Kazakhstan Macroeconomic Situation

SigmaBleyzer

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

November-December2011

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- **During the first eleven months of 2011, GDP grew by 7.5%.**
- **In January-November, industry increased by just 3.8% on slowing output growth in mining.**
- **The eleven-month state budget deficit stood at just 0.7% of projected full year GDP.**
- **In November, consumer inflation eased below 8% thanks to stable prices of foods.**
- **In January-October, the trade in goods surplus widened to $42.3 billion.**
- **During the first three quarters of 2011, the current account deficit swelled to over $9 billion.**
- **By the end of November, Kazakhstan's forex reserves exceeded $75 billion.**

Executive Summary

Kazakhstan is entering 2012 on solid footing, with GDP growing by over 7% in annual terms. Strong consumer demand, fueled by increasing public wages and social benefits, a record harvest and booming commodity exports helped sustain a robust pace of recovery in 2011.

In fact, the record high harvest helped offset a recent deceleration in other goods-producing parts of the economy. Indeed, output growth in mining, the very sector that dominates Kazakh industry, continued to slow in the last quarter of 2011. As a result, in January-November, industry saw a modest gain of just 3.8% versus over 10% a year ago. In addition, signs of weakness are beginning to emerge in manufacturing as the drop in global demand is starting to affect Kazakh metallurgy. Meanwhile, business confidence in industry fell in November to the lowest level since July 2010, pointing to weaker factory activity going forward. On the upside, machine building, chemicals and production of construction materials continued to register healthy gains thanks to a surge in car sales as well as solid foreign demand for Kazakh fertilizers and uranium and a booming investment and construction activity in neighboring Central Asian economies.

In January-November 2011, the state budget deficit stood at just 0.7% of projected full-year GDP, as booming tax revenues and proceeds from an export duty on crude oil helped finance higher payrolls in the public sector. That being said, public finances are now even more hooked on oil revenues, partly as a consequence of the financial crisis of 2009. On that note, the recently approved budget is a welcome step to lessen the public sector's addiction to transfers from the National Oil Fund. In particular, the government intends to reduce the Republican budget deficit to just 1.3% of GDP by the end of 2014. This medium-term fiscal consolidation should help diminish the dependence on the resource-based part of the economy.

Thanks to stable and falling prices of foods, consumer inflation in Kazakhstan continued to trend down, staying below 8% in November. Meanwhile, slower growth of money supply, partly thanks to the actions of the central banks but mostly because of the reluctance of commercial banks to resume lending, is curbing inflationary pressures as well. Indeed, although commercial banks are much less vulnerable to external shocks, a strong rebound in bank lending is unlikely to happen in 2012 as banks will continue to muddle through, struggling to access long-term funding and clean up their balance sheets.

Finally, strong commodity prices and growing exports to emerging economies helped push the trade in goods surplus to $42.3 billion in the first ten months of 2011. Thank to this, Kazakhstan is reporting a record high current account surplus – over $9 billion during the first three quarters of 2011. That being said, the current account surplus looks set to narrow in the medium term on growing imports and rekindled worries over the strength of the world economy, which, at the very least, may stall the growth of commodity prices.

Past swings of the current account into deficits led to losses of forex reserves, putting pressure on the exchange rate and increasing exposure to external shocks. Yet this time, the government is much better prepared to face these threats. Kazakhstan is ending the year with over $75 billion in forex reserves – nearly $30 billion higher than at the beginning of 2009. In addition, the sovereign balance sheet has significantly improved – net foreign assets of the government may exceed 41% of GDP by the end of 2011 – up from 37% a year ago. This provides a solid cushion against negative terms-of-trade shocks that can be triggered by the failure to solve the European debt crisis. In fact, a recent upgrade of Kazakhstan's sovereign rating by Fitch is yet more proof of the country's ability to withstand most economic hardships that may materialize in 2012.

