Kazakhstan

Macroeconomic Situation

October 2007

Sergiy Kasyanenko, Edilberto L. Segura, Leilya Shamelova

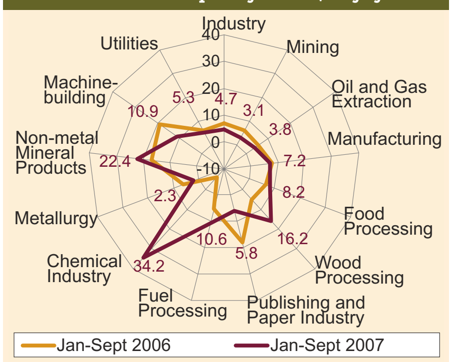
Summary

- Despite the latest global financial turmoil, Kazakhstan's economy continued to expand at a robust rate, growing by 9.7% year-over-year during the first nine months of 2007.
- Although industrial growth is still mostly driven by the expansion of the mining industry, manufacturing has been consistently achieving a more balanced and diversified performance.
- Kazakhstan continues to enjoy rather benign fiscal conditions as in January-September the state budget deficit remained below 1% of projected full year GDP.
- Surging prices of foods pushed the consumer price index further above the 10% level.
- Inflationary pressures are expected to subside as domestic credit posted a visible sign of moderation on the back of tighter international credit markets.
- Rapid growth of imports has been exacting a toll on the expansion of the trade in goods surplus in 2007.
- According to the World Competitiveness Report 2007-2008, Kazakhstan managed to secure a competitive edge against most of its rivals in the region.

Economic Growth

Despite the latest strain in the global credit market, Kazakhstan's economy entered the fourth quarter on a solid note, as economic activities continued to expand at a robust rate. Preliminary estimates by the Ministry of Economic Affairs and Budget Planning placed GDP growth at 9.7% year-over-year (yoy) during the first three quarters of 2007. In essence, thriving domestic demand kept the economy on course for strong growth as gross fixed capital formation (up by 11.9% yoy) and private consumption (up by 10.7% yoy) did not show signs of deterioration. The readings on the external sector have been fundamentally solid as well. However, unprecedented acceleration of imports, fueled by booming domestic demand, may trigger some moderation of net exports this year.

Industrial Output by Sector, % yoy

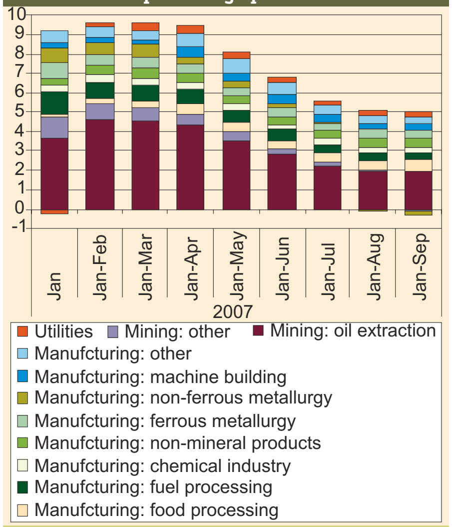


Source: ASRK

So far, the risk of the contagion of the global financial turmoil to the real economy remains relatively balanced. Robust performance of construction and service sectors continues to shape the economic outlook as financial and construction activities contributed nearly half to GDP growth in January-September 2007. At the same time, restricted access to international money markets by Kazakh banks affected domestic lending institutions as the stock of domestic credit leveled out in recent months. However, the moderation of the Kazakh financial sector is very unlikely to add severe constraints to the rest of the economy or tip Kazakhstan into recession. Brisk expansion of construction and banking sectors during the first nine months of this year ensures sufficient capacity to ride out the credit squeeze without a sharp deceleration of economic growth in 2007.

In addition, resilient growth of construction and service industries helped to balance a moderate deceleration of industrial production. In January-September, industry advanced by 4.7% yoy as slower growth of the oil extraction sector (up by only 3.8% yoy as compared to 5.3% yoy a year ago) restrained overall performance of the mining industry (up by a modest 3.1% yoy).

