

December 20, 2017

## Kazakhstan's financial system is becoming more stable but imbalances remain

### Structural Financial Stress Index for Kazakhstan

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For more details on index construction methodology, please refer to the [Structural Financial Stress Index \(ACRA SFSI\) Calculation Methodology](#)

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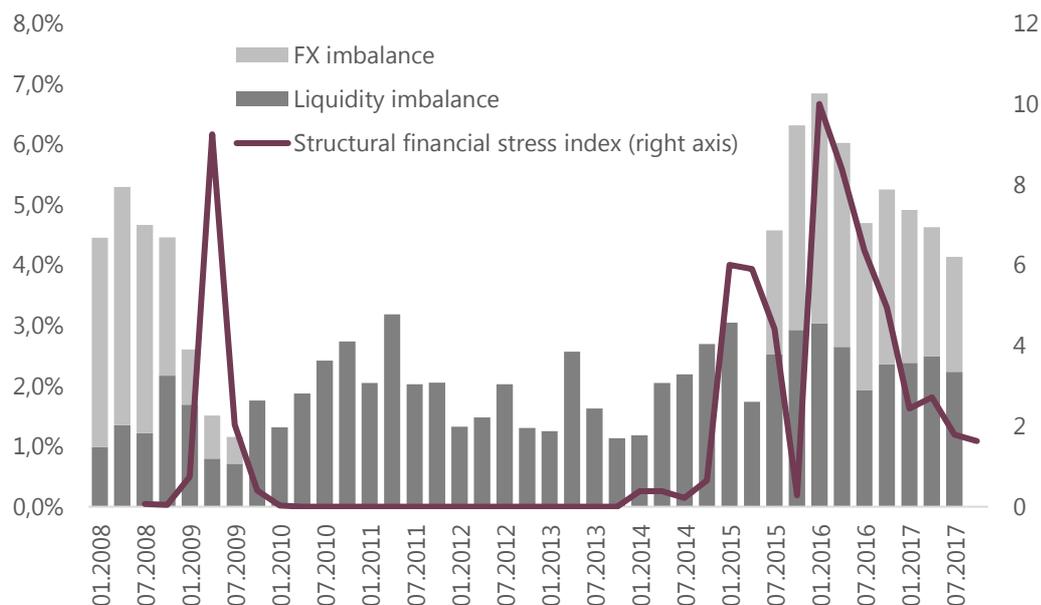
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- **ACRA launches a quarterly publication of the Structural Financial Stress Index for Kazakhstan: ACRA SFSI KZ.** The index gauges financial stability of the country and assesses its vulnerability to specific risk types by aggregating information on maturity and currency structure of assets and liabilities at sector level. In contrast to ACRA FSI for Russia, the structural index measures potential financial instability directly rather than indirectly based on external signs of a financial crisis.
- **By virtue of no new trigger events as of December 2017, the financial system of Kazakhstan is in a relatively stable mode:** ACRA SFSI KZ is now at 15% of its maximum registered levels. However, it is worth noting that the situation may change rapidly due to the relatively high remaining liquidity and FX imbalances.
- **The slowly declining FX imbalance in the banking sector is one of the key structural issues.** Amid free-floating exchange rate, this factor may become the source of a systemic risk.

Based on ACRA SFSI KZ, we highlight three periods of increased financial stress in Kazakhstan in the last ten years: from late 2008 to early 2009, early 2015, and from late 2015 to early 2016. The last two periods could be fundamentally combined into one as both of them initially resulted from a slump in global crude oil prices in 2014. Nevertheless, we think they are quite interesting and consider them separately. Analysis based on the Index data allows to mark three events in 2014-2016 that generated stress as well as to understand crisis mechanics in more detail (see Figure 2).

**Figure 1. Structural Financial Stress Index for Kazakhstan (ACRA SFSI KZ)**



Source: ACRA estimates

In order to evaluate how close the financial system is to a crisis, ACRA uses two approaches:

(1) Financial Stress Index (ACRA FSI) measuring financial instability indirectly based on external signs of a financial crisis: volatility in the key financial markets, interest rate spreads, etc.

