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Kazakhstan Macroeconomic Situation

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Sergiy Kasyanenko, Edilberto L. Segura

Summary

- Recent developments at the global financial markets are expected to cause only a temporary moderation of the economic growth.
- Capacity constraints in the oil extraction industry continue to exact a toll on industrial growth, which in January-August amounted to only 5% year-over-year.
- The state budget remained relatively balanced, as the deficit hit only 0.7% of projected full year GDP.
- In September, the consumer price index crossed over the 10% level.
- Kazakhstan's economy continues to post the strong foreign trade surplus, which reached USD 7.6 billion during the first seven months of the year.
- Reserved growth of exports in the first half of 2007 dragged the current account deeper into negative territory. At the same time foreign direct investments amounted to USD 2.05 billion covering about 86% of the current account gap.
- In the first half of 2007, the stock of external debt jumped by 24.4% since the beginning of the year to USD 92.1 billion.
- The IMF believes that emerging market risks remain mostly balanced.
- According to the Doing Business Report 2008, Kazakhstan compares rather favorably to its neighboring competitors.

Economic Growth

Economic outlook in Kazakhstan is mostly shaped by two key developments. First, as the impact of the extracting sectors is not anticipated to fade in the medium term, the evolution of the industrial activity will continue to be influenced by economy's capacity to support sustainable expansion of the production and transit capacities in the mining industries. Indeed, it appears that a recent moderate deceleration of industrial growth was basically linked to the slower expansion of the domestic crude oil extraction.

Second, the ongoing global credit crunch has noticeably restricted the capacity of the domestic highly-leveraged lending institutions to borrow from abroad. Eventual moderation of the credit, issued by Kazakh banks to corporations and households, may exert downward pressures on sectors, heavily relying on banks' loans. Apparently, construction may bear the highest exposure to this financing risk. As financial sector and construction have been gradually emerging as important drivers of GDP growth, this moderation may lead to slower economic growth — a trend that can stretch out into the coming year. On the positive side, external liquidity constraints will encourage domestic financial intermediaries and the corporate sector to implement more prudent business models, which strike a better balance between external and internal sources of funding.

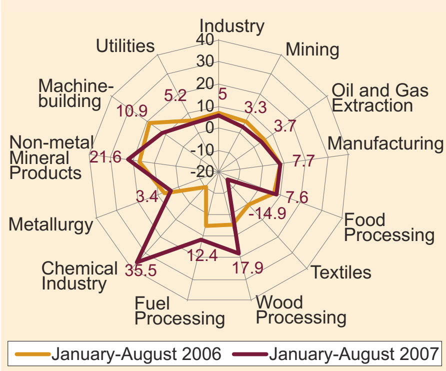
In January-August, the growth of industrial output gained 5% year-over-year (yoy). A deceleration of the mining industry, where output advanced by a modest 3.3% yoy against 5.8% yoy in January-August 2006, continued to exact a toll on overall industrial expansion. Extracting industries account for more than a half of total industrial output. Furthermore, output growth in the oil and gas extraction industry (about 50% of total industrial output) slipped to 3.7% yoy after hitting its peak in the first quarter of 2007. Several factors may explain slower expansion of the oil extraction industry in 2007. First, nearly 70% of all FDI inflows into the oil and gas industry has recently been deployed in geological exploration and investigations rather than in capacity extension.

Second, in January-August, one of the largest producers of crude oil and gas condensate — state controlled company JSC KazMunayGas (KMG) — increased its oil production by only 1% yoy. KMG's aggressive domestic and international expansion strategies (including a purchase of 75% of Rompetrol Holding SA (Switzerland) for about USD 3.6 billion at the end of August) may have favored asset acquisitions over the enlargement of existing capacities.

