Kazakhstan Macroeconomic Situation

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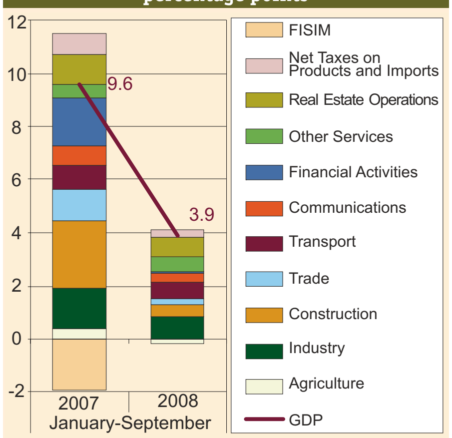
Summary

- During the first three quarters of 2008, GDP grew by 3.9% yoy.
- The government expanded its economic stabilization program to USD 18.1% billion.
- A revised draft of the three-year budget envisions the republican budget deficit to stay at about 3.5% of GDP in 2009 and 2010 and at 2.4% in 2011.
- In January-October, the state budget deficit stood at about 1.1% of projected full-year GDP.
- In November, the consumer price index grew by 11.3% yoy or by 9.2% since the beginning of this year.
- The stock of domestic credit inched up by only 1% yoy in October compared to 75% yoy a year ago.
- In January-September, the foreign trade surplus widened to USD 28.1 billon, increasing by nearly 180% yoy.

Economic Growth

During the first three quarters of 2008, GDP growth in Kazakhstan slowed to 3.9% year-over-year (yoy) from 9.6% yoy a year ago. Essentially, this moderation of economic growth was mostly driven by the flagging construction and services sectors, which were hit by the abrupt deceleration in bank lending. Indeed, construction grew by only 3.9% yoy compared to 30.4% yoy the year before, while the services sector slowed down to 4.8% yoy from 12% yoy in January-September 2007. In particular, trade and financial services grew by only 2.5% yoy and 1.3% yoy, respectively, compared to 10% yoy and 47.1% yoy a year ago. As a result, in January-September 2008, the contribution of these two sectors to GDP growth shrank to less than 10% from nearly one third in the same period of 2007. Furthermore, while the joint contribution of construction, trade and financial services to GDP growth stood at about 60% during the first nine months of last year, this contribution contracted by three times in 2008 to 20%.

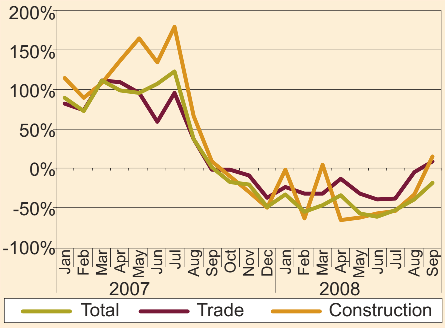
Contributions to GDP Growth by Sector, percentage points



FISIM — Financial Intermediation Services Indirectly Measured
Source: ASRK, The Bleyzer Foundation

All told, the ongoing global credit crunch has been spreading out of the Kazakh banking sector into the real economy. Indeed, the highly leveraged trade and construction sectors (jointly accounting for over 40% of total outstanding domestic credit and for nearly 50% of all newly issued loans) found it increasingly difficult to get credit, while interest rates on new loans surged by 2 percentage points on average during the first nine months of 2008. As a result, lending to these sectors, previously funded by unsustainable inflows of abundant foreign capital, took a nose dive as Kazakh banks lost access to international credit markets. During the first nine months of 2008, the average monthly volume of new loans issued to trade and construction sectors dropped by 23% yoy and 35% yoy, respectively, compared to growth of 74% and 111% yoy the year before. This means that both sectors have been experiencing significant funding pressures, which has forced them to cut back on business activities.

