Kazakhstan Macroeconomic Situation

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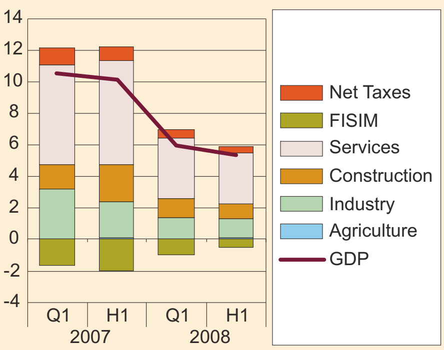
Summary

- In the first half of 2008, GDP grew by 5.4% yoy.
- In January-July, the state budget deficit stood at USD 735 million or 0.6% of projected full year GDP.
- The government submitted a new Tax Code and its first three-year budget to the Parliament.
- Consumer prices increased by 0.8% mom in August.
- In July, domestic credit inched up by only 5.9% yoy.
- The foreign trade surplus reached USD 17.95 billion in January-June, growing by 156% yoy.
- Kazakhstan's forex reserves totaled USD 48 billion in August.
- According to the World Banks' Doing Business in 2009, Kazakhstan has improved its position in the Ease of Doing Business ranking to 70th place from 80th a year ago.

Economic Growth

In the first half of 2008, GDP growth in Kazakhstan fell by nearly half to 5.4% yoy from 10.2% yoy a year ago, as value added grew slower in all key sectors of the economy (industry, construction and services.) In particular, industry grew by 3.8% yoy in January-June 2008 (compared to 6.8% yoy a year ago) as output in manufacturing remained virtually flat (manufacturing gained 9.8% yoy in January-June 2007). Construction, hit by tight credit conditions and falling housing prices, decelerated to 12.5% yoy from an impressive 36.8% yoy growth a year ago. Finally, the services sector slowed to 5.6% yoy (12.1% yoy a year ago) on the back of the anemic banking sector and weak retail trade. After all, during the first half of this year, retail trade grew by only 2.1% yoy (up by 11.1% yoy a year ago), while domestic credit increased by only 10.3% yoy (up by 110.7% yoy a year ago). As a result, the contribution of trade and financial activities to GDP growth shrank almost in half from 35% a year ago to less than one fifth in the first half of 2008. Indeed, while these two sectors alone ensured more than half of the value added growth in the services sector in January-June 2007, they barely generated one third this year.

Contributions to GDP growth by sector, percentage points

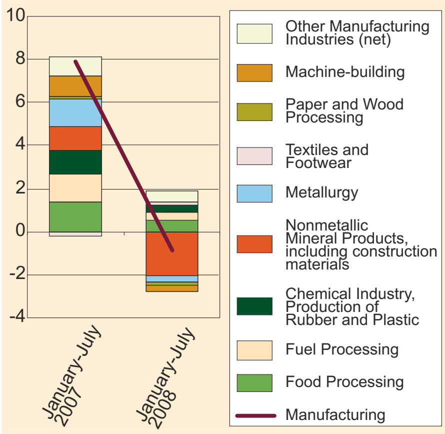


Source: ASRK, The Bleyzer Foundation

Weak performance of the manufacturing sector, which remains beset with stagnating output in industries producing construction materials, continues to be a drag on Kazakh industry. Indeed, during the first seven months of 2008, industry advanced by 3.3% yoy compared to 5.6% yoy growth in January-July 2007, as manufacturing declined by 0.9 % yoy. Essentially, the mining industry (which grew by 1.7 percentage points (pp) higher than a year ago) and the utilities sector (posting a growth of 4.2 pp higher than a year ago) helped maintain output growth in the industry. After all, the oil and gas extracting industry, which accounts for almost 60% of total industrial output, has been posting healthy output gains. During the first seven months of this year, crude oil extraction increased by 6.4% yoy to 33.7 million tons.

All told, the oil extraction industry looks increasingly likely to remain as the locomotive for the Kazakh economy in the medium-term. Crude oil output is projected to increase to 70 million tons in 2008, which is about 1.8% of total world production. Equally important, output from the Kashagan oil field is expected to lift the country's crude oil production to 150 million tons by 2015. The first stage of the experimental exploration works (EEW) at this field runs according to a schedule. The output capacity during this EEW stage is to stay at 20.9 million tons of oil a year or 1.3 million barrels per day (bpd), while commercial operations are to be launched in 2014. At that time, Kashagan's output is to be increased to 70 million tons per year or 1.5 million bpd.