Third, in October 2006, China's CITIC Group took over the oil and gas company Karazhanbasmunai (KBM), previously owned by Canada's Nations Energy and producing about 50,000 barrels per day. As KBM's ownership changed, several upgrades of production capacities were postponed, which resulted in a 4.8% yoy drop of output in the first half of 2007. Moreover, KazMunaiGas Exploration and Production (KMG EP) — the second largest oil producer in Kazkhstan (61% of which is owned by its parent company KMG) holds a call option for a 50% stake in KBM. These ownership aw well as administrative uncertainties (further intensified by the domestic expansion strategies of KMG and its recent integration into the JSC Kazakhstan State Asset Management Holding "Samruk"), may have delayed more vigorous development of production capacities in the oil extraction industry.

On the positive side, Kazakhstan's oil extraction industry enjoys a rather favorable outlook (underpinned by skyrocketing world oil prices) and its facilities are to be expanded with major oil extraction and transit projects underway.

Industrial Output by Sector, % yoy



Source: ASRK

In addition, manufacturing has been registering encouraging signs of the diminishing reliance on metallurgy as a leading growth factor. Despite a dominant share of metallurgy in manufacturing output (which exceeds 42%), a deceleration of this industry to 3.4% yoy in January-August from 6.3% a year ago does not appear to be exerting a noticeable downward burden on the overall performance of manufacturing.

These developments may imply that Kazakhstan's' manufacturing sector has been gradually evolving toward higher immunity against volatile world metal

	2006		2006, % change yoy			2007, % change yoy				2007 TBF projections, % change yoy			IMF*	
	KZT, billion	% of GDP	Q1	H1	9M	12M	Q1	H1	9M	pessimistic	realistic	optimistic	2007	2008
Agriculture	561	5.5	3.8	4.1	8.2	6	3.7	3.8	8.1	6	6	7.5	–	–
Industry	3,019	29.5	1.8	5	6.8	7.3	9.4	6.8	4.7	3	4	5	–	–
Mining	1,647	16.1	–1.5	3.6	6.1	7.5	8.9	5.3	3.1	1.5	2	3	–	–
Manufacturing	1,188	11.6	5.8	6.7	7.8	7.9	11	8.9	7.2	5.5	6.5	7.5	–	–
Utilities	184	1.8	5.3	6.3	6	2.7	5.2	5.4	5.3	2	2.5	3	–	–
Construction	1,001	9.8	36.9	38	35.2	36	43.4	36.8	n/a	25	30	35	–	–
Services	5,273	51.7	9.9	11	10.8	11	11.1	12.1	n/a	9.4	10.7	11.3	–	–
Trade	1,165	11.4	9.3	9.5	9.6	9.8	9.6	9.9	n/a	9.5	10	10	–	–
Transportation	951	9.3	6.5	6.5	7	7	5.7	7.1	n/a	5	6	6	–	–
Comunications	227	2.2	30	26	21.7	30	32	31.7	32.8	30	30	30	–	–
Financial Activities	476	4.7	15.1	49	41.4	42	53.9	62.7	n/a	35	40	45	–	–
Real Estate Operations	1,516	14.9	10.7	9.2	10	8.7	9.3	7.8	n/a	6	8	8.5	–	–
Education	322	3.1	5.6	4.5	3.4	4.5	3	3.8	n/a	4	4	4	–	–
FISIM	–306	–3	62.3	54	53.4	53	56.5	73.2	n/a	80	75	75	–	–
Net Taxes	666	6.5	26.5	13	16	13	15.2	13.4	n/a	11	12	12	–	–
GDP	10,214	100	7.7	9.3	10.6	11	10.5	10.2	n/a	7.0	8.5	9.5	8.7	7.8

n/a — data is not yet available
* IMF World Economic Outlook, October 2007
Source: ASRK, The Bleyzer Foundation

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Chief Economist Edilberto L. Segura
Editor Rina Bleyzer Rudkin

prices. Evidently, enduring rapid expansion of various manufacturing sectors (namely, food processing, the chemical industry, fuel processing and production of construction materials) helps sustain high output growth in manufacturing even with a slowing metallurgical industry.

