SigmaBleyzer

Kazakhstan
Macroeconomic Situation

THE BLEYZER FOUNDATION

November 2010

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- **In January-September, GDP grew by 7.5% yoy.**
- **Industry grew by nearly 11% yoy in October on stronger exports.**
- **In January-October, tax revenues jumped by 28% yoy and the state budget deficit stood at 2.6% of projected full year GDP.**
- **Consumer prices increased by 7.3% yoy in October on dearer cereals and other foods.**
- **During the first three quarters of 2010, the current account surplus widened to $4.7 billion compared to a deficit of $4.6 billion a year ago.**
- **Kazakhstan moved to 59th place in the 2011 Doing Business ranking.**

Executive Summary

During the first three quarters of 2010, the Kazakh economy grew by 7.5% thanks to an industrial turnaround and a robust uptick in the service producing sectors. The services component of GDP increased thanks to a stronger trade sector, as consumers started to spend again. Although consumer confidence has somewhat retrenched since July on resurfaced fears over food price inflation, solid gains in income and jobs should sustain personal consumption.

That being said, with exports representing over half of GDP, industry will be the principle driver of economic growth. Meanwhile, a smaller weight of consumers in the Kazakh economy makes their contribution less visible. Furthermore, since local supply still heavily depends on imports, increasing consumer spending will have a larger impact on imports rather than domestic output.

Stronger exports continue to add strength to Kazakh mining and manufacturing. In October, industry gained 11% yoy thanks to the global manufacturing recovery and growing Chinese appetite for natural resources. China remains an integral part of the manufacturing rebound as well thanks to its demand for industrial metals. However, the role of China extends well beyond Kazakh metallurgy. For example, China is the biggest buyer of Kazakh uranium and has recently signed a long-term uranium supply contract with Kazakhstan.

Since the export-driven industrial sector is the principle destination for capital investments, the outlook for business spending is optimistic. Indeed, a steady expansion of oil production capacity will ensure continued growth of investments in that sector, as Kazakhstan strives to become one of the world's top 5 oil producers within the next decade. As a result, the oil industry will need much more storage and transit capacity. This should support investments into the transportation industry, which is the next biggest sector by capital spending.

Higher public spending on infrastructure and economic diversification projects are expected as well. The new 2011-2013 budget, approved by the parliament in November, makes public investments and social protection top priorities. There are good reasons to believe that the country can afford this fiscal policy. Tax revenues are bouncing back on booming foreign trade, while public finances remain in good shape - the debt to GDP ratio is low and assets of the National Oil Fund are approaching $30 billion.

Still, inflation remains a worry as global food prices continue to grow following crop failures in some key grain-producing regions. On the upside, food prices are still below the peak reached in 2008. Despite a 2.4% reduction in world grain output, the global supply of grains is only marginally lower than a year ago.

Finally, the World Bank recently named Kazakhstan as the top reformer in the world. This year, Kazakhstan improved its overall position in the Doing Business ranking by an impressive 15 points, moving up to the 59th position.

	2005	2006	2007	2008	2009	2010*
GDP growth, % change yoy	9.7%	10.7%	8.9%	3.3%	1.2%	4-5%
GDP per capita, $	3 754	5 262	6 757	8 398	6 710	8 000
Industrial production, % change yoy	4.8%	7.2%	5.0%	2.1%	1.5%	-
State budget deficit, % of GDP	0.6%	0.8%	-1.7%	-2.1%	-3.1%	-
Governmet external debt (including NBK), % of GDP	1.8%	2.9%	1.8%	1.6%	2.4%	-
Unemployment, end of period	8.1%	7.8%	7.3%	6.6%	6.3%	-
Inflation, end of period	7.6%	8.4%	18.8%	9.5%	6.2%	6-8%
Retail sales, % change yoy	13.5%	15.0%	10.7%	3.1%	-2.0%	-
Gross forex reserves of the NBK, $ billion, end of period	7.1	19.1	17.6	19.9	23.2	-
Assets of the National Oil Fund, $ billion, end of period	8.1	14.1	21.0	27.5	24.4	-
Current Account Balance, $ billion	-1.1	-2.0	-8.2	6.6	-3.4	2.0
External debt, $ billion	43.4	74.0	96.9	108.1	111.7	120.0
Exchange rate, tenge/$, annual average	132.9	126.1	122.6	120.3	147.5	145.0

