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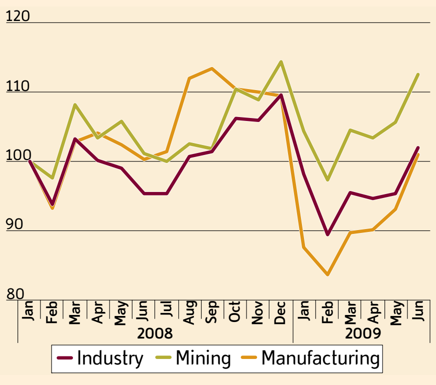
Summary

- There are signs that the economic slowdown may be losing speed as industry gained 3.1% in the second quarter against the first three months of 2009.
- Still, in January-June, Kazakhstan's GDP fell by 2.3% yoy, pulled back by the anemic construction sector.
- By the end of July, the state budget deficit stood at 0.6% of projected full year GDP.
- In August, inflation slowed to 6.2% yoy compared to over 20% a year ago.
- In January-June, the foreign trade surplus stood at USD 4 billion compared to USD 18 billion a year ago.
- During the first half of 2009, the current account deficit totaled USD 2.8 billion.

Economic Growth

Weak domestic and foreign demand continue to weigh down on business activity in Kazakhstan. That said, there are signs that the economic slowdown may be losing speed. Indeed, during the first half of this year, industry shrank by 2.7% year-over-year (yoy), compared to a decline of 4.7% yoy in the first quarter of 2009.[1] More than that, a reversal of the downtrend appears to be emerging in manufacturing (see chart 1). During the first quarter of this year, output in manufacturing declined by almost 12% yoy, while it fell by only 9.5% yoy in the first half of 2009. This means that in the second quarter of 2009, manufacturing grew by about 9% compared to the quarter before. As a result, in April-June, industry gained 3.1% against the first three months of this year.

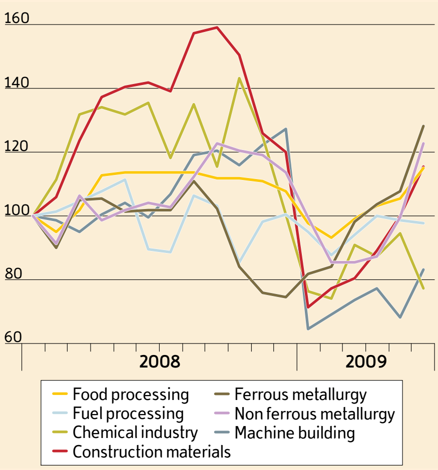
Monthly industrial output, January 2008=100 [1]



Source: ASRK, The Bleyzer Foundation

Essentially, stronger performance of metallurgy during the second quarter of 2009 helped to boost manufacturing output (see chart 2). In particular, during the second quarter of this year, output in the ferrous and non-ferrous metal industries grew by 10% yoy and 1.7% yoy against the same quarter of last year, respectively (or by 28.3% and 14.6%, compared to the first quarter of 2009). In April-June, production of ferro-alloys, refined copper and flat rolled steel jumped by 33.1%, 28.5% and 23.8% against the first quarter of 2009. It appears that foreign demand may be returning, helped by the stronger growth in Asia. After all, China's insatiable appetite for industrial metals as well as its resilient economic performance fueled Kazakhstan's exports to China in the second quarter of 2009. Indeed, during April-June 2009, Kazakhstan's exports to China grew by about 18% compared to the quarter before, as exports of ferro-alloys, refined copper and iron and steel gained 28.5%, 69% and 6.5%, respectively. As a result, during the first half of 2009, Kazakh exports of iron and steel, metal oars and non-ferrous metals[2] to China surged by 57% yoy.

