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- Preliminary estimates put GDP growth at 7.5% yoy in the first three quarters of 2010.
- In January–September, the state budget deficit stood at 2.3% of projected full-year GDP.
- The 2010 budget deficit was revised downward on a more optimistic assessment of the economic recovery.
- Higher food prices pushed annual inflation to 6.7% yoy in September.
- During the first eight months of 2010, the trade in goods surplus grew to \$22 billion.
- In the first half of 2010, the current account surplus reached \$5 billion compared to a deficit of \$4 billion a year ago.

Executive Summary

Recovering global demand for energy, metals and chemicals continues to underpin the economy of Kazakhstan. Indeed, preliminary estimates put GDP growth at 7.5% yoy in the first three quarters of 2010 on an export-driven pickup in factory activity. Kazakhstan is benefiting from the specific nature of the global economic recovery. A robust growth of big emerging economies boosts demand for energy and industrial metals. Meanwhile, inventory restocking in advanced economies and surging demand for capital goods in the developing world are supporting growth in Kazakh manufacturing. Demand from Russia and neighboring Central Asian republics, which have been recovering faster than Eastern European economies, is returning as well. Lastly, economic ties between China and Kazakhstan are becoming deeper. This means that Kazakhstan is likely to continue to outperform its peers thanks to China's gravitational pull.

However, personal consumption and residential investments still have to regain their precrisis strength. The housing market, battered by the collapse of bank lending, is gradually stabilizing, although construction activity remains soft. It is hard to see the construction industry steaming ahead without a return of Kazakh banks to the international credit markets. This means that years of slow growth in construction may lie ahead as the dust from the debt restructuring of Kazakh banks and the burst of the housing bubble settles.

On the upside, personal consumption fared rather well, while the consumer sentiment index remains at its highest point in over two years. These gains in consumer confidence are built on growing

jobs and wages, which is the basic foundation for a self-sustaining recovery. That said, personal consumption is just over 40% of GDP, which means that investments and exports are still playing a more important role in driving economic growth. With tight access to international funds, Kazakhstan may find it hard to finance investments in the non-oil economy and near-term economic prospects will continue to depend on exports.

Nevertheless, the government can always step in if foreign or domestic demand weakens. Thanks to booming oil exports, the sovereign balance sheet remains particularly healthy. Meanwhile, tax revenues are rapidly regaining lost ground thanks to a stronger economic recovery. All of this helps minimize the risks of premature fiscal austerity.

The recent surge in world grain prices has been felt in Kazakhstan as well. Still, a pickup in food prices is driven by supply shortages, and its impact on inflation is likely to fade once international agricultural markets stabilize. The central bank is unlikely to tighten its policy stance unless Kazakh lenders feel more confident about issuing new loans to companies and consumers.

Finally, In January–August the trade in goods surplus swelled to nearly \$22 billion on rapidly growing overseas shipments to China. Exports to developed economies are growing again. Although these gains are mostly driven by higher energy prices, a worldwide turnaround of durable goods manufacturing boosts demand for Kazakh ferrous and non-ferrous metals as well.

	2005	2006	2007	2008	2009	2010*
GDP growth, % change yoy	9.7%	10.7%	8.9%	3.3%	1.2%	4–5%
GDP per capita, \$	3 754	5 262	6 757	8 398	6 710	8 000
Industrial production, % change yoy	4.8%	7.2%	5.0%	2.1%	1.5%	-
State budget deficit, % of GDP	0.6%	0.8%	-1.7%	-2.1%	-3.1%	-
Government external debt (including NBK), % of GDP	1.8%	2.9%	1.8%	1.6%	2.4%	-
Unemployment, end of period	8.1%	7.8%	7.3%	6.6%	6.3%	-
Inflation, end of period	7.6%	8.4%	18.8%	9.5%	6.2%	6–8%
Retail sales, % change yoy	13.5%	15.0%	10.7%	3.1%	-2.0%	-
Gross forex reserves of the NBK, \$ billion, end of period	7.1	19.1	17.6	19.9	23.2	-
Assets of the National Oil Fund, \$ billion, end of period	8.1	14.1	21.0	27.5	24.4	-
Current Account Balance, \$ billion	-1.1	-2.0	-8.2	6.6	-3.4	2.0
External debt, \$ billion	43.4	74.0	96.9	108.1	111.7	120.0
Exchange rate, tenge/\$, annual average	132.9	126.1	122.6	120.3	147.5	145.0

