SigmaBleyzer

Kazakhstan
Macroeconomic Situation

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Summary

- GDP grew by 3.2% yoy in 2008.
- In January, industrial production shrank by 1.8% yoy.
- The state budget ended the first month of 2009 with a surplus of about 0.5% of the projected full year GDP.
- The government spent USD 5 billion to support the banking sector.
- In January, inflation decelerated to 8.7% yoy.
- In 2008, the foreign trade surplus stood at USD 33.3 billion or 25% of GDP.

Economic Growth

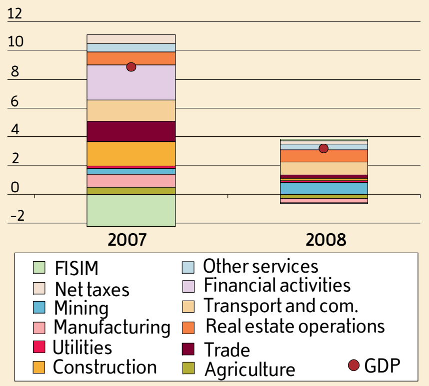
In 2008, GDP growth in Kazakhstan fell to 3.2% yoy from 8.9% yoy in 2007. Essentially, weaknesses in the banking system triggered a broad-based slowdown, as all sectors (with the exception of the mining industry) posted a sharp deceleration of economic growth. In particular, construction and the financial sector, which jointly generated nearly 50% of GDP growth in 2007, saw this contribution shrink to less than 5% in 2008 (see chart 1) as growth in these two sectors remained virtually flat. In 2008, construction grew by only 1.9% yoy (compared to 17% yoy in 2007), while the financial sector shrank by 0.5% yoy (compared to a record growth of 52.1% yoy in 2007). However, despite a sizeable deceleration of the financial sector, services still ensured about two third of the overall economic growth on the back of resilient growth in a broad group of service sectors. This group includes transportation, business services, education and health care, and accounts for about 60% of all services. The relatively stable performance of these sectors can be attributed to their reliance on the corporate sector and the government. Meanwhile, consumer-oriented sectors (for example retail trade) were subject to a much more serious deterioration of business conditions in 2008 as households faced a sharp reduction in the growth of real incomes and the limited access to credit.

Indeed, preliminary data on GDP by expenditure shows that real household consumption remained virtually flat in 2008, having grown by 12% yoy on average during the last five years. Tight access to credit restrained investment demand as well. In 2008, investments into fixed capital grew by only 4.6% yoy. As a result, gross fixed capital formation fell by more than 10% as companies ran down their inventories. During the last ten years, the share of gross fixed capital formation in GDP almost doubled to 30%, while the share of private consumption shrank below 45% (see chart 2). Furthermore, in 2005-2007, the contribution of private consumption to GDP growth lagged behind the contribution of gross fixed capital formation. This added extra risk to the sustainability of economic growth since investment demand is more volatile and is very sensitive to business cycles. After all, a sharp weakening of investment activities (including a sudden deceleration of construction works to 1.8% yoy in 2008 compared to 25% average growth in 2004-2007) exerted considerable downward pressure on the real economy in 2008.

On a positive note, flagging consumer and investment demand curbed the growth of imports, which helped to restore a large positive contribution of net exports to GDP growth in 2008. Indeed, high commodity prices and a 10% reduction in imports brought the share of net exports in GDP to about 20%, compared to only 6.7% in 2007. All told, GDP growth in 2008 was supported by strong global demand for commodities during the first half of the year and a reduction of spending on imports. However, this increased reliance on external demand implies that the Kazakh economy will continue to slow in the first half of 2009, as global demand for metals and crude oil is unlikely to recover in the near-term. Demand for imports looks certain to shrink as well on the back of a 23% devaluation of the national currency against the US dollar in February 2009. Still, a high share of net exports in GDP made Kazakhstan particularly sensitive to the performance of the global economy in 2009. Therefore, even if imports continue to fall, a possible sharp deceleration of exports will certainly put a drag on economic growth in Kazakhstan.

