SigmaBleyzer

Kazakhsatn
Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

April 2011

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- **Preliminary estimates place GDP growth at 6.5% in the first quarter of 2011.**
- **In January-March, industry grew by 6% thanks to solid output gains in mining and manufacturing.**
- **During the first three months of 2011, retail sales increased by 14.3%.**
- **The first quarter state budget deficit stood at about 0.4% of projected full-year GDP.**
- **Consumer prices grew somewhat slower in March, increasing by 8.6% versus the same month a year ago.**
- **In January– February, foreign trade surplus jumped to $7.7 billion – 44% higher than a year ago.**
- **On April 8th, Kazakhstan's President, Nursultan Nazarbayev, was sworn in for a new five-year term after securing a landslide victory in the early presidential elections.**

Executive Summary

According to preliminary estimates, the economy grew by 6.5% during the first three months of 2011. In particular, industry is expanding at a robust pace thanks to continued growth in mining and manufacturing. Companies feel more confident about economic conditions thanks to strong exports and booming commodity prices, which remain on an uptrend and are likely to stay strong thanks to buoyant economic activity in emerging markets. This should help sustain Kazakh exports of metals and crude oil and support favorable external conditions in the medium term.

Domestic demand is recovering as well. In January-March, retail sales increased by 14.3% - up from 11.5% growth in the first quarter of 2010. Above all, consumers feel more optimistic about the economy - in March, the consumer sentiment index advanced for the second straight month, mostly thanks to employment gains and higher wages. Education and healthcare accounted for about 40% of all new jobs created over the past twelve months. Job growth in industry and construction remained strong as well. Meanwhile, the sectors that saw the biggest gain in employment reported faster growth of wages as well. The Kazakh economy is creating more better-paying jobs, which contributes to stronger consumer buying power. In addition, consumer credit is on the mend, which adds an extra boost to personal spending.

All told, high commodity prices and recovering consumer spending should help sustain robust economic growth in 2011. Business investments are growing on more upbeat expectations and continued expansion of resource-based sectors. The construction industry is gradually turning the corner as well, and residential investments are trending up. Mortgage use appears to be stabilizing, yet tight access to lending is still a big constraint to a faster rebound of the real estate market. On the upside, banks are starting to loosen their purse strings on lending due to more stable economic outlook. Thus, the improved availability of credit will support home values, further boosting the confidence of homeowners and homebuilders.

Consumer prices grew somewhat slower in March thanks to a gradual moderation of food inflation, both in Kazakhstan and worldwide. Still, global grain prices remain highly volatile as policy tightening in the emerging economies, imports restrictions in wheat-producing countries and unstable weather conditions add much uncertainty to the global demand and supply of staple foods. On the upside, better crops are projected for the CIS region in 2011, which should help ease food inflation in the second half of this year. In addition, tepid bank lending continues to restrict money supply. Meanwhile, the central bank has been issuing short-term notes to mop up extra liquidity brought to the market with its foreign currency purchases.

Kazakh lenders are still cautious to issue new loans. Banks are hoarding liquid assets and are using bumper profits to repay government loans and buy back shares purchased by the state at the height of the global financial crisis. All said, Kazakh banks will continue to repair their balance sheets in 2011 – nearly a third of all loans are still classified as nonperforming. This means that only a modest uptick in credit is likely, which should partly quell emerging inflationary pressures.

Kazakh exports bounced back thanks to a return of crude oil exports to more normal levels. Meanwhile, imports, although recovering on improving consumer spending and a stronger demand for investments goods, remain well below their precrisis levels. As a result, in February, Kazakhstan reported a new record monthly foreign trade surplus of $5.3 billion.

	2006	2007	2008	2009	2010	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%	2.6%	2.5%
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%	8-9%
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	119.2	125.0
Exchange rate, tenge/$, annual average	126.1	122.6	120.3	147.5	147.4	142.0

Where Opportunities Emerge.

