# Kazakhstan

# Macroeconomic Situation

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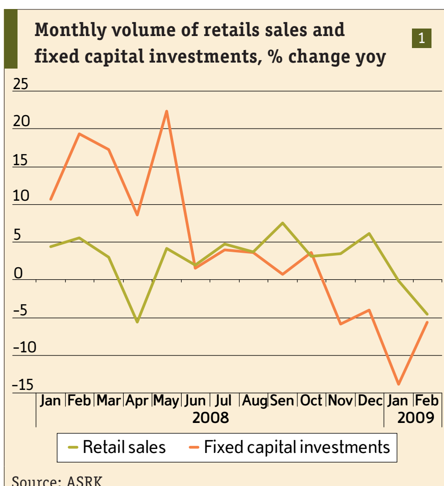
## Summary


- During the first two months of 2009, industrial production fell by 3.2% yoy.
- The government lowered its projections of GDP growth in 2009 down to 1% from the previous estimate of 2.7%.
- In January-February, the state budget registered a surplus of 0.55% of projected full year GDP.
- Consumer prices grew by 8.7% yoy in February.
- In January, the foreign trade surplus amounted to USD 750 million.
- In 2008, gross external debt stood at USD 107.8 billion or 82% of GDP.

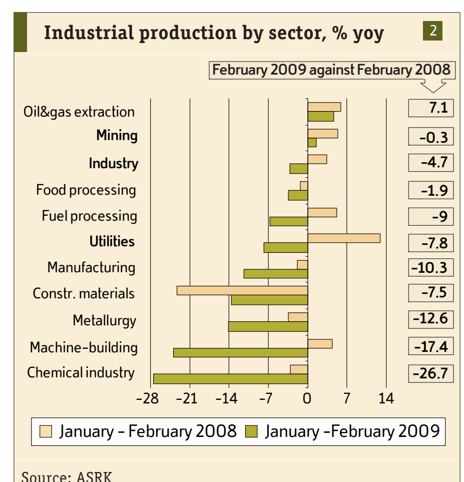

## Economic Growth

Kazakhstan's industrial sector remains under increasing pressure from anemic domestic consumer and investment demand as well as the weakening global economy. In February, retail sales fell for the second month in a row, shrinking by 4.5% yoy, while fixed capital investments declined by 5.6% yoy (see chart 1). Apparently, both consumers and businesses continue to slash expenditures on fears of an extended period of economic slowdown. According to the Consumer Opinion Surveys conducted by the ASRK, the consumer confidence index fell by 9 percentage points in January-February, pushing it into negative territory for the first time in two years. This means that a growing number of households intend to delay spending on durable goods. This does not bode well for retail trade, as the share of non-food products in retail sales has grown to nearly 70% over the last several years on the back of past shopping sprees for cars, furniture, electronics and other durable items. Essentially, a retrenchment in private consumption is gathering ground as consumers, who are already over extended by stagnating real wages and tight bank lending, continue to downgrade their expectations. Several factors may explain this accelerated erosion of consumer confidence. First, an abrupt decline in world crude oil prices during the last quarter of 2008 came as a large unanticipated negative shock to Kazakh economy. Second, weaknesses in the banking sector intensified, prompting the government to take a controlling stake in the largest commercial bank. This implies that consumers can hardly expect a loosening of credit conditions in the near term. Lastly, a large one-off currency devaluation at the beginning of February considerably dented the financial position of households that borrowed in foreign currencies, and may have rekindled inflationary expectations due to higher prices of imports. Add to this falling real estate prices, which eat into the households' wealth, and the likely result will be a continued weakening of consumer demand.




