SigmaBleyzer

Kazakhstan
Macroeconomic Situation

THE BLEYZER FOUNDATION

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Sergey Kasyanenko, Edilberto L. Segura

- **Kazakhstan's economy is on track to expand by around 6% yoy in 2010.**
- **The housing market is showing signs of life, with home values increasing for the 6th straight month in November.**
- **In January-November, the state budget deficit stood at only 2.6% of projected full year GDP.**
- **Consumer prices grew by 7.8% yoy in November.**
- **In January-October, exports jumped by 40.6% yoy to $47.3 billion.**

Executive Summary

A strong rebound of foreign demand for metals and energy was central to Kazakhstan's economic recovery in 2010. Indeed, local manufacturing, which is still heavily dependent on metallurgy, has been returning to firmer footing thanks to inventory restocking by global steelmakers and car manufacturers. Meanwhile, solid economic growth in emerging Asia helped keep commodity prices on the uptrend. As a result, booming exports have put the economy on track to expand by about 6% after a modest growth of only 1.2% in 2009.

Domestic demand is getting stronger as well, with retail sales posting double digit gains following lackluster performance a year ago. Consumers, who pulled back during the economic downturn, are eager to spend again thanks to improving job security. Meanwhile, salary hikes in the public sector as well as increasing social spending are supporting solid gains in personal income. As wages in the non-oil economy increase, especially in the service providing sectors, both the share of wages and personal spending in national output will grow. This should help to gradually lessen reliance on overseas demand as a source of economic growth.

That said, in the near-term the performance of Kazakh economy will remain linked to global business cycles. More than that, the strength of economic growth in China, which has considerably strengthened its economic links with Kazakhstan, will remain integral to Kazakhstan's economic recovery. Indeed, Kazakh industry grew slower in the third quarter of 2010 as policy tightening in China (as well as the European debt crisis) created concerns over the global economic outlook. On the upside, the latest upward movements of commodity prices, such as copper and crude oil, imply that the global economic recovery is becoming more solidly entrenched. Meanwhile, November's readings on global manufacturing activity registered renewed strength in China, India, Germany and the UK.

On the flip side, higher commodity prices are raising consumer prices in Kazakhstan. Indeed, in November, inflation rose to its highest level in 2010 on dearer prices of foods due to wheat harvest failures in the FSU region. That said, price pressures on the global agricultural markets may ease as current supply constraints still pale in comparison to the 2008 food crisis. However, the region remains particularly exposed to unfavorable weather conditions (and, as a result, spikes in food prices) because of the inferior technology and planting material in agriculture.

Meanwhile, monetary sources of inflation remain at bay as money supply is expanding at a much slower pace compared to the years prior to the financial crisis. After all, banks remain beset by the poor quality of their loan portfolios. This means that next year, the banking industry will still be facing constraints on its capacity to resume lending as efforts to tackle bad loans will be a drain on resources.

Finally, the government is increasingly likely to close this fiscal year with a lower budget deficit than its initial projections thanks to booming tax revenues. In addition, higher revenues help maintain social spending and step up public investments. As a result, fiscal policy remains supportive to economic growth. True, higher spending on pensions and public sector payroll stokes inflationary risks and may boost imports. However, expansionary fiscal policy may also accelerate economic diversification. Indeed, Kazakhstan has one of the friendliest business environments in the region. As a result, stronger domestic demand is more likely to trigger a supply response in Kazakhstan compared to peer economies.

	2005	2006	2007	2008	2009	2010*
GDP growth, % change yoy	9.7%	10.7%	8.9%	3.3%	1.2%	5-6%
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%	7-8%
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	-4.2	3.0
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	146.0

* Projections

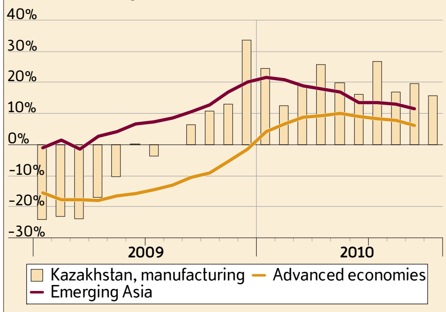
Source: ASRK, NBK, Ministry of Finance of Kazakhstan, IMF, Economist Intelligence Unit

Where Opportunities Emerge.

