid-sized banks so far, which are mostly relative newcomers with extensive retail banking operations and

⁹ Even in neighboring Kyrgyz Republic, the banking system has attracted massive foreign investment (rather than debt). The country has weathered the crisis better so far. At end-2007, foreign banks accounted for 65% of banking sector capital in the Kyrgyz Republic. Ironically, most of the foreign investment has come from Kazakhstan.

¹⁰ Three Kazakhstani banks are listed at the London Stock Exchange: Kazkommertsbank, Halyk Bank, and Alliance Bank.

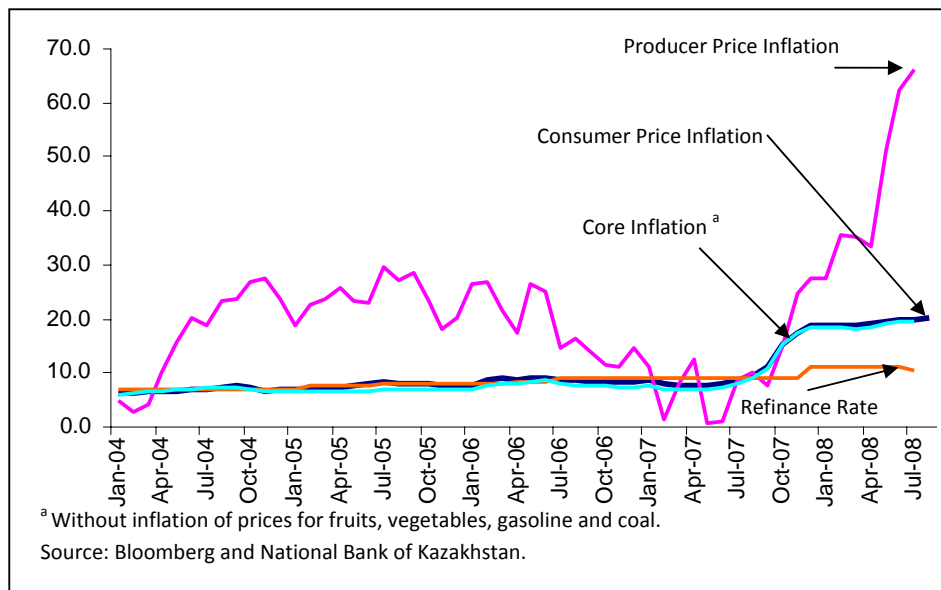
high dependence on foreign borrowing. In July 2008, however, Alnair Capital, a private equity group backed by capital from Abu Dhabi, bought a 25% stake in Kazkommertsbank.¹¹

30. From the Kazakhstani point of view, strategic buyers are now frequently seen as White Knights. How many of these knights will ultimately turn out to be Don Cichotes will depend on bank-specific circumstance, sector developments, and macroeconomic factors.

The Macroeconomic Dimension

31. As indicated above, NBK as the lender of last resort responded to the crisis by providing liquidity to banks to avoid a systemic crisis and mitigate the effects of the turmoil on the real economy. It opened a short-term credit line and massively injected money into the system (para. 16). Further, NBK's refinance rate has remained low, despite increasing inflationary pressures (Chart 5). An increase in reserve requirement originally planned for August 2007 was repeatedly postponed. Ultimately, reserve requirements have been lowered.¹²

Chart 5: Price Stability



32. This monetary policy approach has certainly helped to stabilize the situation. Bank failures have been avoided. Over time, bank lending has started to increase again (para. 21). An outright credit crunch has been prevented. However, the fast credit expansion that had fueled growth of the non-oil sectors of the economy since 2004 came to an abrupt halt in mid-2007. In real terms, i.e. considering inflation, bank credit has declined by 15-25% (depending on the deflator used) since then. This constitutes a massive financial shock for the real economy.