Contributions to Growth in Manufacturing by Manufacturing Sectors, percentage points



Source: ASRK, The Bleyzer Foundation

Performance of manufacturing remains under pressure from the decelerating construction industry. Industries producing construction materials continue to stagnate. In particular, production of cement, concrete and bricks fell by 10.1 % yoy, 18% yoy and 23.8% yoy, respectively. A previous boom in the construction sector supported expansion of the industries producing construction material to 8% of total manufacturing output. As a result, a sharp deceleration of production in those industries wiped out positive, albeit modest, gains in food and fuel processing. Still, the impact of this deceleration on overall industrial output remains relatively trivial, as the share of industries producing construction materials accounts for only 3% of total industrial production.

The fundamentals of Kazakhstan's economy remain favorable for strong and resilient GDP growth in the future. Essentially, strong demand for commodities from developing countries will continue to boost Kazakhstan's export revenues. This will help to accumulate foreign reserves and ensure a stable flow of fiscal revenues to the government. Equally important, the financial health of Kazakh consumers, who still account for less than 50% of GDP, is likely to improve as inflation decelerates and the housing market stabilizes. GDP per capita may approach USD 9,000 in 2008, which means that consumer spending (at present, mostly allocated to foods and other staple household goods) is poised to reemerge as a strong domestic source of economic growth.

Fiscal Policy

In January-July 2008, the state budget deficit stood at USD 735 million or about 0.6% of projected full year GDP. Budget revenues increased by 28.2% yoy in nominal terms to USD 16.8 billion, supported by a 19% yoy growth of fiscal revenues and nearly USD 4 billion of transfers from the National Oil Fund (or about 23% of all budget revenues). Still, in real terms fiscal revenues remained flat as inflation stood at 20% yoy. Indeed, the slowing economy brought VAT revenues, which account for about one fourth of all tax revenues, to a halt, as VAT proceeds from goods and services produced in Kazakhstan (about 17% of all VAT revenues) shrank by nearly 40% yoy. Decelerating imports have been exerting a toll on tax revenues as well. For example, proceeds from excises on imported vehicles declined by 43% yoy, while revenues from import duties fell by 7% yoy. Yet, strong exports, supported by high commodity prices, still allowed the government to collect USD 1.3 billion in taxes on foreign trade or twice as much as a year ago. Meanwhile, the corporate income tax (CIT) and the personal income tax (both accounting for over 50% of total fiscal revenues) grew by a healthy 34% yoy and 26% yoy, respectively.

Budget expenditures (excluding net budget credits and purchases of financial assets) amounted to USD 15.7 billion and grew by 33.2%. This means that the state budget posted a non-financial cash surplus of USD 1.1 billion or 0.9% of full year GDP. Current expenditures of the state budget grew by 38% yoy as spending on wages, social transfers and government purchases of goods and services increased by 26% yoy, 32% yoy, and 43% yoy, respectively. At the same time, capital expenditures surged by 88% yoy to USD 4.4 billion. Finally, purchases of financial assets advanced by 57% to USD 2.3 billion. Essentially, the government has been injecting capital into state-run developmental institutions. In particular, the capital of the Kazyna Sustainable Development Fund, which was established in 2006 to modernize Kazakhstan's non-oil economy, was increased by USD 1.1 billion.

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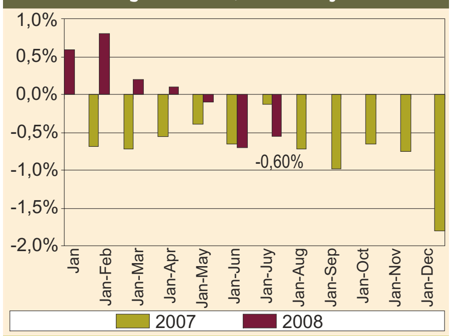
This fall, the government intends to implement major reforms of public finance in Kazakhstan. New Tax and Budget Codes and a three-year budget have already been submitted to the Parliament for deliberations. In particular, the new Tax Code envisions a reduction of the VAT rate to 12% in 2009, while the CIT is to be gradually lowered from 30% to 20% in 2009, to 17.5% in 2010 and to 15% in 2011. The social security tax will be set at a flat 11% rate, which will replace the current regressive scale of 5% to 13%, and a flat personal income tax will remain at 10%. In addition, a new scale for the mineral extraction tax (MET), which will depend on price and output levels, will be introduced to ensure a better link between tax payments and global commodity prices. Finally, amendments to the Budget Code mandate that the government develop a three-year budget based on long-term economic projections. A draft version of the first three-year budget was prepared as well. A unique feature of this document is that it assumes a rather conservative scenario for the evolution of world crude oil prices. In particular, the government conditioned all macroeconomic projections on the USD 60 per barrel world price of crude oil. As a result, GDP is estimated to grow by 5-7% a year in 2009-2013. This means that the nominal GDP may approach USD 150 million in 2009, while GDP per capita is expected to nearly double to USD 16,000 in 2013.