* Projections

Source: ASRK, NBK, Ministry of Finance of Kazakhstan, IMF, Economist Intelligence Unit

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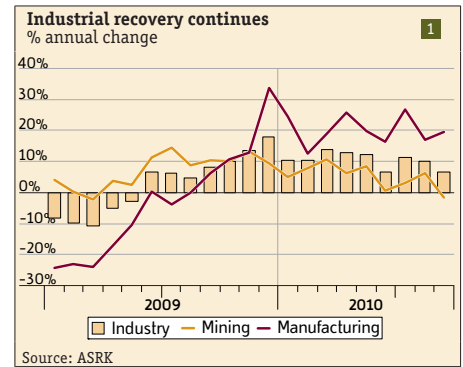
Economic Growth

Recovering global demand for energy and metals continues to underpin the economy of Kazakhstan. Indeed, preliminary estimates show that the economy grew by 7.5% yoy during the first three quarters of 2010. Industry remains central to this rebound, gaining over 10% yoy on booming exports of energy and industrial metals (see chart 1). In particular, output in the mining sector increased by 5% yoy thanks to a steady expansion of the energy sector as well as growing extraction of metal ores. Meanwhile, manufacturing (driven by the rebound of metallurgy, which accounts for over 40% of all output in this sector) bounced back by 19% yoy. A combination of stronger local and overseas demand sustains double-digit gains in other key manufacturing sectors, including food processing, petrochemicals and machine building (see chart 2).¹

Kazakhstan is benefiting from the specific nature of the ongoing world economic recovery. First, big developing countries (such as China, India and Brazil) have emerged as more dynamic and resilient economies following the global financial crisis. This boosts exports of Kazakh energy and industrial metals. Second, a strong rebound of global manufacturing (on inventory restocking in developed economies and surging demand for capital goods in emerging markets) has prompted a return of global demand for Kazakh ferroalloys and nonferrous metals - key ingredients in stainless steelmaking and manufacturing of durable goods. Large-scale public infrastructure spending is supporting overseas sales of Kazakh steel and building materials. Equally important, Kazakhstan is enjoying a resurgence of demand from Russia, which is recovering thanks to growing oil revenues. Meanwhile, neighboring Central Asian republics (such as Tajikistan and Uzbekistan, which weathered the latest economic downturn relatively better than Eastern European economies) are buying more Kazakh products as well. Lastly, economic ties between China and Kazakhstan are becoming deeper. In fact, China is already the largest export market for Kazakhstan, accounting for nearly 17% of all exports. This means that Kazakhstan is likely to continue to grow faster than its peers thanks to China's gravitational pull.

However, there are signs that the global manufacturing recovery is gradually losing steam. Indeed, the JPMorgan Global Manufacturing Purchasing Managers Index, which tracks activity in the world's biggest manufacturing hubs, eased to a 14-month low in September on decelerating growth in advanced economies, including the U.S., Japan, the Eurozone and the UK. This deceleration may reflect a moderation of the inventory cycle in advanced economies, where business inventories are returning to normal levels. Yet on the contrary, the HSBC China Manufacturing Purchasing Managers Index hit a 5-month high in September mostly thanks to stronger domestic demand. Still, having regained some of its strength since a drop in July, this index remains below a record high in April. A recent hike in the benchmark interest rate by China's central bank is likely to slow industrial growth in China as well. On the upside, as the Chinese economy becomes more and more dependent on domestic demand, its growth will continue to surpass that of advanced economies (see chart 3). This is likely to sustain output recovery in Kazakh manufacturing.

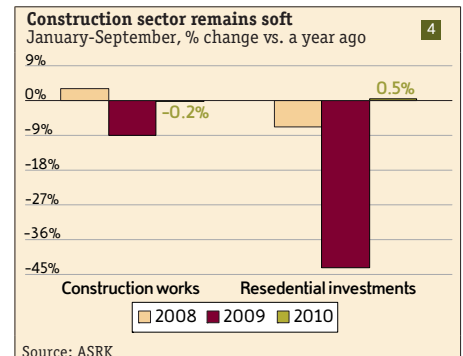
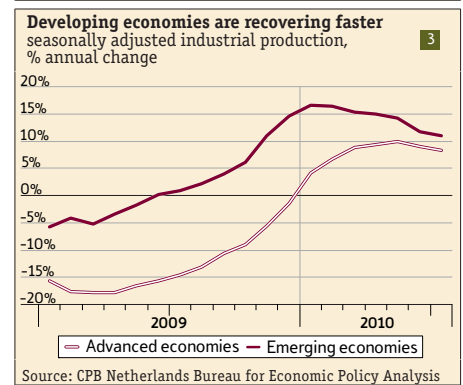
Meanwhile, two main domestic sources of economic growth - personal consumption and residential investments - still have to regain their precrisis strength. The housing market, battered by the collapse of bank lending, is gradually stabilizing, although construction activity remains soft. The volume of construction works and residential investments are still about 10% and 40% lower than two years ago (see chart 4). On the upside, September was the fourth consecutive month of growing home values, while home sales were up by 17% compared to the first three quarter a year ago. This means that the housing market may have already reached bottom and is