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Editor Rina Bleyzer O'Malley

Economic Growth

Economic growth in Kazakhstan is stabilizing, following a v-shaped recovery in 2010. In January-March, the composite short-term indicator was 7.1% higher compared to the first quarter a year ago. Thus, according to preliminary estimates, the economy grew by 6.5% during the first three months of 2011 (see chart 1). In addition, the latest data points to stronger growth at the end of the first quarter as economic activity in industry, trade, transportation, and communications improved faster in March than in the first two months of 2011 (see chart 2).

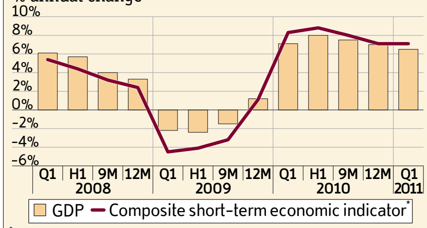
Industry grew by 6% in January-March on continued growth in mining and manufacturing (up by 5% and 8% respectively). Industrial companies feel more confident about economic conditions (see chart 3) thanks to strong exports and booming commodity prices. World prices of metals and energy have recovered a great deal since the beginning of the Great Recession (see chart 4), which bodes well for Kazakh mining and metallurgy, jointly accounting for nearly 3/4th of all industrial output. In addition, the World Economic Outlook, released by the IMF in April, points to a strengthening global economic recovery on buoyant economic activity in emerging markets. This should help sustain Kazakh exports of metals and crude oil and support favorable external conditions in the medium term.

Domestic demand remains strong as well. In January-March, retail sales increased by 14.3% - up from 11.5% growth in the first quarter of 2010. Above all, consumers are increasingly willing to spend more thanks to improving economic conditions; in March, the consumer sentiment index advanced for the second straight month. Consumers remain upbeat mostly thanks to employment gains and higher income. In the first quarter of 2011, nonfarm employment (including self-employed persons) was up by 1.2% against the same quarter a year ago, while the jobless rate fell to 5.5% from 6.2% in the first quarter of 2010. In February, payroll employment grew by 2.1% thanks to 114,000 new jobs created since February 2010. Education and healthcare accounted for about 40% of all job gains, while industry and construction added 19,000 and 10,800 more jobs, respectively. Meanwhile, in February, an average monthly salary was 8.2% higher on an inflation-adjusted basis versus the same month a year ago. More than that, the sectors that saw the biggest gain in employment reported a faster growth of wages as well. Thus, wages in education and healthcare were up by an inflation-adjusted 12% and 15%, respectively, on recent increases in public-sector pay. Meanwhile, wages in mining, construction and financial activities (where the annual increase in employment stood at 6.5%, 5.7% and 3.5% respectively) remain well above the national average.[1] The Kazakh economy is creating more better-paying jobs, which contributes to stronger consumer buying power. In addition, consumer credit is on the mend (see chart 5), providing an extra boost to personal spending.

All told, high commodity prices and recovering consumer spending should help sustain robust economic growth in 2011. In addition, business investments are growing on more optimistic expectations and continued expansion of resource-based sectors. For example, in the first quarter of 2011, fixed capital investments were up by 7.4% (compared to a decline of 7.3% a year ago) on higher investments in manufacturing (up by 30%), transportation (up by 57%) and real estate operations (up by 39%). The construction industry is gradually turning the corner as well – in January-March 2011, the volume of construction works increased by 3.1% (versus a decline of nearly 9% in the first quarter of 2010). Residential investments jumped by 42% against the first quarter of 2010 – the first quarterly gain since the beginning of the crisis. However, tight access to mortgage lending remains a big constraint to a faster rebound of the real estate market. For example, in February, mortgage debt outstanding was 1.6% lower than a year ago, although the pace of decline slowed considerably from 5.8% in February 2010. On the upside, there are signs that mortgage use is stabilizing with home loans outstanding remaining unchanged in February. Thus, as banks are starting

Economic recovery is stabilizing 1

% annual change

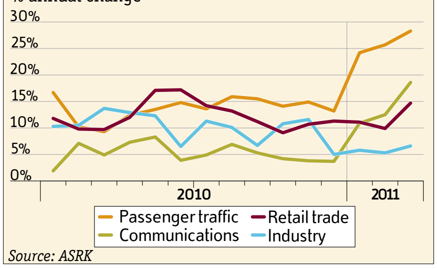


The composite economic indicator tracks output of major sectors (i.e. agriculture, industry, construction, trade, transport, and communications), which account for over two-thirds of the Kazakh economy.