Monthly Volume of New Bank Lending to Trade and Construction Sectors, % yoy



Source: NBK, The Bleyzer Foundation

Banks' access to funding still remains tight, which means that sectors relying on bank lending will be subjected to stricter budget constraints in the near term. However, recent data provides some evidence that Kazakhstan's economic performance may soon stabilize. First, bank lending looks likely to stage a modest recovery, albeit on a low base, helped by the recently announced economic stabilization program. Second, interest rates on new loans have been declining after having surged this summer. Indeed, the average interest rate on new loans is only 90 basis points (bp) higher than in October 2007, while the average interest rate on loans issued to the construction sector is only 50 bp above last year's level. Third, the unemployment rate fell from 7.3% in October 2007 to 6.6% in October 2008. Although the construction sector shed 12,400 thousand jobs during the last twelve months (or 5.2% of total employment in construction), overall employment increased by about 190,000 jobs helped by strong hiring trends in the government and services sectors. Furthermore, in September, the average monthly wage increased by 18% to USD 520, although remaining flat in real terms on the back of higher inflation. This means that the labor market is still relatively tight, which implies that wage growth (and consequently consumer spending) will remain strong once the economy begins to regain speed. Finally, high crude oil prices helped to restore the current account surplus and allowed the government to accumulate additional forex reserves to fix the ailing economy. Although world oil prices retreated below USD 50 per barrel, the eventual recovery of the world economy is poised to inflate energy prices, especially on the back of the ongoing deceleration of global investments into conventional and renewable energy generation capacities. Meanwhile, a steady expansion of Kazakhstan's crude oil extraction will continue to offset weaker performance of the non-oil economy. Indeed, in January-September 2008, the contribution of industry, where value added advanced by 2.9% yoy, increased to 22% from about 16% a year ago. Nearly 90% of this contribution was produced by the mining sector alone. This means that the performance of the oil sector is increasingly likely to shape the outlook of the entire economy in the next several quarters.

Finally, Kazakhstan recently expanded its economic stabilization program for 2009–2010. All in all, the government estimates that these measures will amount to KZT 2,172 billion (USD 18.1 billion). USD 10 billion will be allocated from the National Oil Fund, liquidity support and other measures of the National Bank will bring an additional USD 2.9 billion, tax cuts will amount to USD 4.2 billion, while USD 1 billion will come from the Distressed Assets Fund. These resources will be spent to (i) stabilize the financial system (at least USD 4 billion), (ii) support the residential construction sector (USD 3 billion), (iii) assist small and medium enterprises (USD 1 billion), (iv) support agriculture (USD 1 billion), and (v) develop industrial and infrastructure projects (USD 1 billion).

According to the government, 35.6% of all loans issued by the commercial banks are backed by real estate and land. The value of this collateral has sharply declined since the onset of the credit crunch. This means that there is an urgent need to recapitalize banks. For this reason, the government plans to inject USD 4 billion into the four largest banks of Kazakhstan (or about 48% of the equity of these banks), including a purchase of the banks' common stock in the amount of USD 1 billion. An additional USD 3 billion will be allocated to banks as a subordinated debt and an acquisition of preferred nonvoting shares. The government will not purchase more than 25% of voting shares in each of the banks, while the purchase price will be set to the price on the London Stock Exchange on October 24th, 2008 — the date that banks received the offer from the government.

The SamrukKazyna Fund will establish a mortgage lending program to support the residential housing market. In particular, it will borrow funds form the National Oil Fund and accumulation pension funds to open credit lines at commercial banks. These credit lines will be used to issue new mortgages and refinance existing mortgages at a 10.5–12.5% interest rate. SamrukKazyna will also support lending to small and medium enterprises (USD 1 billion), while the state agricultural holding company KazAgro will provide USD 1 billion in additional loans to the agricultural sector.

Kazakhstan's Economic Stabilization Program, 2009–2010

	USD billion	% of projected 2008 GDP
Banking Sector	**10.9**	**8.7%**
Bank recapitalization program	4	3.2%
Acquisition of common stock	*1*	*0.8%*
Subordinated debt and preferred shares	*3*	*2.4%*
Distressed Assets Fund	1	0.8%
Residential Mortgage Lending	3	2.4%
Liquidity support	2.9	2.3%
Sector specific programs	**3**	**2.4%**
SME	1	0.8%
Agriculture	1	0.8%
Industry, infrastructure	1	0.8%
Tax stimulus	**4.2**	**3.4%**
TOTAL	**18.1**	**14.5%**

Source: The Government of Kazakhstan, The Bleyzer Foundation

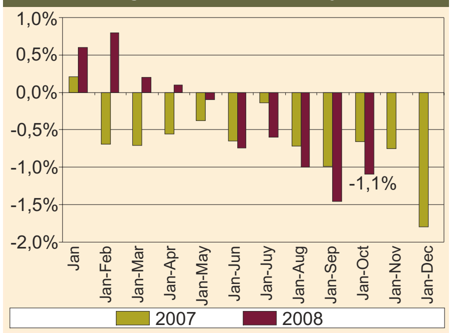
Fiscal Policy

The government of Kazakhstan has modified its three-year budget to account for the recent downward trend of crude oil prices. In particular, budget revenues were recalculated applying USD 40 per barrel as the average oil price in 2009 and USD 50 per barrel in 2010 and 2011 (down from USD 60 per barrel in the initial draft). This means that projections for budget revenues in 2009 were lowered by about USD 2.5 billion and by USD 3.7 billion and USD 5.2 billion in 2010 and 2011, respectively. On top of that, GDP growth is anticipated to slow to 2.7%-4.1% yoy in 2009–2013. In 2013, GDP per capita is forecasted to exceed USD 13,000 compared to an initial projection of USD 15,700. As a result, the government intends to delay financing of some budget programs and will increase transfers from the National Oil Fund to the state budget to offset budget revenue shortfalls. The deficit of the republican budget is anticipated to stay at about 3.5% of GDP in 2009 and 2010 and will be reduced to 2.4% in 2011.