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

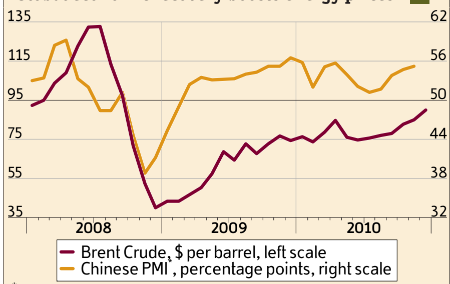
Economic Growth

Global industrial rebound 1
% annual change



Source: ASRK, CPB Netherlands Bureau for Economic Policy Analysis

Global economic recovery boosts energy prices 2



*PMI - Purchasing Managers Index, a reading above 50 indicates expansion
Source: The U.S. Energy Information Agency, China Federation of Logistics & Purchasing

Kazakhstan's economy returned to growth in the last quarter of 2009 and is on track to expand by around 6% yoy in 2010. Indeed, as global industrial recovery took hold last year, local manufacturing has been rapidly regaining lost ground (see chart 1). After all, key Kazakh industries, from metallurgy to the producers of chemicals and building materials, are enjoying a strong rebound of overseas demand. In particular, metallurgy, which accounts for over 40% of total manufacturing output, is driven by booming exports of ferroalloys and nonferrous metals on the turnaround in global steel making and car manufacturing. Meanwhile, the chemical industry is supported by increasing shipments of uranium to energy-hungry China.[1] In fact, China already leads the world in terms of active construction projects as well as future gains in its nuclear capacity.[2] And this ensures long-term demand for Kazakh uranium - Kazakhstan recently signed a 10 year deal to supply uranium to China.

That said, industry grew slower at the beginning of the second half of this year as global restocking of industrial supplies by steelmakers may have eased. In addition, Chinese regulators started to cool real estate lending, which triggered a downward revision of world steel output, further reducing the need to build up inventories. Indeed, Kazakh metallurgy (as well as the extraction of iron ore) reported somewhat smaller gains in the second half of 2010 compared to the first two quarters of this year.

On the upside, Beijing announced plans to shut down 50 million tons of outdated steel capacity in 2010-2015, of which a total of about 9 million tons is scheduled to be decommissioned in 2010. This should add strength to global steel prices. In fact, China steel production was already 4% yoy lower in October than a year ago and 10% below its peak of over 56 million tons in May.[3] Meanwhile, Chinese prices for rebar (steel used to reinforce concrete in roads and buildings), which retreated by 16% from April to July, had recovered by 20% by the beginning of December and are now 24% yoy higher than a year ago.[4] Increasing steel prices, lower iron ore stockpiles at Chinese ports and an export ban in India prompted a rally in iron ore prices as well, which have jumped by over 40% since July. All this should sustain output growth in Kazakh metallurgy and the mining of iron oar.[5]

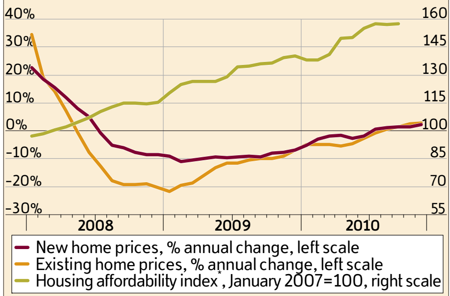
In addition, November readings on global manufacturing activity registered renewed strength in China, India, Germany, and the UK.[6] This means that Kazakh export-oriented industries will continue to benefit from the robust overseas demand for their products, especially nonferrous metals and alloys. In fact, prices of copper, which is widely used in construction and manufacturing, surged to an all-time high at the beginning of December on brighter outlook for the global economy.[7] Growing construction and industry in China, whose imports of refined copper and copper alloys from Kazakhstan already account for over 2% of all Kazakh exports, will keep copper prices steady in 2011.

