KAZAKHSTAN: NATIONAL COMPONENT OF GLOBAL ECONOMIC CRISIS

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The world economy is at the stage of a global crisis triggered by a financial shock; it has not experienced such turmoil since the days of the Great Depression.

The period of robust economic growth quickly gave way to a recession not only in advanced countries; a slowdown in the growth of the gross domestic product (GDP) is also recorded in developing and emerging market countries (see Table 1).

Virtually all countries have been seriously affected by the financial and economic crisis. Advanced economies experienced an unprecedented 7.5% decline in real GDP during the fourth quarter of 2008 (compared to the third quarter), and output continued to fall almost as fast during the first quarter of 2009.

Table 1

Dynamics of the Global Economy, 1991-2009
(*annual % change*)

Average	1991-2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
World	3.1	2.2	2.8	3.6	4.9	4.5	5.1	5.2	3.2	–1.3
Advanced economies	2.8	1.2	1.6	1.9	3.2	2.6	3.0	2.7	0.9	–3.8
Emerging and developing economies	3.6	3.8	4.8	6.3	7.5	7.1	8.0	8.3	6.1	1.6
CIS	n/a	6.1	5.2	7.8	8.2	6.7	8.4	8.6	5.5	–5.1

Note: n/a—no data.

Source: *World Economic Outlook April 2009*, IMF, Washington D.C., April 2009.

The U.S. economy has probably suffered most (as a result of intensified financial strains and the continued fall in the housing sector). West European and advanced Asian countries have been hit hard by the collapse in global trade; the situation is compounded by financial problems of their own and corrections in housing markets.

Emerging economies have also suffered badly: in the fourth quarter of 2008, they contracted by 4% in the aggregate, with the damage inflicted through both financial and trade channels.

The effects of the crisis are most pronounced in East Asian countries that rely heavily on manufacturing exports, in emerging European and CIS economies, which have depended on strong capital inflows to fuel growth.[1]

An analysis of Kazakhstan's economic development is clearly of interest in this context, since for many years it was a leader among the CIS countries in the pace and quality of transformation reforms.

This is evident from the length of the transition period, which is determined using chain indexes of GDP growth in member countries of the Eurasian Economic Community (EurAsEC) in relation to the initial stage of reform.

In particular, Kazakhstan and Belarus surpassed the 1991 GDP level in 2003, Russia in 2006, and Tajikistan in 2008. In other words, the transition period lasted 12 years in Kazakhstan and Belarus, 15 years in Russia, and 17 years in Tajikistan; in Kyrgyzstan, this period is not yet over (see Fig. 1).

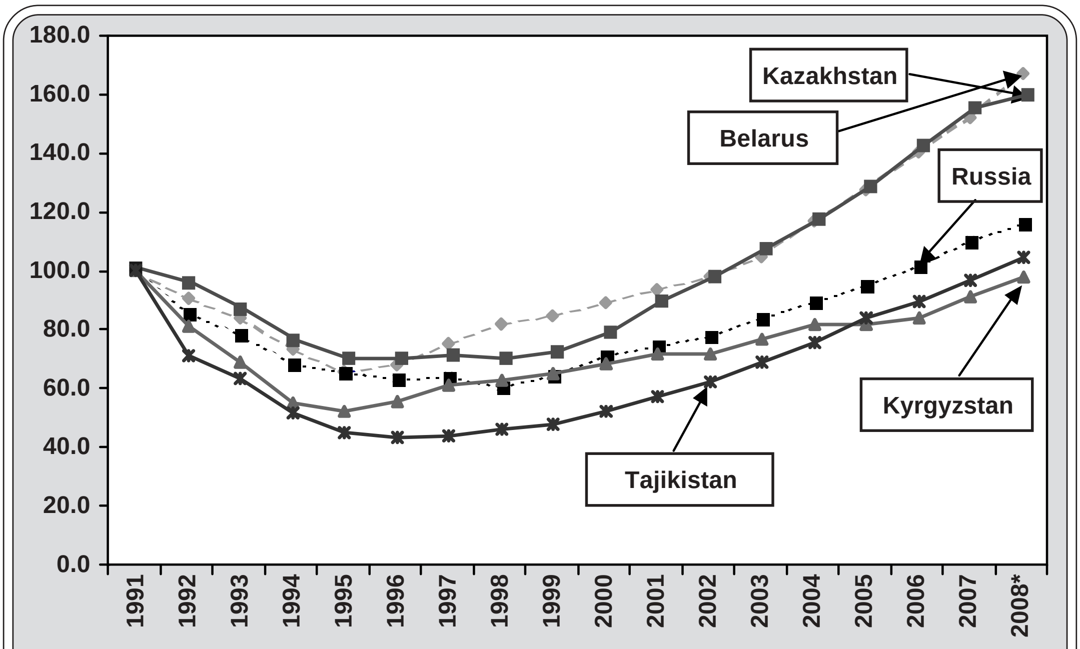
In 2000-2007, cumulative GDP growth in Kazakhstan was 81.3%. A distinctive feature of that period (compared to 1991-1998) was an acceleration of economic growth with a positive impact of exogenous and endogenous factors.

The first group of factors includes a favorable pricing environment in world hydrocarbon and metal markets, and the second, an increase in domestic economic activity. This increased business activity was due to faster growth of fixed investment compared to final consumption, which had a significant impact on the dynamics and nature of structural changes in the production and use of GDP.

[1] See: *World Economic Outlook April 2009*, IMF, Washington D.C., April 2009.

Figure 1

GDP in Kazakhstan and EurAsEC Member Countries, 1991-2008 (*previous year = 100*)



Note: *—operating data.

Source: Calculated and compiled by the authors based on data from the World Development Indicators Database and the CIS Interstate Statistical Committee.

With average annual GDP growth of 8.6%, in 2003-2008 actual final consumption of households rose by 10.7%, and fixed investment, by 17.2% (see Fig. 2).

Among the factors behind dynamic economic growth in Kazakhstan (in recent years) was a simultaneous increase in external and domestic demand, with a significant change in the proportion between them.

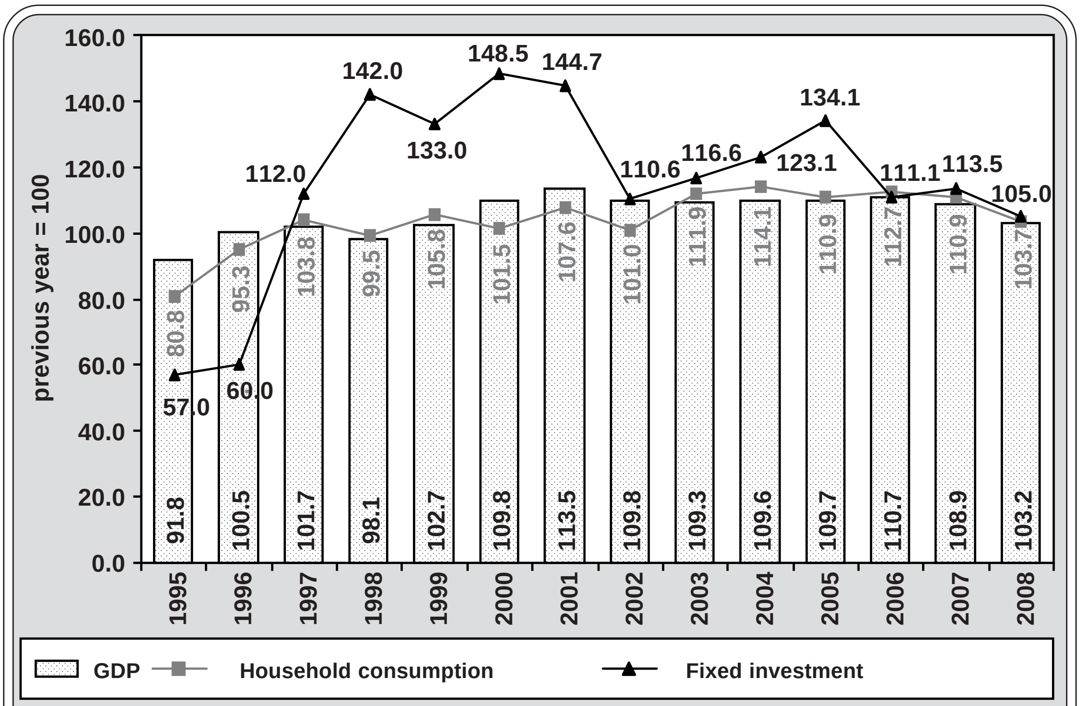
Under extremely favorable conditions in world commodity markets, from 2003 export volume showed unstable dynamics (growth followed by slowdown). From that time on, there was a gradual increase in the impact of domestic demand on the patterns of economic growth.