Contributions to Industrial Growth by Sector, percentage points



Source: ASRK, The Bleyzer Foundation

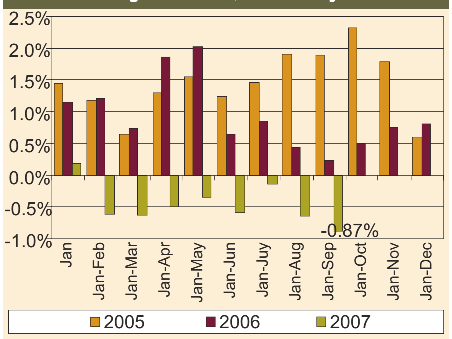
Industrial dynamics remain rather vulnerable to the volatile global demand for base natural resources as the share of the mining industry and metallurgy in total industrial production still exceeds 70%. In addition, stretched national extraction capacities are exacting a visible toll on the overall pace of industrial activities in 2007. Nevertheless, manufacturing, which already generates about 40% of industrial output, grew by a healthy 7.2% yoy despite a deceleration of metallurgy to 2.3% yoy. Currently, manufacturing supports over 55% of total industrial growth as compared to about 40% in the same period of the previous year. Furthermore, during the first three quarters of this year, the contribution of metallurgy to the growth of manufacturing output was twice as low as a year ago. Consequently, the impact of other manufacturing sectors, which are strongly driven by growing domestic demand, has recently become much more pronounced. In particular, steady and robust expansion of food processing, chemical and fuel processing industries as well as production of construction materials contributed about 2/3 to the growth of manufacturing or more than 1/3 to overall industrial growth.

Fiscal Policy

Fiscal conditions remained rather benign as the collection of principle taxes was supported by strong gains in employment and incomes as well as the resilient performance of the corporate sector. Robust consumer spending and increasing business expenditure on capital have been fueling domestic trade and spending on imports, widening the tax base for indirect taxes. In particular, during the first nine months of 2007, proceeds from excises, VAT and custom duties advanced by 25.8% yoy, 30.8% yoy and 38% yoy respectively.

In January-September, state budget revenues grew by 18.7% yoy in nominal terms to KZT 2,042 billion (USD 16.93 billion) while state budget expenditures advanced by 21.4% yoy, totaling KZT 1,935 billion (USD 16 billion). The state budget deficit inched up to KZT 117.9 billion (USD 976 million) or 0.87% of projected full year GDP.

State Budget Balance, % of full year GDP



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

Stronger than expected macroeconomic fundamentals as well as higher projections for non-tax revenues prompted the Parliament of Kazakhstan to revise the 2007 budget law. At the end of October, the President of Kazakhstan signed these amendments, which enlarged budget revenues and expenditures by KZT 175.1 billion (USD 1.45 billion) and KZT 133.7 billion (USD 1.11 billion) respectively. As a result, the budget deficit was reduced by KZT 41.5 billion (USD 344 million) and is anticipated to hit KZT 229.6 billion (USD 1.9 billion), or 1.7% of full-year GDP (compared to the previous estimate of 2.6%).

The lower house of Parliament is drafting the 2008 budget law. Obviously, the government is poised to increase budget expenditures as Kazakhstan still faces significant social and infrastructure needs. At the same time, provisional assumptions on next year's budget imply that the budget deficit will be contained below 1.5% of GDP. These projections are cemented

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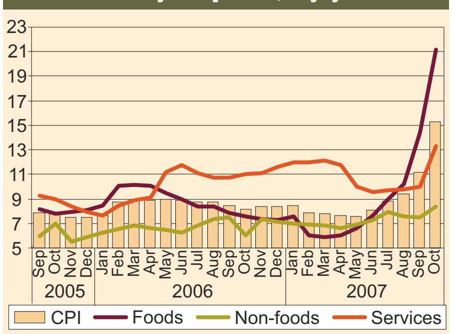
by the strong expectations of robust economic performance and lower inflationary pressures, which will help to preserve solid growth of tax revenues in 2008. Furthermore, the budget is to be granted USD 3.5 billion of transfers as a buffer against unexpected revenue shortfalls.

Monetary Policy

Inflation has recently emerged as the most imminent threat to macroeconomic stability in Kazakhstan. This risk is inspired by the unfavorable confluence of forces, stemming from both monetary and supply sides. First, rapid economic growth intensified overheating risks as strong domestic demand had stretched the economy's supply capacity. Furthermore, booming domestic credit further encouraged consumer and investment spending, adding extra demand pressures to the inflationary outlook. Second, the sharp rise in oil prices (driven by frequent global supply interruptions, record low levels of petroleum stock in the US and a weak US dollar) fanned domestic prices of fuels with a direct impact on costs of transportation and utilities. In addition, adverse weather conditions set off global supply disruptions of agricultural commodities, prompting a surge in food prices.

