Kazakhstan
Macroeconomic Situation

June 2009

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Summary

- In the first quarter of 2009, GDP fell by a relatively modest 2.2% yoy.
- In January-April 2009, industry declined by 4.8% yoy.
- By the end of April, the state budget surplus stood at 0.3% of GDP.
- Fitch affirmed Kazakhstan's long-term foreign and local currency rating and removed them from negative rating watch.
- In May, consumer prices grew by only 8.4% yoy.
- The government finalized recapitalization of the third largest Kazakh lender.
- During the first quarter of 2009, the foreign trade surplus stood at USD 2 billion, more than four times lower than in the same quarter of 2008.

Economic Growth

In January-March 2009, Kazakhstan's economy shrank by 2.2% year-over-year (yoy) compared to 6.1% yoy growth during the first quarter the year before. Data on economic performance in key sectors suggests an economy-wide adjustment to weaker domestic and external demand. In particular, falling output in manufacturing (down by 11.8% yoy), construction (down by 6.6% yoy), trade and transportation (down by 5.3% yoy and 5% yoy, respectively) subtracted nearly 3 percentage points from economic growth (see chart 1). Still, Kazakhstan survived the first quarter of this year relatively unscathed, as its peer CIS countries were on track to experience a painful economic downturn (for example, the Russian economy shrank by 9.5% yoy in the first quarter of 2009).

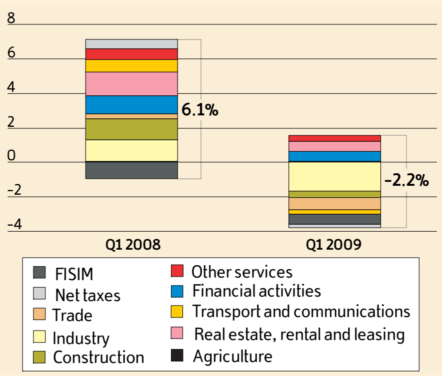
Several factors may be behind this economic resilience. First, the share of manufacturing in Kazakh GDP remains at a relatively low level of about 12% (for comparison, manufacturing accounts for more than 15% of the Russian economy). As a result, falling global demand for metals and machinery had a smaller impact on Kazakhstan than on other economies in the region. After all, Kazakh industry remains strongly linked to the performance of the mining sector, which accounts for nearly 19% of GDP (see chart 2). This means that the ongoing expansion of the production capacity in the oil and gas sector, which is driven by large foreign investments, will continue to underpin overall industrial growth. Furthermore, the country still has plenty of untapped oil reserves to be developed. Indeed, in 2008 crude oil production grew by 6.2% yoy in Kazakhstan, while it remained virtually flat in Russia.

Second, personal consumption expenditures account for only 41% of GDP. This means that weaker consumer demand is likely to have a lesser impact on GDP growth than in other consumer-driven economies. True, a large share of net exports (about 20% of GDP in 2008) represents a significant exposure to volatile global demand. Furthermore, Kazakh exports are dominated by mineral products (about 3/4th of all exports). This narrow diversification makes exports particularly sensitive to the evolution of global energy demand. On the positive side, according to the International Energy Agency (IEA), China, India and the Middle East will generate over 80% of the projected annual increase in world oil demand. Thus, Kazakhstan's dependence on the demand from the ailing OECD economies is likely to ease in the medium term.[1]

Lastly, the share of gross fixed capital formation in GDP exceeds 25%. Thus, potential weakening of investment activities may emerge as a major risk to economic recovery. Indeed, during the first four months of 2009, investment outlays by the government fell by about 14% yoy, while capital expenditures funded from retained earnings and borrowed funds declined by 18% yoy and 52% yoy, respectively. Nevertheless, total fixed capital investment grew by a robust 6.3% yoy as foreign investment more than doubled. After all, oil and gas extraction and transportation and communications are two sectors absorbing half of all capital expenditures. Since foreign companies maintain a significant presence in these industries, foreign investments are likely to make up for a decrease in investment activities by the government and local businesses.