The average increase in external demand in 2003-2004 was 9.4% compared to 3.8% in 2005-2006, and in 2007-2008 it was 5.4%. The total impact of domestic factors regulating business activity levels was enough to offset the impact of external demand on the country's economic dynamics. In 2005-2006, the average increase in domestic demand was 22.3% compared to 11.5% in 2003-2004; in 2007-2008, the figure was 6.7%.

Overall, the expansion of the domestic market was due to both an increase in domestic production and rising imports. Imports contracted in 2001, 2003 and 2008, while in other years they expanded (see Fig. 3 on p. 121).

Figure 2

GDP, Final Household Consumption and Fixed Investment in Kazakhstan, 1995-2008 (*index, previous year = 100*)



Source: Compiled by the authors based on data from the Kazakhstan Statistics Agency.

From the beginning of 2000, living standards in Kazakhstan began to improve, which led to an increase in demand for various goods. Coupled with an increase in investment by industrial and financial entities, this gradually accelerated domestic production growth.

During 2000-2007, the average annual rate of growth in industrial production was 14.9% compared to negative growth in the 1990s (–15.7%), and agricultural production increased 1.4-fold. The building sector demonstrated even higher growth rates (for reasons examined below).

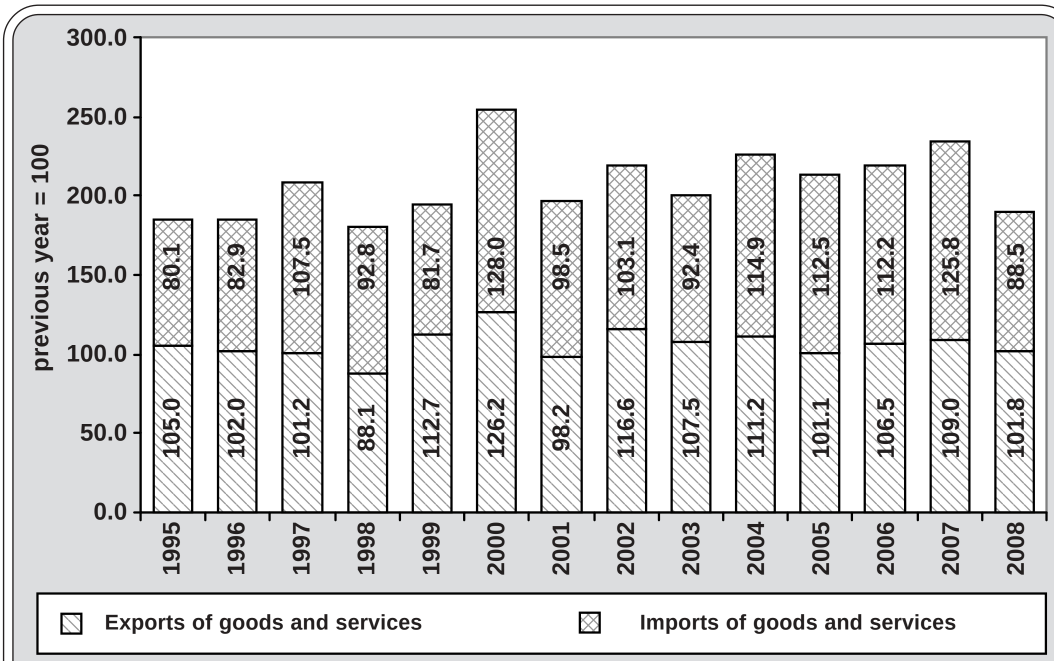
As a result, the production of goods for the domestic market increased significantly. But this did not reverse the trend toward faster growth of imports compared to exports, especially imports of food products and, naturally, machinery and equipment, which have traditionally dominated in the total volume of Kazakhstan imports (an average of 43.5% during 2001-2008).

A favorable combination of domestic business activity and conditions in the global raw materials market led to an increase in gross capital formation; in 2001-2007, its share of GDP was in the range of 29.7%-37.2% (in post-crisis 1999, 13.7%).

During these years, under the impact of a decline in exports as a share of GDP (from 56.6% to 49.4%) and in the share of household expenditure (see Fig. 4), gross capital formation steadily increased, reaching a maximum for the entire period in 2007 (37.2%) but falling substantially in 2008 (see Table 2).

Figure 3

Exports and Imports of Goods and Services in Kazakhstan, 1995-2008 (*previous year =100*)



Source: Compiled by the authors based on data from the Kazakhstan Statistics Agency.

Table 2

Structure of GDP Use for Gross Capital Formation, 1995-2008 (*% of GDP*)

Indicators	1995	1996	1997	1998	1999	2000	2001
Gross capital formation, of which:	19.9	20.5	19.6	21.7	13.7	18.5	29.7
gross fixed capital formation	23.1	17.2	16.3	15.5	16.2	17.3	23.7
changes in inventories	–3.2	3.3	3.4	6.2	–2.5	1.2	6.0
	2002	2003	2004	2005	2006	2007	2008
Gross capital formation, of which:	33.8	28.9	26.3	30.1	33.4	37.2	26.3
gross fixed capital formation	24.0	23.0	25.1	28.0	30.2	30.0	27.3
changes in inventories	9.8	5.8	1.2	2.1	3.2	7.1	–1.0

Source: Compiled by the authors based on data from the Kazakhstan Statistics Agency.

The above data show that the balance between investment demand and final consumption was particularly responsive to changes in export earnings and determined the specifics of the functioning of the domestic market. The fluctuations in investment spending on the reproduction of fixed capital were offset by gradual changes in the dynamics of final consumption.

