Kazakhstan

Macroeconomic Situation

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- **Preliminary estimates place GDP growth at 7% in 2010 versus only 1.2% in 2009.**
- **The central bank expects GDP growth to average 5% over the next three years.**
- **Last year, Kazakh industry grew by 10% on a solid turnaround in manufacturing and continued expansion in mining.**
- **In 2010, employment grew by 2.6%, while the jobless rate fell to 5.5% in December.**
- **Kazakhstan ended last year with the state budget deficit at about 2.8% of projected full year GDP.**
- **Consumer prices were 7.8% higher than in 2009 on increasing global prices of foods.**
- **In January-November 2010, the trade in goods surplus jumped to $29 billion from $12.2 billion a year ago.**

Executive Summary

Kazakhstan is entering this year on much stronger footing. Estimates place GDP growth at 7% in 2010 thanks to a broad-based recovery of the export-oriented and service-providing parts of the economy. In particular, last year industry grew by 10% due to a solid turnaround in manufacturing and continued expansion in mining. All key manufacturing industries - from food processing to metallurgy - posted strong gains, being driven by both booming overseas demand and growing domestic consumption.

After all, consumer sentiment has recovered a great deal over the course of the last year thanks to improving employment prospects and higher public spending. Indeed, in 2010, employment grew by 2.6%, while the jobless rate fell to the lowest readings on record. The service-providing sectors continued to drive job-creation in Kazakhstan as two of the biggest service industries - education and healthcare - posted robust employment gains. Goods-producing industries saw steady job growth as well. Meanwhile, real wages have been on the uptrend, mostly thanks to public-sector salary hikes. The combination of higher wages and more jobs contributed to increased consumer purchasing power - retail sales bounced back by 12.3% following a 4% decline in 2009.

There are signs that the housing market is turning the corner - apartment prices registered their first annual gain since 2007. Still, residential investment activity remains well below its precrisis level, which means that the construction industry may lag behind the overall economic recovery. The housing market aside, the economic recovery in Kazakhstan is becoming more self sustaining. Indeed, consumer retrenchment is easing, while commodity-producing industries - a mainstay of the economy - are enjoying strong overseas demand. In particular, China has emerged as the biggest trading partner for Kazakhstan and exports of ferrous and nonferrous metals prompted a turnaround in metallurgy.

With the persistence of the global economic trends set last year, the 2011 outlook for Kazakh commodity producers remains favorable. After all, commodity prices play a central role in the official economic forecast for 2011. In its most likely scenario, GDP will grow by about 5% over the next three years provided that petroleum prices stay at $80 per barrel - a rather conservative assumption compared to international projections and recent trends.

That said, fiscal and monetary policies will continue to prop up domestic demand. Yet there is no imminent threat of fiscal tightening - the state budget deficit stood at only 2.8% in 2010 thanks to a rebound of tax revenues. The monetary policy will remain supportive of economic recovery as well. After all, monetary sources of inflation are still under control as Kazakh lenders, beset by a large overhang of nonperforming loans, will find it hard to boost lending in 2011.

Lastly, increasing commodity prices were the main driver of Kazak exports in 2010. More specifically, exports of agricultural commodities posted robust gains thanks to tighter global supply and increasing demand from the large emerging markets. Exports of crude oil and base metals were propped up by surging demand in China and a turnaround in the global manufacturing hubs. Meanwhile, imports continued to decline on weaker demand for investment goods and consumers' reluctance to purchase foreign-made durable products. As a result, in January-November 2010, the trade in goods surplus swelled to $29 billion from $12.2 billion a year ago.

	2006	2007	2008	2009	2010[e]	2011[f]
GDP growth, % change yoy	10.7%	8.9%	3.3%	1.2%	7%	5%
GDP per capita, $	5 262	6 757	8 398	6 710	8 100	9 200
Industrial production, % change yoy	7.2%	5.0%	2.1%	1.5%	10%	5%
State budget deficit, % of GDP	0.8%	-1.7%	-2.1%	-2.9%	-2.8%	-2.5%
Governmet external debt (including NBK), % of GDP	2.9%	1.8%	1.6%	2.4%	2.7%	2.0%
Unemployment, end of period	7.8%	7.3%	6.6%	6.6%	5.8%	5.5%
Inflation, end of period	8.4%	18.8%	9.5%	6.2%	7.8%	7-8%
Retail sales, % change yoy	15.0%	10.7%	3.1%	-3.9%	12.3%	-
Gross forex reserves of the NBK, $ billion, end of period	19.1	17.6	19.9	23.2	28.3	-
Assets of the National Oil Fund, $ billion, end of period	14.1	21.0	27.5	24.4	30.6	-
Current Account Balance, $ billion	-2.0	-8.2	6.6	-4.2	4.9	3.0
External debt, $ billion	74.0	96.9	108.1	111.7	112.0	120.0
Exchange rate, tenge/$, annual average	126.1	122.6	120.3	147.5	147.4	142.0