Source: ASRK

Output growth accelerated in March 2

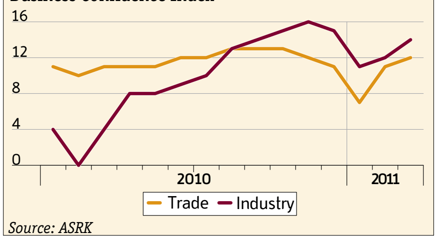
% annual change



Source: ASRK

Business sentiment is improving 3

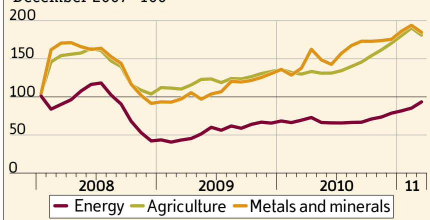
Business Confidence Index



Source: ASRK

Commodity prices are roaring back 4

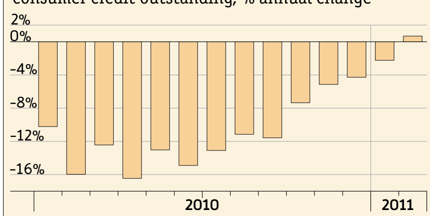
December 2007=100



Source: World Bank

Consumer credit is recovering 5

consumer credit outstanding, % annual change



Source: NBK

[1]In February, average wages in mining, construction and financial activities were 81%, 32% and 114% above the national average.

to loosen their purse strings on lending due to a more stable economic outlook, improved availability of credit will support home values (see chart 6), which should further boost the confidence of homeowners and homebuilders.

Fiscal Policy

The state budget deficit stood at about 0.4% of GDP in the first quarter of 2011 (see chart 7). Tax revenues continue to boom (up by 49%) on robust growth of wages, trade and exports. As a result, the share of tax revenues in total budget revenues increased to 82% from 61% in the first quarter of 2010. In fact, the government collects nearly a quarter more in tax revenues compared to its initial projections. Brisk retail sales and a solid expansion of the service-providing sectors sustain VAT revenues (over a fifth of all tax revenues), with VAT on domestically produced goods and services exceeding projected levels by more than two times. Equally important, corporate profits are improving thanks to strong sales in manufacturing, trade, construction, transportation, and telecommunications. As a result, corporate tax revenues, which account for over 28% of all tax revenues, continue to beat expectations. This means that fewer funds are withdrawn from the National Oil Fund to finance budget spending. Indeed, in the first quarter of 2011, just $1 billion of these transfers were received by the state budget versus nearly $2.5 billion a year ago.[2] This puts the non-oil state budget deficit (excluding payments from the National Oil Fund) at about 1% of GDP versus 2% in the first quarter of 2010.

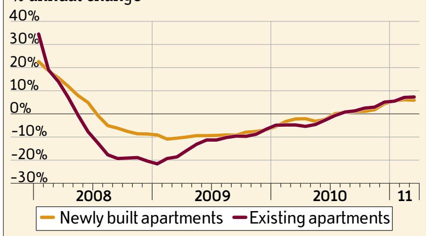
In January-March 2011, state budget expenditure grew by 19% on growing spending on education (up by 28%), healthcare (up by 22%) and social protection (up by 28%). These three expenditure items now account for over 61% of total public spending compared to 58% a year ago. A growing share of budget resources devoted to social spending does reflect recent increases of pensions and public sector wages. For example, last year average wages in education and healthcare were raised by 25%; a further 30% increase is planned for 2011. Meanwhile, stipends and minimum pensions were increased by 30%. Government spending in Kazakhstan, which is still well below levels in peer economies (see chart 8), is set to expand as the country upgrades its social security system and invests in public infrastructure. More than that, more generous social welfare supports domestic demand, which is instrumental in reducing reliance on exports. Lastly, public spending on education, healthcare and infrastructure boosts productivity, which should help soften the inflationary pressures of this spending-driven fiscal policy.