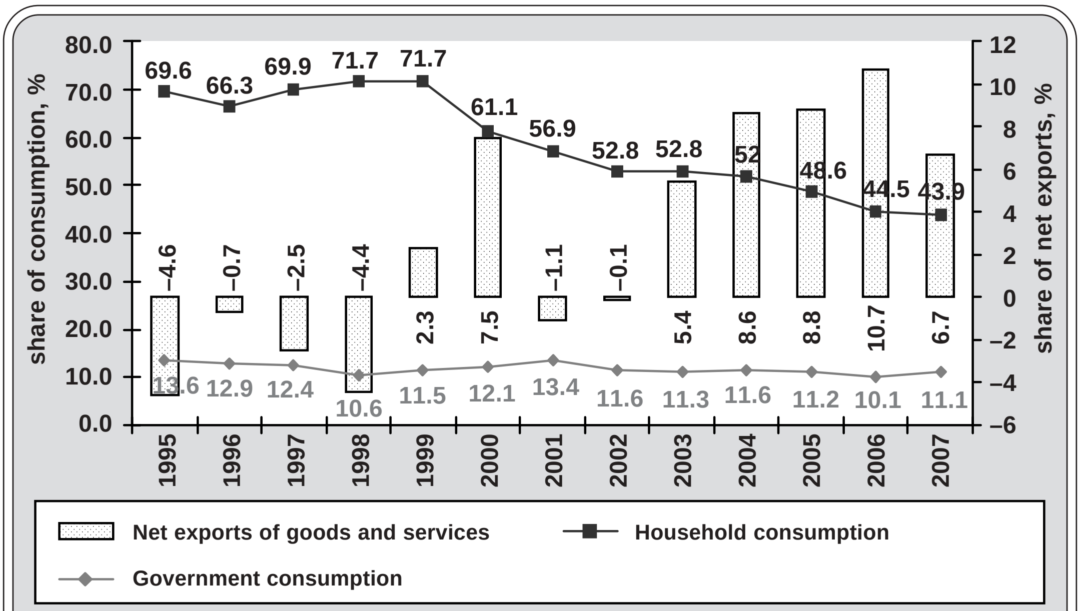
At the same time, it should be noted that whereas GDP in 2007 was 1.5 times above the pre-reform level of 1991, the figure for fixed investment was 1.2 times. The latter indicator surpassed the 1991 level in 2006, whereas GDP surpassed it in 2003. According to Joseph Stiglitz, the level of gross fixed investment is "a far more important sign of a burgeoning market economy"[2] than, say, the privatization of industry or natural resources. It is a sign that Kazakhstan is fast becoming an extractive economy rather than a modern industrial economy.

In contrast to the "crisis" decade of the 1990s, the positive dynamics of final consumption was an important factor in the development of the domestic market in 2001-2007; during that period, real household income and wages rose.

Since 1999, there has been a steady trend toward a decline in the share of household consumption in the structure of GDP use, while the share of government consumption has remained within the range of 10.2%-13.6% (see Fig. 4).

Figure 4

Structure of GDP Use in Kazakhstan, 1995-2007



Source: Compiled by the authors based on data from the Kazakhstan Statistics Agency.

In 2001-2007, real household income increased by 133%, and real wages by 128%. Taking into account all sources of income, let us note that household income increased primarily due to rising wages,

[2] J. Stiglitz, *Whither Reform? Ten Years of the Transition*, World Bank, nnual Bank Conference on Development Economics, Washington D.C., 28-30 April, 1999, p. 3.

and this in turn helped to reduce poverty. The proportion of people with money income below subsistence level fell from 46.7% in 2001 to 12.3% in 2008 (in 2007 it was 12.7%). But in 2008 (compared to 2007) real wages shrank by 2.5%, and real money income growth slowed to 103.4%; in 2007, the figure was 118.9% (compared to 2006).

An analysis of GDP dynamics (see Fig. 1) reveals two indicators occurring at almost equal intervals: 13.5% (2001) and 10.7% (2006); according to the cycle theory, this signals the beginning of the first and second phases of recovery.

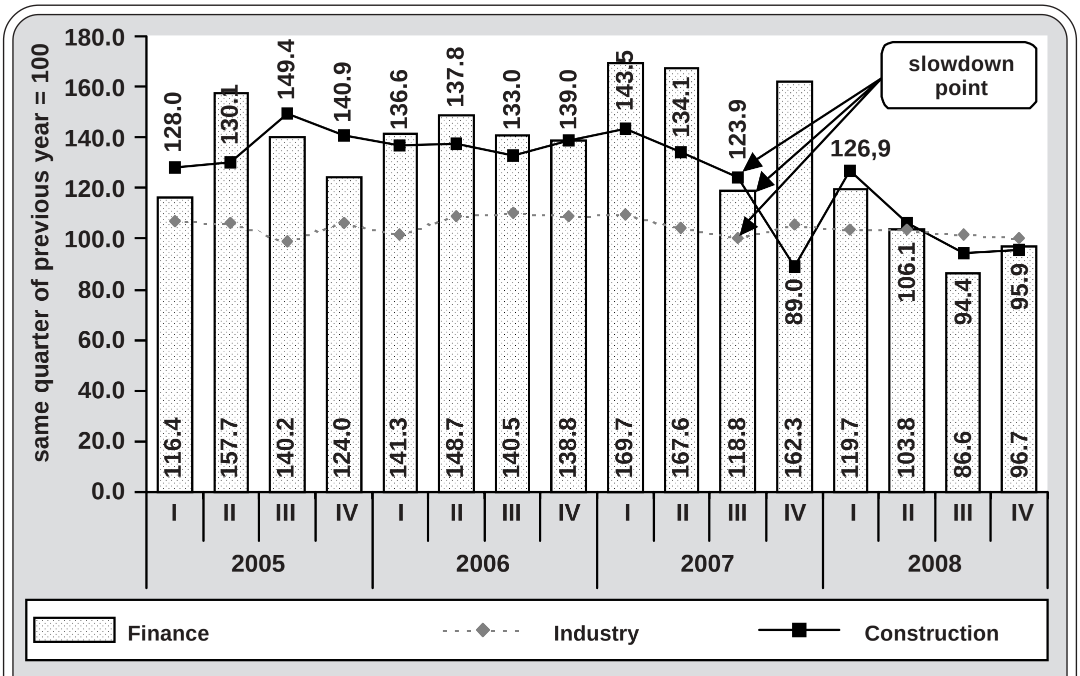
On this basis, it would have been logical to assume already at that time that the following 3-5 years would bring an insignificant upturn (with slight fluctuations in dynamics), whereupon the economy would enter the first phase of the downturn. But high hydrocarbon prices prevented an adequate assessment of the economic situation in the country.

During 2005 and up to the first half of 2007, there was growth in the construction industry and, as a result, in the financial sector (see Fig. 5).

Figure 5

Gross Value Added in Industry, Construction and Finance in Kazakhstan, 2005-2008

(*volume index, same quarter of previous year = 100*)



Source: Compiled by the authors based on data from the Kazakhstan Statistics Agency.

To some extent, this was a reflection of processes in world housing markets as housing bubbles began to form in many countries (including developed ones). In Kazakhstan, this was also connected with the fact that investment in housing construction was the best financial instrument for lack of a developed stock market in the republic.

At that time, construction contributed up to 25% of GDP growth in the country (see Table 3), whereas previously national economic growth was mainly driven by industry, particularly the oil sector.

Table 3

Sectoral Contribution to Economic Growth in Kazakhstan, 2000-2007 (%)

Sector/Year	2000	2001	2002	2003	2004	2005	2006	2007
Industry	44.6	32.59	32.7	29.0	32.3	14.4	20.5	16.6
Construction	6.7	10.37	11.2	6.5	9.4	24.7	26.2	18.6
Trade	6.9	12.59	10.6	12.9	12.5	12.4	11.2	16.4
Real estate transactions	n/a	n/a	n/a	17.2	14.6	14.4	12.2	9.9
Other sectors	n/a	n/a	n/a	34.4	31.2	34.1	29.9	38.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: n/a—no data; the contribution of other sectors in 2000-2002 was not calculated due to the lack of data on "real estate transactions."