	2006	2007	2008	2009	2010	2011[f]
GDP growth, % change yoy	10.7%	8.9%	3.3%	1.2%	7%	7%
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%	-2.0%
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%	9%
Retail sales, % change yoy	15.0%	10.7%	3.1%	-3.9%	12.3%	12.5%
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	130.0
Exchange rate, tenge/$, annual average	126.1	122.6	120.3	147.5	147.4	147.0

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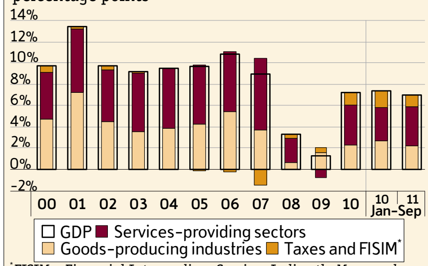
Economic Growth

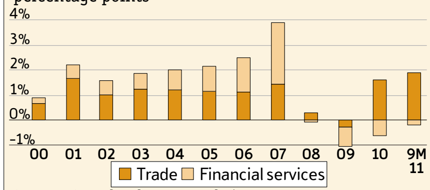
During the first three quarters of 2011, the Kazakh economy grew by 7% thanks to strong performance of service-providing industries in general, and trade in particular. Indeed, a solid rebound of household consumption on increasing incomes, higher public spending as well as low joblessness are sustaining a recovery of consumer driven service industries. In particular, trade, which consistently contributed over one percentage point to economic growth before the crisis, is taking center stage again, helping to offset continued weakness of the financial industry (see chart 2). In November, consumer confidence reached another record, with over a third of households expecting better economic conditions in the future. This consumer optimism will help drive personal consumption going forward. Indeed, in January-November 2011, retail sales grew by 12.5% – just a shade below the 12.8% growth during the first three quarters of this year. After all, a sound labor market adds resilience to consumer spending – in October, payroll employment was 4.5% higher than a year ago, while real wages grew by 8.3%.

Contributions to GDP growth 1
percentage points



*FISIM – Financial Intermediary Services Indirectly Measured
Source: ASRK, The Bleyzer Foundation

Contributions of trade and finance to economic growth 2
percentage points

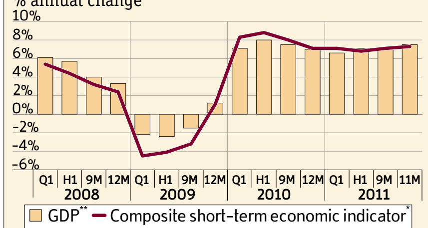


Source: ASRK, The Bleyzer Foundation

Domestic trade aside, other service-providing sectors of the economy continue to expand at a healthy pace as well. For example, during the first eleven months of this year, freight and passenger traffic jumped 16% and 26.5%, respectively, growing faster than in the first three quarters of 2011. Meanwhile, an uptrend in postal and telecommunication services still remains firmly in place. All this means that services will keep providing a substantial boost to economic growth. Add to this a booming agro industry, and year-end economic growth should easily hit 7%.

In fact, with a record high harvest, agriculture grew by 27.3% in January-November 2011, helping to offset a deceleration in other goods-producing parts of the economy. Thanks to the solid contribution of agriculture, the monthly short-term economic indicator that closely tracks overall economic growth has been increasing at above 9% since September. Thus, preliminary estimates place GDP growth at about 7.5% during the first eleven months of 2011 (see chart 3).

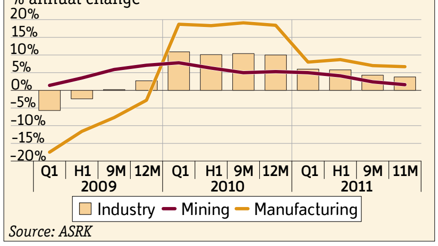
The short-term economic indicator 3
% annual change



*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.
**Preliminary estimates, H1 2011
Source: ASRK

