SigmaBleyzer

Kazakhstan

Macroeconomic Situation

THE BLEYZER FOUNDATION

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- **Last year the Kazakh economy grew by 1.2%.**
- **In 2009, the state budget deficit approached 3% of GDP.**
- **In 2009, consumer prices grew by only 6.2% compared with 10% and 19% in 2008 and 2007.**
- **Funding pressure in the banking sector are likely to persist in 2010.**

Executive Summary

Last year the Kazakh economy grew by only 1% as tight bank lending restrained private demand. Nevertheless, steady growth in the mining industry has mitigated difficulties in other sectors. Meanwhile, improving foreign demand for Kazakh metals supported a turnaround in manufacturing during the second half of 2009. That said, on the balance, near-term economic performance will be driven by external factors, most importantly by the strength of the economic rebound in developing countries. At the same time, domestic demand is unlikely to regain its precrisis momentum under the weight of the ongoing restructuring in the banking sector.

Stabilization of the banking sector and social protection were the main priorities of the Kazakh government in 2009. At the beginning of the year, the government withdrew the equivalent of 15% of GDP from its Oil Fund to support the financial sector and the real economy. This helped stabilize the banking sector, while a full-scale financial panic was avoided. Investors' confidence appears to be returning and debt renegotiation talks are advancing, which will allow distressed banks to reemerge as viable lenders. Indeed, in January, Fitch revised outlooks for the two largest Kazakh banks to stable, while, according to S&P, the likelihood of new bank defaults in Kazakhstan remains very low.

In 2009, the state budget deficit approached 3% of GDP or about 10% if transfers from the National Oil Fund, which amounted to over 30% of all budget revenues, are not included. However, public external debt stood at around 2% of GDP, while total public and publicly guaranteed debt remained below 13% of GDP. That said, the low levels of external debt and large forex reserves are still supporting a sufficient degree of fiscal flexibility to prop up the economy.

Last year, monetary policy was broadly successful as well. In 2009, consumer prices grew by only 6.2% compared with 10% and 19% in 2008 and 2007. Meanwhile, the central bank expects inflation to remain within 6-8% in 2010 as incomes and credit growth remain subdued.

Funding pressure in the banking sector are likely to persist due to the lack of external financing, large losses and a growing share of bad loans. Foreign debt restructuring by Alliance Bank, BTA Bank, and BTA-owned Temirbank weighs on the banking sector recovery as well. Furthermore, the government still has to define its exit strategy from the banks' capital, which adds to the uncertainty in the banking industry.

Currency devaluation in February 2009 helped protect forex reserves and curbed the current account gap. Indeed, falling demand for imports and a reversal of the downtrend in export prices helped narrow the current account deficit to only $0.5 billion in the third quarter of 2009. Meanwhile, by the beginning of this year, Kazakhstan had $47.6 billion in forex reserves, which will allow the central bank to move back toward a more flexible exchange rate in 2010.

	2005	2006	2007	2008	2009*	2010**
GDP growth, % change yoy	9.7%	10.7%	8.9%	3.3%	1.2%	2.0%
GDP per capita, $	3 754	5 262	6 757	8 398	6 900	8 300
Industrial production, % change yoy	4.8%	7.2%	5.0%	2.1%	1.5%	-
State budget deficit, % of GDP	0.6%	0.8%	-1.7%	-2.1%	-3.1%	-
Governmet external debt (including NBK), % of GDP	1.8%	2.9%	1.8%	1.6%	2.4%	-
Unemployment, end of period	8.1%	7.8%	7.3%	6.6%	6.3%	-
Inflation, end of period	7.6%	8.4%	18.8%	9.5%	6.2%	6-8%
Retail sales, % change yoy	13.5%	15.0%	10.7%	3.1%	-2.0%	-
Gross forex reserves of the NBK, $ billion, end of period	7.1	19.1	17.6	19.9	23.2	-
Assets of the National Oil Fund, $ billion, end of period	8.1	14.1	21.0	27.5	24.4	-
Current Account Balance, $ billion	-1.1	-2.0	-8.2	6.6	-2.8	2.0
External debt, $ billion	43.4	74.0	96.9	108.1	111.3	120.0
Exchange rate, tenge/$, annual average	132.9	126.1	122.6	120.3	147.5	145.0

