

Macroeconomic Situation

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Summary

- During the first eight months of 2008, industry grew by 3% yoy.
- In January-August, the state budget posted a deficit of USD 1.3 billion or about 1% of projected full year GDP.
- In September, consumer prices grew by 18.2% yoy.
- In August, domestic credit inched up by less than 2% yoy.
- Kazakhstan entered the second half of the year with a current account surplus of USD 6.5 billion.
- In January-July, the foreign trade surplus reached USD 21 billion.
- In September, Kazakhstan's forex reserves grew to USD 49.5 billion.

Economic Growth

As the international credit crisis continues to exert a toll on the global economy, Kazakhstan is increasingly likely to see slower economic growth in the near-term. Indeed, the International Monetary Fund (IMF) expects Kazakhstan to grow by 4.3% yoy and 5.3% yoy in 2008 and 2009, respectively. International credit markets remain tight, while a moderation of the global economy triggered a downward correction of the prices of energy and industrial metals — staple export commodities of Kazakhstan.

However, these global trends have merely tilted the balance in favor of lower GDP growth rather than a sharp economic slowdown. Several factors continue to support a strong economic outlook for Kazakhstan. First, although world crude oil prices are down by nearly 50% from their peak in July, increasing oil extraction will help to offset a downward price correction. Second, the government has accumulated large forex reserves, which can be tapped to stabilize the economy. Third, the external financing needs of Kazakh banks will begin to ease in the first half of 2009. The amount of banks' foreign debt to be repaid or refinanced peaked in the first half of 2008, with over USD 5 billion due in the third quarter alone. It is projected to decline by about 50% to an average of USD 3.3 billion during the next two quarters. Then, these repayments will amount to USD 2 billion per quarter on average through the rest of 2009.

Equally important, Kazakhstan's consolidated political system helps to shorten the policy response lag to contain the impact of the global financial crisis. In addition to the previously announced stabilization measures, the government has increased deposit insurance for each bank account by over 7 times to USD 41,800. Furthermore, in 2008 the government will receive USD 10 billion from the National Oil Fund to implement its economic stabilization program. These funds will be spent to recapitalize the four largest commercial banks of Kazakhstan. And finally, the country's minimal amount of the foreign external debt leaves plenty of

room to borrow from abroad against future oil revenues.

In January-August, industrial output amounted to USD 60.8 billion and grew by 3% yoy, compared to 5% yoy a year ago. Resilient growth in the mining industry and utilities continued to offset a deceleration in the manufacturing sector. While output in manufacturing remained virtually flat in January-August, output in the mining industry and utilities accelerated to 5.3% yoy and 9% yoy, respectively. Manufacturing remained under the pressure of tight liquidity in the banking sector, slowing domestic investment and consumer demand and a weakening construction sector. As a result, industries producing construction materials have been stagnating since the beginning of the year. A decelerating construction sector and a recent fall of the prices of industrial metals do not bode well for Kazakh metallurgy as well. Metallurgy (which accounts for about 45% of total manufacturing output) gained only 1.2% yoy, compared to 3.4% yoy in January-August 2007.



The mining industry grew on the back of a steady expansion of crude oil and gas extraction, which increased by 5.3% yoy. In particular, crude oil output totaled 38.3 million tons in January-August or up by 5.1% yoy, while natural gas production expanded to 13.05 billion cubic meters, growing by 15.7% yoy.

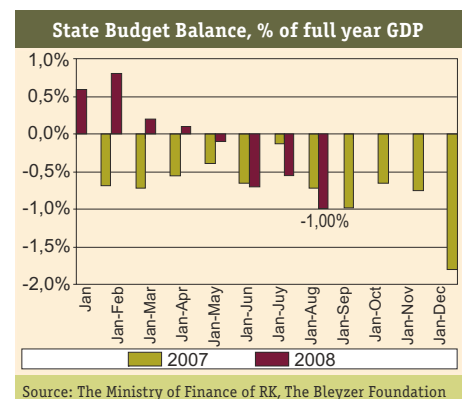
Finally, a good harvest helped to boost output in agriculture to 20.2% yoy compared to 3.1% yoy in January-August 2007. Although agriculture accounts for only 7% of value added, its extraordinary performance is likely to partially offset a slower growth in construction and services.

Fiscal Policy

In January-August, the state budget registered a deficit of KZT 154.04 billion (USD 1.3 billion) or about 1% of projected full year GDP. Still, the government's cash balance (which excludes purchase of financial assets and equity injections into the national investment funds) remained in surplus of about USD 700 million or 0.5% of GDP. The cash

balance is projected to post a trivial deficit of 0.3% of GDP in 2008. Budget revenues grew by 26.2% yoy and amounted to USD 18.9 billion. Fiscal revenues, which account for over 75% of total budget revenues, increased by a healthy 20% yoy. Meanwhile, transfers from the National Oil Fund to the state budget totaled USD 3.9 billion. Although budget revenues remained robust despite slowing economic growth and were supported by record high crude oil prices, falling oil prices may force the government to increase withdrawals from the National Oil Fund to make up for a cyclical deceleration of tax revenues in the future.