Monetary Policy

Consumer prices grew somewhat slower in March, increasing by only 0.5% against previous months – the lowest monthly growth since August 2010. A gradual moderation of food inflation, both in Kazakhstan and worldwide, is contributing to this trend (see chart 9). That said, global grain prices remain highly volatile as policy tightening in the emerging economies[3], imports restrictions in wheat-producing countries and unstable weather conditions add much uncertainty to global demand and supply (see chart 10). On the upside, this year's wheat harvest is expected to increase by 3.4%, mostly thanks to better crops in the CIS region.[4] This should help ease food inflation in the second half of 2011.

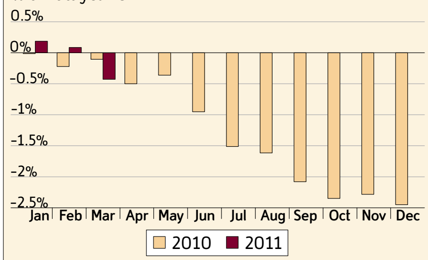
Core inflation (which excludes more volatile prices of fruits, vegetables and fuels) points to a moderation of inflationary pressures as well (see chart 11). At 7.8% in March, it is still within the 2011 inflation target set by the central bank at 6%-8%. However, last year real wages grew by 7% - twice as fast as overall productivity growth. As a result, increasing labor costs risk triggering a wage-price spiral due to higher inflation expectations. On that

Home prices strengthened in March 6
% annual change



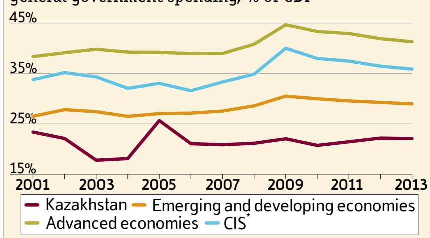
Source: ASRK

State budget balance 7
% of full year GDP



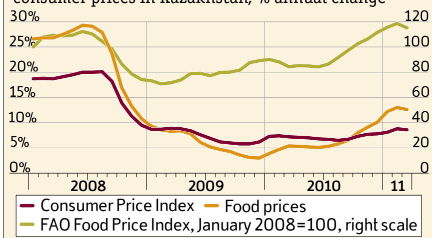
Source: Ministry of Public Finance, ASRK

The Kazakh government spends less than other countries 8
general government spending, % of GDP



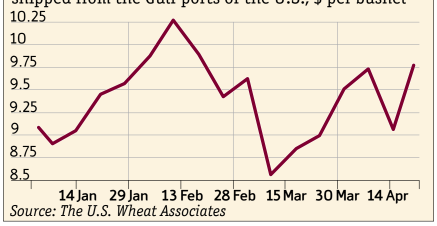
*Commonwealth of Independent States
Source: Ministry of Public Finance, ASRK, IMF

Food prices are growing slower 9
consumer prices in Kazakhstan, % annual change



Source: ASRK, The Food and Agriculture Organization of the United Nations

Grain prices remain volatile 10
weekly export cash prices of hard red winter wheat shipped from the Gulf ports of the U.S., $ per bushel



Source: The U.S. Wheat Associates

[2]For example, during the first two months of 2011, only 10% of the planned amount was transferred from the National Oil Fund to the state budget.
[3]For example, at the beginning of April, China raised interest rates for the fourth time in five months. Meanwhile, the European Central Bank raised its policy interest rates by 25 basis points – the first rate hike in over two years.
[4]Source: The Food and Agriculture Organization of the United Nations. In particular, a significant increase in wheat production is expected in Kazakhstan – up by about 56%.

