Kazakhstan Macroeconomic Situation

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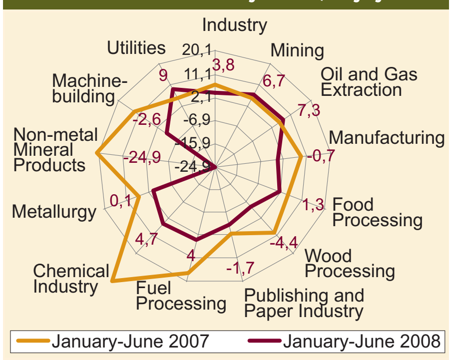
Summary

- In the first half of 2008, industry grew by 3.8% yoy.
- The state budget remained in deficit in June at 0.74% of projected full year GDP.
- In July, the consumer price index grew by 0.9% compared to the month before.
- Domestic credit growth decelerated to a modest 10.4% yoy in January-June.
- During the first five months of the year, the foreign trade surplus totaled USD 14.43 billion.
- High energy prices helped to fix a credit crunch-induced fall in forex reserves.

Economic Growth

Weaker domestic demand and anemic bank lending remain as key challenges to economic growth in Kazakhstan. This means that GDP is likely to grow by around 5% yoy this year. Indeed, readings on business inventories may imply that economic activity moderated in the first half of 2008. In particular, in January-March, business inventories shrank after having increased for four consecutive years (the buildup in business inventories expanded from 1.2% of GDP in 2004 to 5.6% in 2007). Higher production costs, decelerating imports, tighter credit and worsening business sentiments may explain this decline. However, this may also mean that domestic production is likely to improve in the second half of the year, as businesses will begin to replenish depleted inventories and the financial sector stabilizes. In addition, high global commodity prices help to maintain a healthy fiscal position and remedy Kazakhstan's external imbalances. After all, the current account registered a strong surplus of nearly USD 4 billion in the first quarter of 2008. Although world oil prices have recently retreated below USD 120 a barrel on fears of weaker global economy, crude oil is still trading at a price exceeding last year's level by more than 50%. As a result, the government will continue to earn export and tax revenues to smooth the adjustment of domestic banking and construction sectors to still tight global liquidity conditions.

Industrial Growth by Sector, % yoy



Source: ASRK

During the first half 2008, industrial production grew by 3.8 % yoy compared to 6.8% yoy a year ago. The mining industry, which accounts for over two thirds of total industrial output, accelerated to 6.7% yoy from 5.3% yoy in January-June 2007. This growth was mostly driven by a healthy expansion of the oil and gas extraction industries (which contributed 57% to total industrial output). In particular, crude oil extraction grew by 7.8% yoy to 29.2 million tons. Essentially, this output gain was ensured by the output expansion at the Tengiz oil field operated by the Tengizchevroil joint venture (TCO). The TCO produced on average 305,000 barrels per day (b/d) in 2007 or nearly one forth of the country's total crude oil output. However, the TCO's expansion projects increased production capacity by more than 20% in spring 2008. Although the TCO will reduce crude oil production by nearly half in the summer due to annual maintenance, the company still expects to bring its output level to 540,000 b/d by the end of 2008. Meanwhile oil production at other major oil fields either remained flat or posted only trivial gains. For example, oil production at the Karachaganak oil field, which jointly with the TCO accounts for over 40% of total crude oil production in Kazakhstan, grew by less than 4% yoy.

Tightening capacity of oil transit infrastructure is a major bottleneck of the oil industry in Kazakhstan. Above all, the Caspian Pipeline Consortium (CPC), which is used to export at least 50% of all Kazakh oil, has to be upgraded to allow for higher volumes of oil transit. This issue is particularly critical for the TCO as the company exports almost all of its output through the CPC. Thus, Chevron, which owns 15% of the CPC and 50% of the TCO, is likely to persuade other CPC shareholders to implement pipeline expansion projects (provided that this initiative gains shareholder approval, the CPC capacity is projected to increase by 2.5 times by 2013). On a positive note, the ongoing development of the oil transit routes to China (in 2007, Kazakhstan transported about 7% of its total crude oil exports to China through the Atasu-Alashankou pipeline) and a regional partnership between Kazakhstan and Azerbaijan on oil shipment across the Caspian sea will help to diversify and expand Kazakh oil transit infrastructure.

