Kazakhstan
Macroeconomic Situation

March 2008

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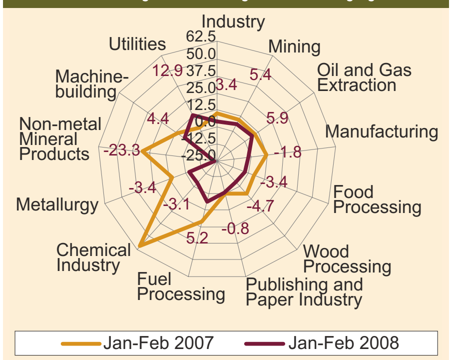
Summary

- In January-February, industry gained 3.4% yoy.
- The state budget surplus stood at USD 1.06 billion in February, or about 0.8% of projected full year GDP.
- Consumer price inflation moderated in March, as monthly inflation decelerated to 0.6% from 1.1% since the beginning of the year.
- In March, Kazakhstan's international reserves stood at USD 42.3 billion.
- The trade in goods surplus was at USD 2.9 billion in January, almost twice as high as in the same month a year ago.
- The current account deficit is expected to shrink to 6% of GDP in 2008.
- The EBRD plans to invest around USD 1 billion into Kazakhstan in 2008.

Economic Growth

In the context of today's global financial turbulence, sustainable economic growth is a key priority for the Kazakh government in 2008. Thus, the authorities put much effort into enhancing the competitiveness of the domestic economy through modernization of public infrastructure, implementing public administration reform and effective social policy. Still, the mining industry will remain a major determinant of economic performance, as the government attempts to encourage further expansion of domestic extracting capacities. Favorable world commodity prices, growth of household incomes and financial stability of the corporate sector will continue to boost aggregate demand supporting the real economy.

Industry Growth by Sector, % yoy



Source: ASRK

In January-February, the value of industrial production amounted to USD 12.5 billion, growing by 3.4 %yoy. Mining maintained solid performance, surging by 5.4% yoy on the back of growing oil and gas extraction. Crude oil, a key contributor to the country's industry, gained 5.9% yoy as Kazakhstan extracted 9.3 million tons of crude oil during the first two months of this year (up by 4.5% yoy). The government expects to increase capacity of oil extraction to 69-70 million tons in 2008. In particular, exploration of hydrocarbon reserves at the Zhambyl deposit in the Caspian Sea with estimated reserves of 120 million tons will provide higher growth rates for the oil extraction industry. On top of that, as more investments are channeled into the oil pipelines infrastructure, higher transit capacity will provide additional support to the oil industry.

Manufacturing shrank by 1.8 % yoy due to a fall in food processing by 3.1 % yoy and a contraction of industries, producing construction materials (down by -23.3% yoy). These developments were driven by tight supply of agricultural commodities and slowing construction, which have cooled down due to funding difficulties and posted weaker performance in January-February, up by only 0.2 % yoy (compared to 1.4 % in the same period of 2007). In particular, the average volume of new mortgages issued to households in the aftermath of the global liquidity crisis (September 2007 — January 2008) fell by almost 4 times as compared to the first 8 months of 2007, while the average monthly credit to the construction sector declined by 1.92 times. All told, prices of new residential housing have remained nearly flat since September of last year, while prices of pre-owned residential housing fell by 5.2%.

On a positive note, the government's national program on residential construction will allocate about USD 2.5 billion to assist real-estate developers with ongoing and new construction projects in 2008-2010. The importance of the construction sector for overall economic performance is difficult to underestimate as a share of construction in the value added remains at about 10%.

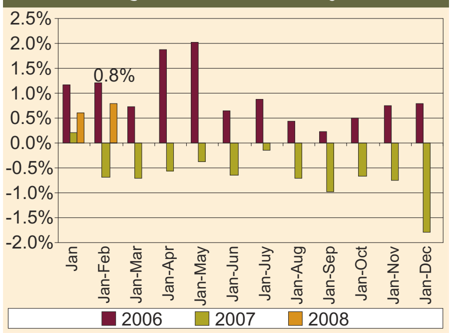
In addition, it bears emphasizing that tighter global agricultural markets may elevate the significance of the domestic agricultural sector in terms of its capacity to supply the domestic market with a sufficient stock of agricultural commodities. The performance of agriculture has remained relatively strong as agricultural output increased by 3.6% yoy during the first two months of 2008. In addition, the government committed KZT 64 billion (USD 533 million) to alleviate tighter credit conditions in agriculture and improve productivity of this sector. The lion's share (USD 340 million) will be allocated to the national holding company KazAgro and its subsidiaries. These funds are expected to be spent on various efficiency projects in agriculture as well as on domestic grain reserves. In March, the government decided to build up national grain reserves instead of imposing curbs on exports of grains.