Broad-based rebound in manufacturing

	Jan-Sep 2010 vs. Jan-Sep 2009	Share in manufact.
Manufacturing	19.1%	
Food processing	12.1%	18.3%
Fuel processing	15.6%	8.7%
Chemical industry	76.5%	2.7%
Construction materials	35.2%	5.1%
Metallurgy	12.2%	42.8%
Machine building	55.8%	8.7%

Source: ASRK



¹For example, in January-August, exports of Kazakh inorganic chemicals, which include rare earth metals, radioactive elements and compounds used in manufacturing of fertilizers and household chemicals (such as detergent and bleaches), increased by 40% to \$1.6 billion.

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gradually turning the corner. Still, it is hard to see the construction industry moving ahead without a return of Kazakh banks to international credit markets. This means that years of slow growth in construction may lie ahead as the dust from the debt restructuring of Kazakh banks and the burst of the housing bubble settles.

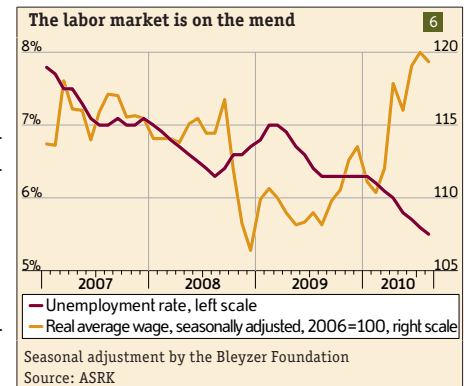
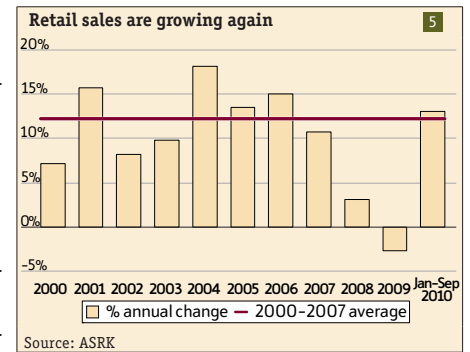
On the upside, personal consumption fared rather well on stronger growth of real wages, increasing employment and higher pay in the public sector. In particular, during the first three quarters of 2010, retail sales jumped by 13% yoy (see chart 5), while the consumer sentiment index reached its highest point in over two years. After all, these gains in consumer confidence are mostly built on better job security and growing wages, which is the basic foundation for self-sustaining growth. Indeed, the unemployment rate in August was only 5.5% (compared to 6.3% a year ago), while average real wages were about 13% higher than at the peak of the recession (see chart 6). Industry, which employs over one-tenth of all payroll employees², leads in both wage and employment growth (see chart 7). At the same time, employment in service producing industries (such as trade, real estate operations, and administrative, professional and technical services) is growing as well. This may point to a broad-based pick up in economic activities as the services industry is more responsive to the strength of domestic demand. Finally, higher wages and more jobs are reported in government-related sectors (which include public administration, education, healthcare and social assistance and account for over 20% of all employed workers). Below average public-sector pay and increasing demand for high quality public services do imply that this sector should remain a source of steady income and employment gains in the future.

That said, personal consumption is just over 40% of GDP, which means that investments and exports are still playing a more important role in driving economic growth. Furthermore, the recovery of consumer spending (46% of which still goes to food) may easily stumble if the latest uptick in world food prices proves more lasting. With tight access to international funds, Kazakhstan will still find it hard to finance investments in the non-oil economy. This means that near-term economic growth will still be driven by exports, which, despite a recent cooling of the global manufacturing recovery, should sustain GDP growth at around 5-6% in 2010.