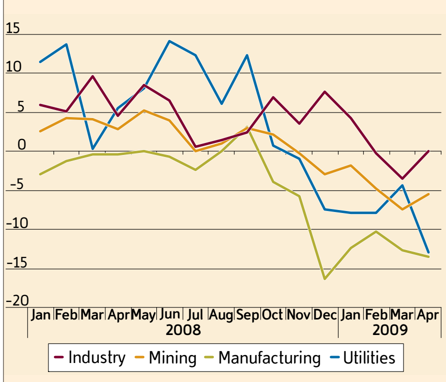
In January-April 2009, industry declined by 4.8% yoy as output contraction in manufacturing continued to gather speed (see chart 4). In particular, the chemical industry, machinery and metallurgy (or about half of all manufac-

Contributions to GDP growth, percentage points 1



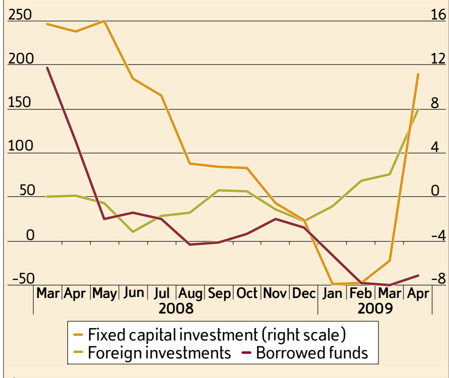
Source: ASRK, The Bleyzer Foundation

Industrial production, % change yoy 2



Source: ASRK, The Bleyzer Foundation

Fixed capital investment by source of funds, monthly* % change yoy 3



* three months moving average
Source: ASRK, The Bleyzer Foundation

[1] In 2008, China was already the fourth largest importer of Kazakh crude oil (about 10% of all crude oil exports), following Italy, Switzerland and France. In June, the IEA improved its oil demand forecast for 2009, which may provide additional support to the recent oil price rally.

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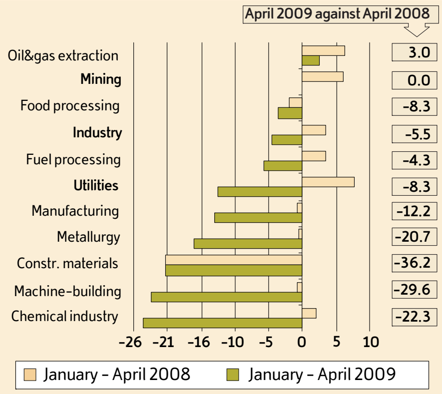
Industrial production by sector, % yoy 4



Source: ASRK

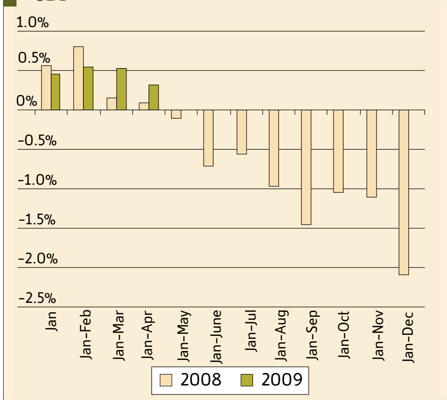
turing) posted large double digit production cuts as a response to weakening domestic and external demand.

Fiscal Policy

At the end of April, the state budget surplus stood at USD 375 million or about 0.3% of GDP (see chart 5). State budget revenues grew to USD 7.5 billion or up by 5.8% yoy, while budget expenditures increased by 7.3% yoy to USD 6.9 billion.

Transfers from the National Oil Fund continue to provide significant support to the budget as during the first four months of this year, fiscal revenues were down by almost 12% yoy. That said, the share of transfers in total budget revenues grew to about 30% compared to only 15% the year before. Meanwhile, tax revenues continued to decline as the economy slowed down. In particular, in January-April

State budget balance, % of full year GDP 5



Source: Ministry of Public Finance

2009, proceeds from the VAT, personal and corporate income tax fell by 28.5% yoy, 11.9% yoy and 9.4% yoy, respectively. Lastly, proceeds from customs duties dropped by 26% yoy as revenues from import duties (about 3/4th of all revenues of taxes on international commerce) decreased by 25% yoy, following a sharp deceleration of imports.

On the expenditure side, the budget remained skewed toward current expenditures at the expanse of capital expenditures. Indeed, current expenditures grew by 19% yoy to 73% of total budget spending (compared to only 63% the year before). In particular, current transfers were pushed up by the higher wage bill in the public sector (up by 28% yoy) and increasing transfers to the population (up by 24% yoy) on the back of higher stipends and pension payments.

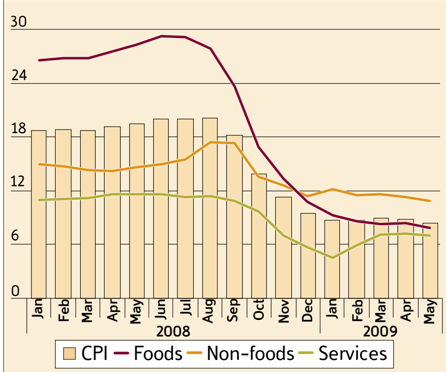
Meanwhile, government capital spending shrank by 24% yoy on the back of spending cuts on construction of roads and housing. Furthermore, capital spending of the local budgets dropped by nearly 60% yoy as capital transfers from the central government declined by 17% yoy. Lastly, constrained by falling budget revenues, the government spent 60% less on purchases of financial assets.

