Kazakhstan Macroeconomic Situation

August 2007

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Summary

- According to preliminary estimates, real GDP grew by 10.2% (year-over-year) yoy during the first half of 2007.
- In January-June, industry advanced by 6.8% yoy.
- Although the collection of principle taxes remained robust in January-June, the state budget deficit widened to KZT 77.8 billion (or 0.6% of projected full-year GDP) on the back of moderate fiscal loosening.
- In July, the consumer price index (CPI) continued to accelerate, growing by 8.8% yoy compared to 8.1% in the month before.
- In January-May, the foreign trade surplus stood at USD 5.7 billion, declining by 3% yoy as the growth of imports has been consistently overtaking the growth of exports since the beginning of 2007.
- The extracting industry of Kazakhstan continues to be a powerful magnet for foreign investors.
- Kazakhstan participated in bilateral negotiations on its WTO accession with the governments of Canada and the United States.

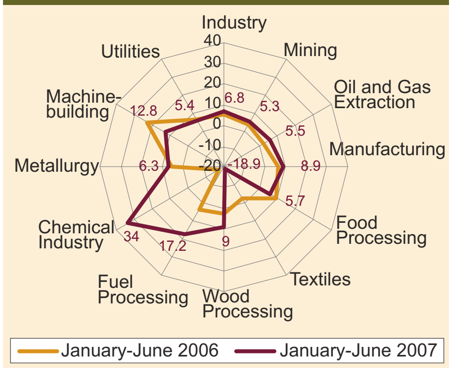
Economic Growth

According to t the Ministry of Economy and Budgetary Planning, preliminary estimates place the rate of real GDP growth at 10.2% year-over-year (yoy) in the first half of 2007.

During the first half of 2007, industry continued to decelerate, growing by 6.8% yoy compared to 8.1% yoy in January-May. In January-June, output in the mining industry gained 5.3% yoy as the extraction of oil and gas advanced by only 5.5% yoy, compared to 7.4% yoy a month before. Output growth of the extracting industry in Kazakhstan has been following an obvious cyclical pattern shaped by the dynamics of the oil and gas extracting sectors. Although the correlation between the output growth of crude oil extraction and either percentage change or levels of world crude oil prices is negative, lagged oil prices tend to exhibit a positive correlation with output growth in the oil and gas industry. Obviously, the growing oil and gas industry in Kazakhstan largely relies on the adequate expansion of production and transit capacities to post substantial output gains. Presumably, companies in the oil extracting industry can accelerate investments into production facilities when extra profits are obtained during periods of oil price hikes. Thus, the contribution of the current high oil prices to output growth may become more pronounced in the future, while it may have a rather modest impact on current output levels due to the restrictions imposed by the available production and transportation capacities.

In April 2007, the mining sector slipped into deceleration mode after hitting its highest growth rate in the first quarter of this year on the back of the moderate output decline registered a year ago. Although this deceleration could spell minor trouble for GDP growth as overall industrial performance still heavily relies on the robust expansion of the mining industry, the increasing impact of construction and service sectors (where comparable deceleration trends failed to be detected) is anticipated to offset slowing industry.

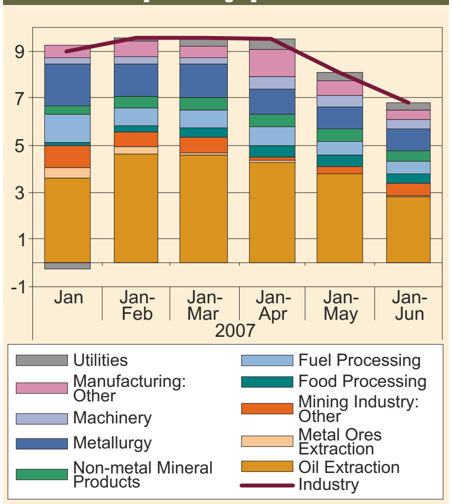
Industrial Output by Sector, % yoy



Source: ASRK

On the positive side, the performance of manufacturing remained strong as manufacturing output gained 8.9% yoy in January-June 2007. However, a tendency toward decelerating growth has been taking a more distinct shape in manufacturing as well on the back of shrinking growth rates in metallurgy, food processing, machinery and fuel processing.