Fiscal Policy

A stronger than anticipated economic recovery has prompted the government to re-calibrate its 2010 budget targets. In October, they were reset to adjust for a more optimistic assessment of year-end GDP, which is expected to total \$130 billion. This means that this year, the economy is likely to grow by about 5% yoy - up from an initial estimate of only 2% yoy. The government expects to collect nearly \$1 billion more in tax revenues, mostly thanks to the reintroduction of an export duty on crude oil and a reduction of VAT refunds. Meanwhile, budget expenditures before net lending and financial operations was raised by only \$165 million. Still, more public spending on infrastructure and construction projects will keep the republican budget deficit after net lending and financial operations unchanged at about \$5.5 billion or 4.2% of GDP (down from 4.6% in the previous estimate).

In fact, the latest reading on government revenues does testify to a robust growth of tax collection. In particular, new republican budget projections imply that tax revenues should grow by 30% yoy in 2010 to meet the target. So far, the growth of tax revenues is encouraging (see chart 8). Indeed, the republican budget tax revenues have to increase by only 18% yoy in the last quarter of 2010 to hit the revised annual target of about \$12.8 billion.



	Average wage		Employment	
	% real annual change	% of national average	% annual change	% of total
Total	10.5%		3.6%	
<i>Large and medium size companies</i>				
Agriculture	12.1%	48%	-4.4%	2.4%
Industry	13.8%	120%	1.7%	13.0%
Mining	20.6%	195%	3.0%	3.2%
Manufacturing	10.9%	101%	1.0%	7.0%
Construction	9.3%	134%	-4.0%	3.9%
Trade	6.4%	91%	7.0%	2.3%
Transport and warehousing	8.1%	131%	0.7%	4.1%
Finance and insurance	5.8%	193%	0.2%	1.3%
Real estate operations	6.3%	87%	13.5%	0.5%
Professional and technical services	6.1%	175%	4.2%	1.5%
Administrative services	2.4%	118%	12.2%	1.9%
Public administration	16.9%	94%	1.4%	4.5%
Education	13.5%	63%	3.4%	10.9%
Healthcare and social assistance	15.1%	71%	5.5%	5.9%
Leisure and hospitality	10.0%	68%	10.4%	0.9%

²Official statistics distinguish between payroll employees (about two thirds of all employed) and self-employed. About 85% of all self-employed work in agriculture and trade.

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During the first three quarters of 2010, state budget tax revenues³ jumped by 26% yoy in nominal terms (see chart 9) on stronger proceeds from corporate and income taxes and a rapid recovery of taxes on consumption (such as VAT, excises and custom duties). Booming retail trade and increasing private and public sector payrolls are expanding the tax base. Meanwhile, state budget expenditures grew by about 18% yoy on higher social welfare payments and the public-sector wage bill as well, as increasing public investments. This puts the state budget deficit (including net lending and financial operations) at only 2.3% of projected full year GDP (compared to 1.4% a year ago).

With the projected year-end budget deficit of about 4% of GDP and tax revenues rapidly regaining lost ground, the need for fiscal consolidation looks less pressing in Kazakhstan than in many other parts of the world. This helps minimize the risks of premature fiscal austerity, which clouds the economic outlook of developed and Eastern European economies. Indeed, thanks to booming oil exports, the sovereign balance sheet of Kazakhstan remains particularly healthy. Kazakhstan has over \$57 billion in foreign reserves and public external debt is still less than \$2.5 billion (or below 2% of GDP).⁴

That said, the government aims to pursue gradual fiscal consolidation to lessen the reliance of the state budget on revenues from the oil sector. Indeed, the share of transfers from the National Oil Fund in total revenues is to narrow from as high as 32% in 2009 to about one quarter in 2013, as the annual size of these transfers is capped at about \$8 billion. This assumes continued strong gains in tax revenues. The 2011-2013 draft budget implies that the republican budget tax revenues must grow by over one third to bring the budget deficit to 2.8% of GDP. Tax revenues should grow by another 13% both in 2012 and 2013 to reduce this deficit to 1.5% by the end of 2013.

