Kazakhstan Macroeconomic Situation

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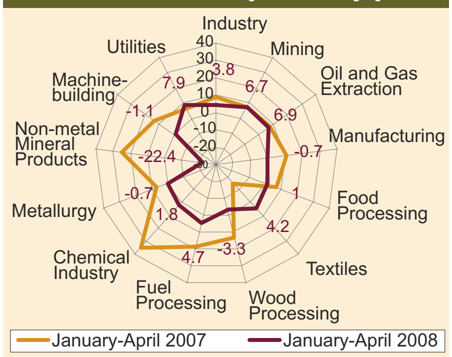
Summary

- Industry grew by 3.8% yoy in January-May 2008.
- Government estimates the grain harvest to total 16–17 million tons in 2008.
- The Consumer Price Index grew by 1.2% mom in June 2008.
- Kazakhstan's foreign exchange reserves approached USD 46.5 billion.
- The current account surplus stood at USD 3.9 billion in the first quarter of 2008.
- In January-March 2008, Kazakhstan's stock of total external debt settled at USD 98.7 billion.
- The EBRD will create the Kazakhstan Growth Fund to support non-extractive industries.

Economic Growth

In the first half of 2008, Kazakhstan's economy was still on course for moderate growth. Consumer demand was supported by accommodative fiscal and monetary policies. On top of that, local businesses continue to thrive as the share of companies with a return on sales exceeding 40% grew to 20.8% in the first quarter of 2008 (compared to 18.6% at the end of 2007). More importantly, small and medium enterprises reported higher profitability, benefiting from the recent elimination of some administrative and regulatory barriers to business activities. Meanwhile, according to the Business Activity Survey, released by the Agency on Statistics of Kazakhstan (ASRK), real-estate developers continue to suffer from increasing costs of construction materials, sluggish demand and falling housing prices.

Industrial Growth by Sector, % yoy



Source: ASRK

In January-May, industrial production increased by 3.8% yoy on the back of accelerating output in the mining sector, which was up by 6.7% yoy. Crude oil extraction advanced by 7.2% yoy and totaled 24.3 million tons. Output in manufacturing remained virtually flat, marginally declining by 0.7% yoy. Above all, a moderation of the local construction sector weakens demand for construction materials. Indeed, production of non-metal mineral products was down by 22.4% yoy as production of bricks, cement and concrete products shrank by 16.9% yoy, 10.9% yoy and 35.8% yoy, respectively. Fuel processing and chemical industries grew by a humble 4.7% yoy and 1.8% yoy, respectively (compared to 18.5% yoy and 34.2% yoy a year ago). Tight production capacities in the domestic fuel processing industry may partially explain this trend. Furthermore, higher prices of gasoline and fertilizers may have dented demand for primary products of these industries. Finally, output in food processing has recovered for the first time since the beginning of the year, as the manufacturing sector posted a modest increase of 1% yoy in January-May.

Facing tightening supply and transit capacities, the government continues to develop vital infrastructure in the energy sector. Official projections of crude oil production were increased to 150 million tons by 2015 from the current 70 million tons per year. A purchase of the Georgian Batumi port by the national oil company KazMunaiGaz is expected to increase the oil transit capacity of the Baku-Supsa oil pipeline. On top of that, an alternative export route to China will allow for shipping of 20 million tons per year. Finally, the upgraded Caspian Pipeline Consortium will provide capacity for an additional 50 million tons of crude oil per year.

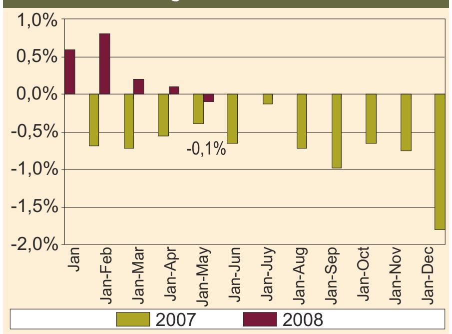
As crude oil prices are anticipated to continue their record-breaking run amid tightening global supply and strong demand for energy from emerging markets, Kazakhstan will definitely benefit from growing oil extraction. Furthermore, lingering uncertainties surrounding key oil exploration projects are likely to abate as Kazakhstan has recently agreed to postpone the start of commercial production at the Kashagan oil field until October 2013. This will give a consortium of private investors developing the Kashagan oil field more flexibility to complete the project on schedule as costs are estimated to swell from USD 100–130 billion to USD 150 billion. In addition, there are some changes in the royalty structure of the production sharing agreement, which should ensure a more stable tax regime for the consortium and reduce risks to investors. In particular, the consortium will pay 3.5% of output to the government at global prices above USD 45 a barrel, 7.5–8% at USD 130, and 12.5% at USD 195.

