Kazakhstan Macroeconomic Situation

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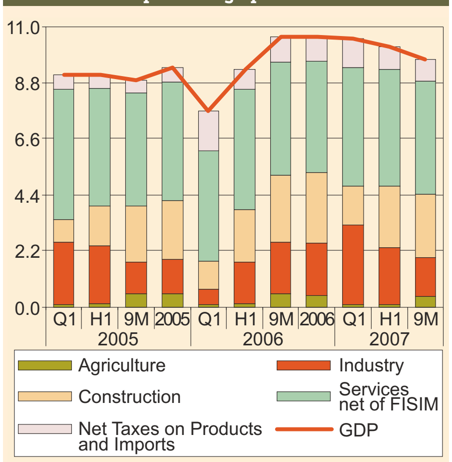
Summary

- Construction and services are the key sectors driving economic growth in Kazakhstan.
- In January-October, the state budget deficit stood at KZT 78.63 billion (USD 650.9 million), settling at 0.6% of projected full year GDP.
- The recently approved budget law envisions the republican budget deficit at 1.4% of GDP in 2008.
- Monetary developments in Kazakhstan are shaped by renewed inflation pressures and a visible moderation of domestic credit.
- Inflation hit 17.5% yoy in November, propelled by soaring food prices.
- In October, domestic credit posted a delicate recovery of 1.3% month-over-month as households and the corporate sector resumed borrowing.
- The economy ended the third quarter with a USD 10.08 billion trade of goods surplus.
- So far, Kazakhstan's banking system appears to be withstanding the global credit crunch.

Economic Growth

Resilient performance of construction and services continues to underpin economic expansion in Kazakhstan. Indeed, in January-September 2007, the contribution of construction (up by 30.4% yoy) and services (up by 8.8% yoy) to GDP growth increased to 71% from less than two thirds a year before.

Contributions to GDP Growth by Sector, percentage points

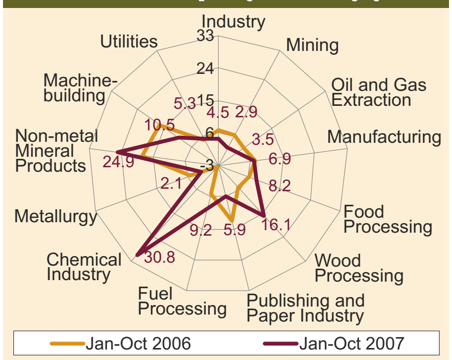


Source: ASRK, The Bleyzer Foundation

Despite a wider statistical base, the economic capacity to support high growth rates is still strong. The service sector and construction, which are crucial to the economic outlook, appear to be rather unevenly affected by the recent global liquidity tightening. As a result, slowdown risks in the service sector are relatively balanced, as growing demand for services helps to offset a slump in the financial sector. Although the banking sector exhibits visible signs of moderation due to a shortage of external funding, the other service industries, mostly driven by surging domestic demand, are fundamentally solid. In January-October 2007, the growth of the transportation sector stayed mostly on par with last year's performance, while telecommunications advanced by 33.6% yoy as compared to 20.9% yoy a year before. Retail and wholesale trade achieved healthy growth as well, increasing by 10.2% yoy and 9.5% yoy respectively. In addition, the banking industry posted some encouraging developments. If in September, the stock of domestic credit marginally declined as compared to the month before, in October it returned to a steady, albeit smoother uptrend. Furthermore, banks' profitability and capital adequacy ratios improved somewhat compared to last year's levels. Finally, construction, which may suffer the most from slowing domestic lending, enjoys rather generous state backing, as the government is committed to inject sizable funds (both during the remaining months of this year and in 2008) into this sector. The government has recently pledged to allocate nearly USD 400 million to facilitate the completion of ongoing residential housing projects.

Kazakhstan is essentially a middle income country as GDP per capita is expected to approach USD 7,000 in 2007. As a result, rapidly growing household incomes boost domestic demand as well as change the composition of domestic consumption, which is traditionally dominated by foods. More affluent consumers opt for higher quality goods and services, shift away from food to non-food items and services as well as seek improvements of their living conditions. Hence, the demand for services and housing is not anticipated to abate. Furthermore, a strong and growing domestic corporate sector supports demand for business services, commercial real estate and infrastructure. Considering the relatively low levels of service consumption and floor space (both residential and commercial) per person in Kazakhstan, it can be safely argued that there is still plenty of room for services and construction to grow.