Contributions to Industry Growth by Sector, percentage points



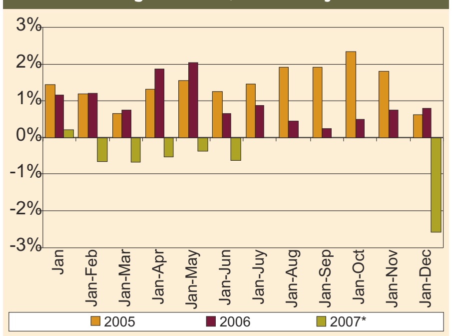
Source: ASRK, The Bleyzer Foundation

The oil extracting industry continues to be the key driver of industrial production, consistently contributing more than 50% to output growth. The performance of manufacturing, in turn, is closely linked to the strong output growth in metallurgy, which posted a robust revival on the back of record high growth of the production of ferrous metals (up by 12.3% yoy on average in January-June 2007, compared to 5.2% yoy average growth in the same period of last year) as well as a solid recovery of non-ferrous metallurgy (up by 5.6% yoy on average during the first half of this year, compared to a decline of 2.7% yoy a year ago). Notwithstanding the high dependence of Kazakhstan's industry on world commodity markets (manifested through the dominance of the oil extracting sector over the mining industry and metallurgy over manufacturing), there is a budding trend for other manufacturing sectors to gradually grow into a more solid platform, which could insure uninterrupted industrial growth in the future. With the exception of food processing and fuel processing (which account for about 7% and 3% of total industrial output respectively), other manufacturing sectors barely contribute more than 2% to industrial production. Yet, largely due to their low statistical base, these industries managed to post double digit growth rates on the back of insatiable demand for investment and intermediary goods from the extracting sectors and construction. For example, such manufacturing sectors as the chemical industry, production of non-metallic mineral products (including various construction materials such as bricks, ceramics and cement), and machine building grew by 34% yoy, 20.5% yoy and 12.8% yoy respectively during the first half of this year. As a result, their production base considerably widened, which, on the back of consistently strong output growth in these sectors, reveals an obvious tendency towards the strengthening impact of these sectors on the growth of industrial production. If during the first half of this year, the contribution of the oil extracting industry and metallurgy to the overall expansion of industry remained relatively constant and fluctuated within 55-60%, the combined contribution of food processing, manufacturing of non-metallic mineral products and machine building was on a steady upward trend generating nearly one fifth (or 1.3 percentage points) of the 6.8% yoy growth of industry in January-June.

Fiscal Policy

During the first half of 2007, state budget revenues increased by only 5% yoy in nominal terms to KZT 1,314 billion (USD 10.8 billion). State budget expenditures, in turn, grew by 9.5% yoy amounting to KZT 1,217 billion (USD 9.95 billion). As a result, the state budget deficit (including deficit of operations with financial assets) widened to KZT 77.8 billion (USD 636 million).

State Budget Deficit, % of full year GDP



* The year-end state budget deficit is projected at 2.6% of GDP
Source: Ministry of Finance of RK

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The collection of principle taxes remained fairly strong on the back of growing population incomes and booming imports. In particular, proceeds from the personal income tax, social tax, VAT, excises and custom duties increased by 33.5% yoy, 27.2% yoy 27.9% yoy 29.2% yoy and 41.3% yoy respectively. These taxes generated nearly 60% of all fiscal revenues collected into the state budget. About 35% of fiscal revenues came from the corporate income tax and payments for the utilization of natural resources. Although in the first half of 2007, the total amount of the corporate income tax (CIT) received by the state budget fell by 24% yoy as a result of the CIT distribution shift (which commands direct allocation of all CIT revenues accrued from the extracting industry to the National Fund of the RK (NFRK)), CIT revenues from the non-oil sector soared by 30% yoy. Thus, it is reasonable to expect that improving profitability of the domestic non-oil industries will help to compensate the state budget for the withdrawal of oil sector related fiscal revenues. Finally, in January-June, the state budget received a transfer from the NFRK in the amount of KZT 155 billion (USD 1.27 billion) to cover its expenditure.