In January-June 2008, output in manufacturing remained virtually flat, decreasing by 0.7% yoy as industries producing construction materials remained under the pressure of the weakening housing market. In particular, the lackluster construction sector caused the production of cement and concrete to decrease by 10.2% yoy and 21.5% yoy, respectively (compared to 25.6% yoy and 18.8% yoy gains a year ago).

Fuel processing industry growth decelerated to 4% yoy as production of petrol fell by 2.2% yoy, while diesel fuel increased by only 4.6% yoy. Output in metallurgy, which represents about 45% of the entire manufacturing sector, remained virtually unchanged, inching up by 0.1% yoy. Extreme weather conditions, maintenance of production facilities and disruptions of electricity supply during the first few months of this year may partially explain this trend. This means that performance of the metallurgical sector may improve in the second half of 2008.

Output in the food processing industry increased for the first time in 2008 by 1.3% yoy, although production of vegetable oil, butter and milk still has to recover to the last year's levels. However, this year local producers of milk, butter and vegetable oil are poised to endure intensified competition with their Ukrainian peers (who are the key suppliers of food imports in Kazakhstan) and the increasing burden of higher production costs. Indeed, during the first five months of this year, Ukraine exported about 3 thousands tons of milk (though still less than 3% of domestic production in Kazakhstan) and 1.7 thousands tons of butter (about one forth of Kazakh production) to Kazakhstan compared to around 3 tons and less than one ton of milk and butter, respectively, a year ago.

Fiscal Policy

The first half of 2008, the state budget registered a deficit of KZT 112.22 billion (USD 0.93 billion) or about 0.7 % of projected full year GDP. State budget revenues grew by 21.7% yoy in nominal terms amounting to USD 13.3 billion. Meanwhile, the share of tax revenues in total revenues shrank to 74% from about 80% a year ago as transfers from the National Oil Fund to the state budget surged by 120.3% yoy to USD 2.8 billion. This means that high crude oil prices help to offset fiscal revenue shortfalls brought on by slower economic growth. Indeed, despite growing by 14% yoy in nominal terms, CPI-adjusted tax revenues shrank by about 4.5% yoy. In particular, VAT revenues, which account for about one fifth of total tax revenues, remained flat compared to a 27.9% yoy growth in the first half of 2007. Moreover, VAT revenues from goods and services produced in Kazakhstan dropped by 34% yoy (compared to an increase of 16% yoy in January-June 2007), while VAT revenues from imports, which generate over 70% of all VAT revenues, grew by a modest 10.1% yoy (up by 37% yoy a year ago). This slower growth of VAT revenues may be partially attributed to a cut of the VAT rate from 14% to 13% in January 2008. There is, however, another possible explanation. Weaker domestic demand depresses sales of both locally produced and imported goods, which curbs VAT revenues. Indeed, during the first half of this year, retail sales inched up by only 2.1% yoy (up by 11.1% yoy a year ago), while imports decelerated to 14.8% yoy from 51.7% yoy in January-May 2007.

On a positive note, revenues from the corporate income tax (CIT) on the non-oil economy (over one third of all tax revenues of the state budget) grew by a healthy 29% yoy. This may imply that, despite increasing production costs, the corporate sector has managed maintain strong profit margins. Finally, booming oil exports supported a 70% yoy growth of tax revenues of the National Oil Fund, as CIT revenues from oil producers jumped by 66% yoy to USD 3.6 billion during the first six months of 2008.

On top of that, a duty on crude oil exports, introduced in May, will help to bring additional tax revenues to the budget. Furthermore, the government intends to

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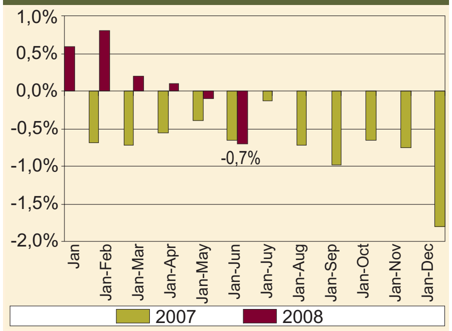
State Budget Balance, % of GDP



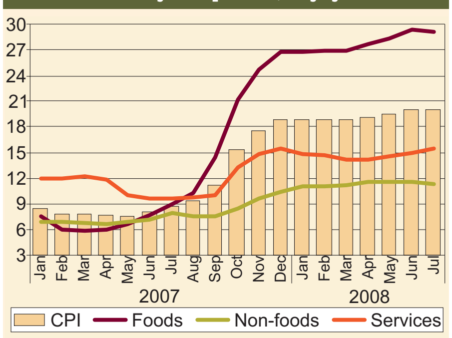
Source: The Ministry of Finance of RK, The Bleyzer Foundation

expand the list of oil producing companies subject to this new tax. In particular, the Karachaganak Petroleum Operating (KPO) became the first foreign joint venture operating under the production sharing agreement that paid around USD 80 million in crude oil export duties in June.