Equally important, crude oil is trading close to a 26-month high (see chart 2), which provides additional evidence of the strength of the global economy. Although abnormally cold weather conditions in Europe may be pushing crude oil spot prices above $90 per barrel, long-term fundamentals still point to an upward trend in commodity prices. Indeed, according to the U.S. Energy Information Agency[8], the non-OECD regions, especially China, India, the Middle East, and Brazil, will account for most of the growth in world oil consumption in 2011. As a result, next year average WTI crude oil spot prices are expected to be 9% higher compared to 2010.

Domestic demand is improving as well. In particular, retail sales are posting double digit gains following lackluster performance a year ago. Consumers appear to be ready to spend again as increasing employment and income are boosting confidence. In particular,

[1] Exports of Kazakh uranium to China more than doubled in volume and grew by over 48% yoy in value during the first 10 months of 2010.
[2] Source: The U.S. Energy Information Agency, International Energy Outlook 2010.
[3] Source: The World Steel Association.
[4] Source: Bloomberg.
[5] In October alone, exports of rolled steel from Kazakhstan to China grew by over 75% yoy.
[6] Source: JPMorgan Global Manufacturing PMI.
[7] This surge may be partially explained by the launch of the new exchange-traded funds in copper in London. That said, investors' bets on the prices of copper do reflect a widening gab between the growth of supply of and demand for copper.
[8] Short-term Energy Outlook, December 8th, 2010.

in the third quarter of 2010, the jobless rate stood at just 5.6% - the lowest reading in over three years - on strong hiring in construction, trade, transportation, and professional and business services. Meanwhile, real wages were nearly 10% yoy higher in September compared to a year ago, partially thanks to increasing pay in the mining industry, but mostly on the back of salary hikes in the public sector (including public administration, education and healthcare). As wages in education and healthcare in particular (and in the service-providing industries in general) catch up with the rest of the economy, both the share of wages and personal spending in the national output will grow.[9] This should help Kazakhstan gradually lessen its reliance on overseas demand as a source of economic growth.



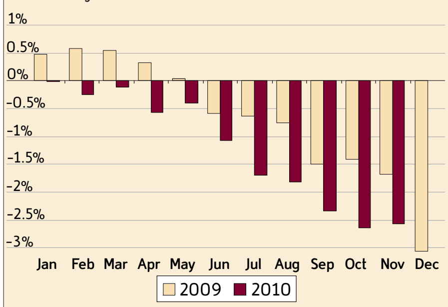
Home prices are starting to strengthen
seasonally adjusted

* A ratio between the real value of new home prices and real wages
Source: ASRK, The Bleyzer Foundation

Lastly, the housing market, battered by the sudden stop of mortgage lending, is showing some signs of life. In particular, in November prices of new and existing apartments were 2% yoy and 3% yoy higher than a year ago (see chart 3). Although new and existing home values are still 13% and 26% below their peaks at the end of 2007, they have been posting monthly gains for the last six months. And because wages resumed growing in real terms in 2009, housing is now more affordable. This means that as banks gradually unfreeze mortgage lending, housing prices will continue to strengthen, which should support stronger investments and business activity in the construction industry in 2011.

Fiscal Policy

During the first eleven months of 2010, the state budget deficit stood at about $3.4 billion or 2.6% of projected full year GDP (see chart 4). Tax revenues continued to rally, jumping by over 30% yoy on growing domestic and foreign trade, improving corporate profits and stronger local output. Indeed, the republican budget tax revenues (which are mainly comprised of the corporate income tax proceeds, VAT revenues and custom duties) grew by nearly 42% yoy.[10] This implies that the government is on track to keep the year-end republican budget deficit well below its initial target of 4.2% of GDP or about $5.5 billion.[11] After all, initial assumptions on the pace of economic recovery and average oil prices proved to be rather conservative compared to actual trends. Indeed, by the end of November, tax revenues of the republican budget were just 4% short of the annual target, which was raised only two months ago.[12]



