Kazakhsatn
Macroeconomic Situation

March 2011

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- **In January-February, industrial output grew by 5.6% on continued expansion in mining and solid gains in manufacturing.**
- **During the first two months of 2011, retail sales increased by 10.6%.**
- **A strong rebound of tax revenues helped keep the state budget in surplus in February.**
- **Food inflation was somewhat lower in February; however, the annual increase in consumer prices approached 9%.**
- **The National Bank raised the key policy rate by 50 basis points to stem inflationary pressures.**
- **In February, Kazakhstan's forex reserves were $7.5 billion higher than at the beginning of the year.**

Executive Summary

The economy of Kazakhstan continues to benefit from surging energy prices and strong demand for industrial metals in China. That said, a return to normal output levels brought a more moderate pace of growth. In addition, fixed capital investments, especially in manufacturing, still have to regain their precrisis strength to ensure a steady expansion of output. Meanwhile, Kazakhstan still needs substantial investments to sustain production gains in the mining sector as higher capital and more time are necessary to expand crude oil output and transit infrastructure. In fact, the Caspian Pipeline Consortium, which links Kazakh oil fields to the Russian oil terminal in the Black Sea, is already reaching its capacity. On the upside, the consortium agreed to double its transit capacity, while planned investments into oil and gas pipelines linking China and Kazakhstan will ensure higher energy exports and better geographic diversification of overseas markets.

Business and consumer sentiment remains upbeat, which boosts investment and personal consumption. For example, in January-February, fixed capital investments grew by more than 12%, while retail sales increased by 10.6%. After all, continued employment gains, wage increases and higher social transfers contribute to consumer purchasing power, which brightens outlook for retailers and producers of consumer goods. There are signs that a recovery in the housing sector is gradually gaining momentum. In January-February, the volume of construction works increased by 4% while investments into residential housing jumped by 77.8% thanks to a solid rebound of investment activity in the first two months of 2011. Equally important, home values are growing again which supports invertors' confidence, especially on the back of the substantial pent-up demand for housing.

That said, global food inflation, which prompted recent policy tightening in large emerging markets, continues to push up consumer prices in Kazakhstan. In February, consumer prices grew by 8.8% versus a year ago on higher prices of grains and other staple foods. And as a response to intensified inflationary pressures, the central bank of Kazakhstan is raising its key policy rate for the first time in 18 months. Meanwhile the government is restraining exports of grains to stabilize domestic food prices. All said, agricultural prices are unlikly to retreat in the near term due to supply constarints brought by the poor garin harvest. However, policy tightening both in the developed and developing countries will surely slow the pace of the food inflation worldwide.

Exports of Kazakh goods stood flat in January as overseas shipments of crude oil fell by a third on a sharp drop of exports to the European Union. This decline, however, was caused by one-off factors, such as maintenance work at the Caspian Pipeline Consortium and unfavorable weather on the Black Sea. Therefore, exports of Kazakh energy resources should return to normal levels in the coming months. After all, exports of other goods, which performed well in 2010, continued to post solid gains in 2011 as well. In particular, exports of nonferrous metals, crude oil and uranium to China remained strong. Meanwhile, exports of ferroalloys continued to grow on solid demand from Germany and Japan. The natural disaster in Japan risks disrupting global supply chains because Japan, which is big buyer of ferroalloys from Kazakhstan, produces key components and parts used in manufacturing. However, global manufacturing is unlikely to experience a contraction comparable to the recession-driven output declines, while the impact of the industrial slowdown in Japan is likely to fade over the course of the next several quarters as global producers switch to alternative suppliers.