During the first eight months of 2007, output growth in manufacturing remained mostly on par with last year, amounting to 7.7% yoy. Food processing gained 7.6% yoy, the chemical industry advanced by 35.5% yoy, fuel processing and manufacturing of non-metal mineral products posted 12.4% yoy and 21.6% yoy increases respectively. Robust performance of these sectors helped to offset dwindling growth rates in metallurgy, which has been suffering from the sluggish performance of non-ferrous metallurgy (down by 1.1% yoy). On the back of erratic world prices for copper as well as wobbling prices of zinc and aluminum, Kazakhstan's production of zinc, copper and aluminum shrank by 1.4% yoy, 2.1% yoy and 0.3% yoy.

Undeniably, global financial turmoil will trigger economic growth moderation in Kazakhstan. This slowdown, however, are not anticipated to shift the economy from the robust path for expansion. As GDP growth has been consistently overshooting 9% yoy for the last seven years, a reasonable moderation of economic activities will help to mitigate budding overheating risks, which lately became rather pronounced through mounting inflationary pressures and thriving asset prices. As a result, recent developments at the global financial markets are likely to prompt a gradual and necessary cooling of Kazakhstan's economy toward more sustainable and stable long-term growth trend.

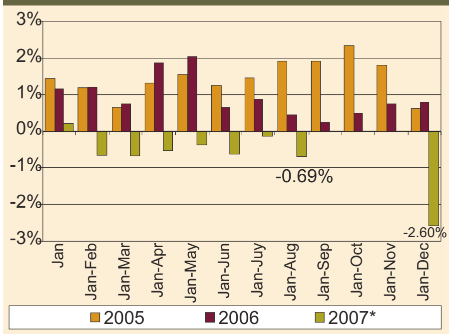
GDP growth in 2007 is expected to fall within the range of 7-9% yoy. It bears emphasizing that even the most pessimistic assumptions on the annual growth rates of industry, construction and financial sector generate GDP growth at 7% yoy. This conclusion is broadly consistent with a consensus perception that ongoing global credit crunch may crop Kazakhstan's GDP growth by 1-2 percentage points in 2007 and 2008.

Fiscal Policy

The government of Kazakhstan enjoys fairly benign fiscal situation supported by strong oil revenues, increasing tax proceeds from the non-oil private sector and rapidly growing household incomes. In addition, ongoing efforts to improve customs and VAT administration as well as growing share of organized retail trade (in January-September 2007, the share of open-air market retail trade and trade by private entrepreneurs shrank to 47.4% from 53.4% a year ago) will eventually contribute to more transparent and efficient taxation of domestic and foreign trade, further widening revenue base of indirect taxes.

In January-August, state budget revenues grew by 14.7% yoy in nominal terms amounting to KZT 1,797 billion (USD 14.85 billion). Although, tax revenues slipped by 3.5% yoy, state budget revenues were considerably boosted with transfers from the National Fund of the Republic of Kazakhstan, which totaled KZT 171 billion (USD 1.41 billion). State budget expenditures (net of balance of operations with financial assets, surged by 17.6% yoy in nominal terms to KZT 1,675 billion (USD 13.84 billion), pushing the state budget deficit to KZT 85.81 billion (USD 0.71 billion) or 0.7% of projected full year GDP.

State Budget Balance, % of full year GDP



* The year-end state budget deficit is projected at 2.6% of GDP
Source: Ministry of Finance of RK

