SigmaBleyzer

Kazakhstan Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

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- **Thanks to better weather conditions, Kazakhstan is on track to have its best harvest in 60 years.**
- **Industrial production grew by 4.3% during the first three quarters of 2011.**
- **In January-August, exports jumped by 46%, pushing the trade surplus to $33.7 billion.**
- **Falling food prices helped slow inflation, with consumer prices increasing by just 8.7% in September.**
- **In January-September, the state budget deficit was just 0.5% of projected full year GDP.**
- **At the end of September, the total forex reserves of Kazakhstan stood at $72.5 billion.**
- **During the first half of 2011, foreign liabilities of the banking sector shrank by 6.5% to just $18.6 billion.**
- **The World Bank placed Kazakhstan among the top 50 economies in terms of the ease of doing business. Over the last year, the country's rating has moved up by 11 points to the 47th position.**

Executive Summary

The world economy has been recently experiencing quite a bit of turbulence. European leaders are struggling to draw a quick and credible solution to Greece's problems, which elevates the threat of a contagion to larger EU economies. Meanwhile, fiscal austerity in the advanced economies in general (and in the U.S. in particular) is becoming a drag on global growth. These fiscal worries not only depress demand, but also raise uncertainties over the future of taxes and spending due to sharp political disagreements about how to fix the debt problems. Lastly, fresh data on economic growth in China and manufacturing activity in the Eurozone appears to confirm investors' concerns that a global economic slowdown may be taking hold.

That being said, strong commodity prices, increasing private consumption and a record grain harvest are sustaining growth momentum in Kazakhstan. Thus, despite the recent shift of the global economic risks to the downside, the country's GDP is still on track to grow by about 7% in 2011. In particular, several factors will continue to support economic activity in Kazakhstan.

First, the country is less exposed to the economic slowdown in the Eurozone as it exports mostly crude oil to that region. Thanks to tightness in the European energy market, the Brent crude oil price remains comfortably above $100 per barrel. Meanwhile, Chinese energy needs will continue to grow, which will keep world energy prices on the uptrend and, thus, will help sustain Kazakh export revenues.

Second, a strong rebound of personal consumption is helping to rebalance Kazakh manufacturing toward the domestic consumer. Indeed, consumer optimism is at a record high since the beginning of the economic slowdown, which is driving retail sales – they increased by 13% in the first three quarters of 2011. This gradual shift toward personal consumption as a main source of economic growth should move the Kazak economy toward more sustainable footing, since personal consumption is a less volatile component of the national economy.

Third, September marked the seventh consecutive month of annual growth of bank landing, while several encouraging trends appear to be taking hold. In particular, consumers are more confident about resuming borrowing, which adds extra strength to personal spending and residential housing activity. At the same time, tight forex liquidity favors borrowing in national currency. This should help reduce currency mismatch risks in the banking industry, which is increasingly relying on domestic deposits to fund new credit. Meanwhile, a solid pickup of corporate lending drives business investments – January-September 2011, fixed capital investments financed with loans jumped by over a third.

Lastly, this year, the World Bank placed Kazakhstan among the top 50 economies in terms of the ease of doing business. As a result, it is now a better place to do business compared to many EU member states as well as such emerging giants as China, India, Brazil, and Russia. The ease of paying taxes and investor protection are some of the key strengths of Kazakhstan, which is a big step toward encouraging more foreign investments into the nonoil sectors of the economy.

	2006	2007	2008	2009	2010	2011[f]
GDP growth, % change yoy	10.7%	8.9%	3.3%	1.2%	7%	7%
GDP per capita, $	5 262	6 757	8 398	6 710	9 100	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%	-2.5%	-2.0%
Governmet external debt (including NBK), % of GDP	2.9%	1.8%	1.6%	2.4%	2.6%	2.5%
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%	9%
Retail sales, % change yoy	15.0%	10.7%	3.1%	-3.9%	12.3%	12.5%
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	119.2	130.0
Exchange rate, tenge/$, annual average	126.1	122.6	120.3	147.5	147.4	147.0

Where Opportunities Emerge.

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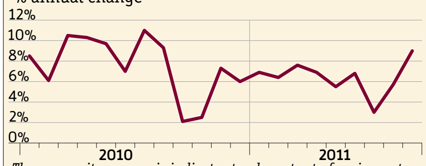
Editor Rina Bleyzer O'Malley

Economic Growth

Strong commodity prices, a solid pickup in private consumption and a record grain harvest are sustaining growth momentum in Kazakhstan. Thus, despite a recent shift of global economic risks to the downside, GDP is still on track to grow by about 7% in 2011. In fact, in September, the short-term economic indicator increased by the most in over a year, supporting the notion that economic growth strengthened at the end of the third quarter (see chart 1). Several factors will continue to support economic activity in Kazakhstan. First, the country is less exposed to economic slowdown in the Eurozone as it exports mostly crude oil to that region. Thanks to tightness in the European energy market, the Brent crude oil price remains comfortably above $100 per barrel or more than 30% higher than a year ago. Slower growth in China, which is the second largest buyer of Kazakh oil accounting for over 16% of all exports of this commodity, is of bigger concern. Yet, even with GDP growth slower than 9%, Chinese energy needs will continue to grow – according to the latest estimates of the U.S. Energy Information Administration, Chinese demand for crude oil will increase by close to 6% in 2012 versus just a 0.4% increase worldwide. This will keep world energy prices on the uptrend and, thus, will help sustain Kazakh export revenues.