	2006	2007	2008	2009	2010[e]	2011[f]
GDP growth, % change yoy	10.7%	8.9%	3.3%	1.2%	7%	5%
GDP per capita, $	5 262	6 757	8 398	6 710	9 100	9 200
Industrial production, % change yoy	7.2%	5.0%	2.1%	1.5%	10%	5%
State budget deficit, % of GDP	0.8%	-1.7%	-2.1%	-2.9%	-2.5%	-2.5%
Governmet external debt (including NBK), % of GDP	2.9%	1.8%	1.6%	2.4%	2.7%	2.0%
Unemployment, end of period	7.8%	7.3%	6.6%	6.6%	5.8%	5.5%
Inflation, end of period	8.4%	18.8%	9.5%	6.2%	7.8%	7-8%
Retail sales, % change yoy	15.0%	10.7%	3.1%	-3.9%	12.3%	-
Gross forex reserves of the NBK, $ billion, end of period	19.1	17.6	19.9	23.2	28.3	-
Assets of the National Oil Fund, $ billion, end of period	14.1	21.0	27.5	24.4	30.6	-
Current Account Balance, $ billion	-2.0	-8.2	6.6	-4.2	4.9	3.0
External debt, $ billion	74.0	96.9	108.1	111.7	112.0	120.0
Exchange rate, tenge/$, annual average	126.1	122.6	120.3	147.5	147.4	142.0

Where Opportunities Emerge.

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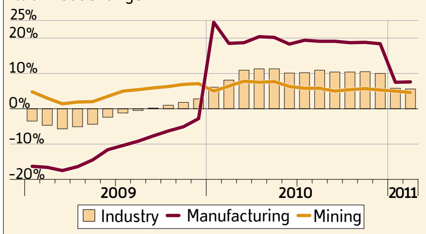
Economic Growth

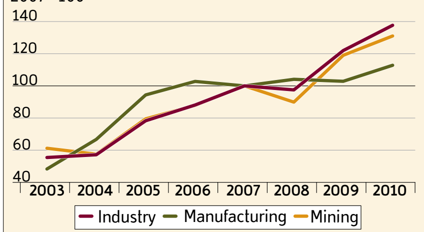
The economy of Kazakhstan, which grew by 7% in 2010, continues to benefit from surging energy prices and strong demand for industrial metals in China. In particular, during the first two months of 2011, industrial production was up by 5.6% on a 4.6% growth in mining and a 7.6% gain in manufacturing (see chart 1). That said, industry grew slower than a year ago, when large idle capacity was brought back online following a sharp drop in output during the global economic downturn. As domestic and overseas demand returns to normal levels, industry is likely to expand at a more moderate pace. After all, fixed capital investments, especially in manufacturing, still have to regain their precrisis strength to ensure a steady expansion of output (see chart 2). Meanwhile, production gains in the mining sector[1] are restrained by the relatively higher capital and time requirements to increase output.[2] In addition, new production in the mining sector must be met with an expanded transit infrastructure as most of the Kazakh energy resources are exported. Indeed, the Caspian Pipeline Consortium, which links Kazakh oil fields to the Russian oil terminal in the Black Sea, is already reaching its capacity. In fact, at the end of 2010, the consortium members agreed to invest over $5 billion to double its transit capacity by 2014. Finally, Kazakhstan continues to diversify its oil and gas transit infrastructure, namely by increasing energy exports to China. According to the Oil and Gas Ministry of Kazakhstan, the annual transit capacity of the Kazakhstan-China oil pipeline will be increased to 12 million tons by the end of this year, with plans to expand it to 20 million tons per year.

Industry remains on an uptrend 1
% annual change



Source: ASRK

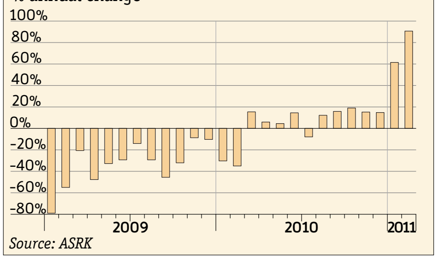
Fixed capital investments are recovering 2
2007=100



Source: ASRK

The energy sector aside, there are signs that investment activity is gradually improving. After all, businesses in industry and trade are more confident about current and future economic conditions,[3] which boosts investments. Indeed, in January-February 2011, fixed capital investments were up 12.5% versus a decline of 9.5% a year ago. In particular, capital spending in manufacturing and real estate services grew by 24% and 58%, respectively, while investments in transportation surged by nearly three times.