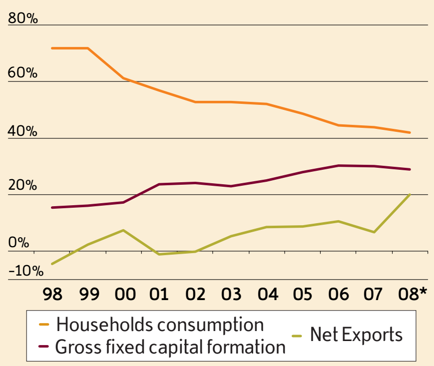
True, a weaker currency may help shift consumer spending to local producers. However, with the exception of staple foods and energy resources, local markets heavily rely on imports of non-food consumer products, durable goods and capital equipment (see chart 3). Furthermore, although consumers cut purchases of big ticket items such as cars and furniture, spending on other consumer goods remained strong. In particular, while in 2009 imports of passenger vehicles, computers and furniture fell by 60% yoy, 30% yoy, and 45% yoy, re-

Contributions to GDP Growth, percentage points 1



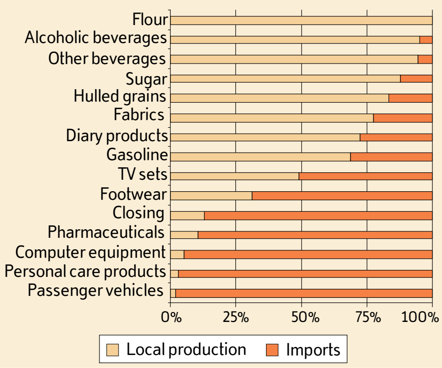
Source: ASRK, The Bleyzer Foundation

GDP structure by expenditure, % of GDP 2



*estimates based on data for 9 months of 2008
Source: ASRK

Supply of selected products, % of total 3



Source: ASRK

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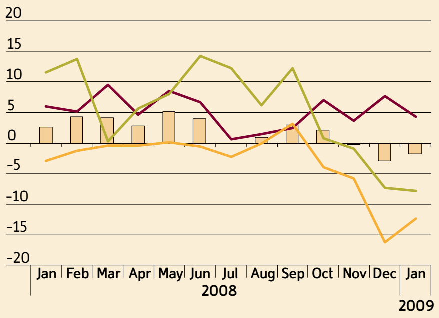
spectively, imports of footwear, clothing and TV sets grew by 29% yoy, 21% yoy and 160% yoy. This suggests that the Tenge devaluation may not quickly translate into a local supply response because of the few strong local consumer brands (with the exception of the food industry). On the other hand, a combination of currency devaluation and a recent reduction of taxes on the non-oil economy will eventually enhance the competitiveness of consumer-oriented industries. Still, in the near-term, currency depreciation will mostly help to contain the current account deficit rather than boost local supply.

Finally, 2009 is likely to see only a modest recovery of consumer demand as households' access to bank loans remains tight. Indeed, in 2008 net credit to households dropped by nearly USD 2 billion, which brought the ratio of loans to households to GDP to 14.6%, compared to 20% at the end of 2007. Likewise, investment demand may continue to decelerate as firms usually postpone investment decisions during economic downturns. On the positive side, a depletion of inventories in 2008 may prompt businesses to increase production in 2009. However, the construction sector will remain weak unless housing prices stabilize and banks resume mortgage lending. This means that local producers of construction materials (which account for about half of the industrial output outside of food processing, metallurgy, fuel processing, machine building and the chemical industry) will continue to struggle.

In January, industrial production fell by 1.8% yoy compared to 2.6% yoy growth a year ago. Essentially, a combination of a sharp fall of manufacturing output and a reversal of the growth trend in utilities wiped out continuing positive gains in the mining sector. As a result, industrial output declined for the third month in a row (see chart 4). Nevertheless, in January, manufacturing contracted at a slower rate than the month before, shrinking by 12.4% yoy. Better performance of food processing and metallurgy, where output declined by 3.2% yoy and 15.6% yoy, respectively, compared to 11.9% yoy and 20.6% yoy declines in December, stood behind this trend. Meanwhile, production cuts have been gathering speed in the fuel processing and chemical industries and machine building. Production of construction materials did not show signs of recovery either, losing 20% yoy in January. These four sectors, producing slightly over one fourth of industrial output, may remain under stress in the near-term as companies adjust to weakening demand by mothballing excess capacity.