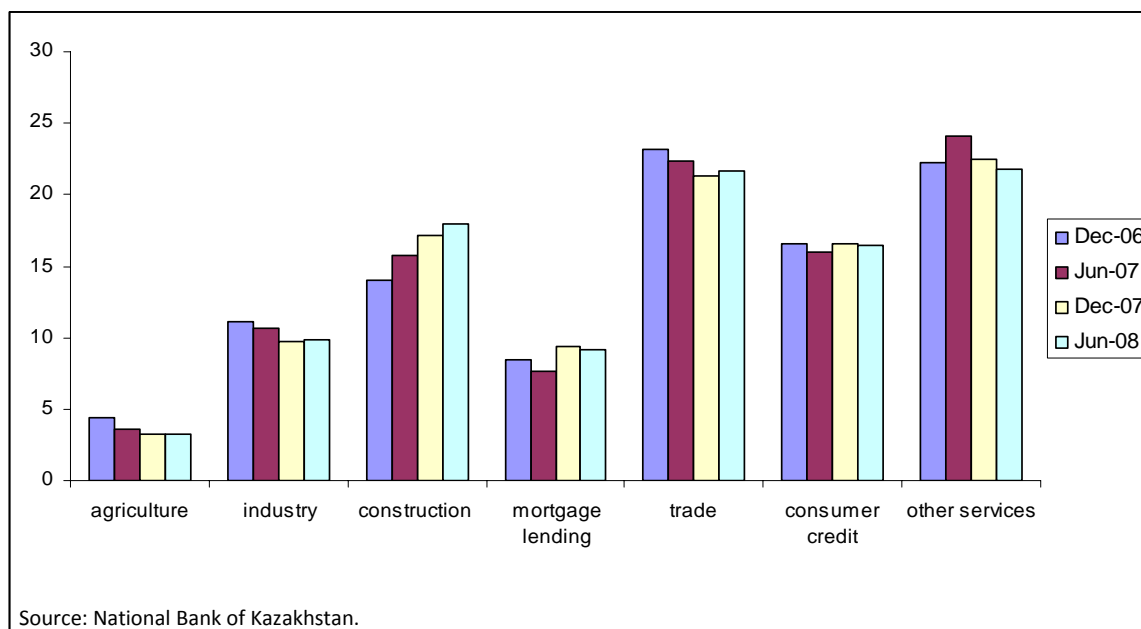
33. Initially, the construction sector was most affected. However, the measures taken by the authorities turned this into its opposite: The share of construction and mortgage lending in banks' credit portfolio has actually further increased since mid-2007 (Chart 6). It appears that the Government has done too much to keep the property sector afloat. This does not only go at the

¹¹ There have been unconfirmed reports that Kazakhstani investors are also related to Alnair Capital. This would make the deal, at least partly, a redistribution of ownership rights between domestic investors.

¹² Before the crisis, reserve requirements for foreign borrowing were at 8% and for domestic borrowing at 6%. An increase to 10% for foreign borrowing announced for August 2007 was first postponed to January 2008 and then to July 2008. On 1 July 2008, requirements were increased to 10% for foreign borrowing and reduced to 5% for domestic borrowing. On 29 July 2008, however, requirements for foreign borrowing were reduced to 7%. NBK has been sending mixed signals.

expense of other sectors. In all probability, it also means that the adjustment needed after the burst of the property bubble is being delayed. This may well increase the overall cost of the crisis.

Chart 6: Composition of Loan Portfolio of Banking Sector (%)



34. Another key measure taken by NBK after unexpected exchange rate fluctuations at end-August and early September 2007 was to peg the Tenge (informally) to the US Dollar.¹³ Since then, it has been floating within a very narrow band. Previously, the exchange rate had been floating more or less freely while the authorities were taking steps to introduce inflation targeting monetary policy, i.e. completely abandon the exchange rate anchor. The reasons behind the policy reversal were apparently (i) the foreign currency exposure of the banking and the corporate sector, which total foreign debts are similar to that of the banking sector;¹⁴ (ii) high levels of Dollar denominated loans and deposits and the perceived need to protect depositors and borrowers from exchange rate risk; (iii) the broader advantages of an exchange rate target, which is simple to implement, transparent, and easily understood by the public; and (iv) traditions—like other transition economies Kazakhstan had pegged its currency to the US Dollar in the 1990s. There has also been the expectation that a peg will bring inflation on a downward path. The International Monetary Fund (IMF) has explicitly endorsed the new exchange rate regime as adequate for the current period of uncertainty.¹⁵