Finally, the risk is that the recovery of domestic demand may be longer and weaker because businesses have reduced investment spending as well. In January-February, fixed capital investments declined 9.7% yoy as fixed capital investments into industry and real estate, renting and business activities (economic sectors that account for over 75% of all fixed capital investment) fell by 25.4% yoy and 14.9% yoy, respectively. Weak investment spending may be associated with two key factors. First, falling crude oil prices reduced the profit margins of oil producing companies, which depressed capital outlays in the mining industry and investments into geological exploration. Second, tight credit conditions continue to block the flow of funds to the construction sector. As a result, in January-February 2009, less than 10% of all fixed capital investment was financed with borrowed funds compared to more than 25% a year ago. On the positive side, the share of foreign investors in capital spending doubled to 41% from 20.6% in January-February 2008. After all, foreign oil producing companies continue to expand their production capacities in Kazakhstan as the global economic slowdown and low oil prices may help bring the cost of this expansion down. Indeed, Cambridge Energy Research Associates, which tracks capital expenditure in the oil industry, sees a strong downward pressure on upstream capital costs, which peaked in the third quarter of 2008. This means that oil companies operating in Kazakhstan are likely to benefit from lower costs of equipment, materials and labor. In particular, Royal Dutch Shell PLC plans to invest USD 900 million in Kazakhstan in 2009, primarily into the Kashagan offshore oil field. Meanwhile, Tengizchevroil may expand the production capacity of its Tengiz oil field to 0.75-1 million barrels per day.

In February, industry lost 4.7% yoy, following a downtrend that stretches back to November. As a result, in January-February 2009, industrial production declined by 3.2% yoy compared to 3.4% yoy growth a year ago (see chart 2). The manufacturing sector continued posting double digit production declines, shrinking by 11.4% yoy in January-February. On a positive note, in February output in key manufacturing sectors (with the exception of fuel processing, which is facing a reduction of demand from construction and trade) fell at a slower rate than the month before. However, a comparison of industrial performance during the first two months of 2008 and 2009 shows that output contraction decelerated only in sectors producing construction materials (primarily due to the sharp downward adjustment of output in that sector in 2008). Meanwhile, performance of other manufacturing sectors visi-

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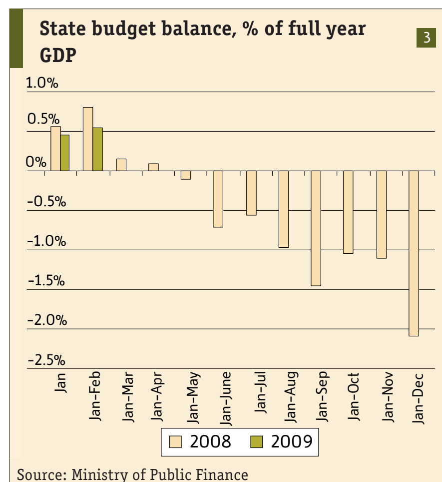
bly weakened. This means that manufacturing output will continue to slide until global and domestic demand stabilizes. In particular, fuel processing (where output fell by 6.7% yoy in January-February 2009) may see its pace of decline stepping up as demand for gasoline and other fossil fuels falls on the back of the anemic transportation industry. Indeed, in January-February 2009, the volume of freight transportation declined by 4.1% yoy (up by 3.1% yoy a year ago), while the volume of passenger transportation inched up by only 0.5% yoy (up by 4.9% yoy a year ago).

Finally, it appears that economic weakness is spreading beyond the manufacturing industry into the extracting sector. In particular, in February, output in the mining industry stalled for the first time in more than a year, marginally shrinking by 0.3% yoy. Although oil and gas extraction grew by 4.7% yoy, a sharp reduction in coal production (down by 21.4% yoy) and falling extraction of metal ore (down by 5.4% yoy) offset positive growth in other mining industries. However, if lower output of metal ore may be associated with falling global demand for steel, falling coal production may be rooted in decreasing output of utilities (down by 7.8% yoy). Indeed, in January-February, electricity generation shrank by 9.6% yoy, which may have caused a reduction of demand for coal since about 80% of electricity is produced by fossil fuel-fired plants, while more than a third of all locally produced coal is consumed by the utilities sector.

## Fiscal Policy

The government of Kazakhstan has revised its macroeconomic projections for 2009-2011 as a response to currency devaluation and intensified global economic slowdown. In particular, assumptions on crude oil prices were lowered to 40 USD per barrel in 2009 and to 50 USD per barrel in 2010. As a result, real GDP growth in 2009 is forecast to advance by only 1% - down from the previous estimate of 2.7%, while consumer prices are anticipated to grow by 11% in 2009. The republican budget revenues were reduced by KZT 23.4 billion (USD 155 million) to KZT 2,837 billion (USD 18.9 billion), while budget expenditures were cut by KZT 21.2 billion to KZT 3,411 billion (USD 22.7 billion). This means that the deficit of the republican budget will stay at KZT 573.6 billion (USD 3.8 billion) or about 3.4% of GDP.