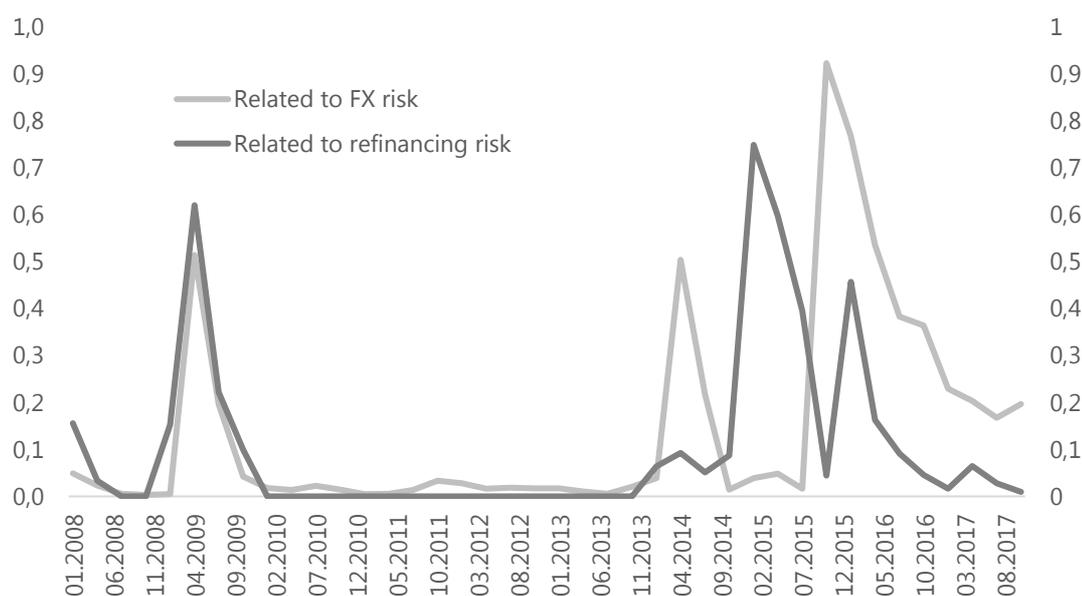
(2) Structural Financial Stress Index (ACRA SFSI) that measures potential financial instability directly by aggregating information on the financial position of economic agents and by assessing their vulnerability to specific types of risk (this commentary utilizes that approach).

### The 2009 crisis

As in many other mineral-exporting countries alike, a drop in export revenues and FX risk materialization accompanied the 2009 crisis in Kazakhstan. Substantial currency imbalance of households exacerbated this shock (see Figure 6). It arose on the back of foreign currency lending growth in 2005-2008 (4.6x) significantly outpacing the increase of foreign currency liquidity reserves of households and foreign currency deposits (3.3x). Banks were driving up foreign currency lending while being aware that foreign currency-denominated income of the households does not cover their future loan payments. FX risk was underestimated, and regulations put no pressure on banks to consider this risk in full: net FX position of banks including the expected interest income/expenses was negative.

The exchange rate policy and the related expectations likely contributed to the underestimation of the FX risk. In fact, from mid-2000 to early 2016, KZT/USD exchange rate played a role of a short-term operating target of the exchange rate policy, and the KZT/RUB exchange rate – as a long-term target thereof (see Figure 3). The above is related to close economic ties between Russia and Kazakhstan: a little less than 50% of imported goods are Russian-produced, and Eurasian Economic Union integration aggravates interdependence of labor and capital markets. In addition, the similarity of economic and export profiles of the countries explains the presence of many common factors in play for fundamental exchange rates of national currencies against major global currencies. Retaining the tenge peg to the US dollar at the time of Russian ruble devaluation resulted in a substantial strengthening of tenge against the ruble, sharp increase of imports, and capital outflow amid future depreciation expectations. Keeping the peg to dollar in such environment is possible only at a very high cost (which would be lower if the main trade partner of Kazakhstan were a country not involved in oil or gas exports). Nevertheless, the short-term target seems to have been regarded as relatively stable.