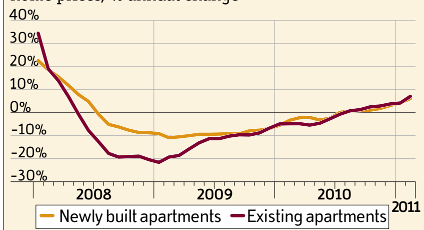
Residential investments are recovering 3
% annual change



Source: ASRK

Consumer spending remains strong as well thanks to improving sentiment (in February, the consumer sentiment index was 4 percentage points higher than a year ago) and better financial conditions of households. In particular, in January employment was 3.4% higher than a year ago, while real wages grew by 7.5%. Meanwhile, per capita income was 8.2% higher in real terms than in January 2010. These income gains are supported by increasing salaries in the private sector and significant wage hikes in the public sector, for example, in education and healthcare. Increasing social transfers are contributing to consumer buying power as well. As a result, in February, retails sales grew by 9.9% versus a year ago, which puts the two-month gain in retail sales at 10.6%. Other service-providing sectors of the economy are reporting solid growth as well. Passenger and freight traffic grew by 25% and 17.5%, respectively. Growth in telecommunication services stood at 12.5% in January-February 2011 thanks to solid gains in wireless and internet services. Finally, in February, existing home sales jumped by 16% versus the previous month, posting a 7.8% annual gain.

Home prices remain on the uptrend 4
home prices, % annual change



Source: ASRK

The recovery in the housing sector is gradually gaining momentum. In January-February, the volume of construction works increased by nearly 4% following a modest 1% growth in all of 2010. Investments into residential housing jumped by 77.8% thanks to a solid rebound of investment activity in the first two months of 2011 (see chart 3). After all, home values are growing again (see chart 4), which boosts investor confidence, especially on the back of the substantial pent-up demand for housing.

All told, the economic recovery in Kazakhstan looks certain to continue to broaden this year thanks to gains in service-providing industries and residential construction. Meanwhile, the goods-producing part of the economy will benefit from surging global commodity prices. Indeed, lingering unrest in the Middle East may keep crude oil prices, which have already been rising on the back

[1]The mining sector still accounts for over two thirds of all fixed capital investments and output in Kazakh industry.

[2]For example, last year the mining companies spent over $1.7 billion on geological exploration alone, compared to about $3 billion of total annual fixed capital investments in Kazakh manufacturing.

[3]In February, the business confidence index in industry was at 12% compared to 0% a year ago.

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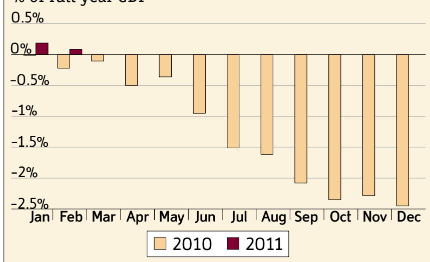
of booming energy consumption in the large emerging economies, at an elevated level in the foreseeable future. Furthermore, as the latest nuclear accident in Japan is prompting a global retrenchment in the nuclear industry, a shift of energy demand to conventional sources (like crude oil, coal and natural gas) may be sustaining upward price pressures. True, Kazakhstan, which is the world biggest producer of uranium, may see lower export revenues on a short-term reduction of the global demand for uranium.[4] After all, China, which is the primary buyer of Kazakh uranium, has suspended all new nuclear projects to perform a safety review. Still, in the medium-term, China will remain the world leader in building new nuclear plants, which are needed to meet its surging demand for electricity. This means that any losses of Kazakh export revenues from lower uranium prices will be short-lived. More than that, they will be offset by higher prices of crude oil, which still accounts for the largest share of Kazakh exports.

Fiscal Policy

In January-February, the state budget posted a small surplus of about $135 million or 0.08% of projected full year GDP (see chart 5). State budget revenues increased by 25% versus the first two months of 2010 on continued improvements in tax revenues. In particular, tax revenues jumped by over 42% on increasing collection of main taxes (such as corporate income tax and VAT), which testifies to the strength of the ongoing economic recovery in Kazakhstan.

