Kazakhstan Macroeconomic Situation

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Summary

- Although the economy should grow slower in 2008, Kazakhstan's rich natural resources will remain a key competitive advantage supporting robust and sustainable economic development.
- Industry advanced by 4.5% yoy in January-November.
- The 2008 republican budget appears to strike a reasonable balance among country's pressing economic objectives.
- The consumer price index rose at the fastest pace in 10 years as inflation hit 18.8% yoy in December.
- In January-October, the trade in goods surplus settled at USD 11.07 billion.
- The current account deficit amounted to USD 5.3 billion in January-September.

Economic Growth

The latest global financial crisis has limited negative implications for Kazakhstan's medium-term economic outlook. Above all, the country's rich subsoil and land resources represent a solid basis for sustainable economic expansion. Furthermore, 2007 parliamentary elections facilitated the creation of an integral body politic, supporting further acceleration of essential structural and developmental reforms. This means that the government can visibly improve its capacity to manage national resources efficiently as well as advance with the diversification of the oil dependent economy.

Meanwhile, 2007 saw several economic developments that obviously eroded Kazakhstan's short-term outlook. First, the continuing global credit crunch considerably restricted the access of Kazakh banks to international financial markets. As a result, domestic lending institutions ceased to go on expanding their credit portfolios as fast as in the first half of 2007. Second, the oil extracting industry experienced a setback to its production growth as the launch of operations at the largest oil field (Kashagan) was further delayed. Finally, consumer price inflation accelerated to double-digit rates on the back of skyrocketing food prices, driven by mounting demand pressures and global supply shortages.

The big question is not whether the economy will cool down in 2008; it almost certainly will (especially on the back of the unprecedented double-digit GDP growth registered in the past several years). It is whether Kazakhstan has the capacity to support a smooth and prompt adjustment to recent economic turbulence. However, the picture is far from bleak. After all, the broad economy managed to remain on relatively firm footing in the aftermath of global liquidity tightening. Strong gains in employment and income as well as robust investment activities still provide breathing space in terms of aggregate demand for economic expansion. Although the financial sector was visibly hit at the height of the crisis, it has since been registering some positive developments. Indeed, the latest readings on the banking sector reveal bank credit resuming growth, albeit rather modestly. More importantly, Kazakh commercial banks appear to be on the way toward adopting more prudent business models that allow for better diversification of funding sources.

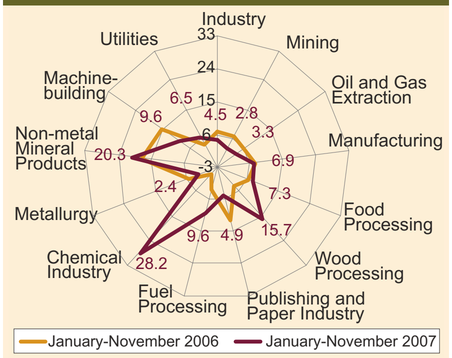
Although the contribution of industry to economic growth has been on a steady downtrend, the industrial sector still plays a key role in economic development as it produces nearly one third of the country's GDP. More importantly, the mining sector accounts for more than half of all industry. Considering the large share of metallurgy in manufacturing, it can be safely argued that nearly two thirds of the industrial sector is directly influenced by the global demand for crude oil and base metals. On top of that, these sectors are highly capital intensive, which implies that a visible acceleration of industrial production can only be achieved with large-scale investments into production facilities. All these means that a combination of volatile global demand and a shortage of investments into the domestic extraction industry may emerge as a formidable challenge for industrial growth in Kazakhstan.

Indeed, despite surging crude oil prices, the production of crude oil posted rather modest gains in 2007 on the back of sluggish expansion of domestic extraction capacities. Furthermore, recent modifications to the country's subsoil resources law (which extends the power of authorities to revise, change or cancel contracts with private companies) may further discourage investments into the domestic oil extraction industry, dominated by international oil corporations. This law was adopted as a response to the dispute between the government of Kazakhstan and a consortium of private investors developing the country's largest oil field (Kashagan). According to the report published by the Platform (a London-based oil industry watchdog), Kazakhstan may lose up to $20 billion in the next decade due to the failure of Kashagan's private operator to meet initially set project cost targets and completion deadlines.