Industrial Output by Sector, % yoy



Source: ASRK

During the first ten months of 2007, industry grew by 4.5% yoy on the back of a rather modest expansion of the extracting industry, which gained 2.9% yoy as compared to 6.3% yoy a year before. Remarkably, the contribution of industry to GDP growth has been following a steady downtrend, shrinking to about 15% in January-September from nearly 20% during the same period of the previous year. This development may add further support to the argument that the Kazakh economy is gradually moving toward weaker dependence on the oil extracting industry.

In January-October, the oil extracting industry advanced by 3.5% yoy (up by 5.6% yoy a year before) as the extraction of crude oil inched up by 2.1% yoy (up by 6.8% yoy a year before) to 46 million tons. Since year-end crude oil production is unlikely to increase by more than 3% yoy, in 2007 the extracting industry is anticipated to register output growth twice that's half that of 2006. As a result, slower expansion of oil extraction capacities will exact a toll on the overall expansion of industrial output. On a positive note, manufacturing remained on a robust uptrend, increasing by 6.9% yoy in January-October 2007. Furthermore, the contribution of manufacturing to GDP growth has tended to increase. If in January-September of the previous year, manufacturing supported 7.5% of GDP growth, during the first three quarters of 2007 this contribution inched up by 1 percentage point to 8.5%. Essentially, manufacturing, although adversely affected by the sluggish growth of non-ferrous metallurgy, is sustained by strong domestic consumer and investment demand. Growing household incomes support robust expansion of the food processing industry, which gained 8.2% yoy. Booming construction and public spending on large scale infrastructure projects feed demand for building materials. For example, the production of cement, breaks and concrete structures surged by 20.5% yoy, 45.4% yoy and 7% yoy respectively. The chemical industry (up by nearly 31% yoy) benefited from thriving agriculture and exports. In particular, strong demand for fertilizers pushed domestic production by more than 5 times. Finally, growing demand for transportation services, considerably propelled by booming domestic and foreign trade, supported a 9.2% yoy growth of the fuel processing industry. In January-October, the production of gasoline and diesel increased by 14.1% yoy and 9.6% yoy respectively.

Although manufacturing and services are strongly driven by domestic demand, it is still rather premature to claim that economic performance has completely decoupled from the oil sector. Above all, the government heavily relies on oil revenues as a source of social spending and public investments. At the same time, available evidence suggests that Kazakhstan's industry is steadily evolving towards a size and composition that allow for greater influence of domestic factors. Therefore, the expanding size and sophistication of domestic markets will eventually make the economy more resilient to unfavorable external shocks.

Fiscal Policy

In January-October 2007, state budget revenues amounted to KZT 2,291 billion (USD 18.97 billion), increasing by 20.5% yoy in nominal terms. During the same ten months, fiscal revenues marginally surpassed last year's level for the first time since oil-sector tax proceeds were withdrawn from the state bud-

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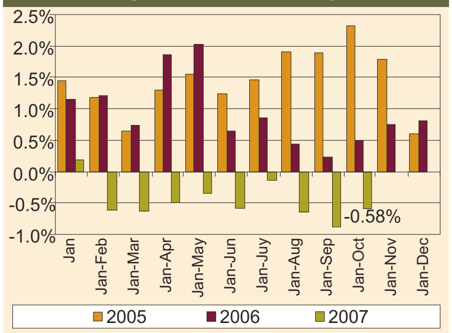
get in June 2006. Although this development indicates that the government was able to collect sufficient non-oil sector fiscal revenues to compensate for the exclusion of oil-sector tax revenues, the state budget still relies on hefty transfers from the National Fund of the Republic of Kazakhstan (NFRK). In January-October, transfers from the NFRK to the state budget amounted to KZT 258 billion (USD 2.14 billion) or 11.3% of all budget revenues. State budget expenditure grew by 22.4% yoy to KZT 2,138 billion (USD 17.7 billion), bringing the state budget deficit to KZT 78.63 billion (USD 650.9 million) or 0.6% of projected full year GDP.