* Projections

Source: ASRK, NBK, Ministry of Finance of Kazakhstan, IMF, Economist Intelligence Unit

Where Opportunities Emerge.

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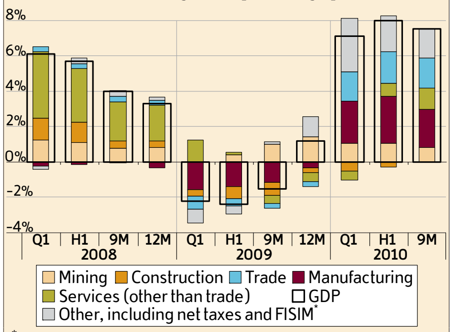
Economic Growth

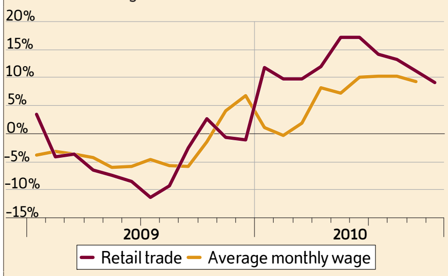
In January-September, the Kazakh economy grew by 7.5% yoy on a robust industrial turnaround and a strengthening recovery in service producing industries. In particular, over the first three quarters of 2010, industry bounced back by over 10%, contributing close to 40% to GDP growth (see chart 1). Meanwhile, the services component of GDP increased by 5.2% yoy thanks to a 13% yoy growth in trade. As a result, the trade sector alone accounts for nearly 60% of the overall growth of service producing industries. This year, the volume of retail trade has been growing at 12% yoy on average each month, as consumers, encouraged by increasing employment and wages, started to spend again (see chart 2). However, resurfaced fears over food price inflation may dent retail sales, particularly given that households still spend over 40% of their disposable income on food. In fact, the consumer confidence index has somewhat retrenched since July. Still, it has recovered a great deal since the end of the recession. Coupled with solid gains in income and jobs, higher consumer confidence should sustain continued growth of personal consumption.

Manufacturing and trade prop up recovery 1
contributions to GDP growth, percentage points



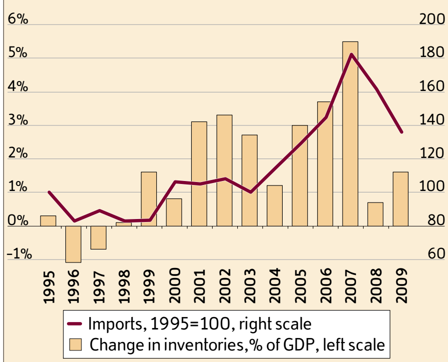
* FISIM - Financial intermediary services indirectly measured
Source: ASRK, The Bleyzer Foundation

Higher wages revive spending 2
% annual change



Source: ASRK

Imports and inventories 3



Source: ASRK, The Bleyzer Foundation

That being said, industry, driven by returning foreign demand, will be the main source of economic growth in the foreseeable future. After all, Kazakh exports represent over half of GDP. With imports shrinking for the third consecutive year[1], net exports may account for a fifth of total output in 2010. Meanwhile, over the last 10 years the share of personal consumption in GDP fell by almost 20 percentage points and may be as low as 40% in 2010. This may partially reflect a low share of labor in GDP, which remained flat at about one third, as sectors where the workers' take in output is relatively high (such as education, healthcare and public administration) lagged behind overall economic growth. As a result, a smaller weight of consumers in the Kazakh economy is dampening the contribution of personal consumption to economic growth. In addition, local supply of many nonfood consumer goods still heavily depends on imports. This means that an uptick in consumer spending tends to have a larger impact on imports versus local production.

