SigmaBleyzer

Kazakhstan
Macroeconomic Situation

THE BLEYZER FOUNDATION

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Summary

- During the first three quarters of 2009, Kazakh GDP fell by only 2.2%.
- By November, Kazakh industry had declined by only 0.2% yoy on the back of a steady growth in oil extraction.
- In January-October, the state budget deficit stood at about 1.4% of projected full year GDP.
- In October, the consumer price index was only 5.8% higher than a year ago.
- In the third quarter of 2009, the current account moved back to a surplus, following three consecutive quarters in the red.
- Kazakhstan has moved to 120th position in the Corruption Perception Index (CPI) from 145th in 2008.
- Kazakhstan, Belarus and Russia agreed to form a customs union from July 1st, 2010.

Economic Growth

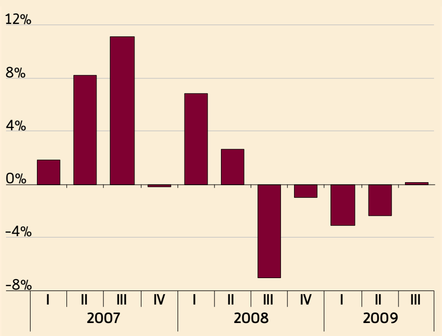
Recent data points to a continued moderation of the economic slowdown in Kazakhstan. Indeed, during the first three quarters of 2009, GDP fell by only 2.2% year-over-year (yoy) compared to a 2.4% yoy drop in the first half of this year. More than that, in the third quarter, seasonally adjusted GDP may have posted a modest quarterly gain, which means that the economy ceased to contract for the first time in five quarters (see chart 1).

Still, the ongoing recovery remains driven by growth in the mining industry, where output gained nearly 5% yoy. This helped to partially neutralize output declines in manufacturing, construction and services (see chart 2). Specifically, the services sector has been declining since the second quarter of 2009 on the back of negative trends in trade and transportation. In January-September 2009, these two sectors subtracted nearly 2 percentage points from economic growth versus a one percentage point contribution a year ago. After all, weak consumer demand and declining construction activities[1] have been exerting a heavy toll on trade and transportation businesses since the onset of the current recession. Lastly, manufacturing is still a drag on Kazakh economic growth as weak foreign demand triggers output cuts in metallurgy and chemicals.

True, the Kazakh economy appears to be more resilient to the global economic crisis compared to other peer countries.[2] However, set against the growth dynamics of the past several years, the economy may be well below its previous trend (see chart 3). Indeed, as booms in construction and banking fizzled out (these two sectors grew on average by 23% and 35% a year in 2003-2007 versus an average GDP growth of 9.6%), the economy is likely to move to a lower trend GDP growth. This means that next year, economic growth will be most likely driven by the foreign demand for Kazakhstan's commodities. On the upside, the downtrend in world commodity prices may be reversing (although prices are still significantly below last year's levels, see chart 4) as improving growth prospects in emerging economies boost demand for raw materials.[3]

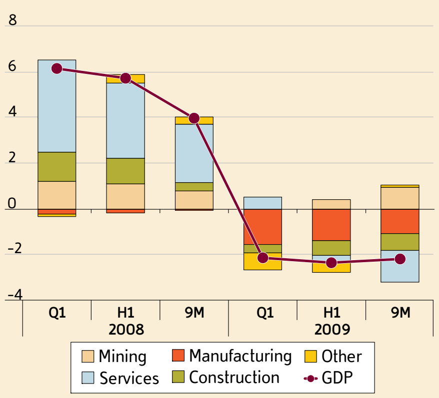
All told, a sustainable recovery of foreign demand will be central to a strong economic rebound in Kazakhstan. First, domestic demand may remain weak in the medium term as gains in household income continue to lag behind pre-crisis levels (see chart 5). Furthermore, bank lending is likely to stay depressed, which will delay a resumption of consumer spending and residential investments. On top of that, consumers play a relatively smaller role in the Kazakh economy. Indeed, the share of household consumption in GDP is below 45%, which is partially due to the fact that workers' compensation represents only a third of the national output (see chart 6). As a result, growth in domestic demand may have a less significant impact on GDP compared to more consumer-oriented economies. Second, the share of net exports in GDP grew to 20% in 2008, which means that a large portion of the national income is earned by the