Industrial production by sector, % to the same month the year before 4

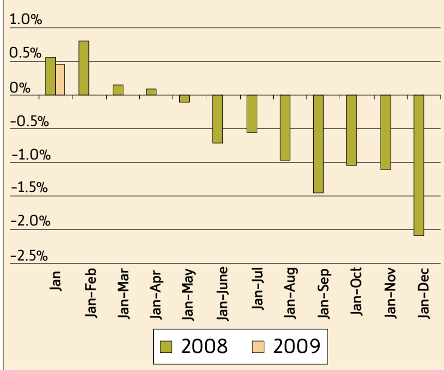


Source: ASRK

Fiscal Policy

In January, the state budget registered a surplus of USD 640 million or 0.46% of projected full year GDP (see chat 5). State budget revenues shrank by 4.5% yoy in nominal terms as tax revenues declined by 16% yoy (in January 2008, tax revenues jumped by 35% yoy). This came as a result of a reduction of the VAT and corporate income tax rates by 1 and 10 percentage points, respectively. It also means that slowing economic growth and stagnating foreign trade (about two thirds of all VAT revenues are earned on imports) may force the government to put a ceiling on its spending in 2009. On a positive note, the government may tap into the National Oil Fund (which had USD 28 billion in assets at the end of January) to compensate for temporary budget revenue shortfalls. Indeed, transfers from the National Oil Fund to the republican budget stood at about USD 250 million in January, or 18% of all republican budget revenues. However, unless global commodity prices recover, the government is likely to ration its expenditures more selectively. For example, in January the share of budget spending on social security and protection climbed to 48% of total spending compared to 40% the year before.

State budget balance, % of full year GDP 5



Source: Ministry of Public Finance

Government funding of the economic stabilization program will remain a priority as well. In February, four Kazakh banks received public funds in the amount of KZT 476 billion (or about USD 3 billion). Samruk-Kazyna National Welfare Fund placed KZT 120 billion in each of the two largest banks - Kazkommertsbank and Halyk Bank. These funds will be used to purchase 25% equity stakes (KZT 36 billion for Kazkommertsbank and KZT 60 billion for Halyk Bank), while the rest will be used to extend credit to the private sector. Samruk-Kazyna has also taken control of Bank TuranAlem (BTA) and Alliance Bank by increasing its stake in both banks to 78% and 76%, respectively. The government increased BTA's capital by KZT 212 billion and deposited KZT 24 billion in Alliance Bank, which may be used to increase the bank's capital. In addition, twelve commercial banks received loans from the Small Enterprise Development Fund (DAMU) in the amount of KZT 117 billion. These funds will be used to refinance loans given out to small businesses and issue new loans at a 12.5% annual interest rate. Finally, Samruk-Kazyna Real Estate Fund deposited KZT 120 billion at ten Kazakh banks to refinance household mortgages at subsidized interest rates of 9% and 11%. All told, the government has already spent nearly USD 5 billion to support the banking sector (see chart 6). These measures should help restore financial stability and encourage bank lending to the private sector.

