SigmaBleyzer

Kazakhstan

Macroeconomic Situation

THE BLEYZER FOUNDATION

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- **According to preliminary estimates, Kazakhstan is on track to post 8% GDP growth in the first half of 2010.**
- **During the first five months of 2010, industrial production gained 12% on stronger export orders.**
- **In January-May 2010, retail sales jumped by 13% as consumers are exiting the crisis-induced spending retrenchment.**
- **The state budget deficit was 0.4% of projected full year GDP.**
- **Inflation pressures remained subdued, with the annual increase in consumer prices at only 7% in May.**
- **The trade in goods surplus widened to $10.6 billion in January-April 2010.**

Executive Summary

The economic recovery continues in Kazakhstan, with GDP on track to grow by 8% yoy in the first half of 2010 compared to a 2.3% drop a year ago. Industry, buoyed by strong export orders, is adding strength to this rebound with growing output in manufacturing and mining. In particular, the mining industry is benefitting from the Chinese demand for Kazakh oil and metal oar, while manufacturing is enjoying the turnaround in the global steel-making industry.

That said, Kazakh metallurgy may face a tougher global environment in the second half of 2010. First, restocking by end-users of industrial metals may be losing momentum. Second, a seasonal drop in demand for steel in Europe in summer will put additional pressure on steelmakers. Third, slower economic growth in China and worldwide may check the recovery of the global demand for steel. And higher oar prices are forcing steel producers to cut output to keep steel prices stable. Nevertheless, long-term demand fundamentals for Kazakh metallurgy, which mostly supplies ferroalloys to the global producers of stainless steel, remain bright. After all, a growing middle class in emerging markets will keep buying white goods and cars, which should sustain global demand for stainless steel.

Kazakh banks are still struggling to regain their credit creation capacity on the back of tight funding and a high share of non-performing loans. On the upside, the financial system is already on the mend as banks are making progress on the restructuring of their foreign debts. In June the creditors of BTA Bank approved a debt restructuring plan, reducing the bank's liabilities by $4.4 billion. Standard & Poor's raised the long-term rating of Alliance Bank from default to B-, while Fitch revised Kazkommertsbank's outlook to stable. Finally, Halyk Savings Bank has already repaid government loans received under the stabilization program. All of this reflects stronger liquidity and capital positions, which adds resilience to the banking sector.

A better than expected economic recovery is helping to boost tax revenues, allowing the government to keep a tight lid on the fiscal deficit. In particular, revenues from the value added tax grew thanks to more taxes paid by local producers, while VAT on imports remained virtually unchanged. This does testify to the broad-based rebound of economic activity, while currency devaluation in 2009 may be encouraging import substitution with locally produced goods. In addition, thanks to stronger global demand for energy, the government may reintroduce a duty on crude oil exports. All of this will help Kazakhstan to maintain a relatively healthier fiscal position versus its regional peers. Indeed, Kazakhstan's fiscal deficit is projected to stay well below average for transition economies in 2010.

Stronger commodity prices and falling imports of industrial machinery, pipes, petroleum products and cars continue to support a healthy external position. Indeed, during the first four months of 2010, the trade in goods surplus exceeded $10 billion and was 4.5 times higher compared to the year before.

	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	6 710	7 600
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	-3.4	2.0
External debt, $ billion	43.4	74.0	96.9	108.1	111.7	120.0
Exchange rate, tenge/$, annual average	132.9	126.1	122.6	120.3	147.5	145.0

* Projections

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

Where Opportunities Emerge.

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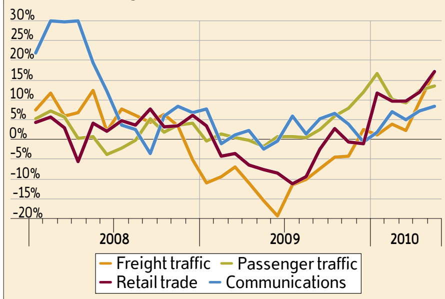
Economic Growth

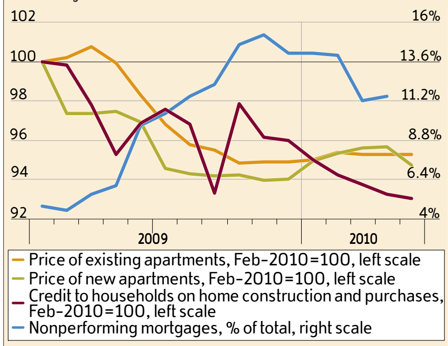
Economic recovery continues in Kazakhstan. Preliminary estimates place GDP growth at 8.3% yoy for the January through May period following a 7.1% gain in the first quarter of 2010. And, according to the Prime Minister of Kazakhstan, the economy is expected to grow by 8% yoy in the first half of 2010 compared to a 2.3% drop a year ago. Industry, buoyed by strong export orders is adding strength to this economic rebound with output in manufacturing and mining up by 20% yoy and 7.7% yoy, respectively, against the first five months of 2009. Indeed, the mining industry is benefitting form the Chinese demand for Kazakh oil and metal oars. Meanwhile, manufacturing is bouncing back thanks to a turnaround in the global steel-making industry. Following two years of falling output, Kazakh metallurgy increased by over 12% yoy in January-May 2010 thanks to a 17% yoy output gain in nonferrous metallurgy.

