Kazakhstan
Macroeconomic Situation

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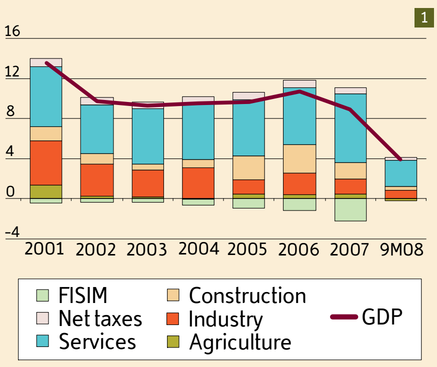
Summary

- Preliminary estimates place GDP growth at around 3% yoy in 2008.
- In 2008, industry grew by 2.2% yoy.
- According to the Law on the Republican Budget 2009-2011, the budget deficit is set at 3.4% of GDP in 2009.
- In 2008, the consumer price index grew by only 9.5% yoy.
- In 2008, the stock of domestic credit grew by 2.7% yoy compared to 55% yoy the year before.
- In January-November 2008, the foreign trade surplus widened to USD 32.7 billion.
- During the first nine moths of 2008, the current account surplus amounted to USD 9 billion.
- The National Bank of Kazakhstan switched to a new exchange rate band of 150 KZT/USD plus/minus 3%.

Economic Growth

2008 has been a challenging year for Kazakhstan. Indeed, having grown by about 10% yoy on average over 2001-2007, the economy slowed down to 3% yoy in 2008 as growth in construction, industry, trade and financial activities decelerated to low single-digit levels. Above all, the seeds for this slowdown were sown several years ago as the changing composition of the growth factors made the economy particularly vulnerable to a sudden disruption of global financial markets. If in 2001-2004, the economic recovery was built on the rapid development of the oil sector, the economy was supported by the ample supply of banking credit in 2005-2007.

Contribution to GDP growth, percentage points



FISIM — Financial Intermediation Services Indirectly Measured
Source: ASRK, The Bleyzer Foundation

In particular, during 2001-2004, industry contributed over 30% to GDP growth as the extraction of crude oil grew on average by 13.5% yoy, supported by the rapid development of production and transit capacities. In 2005-2007, crude oil extraction grew by only 3% yoy on average as time and investments needed to develop new or expand existing oil fields increased. Meanwhile, in 2005-2007, growth in the financial sector accelerated to 43% yoy on average from 19% yoy in 2001-2004. This dynamic advance of the financial industry was fueled with the fast accumulation of external debts by the Kazakh banks. Indeed, the total external debt of the commercial banks ballooned from USD 7.7 billion at the end of 2004 to 47 billion at the beginning of 2008. The ensuing credit boom inflated the real estate bubble, while growth in construction accelerated to 31% yoy from 18% yoy in 2001-2004. This meant that the contribution of construction and the financial sector to GDP growth increased from about 16% on average in 2001-2004 to over 40% in 2005-2007 (see chart 1). As a result, these two sectors ensured nearly half of the economic growth, while producing less than 15% of GDP. However, the sustainability of this growth pattern relied on continuing massive inflows of foreign capital. A sudden stop of these inflows at the onset of the global credit crisis brought economic activities in the construction and banking sector to a halt. This, in turn, triggered a considerable deceleration of GDP growth.

