Kazakhstan

After nearly a decade of GDP growth averaging 10%, a sudden halt in capital to domestic banks, due to global financial market turmoil, triggered a sharp reduction in lending activity and a downturn in growth. A spike in inflation and a drop in foreign exchange reserves added to difficulties. Any further deceleration in growth is expected to be checked by increased oil income, a healthy fiscal position, and still-strong foreign reserves. Key challenges are keeping non-oil growth out of a slump, managing banking sector external debt, and lowering inflation. Long-term prospects remain positive, given the substantial oil wealth.

Economic performance

Midyear 2007 was a turning point for the economy, bringing new macroeconomic difficulties to this petroleum-rich country. In the first half of the year, GDP had grown by 10.2%, but international financial turbulence sharply reduced capital inflows, which in turn restricted bank lending and slowed economic activity: GDP growth fell markedly to 5.8% in the fourth quarter. Expansion for the year is now estimated at 8.5% (Figure 3.4.1).

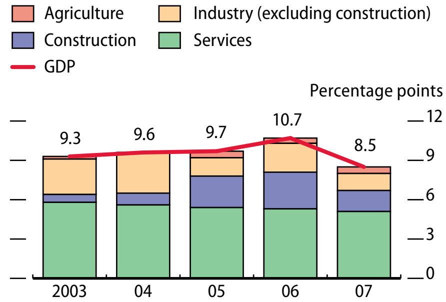
Rapid growth in 2000–2004 had been driven primarily by rising oil production and large hydrocarbon investments that were financed by inflows of foreign direct investment. However, rapid development of the country's non-oil economy has become the main engine of growth since 2005, especially construction and services, and was mostly financed by borrowing from domestic banks.

The banks borrowed from abroad to finance their lending, since the domestic deposit base is small. External debt has surged in recent years and by end-September 2007 it amounted to $93.9 billion (Figure 3.4.2), including $28.4 billion of intracompany loans among oil companies. The private portion amounted to $62.5 billion (equal to about 60% of GDP) with the bulk of this resulting from the rapid expansion of borrowing by local banks after 2004.

Heavy external borrowing allowed domestic banks to keep fueling their lending activity, which more than quadrupled between 2004 and mid-2007 (Figure 3.4.3). In this rapid expansion of credit, local banks became overexposed to the country's booming real estate market, with some 70% of loans (reportedly) directly or indirectly connected to the sector. The phenomenon experienced by Kazakhstan for the past few years, in which credit boom and rising real estate prices were interlinked and mutually reinforcing, acted as a "financial accelerator," risking a housing market bubble and overindebtedness of businesses and households.

This chapter was written by Madi Umbetaliyev, consultant to the Kazakhstan Resident Mission, ADB, Astana.

3.4.1 Contributions to growth (supply)



Source: Agency of Statistics of the Republic of Kazakhstan; International Monetary Fund, *Article IV Consultation*, July 2007.

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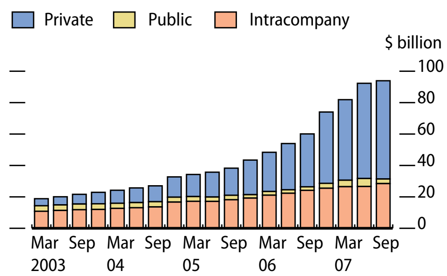
3.4.2 External debt



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 12 February 2008.

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From August, local banks had difficulties in accessing funds from the international markets. This raised their borrowing costs and precipitated a liquidity squeeze, which both reduced their ability to service their foreign debt and led to a sharp increase in domestic interest rates. As a consequence, bank loans to the domestic economy grew by only 1.8% in the fourth quarter. Without access to bank financing, many construction companies suspended activities, and the real estate market stagnated.

The National Bank of Kazakhstan (NBK) as lender of last resort opened a short-term credit line for liquidity support. It injected around $18 billion (gross) into the banking system in August and September, mainly through repurchase agreements and foreign exchange swaps. Money market rates moved from about 6% in June to 12% by end-2007. NBK's credit to banks, however, fell from about $2.2 billion at end-August to $0.6 billion by year-end.