Meanwhile, output growth in mining, the very sector that dominates Kazakh industry, continued to decelerate, increasing by only 1.6% in January-November versus 2.6% in the first three quarters of 2011. As a result, industry saw a gain of just 3.8% versus over 10% a year ago (see chart 4). Although manufacturing grew by close to 7%, there are signs that slowing global demand is starting to affect Kazakhstan. Indeed, metallurgy (which still accounts for nearly 43% of all manufacturing) posted a much more modest increase in production – up by only 6.7% in January–November 2011 versus over 8% in the first nine months of the year. In fact, in November, measured against the same month a year ago output in metallurgy fell for the first time this year, which points to a weakening industrial recovery. A drop of business confidence in industry in November (to the lowest level since July 2010) is yet another sign of a recent weakening in factory activity. On the upside, machine building, chemicals and production of construction materials continued to register robust gains. Several factors are contributing to the strength of these industries. First, local carmakers are benefiting from a surge in car sales both at home and abroad. For example, during the first ten months of 2011, sales of new cars more than doubled, approaching their precrisis levels.[1] Second, high foreign demand for fertilizers and Kazakh uranium[2] are sustaining growth momentum in the chemical industry. Lastly, producers of building materials are expanding output thanks to booming investment and construction activity in neighboring Central Asian economies and a gradual recovery in the local construction industry.

Slowing growth in mining is pushing industrial recovery down 4
% annual change



Source: ASRK

On that note, the local construction industry is starting to show signs of life. In January-November, the volume of construction works was about 3% higher than a year ago, while residential housing investments grew by 25%. Meanwhile, home values continued to firm up, increasing in November by 8% and 9% for new and existing apartments, respectively. Lastly, during the first eleven months of 2011, home sales grew by almost 14% versus the same period a year ago.

[1]Source: Qncepto
[2]For example, during the first 10 months of 2011, Kazakhstan exported 7.6 tons of uranium and its compounds to China, 29% more than a year ago.

Fiscal Policy

In January-November 2011, the state budget deficit stood at just 0.7% of projected full-year GDP (see chart 5). Booming tax revenues, which grew by nearly 40%, helped push total budget revenues by 30%. After all, better corporate profits, booming personal consumption and increasing wages help the government collect more taxes. Indeed, during the first ten months of this year, revenues from the corporate income tax, value added tax and personal income tax increased by 33%, 33% and 19%, respectively. That being said, an increase in the export duty on crude oil to $40 per ton at the beginning of this year proved to be a boon for government coffers. Indeed, thanks to high energy prices (see chart 6), revenues from this duty exceeded $2.5 billion in January-October, accounting for over 12% of all tax revenues. Meanwhile, budget spending grew slower, increasing by 19% mostly due to higher spending on social welfare (which accounts for over 22% of all expenditures) and growing public sector wages (especially in such sectors as public administration and education).

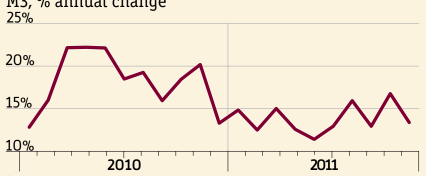
In late November, the President of Kazakhstan signed a law on the 2012-2014 republican budget. In particular, the government plans to reduce the Republican budget deficit to just 1.3% of GDP by the end of 2014 (see chart 7). Equally important, the share of transfers from the National Oil Fund in total budget revenues is projected to fall to about 20% in 2014 from as much as 40% in 2009. Indeed, the tax reform of 2007 (when VAT and corporate income tax rates were cut) and a sharp drop of business activity in trade, construction and finance led to a 30% decrease of tax revenues in 2009. Meanwhile, fiscal stimulus as well as government spending on social welfare to mitigate the impact of rising consumer prices kept budget expenditure on the uptrend. As a result, the reliance on the National Oil Fund has significantly increased since the onset of the global financial crisis. On that note, the use of oil revenues to help the government during economic hardships was exactly the reason to setup the National Oil Fund in the first place. However, an excessive addiction to those transfers may widen the imbalance between the oil and nonoil parts of the economy even further and may lead to big inefficiencies in the public sector. Thus, a plan to reduce the budget deficit in the medium-term is a welcome step because it signals the government's strong commitment to loosening its dependence on the resource-based part of the economy.