However, despite lingering uncertainty that held back investments, prospects for the oil extracting industry are improving. Above all, the Kashagan saga looks increasingly likely to have a happy ending as most of the consortium members have already agreed to pay fines for project delays and sell a portion of their stake in the project to state-owned oil and gas company KazMunayGas. The global outlook for crude oil remains benign as well. Increasing demand for energy from emerging markets and the slow growth of global supply will continue to support high crude oil prices. This means that the launch of Kashagan operations (the projected capacity of this oil field should reach 1.4 million barrels per day by 2015) will considerably boost Kazakhstan's economy. Meanwhile, investments into production and transit infrastructure will continue to fuel construction, transportation and industrial sectors.

In 2007, industry looks increasingly likely to increase by only around 4% year-over-year (yoy) as production growth leveled out at 4.5% yoy just a month before year-end. As a result, the contribution of industry to GDP growth may shrink to less than 15% as compared to about 20% in 2006, when industry advanced by 7.3% yoy.

Industrial Output by Sector, % yoy



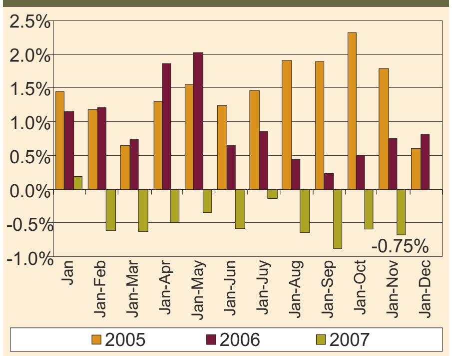
Source: ASRK

On a positive note, manufacturing is in fairly healthy shape as strong gains in industries producing foods, chemicals, fuels and construction materials balanced deceleration in metallurgy. Furthermore, utility industries maintained solid performance as well, advancing by 6.5% yoy in January-November on the back of increasing new residential housing units and robust demand for utilities by domestic businesses.

Fiscal Policy

In January-November, the consolidated budget deficit amounted to KZT 89.97 billion (USD 775 million) or 0.75% of projected full-year GDP.

State Budget Balance, % of full year GDP



Source: Ministry of Finance of RK

In 2008, the government is poised to deal with a series of pressing economic hurdles. First, increasing costs of living call for more generous social payments to citizens, who rely on minimum wages and pensions. Second, infrastructure, health and education sectors still need mammoth public investments. Third, additional public spending may be necessary to forestall possible recessionary consequences of the slowing global economy and tight international money markets. To make things worse, inflation has already crossed the 10% threshold, putting a curb on the expansionary magnitude of fiscal policy. Even so, the 2008 republi-

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can budget appears to strike a reasonable balance among these objectives. Essentially, social security spending will increase only moderately, and is thus unlikely to add excessive momentum to existing inflationary pressures. More importantly, the revenue side of the budget is fundamentally solid. Despite the risk of a slowing private economy, tax revenues are expected to post solid gains on the back of a widening tax base in the non-oil sector. Finally, the assets of Kazakhstan's sovereign wealth fund can be readily used as a standby facility if the country's fiscal position deteriorates.

The government envisions the republican budget deficit to settle at around 1.4% of GDP in 2008 (down by 8.3% yoy in nominal terms as compared to 2007). Above all, a solid fiscal position is anticipated to be maintained on the back of robust collection of principle taxes. Tax revenues are to grow by 36.2% yoy (or to 14.7% of GDP) and will account for over 82% of all revenues (up from 73% in 2007). All of this means that the execution of the republican budget will essentially depend on the performance of the corporate income tax (CIT), value added tax (VAT) and custom duties. Indeed, these three taxes, exclusively integrated into the republican budget, produced over 94% of all tax revenues in January-November 2007. Meanwhile, taxes on trade emerged as key drivers of the republican budget tax revenues. During the first eleven months of this year, proceeds from VAT and custom duties surged by 30.7% yoy and 36.3% yoy respectively. Moreover, VAT plays a rather important role as it ensures over 40% of all tax revenues of the republican budget. On top of this, the tax code provides a 1 percentage point VAT cut to 13% starting January 2008. The government thus expects Kazakhstan's domestic and foreign trade to go on rising at least as fast as in 2007.