[e] Estimate, [f] Forecast
Source: ASRK, NBK, Ministry of Finance of Kazakhstan, IMF, The Bleyzer Foundation

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Economic Growth

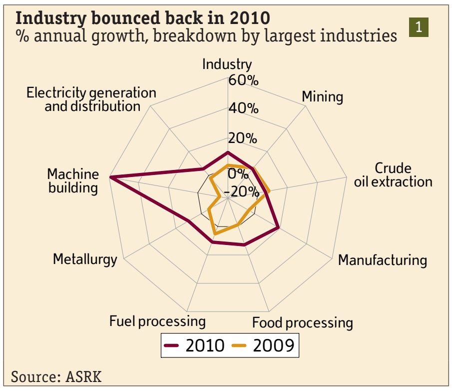
Kazakhstan is entering 2011 on much stronger footing than a year ago. Estimates place GDP growth at 7% versus only 1.2% in 2009 thanks to a broad-based recovery of export-oriented industry as well as the service-producing parts of the economy. Last year, industry grew by 10% versus 1.7% in 2009 on a solid turnaround in manufacturing (up by 18%) and continued expansion in mining (up by over 5%). Furthermore, all key manufacturing industries - from food processing to metallurgy - posted strong gains (see chart 1). This is a sign of industrial recovery being driven by both booming overseas demand and growing domestic consumption.

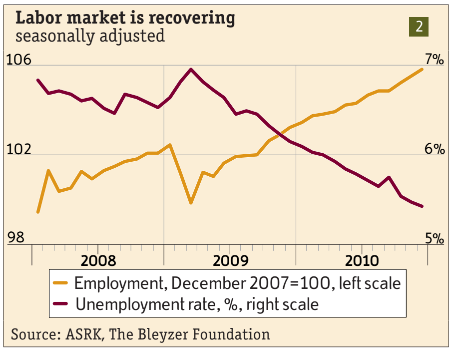
After all, consumer sentiment has recovered a great deal over the course of the last year thanks to the falling unemployment rate and higher consumer income. Indeed, in 2010, employment grew by 2.6%, while the jobless rate fell to 5.5% - one of the lowest readings on record (see chart 2). The service-providing sectors continued to drive job-creation in Kazakhstan. In particular, employment in retail and wholesale trade and in sectors supplying administrative and support services grew by over 8%. Real estate services saw a double-digit job growth, albeit on a low base. Over 6% more jobs were added in professional and business services. Employment in education and healthcare increased by 3% and 5%, respectively. Lastly, goods-producing industries saw a steady job growth as well - employment in mining and manufacturing posted gains of 3.9% and 1.3%, respectively.

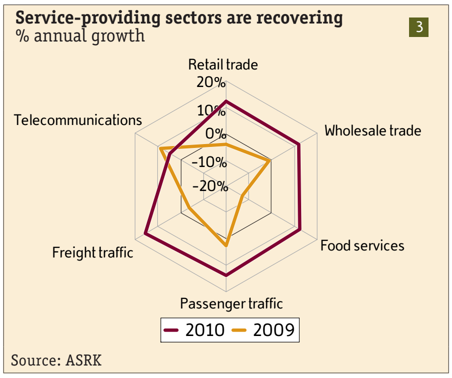
Meanwhile, real wages have been on the uptrend (up by about 7%), mostly thanks to salary increases in the public sector (public administration, education and healthcare). The combination of higher wages and more jobs contributed to increased consumer purchasing power. As a result, the volume of retail trade bounced back by 12.3% (down by 4% in 2009). Business activity in freight and passenger transportation services is booming as well (up by 15% and 13% respectively, see chart 3), adding strength to the service-providing industries, which account for over half of the national economy.