Obviously, consistently high economic growth rekindled overheating concerns, which appeared rather material in light of the unprecedented expansion of the banking sector. Although the central bank has been pursuing moderate monetary tightening, its hands are virtually tied by the unfolding global credit crunch, which spells liquidity trouble for domestic lending institutions. On the positive side, this external liquidity shock is anticipated to trigger a smooth moderation of domestic credit, which will eventually move Kazakhstan's economy onto a sustainable long-term growth path. As a result, a tighter lending environment is expected to correct booming domestic demand, cooling inflationary pressures.

CPI by Component, % yoy

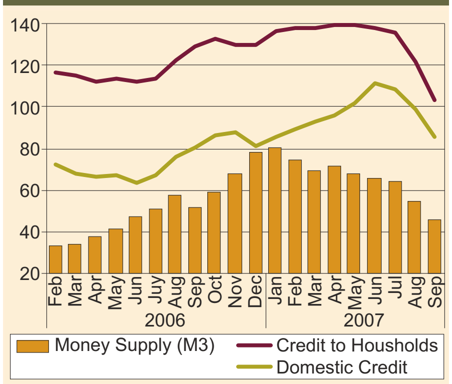


Source: ASRK

According to the National Bank of Kazakhstan (NBRK), the consumer price index (CPI) is forecasted to post record growth in the last quarter of this year. October has steadily lived up to these expectations. Appreciable price movements pushed the CPI over 10%, as inflation picked up at 15.3% yoy. Skyrocketing prices of foods, which surged by 21.2% yoy, have firmly ascertained their principle role in driving inflation. Prices of non-foods and service tariffs resumed their rise as well, advancing by 8.4% yoy and 13.3% yoy respectively.

In September, the money supply (measured by monetary aggregate M3) stood at KZT 4,453 billion (USD 36.8 billion), increasing by 45.9 % yoy. Total domestic credit granted by commercial banks reached KZT 7,118 billion (USD 58.8 billion), increasing by 86.1% yoy in September. On a monthly basis, the money supply continued to follow a downtrend that stretches back to June. Apparently, tighter global credit conditions have been affecting domestic banks, which still rely heavily on foreign funds to run their credit portfolios. In September, a visible deceleration of credit to the corporate sector and households was maintained, as the stock of credit to corporations and households grew by 77.8% yoy and 103% yoy respectively, down from the faster growth registered a month before.

Money Supply (M3) and Domestic Credit, % yoy

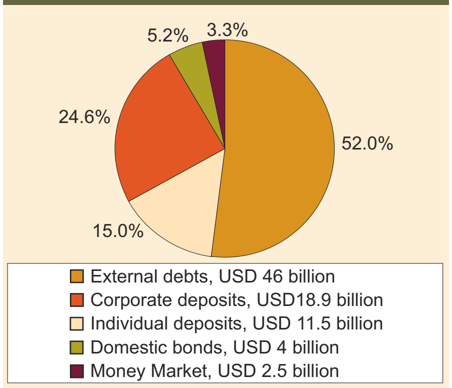


Source: NBRK, The Bleyzer Foundation

Continuing volatility on the international money markets implies restricted access to foreign credit by Kazakh banks. The traditionally high proportion of external borrowing in their funding structure presumes that credit resources available to local businesses and households may become scarcer. Obviously, setbacks in external funding of Kazakh banks must be compensated for by domestic sources. Corporate deposits may represent a feasible alternative, as they still remain the major internal source of funding (about 62% of all deposits) despite the recent drop in deposits. In September, deposits at commercial banks fell by 2.2% month-over-month (mom) to USD 30.5 billion. Although both households and corporations reduced their deposits, it appears that households were more active in readjusting the currency compositions of their deposits. While the share of forex-denominated deposits held by households amounted to 24.7% of total household deposits in July, it jumped to 33.5% in September. This development was mainly affected by August volatility on the local forex retail market. Sharp, albeit short-lived, appreciation of the US dollar raised devaluation expectations, prompting a conversion of KZT-denominated deposits into forex-denominated deposits. In addition, individuals may have been withdrawing their deposits from the banks believed to be most exposed to the global credit turmoil to redeposit them in safer banks. Indeed, in July-September, the stock of household deposits varied quite visibly in most of the top ten commercial banks — falling by 70% at the fourth largest bank (Alliance Bank) and almost doubling at the third largest bank (Halyk Bank). However, the total stock of household deposits attracted by the top ten banks shrank rather modestly by 4.5%.

