SigmaBleyzer

Kazakhstan Macroeconomic Situation

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Summary

- Economic growth is projected at 5% in 2008.
- The government launched a USD 5 billion program to recapitalize the four largest banks.
- In January-September, industry grew by 3% yoy.
- During the first three quarters of 2008, the state budget posted a deficit of 1.5% of projected full-year GDP
- Consumer prices grew by 8.8% during the first ten months of the year.
- In January-August, the foreign trade surplus stood at USD 25 billion.

Economic Growth

According to preliminary estimates by the Ministry of Economy, GDP growth decelerated to 4% yoy in January-September compared to 9.7% yoy a year ago. The latest economic data also prompted Kazakh authorities to downgrade their forecast for GDP growth in 2008 to 5% yoy from the previous 5.3% yoy. Essentially, weaknesses in the domestic banking and construction sectors are augmented by the downward correction of world crude oil and metal prices as the global economy looks increasingly likely to enter a period of below trend growth.

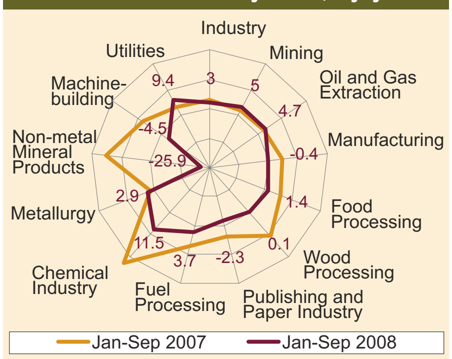
On the positive side, the government promptly developed a new economic stabilization plan, which envisions an injection of USD 15 billion into the banking sector and the real economy by the end of this year. The government of Kazakhstan has recently launched a bank recapitalization program to strengthen the banking system. According to this program, the four largest banks (Alliance Bank, BTA Bank, Halyk Bank and Kazkommertzbank) will be required to inject new capital through the issue of regular and preferred shares. These four banks jointly control over 70% of all outstanding loans and account for about 60% of all overdue loans (or about USD 5 billion). The banks' shareholders will be given the right to purchase new shares. If this right is not realized the government will purchase shares through its investment vehicle, SamrukKazyna. To pay for this purchase, the government will increase the capital of SamrukKazyna by USD 5 billion through a transfer from the National Oil Fund (total assets of this Fund stood at USD 26.3 billion in October). An amendment to the 2008 state budget that authorizes a direct transfer of USD 5 billion from the National Oil Fund to increase the capital of SamrukKazyna has been recently approved and signed by the President.

According to a statement from SamrukKazyna's CEO, the banks' shares will be purchased at their market price on the London Stock Exchange. The BTA Bank, KazKommertzbank, Halyk Bank and Alliance Bank may receive at least USD 2.3 billion, USD 300 million, USD 500 million and USD 370 million, respectively. The ATF bank (Unicredit, Itally) and CenterCredit bank (Kookmin, South Korea), the fifth and sixth largest banks, respectively, announced plans to raise new capital from their parent companies.

In addition, SamrukKazyna plans to sell USD 5 billion of bonds to the National Oil Fund. These funds will be used to finance investment projects in the real economy. Initially, some funds will be deposited at commercial banks to the improve liquidity of the banking sector and revitalize bank lending. The National Bank intends to inject additional liquidity into the banking sector both by using its forex reserves and by reducing the reserve requirement. These measures are expected to amount to $5 billion of extra liquidity. Finally, the $1 billion Assets Stabilization Fund will soon be launched to improve the quality of the banks' credit portfolios. All told, the cost of the recently announced stabilization plan may amount to about 10% of Kazakhstan's GDP.