During the first two months of 2009, the state budget registered a surplus of KZT 92 billion or 0.55% of projected full year GDP (see chart 3). State budget revenues fell by 9.2% yoy as tax revenues decreased by 10.7% yoy. A decline in tax revenues is most likely driven by lower VAT revenues on the back of decelerating retail trade and imports.

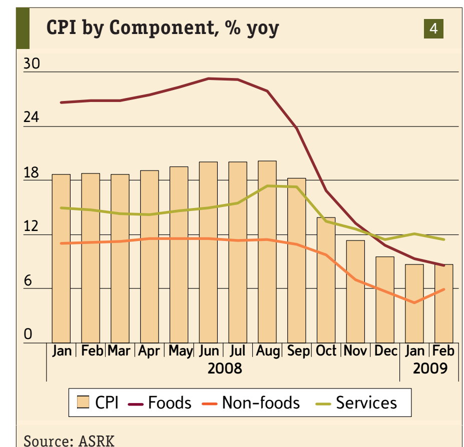


Source: Ministry of Public Finance

In January-February, state budget expenditures inched up by 1.2% yoy as the government cut spending on transportion, the energy sector and public housing. Meanwhile, expenditures on agriculture, social security, education and healthcare continued to grow. Obviously, this trend illustrates a shift in budget priorities, as tighter financial constraints induce the government to cut or delay some investment projects while maintaining vital public services and supporting social protection. Indeed, in January-February 2009, the portion of fixed capital investment funded by the state budget narrowed to 3.7% compared to 6.1% the year before.

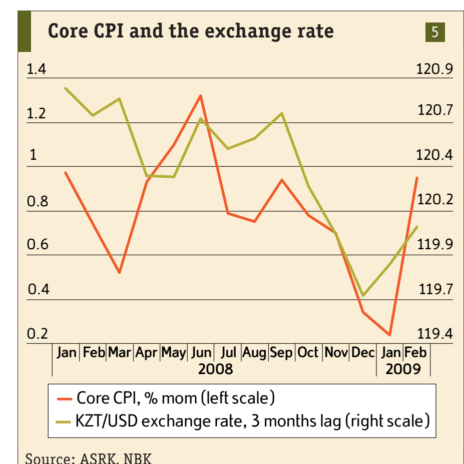
## Monetary Policy

In February, the consumer price index (CPI) increased by 0.8% compared to the month before (mom). Essentially, prices of non-food products (up by 1.8% mom compared to a drop of 0.4% mom in January) were driven by the 22% currency devaluation in February, which inflated prices of imports. As a result, prices of non-food products grew by 6% yoy (see chart 4), offsetting a deceleration of the growth of service tariffs and prices of foods. All told, in February, the CPI grew by 8.7% yoy.



Source: ASRK

However, the exchange rate pass-through to higher prices of imports is likely to continue pushing up domestic inflation in the near term. Indeed, the core CPI (which excludes prices of foods and fuels) appears to exhibit a strong correlation with lagged exchange rate (see chart 5).

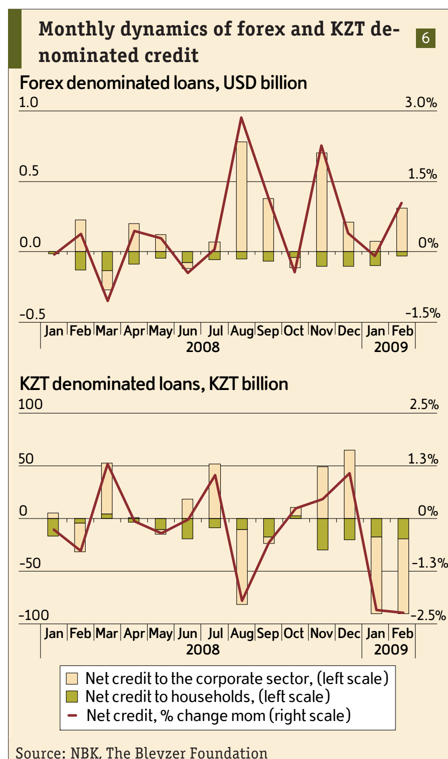


Source: ASRK, NBK

On a positive note, prices of Kazakh imports have been falling since September, following global deflationary trends. Furthermore, weak