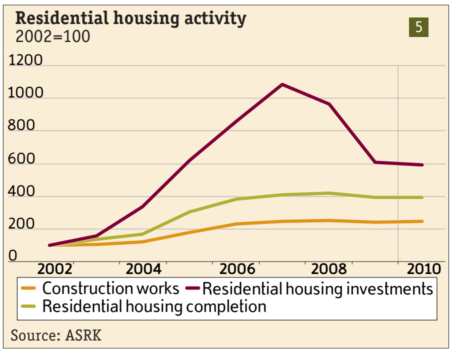
There are signs that the housing market is turning the corner - apartment prices grew by more than 3% in 2010 versus a 7% decline a year ago (see chart 4). Still, residential investment activity remains well below its pre-crisis level, although it ceased its abrupt decline in 2010 (see chart 5). This means that housing supply may tighten in the future, putting additional upward pressure on home prices. That said, the construction industry, which relied heavily on bank credit, will remains a weak spot for the national economy as lenders remain reluctant to issue new mortgages.

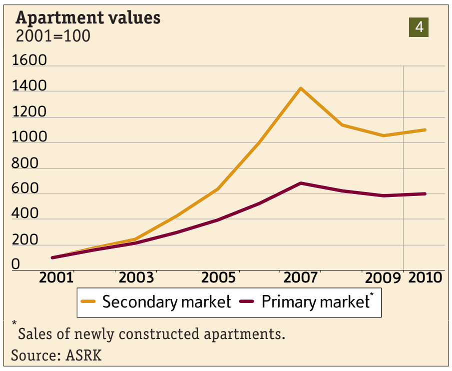
The housing market aside, economic recovery in Kazakhstan is becoming more self sustaining. After all, consumer retrenchment is easing thanks to brighter employment prospects and higher wages. True, fiscal and monetary policies are propping up domestic demand. Yet there is no imminent threat of fiscal tightening thanks to a sizable rainy day fund and a small level of government debt. This means that authorities can choose to tighten fiscal policy when it is least damaging for the recovery. More importantly, commodity-producing industries - a mainstay of the economy - are enjoying strong overseas demand. Indeed, developing countries, such as China and India, do not face debt overhang from the financial crisis and are start-











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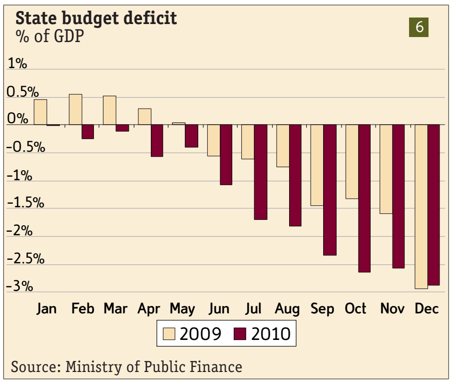
ing to rely more on domestic demand. This should support robust economic growth in the emerging world, adding strength to global commodity markets.

All told, solid economic fundamentals will sustain growth momentum in Kazakhstan in 2011 with energy prices providing a boost to the mining industry. China, hungry for commodities,[1] has emerged as the biggest trading partner for Kazakhstan - in 2010 it accounted for nearly 15% of Kazakh exports of crude oil[2] by volume versus only 8% a year ago. China's massive investment into its nuclear plants bodes well for the Kazakh chemical industry, which is a big supplier of uranium.[3] Meanwhile, strong exports of ferrous and nonferrous metals prompted a turnaround in metallurgy - in 2010, this industry grew by 10% following a 6% contraction a year ago. Machine building is enjoying a relatively strong recovery in neighboring Central Asian states.

With the persistence of the global economic trends set in 2010 (namely robust growth in emerging Asia and continued export-driven rebound in large manufacturing hubs such as Germany and Japan), the 2011 outlook for Kazakh commodity producers remains favorable. After all, commodity prices play a central role in the official economic forecast for 2011. In its most likely scenario, GDP is expected to grow by about 5% over the next three years, assuming that crude oil prices average $80 per barrel - a rather conservative assumption compared to international projections[4].

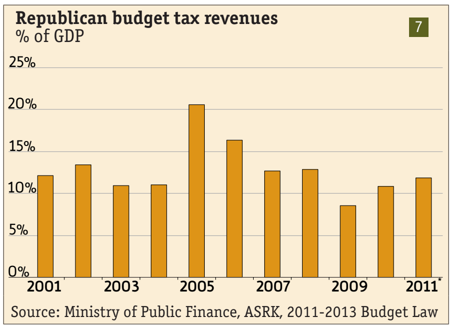
Fiscal Policy

In 2010, the state budget deficit stood at about 2.8% of projected full year GDP compared to a 3% deficit a year ago (see chart 6). In particular, state budget tax revenues jumped by nearly 32%, which pushed the republican budget tax revenues (over 70% of all tax revenues, including VAT, corporate income tax and taxes on foreign trade) 10% above the target. As a result, the republican budget deficit narrowed to about 3% - well below its year-end projection of 4.2%.