Meanwhile, the outlook for business spending (another component of domestic demand) remains optimistic. After all, the export-driven mining industry is the principle destination for capital investments and accounts for over a third of all capital outlays. A steady expansion of the oil production capacity will ensure continued growth of investments in that sector. Indeed, in January-October, fixed capital investments in the mining industry were up by 8.4% yoy. And as oil output is expected to double, Kazakhstan may become one of the world's top 5 oil producers within the next decade. As a result, the oil industry will need much more storage and transit capacity.[2] This should support investments into the transportation industry, which is the next biggest sector by capital spending.

However, the volume of investments in that industry tends to rise and fall with large infrastructure and oil and gas pipeline projects. In fact, investments into the transportation industry were 40% yoy lower in the first ten months of 2010 following the completion of several pipelines.[3] As a result, total fixed capital investments were down by about 2% yoy. On the upside, Kazakhstan purchases most of the capital goods from abroad.[4] This means that imports tend to absorb a large portion of fluctuations in consumer and business spending, which cushions the impact of lower domestic demand on local output.[5] In fact, Kazakh imports fell much faster than personal consumption and investment spending, with most of the adjustment absorbed through inventories (see chart 3).

All said, stronger exports continue to sustain industrial recovery in Kazakhstan. In October, industry grew by nearly 11% yoy on a 9% yoy jump of output in the mining sector and a 16% increase of production of manufacturing goods (see chart 4). In particular, the

[1] In 2010, imports will be approximately 25% lower than at their record high level in 2007 thanks to falling demand for durable consumer goods (such as cars), lower imports of building materials and a sharp contraction of imports of capital goods. As a result, the share of imports in GDP is to shrink to 30% compared to about 44% before the global financial crisis.
[2] The government expects that investments into the energy sector will total $34 billion over the next three years.
[3] Last year the 1,300-km Kazakh section of the Asia Gas Pipeline (linking China and Turkmenistan) was completed. In addition, in July 2009, the 792-km section of the 3,000-km Kazakhstan-China oil pipeline was put online.
[4] Capital goods accounted for 44% of all imports in 2009.
[5] For example, in January-September 2010, imports of pipes were down by 80% yoy.

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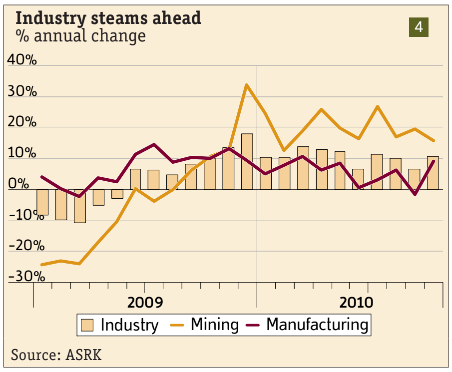


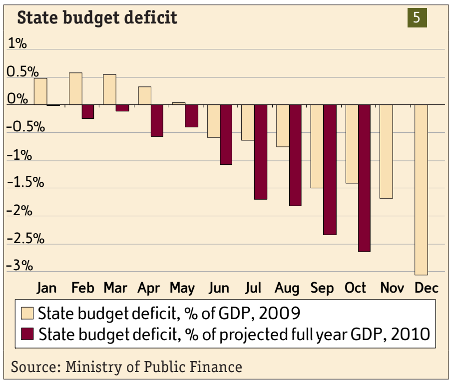
mining industry is benefiting from the global pick up in manufacturing activity and growing Chinese appetite for natural resources. Indeed, exports of iron and nonferrous oars are booming thanks to strong demand from China and Russia. Exports of crude oil are recovering on higher global energy prices and increasing shipments to China. In January-September, China was already the second largest importer (after Italy) of Kazakh crude oil, accounting for 15% of all exports of crude oil by volume (compared to 9% a year ago). If the value of Kazakh exports of crude oil to large developed economies increased mostly thanks to higher oil prices with volumes staying almost unchanged, exports of crude oil to China grew by over 3 million tons or by 71% yoy.