To avoid a collapse in the real estate market and an economic recession in general, the Government allocated $4 billion of budget funds as a rescue package: $1 billion was used in 2007, and the rest will be taken up in 2008. These funds are channeled through domestic banks and target three areas. One part is transferred to construction companies to enable them to complete unfinished residential construction (previously financed by advance payments from putative owners). Another part will be used to finance industrial investment projects (which were suspended by banks). The rest will be used to support small businesses. The funds' allocation is administered by the state-owned Kazyna Sustainable Development Fund. Such support weakened the fiscal stance as the balance moved into deficit for the first time in 3 years (Figure 3.4.4). Revenues rose by 23.5%, but were outpaced by expenditure growth of 37.5%.

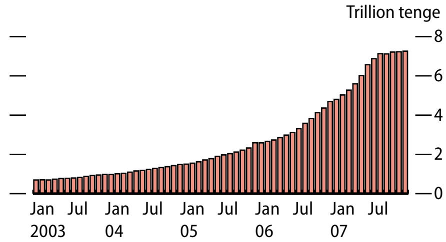
Rumors about a banking crisis and a housing crash, along with a dearth of information, caused steep depreciation of the domestic currency, the tenge. At end-August, during a public holiday, the tenge slumped from T125/$1 to T150–170 in private foreign exchange offices throughout the country. NBK intervened to support the currency to bring the rate back to T120/$1, holding it stable through year-end. In its rescue operations, NBK's foreign exchange reserves dropped by $6 billion in August–October, but reserves subsequently increased somewhat through January 2008 (Figure 3.4.5).

Consumer price inflation in September 2007 moved into double digits for the first time in 7 years (Figure 3.4.6). End-of-year inflation reached 18.8%, pushing annual average inflation to 10.8%. Prices of vegetable oil, bread, and flour were the chief culprits in food price inflation. During 2007, the price of vegetable oil doubled, and those of flour and bread rose by two thirds and by one half, respectively.

Various factors played a part in the climbing prices. Externally, these were, in the main, escalating global food prices. Internally, these were excessive domestic demand fueled by a rapid money expansion, real wages that rose faster than labor productivity, increases in utility and transport tariffs, and structural rigidities that limited competition.

In response to the surge in inflation, the Government introduced a raft of measures including a ban on vegetable oil and oilseed exports; elimination of duties on imports of vegetable oil and reduction of duties on imports of other important foodstuffs; introduction of licensing for

3.4.3 Bank loans to the economy



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 28 February 2008.

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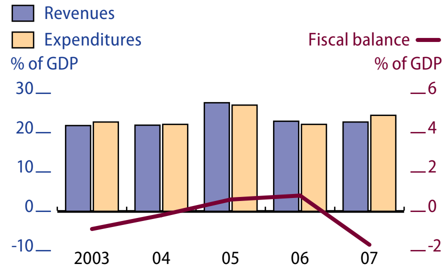
3.4.4 Fiscal indicators



Source: Ministry of Finance of Kazakhstan.

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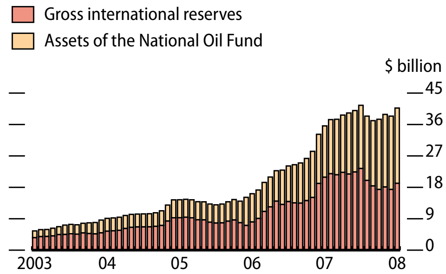
3.4.5 International reserves and assets of the National Oil Fund



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 12 February 2008.

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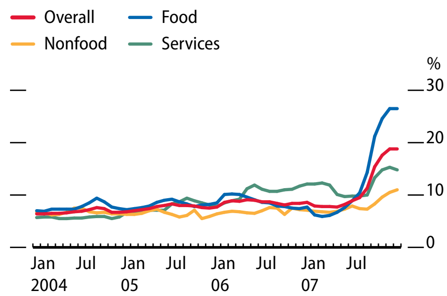
3.4.6 Inflation



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 12 February 2008.