Public funds allocated to the banking sector in January-February 2009, USD billion 6

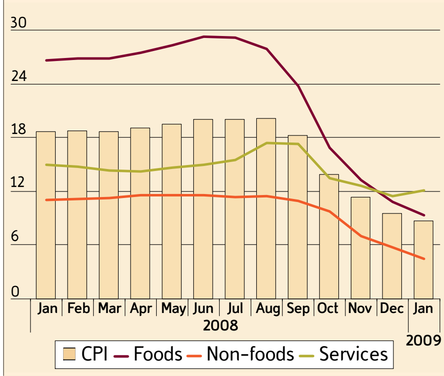
	Funds from Samruk Kazyna	DAMU	Samruk Kazyna Real Etate Fund**
Kazkommertsbank (25%)*	0.80	0.11	0.16
Halyk Bank (25%)	0.80	0.08	0.16
BTA (78%)	1.41	0.15	0.27
Alliance Bank (76%)	0.16	0.12	0.09
ATF bank		0.07	0.02
CenterCredit Bank		0.07	0.02
Kaspi Bank		0.04	0.02
Eurasian Bank		0.02	0.02
TsesnaBank		0.02	0.02
Nurbank		0.05	
Bank Astana-Finance		0.02	
Subsidiary of Sberbank		0.04	
TemirBank			0.02
Total	3.17	0.78	0.80

*bank shares acquired by Samruk-Kazyna
**Samruk-Kazyna Real Estate Fund has deposited USD 1.6 billion at the central bank to fund its mortgage refinancing program
Source: The Government of Kazakhstan

Monetary Policy

In January, the consumer price index (CPI) grew by only 8.7% yoy compared to 18.7% the year before. Slower growth of food prices (up by only 0.2% mom) and falling prices on non-food commodities (down by 0.4% mom) continued to support low inflation (see chart 7). In particular, prices of gasoline and diesel fuel declined by nearly 10% in January, following a downtrend in world crude oil prices. Although inflationary pressures are likely to remain subdued in 2009, a recent one-off devaluation of the national currency looks certain to impact consumer prices through higher prices of imported goods. Indeed, according to the Minister of Industry and Trade, the weaker Tenge may inflate prices of basic foods by 2-12%. Prices of non-food commodities are likely to increase as well due to a high share of imported consumer goods. However, the final pass-through effect of this devaluation on the price level will be defined by a broad set of factors, including the fiscal and monetary policy mix. Obviously, the near-term impact on prices may be significant because of the slow supply reaction. In the medium-term, currency devaluation may help to shift domestic demand to local producers, especially if government efforts to facilitate a supply-side response with fiscal and monetary measures continue.

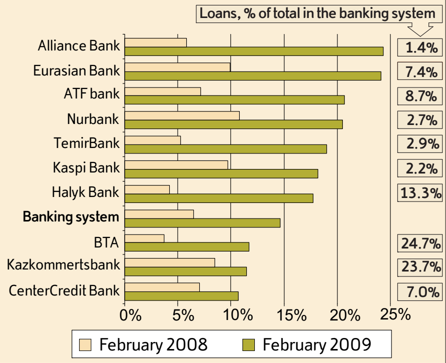
CPI by Component, % yoy 7



Source: ASRK

In January, domestic credit grew by only 2% yoy, shrinking by 1% compared to December 2008. As a result, net domestic credit contracted by a record USD 560 million during the first month of 2009. Although credit to households remained on a downtrend, declining by 10% yoy as banks continued to avoid riskier retail lending, a deceleration of credit in January was driven by declining credit to the corporate sector. Indeed, net credit to the corporate sector shrank by USD 361 billion, losing 10% of its net gain in 2008. This may suggest that banks' capacity to lend (even to the safer corporate clients) is coming under increasing stress due to a shortage of funding and a growing share of bad loans. In particular, in January, banks' clients withdrew USD 1.27 billion from their accounts or about 3% of all deposits (deposits fell in September and October by USD 0.1 billion and USD 1.7 billion, respectively). Households' deposits stayed mostly flat, increasing by 0.5% month-over-month (mom) as households converted their Tenge denominated deposits (down by 20% mom) into forex denominated deposits (up by 29% mom). Meanwhile, corporate deposits fell by 4% mom (or by USD 1.33 billion) as cash-strapped firms have to rely more on their savings in an environment of tighter and more expensive credit. On a positive note, a recent capital injection by the government to support Kazakh banks will surely restore banks' funding base. However, even if it eliminates immediate solvency and liquidity risks, credit risks are poised to intensify as slower economic growth and currency devaluation may turn a large portion of banks' loans sour. Indeed, according to the Agency on Financial Supervision, during the last 12 months the share of overdue loans more than doubled to nearly 15% at the beginning of February 2009 (see chart 8).