A steady expansion of oil production and this year's weak performance of the non-oil economy helped to increase the share of the mining industry in GDP from 11.4% in 2001 to over 20% in January-September 2008. Indeed, since 2000 the oil production capacity of Kazakhstan nearly doubled to 1.4 million barrels per day. This means that despite the robust growth of the non-resource based sectors, the economy still remains profoundly dependent on the oil industry. For example, in 2008, the mining sector grew by 5.3% yoy compared to 2.6% yoy the year before. This higher growth was mostly driven by increasing crude oil production, which advanced by 5.3% yoy compared to 3.1% yoy in 2007. More than that, it helped to offset about 30% of the 9.3 percentage points decline of the growth rate in manufacturing, where output fell by 2.6% yoy in 2008 compared to a growth of 6.7% yoy a year ago. As a result, in 2008, industry decelerated to 2.1% yoy from the 4.5% yoy growth during the last year. Above all, this slower growth resulted from the sharp deterioration of business conditions in manufacturing. In particular, output growth in food processing, the chemical industry and fuel processing more than halved under the pressure of deteriorating domestic and external demand. Output in metallurgy, which generates 42% of total output in manufacturing, shrank by 1.1% yoy as falling global demand for iron and steel triggered an 11.3% yoy reduction of the production of ferrous metals. More important, sectors producing construction materials and transportation vehicles saw their output decline by 23.4% yoy and 21% yoy, respectively. These drops alone subtracted nearly 3 percentage points from the growth in manufacturing. All told, difficulties in the banking industry and construction have spilled over into the manufacturing sectors as well. Indeed, reeling retail lending depressed demand for housing and durable goods and continues to send shock waves through the Kazakh producers of building materials and car manufacturers. Finally, the deteriorating global economy does not bode well for the iron and steel industry. This means that Kazakh metallurgical sector will remain under stress as global consumers of industrial metals continue to face shrinking demand for their products.

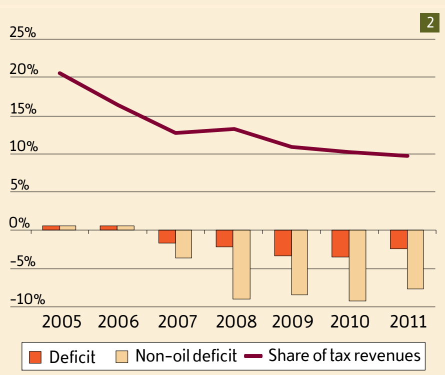
All in all, 2009 appears to pose fresh challenges for Kazakhstan. Above all, a recent downward correction of world crude oil prices, which averaged around USD 100 per barrel in 2008 growing by nearly 40% yoy, looks increasingly likely to rekindle concerns over the sustainability of the country's external financing gap. Metallurgy, which also depends on healthy external demand, may struggle to survive in a more trying global environment. Finally, as foreign creditors continue to shy away from risky bets, capital inflows into Kazakhstan are unlikely to return to pre-crisis levels. This means that the external environment may be less favorable to Kazakhstan in 2009. Nevertheless, there are several bright spots in the country's economic outlook. First, a stable currency, low inflation and tax cuts will help to maintain investors' and consumer confidence and will lay the ground work for a gradual economic recovery. Second, Kazakhstan's economic stabilization program has a good potential to stabilize the banking system and revitalize retail and corporate lending. Third, the central bank will have more room for monetary loosening in an environment of subdued inflationary pressures. Finally, responsible fiscal policy and the ongoing expansion of Kazakhstan's oil production will support the country's international creditworthiness. This will help to keep risk premiums on sovereign and private debts at a competitive level and should facilitate the country's access to international credit markets.

However, many uncertainties continue to cloud the economic outlook. After all, Kazakhstan's recent economic growth was largely supported by favorable external factors such as high commodity prices and record inflows of foreign capital. As the global economic slowdown is still gathering intensity, Kazakhstan can hardly rely on these external drivers as a source for near-term economic recovery. This means that GDP growth in 2009 will almost exclusively rely on the success of domestic stabilization policies. All told, a gradual recovery of bank lending should help stabilize the housing sector and may support economic growth. Still, this growth is unlikely to surpass 3% yoy in 2009.

Fiscal Policy

According to the Law on the Republican Budget 2009-2011, the budget deficit is set at 3.4% of GDP in 2009, up from a 2.1% deficit in 2008 (see chart 2). Although, the government intends to spend 13.5% less in 2009 than in 2008, this higher deficit comes as a result of the reduction of the corporate income tax (CIT) by 10 percentage points (pp) and the value added tax (VAT) by 1 pp. Proceeds from the CIT and VAT generate more than 80% of all tax revenues of the republican budget and account for over half of total republican budget revenues. This means that tax revenues are projected to decrease by 13% yoy in 2009 as revenues from the CIT and VAT fall by approximately 24% yoy and 4% yoy, respectively. Meanwhile, the ratio of tax revenues to GDP is expected to shrink from about 16% on average in 2005-2008 to 10% in 2009-2011. All told, the republican budget will continue to receive sizable transfers from the National Oil Fund to finance the economic stabilization program. Indeed, the ratio of these transfers to GDP surged to nearly 7% in 2008 and will average around 5% in 2009-2011.

