SigmaBleyzer

Kazakhstan Macroeconomic Situation

January 2008

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Summary

- Preliminary estimates place GDP growth at 8.5% year-over-year (yoy) in 2007.
- In 2007, the state budget deficit stood at KZT 215.2 billion (USD 1.8 billion) or 1.7% of GDP.
- The National Bank expects inflation to return to single digits in 2008.
- The consumer price index gained 1.1% month-over-month (mom) in January.
- Money supply was up by only 25.5% yoy in 2007 as domestic credit growth slowed to 54% yoy.
- Kazakhstan's total foreign exchange reserves approached USD 41 billion, as forex reserves of the central bank grew by 10.2% in January to USD 19.2 billion.
- In January-November, the trade in goods surplus stood at USD 12.7 billion.
- Kazakhstan improved its position in the Global Economic Freedom Index in 2007.

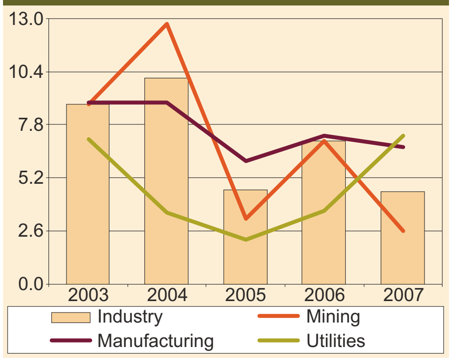
Economic Growth

Despite the visible impact of global financial turbulence on the Kazakh banking industry, the broader economy managed to remain on firm footing in the aftermath of the 2007 liquidity crisis. The government of Kazakhstan estimates that the economy grew by 8.5% yoy in 2007 (10.7% yoy in 2006). Nominal GDP approached USD 102.5 billion or about USD 6,600 per capita (up by 31.3% yoy from USD 5,020 per capita GDP in 2006).

Meanwhile, economic growth in 2008 may moderate as GDP is expected to grow from 5% to 7% this year. Above all, a slower growth of the banking industry, as banks face curbs on their efforts to draw on funds from foreign creditors, is increasingly likely to add new constraints to the rest of the economy. Slower economic growth and tighter international liquidity will almost certainly trim credit growth. On a positive note, all of this may help restrain the widening of the current account gap and will weaken mounting inflationary pressures.

However, high world commodity prices (namely, for crude oil, crops and industrial metals) are expected to support the country's international liquidity and provide sufficient impetus for healthy growth of the broader economy. On top of that, a recent resolution of the Kashagan dispute will stimulate more active development of the country's oil extraction industry, which continues to be a driver of overall economic expansion. According to the agreement between Kashagan consortium members signed on January 14th, Kazakhstan's stake in the project will grow to 16.81 %. The Kashagan oil field (the 4th largest oil field in the world) is expected to become operational in several years. This means that Kazakhstan will obtain considerable oil revenues (in addition to USD 5 billion in payments for project delays) to support sustainable growth of the domestic private sector. Furthermore, more favorable terms of the Kashagan agreement will boost the position of the state-owned oil companies, which will ensure additional tax revenues and dividends to the state. In 2007, the largest state-owned oil and gas company, KazmunaiGaz, increased its output capacity to 16.7 million tons or by 29.5% yoy. Last year, the consolidated income of the company reached USD 10.8 billion, growing by 5.1% yoy.