note, the pass-through of higher wages to inflation in Kazakhstan is likely to be only partial, which should help keep inflation expectations at relatively safe levels. First, most of the wage increases are happening in the non-tradable service-providing public sectors, such as education and healthcare. Service tariffs in those sectors are regulated and are growing slower than overall inflation. For example, in March 2011, consumer prices were 3.7% higher than at the beginning of the year, yet service tariffs in healthcare and education grew by only 1.3% and 0.7%, respectively. In addition, Kazakh consumers spend only a quarter of their income on services, which somewhat mitigates the impact of higher tariffs on inflation. Lastly, most of the nonfood consumer products (especially durable consumer goods, such as automobile and electronics) are still imported. Thus, a gradual appreciation of the exchange rate (from the beginning of 2011, the national currency strengthened by about 1.2% against the U.S. dollar) lessens some inflation pressures as well.

Tepid bank lending, at least for now, continues to restrict money supply (see chart 12), which partly offsets monetary sources of inflation. After all, a recent jump in foreign reserves risks flooding the banking system with excess liquidity. Indeed, the central bank, although having recently switched to a more flexible exchange rate regime, continues to buy forex reserves to avoid a sharp appreciation of the national currency. In March alone, its foreign currency holding increased by $1.8 billion and was nearly $7 billion higher than at the beginning of the year. The central bank has been issuing short-term notes to mop up extra liquidity brought to the market with its foreign currency purchases (see chart 13).

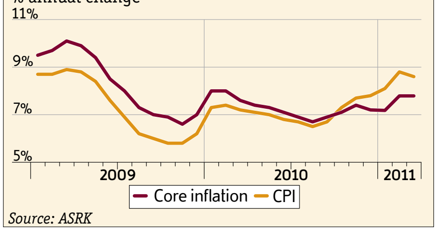
In addition, Kazakh lenders are still cautious about issuing new loans. Banks are hoarding liquid assets – at the end of February, the share of liquid assets in total assets stood at 21%, although it slightly fell compared to the same month a year ago. At the same time, large banks are using bumper profits[5] to repay government loans and buy back shares purchased by the National Welfare Fund Samruk-Kazyna at the height of the global financial crisis in 2009. For example, at the beginning of April, Halyk Bank exercised an option to repurchase 20% of common shares held by Samruk-Kazyna.[6] Meanwhile, Kazkommertsbank is negotiating a buyback of 21% of common shares owned by the state. All told, Kazakh banks will continue to repair their balance sheets in 2011 – nearly a third of all loans are still classified as nonperforming. This means that only a modest uptick in credit is likely, which should partly quell emerging inflationary pressures.

International Trade and Capital

Kazakh exports bounced back in February (increasing by 72% compared to the same month a year ago) thanks to a resumption of crude oil exports, which jumped by 52% to 7.7 million tons.[7] Meanwhile, imports, which remain well below their precrisis levels (see chart 14), grew by 19% on recovering consumer spending and a stronger demand for investments goods (imports of machinery and equipment were up by 36% in February, following by a 32% increase the month before). As a result, Kazakhstan reported a new record monthly foreign trade surplus of $5.3 billion. This puts the total foreign trade surplus for the first two months of 2011 at $7.7 billion – 44% higher than a year ago.

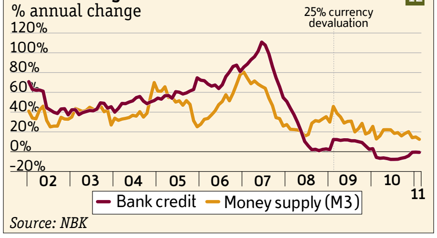
Finally, last year Kazakhstan's total external debt grew by 5.3% to about $120 billion. External debt of the banking sector shrank by about $10 billion following the restructuring of the foreign loans of BTA Bank and Alliance Bank. In fact, the external liabilities of Kazakh banks have been trending down since the beginning of the global financial crisis and are now about $26 billion lower than in 2007 (see chart 15). As a result, new borrowing came mostly from the corporate sector, which borrowed $14.5 billion more in 2010. Still, much of