Services are bouncing back 1
% annual change



Source: ASRK

Home values and credit 2
February 2009=100



Source: ASRK, NBK, AFS

That said, Kazakh production of nonferrous metals is still roughly 7% below its 2007 level, which points to a fragile recovery of the global demand for metals. And restocking by global distributors selling to carmakers and the construction industry, which helped ramp up production at the beginning of this year, may be abating. In fact, demand for steel products in China, the world's biggest steel producer and steel user, appears to be weakening as China bank lending slows on Beijing's curbs to cool the Chinese housing market. In May, Chinese steel prices fell for the first time since January, pointing to the risk of steel production recovering faster than demand. Higher input costs (according to the World Bank, in May 2010 iron ore prices were 65% higher than in 2009) may force steel producers to reduce output to keep steel prices stable. A seasonal drop of demand for steel in Europe in summer will put additional pressure on steelmakers as well. This means that output growth in Kazakh metallurgy is likely to slow in the second half of 2010. On a positive note, ferroalloys (mostly ferrochrome), which are used in the production of stainless steel, account for over 40% of all Kazakh exports of iron and steel, with Netherlands, Japan and China being the biggest export markets. And demand for stainless steel should remain firm on growing consumption of white goods and cars in the emerging markets, where more consumers are entering the middle class. These favorable demand fundamentals as well as supply constraints in South Africa - the world's biggest ferrochrome producer, should sustain production of ferroalloys in Kazakhstan.

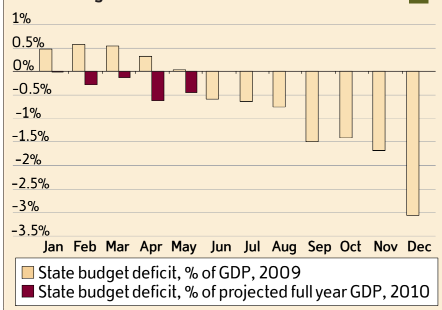
Lastly, it appears that stronger foreign demand for Kazakh products goes together with a recovery of domestic consumption. In January-May 2010, retail sales jumped by 13% versus a 7% decline a year ago. Improving retail sales do indicate that consumers are gradually exiting the crisis-induced spending retrenchment. And this underpins a brighter outlook for other service-producing industries such as transport and communications (see chart 1). During the first five months of 2010, freight and passenger traffic was up by 15% yoy and 12% yoy, respectively, while the volume of communication services grew by roughly 6% yoy. That said, more stable economic conditions, growing real wages and low unemployment are likely to support consumer spending throughout the rest of this year. In fact, in May the consumer sentiment index hit its highest reading in two years, posting the seventh straight month of gains.

However, the construction sector, which accounts for about 8% of GDP, is still weak due to tight bank lending. In particular, during the first five months of 2010, the volume of construction works was down by 5.5% yoy as investments into residential housing fell by 5% yoy. On the upside, residential housing investments have been growing in annual terms for the last three months - the first gains in two years. This should help stabilize activity in the construction industry. Still, in January-May 2010, about 55% less was invested into homebuilding compared to the same period two years ago. All of this points to a rather sluggish return to precrisis growth in construction as banks continue to reduce their exposure to the real-estate sector on falling home values and deteriorating quality of mortgages (see chart 2). Indeed, the housing market is still fragile to sustain stronger demand for mortgages and residential investments. This implies that further price corrections on the housing market cannot be ruled out. In fact, prices of both new and existing apartments barely grew during the first five months of 2010 and are still down versus a year ago. And since loans to the construction sector account for over a fourth of all credit in the banking industry, a tepid recovery of the housing market will remain a significant challenge for Kazakh commercial banks.