**Figure 2. Trigger events in Kazakhstan's economy**

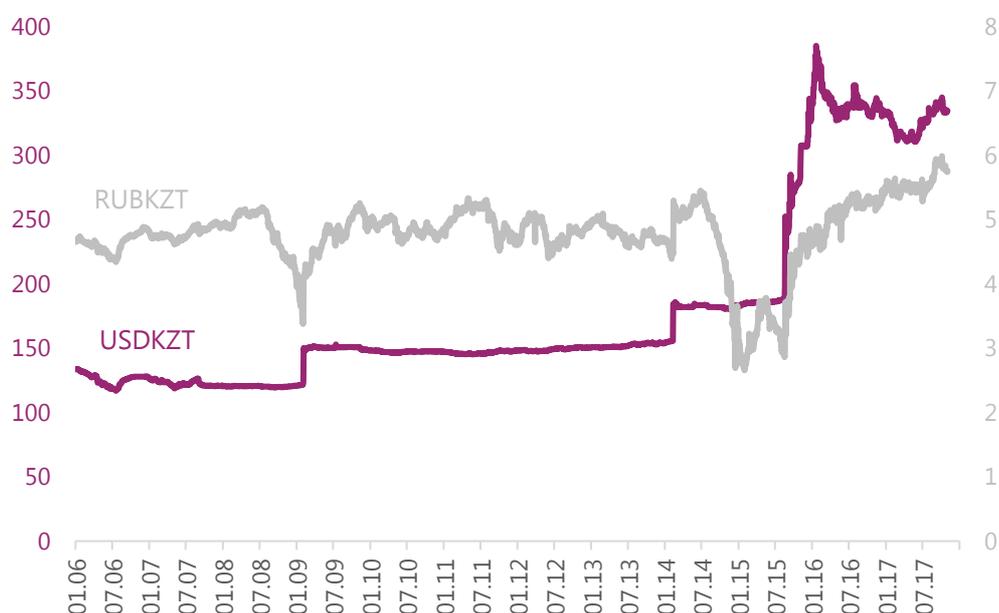


Source: ACRA estimates

In 2010, upon occurrence of the trigger event the imbalance intensified the surge in overdue loans: as at early 2011, BTA Bank had 48% of its lending operations booked on off-balance sheet accounts, and loans overdue for more than 90 days (NPL90+) totaled 36.5% of the portfolio. Another systemically important bank with similar difficulties was Alliance Bank with NPL90+ at 65.5%. The government was forced to become a shareholder of large banks. The share of overdue retail loans increased on average from 3% to 12%.

Foreign currency liquidity was supported by the National Bank of the Republic of Kazakhstan (NBRK) mainly in form of FX market interventions. As sterilization of interventions has not been done to a full extent, they intensified the domestic currency liquidity squeeze and contributed to a concurrent materialization of the refinancing risk.

**Figure 3. Nominal tenge FX rate**



Source: ACRA estimates

By late 2009, FX imbalance of households declined to zero by virtue of FX market interventions and reduced availability of external foreign currency loans for banks as well as changes in regulatory approaches in the country.

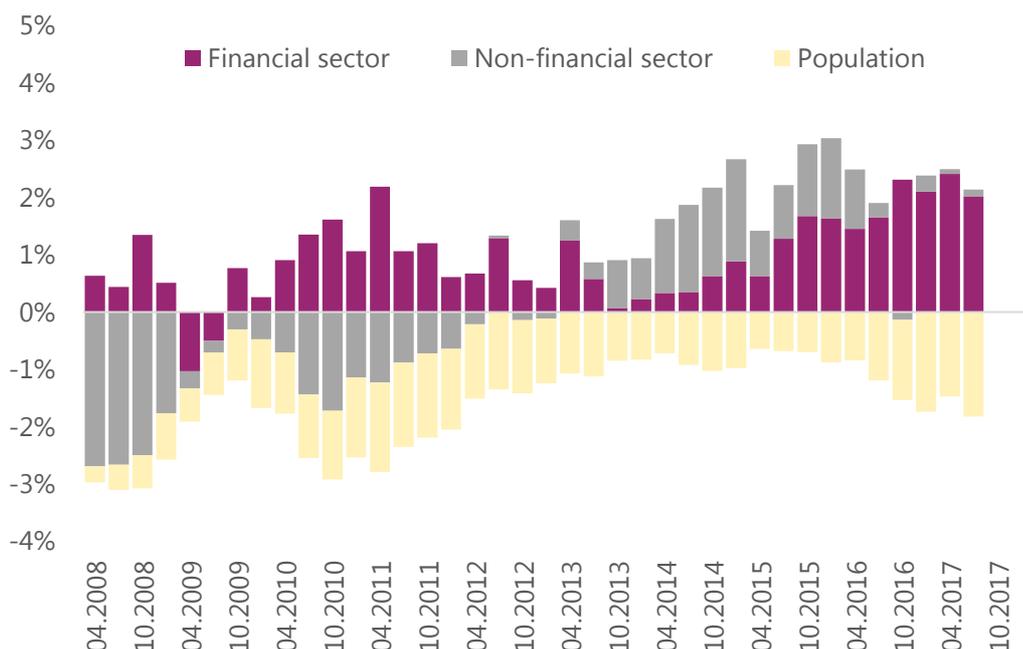
#### The period of 2010-2013

During this period, the Structural Financial Stress Index (ACRA SFSI KZ) was around zero. No trigger events occurred in this period (Figure 3): interest rates on the interbank market were below or close to the rates of the NBRK (structural liquidity surplus), and the tenge exchange rate was fixed to the US dollar. By following the managed exchange rate policy, the regulator was holding the USD/KZT exchange rate close to 150, with the RUB/KZT exchange rate staying in the range of 4.4-5.2, which was possible in a favorable external environment.