As the NBRK intervened in August to curtail devaluation pressures, the exchange rate returned to its pre-crisis level. This explicit commitment of the central bank to maintain exchange rate stability (even at the cost of reserve depletion) will help mitigate potential deposit-run threats faced by domestic banks.

Funding Structure of Kazakh Banks



Source: Agency of the Republic of Kazakhstan on regulation and supervision of financial market and financial organizations

The ongoing liquidity risks are partially driven by the deterioration of the local banks' capacity to access international money markets. This makes it difficult to prolong outstanding loans. The funding base of at least some Kazakh banks may be under pressure due to the redistribution of resources within the banking system. Essentially, the capacity of domestic financial institutions to ride out the credit squeeze is conditional on several factors: (i) their ability to refinance part of their short-term loans through syndicated or bilateral loans; (ii) a sound and balanced maturity profile of assets and liabilities; (iii) their own capital endowment and shareholders' support and (iv) the availability of other assets to cover payments on short-term liabilities. Although access to external funds has recently weakened, most banks report a balanced asset-liabilities maturity profile, which means that they can repay maturing loans from matured assets. Most of the large banks can rely on shareholders' support as in the case of ATF, Alliance and Caspian Bank. Furthermore, several banks have large, identifiable and potentially valuable assets outside of

Kazakhstan and can use them as a source of financing and recapitalization.

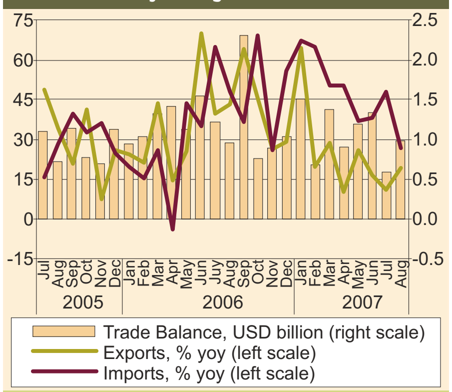
The financial crisis is unlikely to severely damage the banking sector of Kazakhstan. The country's strong performance is supported by improved macroeconomic policies, reforms to enhance the business environment, booming oil prices, and increasing inflows of foreign direct investment. Furthermore, moderate policy tightening to dampen inflationary pressures should leave sufficient space to keep average growth high enough for sustainable improvement of per-capita incomes.

International Trade and Capital

Record high acceleration of imports has been exacting a toll on the expansion of the trade in goods surplus, which fell by 10.3% yoy as compared to January-August 2006. During the first eight months of this year, exports increased by 22.9% yoy while imports jumped by 45.2% yoy, bringing the trade in goods surplus to USD 8.56 billion or nearly 8% of projected full year GDP (as compared to 12.3% in the same period of last year).

September started the season with a foreign trade surplus of USD 987.2 million due to the growth of exports by 19.5% yoy, which totaled USD 3.86 billion. Imports grew by 26.7 % yoy to USD 2.88 billion.

Monthly Foreign Trade Balance



Source: ASRK, NBRK, The Bleyzer Foundation

The first half of the year ended with a moderate current account deficit of USD 2.4 billion, which is around 2.2 % of projected full year GDP. Total current payments exceeded current revenues by 42.4% yoy. The current account deficit was mostly driven by declining income and trade in service balances. In addition, the trade in goods balance registered relatively weaker performance than a year ago.

The Structure of the Current Account

	Trade in Goods balance		Trade in service balance		Income balance		Current transfers balance		Current account
	USD billion	%, yoy	USD billion	%, yoy	USD billion	%, yoy	USD billion	%, yoy	USD billion
H1 2005	5	100	-2	54	-2.5	127	-0.078	-51	0.418
H1 2006	7.4	48	-3	50	-4.05	62	-0.358	359	0.055
H1 2007	7.1	-5	-3.2	6.7	-5.3	30.1	-0.922	158	-2.4

Source: NBRK

The net inflow of foreign direct investments (FDI) in the first half of 2007 amounted to USD 4.1 billion, increasing by 15.8 % yoy. Gross inflow of FDI jumped to USD 6.9 billion and was mainly deployed into oil and gas extraction projects in the North Caspian and Karachaganak oil fields.