35. As outlined above, commercial banks have been able to maintain their foreign debt service and attracted new foreign loans, and deposits have increased somewhat.¹⁶ To what extent this has been facilitated by the peg is difficult to say. However, inflation has not yet been brought on a

¹³ Rumors about a banking and real estate crisis, along with a dearth of information, caused depositors to massively reduce their deposits and change Tenge into foreign currency. In some foreign exchange offices, the Tenge weakened by up to 30% before it bounced back due to central bank interventions. Between July and December 2007, official reserves dropped by almost \$6 billion, since NBK had to provide banks with US Dollars liquidity and defend the exchange rate. Since then, reserves have recovered to pre-crisis levels.

¹⁴ A large share of foreign debt of the non-bank corporate sector may be related to the oil and gas sector, which has earnings in US Dollars. However, a breakdown is not available.

¹⁵ IMF. April 2008. *Republic of Kazakhstan — 2008 Article IV Consultation: Preliminary Conclusions of the IMF Mission*. Washington.

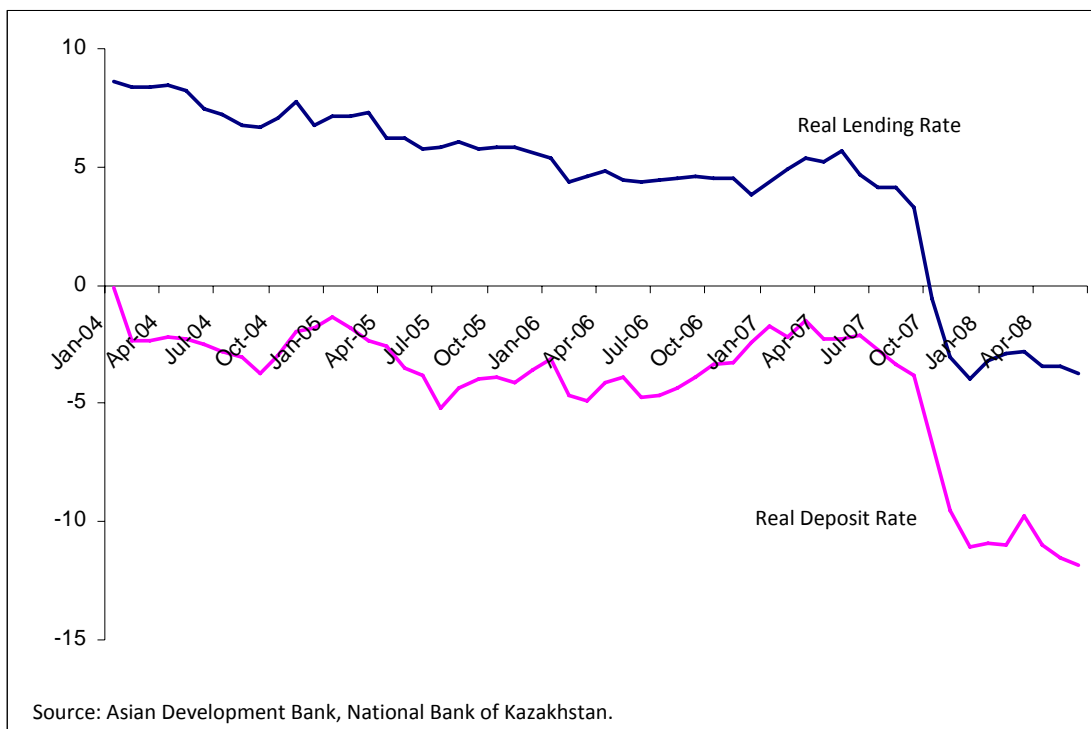
¹⁶ The share of local currency deposits of private households in total deposits had continuously increased before the crisis. However, it declined from 75% in June 2007 to 63% in June 2008. This suggests that the population remains somewhat skeptical about the exchange rate outlook.

downward path (Chart 4), although this typically takes some time after introducing an exchange rate anchor.