After the Kazakhstan economy recovered following the 2009 crisis, liquidity imbalances were small over four consecutive years, and FX imbalances were non-existent. The expected export revenues were more than enough to cover all FX liabilities of the sectors.

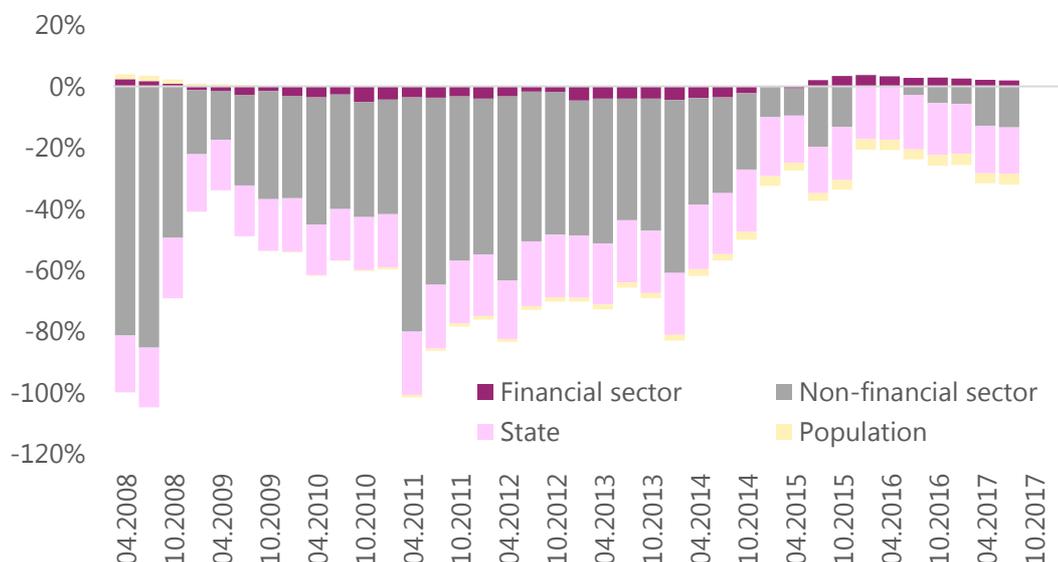
At the same time, external foreign currency liabilities of banks were gradually being replaced by domestic ones, while the share of US dollar-denominated deposits was relatively stable (30%-40%). A substantial liquidity imbalance was seen only in banks, but the liquidity imbalance level was in line with the role of the banking sector in the economy. Increased dependence of the non-financial sector on short-term financing could have been a cause for concern: a slight positive imbalance emerged as early as in 2013, and was only increasing thereafter. Largely, the above was caused by growth in lending to the trade industry outpacing lending to other industries.