Money Supply

In July, the consumer price index (CPI) increased 0.9% compared to the month before as growing food prices and increasing fuel costs continued to exert an upward pressure on the overall price level. As a result, during the first seven months of this year consumer prices grew by 6.6% ytd (compared to 4.6% ytd a year ago). Although, in July seasonal factors helped to curb food price inflation (prices of foods were up by only 0.6% compared to a monthly increase of 1.8% in June), service tariffs and prices of non-food commodities gained 1% mom and 1.2% mom, respectively, under the pressure of higher fuel prices. In particular, in July prices of gasoline and diesel fuel surged by 7.3% mom 11.6% mom, respectively, which means that gasoline prices were 30% higher than in July 2007.

CPI by Component, % yoy

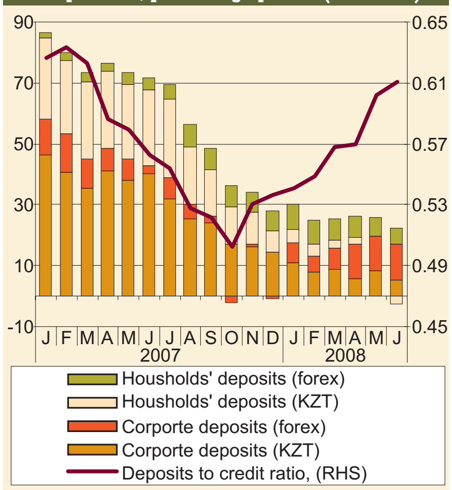


Source: NBK, The Bleyzer Foundation

In June, growth of domestic credit moderated to 10.4% yoy (compared to 110.8% a year ago). Money supply continued to decelerate as well, increasing by 15.7% yoy in July (compared to 66% yoy in July 2007). Above all, commercial banks significantly reduced their lending to households as short-term and long-term credit to households fell by 15.6% and 3.6%, respectively, since the beginning of this year (ytd). The volumes of mortgages and consumer credit shrank by 2.8% ytd and 1.3% ytd respectively. In June alone, the share of credit to households in the amount of newly issued credit fell to 13% from 31% in the same months of 2007. All told, commercial banks still lack the resources to support their retail lending at last year's level. Furthermore, ongoing price correction on the housing market, increasing interest rates and weakening financial conditions of households (due to high inflation and slower growth of incomes) have tightened the borrowing capacity of Kazakh consumers.

Meanwhile, deposits at commercial banks remained on an uptrend, increasing by 13.8% ytd to USD 36.9 million, although this growth was primarily ensured by a 21% ytd increase in corporate deposits. As a result, the share of household deposits in total deposits narrowed to 33% from 37% at the end of 2007. This may imply that decelerating real wages and a slowing economy tend to reduce the amount of disposable income saved by households. Indeed, in January-June, household deposits grew by a modest 1.4% ytd compared to 32.9% ytd during the same period of 2007. Equally important, in June 2008, households contributed a modest 13% to the growth of deposits compared to 40% a year ago. This means that the corporate sector remains a key source of domestic funding for Kazakhstan's banking system.

Growth of deposits at the commercial banks by components, percentage points (left scale)