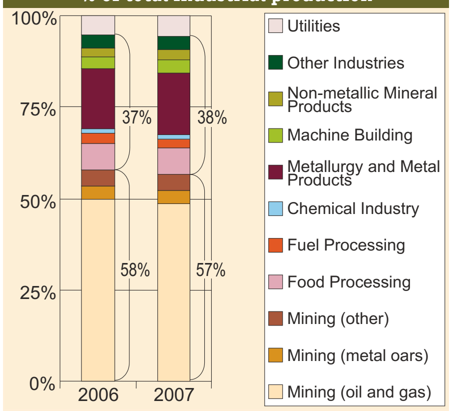
Industrial Growth by Sector, % yoy



Source: ASRK

In 2007, industry posted 4.5% yoy growth rate (as compared to 7% yoy the year before) on the back of slower growth in the mining industry, which gained 2.6% yoy (compared to 7.0% yoy in 2006). Essentially, a deceleration in the oil and gas extraction industry to 3.1% yoy from 6.1% yoy in 2006 as well as the virtually flat performance of the metal oars extraction sector stood behind weaker growth of the mining sector. Crude oil extraction, still key to the overall performance of Kazakhstan's industry, gained a modest 2.2% yoy, totaling 55.6 million tons (or about 1.11 million barrels per day (bpd)) as compared to 6.8% growth a year before. On a positive note, ongoing capacity expansion projects in the oil industry are anticipated to make a visible contribution to the country's crude oil output in 2008. In particular, Chevron Corporation, which operates Tengiz oil field, has recently released a statement reporting that it managed to enlarge its extraction capacity by 90 thousand bpd, while its current capacity of 400 thousand bpd may grow to 540 thousand bpd later this year.

Industry Composition by Sector, % of total industrial production



Source: ASRK, The Bleyzer Foundation

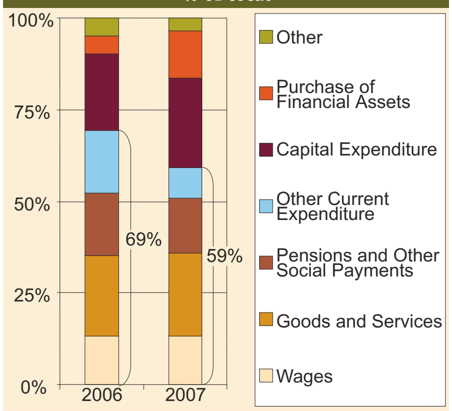
Finally, manufacturing managed to preserve healthy growth rates supported by booming trade and construction, strong agriculture and resilient spending by consumers and businesses. As a result, food processing, production of construction materials, fuel processing, chemical industry (fertilizers) and machine building kept posting strong gains in 2007. More importantly, despite a deceleration in the mining industry and metallurgy (sectors that still account for nearly two thirds of industrial production), manufacturing continued to outperform the mining industry in terms of growth rates. Taking into account the rather modest size of the non-oil industry, it is reasonable to assume that the performance of these sectors will remain solid on the back of robust consumer and investment demand.

Fiscal Policy

In 2007, the state budget deficit amounted to USD 1.8 billion or 1.7 % of projected full-year GDP. Accelerated public spending on construction and real estate sectors during the final months of last year may explain this widening of the budget gap.

This year, the government foresees a moderate expansion of public expenditures as it attempts to satisfy growing demands for social protection and good public infrastructure. The republican budget was approved to have a year-end deficit of about 1.4% of GDP. At the same time, despite optimistic fiscal revenue projections from the non-oil economy, the republican budget will receive a considerable boost from the National Fund of the Republic of Kazakhstan (NFRK). The 2008 republican budget is granted a transfer from the NFRK in the amount of USD 2.84 billion, which is equal to nearly 13% of all budget revenues. As a result, this transfer will offer the government protection against the deterioration of its fiscal revenues, if forthcoming economic developments create a threat to the country's financial stability. Indeed, the government pledged that it may double its support to the banking and construction sectors if budding economic risks materialize into a serious threat.

Composition of State Budget Expenditure, % of total



Source: Ministry of Finance of RK, The Bleyzer Foundation

In 2007, state budget expenditure grew by 35% yoy in nominal terms to KZT 3,208 billion (USD 26.2 billion) or about 25.5% of full year GDP. Although the current expenditure gained only 15% yoy, a 57% growth of capital expenditures and a 2.5 times surge of spending on financial assets were the key contributors to the rapid increase of public spending. As a result, the share of current expenditures in total state budget expenditures shrank to 59%, while the share of capital spending jumped to 24%. Spending on education, culture, health care and social protection accounted for more than 51% of all current and capital expenditure, while the shares of spending on public housing and utilities, transport and communications and agriculture stood at 7.5%, 10.8% and 3.8%. These numbers suggest that public spending on social protection and infrastructure (mainly in the transportation sector) remain top priorities for the government. With luck, such public spending may help Kazakhstan solve pressing developmental challenges. After all, better public roads, education and health care systems will eventually have a significant positive spillover effect on productivity and welfare growth.