Source: Compiled based on data from the Kazakhstan Statistics Agency and the Ministry of the Economy and Budget Planning of the Republic of Kazakhstan.

As can be seen from Table 3, during 2000-2007 industry's contribution to economic growth in Kazakhstan decreased 2.7-fold, while that of construction almost tripled. This was due to the formation and growth of a national housing bubble, which in turn led to a credit boom that also began to acquire the features of a bubble.

In that period, commercial banks began to increase external borrowing, which led to a significant increase in the country's total external debt, which reached $107.8 billion at the end of 2008; 97.8% of this amount was private non-guaranteed external debt. In the past four years, the country's total external debt has more than tripled.

From the end of 2004 to the end of 2007, the external debt of the banking sector swelled from $7.7 billion to $45.9 billion, i.e. 6-fold (compared to a 2.8-fold increase in the republic's total external debt during the same period). In addition, long-term debt service payments (excluding inter-company debt) peaked in 2007 at $16.9 billion (with a further increase to 22.8 billion by the end of 2008).[3] But no proper measures were taken to reduce the amount of external borrowing.

In mid-2007, the bursting of the credit bubble and the deflation of the bubble in the housing market led to a decline in lending. As a result, real economic growth slowed even in sectors that previously demonstrated exuberant growth and had the best conditions in terms of resources, as graphically shown in Fig. 5.

Official agencies claimed that the situation was associated with the U.S. mortgage crisis and called that period the "first wave" of the global crisis. As we see it, such a statement has no real basis and is

[3] Calculated based on data from the National Bank of Kazakhstan.

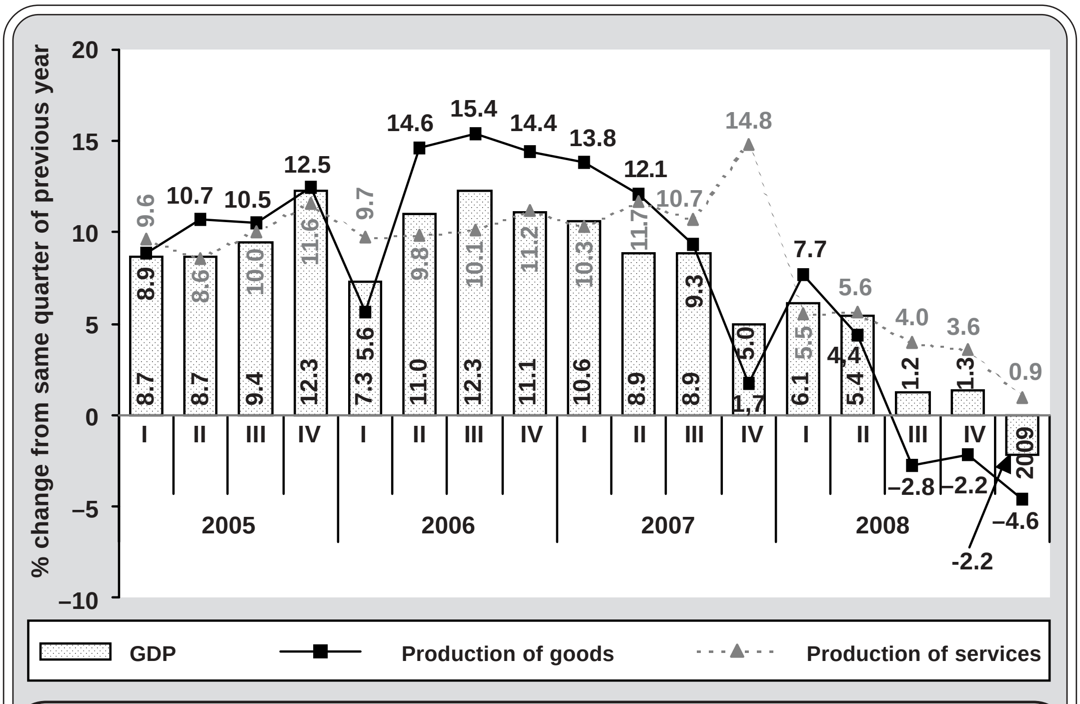
an inadequate reflection of the economic situation that had arisen in the country by that time, while the appeal to the American mortgage crisis is unwarranted.

An analysis of quarterly GDP growth and volume indices for the production of goods (services) in industry, construction and the financial sector shows what actually took place in the country's economy in the second half of 2007, when economic growth began to slow (until the fall of 2008) and when the global financial crisis erupted. That was the period which, in our opinion, constitutes the ***national component*** of the current global financial and economic crisis.

From an analysis of quarterly changes in two main components of GDP (production of goods and production of services) we find that in the past three years the "production of goods"[4] peaked in the 3rd quarter of 2006, followed by a steady decline in growth rates. In 2008, growth surged only to slow down once again. In the third quarter of 2008, the growth of the first component of GDP turned negative (see Fig. 6). This is associated with the unstable (including negative) quarterly dynamics in gross value added in all the three sectors of this GDP component: industry, construction and agriculture.

Figure 6

Quarterly Change in GDP in Kazakhstan, 2005-2009
(*% change from same quarter of previous year*)



Source: Compiled by the authors based on data from the Kazakhstan Statistics Agency.

At the same time, it should be noted that in 2007 the "production of goods" rose by 8.5%, including 5.0% in industry, 8.9% in agriculture, and 16.9% in construction.

[4] "Production of goods" includes three sectors: industry, agriculture and construction.

Positive annual growth is also characteristic of the second component of GDP: "production of services." The largest increase was recorded in "finance": by 52% in 2007 (compared to 2006).[5]

The global financial crisis that erupted in the fall of 2008 subsequently spilled over into world commodity markets and added a significant economic component. This global financial and economic crisis has naturally had an impact on Kazakhstan's economy as well. In 2008, real economic growth was 3.2%, or 2.5 times lower than in 2007 (8.1%). Economic growth slowed significantly for the first time since 1999.

An analysis of CIS performance in 2008 shows that Kazakhstan, the undisputed leader among the CIS countries in macroeconomic indicators (during the past decade), in effect turned into an outsider with the third lowest ranking (ahead of Ukraine with 2.1% and Georgia with 2.0%).

A slowdown in construction (to 1.9%) was coupled with negative growth in finance (–0.5%), agriculture (–5.6%) and manufacturing (–2.6%).[6]

In the first half of 2009, the GDP volume index (same period of the previous year = 100) was 97.7%, including 96.7% for goods and 99.7% for services.

For comparison: the highest GDP growth rate was recorded in Uzbekistan (108.2%), Azerbaijan (103.6%) and Tajikistan (102.8%), and the lowest in Armenia (83.7%) and Russia (86.6%).

The development of Kazakhstan's economy in 2001-2007 can also be traced using a SWOT analysis, which makes it possible to identify its strengths and weaknesses, as well as potential opportunities and threats (see Table 4).

Table 4

The Economy of Kazakhstan:
SWOT Analysis

Strengths	Opportunities
1. Large mineral reserves.	1. Development of large business groups.
2. High rates of economic growth.	2. Continued high rates of economic growth.
3. Relatively low inflation.	3. Continued high level of world oil prices (surplus of capital in the export sector).
4. Small budget deficit.	4. Increase in budget revenues.
5. Low refinance rate.	5. Proportional development of the financial sector.
6. Development level of the banking system.	6. Expansion of credit to the real and consumer sectors.
7. Country's investment rating.	7. Reduction in lending rates.
Weaknesses	**Threats**
1. Dependence of main export items on world prices.	1. Sharp drop in prices for main export items.
2. High level of total external debt.	2. Slowdown in economic growth.