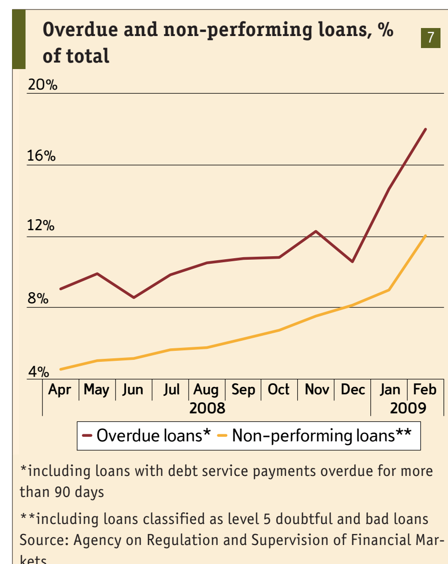
consumer demand will almost certainly limit the power of local retailers to pass on the full impact of the weaker Tenge to consumer prices. Indeed, according to the Customs Control Committee, retail margins over the prices of imported foods, fruits and vegetables tended to shrink in February. At the same time, retail margins for non-food household products slightly increased. This may imply that the exchange rate pass-through to consumer prices is likely to be more visible in sectors with limited capacity for import substitution (for example, consumer electronics and household products) compared to sectors where local competition is stronger such as food processing and agriculture.

In February, currency devaluation brought in a 25% nominal increase in forex-denominated liabilities of banks' borrowers. However, the total stock of forex denominated credit inched up by only 1% mom to USD 27.6 billion as new forex loans in the amount of USD 1.7 billion were offset with USD 1.4 billion of repayments of outstanding loans, including USD 1.1 billion and USD 0.3 billion payed back by companies and households, respectively (see chart 6). Meanwhile, the stock of KZT denominated loans dwindled by 2.2% mom in February (or by 3.3% yoy) as during the first two months of 2009, the volume of newly issued KZT denominated credit fell short of the amount repaid by both households and the corporate sector.



Source: NBK, The Bleyzer Foundation

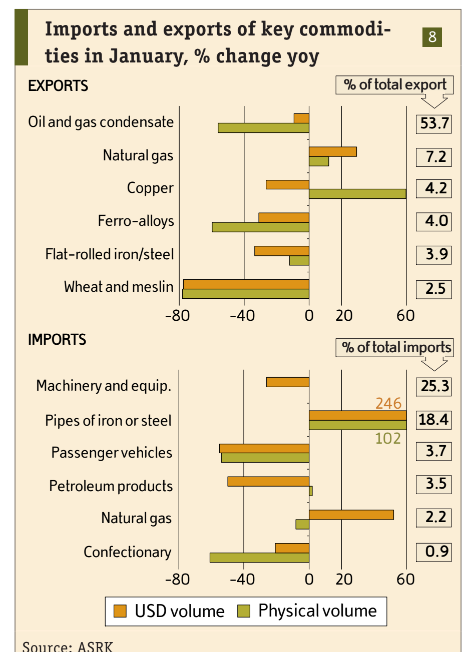
As a result, in February, the stock of domestic credit inched up by only 1.7% yoy to USD 54 billion and was primarily driven by corporate borrowing in foreign currencies. Slower growth of domestic credit and currency depreciation looks certain to elevate credit risks in the banking system. First, slower expansion of credit portfolios deprive banks of future interest income, which may lower profit margins and erode banks' capital. Second, both households and companies remain exposed to currency risks, as about 40% and 50% of all loans issued to households and the corporate sector, respectively, are denominated in foreign currencies. This means that borrowers who earn income in Tenge and repay loans in foreign currencies may be forced to delay debt service payments or even default. As a result, more forex-denominated loans will turn sour as households face higher unemployment and lower wages and corporate profits dwindle (see chart 7). On an optimistic note, the impact of the recently launched bank bailout program should become visible during the next several months. If this program helps to unfreeze the banking sector and revive bank lending, the ratio of bad loans kept on banks' balance sheets may stabilize. However, it is likely that further efforts will be required to help the banks clean up their books by encouraging private investors to purchase troubled assets.