Share of overdue loans* in the banking system, % of total 8



*including non-performing loans
Source: Agency on Financial Supervision

As a result, in February, the three largest international rating agencies (Fitch, S&P and Moody's) downgraded the long-term credit rating of Kazakhstan's major financial institutions. Although all agencies admit that government support may help stabilize the banking sector, they believe that a combination of a weaker Kazakh economy and declining global output could deter the recovery of Kazakhstan's banking system. Fitch has also put Kazakhstan's credit ratings on Rating Watch for fear that a bailout of the banking sector may put a pressure on public finance. These worries are warranted, yet the government still has sufficient resources to resolve problems in the banking sector. Equally important, the government was quick and resolute in its response to the finical crisis. A broad approach to the bank bailout scheme, which includes capital injections, subsidized refinancing of outstanding loans and sector-specific credit programs should help reduce the share of non-performing assets. Furthermore, the government unambiguously de-

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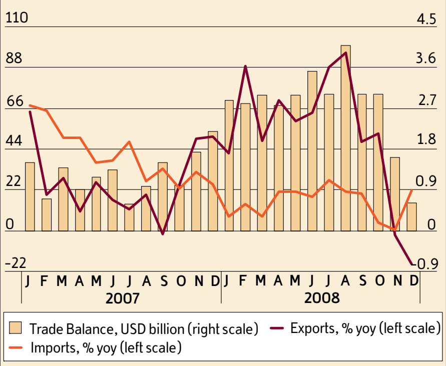
clared that it does not intend to keep acquired banks in state hands. Indeed, if the government plans to sell banks' shares, it is likely to maintain high corporate governance standards and refrain from preferential lending to selected industries. Finally, past experiments with the state ownership of the financial institutions shows that the state is a poor banker, especially if this state-owned bank operates in an emerging market economy. Thus, the success of the Kazak bank recapitalization program will depend on how fast the government is able to clean up problematic banks and then sell them back to private investors. Slower progress in that direction will cost taxpayers dearly and may even inhibit the recovery of the financial system.

International Trade and Capital

High commodity prices and weak demand for imports generated a record foreign trade surplus in Kazakhstan. In 2008, this surplus more than doubled to USD 33.3 billion (or 25% of GDP) as exports increased by 49% yoy, while the growth of imports slowed to 15.7% yoy. As a result, the share of exports of goods in GDP went up to 54% from 48% the year before, while the share of imports of goods in GDP narrowed to 29% (31.3% in 2007). The share of mineral products and metals in exports slightly increased to 88%, which suggests that the Kazakh economy remains critically dependent on the strength of the global demand for energy and industrial commodities. Meanwhile, the share of machinery, equipment and transportation vehicles in total imports dwindled to 41% from 47% the year before. This provides additional evidence on the weakness of local investment and consumer demand for durable products and capital goods.

Foreign Trade, monthly flows 9



Source: ASRK

Finally, monthly dynamics of foreign trade reveals a sharp deceleration of exports, which fell by 18.2% yoy in December (see chart 9). Indeed, falling crude oil prices and stagnating global demand for metals severely hit commodity-producing countries in the last quarter of 2008. This means that economic difficulties in these economies are likely to persist as global commodity prices continue to fall. On a positive note, Kazakhstan is likely to benefit from proximity to China, which may emerge as its key buyer of metals and crude oil. China already purchases over 10% of Kazakhstan's exports and in 2008 it imported about 10% of all crude oil extracted in Kazakhstan. However, Kazakhstan risks falling short of the oil transit capacity if it wants to double its oil output by 2020, including the launch of operation at the giant Kashagan oil field in 2012. Furthermore, investments into oil transit facilities may serve as a good source of investment demand and may provide an extra boost to economic growth. This means that the government should encourage foreign investments into these projects to ensure sustainable growth of crude oil output and exports.

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