[5] Kazakhstan Statistics Agency.
[6] Kazakhstan Statistics Agency and CIS Interstate Statistical Committee.

Table 4 (continued)

3. Continued raw material orientation of the economy. **4. Faster growth of extractive industries compared to the rest of the economy.** **5. Dependence on manufacturing imports from foreign countries (capital deficit in the domestic sector).** **6. Level of financial stability.** **7. Low level of bank capital.**	**3. Faster inflation.** **4. Abrupt change in the tenge exchange rate.** **5. Rising cost of corporate and bank borrowing in international financial markets.** **6. Active market entry by banks with foreign capital.** **7. Increase in global economic risks.**
Source: Compiled by the authors.	

Among the *weaknesses* of the national economy, apart from those listed in Table 4, one can also include: non-competitiveness of domestic goods in world markets due to the low technological level of production; lack of transparency in the activities of many large enterprises; high income inequality; and uneven regional development.

Such are some of the peculiarities in the development of Kazakhstan's economy (including its real sector) during the global financial and economic crisis. Let us note that the financial sector has proved to be particularly sensitive to this crisis because of the specifics of national development.

From 2000 to the first half of 2007, the financial sector in the republic developed rapidly, which was due to the successful development of the national economy as a whole. But from mid-2007 long-standing problems surfaced in the country's economy (particularly in the financial sector); they had a negative impact primarily on the banking sector.

In the fall of 2008, with the outbreak of the world financial crisis (followed by a global economic crisis), the situation was further exacerbated. In this context, it makes sense to conduct a comparative analysis (using modern tools) of financial sector development in order to identify the key problems in this area and determine the possible ways of solving them.

SWOT analysis. The architecture of the financial sector reflecting its *strengths* (see Table 5) is characterized by: an established services market, high liquidity, an effective credit, deposit and investment policy, relatively high degree of asset/liability matching, a comprehensive risk management system, and dynamic growth of total assets and capitalization, equity capital and deposits, insurance premiums and profitability ratios. There is an improvement in the quality of loan and investment portfolios, and also in loan loss provisions. A system of mandatory collective guarantee (insurance) of retail deposits has been introduced in the country. This is coupled with processes such as concentration, centralization, integration and diversification of banking, insurance, pension and fictitious capital.

An analysis of financial sector *opportunities* demonstrates the sector's high potential and adaptability to market mechanisms. The strategic logic of its development includes an intensification of horizontal and vertical ties, regional expansion of financial institutions, rational use of new financial products, growing returns and inputs, network effects and technological dependence; it is necessary to improve the quality of client servicing, maintain socially normal tariff levels, attract household and company savings, and rationalize organizational structures.

Table 5

**The Financial Sector of Kazakhstan:
SWOT Analysis**

Strengths	Opportunities
1. Effective credit, deposit and investment policy, falling interest rates. 2. Relatively high degree of asset/liability matching, phase-in of a comprehensive risk management system. 3. Dynamic growth and boom in total assets, equity capital, loans and deposits, insurance premiums and profitability ratios. 4. Satisfactory level of compliance with international standards, loan and investment portfolio quality, high loan loss provisions. 5. Concept of Financial Sector Development in 2007-2011.	1. Use of new financial products, growing return on them due to significant inputs, network effects and technologies. 2. Maintenance of socially normal tariff levels, attraction of customers' savings, reduction in lending rates. 3. Increase in competition and diversification of financial institutions. Rationalization of organizational structures and improvements in management systems and risk management. 4. Proportional development of the financial sector and improvements in the quality of financial products, services and technologies. 5. Creation of financial capital and competitive banking groups.
Weaknesses	**Threats**
1. Current level of stability, liquidity, capitalization and competitiveness of the financial sector, its fragility. 2. Limited long and medium-term resources. 3. High concentration of industry, regional and corporate risk. 4. Shortage of financial instruments for investment purposes.	1. Competitive imbalance between financial institutions in financial products, services and technologies, the place and time of their use, and customer groups. 2. Active market entry by banks with foreign capital as Kazakhstan accedes to the Agreements of the World Trade Organization. 3. High dependence on fluctuations in world prices for export goods, real sector performance, decline in security yields and in the value of collateral.

Source: Compiled by the authors.

It should be noted that the main parameters of the financial sector have been changing under the impact of inflation and the cost of acquisition and deployment of funds.

According to the World Bank, the average level of bank concentration measured as the share of the three largest banks in total banking sector assets (across 79 countries) is around 0.72. In Kazakhstan, the share of the three largest banks is about 0.62. A comparison of this indicator with the figures for other countries shows that the level of bank concentration in the republic is quite moderate.

A possible rise or fall in the level of bank concentration is primarily associated with the achieved level of competition, which reflects the cyclical development and diversification of business, cost reduction and increased bank efficiency; this is an objective process of bank development. In the last decade, the trend toward an increase in the size of financial institutions and their consolidation has been particularly pronounced in various countries. At the same time, it should be noted that a high concentration of assets is one of the main factors of their competitiveness. That is why further merger and acquisition processes cannot be ruled out. In this case, the share of the three, five or ten largest banks may decline relative to the whole banking system.

In 2008, the assets of the three largest banks fell by 2.7% compared to 2007; a number of other banks ranking among the top ten in terms of this indicator recorded an average increase of 9.7%, although two of them showed negative growth of 8.5% and 13.2%. If this trend continues, the gap between banks will narrow. At the same time, there are market niches that are being filled by small and medium-sized financial institutions with their own specialization and their regional and corporate focus.

An analysis of financial sector *weaknesses* shows that business in this sector has a fractal nature due to the initial conditions of its development. From a strategic perspective, there are a number of contradictions in this sector, including: limited long and medium-term resources and deposits, a persistent excess of demand for low-interest loans over supply, a shortage of tenge-denominated financial instruments for investment purposes, and low effectiveness of information systems.

This sector is characterized by a high concentration of industry and corporate risk, sensitivity to fluctuations in interest rates on financial instruments and changes in the cost of external borrowing, rising operating costs and changes in loan portfolio quality. These parameters fluctuate rhythmically under the impact of inflation, the state of the balance of payments, and supply and demand for loans in financial markets.

An examination of *threats* to the development of the financial sector shows that it is highly dependent on growth in the real sector, especially its export industries. Of significant importance are fluctuations in world prices for the republic's main export products and a decline in yields on government and corporate securities.

Periodic disruptions in the competitive balance, caused especially by banks with foreign capital, are an inherent feature of financial markets; this is associated with various combinations of financial products and the amount of value added, the time and geography of their use, and the diversity of customer groups.

Thus, there is an imperative need for a functional fragmentation of the financial sector, intensive use of new technologies, neutralization of macroeconomic risks, an increase in the relative size of financial institutions, measures to halt the decline in return on assets, and provision of incentives using the latest methods of business organization.

Relative to the investment needs of the real sector, financial sector resources are asymmetrical; assets grow rapidly, while capital is in short supply.

Overall, the financial sector of Kazakhstan's economy, as noted above, is developing dynamically due to such an important factor as the crystallization of positive trends in the development of the sector. These include: an increase in assets and liabilities, capital and deposits, insurance premiums and transactions on the stock exchange (KASE) as a share of GDP, an increase in credit to the real sector and in the share of loans in tenge, a gradual reduction in interest rates, diversification of banking business, and improvement in the quality of risk management.