GDP growth, seasonally adjusted annual rate* 1



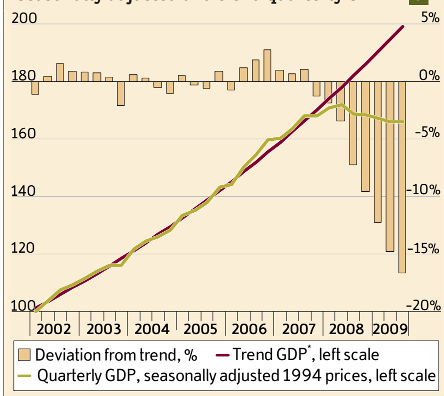
*Based on quarterly GDP in average 1994 prices. All seasonal adjustments are performed with the X-12-ARIMA seasonal adjustment software.
Source: ASRK, The Bleyzer Foundation

Contributions to GDP growth, percentage points 2



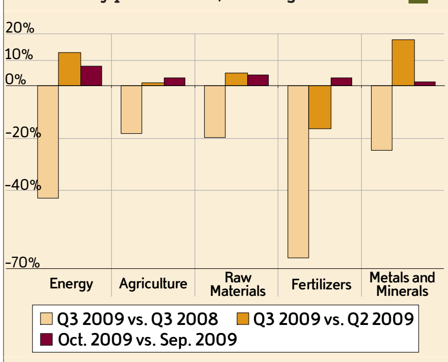
Source: ASRK, The Bleyzer Foundation

Seasonally adjusted and trend quarterly GDP 3



*The trend GDP growth (9.5% annual rate) was estimated as an exponential trend using data spanning from the first quarter of 2002 to the fourth quarter of 2007.
Source: ASRK, The Bleyzer Foundation

Commodity price indices, % change 4



Source: The World Bank

[1]During the first three quarters of this year, construction declined by nearly 9% yoy.
[2]For example, during the first 9 months of 2009, GDP declined by over 10% in Russia and Ukraine. Source: The Interstate Statistical Committee of the Commonwealth of Independent States.
[3]By the end of November, the Baltic Dry Index (BDI) was nearly 5 times higher than a year ago, as demand for shipping capacity of raw materials rebounded from its record low level at the end of 2008.

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Where Opportunities Emerge.

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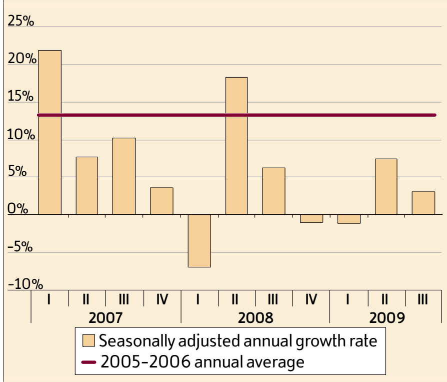
Real per capita household income 5

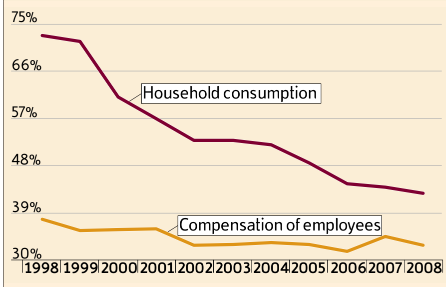


Source: ASRK, The Bleyzer Foundation

state-owned and private export-oriented mining companies. Although the government allocates a substantial share of the country's oil wealth to public infrastructure projects and social protection, it relies on international oil firms for expertise and financing of the development of the new oil fields.[4] Indeed, these companies remain the principle source of capital accumulation and foreign investments in Kazakhstan. This implies that investments into the extraction and transit capacity of the Kazakhstan oil industry will be the likeliest source of GDP growth in the foreseeable future.