The turnaround in manufacturing activity appears to be more broad-based with solid gains in food processing on stronger domestic consumption. In January-October, production of foods and beverages was up by 12.7% yoy and 42.4% yoy, respectively. Weaker currency[6] is helping local producers of capital and durable consumer goods as well. This may partially explain a 57% gain in machine building on growing output of cars, electronics and electric equipment. That said, China remains an integral part of the manufacturing rebound thanks to its demand for Kazakh non-ferrous metals, namely copper and aluminum. Meanwhile, recovering durable goods manufacturing in developed economies drives demand for Kazakh ferroalloys.[7] And this supports recovery of the metallurgical industry, where output fell sharply during the economic downturn. Indeed, metallurgy, which generates about 40% of all manufacturing output in Kazakhstan, grew by 11.3% yoy, contributing 4.4 percentage points to the overall growth of manufacturing production.

The role of China extends well beyond Kazakh metallurgy. Exports of Kazakh fertilizers, chemicals and plastics to China are growing as well. In particular, the chemical industry was up by 36.8% yoy on higher exports of inorganic chemicals, namely uranium. And China, which is already the biggest buyer of Kazakh uranium (exports to China nearly doubled during the first three quarters of 2010), has recently signed a long-term uranium supply contract with Kazakhstan.

Finally, improving business activity in industry and trade is supporting other sectors as well. In January-October 2010, freight and passenger traffic was up by 12% yoy and 13.7% yoy. Meanwhile, more stable conditions in the construction industry (residential housing investments were up by 2.4% yoy, while the volume of construction works ceased to decline and stayed at the same level as a year ago) help producers of building materials (manufacturing of construction supplies was up by 44.7% yoy).

Fiscal Policy



During the first 10 months of 2010, the state budget deficit stood at about $3.4 billion or 2.6% of projected full year GDP (see chart 5). Tax revenues continued to improve, increasing by 28% yoy on growing corporate profits and increasing domestic output. In particular, in January-October, proceeds from the corporate income tax (CIT accounts for 27% of all tax revenues) jumped by 37% yoy. The value added tax (VAT provides another 24% of tax revenues) brought 17% yoy more to the state treasury thanks to a robust rebound of VAT paid by local producers of goods and services (up by 114% yoy). That said, over half of all tax revenues is collected from just two taxes - CIT and VAT. And proceeds from both taxes still closely follow global business cycles. In particular, the mining industry generates about 24% of all corporate profits in the economy, while VAT on imports accounts for 70% of all VAT revenues. As a result, notwithstanding modest economic growth in 2009, tax revenues plunged by 21% yoy on shrinking corporate profits and a sharp reduction of imports (particularly imports of capital goods). On the upside, big and medium companies are reporting solid gains in pretax earnings.[8] Meanwhile, expanding local production (thanks to stronger overseas demand as well as improved cost competitiveness following currency devaluation in February 2009) diminishes Kazakhstan's reliance on the VAT on imports. And a recovery of foreign trade boosts revenues from custom duties (about 12% of all tax revenues), which more than doubled on higher exports.