During the first nine months of 2008, industrial output grew by 3% yoy compared to 4.7% yoy a year ago. Manufacturing sector remained weak, decelerating by 0.4% yoy on the back of continuing stagnation of the industries producing construction materials and slowing metallurgy. Indeed, the production of ferrous metals (about 1/5th of all manufacturing) dropped by 3.1% yoy compared to 10% yoy the year before. Above all, ferrous metallurgy sees flagging export sales, as global demand for iron and steel continues to weaken. In January-September, production of crude and flat-rolled steel fell by 0.9% yoy and 8.6% yoy, respectively. Although iron and steel contribute less than 10% to overall export revenues of Kazakhstan, the metallurgical sector remains rather dependent on external demand as nearly 30% and 80% of domestically produced crude and flat-rolled steel, respectively, are exported. Furthermore, Iran, Russia, China, the Netherlands and Japan jointly account for over 70% of all Kazakh exports of iron and steel. Deteriorating growth prospects for these countries imply that Kazakh ferrous metallurgy looks increasingly likely to stay weak for at least several quarters. Indeed, Kazakhstan's largest steelmaker, Arcelor Mittal Temirtau, has already announced a reduction in output (from 4.2 million tons last year to 3.8 million tons in 2008) and may revise its business expansion plans.

Industrial Growth by Sector, %yoy



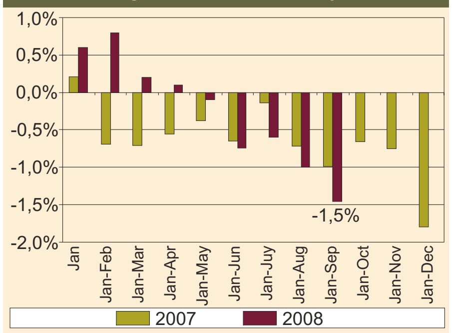
Source: ASRK

The economy of Kazakhstan remains dependent on exports of crude oil. This means that ongoing expansion of crude oil and natural gas extraction capacities will continue to support industrial growth. Crude oil and gas condensate production grew by 4.7% yoy compared to 3.9% yoy a year before. TengizChevroil, which develops the Tengiz oil field, increased its production capacity by 540,000 barrels per day (bpd). Equally important, the government has recently concluded a final agreement defining the terms of the Kashagan oil field development. According to this agreement, the national oil and gas company KazMunaiGas (KMG) will double its stake in the project from 8.33% to 16.81%. Italian Eni has lost its role as an operator of the field and a new company, the North Caspian Operating Company (NCOC), will run the project starting 2009. The first phase of crude oil extraction (75,000 bpd) is to be launched by December 1st 2012, while full-scale commercial operations (450,000 bpd) should begin starting 2014. Kazakhstan will also be entitled to compensation for all delays and modifications of exploration works. The share of the KMG in Kashagan's production sharing agreement was set to 10%. Finally, the revenues of the state budget from the Kashagan oil field will be defined according to the following scheme: the NCOC pays 3.5% of the output if the world oil price equals USD 45 a barrel, 5% at USD 65, and 5%-12% at USD 85 — USD 180. As a result, by the end of this 40-year project, the consortium is expected to pay about USD 70 billion to Kazakhstan.

Fiscal Policy

The government has amended the 2008 republican budget. According to the Ministry of Finance, budget revenues are to increase by USD 5.06 billion and will total USD 27.8 billion. These additional revenues will come as a transfer from the National Oil Fund. Expenditures of the republican budget will grow as well, which reflects spending on economic stabilization programs. However, the republican budget deficit was kept unchanged at 2.1% of GDP.

State Budget Balance, % of full year GDP



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

During the first nine months of 2008, the state budget deficit widened to USD 1.9 billion or 1.5% of projected full-year GDP. Revenues amounted to USD 21 billion growing by 23.5% yoy. Tax reve-