Finally, more signs of economic stabilization appear to be emerging. In October, retail sales were only 0.3% below last year's level. Meanwhile, industrial production reported the third consecutive monthly gain, growing by 8.2% versus September. As a result, in January-October, industrial production dropped by only 0.2% yoy, compared to an average 13% industrial contraction in the CIS region.[5] Kazakh manufacturing appears to be on the mend as well. Its monthly output has been increasing since August, while in October production of manufacturing goods was nearly 5% yoy higher than in October 2008 - the first significant annual gain in 12 months. Equally important, the national unemployment rate remained below 7% during the last seven quarters. The unemployment rates in Astana and Almaty (Kazakhstan's two largest metros) retreated from their peak levels of 7.3% and 8.2%, respectively, in the first quarter of 2009 to 6.1% and 7.5% in the third quarter.

Household consumption and compensation of employees, % of GDP 6

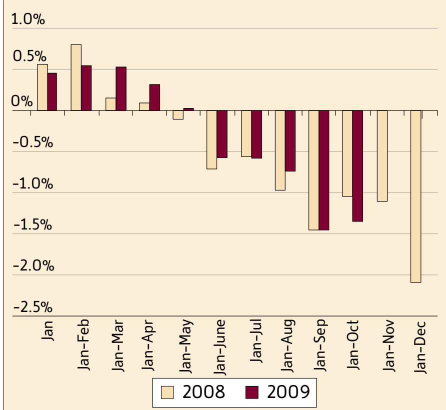


Source: ASRK

Fiscal Policy

During the first ten months of 2009, total tax collections were down 24% from last year's level. However, the budget deficit stood at only 1.4% of projected full year GDP (see chart 7). After all, revenue shortfalls were offset with transfers from the National Oil Fund, which more than doubled compared to January-October 2008. In addition, the government rolled back some of its investment programs and purchases of financial assets. This helped keep a tighter lid on budget spending without drastic cuts of entitlement benefits. Furthermore, several amendments were introduced into the 2010-2011 budget and the Tax Code to consolidate the country's fiscal position. In particular, Kazakhstan will keep its mineral extraction tax rate and corporate income tax rate (20%) at 2009 levels until 2013. The corporate income tax rate will be reduced to 17.5% and 15% in 2013 and 2014, respectively. Meanwhile, the economy is expected to grow by 2.4% in 2010 and the budget deficit is to stay at about 4.1% of GDP. Finally, the government intends to spend more on social protection at the expense of other budget programs.

State budget balance, % of full year GDP 7



Source: Ministry of Finance of the RK

The budget deficit is projected to decline to 3.5% in 2012. This means that the government will increase domestic and international borrowing to cover the resulting gap. Indeed, next year Kazakhstan plans to borrow $500 million on the external market for the first time in a decade. Still, at present total public external debt does not exceed 2% of GDP. Thus, this new external borrowing is unlikely to undermine the creditworthiness of the country. On top of that, by the end of October, the assets of the National Oil Fund stood at about $24 billion, which is a solid caution against sudden adverse shocks. In fact, rising oil prices add to the confidence of Kazakhstan's foreign creditors. By the end of November, the credit-default swaps on government bonds fell to 257 basis points (bps) from a height of 1,646 bps in February.