36. NBK (and the IMF) expect inflationary pressures to ease in the second half of 2008. NBK is, thus, much less concerned about inflation than banking sector stability and economic growth. It is beyond the scope of this paper to discuss in any detail whether this approach is justified. With an exchange rate peg, interest rates become a function of capital flows and are not available any more for fighting inflation. In other words, to the degree NBK has gained control over the exchange by introducing the peg it has lost independent control over inflation.¹⁷ Further, one may argue that the current stock of money became inflationary with the bursting of the property and credit bubble. Trying to boost lending under these circumstances may add fuel to fire.¹⁸ In any case, if inflation is not quickly brought under control, it could backfire on both, banking sector stability and economic growth. It would also undermine the credibility of the exchange rate peg.

37. Introducing the peg has raised the stakes. Having to abandon the peg under pressure would be negative for NBK's reputation. It would also be potentially devastating for the banking system, which has, perhaps partly due to the peg, not yet reduced its exposure to foreign borrowing. NBK may, therefore, want to consider widening the band sooner rather than later. Afterwards, it may want to proceed with its efforts to switch to inflation targeting.¹⁹

Chart 7: Real Interest Rates (% p.a.)^a



^a The deflator is the consumer price index. Deflated by the producer price index, the rates would be even lower.

¹⁷ A country that chooses a fixed exchange rate system subordinates its monetary policy to the exchange rate objective and is unable to operate an inflation-targeting system, especially when capital can move freely in and out of the country. Since the public will have no assurance that the authorities will give the inflation target precedence over the exchange rate target or vice versa, neither policy will enjoy the credibility needed for success.

¹⁸ Kazakhstan imports food and is, therefore, negatively affected by global food price increases. However, rising food prices explain only about 40% of inflation in Kazakhstan and core inflation is almost as high as overall inflation (Chart 5).

¹⁹ See, Warren Coats. 2008. *Kazakhstan: The Case for Floating and Inflation Forecast Targeting*. Almaty (Policy Analysis prepared under the ADB funded technical assistance project TA 4431-KAZ Financial Sector Governance).

38. Rapidly rising inflation has not yet resulted in a real appreciation of the Tenge vis-à-vis Kazakhstan's main trade partners, many of which also experience accelerating inflation. However, there is anecdotal evidence that inflation has started to negatively affect private consumption. Price increases, particularly for foodstuff, have eroded real incomes and damaged consumer confidence. Further, real interest rates for deposit (and even loans) are highly negative (Chart 7). This is certainly not helping to attract deposits to improve the funding structure of the banking system.

39. Due to tighter credit conditions and higher inflation, real growth has slowed in all non-oil sectors of the Kazakhstani economy. GDP growth declined from 10% before the crisis to 6.1% in the first quarter of 2008. Growth of industrial production slowed from 7% before the crisis to 3.7% (first half of 2008), growth of agricultural production from 9% to 3.7%, growth of services from 13% to 7%. Stakeholders are well aware that a deteriorating economy may further exacerbate the banking crisis.

40. Having said this, Kazakhstan fiscal and balance of payment situation has remained sound. Kazakhstan is no transfer risk case. Export revenues have remained high and the current account, which's deficit grew to minus 7% of GDP in 2007, may well improve due to falling imports. Official reserves and the assets of the National Oil funds are high and increasing; they together amounted to almost \$50 billion in August 2008. The budget is in surplus (before transfers to the National Fund) and public debt levels are very low. Even if individual banks face protracted difficulties to attract foreign funds, the sovereign should have access to international capital markets any time—unless commodity prices collapse or something goes wrong with Kazakhstan's oil export pipelines.

The Development Dimension: Initial Thoughts

41. In a crisis management situation, it is always difficult to keep the broader development picture in sight. However, many of the measures taken to address the crisis have a development dimension. Further, while it may not be prudent to draw lessons from the crisis build up too quickly, it would be irresponsible to wait for too long. It may not be too early to start asking first questions.