Finally, the cold winter, unexpected in the southern parts of Kazakhstan, increased consumption of electricity and gas, increasing output growth of utilities by 12.9% yoy.

Fiscal Policy

Kazakhstan began the 2008 fiscal year with the state budget in surplus on the heels of a 1.7% state budget deficit in 2007. In February, the state budget surplus amounted to USD 1.06 billion or 0.8% of projected full year GDP. The government of Kazakhstan managed to keep expenditures constant in GDP terms in 2007 at 21-22%, even with the unplanned release of an additional USD 1.1 billion to support the real economy. Further spending of USD 3 billion in 2008 will be worth about 2.7% of projected GDP. State budget revenues were supported by strong fiscal revenues, which increased by nearly 35% yoy as proceeds from the corporate income tax, personal income tax and VAT grew by 21.2% yoy, 8.4% yoy and 125.3% yoy respectively.

State Budget Balance, % of full year GDP



Source: The Ministry of Finance of RK, The Bleyzer Foundation

These developments may foresee a sound fiscal outlook since they imply that tax revenues tend to remain strong despite a slowing economy. This year, the government envisions a moderate expansion of public expenditures. A key priority is given to social protection and good public infrastructure. In January-February, average wages, pensions and social benefits grew by 19.1 % yoy, 29.3% yoy and 0.9% yoy respectively. The republican budget was approved with a year-end deficit of about 1.4% of GDP. Equally important, this year the government is guaranteed to receive generous transfers from the National Fund of Kazakhstan (NFRK) in excess of USD 2.8 billion (or about 2.3% of GDP). As a result, the government will have protection against the deterioration of its budget balance if global economic shocks create a threat to the country's financial stability. The Kazakh authorities have already indicated that they may back the banking and construction sectors if budding economic risks materialize into a serious threat. However, the Ministry of Finance has encouraged domestic banks to find an independent solution to liquidity problems. Starting in 2008, financing of commercial banks is held via the Fund of Sustainable Development "Kazyna".

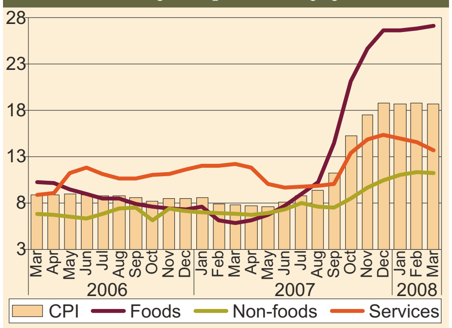
The growth of the non-hydrocarbon economy was driven by retail trade and construction, two sectors that benefited from surging bank credit and strong growth in personal incomes. According to the Kazakh Statistics Agency (ASRK), average money incomes rose by 24% yoy in January 2008.

Another way to reinforce the country's fiscal position is to enhance the efficiency of the budgetary process, strengthen financial discipline and improve tax compliance. The government is apparently aware of existing problems and is making a significant effort to address them. Several ongoing initiatives, including budget planning reform and a revision of the Tax Code, may help to improve transparency and efficiency of the public sector. A recent moratorium on inspections of small and medium-sized businesses aims to reduce the regulatory burden on the SME sector. A new Tax Code, which is expected to be approved by September, may offer additional tax incentives to the non-oil sectors of the economy. Expected budget losses will be compensated for by higher returns from the oil sector, which is still the principal source of export revenues and foreign direct investments.

Monetary Policy

In January-March, the consumer price index increased by 18.7% yoy, mainly driven by skyrocketing food prices, which accelerated by 26.8 % yoy. Prices of non-foods and service tariffs gained 11.2% yoy and 14.3 % yoy respectively. On a positive note, inflationary pressures appeared to have moderated slightly as a monthly increase in the CPI fell from 1.1% in January to 0.6% in March.

CPI by Component, % yoy



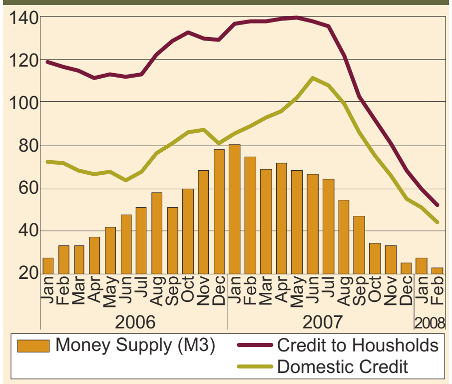
Source: NBK

Inflationary pressures in Kazakhstan have been affected by the global trend of growing commodity prices. The price of crude oil reached another milestone in mid March 2008, jumping to an inflation adjusted record high of USD 111 (going down later on though). The weaker dollar that has propelled oil and other commodity prices higher sent light, sweet crude for April delivery past USD 111 a barrel on the New York Mercantile Exchange. That's the level many analysts consider to be the true record high for oil, after its USD 38 per barrel price from 1980 is translated into 2008 dollars. The dearer cost of crops was triggered by unfavorable weather conditions and shortage of harvest in Europe, Canada and Australia.