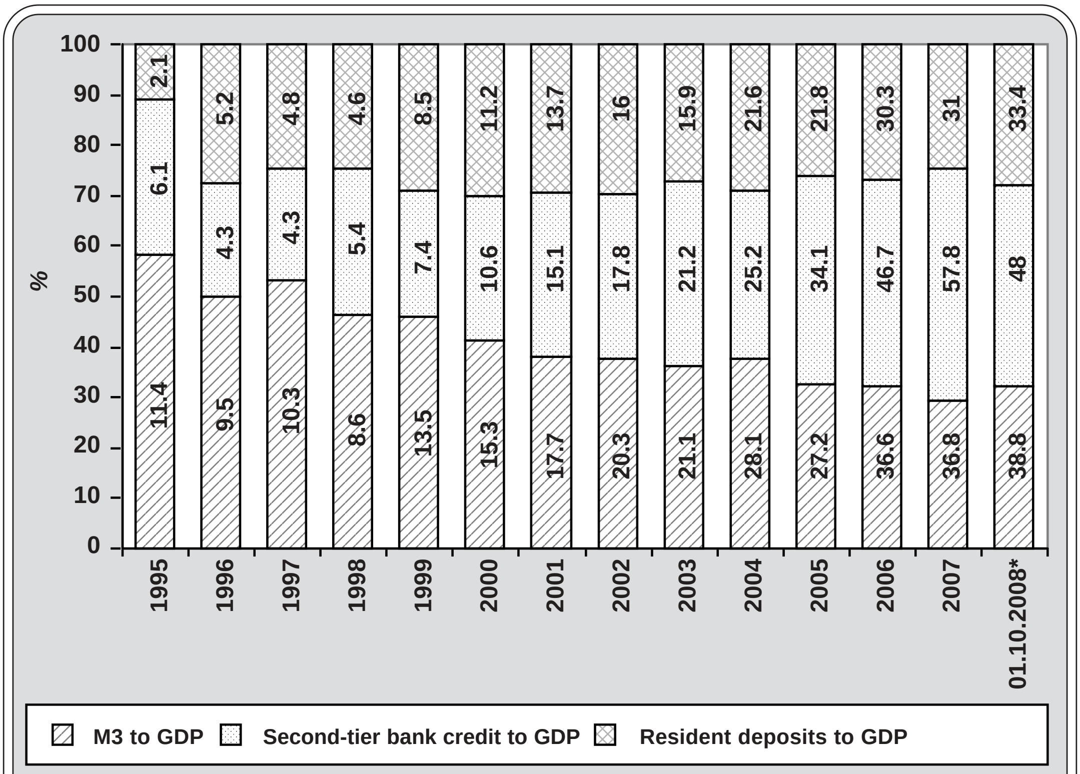
It should be noted that on the whole the structure of the financial sector is complex and non-uniform, combining homogeneous and heterogeneous elements.

An important integrated indicator of financial sector development in Kazakhstan is the depth (level) of financial intermediation (financial depth) measured as the ratio of credit to the economy to GDP. During 1995-2007, financial intermediation in the country's economy deepened as the ratio increased from 6.1% to 57.8% (9.5-fold).

But the results of the first three quarters of 2008 showed that because of tighter credit in foreign markets this indicator fell to 48% (see Fig. 7). This has significantly narrowed the gap between the levels of credit and household savings, as well as the level of monetization of the economy.

Figure 7

Financial Depth in Kazakhstan, 1995-2008



Note: *—annualized GDP data.

Source: Compiled by the authors based on data from the National Bank of Kazakhstan.

In the opinion of the National Bank of Kazakhstan (NBK), the current "complicated conditions create new opportunities and challenges for the Kazakhstani banking system with regard to determining their main factors of growth in the future."[7] This implies a further diversification of the resource base and improvements in risk management systems and in management quality based on international principles of corporate governance.

[7] *Financial Stability Report*, National Bank of Kazakhstan, Almaty, 2008, p. 42.

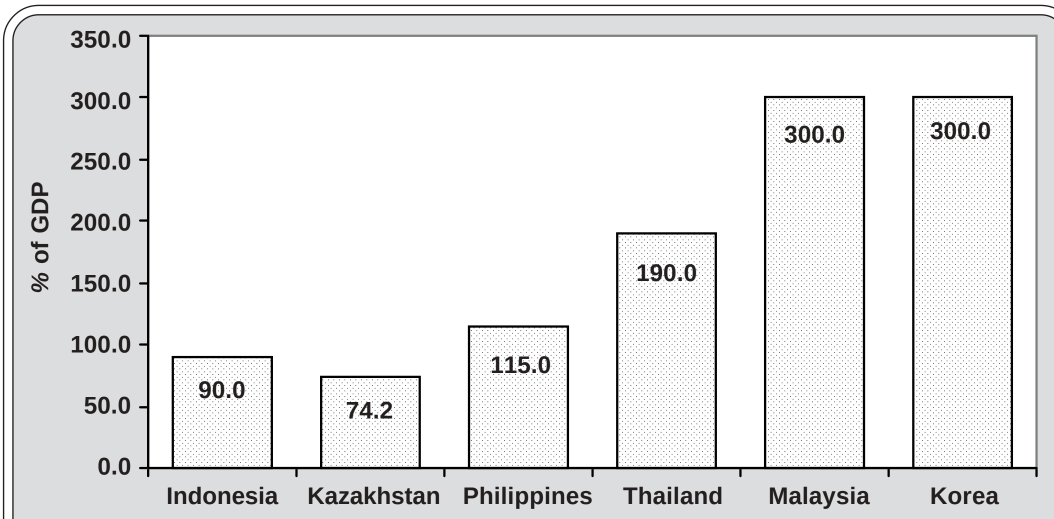
Improving relative indicators of financial sector assets reflect the sector's growing role in the national economy; its share of GDP steadily increased, reaching a maximum in 2006 (97.2% at the beginning of October 2006),[8] but in 2007-2008 it declined.

An increase in this relative indicator points to strengthening links between the real and financial sectors, and this in turn increases the risk of occurrence of interdependent crisis phenomena. Despite their impact on the republic's economy in 2007-2008, the number of financial institutions in the banking, insurance and pension sectors (their assets prevail in the structure of the financial sector) remained fairly stable.

For comparison: In Asian countries hit by the 1997-1998 financial crisis, the level of financial intermediation measured by the ratio of financial sector assets to GDP and, accordingly, the degree of vulnerability to systemic crises were higher than in Kazakhstan (see Fig. 8).

Figure 8

Financial Sector Assets
in Some Asian Countries and Kazakhstan (*% of GDP*)



Source: Compiled by the authors based on data from the International Monetary Fund and the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations (FSA).

The banking sector has a key place in the financial sector of the national economy; in the past five years, its share of total financial sector assets was over 75% (on average).

Whereas in 2001 the ratio of banking assets to GDP was 25%, in 2006 it exceeded 100%. But in the following two years this indicator fell to 79% (see Table 6).

It should be noted that in terms of this indicator Kazakhstan has surpassed the banking system of East European countries (50-60%) and reached the level of developed countries (in some of them it exceeds 100%).

[8] See: *Otchot o finansovoi stabilnosti*, National Bank of Kazakhstan, Almaty, 2006, p. 43.