Kazakh agriculture continues to reap the benefits of good harvests and high world prices for staple foods. Indeed, during the last harvest season, Kazakhstan managed to secure record high grain export revenues, earning USD 2 billion from exports and an additional USD 1 billion from sales at the domestic market. This year, Kazakhstan is expected to harvest 16–17 million tons of grain. In 2007, the total volume of harvested crops reached 20 million tons, up by 22% yoy, largely due to favorable weather conditions and extraordinary gains in yields.

Fiscal Policy

In January-May, the state budget registered a deficit of KZT 16.56 billion (USD 138 million) or about 0.1% of projected full year GDP. Budget expenditures grew by 27.9% yoy in nominal terms while budget revenues advanced by 26.4% yoy. This year, the state budget is fundamentally supported by generous transfers from the National Oil Fund (NFRK), which amounted to USD 2.35 billion growing by 167% yoy against January-May 2007. Indeed, while tax revenues remained strong (increasing by 17.2% yoy), their share in total budget revenues narrowed to about 75% from 81% a year ago. At the same time, the share of NFRK transfers in budget revenues more than doubled to 21% from below 10% in January-May 2007. All told, higher volumes of NFRK transfers to the state budget generated nearly two thirds of the growth of budget revenues during the first five months of this year. This means that Kazakhstan's fiscal position remains rather sensitive to the performance of the national energy sector. At present, this link helps to maintain the strength of the country's budget as decelerating non-oil tax revenues (due to slower economic growth) are compensated with tax proceeds from booming crude oil exports. Furthermore, this strength endows the government with the sufficient spending flexibility to revitalize economic activities with various fiscal stimuli.

State Budget Balance, % of GDP



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

Equally important, ongoing initiatives to rationalize Kazakhstan's taxation system bode well for economic development. At the end of June, the government presented a draft of a new Tax Code, which is expected to be approved by the Parliament this fall. Above all, this Tax Code is designed to simplify and streamline tax administration and align tax accounting with international standards. In particular, its provisions aim to minimize paper work, reduce the number of mandatory tax procedures and forms, consolidate and synchronize tax payments and tax reporting and introduce risk-based supervision of tax compliance. A national tax control is to observe the EU standards of tax compliance management by dividing taxpayers into two groups based on the estimated tax evasion risk, which helps to prevent discretionary and biased tax inspections. This means that companies with a moderate tax evasion risk will benefit from a more lenient supervision by tax authorities. Impartial and occasional tax inspections as well as a wider application of electronic tax reporting will be introduced to reduce corruption and improve fairness and transparency of tax administration. In addition, the government wants to reduce tax exemptions and unify tax privileges given to special economic zones (SEZs) and preferential investment projects. Finally, special provisions are included to guarantee stability and predictability of the national tax system.

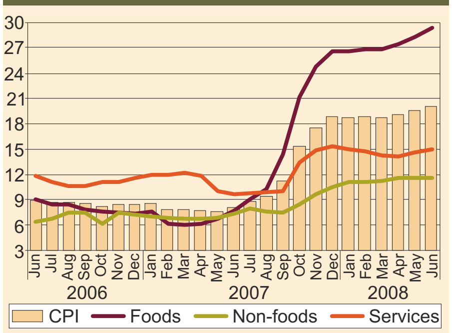
On top of this administrative simplification, the government intends to reduce the overall tax burden by slashing key tax rates. The corporate income tax may be lowered (currently it is set at 30%), advance tax payments for small and medium sized enterprises will be eliminated, the VAT may be cut by 1 percentage point to 12%, while a social tax scale of 5–13% is to be replaced with a flat tax rate.

At the same time, tax treatment of the extractive industry will go through the long-awaited rationalization. In particular, royalty payments will be replaced with a mineral-extraction tax (MET), while a rent tax on hydrocarbons will be substituted with an export duty, which was already introduced in May 2008. The practice of signing product sharing and stabile tax regime agreements (PSA) with minerals users will be abolished. Only agreements signed before 2009 will remain valid. This means that 15 existing PSAs, including the largest mineral users at the Tengiz, Kashagan and Karachaganak oil fields, will be exempt from the new tax rules. It is still too early to judge whether these changes will increase the tax burden on the mining sector as MET rates are to be set after the new corporate income tax rate is approved. On the optimistic side, the government vows to allow for a reasonable and competitive return on all investments into natural resources. This pledge as well as more transparent tax treatment of mineral users may help to establish a stable and predictable tax environment in the mining sector as well.