State Budget Balance, % of full year GDP



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

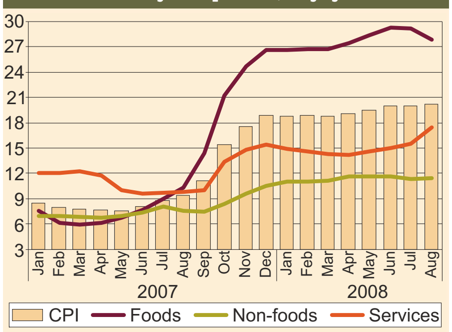
In 2009, republican budget revenues will amount to KZT 3,160.4 billion or about 17.6% of GDP and are to increase by about 16% yoy. However, this projection also assumes that transfers from the National Oil Fund will come close to 30% of budget revenues. Indeed, revenue losses due to ongoing tax reform are estimated to total KZT 534.5 billion in 2009. To compensate for these revenue shortfalls, the National Oil Fund will transfer KZT 843 billion to the government in 2009, KZT 1,076 billion in 2010 and KZT 1,012 billion in 2011. Meanwhile, the assets of the National Oil Fund are to grow to USD 48.4 billion by 2011.

Budget spending is projected at 20.6% of GDP in 2009. This means that the republican budget deficit will stay at 3% of GDP in 2009-2010 and is assumed to narrow to 2% of GDP in 2011.

Monetary Policy

During the first eight months of 2008, consumer prices (CPI) grew by 7.5% ytd or by 20.1% yoy compared to August 2007. On a monthly basis, the CPI advanced by 0.8% on the back of accelerating prices of non-food commodities and service tariffs. Meanwhile, food prices remained flat in August due to a seasonal expansion of supply of agricultural products. It appears that major inflationary pressures are presently rooted in the volatile prices of fossil fuels. To stabilize these prices, the government extended its previous ban on exports of petroleum products, which was to expire in September, to the beginning of 2009. All told, the inflationary outlook for the remaining four months of the year remains favorable. First, a good harvest (both in Kazakhstan and in the major global agricultural centers) will help to freeze food prices. Indeed the global food price index, calculated by the UN's Food and Agriculture Organization, fell by 5.6% mom in August (although it was still 25.6% yoy above its level in August 2007), which implies that supply conditions on the global agricultural markets have been gradually improving. Second, a fall in crude oil prices is likely to trigger a downward correction of fuel prices in Kazakhstan. This means that monthly inflation is likely to stay below 1% throughout the rest of the year. Thus, the CPI may fall close to 10% by the end of 2008.

CPI by Component, % yoy

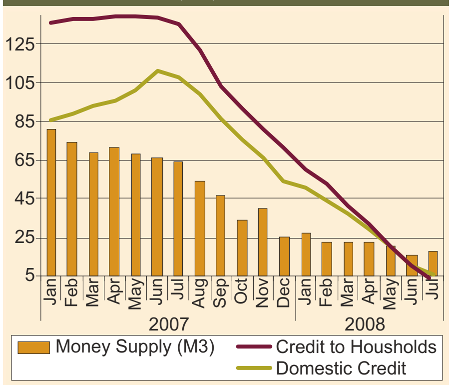


Source: NBK

The stock of domestic credit leveled out at USD 60.7 billion, advancing by only 5.9% yoy compared to 107.7% yoy a year ago. Credits to households remained on a downtrend that stretches back to December 2007 and fell by 4.9% since the beginning of 2008. At the same time, credits to the corporate sector increased by 3.1% during the first seven months of 2008.

Collapsing housing prices, weakening borrowing capacity of households and a buildup of non-performing loans prompted banks to tighten their credit policy. On a positive note, the loss absorption capacity of Kazakh banks remains at a comfortable level. According to the Agency on Financial Supervision (AFS), banks have amassed about USD 6 billion (or 8% of all loans) in provisions against credit risks. This amount exceeds the volume of 90 days overdue and non-performing loans, which totaled 4.3% and 2.8% of all loans, respectively.

Money Supply (M3) and Domestic Credit



Source. NBK, The Bleyzer Foundation

In July, deposits at commercial banks totaled USD 38.6 billion, growing by 21.7% yoy or by USD 6.2 billion since the beginning of the year. The corporate sector reestablished itself as a main source of the internal funds for the banking system, increasing its bank deposits by USD 5.9 billion during the first seven months of 2008. Meanwhile, households, squeezed by a sluggish growth of real incomes (in January-June, households' real incomes grew by only 3.8% yoy, compared to 18.5% yoy a year ago), increased their deposits by only USD 300 million.