Monthly output in manufacturing, January 2008=100 [2]

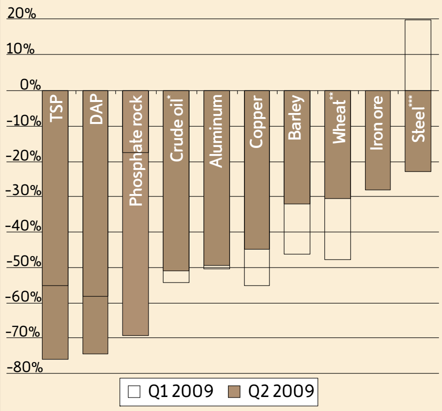


These industries account for bout 85% of all output in manufacturing
Source: ASRK, The Bleyzer Foundation

Although a resurgence in foreign demand from China adds strength to the Kazakh manufacturing sector, world commodity prices remain low on the back of weaker global demand (see chart 3). In particular, prices of fertilizers (one of the key export commodities of the Kazakh chemical industry) continue to fall. According to the International Fertilizer Industry Association (IFA), world fertilizer consumption is estimated to drop by 5.1% in 2008-09. This means that Kazakhstan's producers of fertilizers and related chemicals will continue to face difficulties in the near term.

In April-June 2009, production of construction materials recovered by about 33% against the first quarter. Still, readings on the construction sector are mixed. In particular, during the second quarter of 2009, the average monthly growth rate of the volume of construction works and investments into residential housing accelerated to 28% and 15%, respectively. At the same time, construction activity remains weaker than the year before. In January-June 2009, the volume of construction works and investments into residential housing fell by 11% yoy and 49% yoy, respectively. Furthermore, despite a 7.3% yoy growth of fixed capital investments in the first half of 2009, capital outlays on construction

Commodity prices, % change against the same quarter of 2008 [3]



TSP - triple super phosphate fertilizers
DAP - diammonium phosphates fertilizers
* average spot price
** average U.S. and Canada price
*** steel products index
Source: The World Bank, Commodity Price Data (Pink Sheet)

[1] Growing output in the oil and gas extraction industry continues to shield Kazakhstan against double digit declines in industrial output experienced by the majority of the CIS economies. According to the CIS Statistical Committee, industrial production of the CIS member states shrank by 15% yoy during the first half of this year.

[2] Iron and steel, ores, copper, zinc, lead and aluminum and articles made of non-ferrous metals accounted for over 60% of all Kazakh exports to China in January-June 2009.

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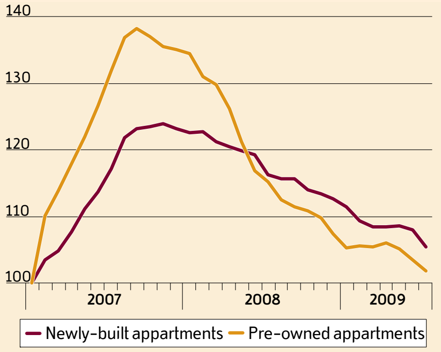
Residential apartment values, January 2007=100 4



Source: ASRK

and building maintenance fell by 22.3% yoy. Lastly, downward price pressures on the housing market persist (see chart 4), which reflects a lack of demand due to tight access to bank credit and slower growth of household incomes.

Weaker construction activities in the second quarter virtually canceled out a revival in manufacturing. As a result, in January-June, Kazakhstan's GDP fell by 2.3% yoy as construction declined by nearly 10% yoy (versus a decline of 6.6% yoy in the first quarter of this year, see chart 5). Lower volume of construction works, in turn, has been exerting a toll on the transportation sector. Indeed, during the second quarter of 2009, automobile freight traffic[3] dropped by 15.5% yoy versus the same quarter of 2008 (compared to a decline of 2.6% yoy in the first quarter of 2009). Falling retail sales have contributed to the sector's woes as well. During the second quarter of 2009, retail sales decreased by over 13% yoy compared to a drop of only 3.5% yoy in the first quarter of this year.[4] All told, in January-June 2009, the transportation sector posted a decline of 11.7% yoy, dragging the services sector of the economy into negative territory (although output in the services sector edged down by only 0.3% yoy). On a positive note, in April-June, both retail sales and freight traffic grew on a quarter-over-quarter comparison (up by 2.2% and 7.3%, respectively).