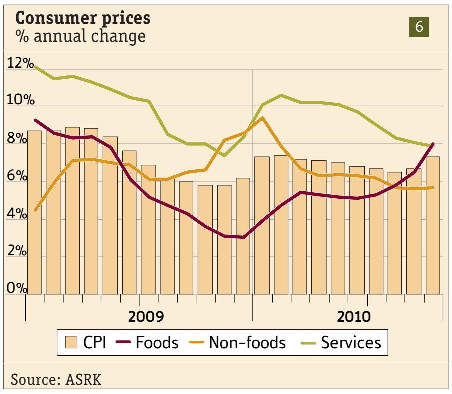
[6] From February 2009 to September 2010, the tenge lost 16.5% in real terms against major trading partners (excluding trade in crude oil). Source: The National Bank of Kazakhstan.
[7] Ferroalloys are key ingredients in steelmaking (ferro-silico-manganese is 11% of all Kazakh exports of ferroalloys) and stainless steel production (ferro-chromium is over 80% of all Kazakh exports of ferroalloys), with industrial usage that spans from manufacturing of cars and industrial machinery to manufacturing of household goods. Germany, Japan, South Korea, and the USA are the largest export markets in advanced economies for Kazakh producers of ferroalloys.
[8] According to the ASRK, pretax earnings of large and medium financial and nonfinancial companies grew by nearly 80% yoy over the first three quarters of 2010.

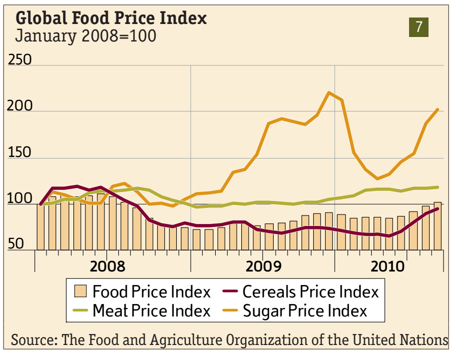
Meanwhile, social welfare remains the priority spending item for the government. Indeed, in January-October, state budget expenditures grew by 17.5% yoy thanks to a 20% yoy increase in spending on healthcare and social benefits (over a third of total budget spending). Spending on public administration was up by over 30% yoy on higher wages in the public sector.

Finally, in November, the lower house of the Kazakh parliament approved the 2011-2013 republican budget. In particular, the 2011 budget deficit is expected at 2.8% of GDP with a further reduction to 1.5% of GDP by 2013. In addition to large-scale infrastructure projects, higher budget spending on social protection and benefits will continue to drive public spending. For example, in November, the parliament approved a law envisioning a 30% increase in pensions in 2011. It is in sharp contrast to fiscal austerity measures (which frequently include cuts to social spending) being implemented by many advanced and some developing countries to reduce budget deficits and stabilize debt to GDP ratios. In fact, Kazakhstan's public finances remain in rather good shape - the public debt to GDP ratio is low[9], while assets of the National Oil Fund totaled $29.4 billion in October. Furthermore, the government managed to restructure the biggest Kazakh lender (which last year defaulted on about $12 billion of debts) without imposing unmanageable costs on taxpayers.[10] This ensures more fiscal flexibility to continue supporting economic recovery in Kazakhstan.

Monetary Policy

In October, consumer prices (CPI) grew by 0.9% versus the month before, which pushed annual inflation to 7.3% yoy. Higher food prices (up by 1.3% versus September or 8% yoy compared to a year ago) remain behind the CPI uptrend observed during the last several months (see chart 6). In particular, in October, prices of flour, cereals and bread were 4%, 9% and 2.4% higher than in the previous month, respectively. After all, higher local food prices reflect tighter supply conditions on the global agricultural markets following crop failures in some key grain-producing countries (for example, Pakistan and Russia). As a result, global food prices reversed their downtrend in the second half of this year and were up by 21% in October versus June (cereal prices increased even faster by about 45%, see chart 7). Still, global food prices remain below the peak reached in 2008. According to the latest world agricultural supply and demand estimates by the U.S. Department of Agriculture, despite a 2.4% reduction of world grain production, global supply of grains is only 0.5% lower than a year ago (and 2.3% higher than in 2008/09). This means that at present, there is less upward pressure on global food prices than during the 2008 food crisis.