State budget deficit
% of GDP
6
Source: Ministry of Public Finance

State budget spending increased by 19% on higher public sector wages and social benefits. In addition, the government spent 55% more on purchases of financial assets as it injected more capital into the state development agencies, which implemented economic diversification programs.

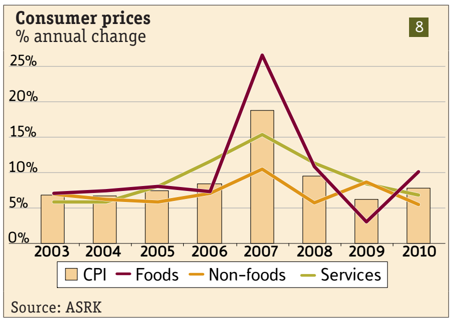


Republican budget tax revenues
% of GDP
7
Source: Ministry of Public Finance, ASRK, 2011-2013 Budget Law

The republican budget deficit is expected to stay below 3% of GDP this year. In particular, fiscal policy will be supporting personal consumption. Pension payments were increased by 30% while a similar planned hike in public sector wages was announced earlier in January. This higher social spending will be contributing to the budget deficit. At the same time, budget revenues are likely to remain strong. First, at the beginning of this year, the government doubled its oil export duty to $40 per ton. Second, a recovering economy will continue to broaden the tax base as corporate earnings and trade improve. To meet this year's target, the republican budget tax revenues have to increase by 22% to just below 12% of GDP. This seems to be a realistic revenue level, comparable to precrisis years (see chart 7). Finally, Kazakhstan's economic development programs will be financed with transfers from the National Oil Fund, which will exceed $8 billion per year over the next three years. After all, the government has sufficient resources to fund these programs. In 2010, the assets of the National Oil Fund, which provided 28% of all budget revenues, increased by over $6 billion to $30.5 billion by the end of 2010.

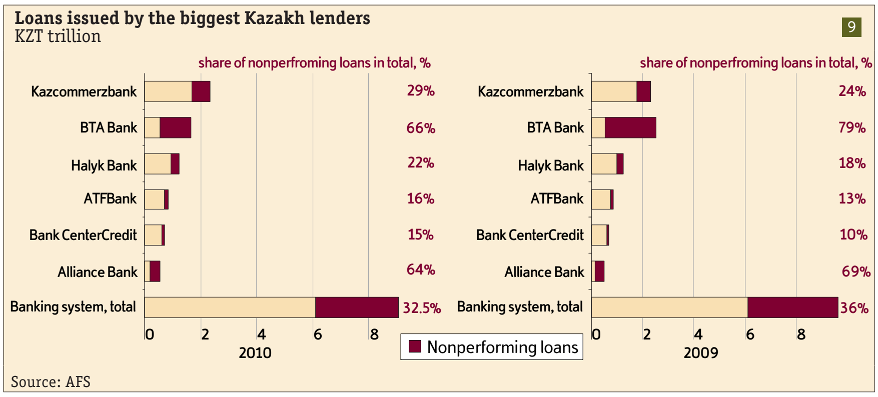
Monetary Policy

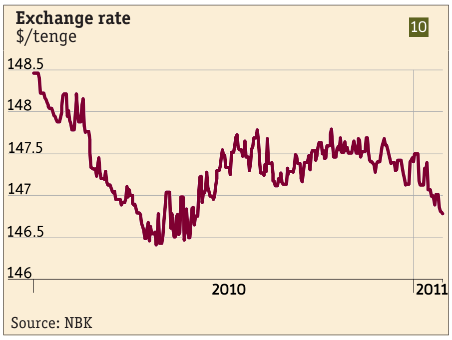
A looser fiscal policy may, however, elevate inflationary risks. In 2010, a spike in food prices, which grew by 10% versus only 3% in 2009, was one of the main drivers of higher inflation. By the end of the year, consumer prices were 7.8% higher than in December 2009 (see chart 8). True, higher food prices were triggered by crop failures in the CIS region. However, rapidly increasing wages may eventually rekindle inflationary expectations, forcing the central bank to tighten monetary policy.