**Figure 4. Liquidity imbalances by sectors (positive values correspond to a liquidity deficit)**



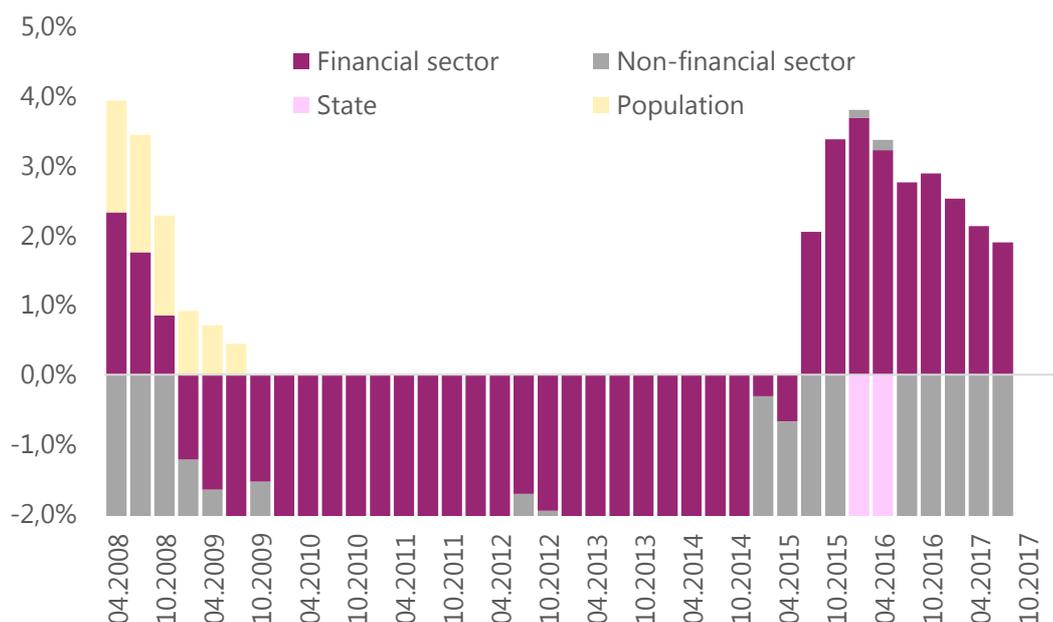
Source: ACRA estimates

**Figure 5. FX imbalances by sectors (positive values correspond to potentially uncovered share of foreign currency liabilities)**



Source: ACRA estimates

Figure 6. FX imbalances by sectors (a zoom-in of the positive portion of Figure 5).



Source: ACRA estimates

### The period of 2014-2016

Kazakhstan's financial system was relatively stable when the decline in crude oil prices started in 2014. The first devaluation of tenge to the US dollar by 19% (in February 2014) did not significantly aggravate the expected financial standing of banks and non-financial companies even if it represented a potentially important trigger event (see Figure 3). For the lack of an acute phase of the crisis, devaluation expectations resulted in a shift toward predominance of foreign currency deposits of households and non-financial companies (even including the currency revaluation effect); these changes were incremental.

Within almost entire 2014, no surge was seen in information asymmetry and uncertainty threatening the system's stability. However, in December 2014 lending operations on the Russian interbank market virtually stopped and a significant liquidity deficit emerged in the banking system, while the shift in exchange rate expectations resulted in a panic foreign currency demand. In responding to these developments, the Central Bank of the Russian Federation decided to sharply hike the key interest rate and to abandon its policy aimed at mitigation of FX market fluctuations. Keeping the tenge peg to the dollar target failed to curb the increase in devaluation expectations in Kazakhstan. Resulting from the tenge appreciation against the ruble, dollarization of deposits accelerated, and households and legal entities raised their propensity to import. Amid regulator's interventions and increased preference for liquidity (including in form of cash tenge), certain liquidity deficit arose in Kazakhstan's financial system as well, which constituted the second trigger event after crude oil prices started their slide. The effect of this trigger event on the financial stress level was tangible: banks and non-financial companies with dependence on short-term financing found themselves close to refinancing risk materialization and payment defaults.

By early 2015, uncertainty increased substantially: the financial system exhibited high volatility in terms of transaction amounts, interest rates, and yields of various instruments. According to ACRA SFSI KZ, this period was less acute but more long-lived as compared to the period of early 2009.

The FX imbalance in the financial sector has increased notably driven by the response from households and banks. Finally, when the NBRK abandoned the fixed exchange rate policy in late 2015 the changes that have occurred in the expected standing of companies were found to be much stronger than those in early 2014. The index marks this period as comparable in terms of acuteness and as a more long-lived one than the 2009 crisis.

The situation in the financial system turned into a challenge for the regulator. The key monetary policy tool for the NBRK – as well as for the Bank of Russia – was its base interest rate (versus FX market interventions). By virtue of a surge in short-term rates, deposit dollarization level declined, and tenge-denominated assets became more attractive, which smoothened the liquidity issues as compared to the late-2014 period. Monetary financing of budget deficit continues supporting the financial sector's liquidity in December 2017.

#### The current status

As of December 2017, the slowly declining FX imbalance in the banking sector is, in ACRA's opinion, the key structural issue for Kazakhstan's financial system (Figure 6). Amid free-floating exchange rate, this factor may become the source of a systemic risk.

The liquidity imbalance of 2013-2016 appears to have materialized through increase in overdue loans provided to trade and construction industries, which we are witnessing in 2017. Contraction of households' real disposable income that started in 2015 could have been the reason for the above. As this issue's scope is limited to two subsectors, its importance is not that high as that of an FX imbalance.

For the lack of new trigger events as of December 2017, the financial system of Kazakhstan is relatively stable: ACRA SFSI KZ is now at 15% of its maximum registered levels. However, it is worth noting that the situation may change rapidly due to the relatively high remaining liquidity and FX imbalances.

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