Kazakhstan Macroeconomic Situation

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Summary

- The government estimates economic growth at 5.5 % in the first half of 2008.
- In January-March, industry gained 3.7% yoy.
- The first quarter of 2008 ended with a state budget surplus at USD 193.3 million (KZT 23.2 billion), or about 0.2% of projected full year GDP.
- Consumer prices increased by 3.4% in January-April.
- The trade in goods surplus doubled since the beginning of the year and stood at almost USD 6 billion.
- The current account deficit is expected to shrink to 6% of GDP in 2008.
- Fitch expects further growth of the oil industry in Kazakhstan despite the imposed export duty on crude oil.
- Kazakhstan's benign economic prospects boost the interest of foreign investors willing to diversify into emerging markets.

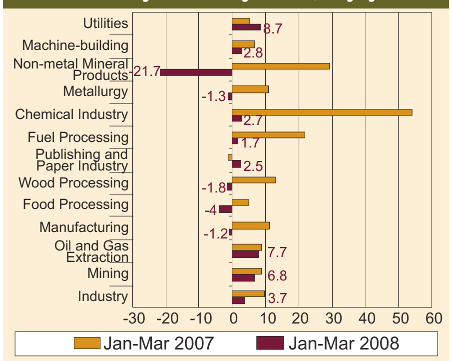
Economic Growth

Despite the overheating of the financial sector, Kazakhstan's economy has gradually recovered and demonstrated solid performance. Prudent measures of the government since September of last year have improved key macroeconomic indicators. In January-March 2008, GDP grew by 5.3%, which is in line with government estimates. Industry advanced by 3.7% yoy on the back of steady growth of the mining industry by 6.8%, which is driven by strong demand for energy resources and favorable commodity prices. Crude oil remains a key contributor to industry. Since the beginning of the year, the largest national operator KazMunaiGaz has extracted 4.4 million tons of crude oil and gas condensate, an increase of 9% yoy. The company estimates its annual volume of oil and gas extraction at about 17.4 million tons or 25% of the country's overall extraction capacity. The fuel processing industry has also improved its production power and in January-March advanced by 76.9% yoy. The profits of the national oil company increased by 0.9% yoy and totaled USD 3.5 billion.

In the first quarter, manufacturing decelerated by 1.2% yoy as the production of construction materials fell by 21.7%, food processing by 4% and nonferrous metallurgy by 3.5%. On a monthly basis, manufacturing accelerated by 10.2%. The investment portfolio in the manufacturing industry for 2008 consists of 182 approved projects and amounted to USD 6.9 billion.

Despite weaker performance of domestic construction, investments into residential construction increased by 38.5%. Furthermore, the government's national program allocates USD 2 billion to back the construction industry. Half of the money was allocated to Kazyna, a state-run development holding company. Kazyna is to deposit USD 405 million in commercial banks for loans to finance residential construction and USD 200 million to finance large construction projects. The remaining USD 405 million will be deposited in commercial banks to issue loans to small and medium-sized enterprises.

Industry Growth by Sector, % yoy



Source: ASRK

The government banned export of wheat until September of this year as a response to surging world food prices and tight supply conditions on global grain markets. Kazakhstan exported over 8 million tons of wheat, including the grain equivalent of flour in 2007. At present, the country's grain reserves are at 8.1 million tons and considering export volumes per month are at about 1.1-1.4 million tons, the export capacity of Kazakhstan is 1.2 million tons of wheat. As a result, the government restricted export of grains to prevent the domestic market from a shortage of grain and price volatilities. At the same time, local producers are allowed to export wheat flour to maintain production levels.

Kazakhstan is the fifth largest exporter of grain in the world and the largest exporter of wheat flour. In 2007, the country's crop volume totaled a record 22 million tons; the exports of grain amounted to 2.7% of all exports, growing by 128% as compared to 2006. Kazakhstan sells the lion's share of its wheat to CIS countries. Since the region's winter crops were damaged by severe weather conditions, countries like Kyrgyzstan, Tajikistan, and Uzbekistan were hoping to offset their own crop failures by importing wheat from Kazakhstan. Thus, the impact of this export ban on wheat is likely to be most visible in Kazakhstan's Asian CIS neighbors.

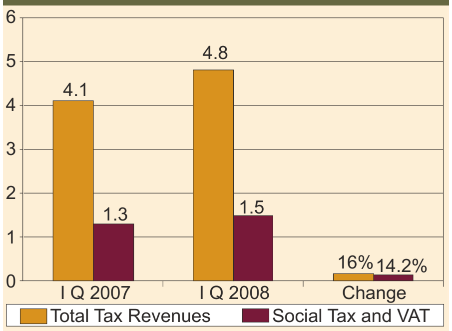
Investment demand appears to remain robust and in January-March, gross fixed capital investments advanced by 16% yoy (as compared to 7.1% in the same quarter of the previous year). Nominal wages continue to grow as well. The average nominal wage was equal to USD 455 or up by 19.5% yoy in February, though a real gain in wages settled at only 0.6% on the back of double-digit inflation.