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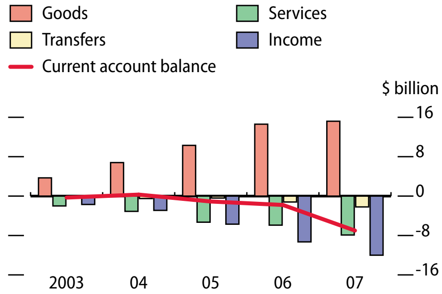
wheat exports; creation of wheat stabilization funds in the regions; and administrative control through "memorandums" limiting price increases over various basic food items and temporary freezes on any further utility and transport tariffs.

The current account deficit increased from $1.8 billion in 2006 to $7.0 billion (about 6.8% of GDP) in 2007. With high world oil prices, the trade balance remained positive, though below a year earlier. However, the trade surplus was swamped by spending on services (mainly transport, construction, and oil exploration services), repatriation of income by foreign direct investors, and current transfer outflows (Figure 3.4.7).

3.4.7 Current account components



Sources: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 28 February 2008; staff estimates.

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Economic prospects

GDP growth is projected to fall to 5.0% in 2008, and a modest increase to 6.3% is penciled in for 2009. These are much lower rates than in recent years, and below earlier expectations. Global oil price increases, strong growth in government expenditures, and large investments in the oil sector are all positives in the outlook. The banking problems and associated difficulties in the areas of construction and real estate development, despite the pledge of substantial government assistance, are the main negatives that will damp growth. Moreover banks, which must repay about $14 billion in 2008 while facing restricted access to external financing, may limit credit, an increasingly important element in maintaining both investment and domestic demand.

Inflation is the Government's priority. NBK has announced a 2-year monetary program which, in the baseline scenario, targets end-of-period inflation of below 10% and average inflation of 16–18% in 2008, achieved by holding expansion in credit to the economy at 9.5%. For 2009, the average inflation target is 8.5–10.5%. Memorandums, which are used to control prices for basic consumer items, will no doubt be continued but they risk developing black markets and discouraging domestic production.

The current account balance is expected to maintain large deficits of about 5.6% and 4.1% in 2008 and 2009, respectively (though improved as a share of GDP compared with 2007). Oil exports will continue rising, based largely on continued increases in global prices and moderately higher oil production from existing fields (Figure 3.4.8). Non-oil commodity exports (mainly metals and grain) will also see strong gains. Import growth is expected to decelerate, reflecting the slowdown in economic activity. Despite an improvement in the trade balance to $1.0 billion–1.5 billion, the current account deficit will remain heavy, given the continued ramping up of imports and services for oil and gas projects, and repatriation of income.

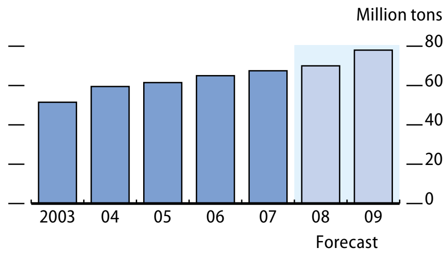
Striking the right balance between monetary and fiscal policies in order to keep the non-oil sector from slumping, yet maintaining progress in bringing down inflation enough to keep an anchor on expectations, will be the main challenge. A prompt but careful readjustment of macroeconomic management should ensure a soft landing for the domestic economy. This would allow an acceleration of structural reform.

3.4.1 Selected economic indicators

	2008	2009
GDP growth	5.0	6.3
Inflation	17.4	10.7
Current account balance (% of GDP)	-5.6	-4.1

Source: Staff estimates.

3.4.8 Oil production



Sources: Agency of Statistics of the Republic of Kazakhstan; staff estimates.

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