The Republican Budget Balance, % of GDP



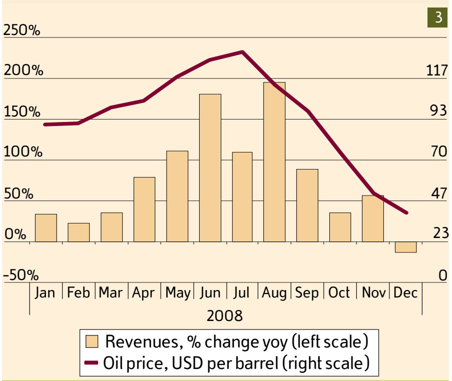
Non-oil deficit - republican budget deficit without transfers from the National Oil Fund.
Source: Ministry of Finance, the government of Kazakhstan, The Bleyzer Foundation

Although the announced fiscal loosening may force the government to cut back or delay its non-essential expenditure programs, spending on social security and protection will continue to grow. In particular, starting January 2009 minimum wages and pensions will be raised by 12% and 25% in nominal terms, respectively. This may add an extra boost to consumer demand, while the inflationary implications are likely to remain restrained as these increases amount to only a 6% growth in real terms against January 2007.

In 2008, the state budget deficit totaled USD 2.75 billion or about 2.2% of GDP. Budget revenues grew by 33% yoy as transfers from the National Oil Fund to the state budget amounted to nearly USD 9 billion, surging by over 4 times compared to 2007. Essentially, these transfers were used to increase the capital of the Samruk-Kazyna National Welfare Fund (Samruk-Kazyna). This fund will implement the government economic stabilization program through the recapitalization of the systemic banks and investments into the real sector of the economy. In particular, the first phase of the liquidity support of the banking sector, during which Samruk-Kazyna will deposit USD 1 billion at each of the two largest banks - Halyk Bank and Kazkommertsbank, may be completed by the end of January. The government is to take a 25% stake in each of the banks as part of this deal. In addition, the government will nationalize the largest bank of Kazakhstan, BTA Bank, by increasing its stake in the bank's capital to 78.14% to maintain healthy capital adequacy ratios. Finally, Samruk-Kazyna will start selling bonds to the National Oil fund in the amount of USD 4 billion to finance other components of the stabilization program.

This means that the performance of the oil sector remains crucial to the budget outlook. Indeed, record high oil prices helped to boost the revenues of the National Oil Fund by over USD 13 billion in 2008 as tax revenues from the oil producers jumped by 68% yoy or to USD 1.2 billion per month on average. Although about two thirds of these revenues were spent by the government in 2008, the assets of the Oil Fund still grew by 17% yoy to USD 27 billion. However, a sharp downward correction of the world crude oil prices looks increasingly likely to exert a heavy toll on the revenues of the Oil Fund in 2009 (see chart 3). True, lower oil prices will be partially offset with increasing crude oil output. Nevertheless, the monthly revenues of the Oil Fund are likely to go under USD 1 billion if global demand for energy remains weak. In particular, the government projects that the revenues of the Oil Fund will fall by 44% in 2009 compared to 2008. As a result, the assets of the National Oil Fund may grow significantly slower than during the last several years as the lion's share of the fund's revenues will be transferred to the state budget. Indeed, according to the Law on the Republican Budget, these transfers may exceed USD 25 billion in 2009-2011.