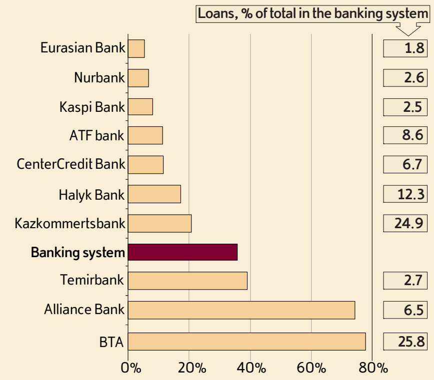
Monetary Policy

Tight access to credit continues to weigh down on economic growth in Kazakhstan. After all, Kazakh banks lack resources to create new credit because of inability to access external financing, tight domestic liquidity as well as a rapidly growing share of non-performing loans. In October, the stock of domestic credit remained virtually flat compared to the previous year, declining by about 2% if adjusted for currency devaluation. On top of that, large external debt repayments have been draining banks' funding. Indeed, according to the National Bank of Kazakhstan (NBK), commercial banks reduced their external debt by $7 billion in the first half of 2009, compared to a reduction of less than $1 billion a year ago.

[4] Several recent bilateral agreements between Kazakhstan and other countries (most notably, a $10 billion deal with China) may reduce the role of international oil companies in the Kazakh economy. In November, the state owned China National Petroleum Corporation, jointly with the Kazakh national oil company KazMunaiGas, acquired Kazakh oil producer MangistauMunaiGas (which produces 120 thousand barrels per day (b/d) and has oil reserves of about 800 million tons) for $2.6 billion. Earlier this month, the state-run Sinochem, China's largest chemicals trader, bought Kazakh independent oil producer Sumbe (which currently produces 4 thousands b/d and has 66 million barrels in reserves) for $320 million. Lastly, in September, China Investment Corporation paid nearly $1 billion for an 11% stake in KazMunaiGas Exploration and Production - a London-listed upstream subsidiary of KazMunaiGas.

[5] Source: The Interstate Statistical Committee of the Commonwealth of Independent States.

Non-performing loans, % of all loans 8

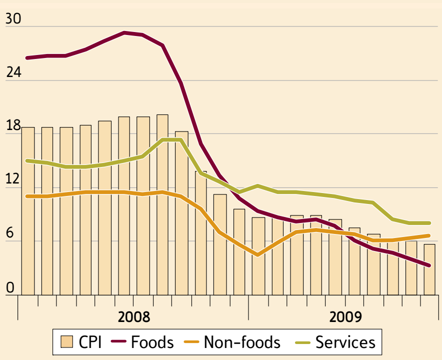


Source: Agency on Financial Supervision of the RK

Meanwhile, the share of non-performing loans in the banking system grew to 36% in October from 8% at the beginning of 2009. True, about 72% of all non-performing loans sit on the books of just three lenders - BTA Bank, Temirbank and Alliance Bank (see chart 8). These banks defaulted on foreign liabilities and are negotiating debt restructuring with foreign creditors (at present, four Kazakh banks are restructuring more than $20 billion of foreign debts, or about 60% of the industry total).[6] Still, the share of non-performing loans of other large banks is either 20% or approaching that level. This means that banks have to allocate extra provisions to offset potential credit losses, which leaves banks with fewer funds to extend new loans.

On a positive note, in October the consumer price index was only 5.8% higher than a year ago (see chart 9). This allows the central bank to pursue supportive monetary policy. The NBK may even lower its refinancing rate (which, at present, is set at 7%) if the disinflation trend continues in 2010. After all, loose monetary policy and a massive injection of public funds into the banking system helped to restore a resemblance of normalcy in the country's financial sector.