Finally, according to the World Bank's (WB) statement, announced amendments to the Tax Code are by and large consistent with the WB's recommendations from its recent report on taxation in Kazakhstan: A Strategic Plan for Increasing the Neutrality of the Tax System in Non-Extractive Sectors. The World Bank believes that these tax reforms, if implemented, will help to support the harmonized growth of the non-extractive industries in Kazakhstan.

Money Supply

CPI by Component, % yoy

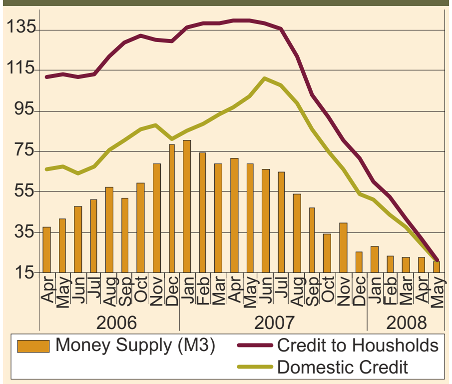


Source: NBK, The Bleyzer Foundation

In June, the consumer price index (CPI) grew by 1.2% compared to the month before (mom) and by 5.7% during the first half of 2008 (ytd). Surging food prices (up by 29.3% yoy) prevailed as the principle cause of inflation. In particular, rice prices climbed by 35.4% mom in June, cereals become more expensive by 3.5% mom while prices of baked goods grew by 4.8% mom. Prices of non-food commodities continued to grow as well due to soaring fuel prices. In June, gas and diesel fuel prices grew by 2% mom and 6.8% mom, respectively.

In May 2008, the money supply (M3) continued to slow, totaling USD 42.4 billion or up by only 20.7% yoy compared to 68.3% yoy in May 2007. Essentially, domestic credit remained on a decelerating trend, increasing by only 21% yoy in contrast to more than 100% yoy growth a year before. Indeed, the stock of domestic credit stood virtually flat at USD 60.2 billion in 2008. Although commercial banks issued about USD 650 million of net credit to the corporate sector during the first five months of this year (or about 10 times less than during the same period of the last year), an equivalent drop in households' net credit helped to erase that gain. Credit to households has declined by over 3% since the beginning of 2008. Higher retail interest rates, which during the past 12 months grew by 230 and 290 basis points for KZT and forex denominated loans respectively, helped to dampen households' appetite for borrowing. In addition, local banks, feeling the squeeze of the liquidity crunch, may have a tendency to extended new loans to safer corporate clients discriminating against households.

Money Supply (M3) and Domestic Credit, % yoy



Source: NBK, The Bleyzer Foundation

This considerable moderation of household credit as well as falling real wages (in May, average real wages lost 1.6% yoy) may foretell a weakening of consumer demand. Indeed, slowing retail trade (up by 2.2% yoy compared to 11.1% in January-May 2007) and decelerating imports may be interpreted as signals of sluggish consumer spending. In addition, this may imply that observed inflationary trends are mostly driven by ongoing adjustments of the relative global prices of staple foods and primary industrial commodities rather than by excess domestic demand. Provided that this adjustment is transitory, the NBU may have some space for accommodative monetary policy to buttress an ailing banking sector.

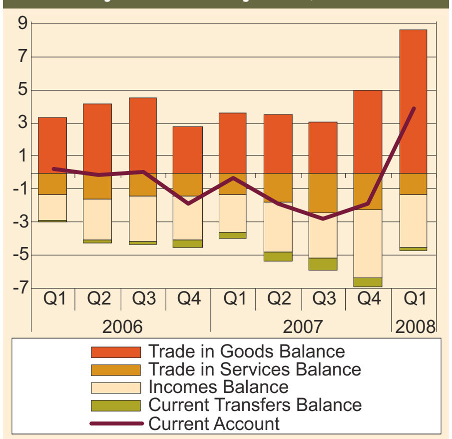
Indeed, at the end of June, the National Bank of Kazakhstan (NBK) loosened its monetary policy by cutting its refinance rate by 50 basis points to 10.5%. In addition, the NBK has lowered the reserve requirements for lenders to 5% on domestic liabilities and to 7% on other liabilities. The monetary authority estimates that this measure will help to boost market liquidity by KZT 90 billion (USD 750 million).