Core inflation and CPI 11
% annual change



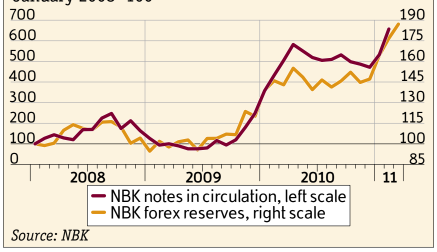
Source: ASRK

Bank lending remains weak 12
% annual change



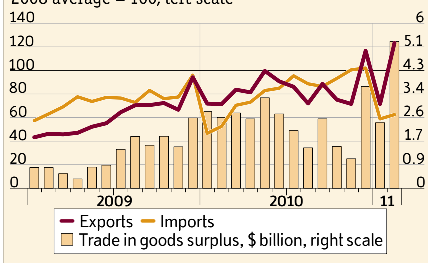
Source: NBK

The central bank withdraws extra liquidity from the market 13
January 2008=100



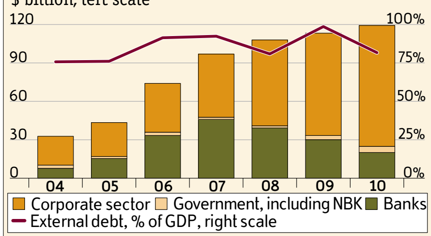
Source: NBK

Exports bounced back in February 14
monthly volumes of exports and imports, 2008 average = 100, left scale



Source: ASRK

Foreign external debt 15
$ billion, left scale



Source: NBK

[5]In 2010, the two largest Kazakh lenders - Kazkommertsbank and Halyk Bank - which control 20% and 18% of all banking assets in Kazakhstan, saw their net profits increase by 16% and 128%, respectively.
[6]Samruk-Kazyna still owns 50.3% of the preferred stock, which entitles it to a 13.3% stake in the bank.
[7]In January, Kazakhstan exported just 3.5 million tons of crude oil (or only two thirds of crude oil exports in January 2010) because of maintenance work at the Caspian Pipeline Consortium and unfavorable weather conditions at the Black Sea.

this was in the form of intra-company loans in the oil and gas sector (about 90% of all intra-company loans are in oil extraction and exploration). In addition, the composition of the foreign debt spells less external risks for Kazakhstan compared to the years in the run-up to the financial crisis. Indeed, in 2007 banks' external liabilities accounted for nearly half of all foreign debts, which made the country particularly vulnerable to the sudden closure of international financial markets. At present, only 17% of all foreign loans represent claims on Kazakh banks, while forex reserves (about $69 billion at the end of March) fully cover the debt portion (foreign debts excluding intra-company loans) of external liabilities.

Increasing foreign debts of the corporate sector also reflect a recent deepening of the economic links between China and Kazakhstan. For example, in 2009, China agreed to lend Kazakhstan $10 billion to finance joint projects in the energy sector. That said, if at the beginning of 2009 China held only 3.6% of all foreign claims on Kazakhstan, this share had widened to 10.5% by the end of 2010.

Other Developments and Reforms Affecting the Investment Climate

On April 8th, Kazakhstan's President, Nursultan Nazarbayev, was sworn in for a new five-year term after securing a landslide victory in the early presidential elections. The Kazakh Parliament's lower house has also approved the President's proposal to appoint Karim Masimov, who was the Prime Minister of Kazakhstan since January 2007, as the head of the country's Cabinet of Ministers. This reelection does contribute to political stability in Kazakhstan – an important factor for foreign investors, especially on the back of heightened political turmoil in the Middle East. Equally important, it will ensure that Kazakhstan will continue to implement reforms that cut red tape, improve the business environment and gradually open up the political process to more competition and greater democracy.