State budget balance 5
% of full year GDP



Source: Ministry of Public Finance, ASRK

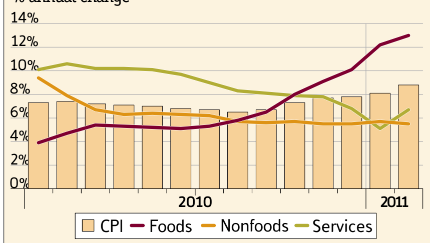
Meanwhile, state budget expenditures grew by 21% as spending on education, healthcare and social transfers (about 64% of the total) increased by 26%, 30.5% and 31% respectively. This reflects both higher wage bill in the public sector as well as recent increases of public pensions and other social benefits.

Finally, at the end of 2010, public and publicly guaranteed debt stood at $21.9 billion or 15% of GDP. In particular, the external debt of the government was $3.8 billion or only 2.6% of GDP, mostly owed to the International Bank for Reconstruction and Development (about $1.6 billion). Over the course of the last year, government debt increased by about $4 billion as Kazakhstan borrowed over $1 billion from the World Bank to cover its budget deficit and to upgrade road infrastructure.

Monetary Policy

Consumer prices grew somewhat slower in February, increasing by 1.5% versus January 2011, when monthly inflation reached 1.7%. As a result, annual inflation stood at 8.8% (see chart 6) as prices of foods (up by 13% versus February 2010) continued to move upwards. In particular, in February, prices of grains, meat, oils and fats were 78%, 15% and 22% higher, respectively, than in February 2010. This does reflect increasing food prices worldwide with the FAO Food Price Index[5] registering a 38% annual gain in February. On the upside, in February, the growth of global food prices slowed to just a 2.6% monthly rate from an average monthly rate of nearly 5% in the second half of 2010.

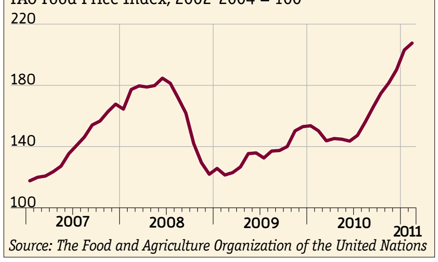
Dearer foods are pushing up inflation in Kazakhstan 6
% annual change



Source: ASRK

Still, global food prices have already surpassed their record high levels reached during the 2008 food crisis (see chart 7). This warrants policy tightening in major emerging economies, where increasing living stanbdards have been behind a shift toward more protein-rich diets, which pushed up global demand for grains. For example, the People's Bank of China has already raised interest rates three times since mid-October, while reserve requirments on bank deposits have been increased six times since late November to restrict credit growth and inflation. Although agricultural prices are unlikly to retreat in the near term due to supply constarints brought on by the poor garin harvest, policy tightening (both in developed and developing countries) will surely slow the pace of global food inflation.[6]

Global foods inflation 7
FAO Food Price Index, 2002-2004 = 100



Source: The Food and Agriculture Organization of the United Nations

Kazakhstan is tightening its monetary policy as well. In March, the central bank raised its key interest rate by 50 basis points for the first time in 18 months. In addition, to stabilize bread

[4]Indeed, according to Ux Consulting, as a response to the accident in Japan, the spot price of uranium fell by about 18% from its two-year high of $73 per pound in the first week of February.

[5]Source: The Food and Agriculture Organization of the United Nations.

[6]According to the latest estimate of the U.S. Department of Agriculture, the global wheat consumption is expected to grow by only 1.7% in 2010/11 versus a 2.5% increase in the previous marketing year. As a result, despite lower production, wheat ending stocks will still be nearly 9% higher than two years ago. This should keep global food inflation at lower rates compared to the 2008 food crisis.

and flour prices, the government has reduced the annual 2010-2011 grain exports quota by 1 million tons to 6 million tons (the country exported 8.4 million tons of grains in the 2009-2010 marketing year). According to the Ministry of Agriculture of Kazakhstan, this year's harvest may total 15-16 million tons of grains thanks to more favorable weather conditions. In 2010, Kazakhstan harvested just 12.2 million tons of grain – down from the record high harvest of nearly 21 million tons in 2009. All told, policy tightening and a better harvest should help cool food inflation in Kazakhstan by the end of 2011.