State budget deficit
% of full year GDP

Source: Ministry of Public Finance

In January-November, state budget spending was up by 20% yoy due to increasing expenditures in education (up by 15% yoy), healthcare (up by 22%), public administration (up by 33% yoy) as well as growing social benefits (up by 20% yoy). Current budget expenditures, which include spending on goods and services, public sector payroll, pension, stipends and other social spending, continued to grow at about the same rate as a year ago. At the same time, bigger than expected budget revenues supported higher spending on public infrastructure and economic development. Indeed, unlike many other countries, this year Kazakhstan felt less pressure to cut public investments in order to maintain other vital public services.[13] In particular, the government stepped up its capital spending (which remained flat in nominal terms in 2009) with higher investments into roads and public utilities. Budget credit grew mostly thanks to new loans issued to support housing and agriculture. Lastly, the government nearly doubled its spending on purchases of financial assets by boosting the capital of state-run economic development agencies.

Monetary Policy

In November, inflation in Kazakhstan rose to its highest level in 2010 on dearer prices of foods. While at the beginning of this year, consumer prices were pushed mostly by higher prices of nonfood products and utility tariffs, increasing food prices have been contributing over 40% to overall inflation since August (see chart 5). Although this surge in food prices, which was mostly caused by harvest failures in the FSU region (see chart 6), may ease as the demand side pressures and supply constraints still pale in compari-

[9] Goods producing industries (mining, manufacturing, utilities and construction) employ 26% of all nonfarm workers. Yet they account for over one third of the total compensation of employees in the economy. For example, education and healthcare provide about one fifth of all nonfarm jobs. However average salaries in education and healthcare are more than 30% lower compared to the economy as a whole. As a result, the ratio of the compensation of employees in education and healthcare to GDP is about 4% compared to a 7% share of the industry, which accounts for only 16% of all nonfarm jobs.
[10] Local budgets rely on less volatile sources of income, such as personal income, social security and property taxes, which provide about 85% of all local budgets tax revenues.
[11] According to the amendments of the 2010 republican budget adopted at the beginning of October.
[12] Tax revenues were also boosted by the reintroduction of export duties on crude oil and petroleum products in the second half of 2010. Next year, the government expects to receive over $1.2 billion from these duties.
[13] Last year, a large portion of budget spending was allocated to support the ailing banking sector, which triggered delays in some public infrastructure projects.

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

Almaty Office, Kazakhstan
286-V Zharokov Street,
Almaty, 050060
Tel./fax +7 (727) 258-5570/71
E-mail: office@sigmableyzer.kz

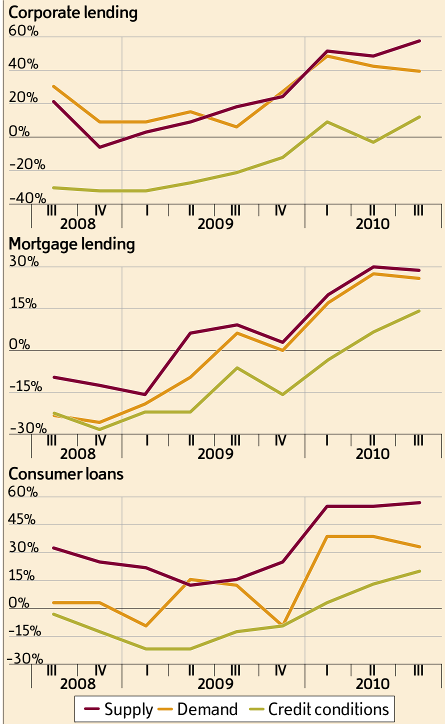
son to the 2008 food crisis[14], the region remains particularly exposed to unfavorable weather conditions. Indeed, crop yields in the FSU region, depressed by inferior technology and planting materials, are still more than two times lower than in the European Union. This means that more investments into agriculture as a response to higher commodity prices should help expand supply and will make crop yields more predictable.