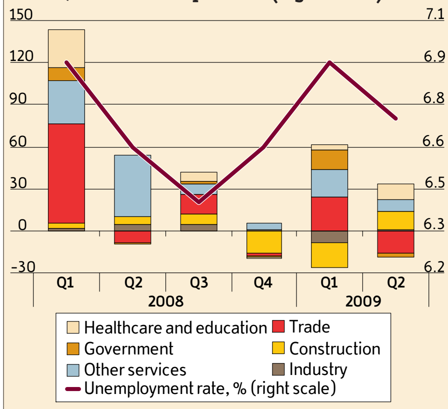
GDP growth in 2009, % change yoy 5

	Q1	H1
GDP	-2.2	-2.3
Agriculture	3.6	2.5
Industry	-5.0	-2.5
Mining	0.0	1.8
Manufacturing	-12.7	-9.5
Construction	-6.6	-9.8
Services	0.9	-0.3
Trade	-5.3	-3.6
Transportation	-5.0	-11.7
Finance	7.1	6.7
Communications	4.2	3.6
Real estate and rental services	3.8	2.8
Net taxes	-3.6	-3.5

Source: ASRK

Lastly, the labor market in Kazakhstan appears to be showing signs of improvement, while there is still little evidence of rising wage pressures. Indeed, during the first half of this year, the growth of monthly nominal wages slowed to about 12% yoy on average from 16% yoy and 28% yoy in 2008 and 2007, respectively. On a positive note, real wages have been growing since January thanks to a significant deceleration of inflation.[5] More importantly, non-farm employment[6] increased in the first and second quarters of 2009, pushing the unemployment rate down to 6.7% (see chart 6). Construction and industry (which provide 10% and 17% of all non-farm jobs, respectively) lost about 1% and 3.6% of jobs over the last three quarters. On the upside, both sectors reported job gains in the second quarter of 2009. Meanwhile, the trade sector, which employs one fifth of all non-farm workers, remains a soft spot in the Kazakh labor market as weak consumer spending forces companies to lay off employees. Indeed, in the second quarter of 2009, the number of jobs in this sector fell by 1.4% compared to the quarter before.

Quarterly change in non-farm employment, thousand of persons (right scale) 6

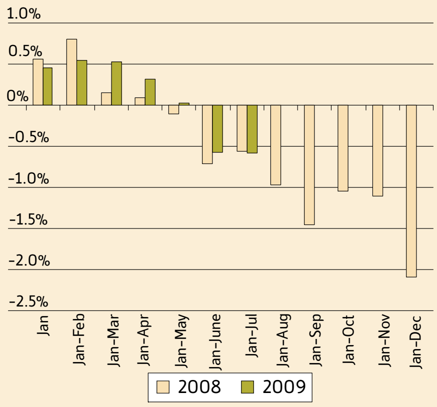


Source: ASRK

Fiscal Policy

In January-July, the state budget reported a deficit of about 0.6% of projected full year GDP (see chart 7). However, the non-oil component[7] of this deficit rose to about 4.3% of GDP compared to 1.7% the year before. This wider budget gap mostly reflects a sharp deterioration of fiscal revenues as a response to a structural shift, brought about by last year's tax reform, and an abrupt recession-driven cyclical decline in tax collection. Indeed, during the first seven months of 2009, fiscal revenues dropped by 20% yoy to only 58% of all state

State budget balance, % of full year GDP 7



Source: The Ministry of Public Finance

[3] Automobile freight traffic accounts for nearly 80% of all freight traffic in Kazakhstan.