Tax revenues, contributing nearly 80% to state budget revenues, were marginally below the amount collected a year ago, which still reflects the impact of last year's amendments on the budget accounting of tax revenues from the oil sector. At the same time, the performance of other taxes remained on a robust uptrend. Proceeds from the personal income tax (up by 37.3% yoy in January-August), social tax (27.6% yoy), VAT (38.5% yoy), excises (26.3% yoy), and custom duties (38.1% yoy) have been consistently increasing by double-digit rates, on the back of booming retail trade and imports and the strong growth of household incomes (up by 21.8% yoy in real terms in July). The energetic acceleration of imports has been driving up VAT and custom duties collection — taxes that generate over one third of all tax revenues. VAT on imports accounts for over two thirds of all VAT revenues, while VAT on imports from Russia stands at about 35% of these proceeds (during the first seven months of 2007, imports from Russia increased by strong 36.7% yoy). Therefore, due to robust consumer and investment spending on imports, VAT revenues are anticipated to continue posting strong growth despite earlier implemented (as well as intended) cuts of the VAT rate. Finally, though proceeds from the corporate income tax (CIT) shrank by 18.8% yoy (due to a withdrawal of CIT on the oil sector from the state budget), CIT proceeds from the non-oil sector surged by 41.8% yoy in August alone. Apparently, improving profitability of the non-oil sector allows the government to gradually ease its reliance on the oil sector in generating budget revenues.

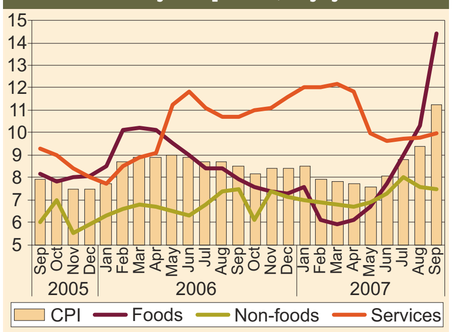
Ironically, excessive sensitivity of fiscal revenues to the volatility of crude oil prices (the foremost weakness of the Kazakhstan's budget system) may at present prove to benefit country's economy. Unfolding trends at the world commodity and money markets appear to guarantee relatively diversified sources of international liquidity for Kazakhstan. As world oil prices continue their record-breaking run, booming oil revenues will mitigate liquidity shortages at the global financial markets.

As a result, the government is unlikely to experience a deterioration of its revenue positions, and will continue implementing a moderate fiscal loosening. Sustainable public spending on social benefits and large-scale infrastructure projects will help to soften downward pressures on the aggregate demand due to a possible moderation of the private consumption and investments. Furthermore, a low level of public debt and high sovereign ratings of Kazakhstan ensure easy access to foreign funds by the government. Therefore, Kazakh authorities have sufficient fiscal capacity and international liquidity to assist state controlled enterprises as well as country's financial institutions, in case these entities may experience short-term liquidity problems due to the global credit crunch.

Monetary Policy

In September, the consumer price index (CPI) crossed over the 10% level for the first time in more than six years, advancing by 11.2% yoy as skyrocketing prices of foods (driven by world prices for crops) moved up by 14.4% yoy. Service tariffs only modestly accelerated to 10% yoy from 9.8% yoy the month before, while the inflation of non-food prices continued on a rather gentle deceleration trend, settling at 7.5% yoy.

CPI by Component, % yoy

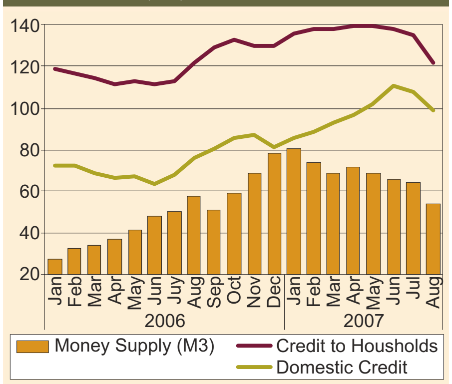


Source: ASRK

In August, money supply (measured with the monetary aggregate M3) rose at the slowest pace in almost 12 months, increasing by 54.2% yoy to KZT 4,572 billion (USD 37.8 billion). The growth of domestic credit declined to 98.95% yoy as both credit to households and the corporate sector continued to loose speed, advancing by 121.7% yoy and 88.3% yoy respectively, compared with faster (135.4% yoy and 95.5% yoy) growth rates registered in July.