Determining domestic policy for the next 7 years, the government is targeting five key priorities: modernization of public infrastructure, further development of state programs, promotion of 30 corporate leaders of Kazakhstan and industrial cluster system, enhancing the business environment, and corporate governance.

Fiscal Policy

Kazakhstan ended the first quarter of 2008 with a state budget surplus of USD 193 million. Revenues totaled USD 6.2 billion while expenditures were USD 6 billion. Corporate income tax, personal income tax, VAT and custom duties grew by 15.4% yoy, 28.8% yoy, 24.3% yoy and 7.1% yoy respectively. As a result, total fiscal revenues advanced by 16% yoy.

Fiscal Revenues, USD billion



Source: The Ministry of Finance of RK, The Bleyzer Foundation

However, tax revenues have grown slower than in 2007 as higher inflation and difficulties in the banking and construction industries generated budget spending this year. Still, these fiscal risks are effectively balanced by booming export revenues brought by record high oil prices. Furthermore, a recently introduced oil export duty is anticipated to increase budget revenues by USD 1 billion this year. The duty in the amount of USD 109.91 per ton (or about USD 15 per barrel) is not constant and will be subject to changes in the global markets. A new tax will be applied to about 50% of all crude oil produced in Kazakhstan. The companies that previously secured tax stability clauses through their production sharing agreements with the government will be exempt from this tax.

The main payer of the export duty will be the third largest oil producer in the country, KazMunaigaz Exploration and Production (KMG E&P). KMG E&P estimates that it may lose up to USD 800 billion due to the introduction of the export duty on crude oil. However, the Ministry of Finance believes that imposition of the new tax will not affect volumes of oil export; moreover, it will motivate national operators to maintain domestic supply and stabilize domestic prices. According to Fitch, the oil export duty is unlikely to impact the credit ratings of the local oil and gas companies as their profit margins are still higher than profit margins of Russian and international counterparts.

Kazakhstan's authorities are considering imposing a metals export duty to boost budget revenues. The duty, which may become effective by the end of this spring, will be applied to all metals and other mining industry products. Kazakhstan is a large exporter of metals like copper, steel and uranium. Following this announcement, major mining companies

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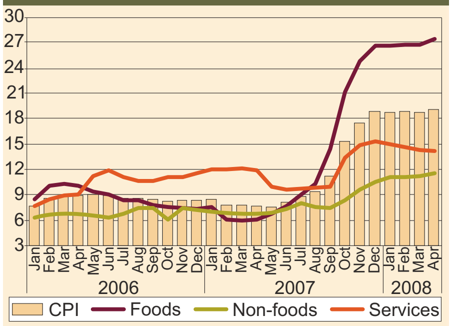
(Kazakhmys and Eurasian Natural Resources Corporation) spoke out against this proposal, arguing that it may damage their international competitiveness.

These developments may signal a sound fiscal outlook, since they imply that tax revenues tend to remain strong despite a slowing economy.

Monetary Policy

In April, the consumer price index was at 19.1% yoy, mainly driven by increasing food prices, which accelerated by 27.5% yoy. Non-foods and services gained 11.6% yoy and 14.2% yoy respectively. On a positive note, inflation dynamics are mostly on par with last year's trends. Since the beginning of 2008, inflation has grown by 3.4% ytd or marginally above the 3.1% ytd registered in April 2007. Furthermore, consumer prices in Kazakhstan appear to be growing slower than in other key players in the region. For example, in April inflation in Ukraine hit 13.1% ytd, while in Russia it settled at 6.3% ytd.

Consumer Price Index (%yoy)



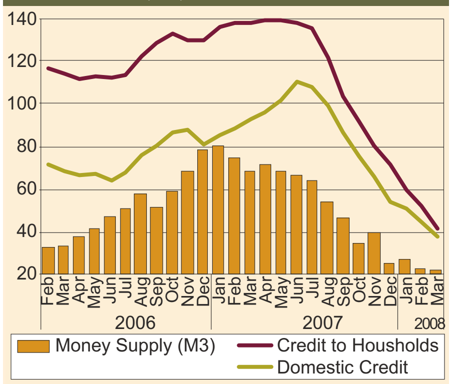
Source: NBK, The Bleyzer Foundation

Inflationary pressures in Kazakhstan have been affected by the global trend of growing commodity prices. Development of alternative energy sources suggests growing demand for vegetable feed is driving food prices. Additionally, the shortage of harvest in major grain exporting countries affected the cost of foods. However, the deceleration of household income will moderate domestic demand, leading to price stability.

According to the NBK, the growth of money supply (M3) settled at 24% yoy in the first quarter of 2008. Domestic credit continued to decelerate, growing by only 37.6% yoy on the back of limited access to international funding resources. On a monthly basis, credit grew by 0.2 % on the back of decreasing credit to households.