Table 6

The Financial Sector in Kazakhstan, 2001-2008 (%)

	2001	2002	2003	2004	2005	2006	2007	2008
Banking sector								
Assets to GDP	25.1	30.6	37.7	48.5	61.9	101.7	87.7	79.4
Credit to GDP	15.9	19.1	24.4	32.7	41.1	68.7	66.6	60.7
Equity to GDP	3.8	4.3	5.0	6.3	7.9	13.4	13.4	12.9
Insurance sector								
Assets to GDP	0.5	0.6	0.5	0.8	0.98	1.55	1.68	1.79
Equity to GDP	0.2	0.2	0.2	0.5	0.61	0.92	0.94	1.08
Insurance premiums to GDP	0.4	0.6	0.6	0.7	0.90	1.38	1.11	0.83
Pension sector								
Assets to GDP	6.0	7.0	7.5	7.9	8.2	8.9	9.4	8.9
Organized financial market								
KASE capitalization to GDP	—	—	10.56	15.41	21.62	35.02	87.06	33.31

Source: Compiled based on FSA data.

In the last nine years, the total assets of the banking, insurance and pension sectors increased 32.9-fold to 13,588.6 billion tenge (KZT), with the fastest growth in insurance sector assets (36.7-fold). In that period, the assets of second-tier banks (STBs) increased 34.9-fold, and pension fund assets, 22-fold.

Banking Sector. From 2000 on, the banking sector as part of Kazakhstan's financial sector developed in an environment of dynamic economic growth, slowing inflation, rising household incomes, increasing creditworthiness of real sector enterprises, and declining cost of funds in international capital markets. This led to an increase in retail deposits at STBs and their total assets.

As a result, the banking sector was characterized by increased lending and an expansion of banking activities in general. According to the generally recognized assessment of all international organizations, before the global financial and economic crisis Kazakhstan's banking system was the most dynamically developing system in the CIS, being several years ahead of the banking systems of Russia and other countries.

In 2004-2005, domestic banks began their expansion into neighboring markets, which was a qualitatively new level of integration into the world financial system. But cross-border lending, like any other kind of lending, is associated with certain risks. Apart from positive aspects, cross-border operations carry serious risks, mainly related to a decline in the quality of domestic bank assets. In addition, domestic STBs began to engage in active external borrowing in the form of loans from foreign financial institutions and issue of their own securities. Banks also actively borrowed in international markets through syndicated and eurobond loans.

At the same time, the growth of bank loan portfolios increased exposure to risk. This was due to an expansion of banking activities through the provision of credit services not only to large and financially stable enterprises, but also to less creditworthy borrowers, as well as the introduction of new credit products (mortgage and consumer loans, loans to small and medium-sized businesses, etc.). All of this together had a negative effect on loan portfolio quality.

In these conditions, supervisory agencies focused their attention on minimizing risks associated with external borrowing, cross-border transactions, consumer and mortgage loans, etc. The main purpose of the measures taken was to prevent various negative phenomena in other sectors of the economy.

One of the first stages in reducing these risks was the introduction in 2006 of limits on foreign currency liquidity depending on term, the establishment of an upper limit on short-term liabilities to non-residents, and a reduction in currency position limits.

In order to reduce bank risks in cross-border transactions, the FSA tightened the requirements for risk weighting of assets. In 2007, given the increase in consumer lending, significant concentration of bank loan portfolios in real estate lending and further expansion into foreign markets, a number of measures were taken to prevent risks associated with these phenomena.[9]

During 2000-2006, annual changes in STB assets demonstrated steadily positive dynamics (except in 2002), with cumulative growth of 420.5%. But in the following two years asset growth slowed significantly, especially in 2008. As noted above, this was caused by two main factors: the bursting of the credit bubble and the deflation of the housing bubble in the second half of 2007. In 2008, the slowdown was even more significant than in 2007, undoubtedly due to the global financial crisis (which broke out in the fall of that year with the collapse of four of the world's largest financial institutions in the United States).

Let us say at once that there were no defaults in the national financial sector during these years because the government provided timely and substantial resource support to the country's financial and real sectors.

Overall, during the period of 2000-2008 STB assets increased 22.5-fold, growing faster than STB equity capital (EC), which increased 20-fold in that period. This proportion is a negative trend in the development of the banking sector in Kazakhstan; it clearly manifested itself during the global crisis.

A further comparative analysis of the dynamics of these two indicators shows that in 2000-2004 STB assets grew faster than STB equity capital, but starting from 2005 to 2008 there was an opposite trend: faster growth of STB equity capital compared to assets (see Fig. 9).

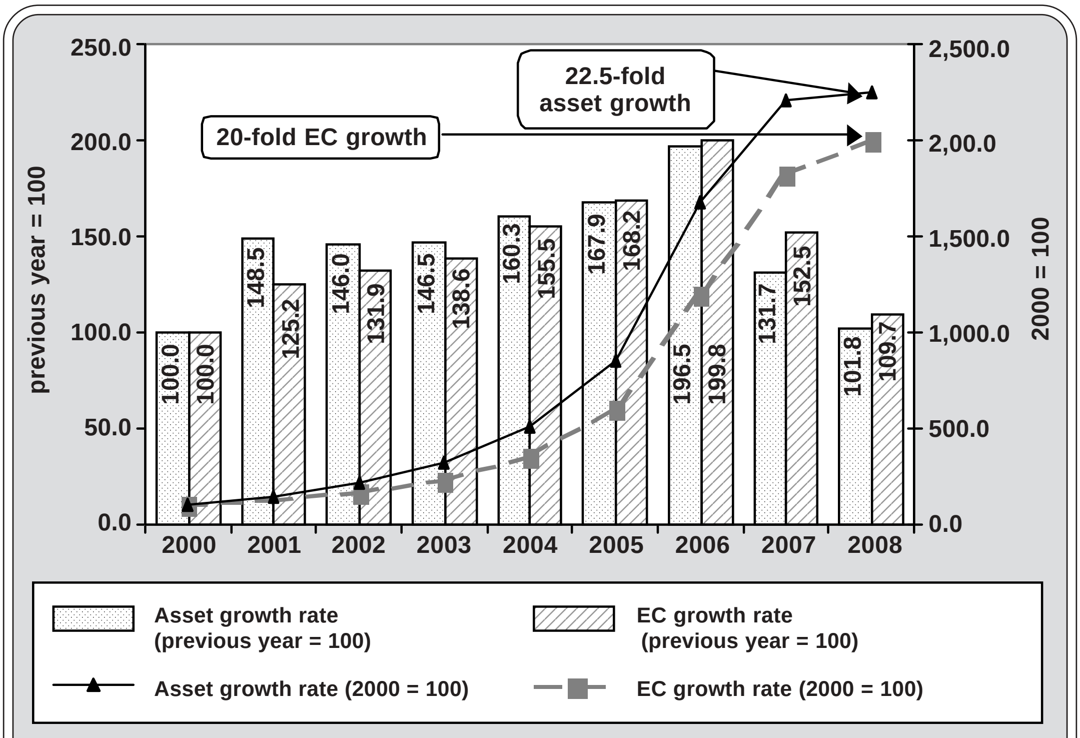
In our opinion, the optimal rate of bank asset growth should be no more than double the rate of GDP growth, i.e., if the economy grows at 10%, the optimal (and safe) rate of asset growth in the banking sector should not exceed 20%.

In 2000-2008, STB equity capital as a share of GDP markedly increased: from 3.8% to 12.9%. At the same time, the ratio of STB equity capital to STB assets declined: from 18.5% in 2000 to 16.4% in 2008.

[9] See: *Annual Report of the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations for 2007*, FSA, Almaty, 2007, p. 16.