Monthly short-term economic indicator 1
% annual change

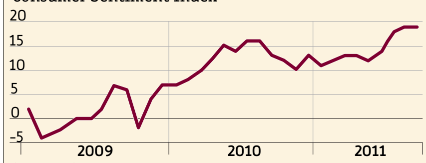


The composite economic indicator tracks output of major sectors (i.e. agriculture, industry, construction, trade, transportation and communication), which account for over two-thirds of the Kazakh economy.
Source: ASRK

Copper prices 2
cash buyer, $ per ton

Source: The London Metal Exchange

Consumers remain optimistic 3
Consumer Sentiment Index



Source: ASRK

That being said, supply side constraints may play a bigger role in limiting the upside potential in Kazakh industry. In fact, during the first three quarters of 2011, industry grew by 4.3% as mining, which still accounts for nearly two thirds of industrial production, posted a relatively modest gain of just 2.4%. After all, maintaining oil extraction growth at previous rates is becoming more difficult due to increasing technological challenges, and, thus, much higher investment costs. For example, a joint venture of state and foreign oil companies, developing the largest offshore Kashagan oil field, has already invested about $33 billion into the first phase of the project. The first oil is expected to flow by the end of 2012, with output reaching about 370,000 barrels a day. However, the second phase of output expansion has stalled because of disagreement about project costs, and should now be completed in 2017 or 2018.[1]

The mining sector aside, weaker foreign demand may have a negative impact on Kazakh manufacturing. In particular, metallurgy still represents more than 40% of Kazakh factory activity. Thus, slower growth of global manufacturing and construction industries, especially in the emerging world, may sap some energy from the ongoing economic recovery in Kazakhstan. In fact, copper prices – a bellwether for industrial metals, which have staged a remarkable recovery since the beginning of the global recovery (see chart 2), have been falling recently (although prices remain much higher than two years ago) on fears of slowing demand in China, which accounts for nearly half of all copper exports from Kazakhstan.

On the upside, a strong rebound of personal consumption and an uptick in construction activity help rebalance Kazakh manufacturing toward domestic consumers, which bodes well for such industries as food processing, manufacturing of building materials and carmakers. Consumer optimism is at a high since the beginning of the economic slowdown (see chart 3), which is driving up retail sales – they increased by 13% in the first three quarters of 2011. A solid turnaround in domestic trade and increasing consumer spending help sustain business activity in transportation, travel and communication services as well.

More importantly, a shift toward personal consumption as a main source of economic growth is a recent development for the Kazakh economy. Prior to the global financial crisis, a big portion of the country's economic growth was driven by capital spending, largely financed through a rapid, albeit unsustainable, expansion of private banks. Yet, unlike investments, personal consumption is a less volatile component of the national economy. Thus, there is reason to believe that the Kazak economy is moving toward more sustainable footing.

Lastly, better weather conditions led to the best harvest in nearly 60 years. As a result, in January-September, output in agriculture was 11% higher than a year ago. This helps offset slowing output growth in industry.

Fiscal Policy

It is worth mentioning that the government is responsible for a big part of the strength in consumer spending. Following the financial crisis and an escalation in the prices of basic consumer staples, the government implemented a series of large upward adjustments to

[1]Source: KazMunaiGaz

social benefits and public sector wages. In July alone, public sector wages were boosted by 30%. A strong rebound of tax revenues, on economic recovery and a higher crude oil export duty, made these policies feasible without denting public finances – in January-September, the state budget deficit was just 0.5% of projected full year GDP (see chart 4).

However, as tax revenues return to more normal growth rates, higher social spending risks widening the structural budget deficit. On that note, the government intends to pursue a more balanced fiscal policy - the recently approved budget is targeting a deficit reduction to just 1.3% of GDP in three years. After all, as inflation gradually decelerates, there is less pressure to adjust nominal social benefits.

Higher world energy prices are a boon to public finance as well. During the first nine months of 2011, the assets of the National Oil Fund, which, among other things, are used to finance budget spending, stood at $40 billion or $9 billion higher than at the start of the year. This financial firepower compares exceptionally well with just $18 billion in the National Oil Fund at the start of 2008. Thus, this time Kazakhstan has a much better buffer against global economic shocks (see chart 5).

Monetary Policy

In September, consumer prices grew by just 0.3% versus the month before as prices of staple foods (such as cereals and fruits and vegetables) continued to fall for the second straight month. As a result, annual inflation slowed to 8.7% as prices of nonfood products were just 5.6% higher than a year ago, while food inflation dropped to its lowest level in 2011 (see chart 6).