All told, the economic slowdown has left a visible imprint on Kazakhstan's public finances. First, the government has to rely on its previously accumulated rainy-day funds to offset falling fiscal revenues and support the financial sector. Second, public spending is redirected to current expenditures (such as wages and welfare payments), while some capital spending programs are put on hold. This fiscal policy adjustment will certainly support the economic recovery, provided that the economic stabilization program is effectively implemented. Lastly, the government still has sufficient capacity to finance fiscal loosening and even extend its fiscal stimulus plan to 2010. Essentially, a minimal level of government debt, large forex reserves (USD 43 billion at the end of May) and the ongoing strengthening of world crude oil prices will enhance the sovereign creditworthiness of Kazakhstan. Indeed, Fitch has recently removed Kazakhstan's sovereign rating from negative watch and affirmed foreign and local currencies long-term rating at "BBB".

Monetary Policy

Inflation remained on a downtrend in May, as the consumer price index (CPI) grew by only 8.4% yoy, compared to nearly 20% yoy in May 2008 (see chart 6). Lower energy and food prices (compared to their peak levels the year before) continue to put a curb on overall inflation despite the currency devaluation pass-through impact on prices of imported consumer products. As a result, the CPI has increased by only 3.5% since the beginning of the year.

CPI by components, % change yoy 6

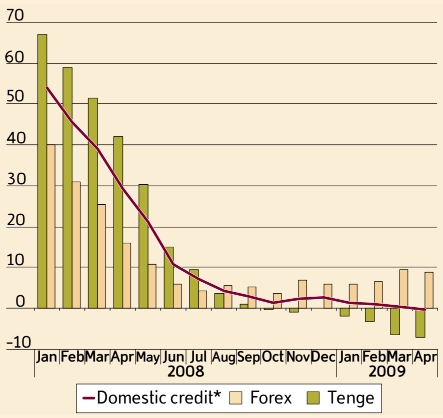


Source: ASRK

This easing of inflationary pressures prompted the National Bank of Kazakhstan to adjust its projection for year-end CPI down to 9%. On top of that, the NBK decided to reduce its refinancing rate by 50 basis points to 9% as lower inflationary risks provide extra space for looser monetary policy.

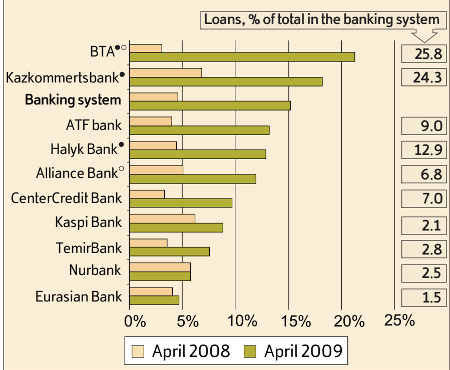
Until now, the impact of public funds injections into the private banks remains to be seen. Indeed, domestic credit has been decelerating since the beginning of the year (see chart 7). This means that looser monetary policy may provide additional support to the ailing banking sector. On a positive note, government actions helped to stabilize bank lending and restore confidence in the banking system. In particular, in April, the volume of new

Forex and Tenge denominated domestic credit, % change yoy 7



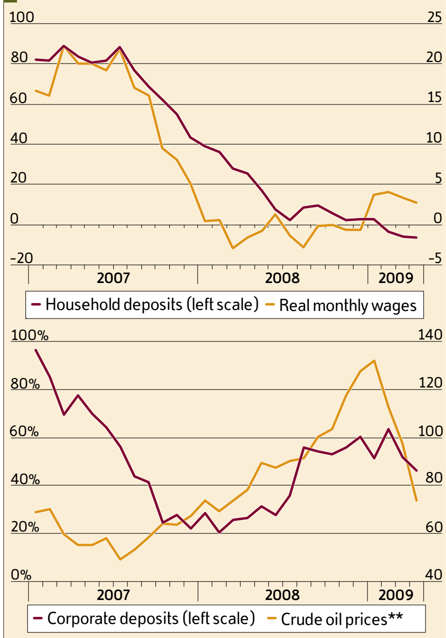
* adjusted with a constant exchange rate
Source: NBK, The Bleyzer Foundation