[4] Sales of new cars represent about 6% of all retail sales in Kazakhstan, while another 14% come from the retail sales of fossil fuels. During the first five months of 2009, imports of passenger cars into Kazakhstan plunged by 37% yoy, while retail prices of gasoline and diesel fuel fell by about a third. Obviously, these trends tend to intensify the observed decline in retail sales.

[5] In 2008, real wages remained mostly flat as consumer prices spiked following the global commodity bubble.

[6] Agriculture employs about 30% of all workers in Kazakhstan versus about 4.5% average for 23 OECD countries. This means that civilian employment in Kazakhstan tends to fluctuate substantially following crop production cycles.

[7] The non-oil budget deficit is measured as the gap between budget spending (excluding debt service, balances on budget loans and operations with financial assets) and budget revenues net of the transfers from the National Oil Fund.

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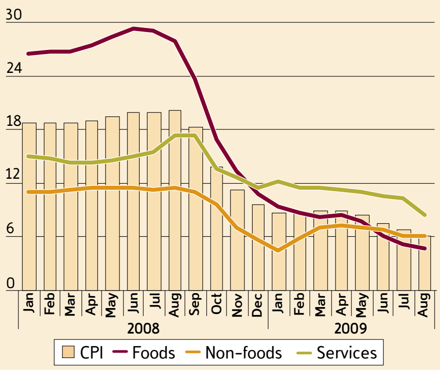
budget revenues (last year, fiscal revenues yielded 74% of all state budget revenues). Proceeds from the corporate income tax and VAT[8] plunged by 32% yoy and 17% yoy, respectively. After all, profits of Kazakh companies suffered a heavy blow due to stagnating domestic and foreign demand, a deep decline of the prices of key export commodities and large losses in the banking system.[9] On top of that, VAT revenues, 3/4th of which are collected on imports, and proceeds from custom duties fell under the pressure of lower volumes and values of the cross-boarder trade flows. That said, the government had to tap the National Oil Fund to close the revenue shortfall and fund its economic stabilization program. In particular, during the first seven months of 2009, transfers from the National Oil Fund to the state budget grew by 72% compared to the year before, amounting to over USD 5 billion. On a positive note, by the end of August, the assets of the Nation Oil Fund stood at USD 22.3 billion, which means that in the near-term the government can comfortably continue balancing decreasing fiscal revenues with non-debt financing.

Meanwhile, state budget expenditures (excluding budget loans and purchases of financial assets) grew by 8% yoy as spending on education, healthcare, social protection and housing[10] advanced by over 20% yoy. In particular, current expenditures, which include wages in the public sector, pensions and welfare transfers as well as spending on goods and services, increased by 19% yoy. However, this higher budget spending was partially offset with a 7% yoy decline of capital spending (about 1/4th of all budget spending) as the government cut or froze spending on some large public projects. All told, the government appears to be striking a reasonable balance between its spending commitments to social protection and investments into public infrastructure. In particular, socially sensitive items remain shielded from spending cuts, while capital spending is delayed, which helps keep a tighter lid on deficit growth.

Monetary Policy

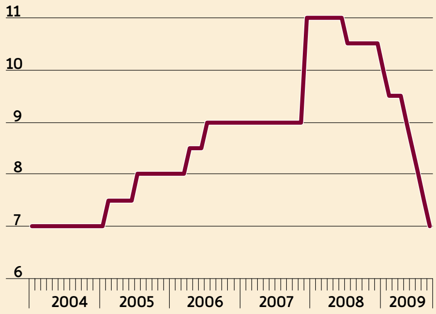
In August, the consumer price index (CPI) grew by only 6.2% yoy compared to 20.1% yoy in August 2008 (see chart 8). Consumer prices increased much slower this year on the back of last year's record high world commodity prices, which peaked in July-August 2008. In particular, during the first eight months of 2009, prices of bread and cereals, key consumer staples in Kazakhstan,[11] inched up by only 0.3% ytd, compared to 16.2% ytd in the first eight months of 2008. Meanwhile, prices of gasoline and diesel fuel declined by 1.6% ytd and 17% ytd, respectively, compared to growth of 17% ytd and 43% ytd in August 2008. This may imply that disinflation dynamics will slow as the high base impact of last year's prices gradually fades away. On a positive note, core inflation, which ignores price volatility of fuels and foods, has been falling since the beginning of 2009 as well. This means that inflationary pressures are still a remote threat to macroeconomic stability. Indeed, sluggish growth of nominal wages and weak bank lending helped to cool consumer demand. On top of that, currency depreciation restrains consumer demand through the higher prices of mostly imported non-food durable and non-durable products, including medicine, clothing, household chemicals and appliances. All told, lower inflation prompted the National Bank of Kazakhstan (NBK) to reduce its refinancing rate in September by 50 basis points for the fifth time in as many months. This rate was set at 7% - the lowest level in over 4 years (see chart 9).