This deceleration of domestic credit represents an adjustment to the global liquidity shortage, as highly leveraged domestic lending institutions suffered a deterioration of their capacity to access external money markets. Kazakh commercial banks tended to maintain a relatively wide disparity between loans and deposits, as the ratio of clients' deposits to outstanding loans fell below 53% at the end of August. Obviously, banks still heavily rely on external funds to cover this funding gap. Therefore, the tightening of global credit markets reduced the flexibility of domestic banks to take out loans from abroad, restricting resources available to roll over previously taken loans or repay them with fresh loans, which has stretched banks' credit supply capacity.

Money Supply (M3) and Domestic Credit, % yoy

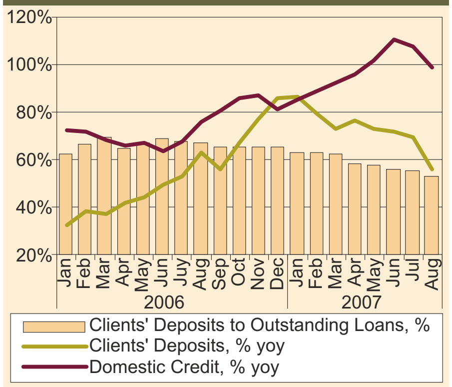


Source: NBRK, The Bleyzer Foundation

The central bank faces a tough trade-off between price stability, jeopardized by mounting inflationary pressures, and its commitment to maintain adequate liquidity in the banking sector. As expected, liquidity threats to the domestic banking sector, which are rather deeply integrated into the international credit market, are given top priority. In August, the National Bank of Kazakhstan (NBRK) intervened both at the foreign exchange market, selling USD 4.6 billion to prevent rapid currency depreciation, and at the money market, pumping USD 10 billion equivalent of short-term liquidity to curb excessive pressure on short-term interbank interest rates. Furthermore, NBRK's refinancing rate was kept unchanged at 9%, while the introduction of stricter minimum reserve requirements on banks' external liabilities was postponed until January 15th, 2008. Although this looser monetary policy closely mirrors actions implemented by central banks around the world, the inflationary outlook in Kazakhstan is not as benign as in most of those countries.

A high share of foods and fuels in the consumer basket excessively exposes price stability in Kazakhstan to global supply shortages as well as to numerous structural deficiencies and rigidities endemic to domestic agricultural and retail markets. Thus, monetary policy aimed at curtailing aggregate demand may have a rather limited impact in the environment of highly volatile prices of agricultural and energy commodities. Apparently, tight supply conditions at the

Commercial Banks' Funding Gap



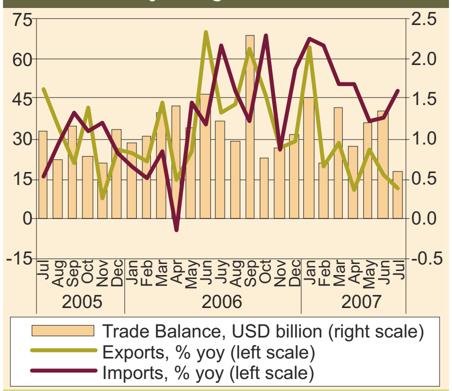
Source: NBRK, The Bleyzer Foundation

global agricultural markets in 2007 may stay behind rekindled inflationary pressures in Kazakhstan. Yet, further structural reforms that strengthen competition and improve efficiency of the domestic retail market and agricultural sector are essential to ensure more frictionless accommodation of adverse supply shocks by Kazakh economy.

International Trade and Capital

Although, in January-July, exports remained on course for moderation relative to last year's performance, they still posted a robust growth of 23.5% yoy increasing to USD 25.5 billion. Imports continue to expand at a fast speed, advancing by 48.6% yoy to USD 17.9 billion. As a result, the foreign trade surplus stood at USD 7.6 billion (compared to USD 8.6 billion in the foreign trade surplus the year before) and dropped by almost 12% yoy, continuing a downward trend that stretches back to April.