Figure 9

STB Assets and Equity Capital in Kazakhstan, 2000-2008
(previous year = 100)



Source: Calculated and compiled by the authors based on data from *Otchot Assotsiatsii finansistov Kazakhstana 2008*, AFK, Almaty, 2009.

During these years, the share of bad loans increased from 2.0% to 2.7%, while the ratio of loan loss provisions to total loans rose from 4.5% to 8.8% (see Table 7).

Due to intensive growth of the STB resource base (mainly through an increase in deposits), since the beginning of the new millennium *the credit potential of the banking sector* in Kazakhstan has increased significantly, with a surge in bank lending in the country's credit market. The amount of loans issued by STBs during 2000-2008 increased 33.4-fold to KZT 9,238.4 billion (more than $76 billion). In that period, the ratio of bank loan portfolio to GDP rose from 7.4% to 60.7% (see Fig. 10).

Most bank loans were used by borrowers to increase their working capital, although in 2008 (compared to 2000) their share declined slightly: from 61.6% to 59.5%. During these years, the proportion of loans used to acquire fixed assets fell from 10% to 4%, while that of loans used for new construction and renovation increased from 5.6% to 9.8%.[10]

Financial institutions should be encouraged to expand the range and improve the quality of financial services, while the state, for its part, should create favorable conditions for an increase in lending

[10] Calculated by the authors based on data from NBK statistical bulletins for 2001 and 2008.

Table 7

Development of the Banking Sector in Kazakhstan, 2000-2008

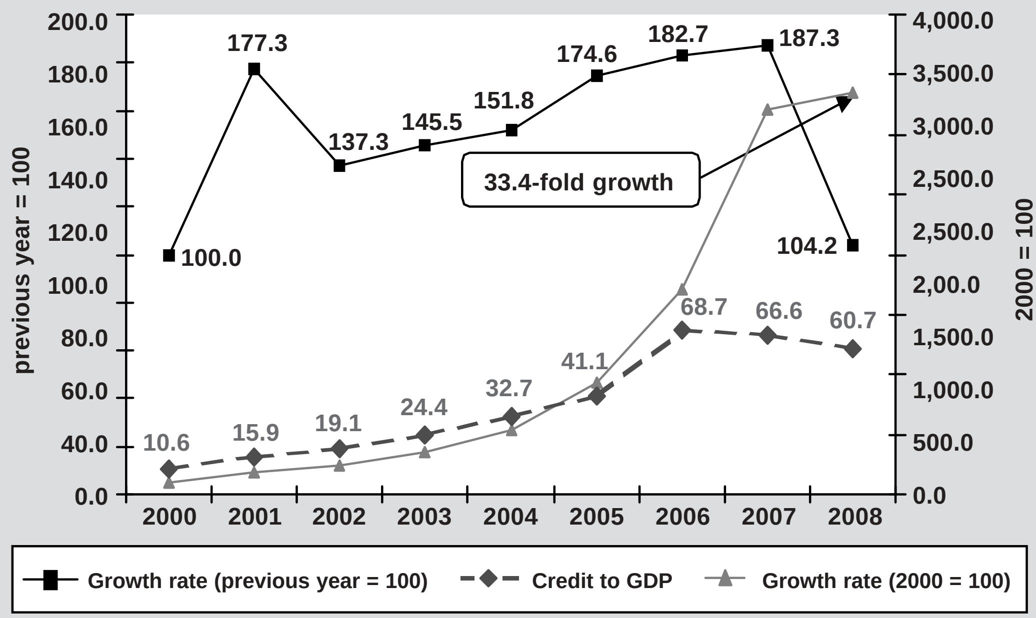
	2000	2001	2002	2003	2004	2005	2006	2007	2008*
STB assets, *billions of tenge*	527.9	784.0	1,145.0	1,677.9	2,689.7	4,515.1	8,872.0	11,683.4	11,899.3
STB equity capital, *billions of tenge*	97.6	122.2	161.2	223.5	347.6	584.8	1,168.6	1,781.8	1,953.9
EC to GDP, %	3.8	3.7	4.3	5.0	6.4	8.0	13.4	13.4	12.9
EC to STB assets, %	18.5	15.6	14.1	13.3	13	13	13.2	15.2	16.4
Share of bad loans, %	2.0	2.1	2.0	2.1	2.9	2.2	1.6	1.5	2.7
Loan loss provisions to total loans, %	4.5	4.7	5.5	6.2	6.5	6.8	7.0	7.7	8.8

Note: *—as of 01.01.2009.

S o u r c e: Compiled by the authors based on FSA and NBK data.

Figure 10

Bank Lending in Kazakhstan, 2000-2008



S o u r c e: Calculated and compiled by the authors based on data from *Otchot Assotsiatsii finansistov Kazakhstana 2008*, AFK, Almaty, 2009.

to the real sector and in mortgage and consumer lending. This can be done by providing tax breaks, various forms and kinds of guarantees for businessmen, credit risk insurance, etc.

A significant impact on lending rates is made by macroeconomic factors such as economic growth, inflation, monetization of the economy, and the balance of payments. Microeconomic factors such as borrowing costs, credit risk factors and in-house costs have a strong effect as well. It is important to take into account both direct and indirect factors affecting the cost of acquisition and deployment of funds. Of crucial importance here are market regulation mechanisms based on the fair value of financial instruments.

For example, low yields on securities traded on the stock market (adjusted for inflation) prevent a reduction in lending rates.

On the whole, the basic conditions affecting the competitiveness of financial institutions should be taken into account from the perspective of comparative advantage (David Ricardo), factor endowments (Eli Heckscher, Bertil Ohlin) and advanced factors (Michael Porter).

During 2000-2008, the deposit base of the banking sector was characterized by a stable structure and dynamic growth, which slowed down in some years (2003, 2005, 2007 and 2008). Nevertheless, during this period the amount of deposits accepted by STBs increased 23.4-fold, reaching (as of 1 January, 2009) KZT 6,872.6 billion, or $57 billion (see Table 8).

Table 8

Bank Deposits in Kazakhstan, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Accepted deposits, billions of tenge	294.0	446.0	610.0	739.0	1,607.8	1,653.5	4,714.0	6,424.0	6,872.6
Growth rate (*previous year = 100*)	100.0	151.7	136.8	121.1	217.6	102.8	285.1	136.3	107.0
Growth rate (*2000 = 100*)	100.0	151.7	207.5	251.4	546.9	562.4	1,603.4	2,185.0	2,337.6
Share of foreign currency deposits, %	50	64	39	48	47	41.9	57.3	60.6	59.0
Share of retail deposits in total deposits, %	31	42	43	46	34	35.5	22	22.5	21.0
Deposits to GDP, %	11.3	15.0	18.6	21.8	29.0	33.9	54.0	48.2	31.1

Source: Calculated and compiled by the authors based on FSA and NBK data.

The slower growth of deposits in 2007 (and, to an even greater extent, in 2008) is associated with high-risk situations, and sometimes with a sense of panic among investors. In these conditions, the deposit base, despite its stable structure and positive dynamics, is sufficiently weak, as indicated by the relatively high ratio of loans to deposits used to assess STB liquidity.

To complete our analysis of the impact of the global crisis on Kazakhstan's economy, let us note that today the situation is stabilizing and showing signs of a recovery.

Meanwhile, despite optimistic forecasts by official agencies (in 2009, according to the Kazakhstan Statistics Agency, economy growth was 2.1%), the consequences of the crisis will continue to affect national economic development for a long time to come. This is confirmed by the experience of other countries; a case in point is the economy of Japan, which felt the effects of the 1990 crisis practically until 2006.