CPI by components, % change yoy 8



Source: ASRK

Refinancing rate, % 9



Source: NBK

This means that the health of the banking system is of major concern to the NBK. Indeed, Kazakh banks continue to face significant funding constraints due to a combination of the closure of international credit markets, deteriorating quality of loans and mounting credit losses. In particular, the share of non-performing loans grew to 32% by the end of August from only 8% at the beginning of 2009. True, nearly 70% of all non-performing loans sit on the books of just two banks - BTA Bank and Alliance Bank,[12] while the share of non-performing loans of other large banks does not exceed 20% (see chart 10). Creditors of Alliance Bank have already agreed to restructure USD 4.2 billion in debt. At the beginning of September, BTA Bank released a debt-restructuring plan, offering USD 1 billion to buy back its USD 10.3 billion debt at an 82.25% discount. Additional options include seven and fifteen-year debt rollovers with a grace period as well as a possibility for a debt for equity swap with an 80% haircut. All told, notwithstanding large injections of

[8] These two taxes generate over half of all fiscal revenues. Proceeds from the personal income tax (PIT) fell by only 5.6% yoy. PIT accounts for about 12% of all state budget tax revenues and is collected by the local budgets. At the same time, the two largest cities - Astana and Almaty, contribute about 44% to the collection of this tax. Slower wage growth and a deeper contraction of the local economies (due to a higher exposure to the construction and retail trade sectors) led to the 24% yoy and 12% yoy declines of PIT collection in Almaty and Astana, respectively.

[9] According to the ASRK, during the first half of 2009, pre-tax profits of large and medium size Kazakh companies shrank by over 65% yoy. Meanwhile, in January-July 2009, commercial banks paid 78% yoy less in income taxes as heavy losses on loan portfolios eroded banks' profits.

[10] Spending on these four items accounted for over 60% of all budget expenditures versus only 53% a year ago.

[11] About 42% of consumer spending in Kazakhstan is allocated to foods.

[12] Both banks defaulted on their foreign debts in April and received large capital injections from the government. The third Kazakh lender in default, Astana Finance, is negotiating with its creditors.

Non-performing loans of the top ten banks, % of total loans [10]

Source: AFS

public money into the financial system, it is likely to take longer for bank lending to return to normal levels as two of the major lenders are going through a lengthy reorganization process.

International Trade and Capital

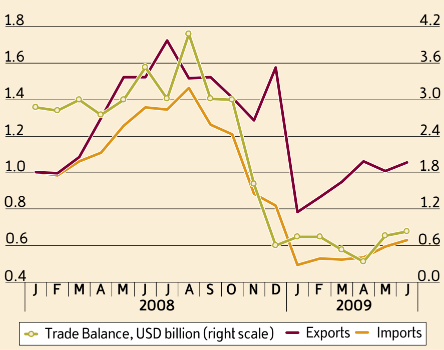
During the first half of 2009, the foreign trade surplus stood at USD 4 billion or down by 78% yoy from USD 18 billion the year before. On the upside, a recovery of world crude oil prices and resilient demand for commodities from emerging Asia add strength to exports (see chart 11). In particular, during the second quarter of 2009, Kazakh exports to China grew by over 10% compared to the first quarter of this year. More than that, this year China trails only Italy as the second largest export market for Kazakhstan, absorbing over 13% of all Kazakh exports.[13]