* Estimates, data on the external debt as of Q3 2009

** Projections

Source: ASRK, NBK, Ministry of Finance of Kazakhstan, IMF, Economist Intelligence Unit

Economic Growth

Kazakhstan faced several major difficulties in 2009, as funding pressures and large write-downs on loans forced several large Kazakh banks to halt payments on foreign debts. Meanwhile, devaluation pressures reemerged on the back of large foreign debt repayments by banks, falling prices of oil and metals and the current account deficit. Yet, notwithstanding these challenges, the country managed to steer away from the sharp recession experienced by many peer economies. According to preliminary estimates, the economy gained only 1%, however it is on track to return to stronger growth in 2010.

First, thanks to the healthier stance of the major resource-intensive developing economies, prices of crude oil and industrial metals are no longer headed downwards (see chart 1). As a result, the Kazakh export-driven mining sector is emerging as the largest contributor to economic growth. In 2009, the extraction of oil and gas condensate increased by nearly 8%, securing a 1.7% annual growth of industrial production. Equally important, a resumption of foreign demand for Kazakh metals in the last quarter of 2009 helped stop a manufacturing decline. This, in turn, added strength to the utilities sector as demand for electricity returned.

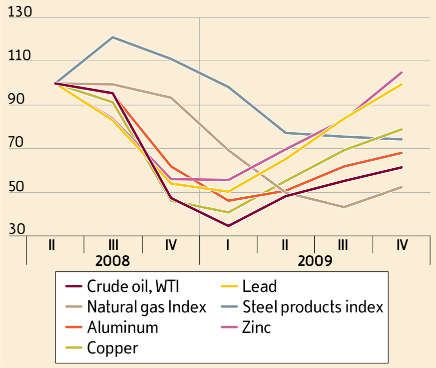
However, metallurgy, which accounts for about 40% of Kazakh manufacturing, is still operating below its precrisis capacity. In December 2009, output in metallurgy remained smaller than two years ago on the back of double digit production cuts at the end of 2008 (see chart 2).

All said, the medium-term economic outlook will remain tightly linked to the performance of the oil industry. This sector continues to absorb most of the foreign direct investment (nearly 70% in the first three quarters of 2009) and accounted for about one third of all fixed capital investments in 2009, which grew by over 40% in the oil and gas industry. In addition, in 2009 Kazakhstan signed several large bilateral agreements to increase and diversify its energy exports. In particular, a $10 billion deal with China stands out as an example to reroute oil and gas exports to faster growing emerging markets. After all, nearly a third of the new demand for liquid fuels is expected to come from China (see chart 3). That said, China is already on track to become the largest trading partner of Kazakhstan - in 2009, it was the second largest importer of Kazakh products, accounting for over 13% of all Kazakh exports.

On top of that, last year saw the completion of oil and natural gas pipelines linking China and Western Kazakhstan. This will help loosen capacity constraints of the Caspian Pipeline Consortium - the main route of Kazakh oil shipments to European consumers. Finally, the Kashagan oil field is to start production by 2013, which means that investments and output in the mining sector will continue expanding. Tight oil supply conditions in other parts of the world and an eventual economic recovery should help keep oil prices firm (see chart 4). This implies that the pace of the global economic rebound will play an important role in Kazakhstan's near-term performance.