In January-June, current expenditure of the state budget grew by only 3.2% yoy. At the same time, expenditures on wages in the public sector, transfers to households and purchases of goods and services in the market (items that account for about 80% of all current expenditures) continued to post high growth increasing by 34% yoy, 27.8% yoy and 33% yoy respectively. Capital expenditures accelerated by nearly 40% yoy, approaching USD 2.32 billion. In addition, the government allocated close to USD 0.5 billion to repay its foreign external debt, compared to a trivial USD 16 million a year ago.

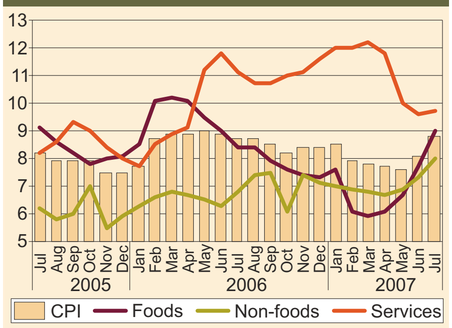
In the first half of 2007, the stock of public and publicly guaranteed external and domestic debt amounted to USD 12.6 billion. External debt of the central government stood at USD 1.35 billion, declining by 24.5% since the beginning of the year (ytd). At the same time, public and publicly guaranteed domestic debt increased by 48.1% ytd to USD 10.76 billion, driven by a 20.2% ytd increase (to USD 3.59 billion) of the domestic debt of the central government and a 69% ytd surge (to USD 7.1 billion) of the domestic debt accumulated by the NBRK.

Monetary Policy

In July, the consumer price index (CPI) continued to accelerate, growing by 8.8% yoy compared to 8.1% in the month before. Prices of food and non-food commodities remained on a rather sharp upward track, growing by 9% yoy and 8% yoy respectively, while the growth of service tariffs stayed relatively flat settling at 9.7% yoy.

On a month-over-month (mom) basis, CPI advanced by 0.9% pushed by a 1.4% mom hike of prices of nonfoods, a 0.8% mom increase in prices of foods and 0.6% mom growth of service tariffs. In July, prices of non-food commodities posted higher growth due to a 12.7% mom rise of prices of construction materials and 6.2% mom growth of gasoline prices. Inflation of service tariffs was principally driven by higher utility tariffs (up by 1.6% yoy), which became more expensive on the back of higher prices of fuels and growing costs of housing stock maintenance. Prices of foods, which are mainly driven by consistently growing prices of meat products and bakery foods, shape the core of inflationary developments in Kazakhstan, as their contribution to yoy CPI inflation has been growing since the beginning of this year to over 40% in the first seven months of 2007. Apparently, expanding domestic consumer demand (due to rapidly growing population incomes, which were up by 20.3% yoy in real terms in May 2007 compared to 12.2% yoy a year ago) fails to be fully absorbed by domestic production, leaking abroad through booming imports and passing through to higher domestic consumer prices. In addition, accelerated growth of world oil prices could spell further troubles for the monetary authorities in maintaining price stability as higher prices of fuels exert strong inflationary impact on prices of non-foods, service tariffs and transportation costs.