Budget developments during the next several years will be shaped by both cyclical economic trends and structural shifts in fiscal policy. The cyclical component of the budget deficit will be driven by the slower growth of the domestic economy and weaker global demand for crude oil and industrial metals — the backbone of Kazakh exports. The structural shift of fiscal policy will result from the adoption of a new Tax Code, which will come into effect at the beginning of 2009. Indeed, in 2009 the corporate income tax will be cut by 10 percentage points (pp) to 20% and will be lowered to 15% by 2011. The VAT rate will be lowered by 1 pp to 12%, while the minimum level of revenues exempt from VAT will be doubled to about USD 320,000. The overall tax burden reduction is estimated at USD 4.2 billion. Although these amendments will depress budget revenues in the near term, in the long-term both the cyclical and structural components of the budget deficit are likely to fade away. First, a lower tax burden will improve the competitiveness of local producers and will free funds for capital investments. As the economy starts to recover, lower tax rates will be offset with a broader tax base. Second, crude oil prices are poised to stage a robust revival once the global economy regains its footing. This means that Kazakhstan will benefit from both higher oil prices and growing exports of energy resources. Meanwhile, a trivial level of public external debt (below 1.5% of GDP) and large assets of the National Oil Fund will help Kazakhstan to balance its fiscal position during this adjustment phase.

In January-October, the state budget deficit narrowed to 1.1% of projected full-year GDP from 1.5% the month before. This resulted from the higher growth of fiscal revenues, which advanced by 25.1% yoy in nominal terms, driven by accelerated collection of corporate and personal income taxes and improving VAT revenues.

State Budget Balance, % of full year GDP



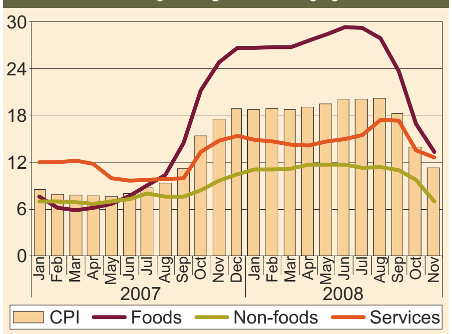
Source: The Ministry of Finance of RK, The Bleyzer Foundation

In January-September, the total public and publicly guaranteed debt of the Republic of Kazakhstan increased by USD 3.9 billion to USD 12.1 billion. In particular, domestic debt of the government and the National Bank (NBK) grew by USD 1.9 billion and USD 2 billion, respectively. This reflects financing of the state budget deficit (mostly with domestic borrowing) and increased circulation of NBK notes to manage market liquidity. Since the beginning of 2008, foreign currency holdings of the NBK have grown by over USD 3.5 billion. As a result, the NBK has increased the volume of its open market operations to drain surplus liquidity and cool inflationary pressures. A smaller budget deficit and the reimbursement of the NBK's short-term notes imply that the stock of public domestic debt may narrow by the end of 2008. Meanwhile, the total external debt of the government remained virtually flat, marginally increasing to USD 1.5 billion.

Monetary Policy

In November, the consumer price index (CPI) inched up by 0.4% compared to the month before (mom). This means that the CPI grew by 11.3% yoy (compared to 16.5% yoy in November 2007) or by 9.2% since the beginning of this year. A deceleration of consumer prices was driven by a 0.7% mom decline of prices of non-food commodities, as prices of petrol and diesel fuel dropped by 16.3% mom and 11.9% mom, respectively. Meanwhile, services tariffs grew by 1% mom on the back of increasing utility tariffs. All told, year-end inflation will stay below 10% yoy if monthly inflation does not surpass 0.73% in December. This scenario may be realized if fuel prices continue to decline, which looks increasingly likely on the back of global oil price trends. However, even if food prices are driven higher by seasonal factors, the CPI will remain close to 10% yoy compared to 18.8% yoy in December 2007.