Non-performing loans, % of total loans 8



°partially owned by the government
•suspended repayments and announced plans to restructure foreign debts
Source: FSA

Household and corporate deposits, % change yoy* 9



* adjusted for exchange rate fluctuations
** 6-months lagged Russia, Urals spot price (USD per barrel)
Source: NBK, ASRK, US Energy Information Administration, The Bleyzer Foundation

loans issued to households in foreign currencies and tenge were up by 25% and 100% compared to the month before, as borrowers took advantage of loan refinancing programs. The volume of newly issued tenge denominated mortgages (about 80% of all issued mortgages) was almost twice as high as during the first quarter on average, while interest rates on these loans were 2.5 percentage points lower than the year before. This means that homeowners will benefit from lower debt service costs and will be able to refinance high interest rate forex-denominated mortgages.

Meanwhile, the exposure of the largest Kazakh lenders to solvency risks has been gradually building up as the share of non-performing loans in their portfolios continues to grow (see chart 8). Two of the 10 largest Kazakh banks - BTA bank and Alliance Bank - have already defaulted on their foreign loans and entered debt restructuring talks with creditors.[2] Alliance Bank, which owes creditors about USD 4 billion, intends to offer a 20% debt buyback at face value and a seven-year rollover with a 50% discount (or a 15-year rollover at par). The debt restructuring process, which is expected to be completed by the middle of July, may pave the way for government majority ownership of Alliance Bank, following the earlier proposal of the National Welfare Fund "Samruk-Kazyna" to buy a 76% stake in the bank. BTA bank, which has USD 11 billion in debt and received USD 2 billion of government funds, is likely to apply a similar debt restructuring scheme, which may be finalized in July.

At the end of May, the government finalized the recapitalization of the third largest lender - Halyk Bank - injecting about USD 400 million of new capital (both as common and preferred shares). In addition, the capital of the second largest bank - Kazkommertsbank - was increased by about USD 300 million. The government injected USD 240 million, while the European Bank of Reconstruction and Development (EBRD) provided an additional USD 40 million, raising its stake in the bank to 9.8% from 8.5%.

In summary, this recapitalization of banks and loan refinancing programs will help put Kazakhstan's financial sector on the path toward recovery. However, the deteriorating quality of banks' assets and approaching repayments of the outstanding foreign loans does imply that the lending activity in the banking sector will remain weak. On a positive note, during the first four months of this year, Kazakh banks have already repaired 43% (or about USD 4.9 billon) of their external debts due in 2009. Emerging signs of economic and financial stabilization in the global markets may facilitate refinancing and restructuring of foreign liabilities of Kazakh lenders. Nevertheless, a sustainable recovery of the banking sector in Kazakhstan requires more extensive reliance on domestic funding sources rather than on wholesale external borrowing. That said, a recent upturn in world crude oil prices and real household incomes in Kazakhstan may lift corporate and retail deposits (see chart 9), improving the funding base of Kazakh banks.

International Trade and Capital

During the first quarter of 2009, exports stood at USD 8 billion (down by 50% yoy), while imports amounted to USD 6 billion (down by 15.6% yoy). The resulting foreign trade surplus was more than four times lower than in the first quarter of 2008. Although, during the first three months of 2009, the volume of exported oil and gas condensate surged by over 60% yoy to 16.2 million tons, a sharp drop in world crude oil prices led to an almost 30% de-

[2] A small Kazakh lender, Astana Financed, has also suspended repayments of its debts.

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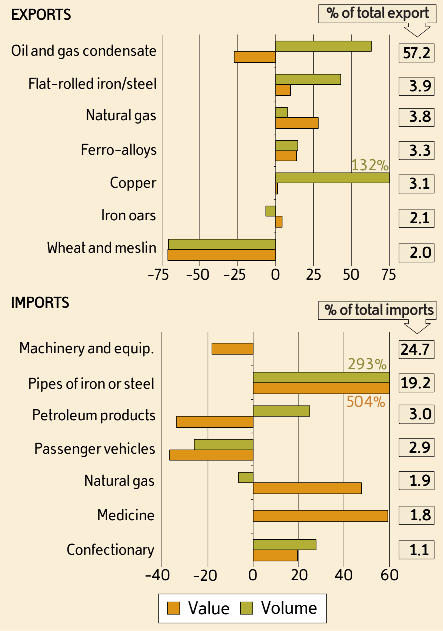
crease in the value of these exports (see chart 10).

Imports and exports of key commodities in January-March, % change yoy 10



Source: ASRK