Budget expenditures amounted to USD 18.2 billion and grew by about 30% yoy. However, this growth was largely driven by higher public investments and state purchases of financial assets. Indeed, capital spending and purchases of financial assets grew by 44% yoy and 52% yoy respectively. At the same time, current budget expenditures, which include spending on wages, pensions and social benefits, grew much slower at about 19% yoy in nominal terms. This means that in real terms the budget spending on these items remained flat or even declined, which may add an additional layer of credibility to the government's anti-inflation program.



In October, Mazhilis — the lower chamber of Kazakh Parliament, approved the first three-year budget and a new Tax Code in the first reading. The deficit of the republican budget is projected to stay at around 3% of GDP in 2009 and 2010 (mostly as a result of the ongoing tax reform that aims to slash key tax rates) and will be reduced to 2% in 2011. Expenditures are to grow by 15.4% yoy and 4.7% yoy in 2010 and 2011, respectively. Budget revenues are expected to accelerate as well, driven by growing oil extraction and the development of the non-oil economy. The government expects Kazakh crude oil output to approach 79.2 million tons next year, 81.3 million tons in 2010 and 81.6 million tons in 2011. In addition, an oil export duty, which was introduced in May, is to double from USD 109.9 to USD 203.8 per ton in the middle of October. According to a new three-year budget, the mineral extraction tax (MIT) is to replace the royalty tax currently imposed on all users of mineral resources, which is expected to bring an additional

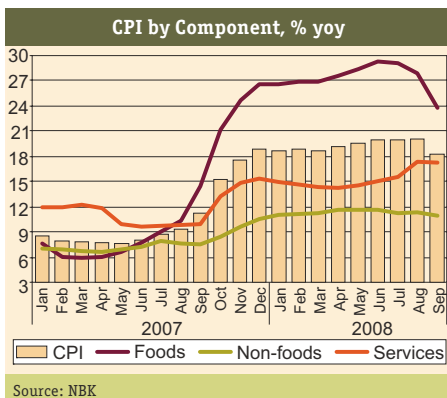
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USD 2.03 billion to the state budget in 2009. An export duty on crude oil and gas condensate will generate another USD 1.9 billion in 2009 compared to USD 756 million this year. As a result, the assets of the National Oil Fund are projected to grow by USD 12.1 billion next year and will amount to USD 48 billion by 2011. Fiscal revenues from the oil sector should compensate for the losses from VAT and corporate income tax (CIT) rate cuts. Revenues from the CIT will amount to USD 5.4 billion in 2009 down from a projected USD 9.4 billion in 2008 as the rate of CIT will be cut to 20% from 30%.

Monetary Policy

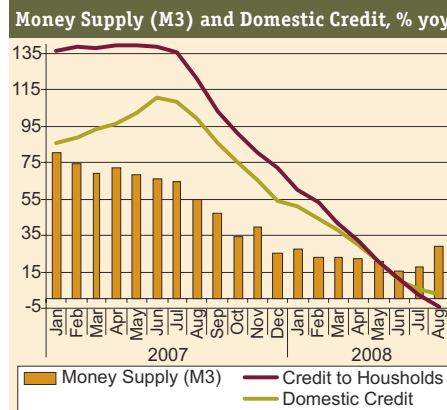
Although high food and energy prices kept the consumer price index (CPI) at 19.2% yoy on average in 2008, inflationary pressures have recently eased. Weaker consumer demand and anemic consumer credit are expected to contribute to a slight deceleration of inflation by the end of this year. More than that, the government estimates that the CPI will stay below 10% yoy in December, compared to 18.8% yoy at the end of 2007.

During the first nine months of 2008, the CPI grew by 8.1% ytd compared to 8.6% ytd a year before. Growth of prices of foods and non-food commodities has visibly moderated to 23.7% yoy and 10.9% yoy, respectively, helped by more favorable supply conditions at the global agricultural markets and falling fuel prices. However, the dynamics of food prices remain mixed. Strong demand for foods and tight local supply of vegetable oil, butter and milk products continue to exert an upward pressure on prices despite good performance in agriculture. Meanwhile, prices of gasoline and diesel fuel decreased by 3.1% mom and 2.7% mom. At the same time, the start of the heating season has raised the prices of utilities by 1.5% mom.



Kazakh banks have continued to limit lending in the second half of the year. In August, the stock of domestic credit leveled out at USD 60.1 billion growing by only 1.9% yoy, compared to nearly 100% yoy a year before. In particular, credit to households fell by 3.7% yoy. This means that household

debt to banks is now USD 780 million lower than in August 2007 and USD 1.2 billion lower than at the beginning of 2008 (or down by 5.7% ytd).



On a positive note, the CPI adjusted value of loans issued by local commercial banks shrank by more than 13%, which may imply that the debt burden on the economy is declining in real terms. However, the real disposable income of an average household remained at the same level in August as a year ago, posting a trivial gain of 0.1% yoy. Meanwhile, prices of newly commissioned and pre-owned housing fell by 6% yoy and 19.4% yoy, respectively. Housing prices in the largest city, Almaty, plunged even deeper by 15% yoy and 47%, respectively. All of this means that higher inflation, slower growth of incomes and falling asset prices is impairing the debt serving capacity of borrowers, which compromises the quality of the banks' loans. Indeed, the share of overdue loans increased from 3.1% to 10.5% during the past twelve months, while the share of non-performing loans jumped from 0.9% to 5.75%. As a result, the banking system faces both higher liquidity and solvency risks.