Monthly Revenues of the National Oil Fund



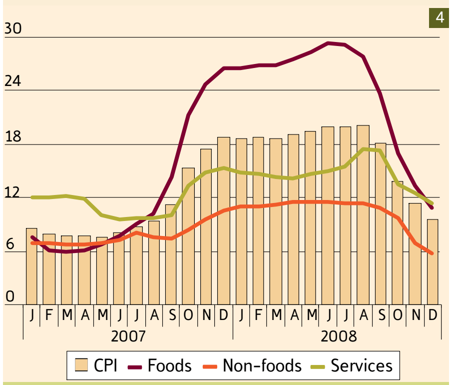
Source: Ministry of Finance of RK, US Energy Information Administration

On the positive side, these transfers are to be used to support the banking system and finance the implementation of tax reform. Both measures bode well for the fiscal sustainability in the long- term, which justifies higher spending from the National Oil Fund during the adjustment period. In particular, a solvent and liquid banking system is indispensable to prop up domestic demand in an environment of rapidly weakening external demand for commodities, while a shift toward more liberal tax treatment of the non-extractive industries should help accelerate economic diversification. Although the required fiscal expansion will certainly widen the budget deficit, stabilization programs and tax reforms will help to achieve a balanced and sustainable fiscal position in the long-term.

Monetary Policy

In 2008, the consumer price index grew by only 9.5% yoy compared to 18.8% yoy at the end of 2007 (see chart 4). Obviously, this trend reflects the impact of the deflating global commodity bubble. Indeed, the food price index, calculated by the Food and Agriculture Association of the United Nations, lost 20% in 2008 or nearly one third from the peak of world commodity prices in June 2008. Since households in Kazakhstan allocate over 40% of their consumption spending to foods, high volatility of global food prices tends to exert a significant impact on local inflationary developments. Furthermore, fluctuations in global energy prices add an extra layer of uncertainty to local inflationary expectations as well. This means that the global deflationary environment is likely to support a favorable outlook for inflation in Kazakhstan as falling global demand will keep commodity prices at bay. After all, prices of non-food commodities in Kazakhstan grew by only 5.7% yoy in 2008 on the back of a double-digit fall of prices of fossil fuels. On top of that, core inflation, which excludes utility tariffs and prices of vegetables, fruits and fossil fuels, slowed to 10.3% yoy in 2008 from 19.5% yoy in 2007. This implies that weaker consumer demand helped to subdue inflationary pressures as well. All told, inflation is likely to remain in single digits in 2009 on the back of strong local and global deflationary trends.

CPI by Component, % yoy



Source: ASRK

In 2008, the stock of domestic credit grew by 2.7% yoy compared to 55% yoy the year before (see chart 5). This came as a result of a considerable tightening in retail lending. Indeed, credit to households shrank by over 9% yoy as KZT and forex denomi-

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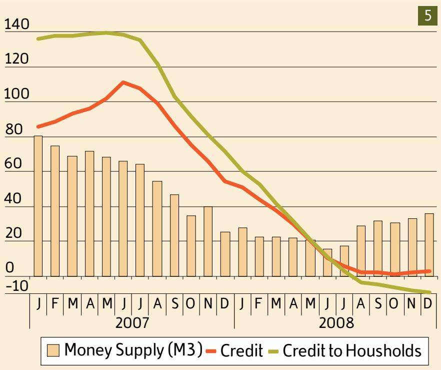
Money Supply (M3) and Domestic Credit, % yoy