Admittedly, domestic banks continue to service their external obligations according to schedule. Banks have already repaid nearly USD 6 billion since the beginning of 2008. However, lending institutions still need to repay about USD 12 billion before the end of this year, while they have only USD 13.5 billion of liquid assets. The quality of the assets and loan portfolios is still a problem to consider. The six largest domestic banks by assets — Kazkommertsbank, BTA, Halyk Bank, Alliance Bank, ATF Bank and Bank CentrCredit -announced credit losses of USD 1.2 billion. The share of losses in total retail loans grew from 4.4% to 8% in the past six moths. The share of loans to the construction sector in the commercial banks' loan portfolios grew from 14.2% to 19.4%, which is relatively low. The share of loans with delayed payments varies from sector to sector, with the highest figures in construction and industry — 6.7% in both.

Money Supply (M3) and Domestic Credit, % yoy



Source: NBK, The Bleyzer Foundation

However, in January-March, 42.9% of all loans were classified as standard loans (39.7% on January 1st, 2008), 55% as doubtful loans (58.8% respectively) and 2.1% as bad loans (1.5%). Deposits continued to grow and amounted to USD 34.3 billion in January-March, up by 5.9% ytd. It is important to note that household deposits advanced by 3.3% ytd.

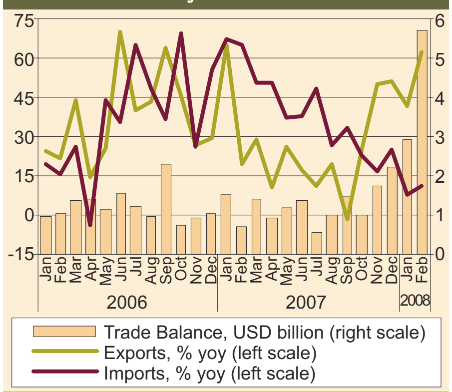
The international liquidity position of the government is solid and improving. In April, forex reserves of the National Bank of Kazakhstan (NBK) stood at USD 20.7 billion, increasing by 19% since the beginning of the year. Assets of the National Oil Fund gained 11% ytd growing to USD 23.35 billion. As a result, gross forex reserves of Kazakhstan amounted to USD 44.03 billion.

The credibility of the banking system is still at an appropriate level, as deposits continue to grow steadily, while major banks are planning to reenter international financial markets later this year. One of the top banks in the country, Halyk Bank, has recently attracted USD 500 million at the LSE through the private placement of bonds. On top of that, the credibility of domestic banks is supported by high profits of Kazakh financial institutions, which grew by 89.3% yoy in the first quarter of 2008. Equally important, a prompt response by Kazakh authorities to the global credit crunch appears to have yielded positive results. The Financial Supervision Agency has considered amending Kazakhstan's law "On Banks and Banking Operations" by including a new provision that allows the government to act as a shareholder of a bank in order to ensure financial stability. In case no investor is found to support a bank that has serious financial problems, the government may be allowed to act as a temporary owner by purchasing a stake in a commercial bank.

International Trade and Capital

Kazakhstan's foreign trade balance amounted to USD 15 billion in January-February 2008, growing by 42% yoy with exports gaining 62% yoy and imports up10.8% yoy. Thus, the slowing of imports is another reason to believe that aggregate demand is cooling down, which should help curb inflation. In January-February, the trade in goods surplus jumped by nearly 160% to USD 5.7 billion (compared to USD 2.2 billion during the same period of last year). This year, growing commodity prices and moderating demand for imports (on the back of a slowing economy) are expected to support expansion of the trade in goods surplus. As the average price of crude oil is anticipated to stay above USD 100 per barrel in 2008 (Goldman Sachs expects that oil prices could even reach USD 200 per barrel) and considering that oil condensate and gas amounted to 69.5% of all exports, booming export will help to reduce the current account gap, which stood at 7% of GDP in 2007.

Monthly Trade Balance



Source. ASRK, The Bleyzer Foundation

Impressive capital inflows mainly as foreign direct investments will help to finance the current account gap in 2008. FDI inflows in 2007 totaled USD 10.3 billion, growing by 64.8% yoy. As a result, the capital account ended 2007 with a surplus of USD 7.4 billion.

Other Developments Affecting Investment Climate

Although recent revisions of Kazakhstan's sovereign and corporate ratings by international rating agencies imply that the economic situation remains fragile, Kazakhstan is becoming a more attractive destination for foreign investors, especially for global companies seeking targets for mergers and acquisitions in emerging markets. The interest in hydrocarbon industry has been replaced by interest in the financial sector. This sector, which is suffering from liquidity problems, looks very promising. In light of the current situation, Kazakh banks are undervalued, and the appearance of foreign investors from major financial institutions will increase the development of domestic banks by expanding opportunities for securitization, improving technology and the quality of business processes. The largest deals were the takeover of ATF Bank by Italian UniCredit and the purchase of 30% of Bank CentrCredit by South Korean Kookmin Bank.

The telecommunications sector is also becoming more interesting. The Russian company STS-Media acquired 20% of the TV and Radio Company 31 Kanal. The deal is estimated at USD 151 million. The French company JCDecaux acquired 50% of RTS Perekrystok. This network operates in the street advertising market and holds about 10% of the external advertising market, which overall totals USD 39 million. The Kazakh advertising market is in third place in the world in terms of growth rates. The Kazakh media advertising market in 2006 alone grew by 37% reaching USD 651 million, 75% of which is accounted for by television.