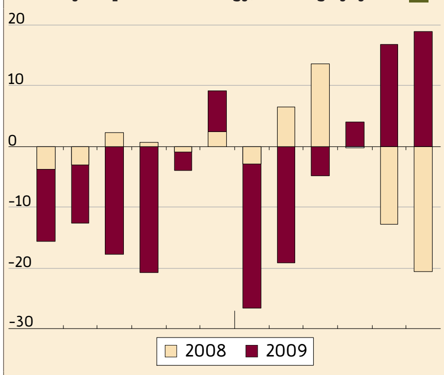
Meanwhile, the strength of domestic demand looks likely to lag behind its pre-crisis levels. Tight bank lending remains a major constraint on domestic consumption and investments. The precrisis credit boom was funded with wholesale foreign borrowing, which led to a five-fold increase in banks' foreign debts. This rapid credit growth created significant excess capacity in construction and elevated risks of a future surge in bad loans. A closure of international credit markets made the refinancing of Kazakhstan's foreign liabilities in the banking sector difficult. At the same time, slower economic growth pushed the share of non-performing loans above 36% by the end of 2009. About two

Commodity prices, quarterly averages, Q2 2008=100 1



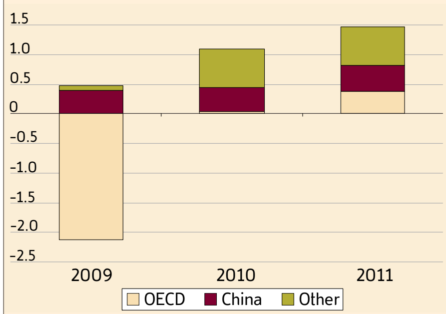
Source: World Bank, Commodity Price Data (Pink Sheet)

Monthly output in metallurgy, % change yoy 2



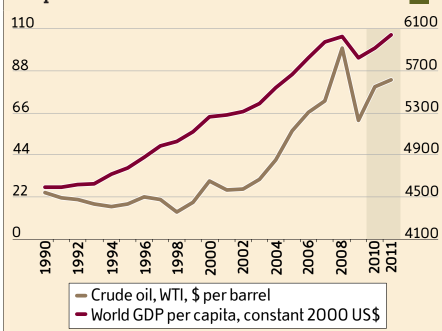
Source: ASRK

World liquid fuels consumption growth, annual change, million barrels per day 3



Source: The U.S. Energy Information Administration, Short-Term Energy Outlook January 2010

Oil prices and world GDP 4



Source: The U.S. Energy Information Administration, The World Bank (WDI, Global Economic Prospects 2010) thirds of these loans sit on the books of just three Kazakh banks, which were behind the precrisis expansion in bank lending. In 2009, all three banks failed to service their debts and are now restructuring about $20 billion of foreign loans. As a result, the creation of new credit may remain weak as funding pressures are unlikely to recede in the coming years, not to mention a significant build up of provisions against credit losses. All said, as the banking sector gradually returns to normalcy, GDP growth may linger in the low single digit territory over the next several years.

On the upside, Kazakhstan's economy appears to be regaining its growth momentum, supported by recovering foreign demand for energy and metals. A stabilization of oil prices, a reduction of the current account deficit and moderate repayments of external debts will help avoid the resumption of depreciation pressures. Finally, real wages increased in 2009, while the unemployment rate stayed below 7% (see chart 5). True, the growth of real wages is well below precrisis levels; however, stable employment conditions and growing incomes should sustain consumer spending. Indeed, the last quarter of 2009 saw a turnaround in retail sales on improving consumer sentiments and a better economic outlook (see chart 6).

Fiscal Policy

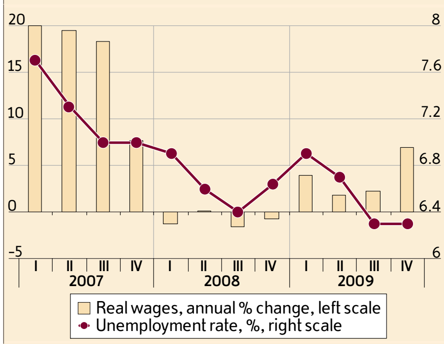
Stabilization of the banking sector and social protection were the main themes of Kazakhstan's fiscal policy in 2009. First, at the beginning of last year, the government withdrew the equivalent of 15% of GDP from its Oil Fund to support the financial sector and the real economy. The resulting injection of public money into the banking sector and the provision of funds to launch loan refinancing programs worked well in stabilizing the banking sector and averting a full-scale financial panic. All of these helped sustain investors' confidence and facilitated debt renegotiation talks.