Consumer prices
% annual change
8
Source: ASRK

[1] China imports about 10% of its annual energy consumption (mostly petroleum) - this is the same amount of energy that is consumed in the UK, the world's sixth largest economy. Source: The U.S. Energy Information Administration.
[2] Kazakh crude oil still represents less than 4% of all imports of petroleum by China. Source: national statistical offices.
[3] Kazakhstan holds 15% of the world's uranium reserves and accounts for over a quarter of the world production. Source: World Nuclear Association.
[4] For example, the U.S. Energy Information Administration expects crude oil prices to average $93 per barrel and $97 per barrel in 2011 and 2012, respectively. According to the latest update by the IMF, a baseline petroleum price for 2011 is $90 per barrel.





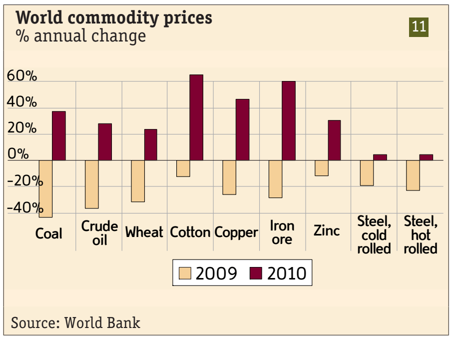
Still, monetary policy will continue to be supportive of the banking industry as the monetary sources of inflation remain subdued. In fact, during the first 11 months of the year, bank credit was 2% lower than a year ago as lenders continued to avoid excessive risk taking. Kazakh banks still have a big overhang of nonperforming loans - nearly a third of all loans at the end of 2010. While there is some improvement since the beginning of 2010, when this share was at 36%, most of this came as a result of the bad debt write-downs by BTA bank following the completion of its debt restructuring. Meanwhile, the biggest Kazakh lenders saw a worsening of the quality of their credit portfolios as lending virtually stalled last year (see chart 9). This means that banks will continue to pursue rather conservative credit policy this year as well.

That said, the baseline scenario for monetary policy assumes no growth in bank lending in 2011, with only a modest recovery in 2012 and 2013. As a result, the central bank expects inflation to stay within a 6-8% range in 2011. Furthermore, the central bank plans to return to a managed floating exchange rate in March (abandoning the current exchange rate corridor). This may help put downward pressure on inflation (many consumer goods are still imported) thanks to a gradual currency appreciation.

After all, the current account surplus was $4.2 billion in January-September 2010 compared to a deficit of $4.6 billion a year ago. Meanwhile, in 2010, the forex reserves of the central bank grew by $5.2 billion to $28.3 billion. This points to a build up of exchange rate appreciation pressures in Kazakhstan (see chart 10).

International Trade and Capital

Strong commodity prices (see chart 11) were the main driver of Kazak exports in 2010. In fact, exports of agricultural commodities (such as grains and cotton) posted robust gain thanks to both tighter global supply conditions and increasing demand from the large emerging markets. Meanwhile, exports of other commodities (most importantly, oil and base metals) were propped up by the surging demand in China and a turnaround in world manufacturing activity. As a result, during the first 11 months of 2010, exports increased by 36% to $51 billion.



At the same time, imports continued to decline, falling by about 13% versus January-November 2009. This can be mostly attributed to weaker demand for investments goods. For example, imports of oil and gas line pipes fell by 70% as domestic investments into transportation infrastructure declined by over a quarter following the completion of major pipelines a year ago. Imports of machinery and equipment were 7% lower than in 2009. Meanwhile, tight consumer lending as well as weaker currency continue to dampen demand for imported durable goods - imports of passenger vehicles dropped by nearly 80%. Indeed, if in 2007 Kazakhstan imported about 32,500 passenger cars per month, last year it bought barely 2,000 cars per month from abroad. As a result, in January-November 2010, the trade in goods surplus swelled to $29 billion from $12.2 billion a year ago.

Other Developments and Reforms Affecting the Investment Climate

Finally, in late December, Standard & Poor's and Fitch raised their sovereign credit rating on Kazakhstan due to its improved macroeconomic stability. Last year, Kazakhstan was praised by the World Bank as a top economic reformer. This, as well as other international rankings, does testify to the country's strong competitive edge over peer economies. As a result, Kazakhstan will remain an attractive target for inventors willing to bet on the economic strength of the region.