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Sustaining Kazakhstan's Macroeconomic Success

Following is an op-ed by Aasim M. Husain, Division Chief, Middle East and Central Asia Department, International Monetary Fund (IMF), published in The Business and Power, a Kazakhstan newspaper in December last year. It may be of interest to those wishing to get a deeper insight into the workings and challenges of Kazakhstan's booming economy.

Kazakhstan maintains mostly consultative relations with the IMF, having paid all of its debts to this organization in the early 2000s.

Kazakhstan's macroeconomic performance record has been impressive. Keeping it that way requires policy action to address growing risks in key areas.

Kazakhstan's macroeconomic achievements are widely recognized and for good reason. Since 2000, per capita income has more than tripled, the unemployment rate has been halved, and close to \$30 billion of foreign exchange reserves have been accumulated by the National Bank (NBK) and the National Fund. Of course, the favorable external environment—especially high oil prices and abundant global liquidity—has helped, but sensible macroeconomic policies have also been key.

However, six years into the economic boom, important challenges have emerged. Inflation has picked up to 8½ percent, and it risks becoming entrenched at that level—or even rising further.

Bank credit is growing at an annual rate of 80 percent, after increasing by an average of almost 60 percent a year over the previous five years. This is a very rapid expansion by any standards. Bank borrowing abroad is fueling the rapid credit growth, and banks' external debt has increased from under \$8 billion at end-2004 to well over \$20 billion now. The easy liquidity conditions are also feeding a sharp escalation of property prices.



**Anvar Saidenov, Chairman
(Governor) of Kazakhstan's
National Bank, has a lot of
important decisions to make in
the months to come.**

Bringing inflation down again has to be a priority. There is no need to look to other countries to see the harmful effects of rising prices. Kazakhstan's own experience is instructive enough. During the late 1990s, when inflation last jumped, the result was a deterioration of economic performance, increased uncertainty, and sharply reduced confidence in the tenge.

Restraining bank credit and external borrowing now will reduce the risk of a much more disruptive slowdown later. For example, sudden tightening of international financial conditions, even for reasons unrelated to Kazakhstan, could spell trouble. With external funding drying up, Kazakhstani banks could be forced to abruptly slow the pace of credit expansion. This, in turn, could affect the quality of their loan portfolios, particularly if there is a sudden turnaround in property prices and a slowdown in economic growth.

What policy steps will mitigate the risks? Tighter monetary policy will have to be a central element. At present, the NBK's main policy interest rate (its deposit rate) is 4 percentage points lower than inflation and almost a full percentage point less than the U.S. Federal Funds rate. This relatively relaxed monetary stance needs to change if inflation and bank credit are to be reined in. Also, increasing banks' reserve requirements will reduce excess liquidity. This will make banks' funding more expensive and prompt them to charge their clients higher interest rates, precisely what is needed to restrain credit demand.

A stronger tenge and greater tenge flexibility are also needed. A stronger currency will directly translate into lower tenge-denominated prices for imports, which will help moderate inflation. In addition, it would reduce the need for the NBK to buy foreign exchange, which in turn should translate into slower tenge liquidity growth and less liquidity for the central bank to mop up. Greater tenge flexibility should help take away the "one-way bet" that encourages even more capital inflows than would otherwise take place, since markets would quickly realize that the tenge could move in either direction, as they did back in July-August.

The worry that tenge appreciation will damage the non-oil sector is misplaced. It is the real exchange rate—the exchange rate adjusted for price movements relative to those in competitor countries—that affects competitiveness, not the nominal one. With the strength of Kazakhstan's economy and the sharp increase in the price of its main export commodities in recent years, some real appreciation is inevitable. It will not help exporters to hold the tenge fixed in nominal terms but settle for higher inflation. Instead, any adverse effect of real appreciation on competitiveness should be offset by intensified efforts to upgrade Kazakhstan's physical and social infrastructure, and by reforms aimed at enhancing the business climate and increasing productivity.

Further prudential tightening will help restrain credit supply. Specific steps could include the extension of the recently-introduced external borrowing limits to all external debt, not just short-term debt. Risk weights used to assess banks' capital adequacy could be tightened further, especially for property loans, foreign currency loans to borrowers without foreign currency earnings, and loans abroad. Depending on the experience over the coming weeks, the new foreign currency liquidity norms may also need to be toughened. And, to make sure that the tighter regulations have the desired effect, supervisory vigilance will need to be enhanced. While banks are unlikely to welcome restraints on their activities, these measures are for their own good. They will protect prudent banks from adverse spillover effects from less prudent banks. And they will help preserve macroeconomic stability, without which even the strongest banks could experience difficulties.

Ideally, tighter fiscal policy should be part of the overall policy tightening. But the surge of government revenue—both oil and non-oil—has made the public impatient to see an impact in terms of higher living standards. This is only fair, but it also means that serious cuts in public spending are unlikely to take place. Indeed, sizable spending increases and tax cuts have already

been announced for next year. This underscores the need for tighter scrutiny to make sure the money is well spent. It also implies an even greater burden on monetary and exchange rate policy to achieve the needed tightening. Although the tightening will translate into losses on the NBK's balance sheet, which the government will ultimately need to compensate, this is a price well worth paying. In fact, monetary and exchange rate policies that seek to avoid such losses becomes severely compromised and risks causing economic instability.

With the right macroeconomic policy in place, the Kazakhstan economy will be nicely positioned to continue its success story.

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Embassy of Kazakhstan to the USA and Canada

1401 16th Street, N.W. Washington, DC 20036

Phone: (202) 232- 5488 ext. 104, Fax: (202) 232- 5845

Contact person: Roman Vassilenko