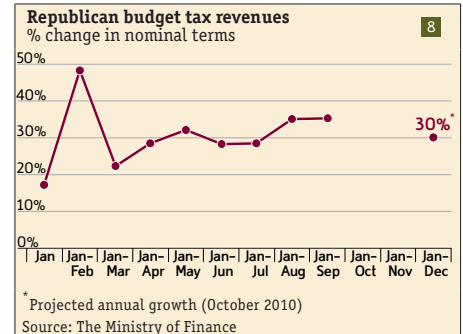
Still, 2011 fiscal projections may look somewhat optimistic. Indeed, provided that inflation stays below 7% in 2011 and gradually decelerates in 2012 and 2013, the economy is likely to expand at about 5% annually from 2011 to 2013. However, last year GDP stayed virtually flat, increasing by 1.2% yoy, yet the republican budget tax revenues fell by an eye-popping 30% yoy. Thus, 5% annual growth may prove insufficient to meet tax revenue targets. This means that spending cuts or adjustment to the size of transfers from the National Oil Fund may be necessary.

On the upside, even if the 2011 tax revenues fall below target, this shortfall is unlikely to be of a serious magnitude and can be easily accommodated through either a delay of some infrastructure projects or higher transfers from the National Oil Fund. First, tax revenues of the republican budget depend on three main sources: the corporate income tax, VAT on imports and export duties. And all three were hit disproportionately hard in 2009.

In particular, last year, pretax corporate earning of large and medium companies fell by 29% yoy (on depressed business activities in the financial sector, construction industry and metallurgy), while imports and exports declined by 25% yoy and 40% yoy respectively.⁵ However, corporate profits and exports are on track to post big gains both this year and next. Second, Kazakhstan will continue to step up its crude oil production (oil extraction is expected to double following the completion of the huge Kashagan field) which will boost exports and custom duties revenues. Finally, projections of tax revenues are broadly in line with their precrisis levels. Indeed, as the economy stabilizes, the share of tax revenues in GDP will normalize back to about 12% after slipping to 8% in 2009 (see chart 10).

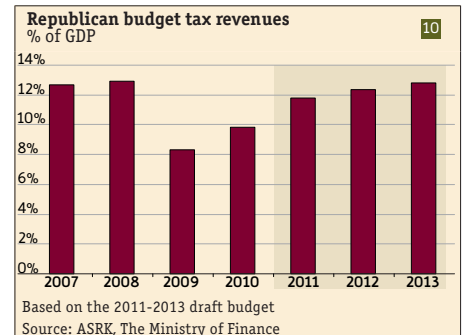
Monetary Policy

In September, consumer prices (CPI) grew by 0.6% versus the month before, which pushed annual inflation to 6.7%. In particular, higher prices of agricultural produce (up by 4% in September vs. August) are making foods more expensive. Prices of foods were



	January-September, % change		
	2010 vs. 2009	2009 vs. 2008	2010 vs. 2008
Tax revenues	26.0%	-20.0%	0.7%
CIT*	37.0%	-38.2%	-15.4%
PIT*	18.3%	0.9%	19.5%
Social tax	9.1%	-10.7%	-2.6%
Property taxes	23.1%	27.8%	57.2%
VAT	21.0%	-23.8%	-7.8%
VAT on domestic products and services	109.5%	-31.0%	44.6%
Custom duties	82.0%	-42.2%	5.3%

CIT - Corporate income tax
PIT - Personal income tax
Social tax - contributions to unemployment insurance, disability insurance, loss-of-income insurance etc.
Source: The Ministry of Finance



³ State budget tax revenues include tax revenues of the republican budget (about of 70% the total) and local budgets. About 90% of all republican budget tax revenues come from the corporate income tax, VAT and custom duties. Meanwhile, local budgets collect individual income and social security taxes, and property taxes (these three taxes generate 85% of all tax revenues of the local budgets).

⁴ At the end of the first half of 2010, the total public and publicly guaranteed debt of Kazakhstan stood at about \$19 billion or less than 15% of projected full-year GDP. \$12.5 billion and \$6.7 billion of this debt are domestic obligations of the government and the central bank, respectively.

⁵ A reduction of the VAT and corporate income tax rates due to the adoption of the new Tax Code has contributed to revenue declines in 2009 as well.

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up by 6.5% yoy in September (see chart 11) on more expensive meat products, dairy, oil and fats. All of this reflects recent developments on the international agricultural markets. Indeed, global grain prices have surged since July due to an export ban in Russia as a summer of severe droughts caused major crop failures in the CIS region.