2008 Republican Budget

	KZT billion	% to GDP	% yoy
Revenues	2,687.28	17.87	21.0%
Tax Revenues	2,209.28	14.69	36.2%
Transfers from NFRK	341.43	2.27	13.2%
Expenditure	2,676.16	17.80	27.8%
Deficit	210.50	1.40	-8.3%

Source: 2008 Budget Law

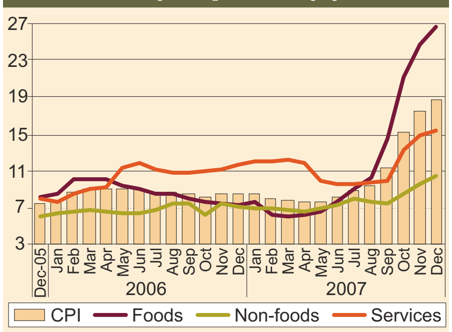
The corporate sector is anticipated to stay healthy as well, supporting strong collection of CIT. CIT proceeds from the thriving non-oil businesses have remained on a robust uptrend, growing by 26.2% yoy in January-November. However, it bears emphasizing that tighter credit conditions may create some headwinds for the private sector. Indeed, a recent enterprise survey by the NBRK indicates that fewer companies were able to obtain bank credit in the last quarter of this year, while companies in manufacturing and construction faced the largest setback. Nevertheless, the private sector still prefers to finance capital investments with its own funds (61.3% and 82.7% of all surveyed companies invested their own funds into fixed and working capital respectively). Furthermore, productivity growth appears to be robust and may help offset the impact of rising production costs on corporate profits. This implies that the private economy still has plenty of room to grow.

Republican budget expenditures will grow by 27.8% yoy as spending on health, education and public housing accelerate. On top of this, the government plans to increase its social security payments. The minimum wage and pensions are set to rise by 7.8% and 9.2%, while the subsistence level (used as a reference point for all social security payments) will be raised by 18.7%. Still, these adjustment, though slightly higher in magnitude than in 2007, appear rather modest considering the double-digit inflation rate.

Monetary Policy

In 2007, the consumer price index (CPI) in Kazakhstan rose at the fastest rate in 10 years as inflation hit 18.8% yoy in December. This unprecedented surge of inflation was triggered by the confluence of domestic and global economic developments, which boosted prices of fuels and staple foods. Above all, robust performance of developing countries visibly expanded global demand for foods, which, on the back of rather unfavorable weather conditions in the key world agricultural centers, resulted in skyrocketing food prices. Indeed, rising food prices emerged as a global phenomenon in 2007, affecting both developed and emerging markets. In Kazakhstan, dearer foods contributed nearly 60% to CPI inflation in 2007 compared to less than 40% the year before. On top of this, record high world energy prices inflated prices of fuels, which propelled inflation of prices of non-food commodities (up by 10.5% yoy) and service tariffs (up by 15.4% yoy).

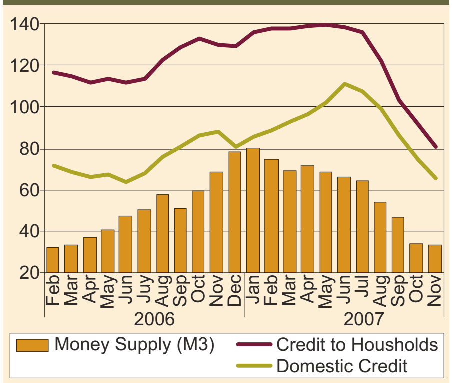
CPI by Component, % yoy



Source: ASRK

In November, money supply continued to decelerate, increasing by 33.5% yoy on the back of a slowdown of domestic credit (up by 65.7% yoy). Evidently, global liquidity tightening has been exerting a visible drag on Kazakh commercial banks, limiting the amount of accessible external funding that can be drawn to expand domestic credit portfolios. Indeed, according to Cbond.info (emerging markets fixed-income watchdog), during the last quarter of 2007, Kazakh banks attracted only USD 401.5 million in syndicated loans as compared to USD 3.3 billion in the same quarter of 2006.