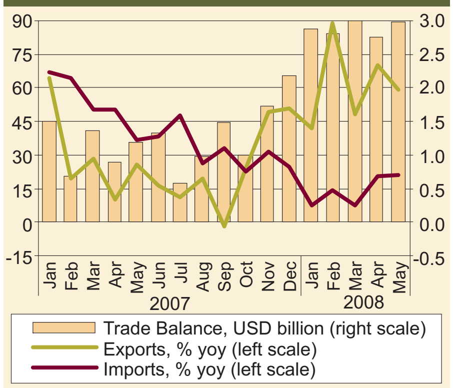
Source: NBK, The Bleyzer Foundation

The ratio of deposits to domestic credit (which can be used as a proxy to measure the capacity of commercial banks to fund their loan portfolios through deposits rather than wholesale borrowing on international markets) slightly improved, as domestic credit remained virtually flat in 2008. However, during the first half of this year, commercial bank assets have increased much slower than a year ago, totaling USD 101.4 billion or up by only 9% yoy compared to 103% yoy the year before. Equally important, the quality of commercial banks' credit portfolios continued to weaken. This trend was further exaggerated by the slower expansion of loans extended by commercial banks. Indeed, as the volume of extended loans grew by only 8.6% yoy and the amount of overdue loans surged by nearly three times to USD 6.4 billion, the share of overdue loans in the banking system increased to 8.6% from 3.3% in June 2007. On a positive note, since the beginning of 2008, Kazakh commercial banks have increased their provisions for risky loans by USD 1.7 billion and added an additional USD 840 billion in capital. All of this may strengthen the loss absorption capacity of Kazakh banks by providing an extra cushion against losses generated by non-performing assets.

International Trade and Capital

Record high world commodity prices continue to boost Kazakhstan's export revenues. During the first five months of 2008, the foreign trade surplus amounted to USD 14.4 billion or more than 2.5 times higher than in January-May 2007. Exports accelerated by 60% yoy as crude oil traded above USD 100 a barrel on average in January-May 2008 compared to about USD 60 a barrel in the same period of 2007. Meanwhile, imports slowed to 14.8% yoy (against 51.7% yoy a year ago).

Monthly Trade Balance



Source. ASRK

A shift in the geographical pattern of Kazakh foreign trade may shed some light on the impact of domestic investment and consumer demand on imports. Indeed, while imports from non-CIS economies, which account for almost half of all imports to Kazakhstan, surged by 65.2% yoy during the first five months of 2007, imports from these states grew by a paltry 4.4% yoy this year. In particular, imports from the UK, Italy, the Netherlands, France, Switzerland and Japan (countries supplying nearly 15% of all imports) shrank by 0.6% yoy, 24.5% yoy, 35.3% yoy, 5% yoy, 62% yoy and 20% yoy, respectively. Meanwhile, imports from Germany, which account for 7% of all imports into Kazakhstan, grew by a meager 1.4% yoy. The lion's share of imports from non-CIS countries is composed of machinery, transportation vehicles, aircraft and equipment for the oil industry. This means that the deceleration of imports is partially driven by weaker investment demand and the limited access of consumers to credit to finance purchases of foreign-made durable goods (such as automobiles and household equipment). Imports from China (about 10% of all imports into Kazakhstan) are perhaps even more vulnerable to declining consumer demand, as textiles, apparel and footwear represent nearly a half of all imports from China into Kazakhstan. High inflation and slow growth of incomes may force consumers to reduce spending on these items. Indeed, having increased by almost two times in 2007, imports from China grew by only 10% yoy in January-May 2008. Finally, Russia remains the largest exporter to Kazakhstan, accounting for about 40% of all imports. However, as metallurgical products represent more than 10% of all imports from Russia and petroleum products contribute another 26%, a 30% yoy increase of imports from Russia in January-May 2008 may merely capture the impact of the higher global costs of these commodities rather than robust demand for Russian goods.

Other Developments Affecting Investment Climate

Fitch issued a new report on Kazakhstan, arguing that high energy prices helped cause a credit crunch-induced fall in forex reserves. Meanwhile, lacking access to external funding, Kazakh banks visibly reduced their lending to the private sector. This means that in the short-term, a combination of stalled credit growth, falling real-estate prices and a moderating economy intensifies the risk of bank asset quality deterioration. However, Kazakhstan's long-term prospects are believed to be benign. Essentially, tight global crude-oil supply capacity and resilient demand for energy from emerging markets are projected to keep oil prices close to USD 100 a barrel, which will support more investment into the oil extraction infrastructure of Kazakhstan.

Arsellor Mittal will invest USD 4 billion to construct the largest metallurgical plant in Kazakhstan. The projected capacity of the new plant is close to 10 million tons of steel a year. This project involves the modernization of the Karmetkombinat plant, which at present produces 4 million tons of steel a year. The company believes that its investment will create an additional 5 thousand jobs in the Karaganda region, which accounts for nearly 11% of total industrial production in Kazakhstan.