Kazakh banks are still struggling to restore their credit creation capacity on the back of tight funding and a high share of non-performing loans, which stabilized at about 35%. On the upside, the financial system is already on the mend as banks are moving forward with the restructuring of their foreign debts. In particular, in June the creditors of BTA Bank approved a debt restructuring plan, reducing the bank's liabilities by $4.4 billion. Standard & Poor's raised the long-term rating of Alliance Bank (which has already completed its restructuring) from default to B-, assigning a stable outlook, while Fitch revised Kazkommertsbank's (the largest lender in Kazakhstan) outlook to stable. Finally, Halyk Savings Bank (the third largest Kazakh bank) has already repaid government loans received in 2009 under the stabilization program. All of this reflects stronger liquidity and capital positions, which adds resilience to the banking sector. Indeed, the ratio of banks' capital to risk-weighted assets (excluding BTA banks, Alliance bank and Termirbank) increased from 16.7% at the beginning of the year to nearly 19% in May. In particular, the capital of the four largest banks (excluding BTA bank and Alliance bank), controlling roughly 60% of all assets in the banking system, grew by over 5% during the first five months of 2010. Meanwhile, in May the ratio of liquid assets to total assets stood at 25% versus 20% at the beginning of 2010. That said, growing capital and improving economic conditions should support a more robust recovery of the banking sector in the medium-term.

The long-term outlook is supported by foreign demand for Kazakh exports, which is likely to stay strong thanks to continued growth in China and other booming emerging markets. In fact, China is already the largest export market for Kazakhstan, absorbing over 15% of all Kazakh exports in January-April 2010 (versus only 9% two years ago). More than that, despite a sharp drop of demand for crude oil from EU countries, the volume of exported Kazakh oil is actually growing (up by about 2% in January-April 2010) thanks to increasing shipments to China (up by over 50% in volume). As a result, this year China already accounts for over 13% of all crude oil and gas condensate exported from Kazakhstan compared to less than 9% a year ago. And this shift of exports to faster growing emerging economies is likely to accelerate due to tighter cooperation between China and Kazakhstan in the energy industry.

State budget deficit 3



Source: Ministry of Finance of Kazakhstan

Fiscal Policy

During the first five months of 2010, the state budget deficit stood at about 0.4% of projected full year GDP (see chart 3). A strong rebound of tax revenues, which grew by over 24% in January-May 2010, will allow the government to keep a tight lid on the fiscal deficit. Equally important, this improvement of tax collection does testify to the broad-based recovery of the economy. In particular, revenues from the value added tax paid by local producers of goods and services increased by almost three times (see chart 4), while increasing foreign trade turnover is supporting revenues from custom duties and tariffs. That said, a robust collection of tax revenues may prompt the government to revise its fiscal projections. According to the Minister of Finance, the government may raise the official GDP growth rate for 2010 to 4% (from its previous estimate of 2%), which may result in an upward revision of tax revenues by about $340 million. In addition, thanks to stronger global demand for energy, the government may reintroduce a duty on crude oil exports, which was eliminated in January 2009. All of this will help Kazakhstan to maintain a relatively healthier fiscal position versus its regional peers. Indeed, according to the European Bank for Reconstruction and Development, Kazakhstan's fiscal deficit is projected to stay well below the average for transition economies in 2010 (see chart 5).

Tax collection improves 4
% annual change

	January-May	
	2009	2010
Tax revenues	**-10.7%**	**24.1%**
Corporate income tax	-17.2%	20.5%
Personal income tax	-8.9%	19.4%
Social tax	-12.6%	8.0%
Property tax	13.6%	33.2%
VAT*	-32.9%	179.0%
VAT on imports	-13.2%	0.5%
Taxes on foreign trade	-36.8%	89.1%

* on goods and services produced in Kazakhstan
Source: Ministry of Finance of Kazakhstan

General government balances* 5
% of GDP

	2009	2010
Kazakhstan	**-2.0**	**-0.6**
Lithuania	-8.9	-9.0
Bulgaria	-3.9	-2.0
Romania	-8.3	-7.7
Ukraine	-11.4	-5.4
Russia	-6.2	-7.1
Turkey	-5.5	-4.1
Average for transition countries	-4.5	-4.6

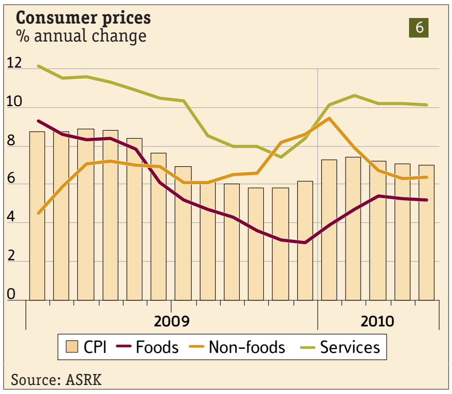
* excluding revenues from privatization
Source: EBRD

Lastly, by the end of May, the total foreign exchange reserves of Kazakhstan, including assets of the National Oil Fund, stood close to $55 billion or over 15% more than in the last quarter of 2008 - the beginning of the global financial crisis. The government has already succeeded in using these reserves to smooth the impact of the global recession on the local economy. Indeed, at the beginning of 2009 it utilized $10 billion of the National Oil Fund assets to stabilize the financial sector and cover the budget deficit. At present, the Kazakh banking sector is better capitalized, while the global economy is on the mend (although the pace of recovery may slow following a rapid turnaround at the beginning of

2010). And a high level of forex reserves implies that the Kazakh government will be able to continue to support the economy without threatening its long-term sovereign creditworthiness.