Other Developments Affecting the Investment Climate

In October, the World Economic Forum issued an update on the World Competitiveness Index, which places Kazakhstan at 61st position out of 131 countries rated. Kazakhstan still enjoys competitive advantages against adjacent Asian countries (with the exception of China) and is judged to be more competitive than two new members of the EU — Romania and Bulgaria. At the same time, more efforts are necessary (to enhance institutions, strengthen primary education and improve financial markets) to preserve the current competitive position as well as advance the country's competitiveness to the level of BRIC countries.

In October, Fitch confirmed Kazakhstan's sovereign ratings, resetting the country's outlook from positive to stable. This change in outlook reflects excessive exposure of the banking sector to foreign indebtedness. Apparently, an ongoing shift in the general attitude toward credit risk assessment raises concerns over the long-term sustainability of highly leveraged domestic lending institutions. However, Kazakh banks are believed to be undergoing a relatively smooth adjustment as their capitalization and profitability remains strong. Furthermore, tighter credit conditions are expected to prompt a necessary transition toward more sustainable and prudent banking business practices. Moody's expressed similar sentiments in its recent Banking System Outlook for Kazakhstan. According to Moody's, refinancing risks and possible deterioration in asset quality may trigger further moderation of the domestic banking system, provided that the global financial crisis persists. At the same time, these risks appear to be relatively well balanced by the improved bank profitability as well as the willingness and capacity of the government and shareholders to support struggling lending institutions.

Country	Global Competitiveness Rank 2007-2008															
	Overall	Subindex A					Subindex B							Subindex C		
			1st pillar	2nd pillar	3d pillar	4th pillar		5th pillar	6th pillar	7th pillar	8th pillar	9th pillar	10th pillar		11th pillar	12th pillar
China	34	44	77	52	7	61	45	78	58	55	118	73	2	50	57	38
India	48	74	48	67	108	101	31	55	36	96	37	62	3	26	26	28
Turkey	53	63	55	59	83	77	51	60	43	126	61	53	18	48	41	53
Russia	58	68	116	65	37	60	48	45	84	33	109	72	9	77	88	57
Kazakhstan	**61**	**66**	**80**	**71**	**25**	**94**	**58**	**57**	**63**	**15**	**80**	**77**	**56**	**84**	**85**	**75**
Uzbekistan	62	69	56	66	103	59	76	49	66	43	115	84	70	51	59	42
Azerbaijan	66	65	83	60	23	103	84	89	95	46	91	83	71	68	80	54
Brazil	72	101	104	78	126	84	55	64	97	104	73	55	10	41	39	44
Ukraine	73	90	115	77	82	74	66	53	101	65	85	93	26	75	81	65
Romania	74	88	94	100	84	52	62	54	74	85	78	59	43	73	73	76
Bulgaria	79	76	109	84	47	56	72	66	90	73	74	65	61	91	92	88
Armenia	93	91	96	87	57	99	101	95	104	40	110	104	111	103	115	94
Mongolia	101	102	120	125	48	98	103	74	96	59	105	106	124	114	126	95
Tajikistan	117	114	88	109	127	104	124	106	119	72	124	123	118	108	121	97
Kyrgyz Republic	119	122	127	110	128	96	112	87	118	67	112	129	117	121	117	120

- **Subindex A: Basic requirements** — 1st pillar: Institutions, 2nd pillar: Infrastructure, 3rd pillar: Macroeconomic stability, 4th pillar: Health and primary education;
- **Subindex B: Efficiency enhancers** — 5th pillar: Higher education and training, 6th pillar: Goods markets efficiency, 7th pillar: Labor markets efficiency, 8th pillar: Financial markets sophistication, 9th pillar: Technological readiness, 10th pillar: Market size;
- **Subindex C: Innovation and sophistication factors** — 11th pillar: Business sophistication, 12th pillar: Innovation.

Source: World Competitiveness Report 2007–2008

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Where Opportunities Emerge.

Astana Office, Kazakhstan
Samal citydistrict, 12 Astana Tower,
20-th floor, office 20-III, Astana, 010000
Tel./fax 8 (3172) 59-25-76/77/78/79/80
E-mail: office@sigmableyzer.kz