42. As indicated above, the Kazakhstani banking sector has not been particularly successful in intermediating domestic savings into productive investment. This is evidenced by massive external funding of the credit expansion and an increasing share of credits for non-productive purposes. That raises, among others, the question whether the Kazakhstani financial sector is diversified enough? Obviously, it is not. Banks dominate. This domination may even have increased over the last years. Official figures for equity and corporate bond market capitalization are impressive (Table 3) but somewhat misleading. Bond market capitalization includes international bonds listed domestically, which accounted for 43% of capitalization at end-2007, and bond registered under issuance programs (shelf-registration mode) that have not been fully sold. The amount of capital raised through local corporate bond issues was equivalent to \$1.4 billion or 1.7% of GDP in 2006 and \$1.2 billion or 1.4% of GDP in 2007.²⁰ This is something, but less than one would have expected. The picture is similar for equity or share capital. Equity market capitalization is the "market value" of all listed companies. Most of the increase seen over the last few years can be explained by rising share prices rather than initial public offerings or secondary issues of shares. Further, many registered share issues were linked to privatization or motivated by tax avoidance schemes rather than capital mobilization for productive investment. A best guess for capital raised through share issues in 2007 is 2-3% of GDP. Again, this is significant, but less than figures for market capitalization or registration of share issues would suggest.

43. A noteworthy diversification of the financial sector is, of course, the development of private pension funds. However, to the degree assets of pension funds have been invested in bonds and shares issued by Kazakhstani banks due to a void of alternatives they have actually supported the fast-track banking sector development.

²⁰ Jurgen Conrad. 2008. Capital Markets in Central Asia. Manila (ADB CWRD Discussion Paper No. 1; forthcoming).

Table 3: Financial Sector Diversification

	2000	2001	2002	2003	2004	2005	2006	2007
Banking sector assets, % of GDP	20.3	25.1	30.3	36.4	45.8	59.5	86.9	91.8
Insurance premiums, % of GDP	0.3	0.4	0.6	0.6	0.7	0.9	1.2	1.2
Pension sector assets, % of GDP	4.3	5.6	7.1	8.0	8.2	8.5	8.9	9.5
Stock market capitalization, % of GDP	7.3	5.4	5.4	7.9	9.1	18.4	70.4	50.9
Stock market index	106	104	140	142	213	646	2,418	2,637
Number of companies listed at stock exchange	23	31	49	41	54	83	69	70
Number of public offerings of equity (shares)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	144	216
Outstanding government bonds, % of GDP	n.a.	n.a.	1.8	3.3	3.5	3.5	3.7	3.3
Listed corporate bonds, % of GDP ^a	1.0	2.6	4.9	8.7	12.2	15.8	15.0	14.3
Number of local currency corporate bond issues	7	3	24	25	46	55	89	79

^a Includes bonds denominated in foreign currency and partly traded abroad and issues that have not been fully sold to investors
Sources: Agency on Regulation and Supervision of Financial Markets and Financial Institutions in Kazakhstan, Kazakhstan Stock Exchange, and National Bank of Kazakhstan.

44. The potential benefits of capital markets have been well established through theoretical and empirical research.²¹ Capital markets tend to accelerate economic growth by increasing financial savings and the quantity and quality of investment. Capital markets allow growing companies to diversify their sources of investment finance. With access to capital markets, such companies can go beyond financing their investment by retained profits and bank loans. This allows them to increase their investment and raise capital at lower cost. Developed capital markets are also beneficial for financial and economic stability. The increase financial sector stability and make an economy less dependent from bank loans. This reduces the risks associated with a credit crunch. With developed bond markets, companies can still have access to finance even in case of a banking crisis. All this is relevant for Kazakhstan.

45. Capital markets also provide individuals with additional financial instruments that may better meet their liquidity needs and risk preferences. In Kazakhstan, there were little alternatives for private investors than putting funds on deposit accounts (at negative real interest rates) or investing in real estate. This was one of the reasons behind the real estate boom. While there is a small but growing mutual fund industry in the country, it is virtually inaccessible to the average Kazakhstani citizen. Many private real estate investors are now in serious difficulties. Meantime, rising inflation is eroding real incomes. While lack of financial sector diversification appears as one of the reasons behind the crisis, the consequences of the crisis may make diversification even harder.

46. Efforts can, or course, be made to substitute developed capital markets through other systems of financial resource allocation. Most share issues in Kazakhstan are actually made by unlisted companies (in 2007 all share issues). Most share transactions apparently take place outside the stock exchange. More funds are channeled into the economy through state-owned development institutions—such as the Small Entrepreneurship Development Fund, Kazakhstan Development Bank, the State Mortgage Company, the Investment Fund, the Innovation Fund, the State Insurance Corporation, etc.—than through capital markets.