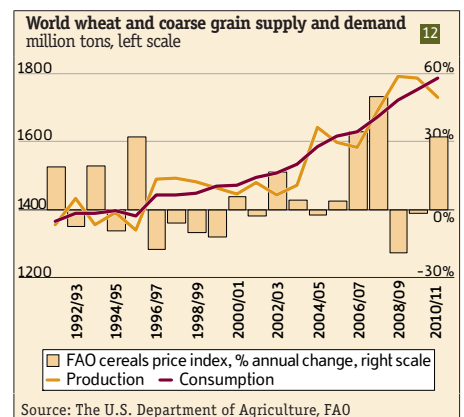
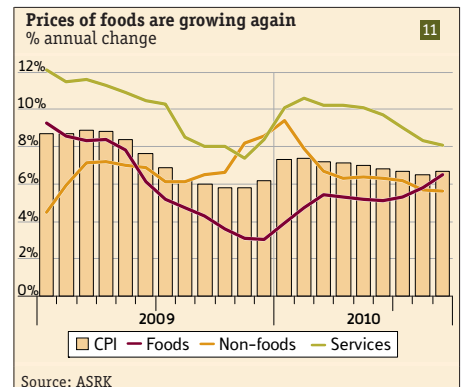
Still, according to the Food and Agriculture Organization of the United Nations (FAO), global cereal production is the third biggest on record (see chart 12). World grains stocks remain well above their levels in 2006 and 2007. This means that there is less upward pressure on food prices compared to the 2007/08 food crisis. Furthermore, increasing investments in global agriculture will help improve supply conditions. In fact, according to the United Nations Conference on Trade and Development, worldwide FDI inflows in agriculture jumped from below \$2 billion on average in 2000-2005 to nearly \$6 billion in 2006-2008. After all, higher grain prices are the best signal for private investors to expand future production and meet growing global demand for foods.

In October, the central bank kept its benchmark interest rate unchanged at 7%. Although the monetary authority acknowledged higher risks of inflation due to increasing wages and employment, monetary policy is unlikely to be tightened unless banks feel more confident about issuing new loans to companies and consumers. After all, a pickup in food prices is driven by supply shortages and its impact on inflation is likely to wane once international agricultural markets stabilize. Meanwhile, banks' capacity to create new credit is still severely distressed, meaning that monetary sources of inflation remain well under control. Indeed, despite some signs of the easing of consumer deleveraging⁶, which stretches back to December 2007, the stock of credit was nearly 7% lower in September 2010 versus the same month a year ago. As a result, the ratio of bank credit to GDP may fall below 40% by the end of 2010, compared to 56% in 2007. This means that at present, the economy depends less on bank credit to finance private consumption and investments. As a result, a tighter monetary policy may have a smaller impact on consumer demand, and, consequently, on prices.

International Trade and Capital

In January-August, the trade in goods surplus swelled to nearly \$22 billion on a 52% yoy rebound in exports and a 7% decline of imports. Above all, China (which two years ago accounted for just 10% of all exports from Kazakhstan) emerged as its biggest overseas market, absorbing nearly 17% of all Kazakh exports. Exports to China jumped by 87% yoy as exports of iron, crude oil, and copper increased by 70% yoy, 178% yoy and 98% yoy, respectively.⁷ Indeed, booming construction and manufacturing in China is fueling demand for energy and base metals. Meanwhile, Kazakh exports to developed economies are recovering as well. For example, exports to Germany, Italy, Japan, France and Canada (about one third of all exports) increased by 342% yoy, 62% yoy, 127% yoy, 58% yoy and 114% yoy, respectively. Although these gains are driven by higher energy prices for the most part, a turnaround of manufacturing of durable goods in those countries (especially in Germany and Japan) boosts demand for Kazakh ferrous and non-ferrous metals. For example, exports of ferroalloys - a key ingredient in stainless steel making - to Germany and Japan were more than 3 and 2 times higher than a year ago.

Finally, in the first half of 2010, the current account surplus widened to \$5 billion compared to a deficit of \$4 billion a year ago. Total foreign external debt (excluding intercompany lending) fell by \$3.7 billion during the first half of 2010. In particular, the external obligations of Kazakh banks fell by about \$5 billion to only \$25 billion (compared \$46 billion at the end of 2007). Meanwhile, the external debt of the non-financial corporate sector grew by over \$5 billion on increasing volumes of intercompany lending. As a result, by the end of the first half of this year, intercompany loans grew to \$55 billion and now account for half of the total external debt of Kazakhstan.



⁶In September 2010, credit to households posted its second consecutive monthly gain, albeit it was still 8% lower than a year ago.
⁷These three commodities account for about three fourth of all Kazakh exports to China (7%, 55% and 11%, respectively).