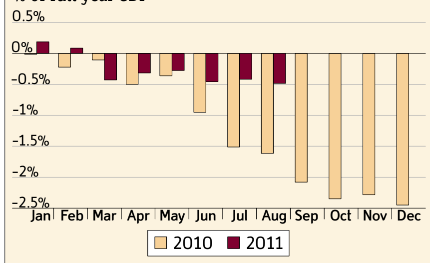
September marked the seventh consecutive month of annual growth in bank landing (see chart 7). Meanwhile, several encouraging trends appear to be taking hold. First, a stronger economic environment may be making consumers more confident in resuming borrowing – credit to households registered its fifth annual gain in September. This should add extra strength to personal spending and residential housing activity. Second, tight forex liquidity favors borrowing in national currency. Thus, the share of bank credit denominated in local currency jumped from 52% at the beginning of 2010 to over 63% in September. This should help reduce currency mismatch risks in the banking industry, where the share of deposits in national currency is about 67%. After all, still problematic access to international debt markets makes Kazakh lenders rely on domestic deposits to fund new credit. Lastly, a solid pickup in bank lending to the corporate sector bodes well for business investments. In fact, in January-September 2011, fixed capital investments financed with loans jumped by nearly 35% in real terms versus the first three quarters a year ago.

International Trade and Capital

In January-August, Kazakhstan's exports jumped by 45.6%, pushing the trade in goods surplus to $33.75 billion. Overseas shipments of crude oil and gas concentrate, which represents about 65% of all exports, grew by 50% thanks to a 18% growth of exports (by volume) to China and a 60% increase to the Netherlands, mostly due to the Middle East supply disruptions. Meanwhile, Chinese demand is also sustaining healthy gains in Kazakh exports of nonferrous metals (for example, copper) and uranium.

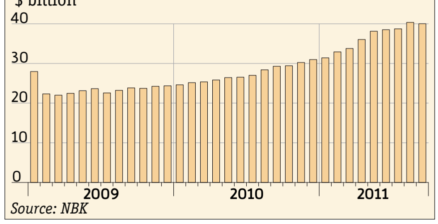
During the first half of 2011, the total external debt of Kazakhstan increased by 5% (or by about $6 billion) since the beginning of the year. That said, the external liabilities of banks dropped to their lowest level since mid-2006 (see chart 8). Thus, most of the new debt resulted from increasing borrowing by other sectors of the economy. In addition, considering that the oil industry accounts for the biggest chunk of the external debt owed by the non-financial companies, most of this new debt came as intercompany lending. As a result, the share of intercompany lending in total external debt grew to 45%.

State budget balance 4
% of full year GDP



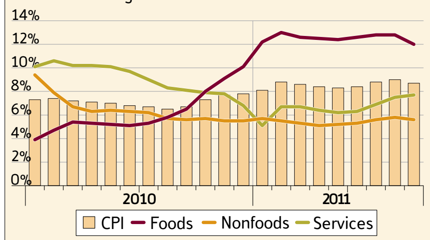
Source: Ministry of Public Finance, ASRK

Assets of the National Oil Fund 5
$ billion



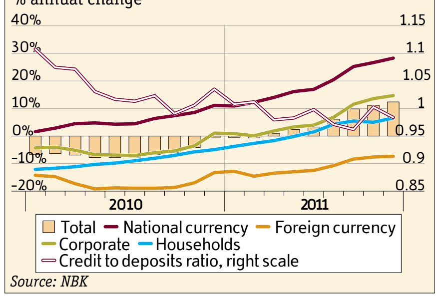
Source: NBK

Consumer inflation 6
% annual change



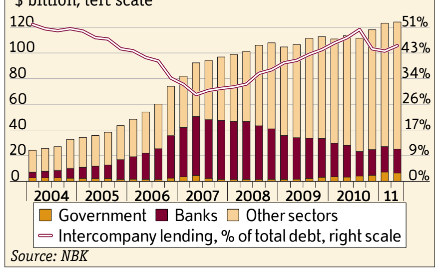
Source: ASRK

Bank credit by currencies and borrowers 7
% annual change



Source: NBK

Foreign external debt 8
$ billion, left scale



Source: NBK

Other Developments Affecting the Investment Climate

The latest Doing Business Report places Kazakhstan among the top 50 economies in terms of the ease of doing business. Over the last year, the country's rating has moved up by 11 points (see chart 9), which makes Kazakhstan a better place to do business than many EU member states as well as such emerging giants as China, India, Brazil and Russia. The ease of paying taxes and investor protection are some of the key strengths of Kazakhstan. This means that the commitment of the government to improving the business climate is bearing fruit. More than that, it implies that Kazakhstan is a credible and reliable partner– which is a big step toward encouraging more foreign investments into the nonoil sectors of the economy.

Doing Business 2012 9
Ease of doing business rank

Economy	Rank	Economy	Rank
Georgia	16	Czech Rep.	64
France	29	Turkey	71
Portugal	30	Romania	72
Netherlands	31	Italy	87
Chile	39	China	91
Spain	44	Russia	120
Kazakhstan	47	Brazil	126
Hungary	51	India	132
Mexico	53		
Bulgaria	59		
Poland	62		

Source: The World Bank