CPI by Component, % yoy

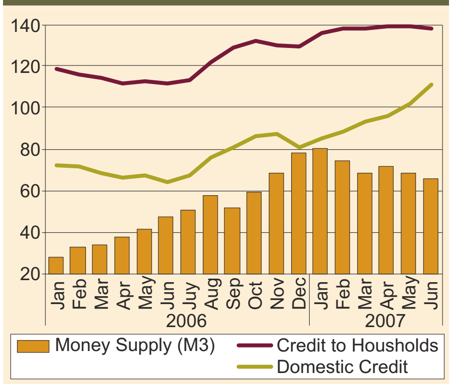


Source: ASRK

In June, money supply (measured with the monetary aggregate M3) amounted to KZT 4,489 billion (USD 36.8 billion) decelerating to 66% yoy from 68% yoy the month before. At the same time, domestic non-government credit rose at the fastest speed in more than six years, growing by a striking 110.8% yoy to KZT 6,569 billion (USD 53.8 billion). Households continued to accumulate debt at a rather hasty rate (in June, credit issued to households grew 138.1% yoy); yet a tendency for this growth to stabilize was preserved. In contrast, the corporate sector has been amassing debt at an accelerated rate since the beginning of the year and in June, credit issued to the corporate sector surged by nearly 100% yoy.

At the end of July, the National Bank of the Republic of Kazakhstan (NBRK) changed the minimum reserve requirement rates imposed on commercial banks (this change will become effective at the end of August). The rate of minimum reserve requirements on domestic liabilities was reduced to 5% from 6%, while the rate on minimum reserve requirements on bonds issued by commercial banks to both residents and non-residents, and on liabilities to non-residents was raised to 10% from 8%. This decision reflects the central bank's intention to restrict external borrowing by domestic credit institutions, which have been aggressively attracting funds at the international markets to satiate expanding domestic demand for credit. A higher minimum reserve requirement rate on external liabilities is expected to both reduce mounting risks of expanding foreign indebtedness of the banking system as well as slow down the ongoing credit boom. As a result, it will help to mitigate inflationary pressures, which are rooted in brisk consumption spending backed by rapid growth of domestic credit.

Money Supply (M3) and Domestic Credit, % yoy

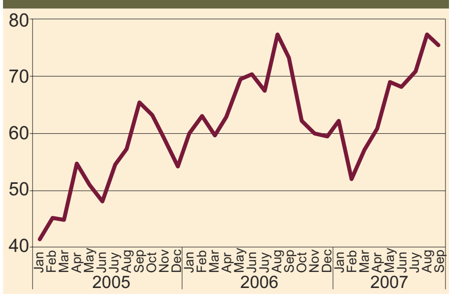


Source: NBRK, The Bleyzer Foundation

International Trade and Capital

In January-May 2007, exports grew by 28.3% yoy to USD 17.5 billion, while imports advanced by 51.7% yoy amounting to USD 11.8 billion. The foreign trade surplus stood at USD 5.7 billion, declining by 3% yoy against the same period of the previous year. As a result, the foreign trade surplus shrank for the second month in a row. This deterioration was largely driven by falling world crude oil prices, as in January-May, ICE Brent declined on average by 4.3% yoy. The expansion of the trade surplus is likely to accelerate in the second half of this year on the back of the resumed growth of world oil prices.

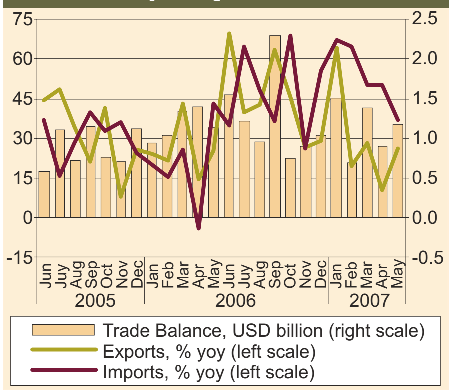
The ICE Futures Brent Index, USD a barrel



Source: IntercontinentalExchange (ICE)