*including loans with debt service payments overdue for more than 90 days
**including loans classified as level 5 doubtful and bad loans
Source: Agency on Regulation and Supervision of Financial Markets

## International Trade and Capital

Falling global commodity prices continue to exact a toll on Kazakhstan's export revenues. In particular, in January, exports fell by 50.5% yoy to USD 2.7 billion - the lowest monthly volume since February 2006. This contraction was triggered by the 52% and 42% declines of prices of crude oil and ferroalloys, respectively (see chart 8). Meanwhile, imports fell in both value and volume across virtually all commodity groups to USD 1.8 billion, decreasing by 21.4% yoy.



Source: ASRK

As a result, in January the foreign trade surplus amounted to USD 0.75 billion or nearly 4 times lower than a year ago (see chart 9). This means that the current account deficit may exceed USD 0.5 billion in the first quarter of 2009. However, the weaker Tenge, falling domestic demand and a possible stabilization of crude oil prices in the second half of this year may help contain the widening of the current account gap beyond 4% of GDP in 2009.

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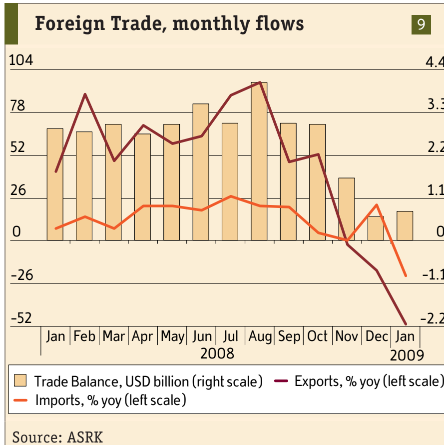
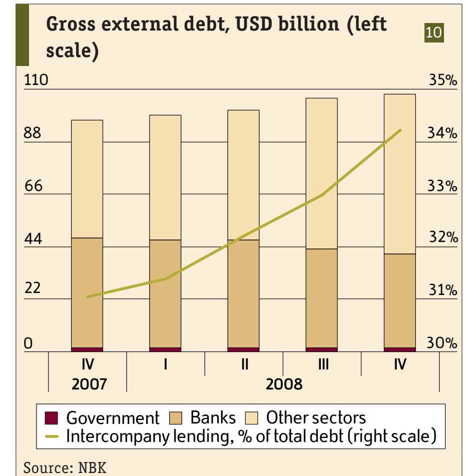



According to the National Bank of Kazakhstan, in 2008 the gross external debt grew by 11.2% yoy (compared to 31% yoy in 2007) to USD 107.8 billion. Meanwhile, faster growth of nominal GDP helped to narrow the ratio of foreign debt to GDP to 82% from 92% at the end of 2007. Essentially, last year the dynamics of foreign external debt was shaped by two main factors. First, Kazakh banks reduced their external debt by 15% yoy to USD 39 billion (see chart 10) on the back of the sizable repayments of external loans and tight global credit markets. Second, other sectors of the economy accumulated an additional USD 17.7 billion in foreign debt (or up by 37% yoy to USD 67 billion). Lastly, the volume of intercompany lending jumped by 23% yoy to USD 37 billion or over one third of all external debt. At the same time, the allocation of foreign debt across sectors reveals a strong bias toward the oil industry. Indeed, more than 55% of all foreign debt outside of the banking sector is concentrated in the mining industry and geological exploration. Furthermore, nearly 90% of this debt came in the form of intercompany lending (about 86% of all intercompany lending). On top of that, more than 60% of all foreign debt that flows into manufacturing is absorbed by metallurgy. All of this implies that foreign capital inflows (both as foreign direct investments and debt flows) into the non-banking sector of Kazakhstan remain skewed toward resource based industries.

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