Quality of Loans Issued by the largest ten commercial banks of Kazakhstan, August 2008

	share of loans in the banking system	% change yoy	% of non-performing	provisions against credit losses, % of all loans
BTA Bank	25.8%	12.6%	2.7%	6.24%
Kazkommertsbank	24.0%	-8.4%	9.4%	13.53%
Halyk Bank	13.1%	31.3%	6.2%	8.30%
ATF Bank	8.9%	3.7%	4.5%	4.80%
Alians Bank	7.9%	-21.1%	7.5%	8.51%
Bank CenterCredit	6.9%	-11.9%	5.3%	6.78%
Temir Bank	2.8%	-13.1%	4.4%	4.65%
The Caspian Bank	2.0%	5.8%	6.9%	7.86%
Nurbank	2.0%	27.4%	7.8%	9.13%
Eurasian Bank	1.3%	-11.9%	6.5%	4.92%
Banking System		2.3%	5.7%	8.21%

Source: Agency on Financial Supervision

Still, the picture is not all bleak. First, banks' provisions against credit losses stood at all time high in August — USD 6.2 billion, or 8.2% of all loans. This is sufficient to cover possible losses from bad and non-performing loans. Second, banks maintain healthy capital adequacy and liquidity ratios. The share of liquid assets in total bank assets accounts for 14.9% or USD 15.6 billion. This means that Kazakh banks will be able to repay their external liabilities due in 2008. Third, according to the central bank, repayments of foreign liabilities of Kazakh banks will fall to USD 3.3 billion on average in the last quarter of 2008 and the first quarter of 2009. In 2009, banks will have to repay about USD 10.6 billion of foreign debt. Finally, authorities continue to support the stability of the national financial system. The government has recently increased deposit insurance for all household deposits to USD 41,800. This level is estimated to cover 99% of all household deposits in the banking sector, which will help to maintain depositors' confidence. The Parliament has recently amended a law on financial stability. Its new provisions prohibit commercial banks from changing interest rates on loans issued to households and the corporate sector for a period of three years. In addition, an Asset Stabilization Fund (ASF) is being established by the government. The ASF will purchase the distressed assets of banks; the government plans to buy up to USD 1 billion of these assets in 2008.

Equally important, Kazakhstan's foreign currency reserves continue to grow. In September, forex reserves of the National Bank of Kazakhstan (NBK) stood at USD 22 billion, while the assets of the National Oil Fund amounted to USD 27.5 billion. As a result, Kazakhstan has USD 49.5 billion of international liquidity, which can be used as a cushion against the future deterioration of global financial and economic conditions.

International Trade and Capital

In January-July, foreign trade in goods posted a surplus of USD 21 billion, which is almost three times higher than a year ago. Export revenues, boosted by high oil prices, grew by 64.7% yoy, while imports continued to decelerate, increasing by 17.5% yoy, compared to 48% yoy during the same period of 2007. Although a recent drop of oil prices is likely to slow exports in the near-term, Kazakh crude oil output expansion and an eventual recovery of global demand for energy will help to support strong foreign trade surpluses in the future. Furthermore, Kazakhstan still needs sizable foreign investments to develop its oil extraction and transit capacities. This means that FDI inflows are likely to remain high. Indeed, during the first half of this year, gross FDI inflows into Kazakhstan stood at USD 7.2 billion with nearly 70% of these investments allocated to oil and gas extraction and exploration.

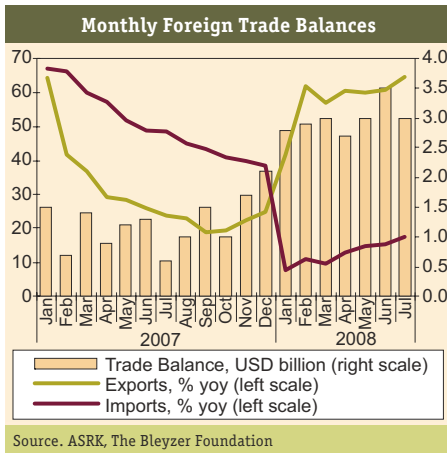
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The outstanding performance of exports helped to strengthen the current account balance, which posted a surplus of USD 6.5 billion in the first half of 2008. This means that Kazakhstan's external financing needs are manageable, while the risks to currency stability remain minimal.

Other Developments Affecting the Investment Climate

According to the Global Competitiveness Report for 2008–2009, Kazakhstan is ranked 66th out of 134 countries by the World Economic Forum. Although Kazakhstan is ranked higher than Greece, the country still lags behind BRIC economies as well as many Eastern European countries. Institutions, infrastructure and technological readiness remain key bottlenecks for the Kazakh economy. At the same time, the country sustains a competitive advantages in terms of macroeconomic stability, education, and labor and goods markets efficiency.