Monetary Policy

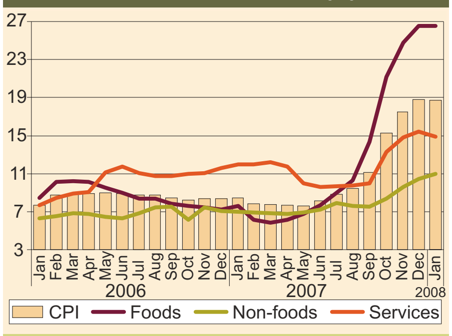
Efforts to contain inflation within a 7.9–9.9% range will be the prime objective of the monetary policy of the National Bank of the Republic of Kazakhstan (NBRK) in 2008. In January, the NBRK issued its policy guidelines and economic projections for this year. There are two scenarios of economic developments simulated by the monetary authority. According to the base-line scenario, the NBRK will adhere to moderately tight and accommodative monetary policy. The central bank will continue to maintain an adequate level of short-term liquidity in the banking system and may provide additional support to the commercial banks in the amount of USD 8 billion in 2008. The exchange rate is expected to remain relatively stable, though depreciation pressures may intensify due to sizable repayments on maturing external obligations of Kazakh banks. At the same time, some moderation of investment and consumer demand may help to contain the growth of imports. This may alleviate budding pressures on the financing of the current account gap. On a positive note, forex reserves of the NBK are at a rather high level. At the end of January, the NBRK accumulated USD 19.2 billion in forex reserves (up by 10.2% since the beginning of the year), which, including USD 21.6 in the assets of the NFRK, brings total international reserves of Kazakhstan to USD 40.8 billion (up by 5.9% in 2008). Thus, the monetary authority has a capacity to intervene and support national currency.

The pessimistic scenario assumes that Kazakh banks will not be able to access external funds to refinance their outstanding liabilities. As a result, domestic credit may cease to grow or even shrink, which will curb the borrowing capacity of the private sector to finance consumption and investment spending. Under this scenario, the country may face some formidable challenges as massive outflows of capital (due to repayments on foreign debts) will create strong depreciation pressures. However, the likelihood of such a scenario is immaterial, as it assumes zero GDP growth both in 2008 and 2009, which is far below even the most conservative projections. Indeed, the NBRK believes that such a scenario may unfold only if rapid deterioration of the global financial crisis continues. Considering recent fiscal and monetary actions of the EU and US authorities, discharged to forestall hard lending of their economies, as well as the resilient performance of emerging markets, it is unreasonable to expect that global economic conditions may worsen to the point that the NBRK's pessimistic scenario becomes a real threat to Kazakhstan.

Regardless of the scenario that actually happens in 2008, the monetary authority will continue to back commercial banks and prevent sharp fluctuations of the national currency. On top of that, the NBRK has recently introduced early warning systems for financial and economic shocks, while the Agency on Supervision of Financial Markets has issued new reserve requirements for commercial banks, which are to increase their reserve base by 2% of accumulated loan portfolios. These institutional developments will facilitate earlier detection and timely response to financial stability shocks and will help to minimize potential economic losses.

Dearer foods on the menu continued to push the consumer price inflation (CPI), which hit 18.7% yoy in January. Food prices gained 26.6% yoy, as prices of many staple food items (e.g. breads, wheat products, oils and meat) posted high double-digit percentage gains. In addition, record high world energy prices inflated prices of fuels, supporting a 11% yoy growth of prices of non-food commodities.

Consumer Price Index, % yoy

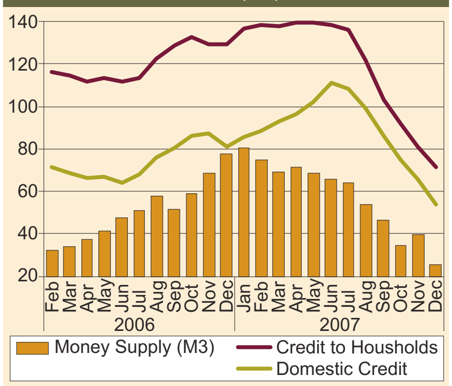


Source: ASRK

On a monthly basis, the CPI advanced by 1.1% mom, which represents a relative improvement after inflation soared to 3% mom on average during the last quarter of 2007. Taking into account that prices of foods tend to grow slower in spring and summer due to seasonal fluctuations in supply, the year-end CPI may range from 10% to 14%. However, as consumer credit cools down on the back of a modest expansion of the banking sector, actual inflation looks increasingly likely to fall closer to the lower bound of that range. Still, significant upside risks to inflation remain a real threat as the still strong global economy fans demand for staple foods and energy materials. Because these commodities account for the lion's share of the consumer basket in Kazakhstan, significant world price fluctuations may visibly influence the country's inflationary outlook.