State Budget Balance, % of full year GDP



Source: Ministry of Finance of RK

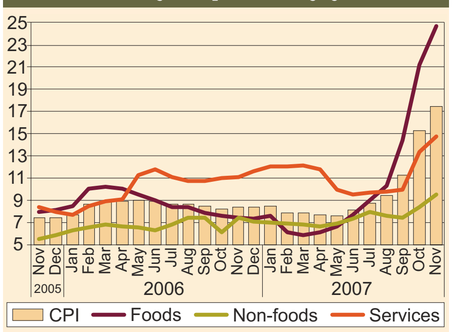
At the beginning of November, the assets of the NFRK stood at KZT 2,442 billion (USD 20.22 billion), posting a nominal gain of nearly 54% yoy. Furthermore, receipts of the NFRK grew by an impressive 67.23% yoy in January-October to USD 7.02 billion, considerably strengthening the country's buffer against adverse short-term shocks. Considering the trivial amount of public external debt, the fiscal position of the government can be considered fundamentally solid. Above all, revenues from the principle taxes are surging at double digit growth rates, supported by higher household incomes, lower unemployment and booming domestic and international trade. In September, average wages grew by 16% yoy in real terms to USD 440 as compared to USD 322 a year before, while unemployment fell to 7% from 7.5% in the third quarter of the last year. Finally, despite the insignificant state budget deficit, the expenditure side of the state budget may indicate that the current fiscal policy is inflating demand pressures. Indeed, state transfers to the population, which mostly include pensions and wages, increased by 22% yoy and 35.5% yoy respectively in January-September. At the same time, capital expenditures grew by 60.5% yoy, suggesting that the country's public infrastructure needs are rather extensive.

On December 4th, the President of the Republic of Kazakhstan signed the 2008 budget law, which targets the republican budget deficit at 1.4% of GDP. According to its macroeconomic assumption, the economy is anticipated to grow by 9.1% yoy on average in 2008-2012, while inflation is to stay within the 6–8% range.

Monetary Policy

Monetary developments in Kazakhstan are shaped by two principle factors. First, taking into account that on average nearly 40% of household expenditures are spent on foods, it is reasonable to expect that the lion's share of income gains go to food consumption. As a result, a combination of mounting demand pressures and stretched supply (despite relatively strong output growth in domestic agriculture) caused domestic food prices to soar. In addition, increasing prices of fuels have been fanning the inflation of utility tariffs and transportation costs (which, presumably, should visibly influence prices of many other goods and services in a large and landlocked country like Kazakhstan). Second, recent global liquidity tightening virtually closed domestic banks' access to foreign borrowing. As a result, Kazakh banks faced curbs on efforts to expand their credit portfolios. As a result, the growth of domestic credit visibly moderated in the fall, making the deceleration trend of the money supply even more pronounced. Although this deceleration may eventually help cool demand pressures, it bears emphasizing that earlier brisk expansion of domestic credit will continue to exert upward pressure on the price level in the short-term.

CPI by Component, % yoy



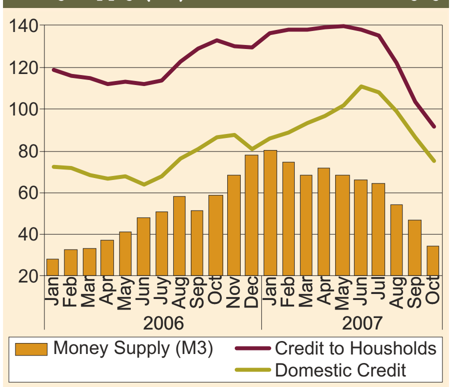
Source: ASRK

Obviously, short-term fluctuations in the prices of foods and energy as well as upward adjustments of administered tariffs are still key to inflationary dynamics of Kazakhstan. However, whether the resulting short-term price swings are within the power of the monetary authority to control may be an irrelevant question. Indeed, any central bank may find it pointless to be seriously concerned about the seasonal volatilities inherent in the prices of agricultural commodities and fuels. Thus, monetary policies, restraining inflationary expectations, are probably the most acceptable strategy to curtail inflation in Kazakhstan. Apparently, the National Bank of Kazakhstan has developed sufficient institutional capacity to implement such an approach. At the end of November, the central bank increased its refinancing rate by 2 percentage points to 11%. Provided that these actions are supported by prudent fiscal policy and structural reforms (which improve competition and reduce the costs of doing business), restoring price stability appears to be a feasible outcome.

In November, consumer price inflation (CPI) hit 17.5% yoy, propelled by the record-breaking run of food prices, which gained 24.7% yoy. In addition, the inflation of prices of non-food commodities and service tariffs continued to evolve along an uptrend that stretches back to September. Despite a deceleration of the monthly CPI to 2.7% from 4.4% the month before, all major determinants of inflation remained the same. In particular, increasing utility tariffs and higher prices of fuels and staple foods have pushed the price level to a new record high.