Food prices aside, monetary sources of inflation remain at bay on the back of weak bank lending - in October bank credit was 6% lower than a year ago. Indeed, money supply is expanding at a much slower rate compared to the years prior to the financial crisis (see chart 7). Although both demand for and supply of credit appear to have improved since the height of the banking crisis, only a small minority of banks report an easing of credit conditions (see chart 8). After all, a typical Kazakh bank still holds a large portion of bad loans, which reduces lenders' appetite for risk. Although the share of nonperforming loans in the banking system dropped from 30% at the beginning of the year to 23% in October, the overall quality of banks' assets continues to stagnate (see chart 9).[15] This means that next year, the banking sector will still be facing constraints on its capacity to resume lending as efforts to tackle bad loans will be a drain on its resources.

International Trade and Capital

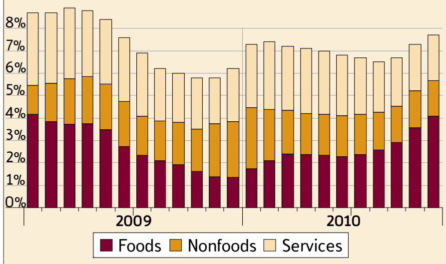
In January-October, exports jumped by 40.6% yoy supported by a continued uptrend in commodity prices, including prices of crude oil, copper and wheat. In particular, exports of iron ore grew by 43% yoy thanks to increasing shipments to Russia (up by 32% yoy) and China (up by 55% yoy). Meanwhile, exports of crude oil and gas concentrate were up by 51% yoy as exports to China surged by 2.5 times. China is driving exports of other Kazakh minerals as well - exports of copper were up by 89% yoy, exports of uranium grew by 49% and exports of zinc by 14% yoy. In addition, a robust economic recovery in the densely populated neighboring Asian countries is supporting a wide range of Kazakh exporters - from producers of foods and beverages to makers of building materials. Finally, exports of Kazakh ferroalloys increased by 63% yoy as exports to Germany and Japan (which jointly account for over half of all exports of Kazakh ferroalloys) jumped by around 150% yoy.

Credit conditions are still tight 8



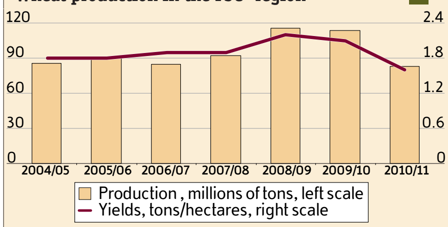
Source: NBK

Dearer foods contribute most to inflation 5
contributions to overall inflation, percentage points

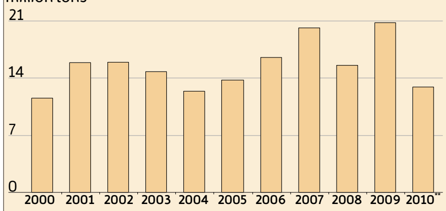


Source: ASRK, The Bleyzer Foundation

Wheat production in the FSU* region 6



Grain production in Kazakhstan
million tons

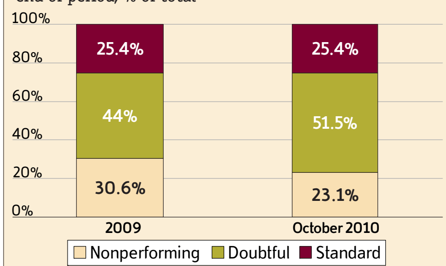


*Former Soviet Union
**As of November 1st, 2010
Source: The U.S. Department of Agriculture, Ministry of Agriculture of Kazakhstan

Money supply (M3) 7
% annual growth, seasonally adjusted

Source: NBK

Classification of banks' loans 9
end of period, % of total



Source: AFS

[14] For example, much of the food price increase in 2008 was blamed on booming ethanol production. Yet according to the Renewable Fuels Association, this year world fuel ethanol production is projected to grow by only 14% compared to a 32% increase from 2007 to 2008.
[15] At the end of 2007, only 1.5% of all loans were classified as nonperforming.