In December 2007, money supply increased by 25.5% yoy and amounted to KZT 4,613 trillion (USD 38.4 billion) or about 36.7% of GDP. Domestic credit continued to decelerate on the back of limited access to external funds by Kazakh banks and advanced by only 54% yoy (compared to 81% yoy in December 2006). Banks continued to issue new loans, albeit at a snail's pace as during the final four months of 2007 domestic credit advanced by 0.4% mom on average — down from 5.4% mom prior to August's financial crisis.

Money Supply (M3), % yoy



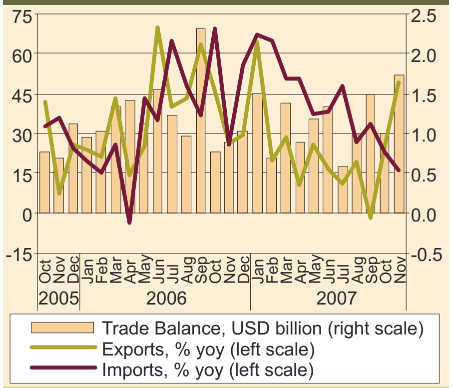
Source: NBRK, The Bleyzer Foundation

Deposits at commercial banks increased by 26% yoy to KZT 3,874 billion (USD 32.2 billion). Households' deposits advanced by 40.5% yoy, while corporate deposits grew by 18.7% yoy. Above all, households tended to pile up forex-denominated deposits in the last two quarters of 2007 as the international liquidity crisis inflated depreciation expectations. Although the growth of deposits stalled in the third quarter of last year on the back of mounting concerns over the health of ailing domestic banks, both households and the corporate sector increased their deposits in the forth quarter. This development may signal that the public trust into Kazakh banks was not severely eroded by the ongoing global financial crisis.

International Trade and Capital

In January-November 2007, the trade in goods surplus settled at USD 12.8 billion (down by 5.3% yoy) as imports increased by 40% yoy and exports grew by 22.3% yoy. On a monthly basis, the trade balance surged by 89% mom and amounted to USD 1.7 billion. In 2007, buoyant imports, helped by booming

Monthly Foreign Trade Balance



Source: NBRK, The Bleyzer Foundation

consumer and investment spending, emerged as a major force, constraining the growth of the trade in goods surplus. For this reason, high world oil prices appeared to be insufficient to prevent the current account gap from dipping into negative territory. On a positive note, slower economic growth, strong oil prices and growing extraction capacity of the domestic oil industry is likely to put a curb on further widening of the current account deficit. Putting together robust FDI inflows into the mining sector and more reserved growth of the current account deficit, it is reasonable to suggest that Kazakhstan's external imbalances will be manageable.

Other Developments Affecting the Investment Climate

In January, the Heritage Foundation published its Global Economic Freedom rating. This survey has been held for 14 years and is based on the assumption that there is a direct convergence between the free market economies and developing nations. According to the latest rating, Kazakhstan is on the 76th place (compared to 83rd place in 2006). Kazakhstan achieved the most progress in the domain of public governance, monetary policy, labor market and foreign trade liberalization. Meanwhile, issues of corruption, investment and property rights protection still demand more policy efforts and closer attention of the government.

Global Economic Freedom Index

Country	Rank	Score
Bulgaria	59	62.92
Romania	68	61.53
Kazakhstan	**76**	**60.5**
Poland	83	59.49
Azerbaijan	107	55.29
Tajikistan	114	54.46
China	126	52.8
Uzbekistan	130	52.31
Ukraine	133	51.1
Russia	134	49.9
Turkmenistan	152	43.36

Source: Heritage Foundation