In October, the money supply grew by 34.4% yoy as the growth of domestic credit continued to slide to 74.9% yoy — the lowest growth rate in more than twelve months. The stock of domestic credit amounted to KZT 7,214 billion (USD 59.72 billion), gaining 1.3% month-over-month (mom). Although this monthly increase in the amount of USD 790 million is relatively modest when compared with the average monthly increment of USD 2.52 billion registered in January-August, it still represents an improvement over the 0.2% mom drop in September. Furthermore, if only households continued to accumulate debts in September (though rather inertly as credit to households inched up by only 0.07% mom), both households and the corporate sector increased borrowing in October, by 1.8% mom and 1.1% mom respectively. Credit issued in foreign currencies recovered as well, growing by 1.1% mom after shedding 2.8% in September. However, the stock of forex-denominated credit is still 2.5% (or about USD 460 million) below its August level, which may imply that banks have been collecting maturing forex-denominated loans to pay off their foreign liabilities.

Money Supply (M3) and Domestic Credit, % yoy

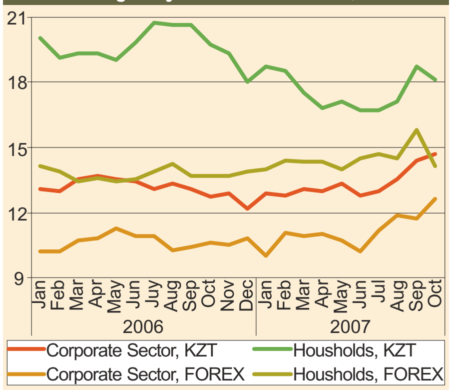


Source: NBRK, The Bleyzer Foundation

A recent resurgence of domestic credit, albeit rather delicate, may indicate that the Kazakh banking industry can manage to navigate through the global financial turmoil with limited collateral damage. Furthermore, banks' aggregate balance sheet is fundamentally strong, as during the first ten months of this year, operational income advanced by 108.7% yoy while net profits swelled by 113% yoy to USD 1.65 billion. In addition, there are some signs of improved efficiency in the banking sector as the return on assets (ROA) increased to 1.74% from 0.64% a year ago, while the income to asset ratio grew to 12.7% from 10.1%.

Global financial developments still imply a greater degree of financial restraint on domestic economic agents as credit becomes more expensive and difficult to obtain. Indeed, nominal interest rates charged by commercial banks appear to be on a steady uptrend, creating some headwinds for consumers and the corporate sector. On the other hand, rekindling of inflation may prompt households to increase borrowing both to take advantage of lower real interest rates and to finance growing expenditure bills.

Nominal Interest Rates Charged by Commercial Banks, %

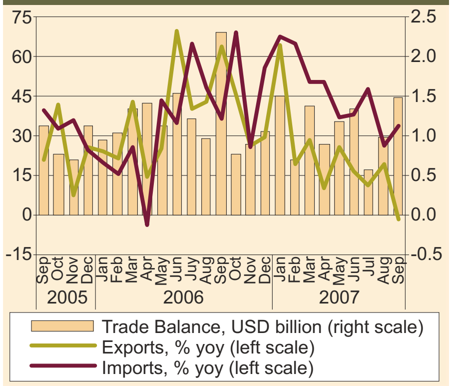


Source: NBRK

International Trade and Capital

The dynamics of Kazakhstan's international trade has been largely affected by rapidly rising imports, fueled by robust consumer and investment demand. Although high world energy prices supported resilient expansion of exports, the trade in goods surplus has been consistently shrinking since the beginning of the second quarter of 2007, on the back of slower output growth in the domestic extracting industry.

Monthly Foreign Trade Balance



Source: ASRK, NBRK, The Bleyzer Foundation

During the first three quarters of this year, imports increased by 43.6% yoy to USD 23.71 billion while exports approached USD 33.8 billion or up by 19% yoy, posting the lowest percentage gain in more than two years. The trade in goods surplus stood at USD 10.08 billion, losing 15.2% yoy against the trade surplus of USD 11.9 billion registered in January-September 2007.

Other Developments Affecting the Investment Climate

In November, several ratings of Kazakh banks were given by international rating agencies. Moody's upgraded the debt ratings (with stable outlook) of ATF Bank; this decision reflects the completion of ATF's acquisition by Bank Austria Creditanstalt, which is expected to improve the bank's corporate governance and risk management. Fitch has affirmed the ratings of Bank TuranAlem (BTA) and Kazkommertsbank (KKB), which are the two largest commercial banks in Kazakhstan. Both banks face material credit risk as they heavily relied on foreign funds to finance expansion. At the same time, these risks appear to be relatively well balanced by strong capitalization, solid performance as well as the willingness of Kazakh authorities to support these institutions in case their conditions visibly deteriorate. These recent rating actions may imply that the banking system of Kazakhstan appears to be withstanding the blow of the global credit crunch thus far.