Second, large forex reserves, accumulated thanks to the prudent management of oil revenues, allowed the government to offset falling tax receipts without significantly increasing new borrowing. Although the state budget deficit approached 3% of GDP in 2009 (or about 10% of GDP if transfers from the National Oil Fund, which amounted to over 30% of all budget revenues, are not included - see chart 7), public external debt stayed at around 2% of GDP (total public and publicly guaranteed debt is at about 13% of GDP).

In 2009, state budget revenues fell by 13% on the back of a 21% decline in tax revenues. In particular, proceeds from the corporate income tax and VAT (which jointly account for over a half of all tax revenues) fell by 30% yoy and 20% yoy, respectively. This reflects lower volumes of domestic and international trade as well as shrinking corporate profits under the weight of heavy losses in the banking industry.[1] Meanwhile, in 2009, the state budget expenditure (excluding purchases of financial assets, budget credits and debt repayments) grew by 14% yoy, following a 22% increase the year before. This growth was driven by increasing state spending on wages, pensions and goods and services. As a result, the budget current expenditures, which now account for over 73% of total spending, increased by 20%, while capital expenditures stayed mostly flat and their share in budget spending dropped below 27% (from over 30% in 2008.) That said, the government appears to be applying income and employment friendly fiscal measures to boost private demand.

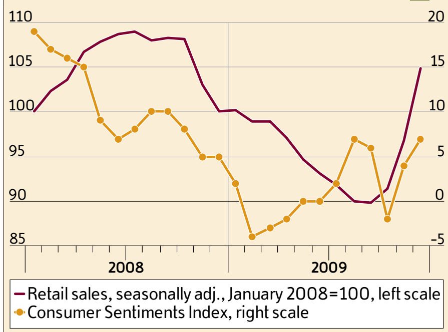
The big question is whether such policies can rekindle inflation. At present, the resurgence of price pressures looks unlikely. First, the state budget current expenditure is

Quarterly unemployment rate and real wages 5



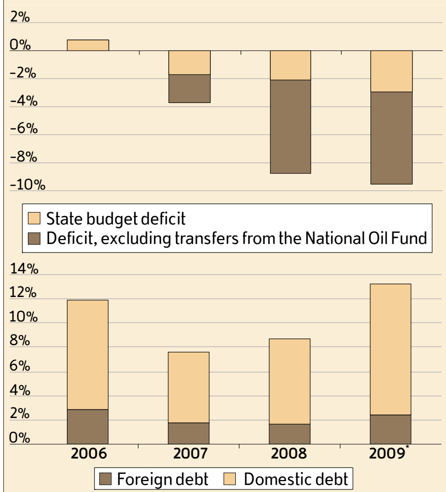
Source: ASRK

Consumer sentiments and retail sales 6



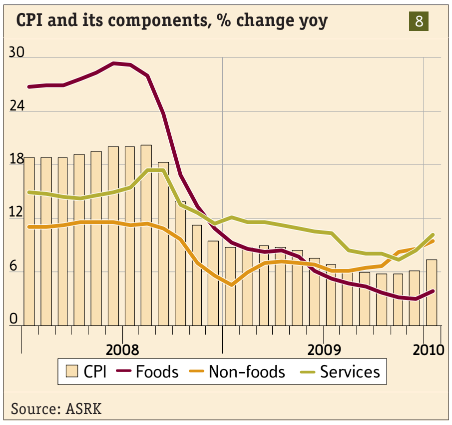
Source: ASRK, The Bleyzer Foundation

State budget deficit and public and publicly guaranteed debt (including domestic debt of the central bank), % of GDP 8