Money Supply (M3) and Domestic Credit, % yoy



Source: NBRK, The Bleyzer Foundation

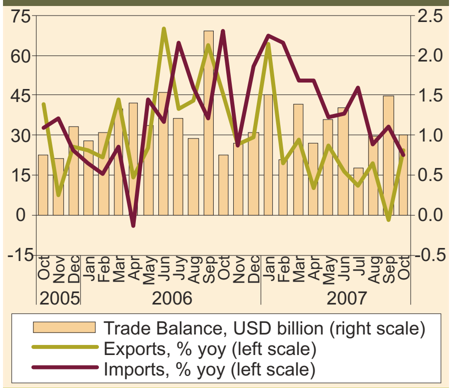
In November, the banking sector staged another modest recovery as domestic credit inched up by 0.2% month-over-month (mom) to KZT 7,228 billion (USD 59.9 billion). However, as domestic credit looks increasingly likely to moderate in the fourth quarter, the degree of financial deepening, measured as the ratio of domestic credit to GDP, will settle at around 60% of GDP in 2007 (which is still above last year's 48.2%). This will put the annual growth of domestic credit at about 55% yoy. Meanwhile, there are some positive readings on the funding side of the banking system as the stock of deposits recovered in November after having registered a three-month decline starting in August. In November, deposits grew by 5.7% mom to KZT 3,835 billion (USD 31.8 billion) as corporate and household deposits advanced by 8.1% mom and 1.9% mom respectively.

However, recent moderation of domestic credit may lead to some deterioration of the quality of credit portfolios held by commercial banks. Rapid growth of credit has helped to maintain relatively low ratios of bad and non-performing loans, but as credit growth further decelerates, banks may face increasing shares of non-performing assets on their balance sheets. However, the likelihood that this scenario will severely damage banks' positions is still rather immaterial. Above all, the recent hurdles of Kazakh banks were largely brought about by the closure of international financial markets rather than by the systematic weaknesses of the internal business models. Bank profitability is still strong, while lending standards are getting tougher, which, presumably, will help to screen out bad borrowers.

International Trade and Capital

Developments in international trade and cross-border capital flows continue to be shaped by the buoyant domestic demand for imports and the ongoing global credit squeeze. Rapidly growing imports of goods and services are putting a curb on the trade surplus and pushing the current account deficit further into negative territory. In January-October, the trade in goods surplus settled at USD 11.07 billion as imports surged by 40.8% yoy while exports increased by only 19.6% yoy. In particular, key imports increased by over 35% yoy, while Kazakhstan's staple exports — mineral products — grew by only 13.6% yoy. As a result, the international trade surplus plunged 12.4% yoy below the level posted a year before.

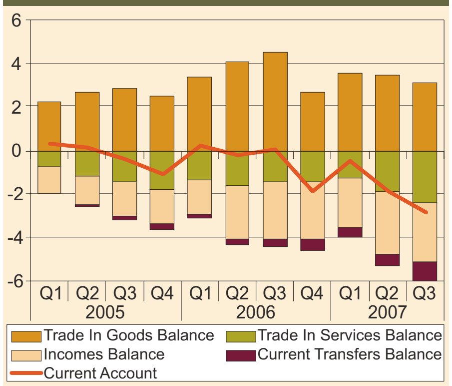
Monthly Foreign Trade Balance



Source: ASRK, NBRK, The Bleyzer Foundation

Unprecedented growth of imports resulted in a record high quarterly current account deficit as well. In the third quarter of 2007, the current account deficit stood at USD 2.87 billion as the trade in goods surplus shrank by 31% yoy while the trade in services deficit swelled by 67% yoy to USD 2.43 billion. On a positive note, the income balance advanced by 3.9% yoy (as compared to 74.1% a year before) as profits repatriated by foreign investors eased down by 1.5% yoy (up by 73% yoy in the same quarter of last year).

Balance of Payments, USD billion



Source: NBRK

In January-September, the current account deficit amounted to USD 5.3 billion as the trade in goods surplus shrank by nearly 15% yoy, while the trade in services deficit jumped by 28.5% yoy. On top of that, the USD 8.1 billion income deficit (driven by the 1.3 times hike of interest and principle payments on foreign loans and debts and a 19.6% yoy increase in repatriated incomes of foreign investors) further widened the current account gap. As a result, the current account deficit will almost certainly stay above 5% of GDP in 2007. On a positive note, about 67% of the current account gap was financed with foreign direct investments. In addition, although the banking sector virtually ceased to borrow from abroad in the third quarter, other sectors of the economy continued to access foreign funds. Finally, the government sits on fat foreign reserves and is willing to use them to fix external funding gaps. More importantly, the current account gap is mostly driven by imports of capital goods and services rather than inflated by current consumption. This means that the country can relatively painlessly absorb the accumulated current account deficit, while a large portion of capital goods in imports implies higher productivity growth in the future.