However, as crude oil prices remain significantly less than last year's level, Kazakhstan current account dives deeper into the red. Preliminary estimates place the current account deficit at USD 1.8 billion in the second quarter of 2009, compared to a surplus of about USD 1 billion in the same quarter a year ago (see chart 12). As a result, during the first half of this year, the current account deficit widened to USD 2.8 billion or to about 6% of Kazakh GDP in January-June 2009. On a positive note, lower oil prices put a curb on the value of profits repatriated by the foreigners, including international oil companies, down by 60% yoy.[14] Furthermore, continuing consumer retrenchment from purchases of imported durable goods helped curb imports (down by 24% yoy in January-June 2009). Finally, the current account gap remains fully covered with net inflows of foreign direct investments, which amounted to USD 4.7 billion or down by only 9.4% yoy.

Other Developments Affecting the Investment Climate

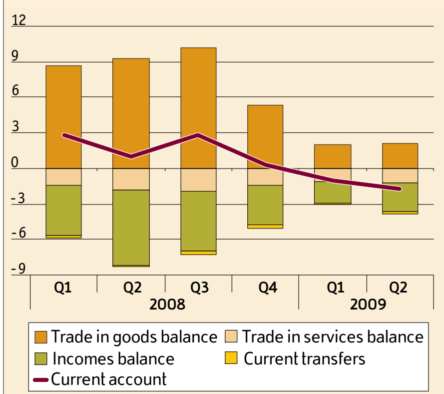
According to the latest Global Competitiveness Report 2009-2010, Kazakhstan holds 67th place out of 133 countries rated by the World Economic Forum (see chart 13). In essence, Kazakhstan's competitive disadvantages are rooted in the excessive reliance of the economy on resource-based sectors and a fragile banking system. On the upside, Kazakhstan managed to maintain its competitiveness relative to the two other largest CIS economies[15] - Russia and Ukraine, which saw substantial downgrades of their competitiveness ratings. Equally important, Kazakhstan has suffered little damage to its fiscal position due to the global financial crisis, while political stability supports the country's commitment to market reforms and economic diversification. This lays the groundwork for the sustainable improvement of Kazakhstan's competitiveness in the future.

Monthly foreign trade flows, January 2008=1 (left scale) [11]



Source: ASRK

Quarterly current account, USD billion [12]



Source: ASRK

The Global Competitiveness Index [13]

	2009–2010	2008–2009
China	29	30
Czech Republic	31	33
Poland	46	53
Azerbaijan	51	69
Mexico	60	60
Turkey	61	63
Russian Federation	63	51
Romania	64	68
Kazakhstan	**67**	**66**
Latvia	68	54
Greece	71	67
Croatia	72	61
Bulgaria	76	76
Ukraine	82	72
Armenia	97	97
Tajikistan	122	116
Kyrgyz Republic	123	122

Source: The World Economic Forum

[13] In 2008, China was the third largest export market for Kazakhstan (10.8% of all exports), following Italy and Switzerland. However, exports of Kazakh mineral fuels and crude oil products accounted for about 92% of all exports to Italy and Switzerland (mineral products represented only 57% of all Kazakh exports to China). This means that stronger demand from China is likely to have favorable implications for the broader Kazakh economy due to a more diversified mix of exports.

[14] Net repatriation of profit earned on foreign direct investments (mostly in the oil sector) fell even deeper - by 63% yoy.

[15] Kazakhstan is the third largest economy in the CIS region. In 2008, the country's nominal GDP stood at USD 132 billion compared to USD 1,607 billion and USD 180 billion in Russia and Ukraine, respectively.