47. To address the current crisis, the Government may be tempted to advise its development organizations, or even large SOEs and the National Fund, to invest in shares and bonds of banks and construction companies to fill the gap left by foreign capital and commercial banks. The state has the funds readily available, which are urgently needed in other parts of the economy. While that was part of the problem that caused the crisis (para. 10) this does not necessarily mean that it cannot be part of the solution. However, there are risks, including the risk to spread bad banking sector assets

²¹ See, for instance, Ajit Singh. 1997. *Financial Liberalization, Stock Markets, and Economic Development*. The Economic Journal, Vol. 107, pp. 771-782.

across the balance sheets of numerous development agencies and SOEs. This could lead to losses for these organizations, postpone a crisis solution, and enhance the overall cost of the crisis.

48. Another idea that the Government has already embraced is to increase state funding for big infrastructure projects to fill the demand gap left by the private sector. Development Bank of Kazakhstan and Eurasian Development Bank have, for instance, each raised \$1 billion of foreign debt funding in the first half of 2008 to finance infrastructure development. This makes a lot of sense. Government financed infrastructure development can indeed help to stabilize the macroeconomic situation. Infrastructure development would also potentially increase the long-term growth prospects of the country. A key question here is how the resource transfer can be organized in the most efficient way and without further undermining the role of private institutions in and outside the financial sector? Further, fiscal support for infrastructure projects should, of course, not prevent necessary adjustments, for instance in the construction sector.

49. Many other questions should be asked for the sake of a successful development of Kazakhstan. State-owned development agencies and SOEs have an enormous leverage in Kazakhstan; 75% of all registered shares are state-owned.²² Is it desirable from a development point of view to further enhance their role? Have the state development agencies driven the country into the right direction so far? What, for instance, has been the role of the State Mortgage Company in the crisis build up? Has the whole system of mortgage finance been designed well enough?

50. Even more fundamentally, how can the situation be addressed that funds accumulate in the public sector that are needed in the private sector? Is there not a clear case for lowering taxes and/or monopoly rents of SOEs to reduce the need for a transfer of development resources from the public to the private sector? Or is the Kazakhstani development model based on the assumption that the public sector is the better developer? Answering these and other questions, if only tentatively, is clearly beyond the scope of this paper. However, a lot depends from the answers for the economic and social welfare of Kazakhstan's population.

51. Monetary policies also have an important impact on development. One obvious question is whether interest rates were set too low in Kazakhstan to allow sustainable development? In view of real lending rates before the crisis (or better before inflation picked up), the answer is probably no. The average real lending rate was 6.2% p.a. in 2005 and 4.5% p.a. in 2006 (Chart 7). This does not appear excessively low. NBK did presumably a good job in accommodating growth. However, deposit rates have been negative for years. In all probability, this has been constraining deposit growth. Further, interest rates for some categories of loans were obviously not risk adequate, neither was the overreliance on foreign borrowing to finance domestic lending. From a development perspective, it may be useful to ask what pushed banks over the edge? Was it weak strategy and risk management or the regulatory framework in this important area? Which role did government policies for SME development, housing sector development, etc. play?

52. Whatever the answers might be, there is an obvious need to address remaining weaknesses in banking sector regulation in a number of areas (para. 13). This is, in part, a capacity building issue. It is encouraging in this context that the Government has reportedly decided to increase the funding for the financial sector regulator. This will help to close regulatory gaps and strengthen enforcement. However, there are broader issues that should be taken into account. Enforcement problems in Kazakhstan (like in other countries in the region) stem from a number of historical and environmental factors, including the political economy of the country, a pronounced desire on the part of company owners to keep company control, lack of transparency of corporate actions, insufficient quality of company data, opaque ownership rights, and weaknesses in the judiciary. Addressing such issues head-on goes beyond what a financial sector regulator can realistically do. This is where the Government must come in.

²² See Central Depository of Kazakhstan. 2007. *Annual Report for 2006*. Almaty.