International Trade and Capital

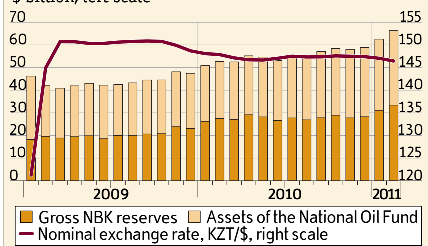
Exports of Kazakh goods stood flat in January at about $4.2 billion as overseas shipments of crude oil fell by a third to 3.5 million tons from 5.2 million tons a year ago. This comes as a result of a sharp drop of exports to the European Union – for example, exports of crude oil to Italy (the biggest consumer of Kazakh crude oil accounting for nearly a fourth of all exports by volume) were down by 32% in January. Exports of crude oil to Austria and France[7] dropped even more – by 56% and 86%, respectively. This decline, however, was caused by one-off factors, such as maintenance work at the Caspian Pipeline Consortium (the key route for Kazakh crude oil to Europe) and bad weather on the Black Sea. This means that exports of Kazakh energy resources should return to normal levels in the coming months. After all, other export categories, which performed well in 2010, continued to post solid gains in 2011 as well. In particular, exports of iron and nonferrous metal ore, copper, zinc, aluminum, and uranium to China remained strong. Meanwhile, exports of ferroalloys grew by 8.6% on solid demand from Germany and Japan. Indeed, continued manufacturing recovery in the advanced economies bodes well for the nonferrous metallurgy of Kazakhstan, whose products are used as inputs in the automobile industry and manufacturing of consumer durable goods, such as electronics.

That said, the natural disaster in Japan risks disrupting global supply chains because Japan, which also accounts for about 26% of all exports of ferroalloys from Kazakhstan, produces key components and parts used in manufacturing. A temporary decline in global manufacturing may have a negative impact on Kazakh nonferrous metallurgy. Still, global manufacturing is unlikely to experience a contraction comparable to the recession-driven output declines, while the impact of an industrial slowdown in Japan is likely to fade over the course of the next several quarters as global producers switch to alternative suppliers.

Meanwhile, improving consumer and investment demand pushed imports up by 21.8% in January. In particular, imports of machinery and equipment (about one fourth of all imports in January) increased by 32% while imports of oil and gas pipes more than doubled. Imports of foods and medicine posted solid gains as well. As a result, the foreign trade surplus stood at $2.44 billion or 12.5% lower than a year ago. Still, the current account (which totaled $5 billion in 2010) is likely to remain in surplus this year as well. First, crude oil prices are well above their 2009 lows, when the current account deficit was at $4.2 billion. Equally important, the monthly volume of imports is nearly 40% lower compared to an average level of about $3 billion in 2007-2008. Currency devaluation in February 2009 and tight consumer credit also imply that demand for imported consumer goods will remain restrained.[8] Finally, imports of investment goods – the largest component of Kazakh imports, accounting for over 40% of all imports, are likely to experience only a modest recovery as well. In fact, during the first three quarters of 2010, imports of investment goods were down by 16% following an 18% decline in 2009.

Lastly, increasing appreciation pressures point to the strengthening external position of Kazakhstan as well. After all, booming commodity prices are sustaining solid inflows of export revenues. In fact, the National Bank of Kazakhstan bought about $4.5 billion in January-February alone to stabilize the exchange rate (last year such an intervention totaled just $2 billion). As a result, by the end of February, the total foreign exchange reserves of Kazakhstan (including assets of the National Oil Fund) stood at $66.4 billion or up by 26% versus February 2010 (see chart 8).[9] All of this prompted the National Bank to switch to a more flexible exchange rate regime starting March 1st 2011. Although the exchange rate is likely to appreciate beyond the previous currency band, the central bank will continue to increase reserves to keep the nominal exchange rate at a competitive level.

Forex reserves of Kazakhstan 8
$ billion, left scale



In February 2009, Kazakhstan set the nominal exchange rate at 150 KZT/$ with a 3% currency band.
Source: NBK

[7]Italy, Austria and France jointly accounted for 43% (or over 28 million tons) of all exports of Kazakh crude oil in 2010.
[8]Imports of consumer goods, which nearly doubled from 2005 to 2008, fell by 19% in 2009. In the first three quarters of 2010. Imports of consumer goods recovered by only 10%.
[9]During the first two months of 2011, forex reserves of Kazakhstan increased by $7.5 billion.