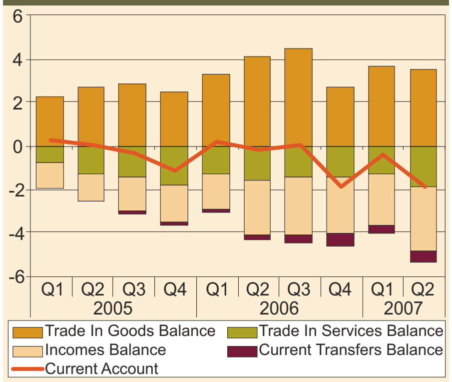
Monthly Foreign Trade Balance



Source: ASRK, NBRK, The Bleyzer Foundation

Kazakhstan's economy ended the first half of this year with a moderate current account deficit that hit USD 2.4 billion (or nearly 2% of the projected full year GDP), driven by the 53.4% yoy decline of trade in goods surplus due to a weaker performance of exports, which shrank by 32.1% yoy. On the positive side, the trade in services deficit and incomes deficit shrank by 37% yoy and 27% yoy respectively, as imports of services posted a substantial decline of 35.2% yoy, while a 24.2% yoy increase in external debt service and repayment was more than offset by a 23.8% yoy contraction of profits, repatriated by foreign direct investors.

Quarterly Current Account, USD billion



Source: NBRK, The Bleyzer Foundation

In January-June, foreign direct investments amounted to USD 2.05 billion, covering about 86% of the current account gap. At the same time, the net inflow of external loans in the amount of USD 9.2 billion helped finance external imbalances.

In the first half of 2007, the stock of public and private external debt jumped by 24.4% since the beginning of the year (ytd) to USD 92.1 billion or nearly 90% of projected full year GDP. The external debt of the government remained relatively flat, yet private external debt grew by 25.4% ytd to USD 77.1 billion, while the amount of external debt served by the monetary authority almost doubled to USD 3.14 billion. Commercial banks account for about 60% of all private external debt (up from 54.3% at the beginning of the year), while 84% of their debt is long term. Although the short-term external debt held by the banks actually declined by 1.4% ytd in January-June, it surged by about 40% during the second quarter alone. In January-July, private external debt absorbed by other sectors of the economy advanced more modestly, gaining 9.1% ytd, while intercompany lending amounted to USD 26.5 billion (34.4% of total private external debt) inching up by less than 4% ytd.

Other Developments Affecting the Investment Climate

In September, the International Monetary Fund (IMF) issued its regular update on global financial stability. The IMF did not raise its assessment of emerging market risks, arguing that the strong macroeconomic fundamentals enjoyed by these countries tends to balance stability threats rooted in the recent global credit crunch. Furthermore, the region seems to have become less sensitive to changes in global liquidity as widening external imbalances can now be safely financed with fat foreign exchange reserves.

At the end of September, the World Bank issued its recent Doing Business Report 2008. Although, Kazakhstan's rankings remained mostly on a par with last year, the country still compares rather favorably to its neighboring competitors.

Ease of...	2007 rank		
	Kazakhstan	CIS	China
Doing Business	**71**	**96**	**83**
Starting a Business	57	73	135
Dealing with Licenses	173	134	175
Employing Workers	22	69	86
Registering Property	72	58	29
Getting Credit	48	81	84
Protecting Investors	51	92	83
Paying Taxes	44	136	168
Trading Across Borders	178	144	42
Enforcing Contracts	28	33	20
Closing a Business	100	94	57

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Astana Office, Kazakhstan
Samal citydistrict, 12 Astana Tower,
20-th floor, office 20-III, Astana, 010000
Tel./fax 8 (3172) 59-25-76/77/78/79/80
E-mail: office@sigmableyzer.kz