CPI by component, % change yoy 9

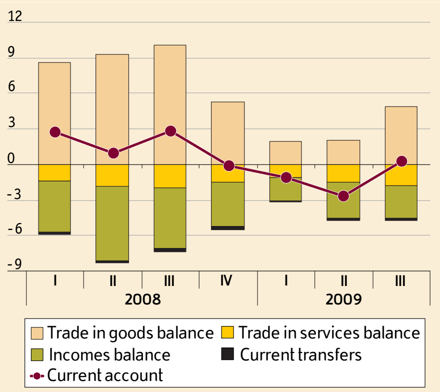


Source: ASRK

International Trade and Capital

During the first nine month of 2009, Kazakh exports fell by 48% yoy as global commodity prices remain well below last year's levels. At the same time, weaker currency and falling demand for imported consumer and investment goods triggered a 27% yoy reduction of imports. In the third quarter, imports grew by only 2% compared to the previous three months. This slower growth of imports and higher export prices and volumes in the third quarter of 2009 helped to increase the trade in goods balance by more than two times versus the quarter before. As a result, the current account balance moved back into surplus, following three consecutive quarters of deficits (see chart 10). Still, in January-September 2009, the current account reported a deficit of $3.4 billion compared to a surplus of $6.7 billion a year ago. Nevertheless, a rapid retrenchment of demand for imports and stronger commodity prices are likely to narrow the current account gap by the end of this year. This will help to reduce the external financing needs of Kazakhstan, leaving less pressure on the exchange rate. In fact, during the first weeks of November, the NBK purchased about $2 billion to prevent strengthening of the national currency, which in November appreciated by 1.3% against the U.S. dollar.

Quarterly current account, $ billion 10



Source: NBK

In October, the gross forex reserves of the NBK rose to a one-year high of $20.8 billion. This, in addition to the current account surplus, helps to ease depreciation pressures. Higher oil prices and a continuous flow of foreign investments into the oil industry may even result in currency appreciation. However, according to a statement by the head of the NBK, the exchange rate is unlikely to be allowed to strengthen below 140 tenge per U.S. dollar. After all, the NBK is likely to keep its loose monetary stance (interest rate cuts and interventions at the forex market) if inflation remains at the current low levels.

Other Developments Affecting the Investment Climate

According to the latest report by Transparency International, an international anti-corruption advocacy organization, Kazakhstan has moved to the 120th position in the Corruption Perception Index (CPI) from the 145th position in 2008. This means that the government achieved good progress in its anti-corruption efforts. Indeed, the country ranks quite favorably versus its regional peers, including Russia, Ukraine and Belarus. However, a low CPI score (2.7 in Kazakhstan, compared to 3.3 in Mexico, 3.6 in China or 5.0 in Poland) implies that corruption remains a serious problem. On the upside, Kazakhstan will chair the Organization for Security and Cooperation in Europe (OSCE) in 2010, which should help to create a strong momentum for institutional and anti-corruption reforms.

The presidents of Russia, Belarus and Kazakhstan have signed an agreement on the creation of a customs union between the three countries from July 1st, 2010. This customs union may ease access of Kazakh and Belarus companies to huge Russian markets. Indeed, the Russian economy (according to the World Bank, Russia's GDP was $1.6 trillion in 2008) is 12 and 27 times larger than the Kazakh and Belarus economies, respectively.

[6] In November, Temirbank, which is 56% owned by BTA Bank, announced that it will stop interest and principal payments on its obligations (which amount to about $1.4 billion) until it agrees and implements a restructuring plan. This restructuring is likely to result in Samruk-Kazyna's majority ownership of Temirbank. Meanwhile, Alliance Bank, which is restructuring over $4 billion of external debts, was granted a three months extension of the deadline to complete this restructuring by March 15th 2010.

Key Macroeconomic Data	2008	latest data	
GDP growth, % change yoy	3.3%	-2.2%	Q3 2009
Industrial production, % change yoy	2.1%	0.7%	January-November 2009
Unemployment, end of period	6.6%	6.4%	October 2009
Inflation, end of period	9.5%	5.8%	November 2009
Retail sales, % change yoy	3.1%	-9.7%	January-October 2009
Gross forex reserves of the NBK, $ billion, end of period	19.9	23.9	November 2009
Assets of the National Oil Fund, $ billion, end of period	27.5	24.2	November 2009
Current Account Balance, $ billion	6.6	-3.4	January-September 2009
External debt, $ billion	108.1	106.7	January-June 2009

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