CPI by Component, % yoy

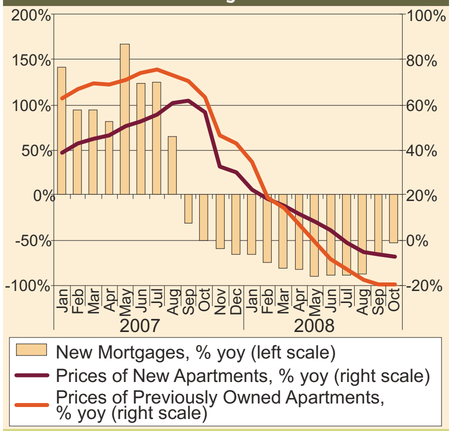


Source: NBK

In October, the stock of domestic credit inched up by only 1% yoy compared to 75% yoy a year ago. Above all, banks continued to maintain a conservative stance toward retail lending. Credit to households shrank by 6.5% yoy as mortgage lending and consumer credit declined by 4.4% yoy and 7.7% yoy, respectively. Furthermore, falling housing prices, anemic growth of real wages and limited access to bank lending have cooled households' enthusiasm for mortgage lending. Indeed, prices of newly commissioned apartments fell by 8.6% yoy on average in November, while prices of previously owned apartments dropped by about 19% yoy. This downward trend has reduced the attractiveness of residential housing purchases.

On a positive note, the ratio of credit to deposits improved to 150% from 187% at the end of 2007. This trend may reflect the growing importance of domestic sources of funding for the Kazakh banking sector. True, most of this improvement resulted from the growth of deposits held by the corporate sector. The stock of these deposits has jumped by 39% since the beginning of 2008, as companies have been hoarding cash to hedge against the credit crunch. However, a recently approved government program to inject equity and funds into the banking system may help to revive bank lending. In addition, on November 18th, the National Bank lowered minimum reserve requirements on domestic liabilities to 2% from 5% and on other liabilities to 3% from 7%. This measure is estimated to free an additional USD 2.9 billion of market liquidity to increase bank lending. All told, the government stabilization program should support a relatively quick and smooth recovery, although in the near term the Kazakh banking system still remains fragile due to funding pressures and an increasing share of bad loans.

Monthly Volume of New Mortgages and Housing Prices

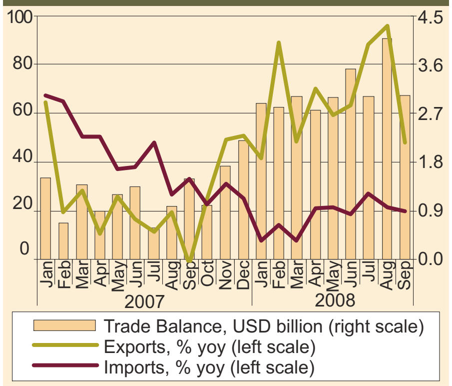


Source: NBK, The Bleyzer Foundation

International Trade and Capital

A sharp downward correction of world crude oil prices is poised to exact a toll on the performance of Kazakh exports. Indeed, in September, exports slowed to 48% yoy — the lowest growth rate since November 2007. Still, increasing domestic production of crude oil and record high global energy prices in the first three quarters of 2008 considerably improved the current account surplus. According to the head of the National Bank, in January-September, the current account surplus exceeded USD 9 billion compared to a deficit of USD 5.4 billion in the same period a year ago. Obviously, this improvement was brought on by record high foreign trade surpluses. In January-September, the foreign trade surplus widened to USD 28.1 billon, increasing by nearly 180% yoy.

Monthly Foreign Trade Balances



Source. ASRK, The Bleyzer Foundation

Indeed, record-breaking crude oil prices emerged as a silver lining for the Kazakh economy in this global credit crunch. The National Bank was able to replenish its forex reserves, which suffered a heavy loss at the onset of the global credit crisis in August 2007. Furthermore, the assets of the National Oil Fund increased by about USD 6 billion during the first eleven months of 2008. As the global economy is moving closer to a recession, these additional resources will help the government to forestall hard lending in Kazakhstan.

Other Development Affecting Investment Climate

According to the latest edition of the Transition Report issued by the European Bank for Reconstruction and Development (EBRD), Kazakhstan is going to experience a period of radical correction of economic growth in the near-term on the back of difficulties in the construction and banking sectors. Furthermore, the EBRD believes that the country's financial stability relies on the stability of the foreign exchange rate due to a significant exposure of the economy to foreign exchange risks. So far, the National Bank has been able to support exchange rate stability helped by record high inflows of export revenues. However, this implies that overall economic performance remains sensitive to developments in the oil sector. Nevertheless, long-term economic prospects are benign. Kazakhstan's growing potential to export oil, metal and agricultural products should ensure robust and sustainable growth in the future.

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