That said, the significant weight of foods in the Kazakh consumer basket implies that inflation will continue to move upward. On a positive note, core inflation (which excludes fluctuations of the prices of foods and fuels as well as utility tariffs) is on par with last year's levels. In October, core inflation was only 6.7% yoy higher than a year ago (compared to 6.74% yoy in October 2009). After all, the money supply is growing much lower than before the financial crisis as bank credit continues to shrink. Indeed, companies and households are reducing their debts, while banks are still reluctant to issue new loans. In particular, in October, the stock of domestic credit was about 6% yoy lower compared to October 2009 on a 7% yoy reduction of credit to households and a 5.4% yoy drop of corporate lending. Although credit denominated in local currency increased by 7.4% yoy (its 8th straight month of annual gains), it failed to offset a 19% yoy drop of forex denominated loans.

Finally, according to the latest loan officer opinion survey by the National Bank of Kazakhstan, credit conditions are likely to remain tight in the majority of banks, while corporate demand for credit has failed to pick up. In contrast, banks' appetite for retail lending appears to be recovering, although most lenders continue to maintain rather conservative lending policies. Indeed, credit to households has been growing for the last three months. However, the average monthly increase was well below $20 million, compared to a monthly average of nearly $1 billion during the 2006-2007 credit boom.

[9] By the end of September, total public debt (external, domestic and claims on the central bank by local commercial banks) stood at about 17% of projected full year GDP. Government external debt accounted for only 2.7% of GDP.
[10] The majority of the creditors of BTA Bank shared the pain by accepting a haircut on their assets.

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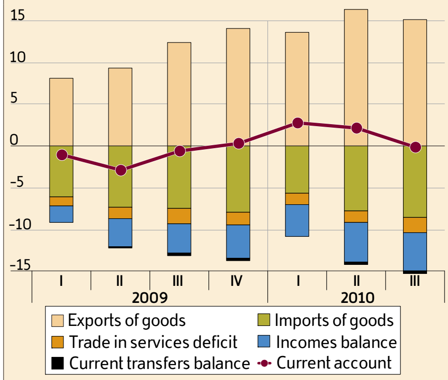
International Trade and Capital

In January-September, exports bounced back by 47% yoy to $43.2 billion. About 24% (or 11 percentage points) of this increase was brought on by 84% yoy growth of exports to China, which is the largest export market for Kazakhstan, accounting for 17% of all exports. Meanwhile, imports were still 10% yoy lower than a year ago or $18.3 billion. As a result, the trade in goods surplus widened to nearly $25 billion and was 2.7 times higher than a year ago.

During the first three quarters of 2010, the current account surplus widened to $4.7 billion compared to a deficit of $4.6 billion a year ago. That being said, according to preliminary estimates, the current account posted a small deficit of about $141 million in the third quarter of 2010. Although exports were 21% yoy higher than in the third quarter of 2009, imports grew by 14% yoy thanks to a stronger domestic economy (see chart 8). Profits repatriated by foreign direct investors (mostly in the oil industry) surged by over 35% yoy, offsetting a higher trade in goods surplus.

Quarterly Current Account 8
$ billion



Source: NBK

Other Developments and Reforms Affecting the Investment Climate

According to the World Bank annual report *Doing Business 2011: Making a Difference for Entrepreneurs*, Kazakhstan was named the top reformer in the world in terms of policy actions undertaken to improve the business climate and ensure the protection of property rights. In particular, procedures to start a business and obtain construction permits were simplified, while the enforcement of property rights and protection of investors were strengthened. As a result, Kazakhstan improved its overall position in the Doing Business ranking by an impressive 15 points, moving up to 59th place from 74th a year ago (see chart 9).

It is much easier to start a new business in Kazakhstan 9

	2010	2011
Doing Business Rank	**74**	**59**
Starting a Business	85	47
Dealing with Construction Permits	156	147
Registering Property	29	28
Getting Credit	69	72
Protecting Investors	57	44
Paying Taxes	53	39
Trading Across Borders	182	181
Enforcing Contracts	36	36
Closing a Business	54	48

Source: The World Bank

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