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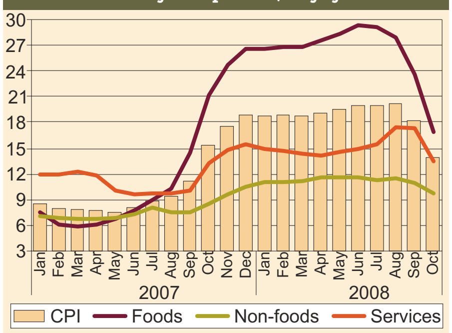
nues grew by 22.4% yoy, as proceeds from the corporate income tax (CIT) and personal income tax (PIT) grew by 32.6% yoy and 22.9% yoy, respectively. Furthermore, budget revenues from the VAT posted a positive gain for the first time in 2008, increasing by 6.5% yoy. Although, proceeds from the VAT on domestically produced goods and services (20% of all VAT revenues) were down by almost 12%, a modest recovery of imports in the second and third quarters of 2008 helped to push VAT revenues from imported goods by 11% yoy. Revenues from taxes on foreign trade (about 12% of all tax revenues) more than doubled as proceeds from export duties surged by more than 11 times following the introduction of a new crude oil export duty in May 2008.

In January -September, budget expenditures grew by 28.3% yoy. Capital expenditures increased by 35% yoy to USD 6 billion or about 1/4th of all budget spending as the government continued to invest in public infrastructure and injected new capital into state-owned developmental institutions. Meanwhile, current expenditures advanced by 18.8% yoy in nominal terms as spending on wages and social transfers (about 50% of all current expenditure) grew by 8.5% yoy and 19.7% yoy, respectively.

Monetary Policy

CPI by Component, % yoy

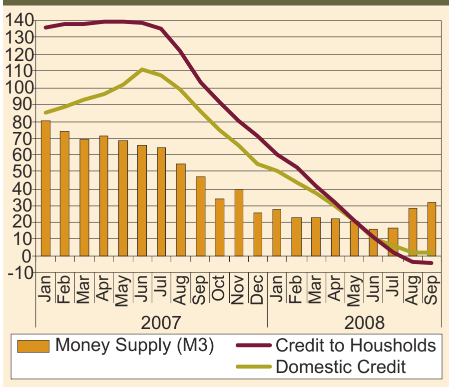


Source: NBK

During the first ten months of 2008, the consumer price index increased by 8.8% ytd or by 13.4% yoy against October 2007. Inflationary pressures have been gradually easing on the back of a slower growth of food prices, which decelerated to 16.9% yoy compared to 21.2% a year ago. Essentially, the impact of a one-off surge of global food prices in the last quarter of the previous year looks increasingly likely to fade away due to better global supply conditions in agriculture and the slowing world economy. Indeed, in October, the global food price index (calculated by the Food and Agriculture Organization of the United Nations) fell by 5.7% yoy to its lowest level since August 2007. In addition, prices of non-food commodities advanced much slower in October than in the months before, growing by 9.7% yoy. The government and major oil producers have signed an agreement to cut fuel prices. As a result, in October, petrol prices fell by 2.7% month-over-month (mom) while prices of diesel fuels dropped by 4.9% mom. At the same time, the beginning of the heating season pushed utility tariffs up by 1.2% mom. All told, inflationary pressures will almost certainly remain restrained in the near-term. This means that Kazakhstan will return back to single digit inflation next year.

In January-September, the stock of domestic credit amounted to USD 60.7 billion growing by only 2.4% yoy in nominal terms. This growth was supported by the positive, albeit modest, accumulation of credit by the corporate sector. Indeed, during the first nine months of 2008, monthly average net lending to the corporate sector amounted to USD 185 million, while net credit to households declined by USD 156 million per month on average. As a result, net credit to the corporate sector grew by 6.3% yoy and net credit to households fell by 4.7% yoy. This means that in 2008, the average monthly growth of domestic credit stood at a paltry USD 29 million compared to over USD 2 billion during the first nine months of 2007. All told, the global credit crunch has been exacting a considerable toll on Kazakhstan's banking system. Obviously, the government-sponsored bank recapitalization program was announced to unfreeze bank lending. In addition, the National Bank of Kazakhstan is increasingly likely to reduce minimum reserve requirements (MRR) for the commercial banks to boost market liquidity. This measure is expected to release an additional USD 4 billion of resources to issue new credit.