However, remarkably fast growth of imports imposes an additional restriction on the growth of the foreign trade surplus. Notwithstanding the relatively rapid expansion of exports, the growth of imports has been surpassing the growth of exports since the beginning of 2007. Although this switch took place partially thanks to the sluggish dynamics of world oil prices, increasing domestic demand for investment and intermediary goods (driven by booming investments, solid industrial performance and impressive output growth in construction) essentially accounts for the acceleration of imports and the meek expansion of the foreign trade surplus. In particular, during the first five months of 2007, imports of machinery and equipment, metallurgical products, chemicals and minerals (commodities that regularly absorb nearly 85% of all demand for imports) grew by over 40% yoy.

Monthly Foreign Trade Balance



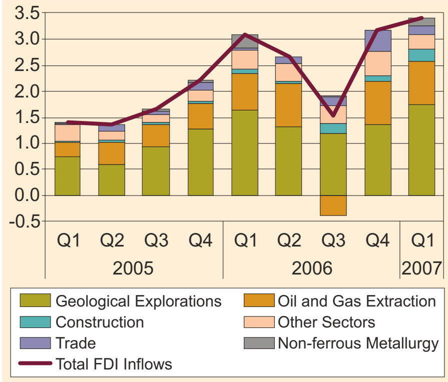
Source: ASRK, NBRK, The Bleyzer Foundation

In May alone, exports amounted to USD 4.08 billion growing by 26% yoy and imports increased by 36.9% yoy to USD 2.89 billion. Supported by stronger crude oil prices, the monthly foreign trade surplus posted a modest recovery of 5% yoy approaching USD 1.2 billion, compared to a decline of 36% yoy registered the month before.

The extracting industry of Kazakhstan continues to be a powerful magnet for foreign investors. During the first quarter of 2007, the gross inflow of FDI into Kazakhstan came close to USD 3.4 billion, outperforming the same quarter of the previous year by nearly 10% yoy. Investments into crude oil and natural gas extraction (USD 823 million, or up by 15.5% yoy) and geological explorations and investigations (USD 1.75 billion, or up by 7.4% yoy) constituted the bulk of gross FDI inflows, as these sectors captured more than 3/4th of the total FDI invested into Kazakhstan during January-March 2007. During the last several years, the pattern of FDI inflows has fundamentally reversed, giving the sector distribution of foreign investments a different composition. In particular, the amount of FDI invested into geological explorations and investigations has been exceeding FDI allocated to the extraction of oil and gas since January 2005.

In the first quarter of 2007, FDI into construction and trade increased by 210.2% yoy and 141.6% yoy respectively. Obviously, this trend reveals growing interest of foreign investors in trade and construction, which have been recently posting exceptionally strong growth rates. Yet the combined share of these sectors in gross FDI inflows still remains relatively low and barely exceeds 11%. Finally, over the first quarter of 2007, FDI into manufacturing declined by 41.1% yoy on the back of lower volumes of FDI into the metallurgical industry. Non-ferrous metallurgy, which consistently accounts for over one third of FDI inflows into manufacturing, attracted USD 134 million of foreign investments or 45% yoy below FDI into this sector during the first quarter of the previous year.

Gross FDI Inflows by Sectors, USD billion



Source: NBRK

During the first seven months of 2007, the foreign exchange reserves of the NBRK increased by 68.4% yoy to 23.41 billion, while the assets of the National Fund of RK surged by 77.2% yoy amounting to USD 18.1 billion.

Other Developments Affecting the Investment Climate

In the middle of July, Kazakhstan and the government of Canada held another round of bilateral negotiations on WTO accession. Canada has expressed its intent to support Kazakhstan's membership in the WTO, while a protocol on the completion of bilateral talks between two countries is anticipated to be signed in September. Encouraging progress was also achieved during similar talks with the US government that took place in Washington, DC in July. At the beginning of August, Washington issued a statement claiming that the US government is prepared to back the provision of membership in the WTO to all countries of Central Asia, including Kazakhstan.