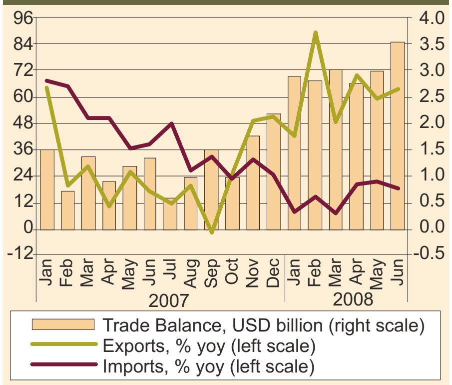
Finally, Kazakhstan's banking sector appears to show encouraging signs of improvement. Indeed, in August Kazakhstan's fourth largest bank, Halyk Bank, managed to close a USD 300 million syndicated loan, which was oversubscribed by nearly 50%. This may imply that foreign creditors are not losing confidence in Kazakhstan's banking system. True, Kazakh banks have to bear higher costs of foreign borrowings amid the ongoing global reassessment of risky assets in emerging markets. However, favorable long-term fundamentals (both domestic and external) will continue to encourage flows of foreign capital into Kazakhstan.

Equally important, Kazakhstan's strong and improving international liquidity position adds an extra layer of security to the country's economic outlook. In August, forex reserves of the National Bank increased by USD 715.4 million and amounted to USD 21.7 billion. Meanwhile, the assets of the National Oil Fund grew to USD 26.5 billion. As a result, the country's total forex reserves stood at USD 48.3 billion, which is four times higher than the country's total short-term debt of USD 12.03 billion and exceeds the total external debt of the banking sector by USD 3.2 billion.

International Trade and Capital

According to the Ministry of Finance, the current account surplus is estimated at USD 6.7 billion in the first half of 2008 compared to a deficit of USD 2.4 billion a year ago. Essentially, record high crude oil prices widened the trade in goods surplus to USD 17.95 billion, which is 2.6 times higher than in January-June 2007. A deceleration of imports helped to improve external balances as well. Indeed, imports increased by only 15.5% yoy, which is 3 times less than a year ago.

Monthly Foreign Trade Balances



Source. ASRK, The Bleyzer Foundation

All told, strong FDI inflows and the current account surplus create a safe cushion against unfavorable external developments and support exchange rate stability. Indeed, according to the National Bank, net FDI inflows stood at USD 2.3 billion in the first quarter of 2008. Until now, more than two thirds of FDI inflows were absorbed by the oil industry and metallurgy. However, a recent purchase of a 23% stake in a Kazakh bank by the Korean Kookmin Bank for USD 500 million (the Kookmin bank is expected to spend USD 1.3 billion to gain full control over its Kazakh acquisition) implies that foreign investors may become more active in the non-oil sector of the Kazakh economy. As Kazakh authorities continue to liberalize the country's non-oil economy and consumer markets mature, it is safe to assume that the attractiveness of Kazakhstan to multinational companies that produce consumer goods and supply consumer-oriented services, including retail financial services, will strengthen.

Other Developments Affecting Investment Climate

The Kazyna Sustainable Development Fund is to allocate USD 83 million to support regional small and medium enterprises (SME). Investment projects in manufacturing, transport and communication sectors will be financed directly without banks' intermediation at an interest rate equal to the National Bank's refinance rate, which at present is fixed at 10.5% compared to an average interest rate of 16.2% charged by the commercial banks for SME loans. Earlier this year, the government allocated USD 1.3 billion to support the development of the SME sector via the Kazyna and local commercial banks.

The President of Kazakhstan approved a new state program "The Way to Europe" for 2009-2011. The key objective of this program is to build a new strategic partnership with European countries. This project will focus on foreign trade, transport and communication management and diplomatic relations between Kazakhstan and the EU. According to the program, Kazakhstan and its European partners will jointly implement investment projects in information technology, energy and SME sectors. This initiative aims to lift the country's living standards close to EU level with reforms in public administration, civil service and the political system.

The World Bank and the IFC have issued their regular Doing Business report for 2009. According to its findings, Kazakhstan has visibly improved its position in the Ease of Doing Business to 70th place from 80th a year ago. In particular, much progress was made in liberalizing property registration (up by 52 positions) and improving access to credit (up by 18 positions). In these areas, Kazakhstan came close to the performance of the OECD countries. Furthermore, in terms of ease of paying taxes, Kazakhstan has a rather competitive position in the region. It takes 9 payments and 271 hours to pay taxes in Kazakhstan compared to 47 payments and 366 hours across the region. If a new Tax Code is approved, Kazakhstan may end up with the most liberal taxation of the non-oil economy both in comparison to its regional peers as well as to OECD economies.

Doing Business in 2009, Kazakhstan's Rank

Ease of Doing Business Rank	70
Starting a Business	78
Dealing with Construction Permits	175
Employing Workers	29
Registering Property	25
Getting Credit	43
Protecting Investors	53
Paying Taxes	49
Trading Across Borders	180
Enforcing Contracts	28
Closing a Business	100

Source: World Bank