Money Supply (M3) and Domestic Credit, % yoy



Source: NBK

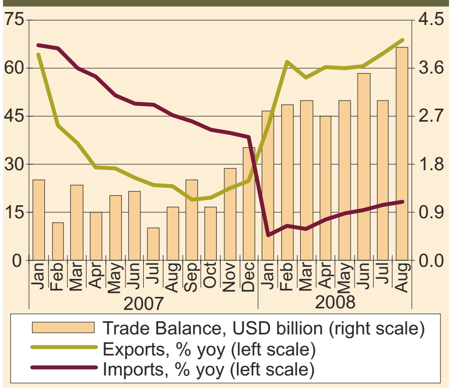
Domestic banks continue to accumulate provisions against possible credit losses. In September, these provisions grew by USD 445 million as more loans were reclassified as riskier. This means that the deteriorating quality of banks' credit portfolios remains a key near-term challenge, which will define the overall financial stability of the banking sector. On a positive note, Kazakh banks managed to maintain high capital adequacy ratios and continue to report positive, albeit declining, profits. At the beginning of October, the capital to assets ratio (CAR) of the Kazakh banking system stood at 12.2% compared to 11.7% a year ago. Furthermore, the CAR of the top five banks (which control over 3/4th of all banking assets) was close to or above 10%. Although, aggregate net profits of the banking system fell by 61.5% yoy in January-September, banks still managed to earn USD 0.6 billion in profits. This means that banks still have spare loss-absorption capacity to manage future growth of non-performing loans. In addition, the recent actions of the government to recapitalize the banking system will certainly enhance the stability of Kazakh's banking sector.

Finally, a newly established Asset Stabilization Fund (ASF) will be used to resolve the issue of non-performing loans. The government will invest KZT 52 billion (USD 433 million) to create the Fund's capital and may increase its size to USD 1 billion by the end of the year. Details on the functioning and operations of this Fund are expected to be released by the end of November.

International Trade and Capital

In January-August, the foreign trade balance registered a surplus of USD 25 billion. On a monthly basis, the trade in goods surplus widened to a record high USD 4 billion supported by strong crude oil prices.

Monthly Foreign Trade Balances



Source. ASRK, The Bleyzer Foundation

In the first half of 2008, the gross external debt of the country stood at USD 100.6 billion. Public debt settled at USD 1.54 billion, falling by USD 18 million since the first quarter of this year. During the first six months, banks reduced their external obligations by 1.8% ytd. Meanwhile, inter-company lending increased by 8.2% ytd to USD 32.4 billion. This growth was mostly driven by new investments of foreign companies into their subsidiaries in Kazakhstan.

Other Development Affecting Investment Climate

Despite the ongoing weakening of the global economy, the largest steelmaker of Kazakhstan, Arcelor Mittal Temirtau, plans to build a new plant with production capacity of 4 million tons of steel a year. The cost of this project is estimated at USD 7 billion. According to the business plan of the company, the existing plant in Temirtau is to increase its production from 5.5 million tons to 6 million tons of steel a year. Construction of a new plant is to be completed by 2013. In 2014, the production capacity of both plants is expected to increase to 10 million tons of steel. This expansion plan may imply that Arcelor Mittal expects the global demand for steel to regain strength in several years. Moreover, the government has included this project in its ambitious 30 corporate leaders program. As a result, Arcelor Mittal may obtain state support (in terms of taxation and regulatory preferences) to complete its production capacity expansion.

On November 10th, Fitch downgraded Kazakhstan's long-term sovereign rating to BBB– and BBB for forex and KZT denominated liabilities, respectively. The country ceiling was lowered to BBB, while the outlook was kept negative. Still, Kazakhstan managed to secure its investment-grade status since the country's fiscal and external liquidity positions remain strong. This new rating, however, reflects ongoing problems in the banking sector as well as growing concerns over the ability to maintain export revenues on the back of a sharp downward adjustment of global commodity prices. This means that a recent rating action by Fitch was mostly based on elevated risks of global economic slowdown and its contagion to the Kazakh economy.