Finally, the unprecedented oil bonanza, supported by record high world oil prices, helps to strengthen Kazakhstan's international liquidity even as the private sector continues to face difficulties accessing international financial markets. By mid-June, the foreign exchange reserves of the National Bank of Kazakhstan stood at USD 21.4 billion or up by 21.2% since the beginning of the year. The assets of the National Oil Fund increased by 19.8% ytd to USD 25.2 billion. As a result, Kazakhstan's total forex reserves approached USD 46.54 billion, gaining more than one fifth since the beginning of this year.

International Trade and Capital

A combination of slowing imports and soaring world commodity prices is facilitating a gradual correction of the external imbalances of Kazakhstan. In the first quarter of 2008, the current account surplus stood at USD 3.9 billion, hitting a record high quarterly level. In the first quarter of 2008, the trade in services deficit stood at USD 1.3 billion growing by a modest 2.4% yoy. In contrast, the incomes deficit increased by almost 40% yoy to USD 3.3 billion as foreign oil companies pocketed higher profits.

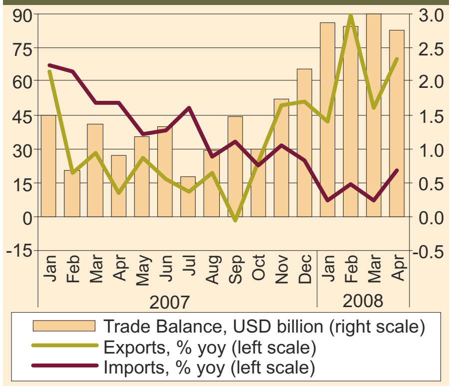
Quarterly Balance of Payments, USD billion



Source. The NBK

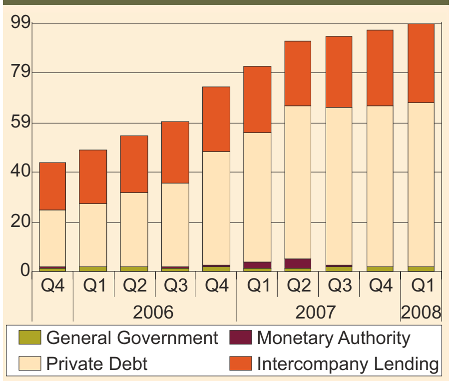
In January-April, the foreign trade surplus totaled USD 11.4 billion, expanding by 153% yoy. High oil prices boosted export revenues to USD 21.5 billion or up by 60.3% yoy, while imports decelerated to 12.7% yoy (compared to 57% a year before).

Monthly Trade Balance, USD billion



Source. ASRK, The Bleyzer Foundation

Foreign External Debt, USD billion



Source: The NBK

In the first quarter of 2008, Kazakhstan's stock of total external debt approached USD 99 billion, increasing by 2.4% since December 2007 or by only USD 2.34 billion, compared to an increase of nearly USD 8 billion in the first quarter of 2007. The stock of public external debt grew by a trivial USD 68 million, while most of the new foreign debt was accumulated by the non-banking private sector in the form of intercompany lending (up by USD 1.15 billion) and long-term loans (up by 2.73 billion). Meanwhile, the banking sector reduced its foreign debt by USD 820 billion in contrast to an increase of USD 5.1 billion a year ago. As a result, total private external debt settled at USD 97 billion, including USD 31.1 billion in direct intercompany lending

Other Developments Affecting Investment Climate

Kazakhstan and the World Bank have agreed to jointly finance a USD 2.5 billion road project to upgrade the trade route between Asian countries and Europe. The World Bank will help to finance and repair the 1,025 km road between Shymkent and Aktobe. This initiative is part of a USD 7.5 billion project to upgrade the 2,800 km road corridor from Kazakhstan's border with China to the border with Russia. The project is expected to be launched in 2009 and will become the largest infrastructure project of the World Bank in Central Asia.

The European Bank for Reconstruction and Development (EBRD) will create the Kazakhstan Growth Fund to support private companies in non-extractive industries. The fund will provide equity or equity related investments, improve corporate governance and transparency as well as support the development and restructuring of medium-sized companies. This fund (with USD 125 million in capital) will be jointly established by the EBRD and the Kazyna Sustainable Development Fund and will focus on non-extractive manufacturing sectors, including construction materials, food processing, metallurgy and textiles.

The government will allocate an additional KZT 160 billion (about USD 1.33 billion) to support the development of small and medium enterprises (SME). In particular, USD 415 million will be provided to the Kazyna Sustainable Development Fund to issue loans to SMEs in Astana and Almaty. The same amount will be lent to Kazakh commercial banks at a 7.5% interest rate to issue loans to SMEs in Astana and Almaty at a 12.5% interest rate (currently 22%). Finally, local budgets will spend about USD 400 million to issue credit to regional SMEs.