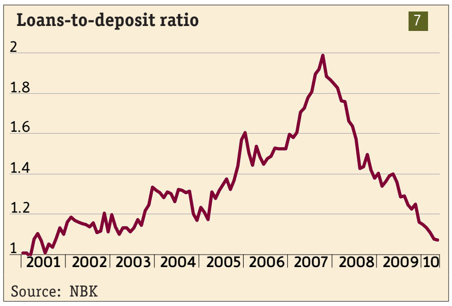
Monetary Policy

In May, consumer prices grew by only 0.6% versus the month before thanks to slower growth of food prices. This puts the annual inflation at 7% yoy - its lowest reading in 2010 (see chart 6). And a seasonal drop of prices of agricultural products in June-September as well as stronger national currency will support a moderate deflation trend in the third quarter of 2010.

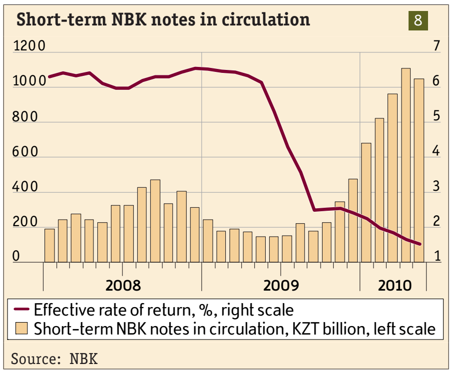


Consumer prices, % annual change (6)
Source: ASRK

Tight bank lending helps to remove inflationary pressures as well. In May, the stock of domestic credit was down for the third consecutive month and is about 7% yoy lower than last year's level. Outstanding bank loans to households and companies declined by 11% yoy and 5% yoy, respectively, which is a sign of continued deleveraging by the private sector. Meanwhile, over the last twelve months bank deposits grew by roughly 22% yoy with household and corporate deposits increasing by 21% and 24% yoy, respectively. As a result, the ratio of bank loans to deposits fell from its precrisis record of about 2 to more normal levels (see chart 7). This means that Kazakh banks are becoming increasingly reliant on retail deposits rather than wholesale international borrowing to fund their growth.


Loans-to-deposit ratio (7)
Source: NBK

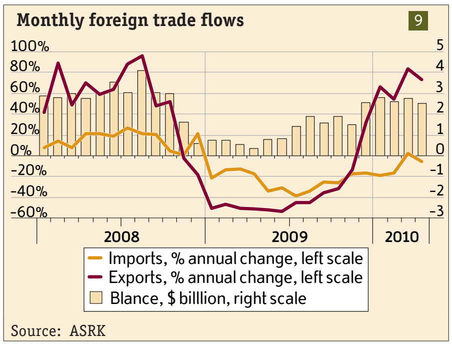
However, this falling loans-to-deposit ratio also implies that banks are still unwilling to make new loans and prefer to build up liquidity buffers by directing deposits into liquid assets. Indeed, the volume of short-term NBK notes in circulation increased by over 6 times since the beginning of 2009 from about $1 billion in May 2009 to over $7 billion in May 2010. Meanwhile, the effective rate of return on these notes fell to a record low 1.5% (see chart 8). After all, credit risks remain high (over a third of all loans in the banking system are nonperforming) which makes banks stick to liquid assets to avoid a liquidity crisis. On the upside, a faster than anticipated economic growth should facilitate the resolution of bad loans, which will sustain a gradual recovery of the banking industry.



Short-term NBK notes in circulation (8)
Source: NBK

International Trade and Capital

During the first four months of 2010, Kazakh exports bounced back by about 70% yoy to $18.3 billion on stronger commodity prices and growing shipments to China. Meanwhile, imports fell by nearly 10% to $7.7 billion on falling imports of industrial machinery, pipes, petroleum products and cars. As a result, the trade in goods surplus exceeded $10 billion and was roughly 4.5 times higher compared to the year before (see chart 9). True, the monthly trade surplus is likely to fall in the second half of 2010 as fears of the sovereign debt crisis in Europe and slower economic growth in China may exert pressure on global demand for energy and industrial metals. However, imports are unlikely to bounce back to the precrisis level as domestic demand remains weak, while the currency devaluation in 2009 may be encouraging import substitution with locally produced goods. Indeed, in January-May 2010, revenues from the value added tax (VAT) grew by 35% yoy, pointing to stronger consumption. However, this boost was brought on by higher revenues on locally produced goods with VAT on imports inching up by only 0.5%.



Monthly foreign trade flows (9)
Source: ASRK