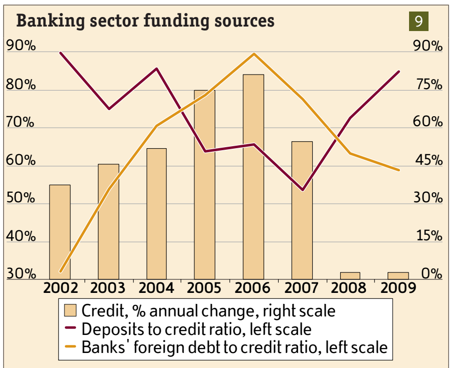


*Estimates
Source: Ministry of Finance of Kazakhstan, NBK

[1] According to the Agency on Financial Supervision, the banking industry of Kazakhstan reported a loss of over $19 billion in 2009.



Source: ASRK



Source: NBK

just returning to its precrisis levels in real terms following a steep deceleration on the back of the double digit inflation in 2008. Second, a weaker currency will continue to restrain consumer demand for imports, which means that higher government spending is unlikely to generate an immediate pressure on the current account deficit. Indeed, in 2009, the state budget current expenditure measured in dollar terms fell by 1.7% yoy. Finally, the supply of credit remains weak as banks struggle to find new domestic and external funding sources. As a result, in 2009 the money supply grew at the lowest pace in ten years. All this implies that the fiscal policy may remain relatively loose without the risk of stoking up inflationary expectations.

In 2010, fiscal policy is likely to remain accommodative as well, partially offsetting sluggish private demand. Low levels of external debt and large forex reserves allow the government to support the economy without putting at risk its long-term fiscal sustainability. Several corrective fiscal measures, including a delay of tax cuts and a spending freeze on some budget programs, add to the government credibility as well. This allows Kazakhstan to tap foreign credit markets for deficit financing at relatively attractive terms. Indeed, according to JPMorgan, emerging sovereign debt spreads over U.S. Treasuries shrank by over 400 bps in 2009. Kazakhstan is already considering issuing its first sovereign Eurobonds in over a decade. The government has also taken a relatively tough stance on the restructuring of banks' debts, refraining from full and unconditional bailouts. Although this may restrain banks' access to international funding in the future, it is likely to speed up debt renegotiations and may accelerate a return to normalcy in the banking industry. In addition, this should strengthen the sovereign creditworthiness of Kazakhstan by limiting fiscal exposure to the banking crisis. In fact, this year, credit default swaps on Kazakhstan's sovereign debt stood at around 200 basis points (bps), having surpassed 1,600 bps at the peak of the global financial distress in February 2009.

Monetary Policy

Last year, monetary policy was broadly successful as well. First, in 2009, consumer prices grew by only 6.2% compared with 10% and 19% in 2008 and 2007. The National Bank (NBK) expects inflation to remain within 6-8% in 2010, which leaves enough room for a gradual and orderly transition toward tighter monetary policy.

In January 2010, consumer prices grew by 7.3% yoy (see chart 8). In particular, increasing utility and telecommunication tariffs pushed monthly inflation to 1.4% - the highest level in two years. At the same time, this increase of service tariffs can be attributed to a one-off adjustment of prices charged by utility companies[2], and the rise of a monthly fee for local land-line phone calls by Kazakhtelecom.

That said, inflation pressures are likely to remain subdued on the back of a slow growth of household incomes and bank lending. In 2009, the stock of tenge denominated credit fell by 5% yoy, while forex denominated credit[3] shrank by 9% yoy. Tenge and forex denominated credit to households declined by 10% yoy and 15% yoy, respectively. Meanwhile, tenge and forex denominated deposits grew by 4% yoy and 20% yoy. Tenge denominated household deposits fell for the second consecutive year, while forex denominated household deposits increased by 42% yoy in 2009, following a 17% yoy gain the year before. This may reflect consumers' willingness to hedge against exchange rate fluctuations. Indeed, prices of many consumer goods are linked to the exchange rate because of the high share of imports. Meanwhile, trust in the national currency still has to recover after last year's devaluation.