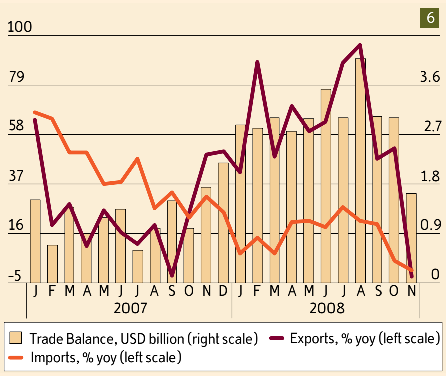
Source: NBK

nated credit to households fell by 8% yoy and 11% yoy, respectively. Furthermore, the volumes of new mortgages and consumer credit were nearly 6 and 3 times lower than in 2007. This means that banks continue to maintain a conservative attitude toward lending to households. This, in turn, further weakened consumer demand, triggering a deceleration of the growth in retail trade from 10% yoy in 2007 to 3.6% yoy in 2008. Meanwhile, prices of new residential apartments fell by 8.7% yoy (up by 30.2% yoy in 2007), while prices of the previously owned apartments plummeted by 20.4% yoy (up by 42.6% yoy in 2007). On a positive note, the last two months of 2008 saw a revival of bank landing to the corporate sector. Indeed, in November and December, domestic credit increased by USD 1.4 billion compared to a rather modest increase of only USD 230 million over the first ten months of 2008. Trade, food processing and the mining industry witnessed some recovery of access to banks' lending. Still, firms' access to credit remains tight. In particular, credit to car makers shrank by 20% yoy in 2008, while credit to producers of construction materials fell by 4% yoy. This means that government actions to unlock bank lending will play a key role in economic recovery. The National Bank has already lowered reserve requirements on banks. On top of that, the refinancing rate was reduced to 9.5%, while lower reserve requirements on banks will be introduced in March. This looser monetary policy and an ongoing recapitalization of Kazakh banks should help to encourage a gradual recovery of bank lending, which will add additional support to domestic consumer and investment demand.

International Trade and Capital

In January-November 2008, the foreign trade surplus widened to USD 32.7 billion as exports grew by 57% yoy while imports decelerated to 15% yoy. However, in November, the volume of exports shrank for the first time in the last thirteen months, declining by 2.3% yoy (see chart 6) on the back of falling global commodity prices. On the positive side, the growth rate of imports continued to decelerate as well. This means that the negative impact of the deteriorating terms of trade on the current account balance is likely to be partially offset with a continuing weakening of domestic demand for imports.

Monthly Foreign Trade Surplus



Source: ASRK

Meanwhile, during the first nine moths of 2008, the current account surplus amounted to USD 9 billion compared to a deficit of USD 5.4 billion the year before. In particular, exports surged by 66% yoy, while imports increased by only 18% yoy. However, according to the National Bank, the growth of exports was almost exclusively driven by record high world prices of foods and industrial commodities. Indeed, booming exports of mineral products (up by 67% yoy), ferrous metals (up by 100% yoy) and grains (up by 90% yoy) were fueled by higher world prices of these products, which grew by 72% yoy, 88% yoy and 94% yoy, respectively. Although, the prices of imports increased as well, a deceleration of imports was observed on the back of declining physical volumes of imported consumer and investments goods (down by 16% yoy and 6% yoy, respectively) and industrial supplies (down by 3% yoy). As a result, imports contracted by 7% yoy in real terms.

Falling crude oil and metal prices look increasingly likely to push the current account balance of Kazakhstan back to a deficit in 2009. This means that depreciation pressures on the national currency intensified. In 2007, the National Bank of Kazakhstan started to manage the Tenge, after nine years of free floating, as the international liquidity crisis deprived Kazakh banks of credit and slowed GDP growth. Thanks to these interventions, in 2008, the exchange rate stayed mostly stable, ending the year at about 121 KZT/USD. But during the last four months, the National Bank had to spent USD 6 billion (including USD 2.7 billion in January 2009 alone) to maintain exchange rate stability. The National Bank was also concerned with the loss of competitiveness of local producers, as the real effective exchange rate had appreciated by about 16% in January 2009. As a result, the National Bank decided to depreciate the Tenge to prevent the loss of its foreign reserves, and maintain the competitiveness of local producers. On February 4th, the National Bank of Kazakhstan announced that it will no longer support the currency at its previous level (120 KZT/USD plus/minus 2%) and will switch to a new band of 150 KZT/USD plus/minus 3%. The interbank market reacted immediately with the Tenge traded at 149.5 KZT/USD.

Other Development Affecting Investment Climate

According to the recent statement by the International Monetary Fund (IMF), Kazakhstan will face a challenging economic environment in 2009. Still, the IMF believes that the government stabilization program may help mitigate economic difficulties. This means that effective and transparent implementation of this program will determine its capacity to achieve the intended goals.

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