However, the National Bank of Kazakhstan (NBK) pledges to maintain price stability, targeting below 10% inflation. To curb double digit inflation, the government ruled against the imposition of grain export quotas, ensuring a commitment from local grain sellers to supply sufficient quantities of grain to the domestic market at fixed prices.

According to the NBK, the growth of money supply (M3) accelerated by only 22.6% yoy in February (compared to 74 % yoy a year before) on the back of the slower growth of domestic credit. The latter shrank by 0.04% mom while deposits grew by 1.3 % mom.

Money Supply (M3) and Domestic Credit, % yoy



Source: NBK, The Bleyzer Foundation

The growth of deposits indicates the confidence of the private sector in the banking system of the country. Furthermore, the survey of the ASRK shows that the stock of household deposits continues to grow even considering the August deposit flight.

In March, the international reserves of the national bank stood at USD 19.5 billion (up by almost 12% since the beginning of the year) while the value of assets of the National Fund grew to USD 23.1 billion. As a result, the aggregate international reserves of Kazakhstan have advanced by 10% since December 2007 to USD 42.4 billion.

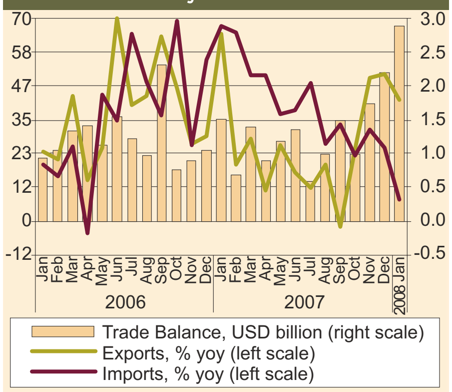
According to the ASRK report for 2007, domestic financial institutions have expanded their reserves for depreciation of credits. This measure may help to compensate for the growth of bad and non-performing loans. Finally, more than half of local banks (out of 33) tightened their credit policies. 68% of financial institutions reduced mortgage loans, while 63% reduced consumer credits. Notably, prudent crediting is true for leading banks (Kazkomertsbank, HalykBank, BTA, Alliance Bank and ATF bank).

Thus, the liquidity crisis encouraged banks to reconsider their business practices towards transparency, diversification of loans and funding resources, and prudent risk management. The Kazakh authorities' approach to providing foreign exchange liquidity to the banks even at the cost of a sharp drop in reserves is motivated by the concern to maintain private sector confidence in the financial system and in the value of the KZT. A loss of trust could rapidly erode economic stability via deposits flight and currency speculation. So far, Kazakhstan seems to be avoiding this.

International Trade and Capital

Kazakhstan's foreign trade balance amounted to USD 15 billion in 2007, growing by 2.9% yoy with exports gaining 24.8% yoy and imports gaining 38.3% yoy. In January 2008 the trade in goods surplus settled at USD 2.9 billion (or almost twice as high as in the same month a year ago), driven by oil and gas output.

Monthly Trade Balance



Source. ASRK, The Bleyzer Foundation

The country's current account deficit is driven by widening deficits on services, incomes and transfers. This partly reflects the structure of foreign-owned companies in the energy sector, as foreign energy majors import business services they cannot get locally, and remit earnings from their Kazakh operations abroad. Furthermore, Kazakhstan's economy attracted workers from the country's poorer Central Asian neighbors, thus leading to growth of outward worker income remittances.

The current account deficit settled at around USD 7 billion in 2007, or 6.9% of GDP. The government estimates a lower ratio of current account deficit in GDP terms in 2008 due to the deceleration of imports and surging commodity prices.

Other Developments Affecting Investment Climate

Kazakhstan's sovereign ratings are supported by a still high average annual GDP growth of 8.5%, strong public finances, including the lowest ratio of gross general government debt to GDP (5.4%). The investment climate in the country is still considered to be favorable.

The European Bank for Reconstruction and Development (EBRD) announced its intention to invest over USD 1 billion in the Kazakh economy. About one half of this amount is expected to flow into the banking sector. The EBRD will continue to support loan programs for small and medium business with five Kazakh commercial banks' contribution to the program this year. The EBRD will also help to reopen the securitized loans market for Kazakh banks in the second half of this year. In 2007, the EBRD invested USD 800 million in Kazakhstan, while its current portfolio is valued at about USD 1.4 billion. Nearly 40% of this portfolio is concentrated in the financial sector.

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