Putting the banking industry on a more sustainable footing requires banks to focus on domestic deposits. Before the financial crisis, the ratio of retail and corporate deposits to credit dropped to 60% (see chart 9), implying that bank lending tended to grow significantly faster than the banks' deposit base. This means that a return to the past credit dynamics may not be feasible as banks are increasingly turning to local funding sources.

[2] Starting January 1st, Kazakhstan introduced differential tariffs for water usage, which led to a 10% monthly increase in water tariffs. In addition, in January the Agency of the Republic of Kazakhstan on regulation of natural monopolies cleared the way for electricity distribution companies to raise electricity prices.

[3] Forex denominated numbers refer to credit and deposit stocks measured in U.S. dollars.

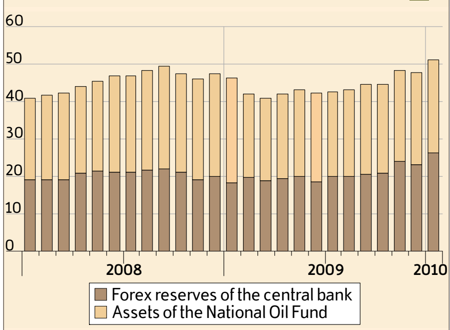
Foreign debt restructuring by Alliance Bank, BTA Bank, and BTA-owned Temirbank is likely to weigh on the banking sector recovery as well. On the upside, the Alliance Bank has already reached an agreement to restructure its $4 billion debt. In January, the National Welfare Fund Samruk-Kazyna acquired Alliance Bank because its shareholders failed to increase bank's capital to regulatory requirements. Samruk-Kazyna will increase bank's capital by $160 million through a purchase of common shares and will convert its demand rights on bank's bonds (about $690 million) into preferred shares. In December, BTA Bank announced a deal to restructure about $5.6 billion of its outstanding debts (or nearly a half of outstanding principal and interest). The bank plans to repay about $1 billion in cash to the creditors and refinance $3 billion with the issue of new debt. This restructuring is expected to be finalized in April (Samruk-Kazyna is expected to own about 85% of the bank). As a result, according to the minister of Economy and Budgetary Planning of Kazakhstan, the total foreign debt of Alliance Bank and BTA Bank may decrease by $10 billion after restructuring.

Finally, at present, Samruk-Kazyna is the largest shareholder of BTA Bank (75.1%), owns Alliance Bank (100%) and holds significant stakes in two other Kazakh banks - Halyk Bank (27.9%) and Kazkommertsbank (21.3%). This means that the government's exit from the banking sector will play an important role in economic recovery. In particular, Samruk-Kazyna may start negotiating the sale of a large stake in BTA Bank to Russia's largest state-owned Sberbank. This means that BTA Bank may reemerge as a viable lender, which should add strength to the eventual recovery of the banking sector. Nevertheless, the government still has to come up with a clear plan to withdraw from the banking industry.

International Trade and Capital

One-off currency devaluation in February 2009 helped protect forex reserves, curbed the current account gap and partially recovered the lost competitiveness of local producers. Indeed, the exchange rate remained mostly stable in 2009, with appreciation pressures reemerging in the last quarter of 2009. A weaker currency, falling private demand for imports and a reversal of the downtrend in export prices helped narrow the current gap to only $0.5 billion in the third quarter of 2009. In 2009, forex reserves grew by 17% to $23.2 billion. This means that by the beginning of this year, Kazakhstan had $47.6 billion in forex reserves and assets of the National Oil Fund (or over 40% of GDP, see chart 10). Meanwhile, according to the NBK, local banks have to repay only $7 billion (only 6% of GDP) in 2010. As external funding pressures retreat, the NBK appears to be moving back toward a more flexible exchange rate. Starting February 5th, the exchange rate band will be widened to -15% and +10% around the 150 tenge per USD target rate (the previous band allowed for only 3% fluctuations).

Forex reserves of Kazakhstan, $ billion 10



Source: NBK