Monetary Policy

Thanks to stable and falling prices of foods, consumer inflation in Kazakhstan continued to trend down in November, staying below 8% for the first time in 2011 (see chart 8). In particular, with the exception of prices of meat, which grew in November due to a seasonal surge in demand, prices of staple foods (such as cereals and fruits and vegetables) are moving down. After all, better grain harvests worldwide are easing price pressures on food commodities (see chart 9). Indeed, December projections by the U.S. Department of Agriculture put the world 2011/12 harvest 4.3% higher than in the previous marketing year. According to the government of Kazakhstan, this year the country had a record harvest – grain crops stood at about 29 million tons, including over 24 million tons of wheat. This will help maintain price stability because higher food prices tend to contribute nearly half of overall growth of consumer prices in Kazakhstan.

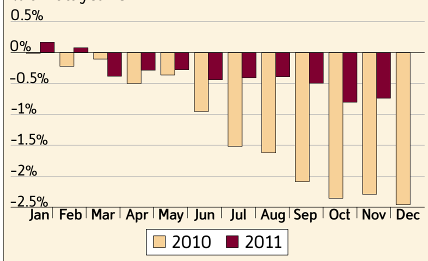
Slower growth of money supply is contributing to diminished inflationary pressures as well. Indeed, while money supply grew by over 40% a year on average from 2001 to 2007, it has recently been expanding much slower (see chart 10). This is partially because the central bank stepped up issuance of its short-term notes during the first half of this year to absorb excess liquidity and sterilize its currency purchases (see chart

Money supply 10
M3, % annual change



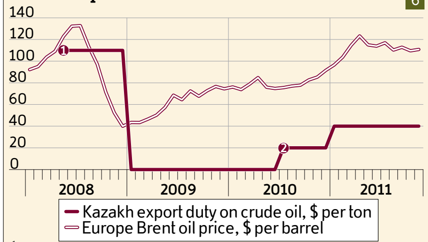
Source: NBK

State budget balance 5
% of full year GDP



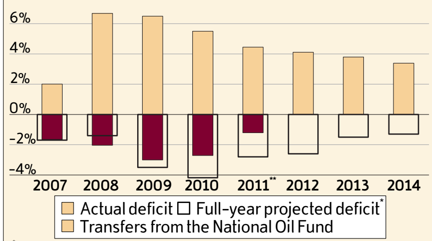
Source: Ministry of Public Finance, ASRK

Crude oil price 6



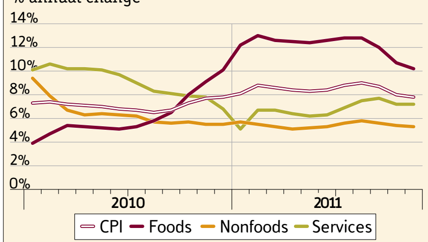
[1] This duty was periodically adjusted based on the world oil price.
[2] A flat export duty on crude oil was reinstated.
Source: The U.S. Energy Information Administration, The Government of Kazakhstan

The Republican budget deficit 7
% of GDP



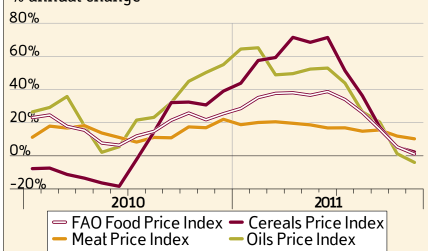
** A final budget revision is usually done each year at the end of October*
*** January-November 2011*
Source: The Ministry of Finance of the Republic of Kazakhstan

Consumer prices 8
% annual change



Source: ASRK

Global food prices 9
% annual change



Source: Food and Agriculture Organization of the United Nations

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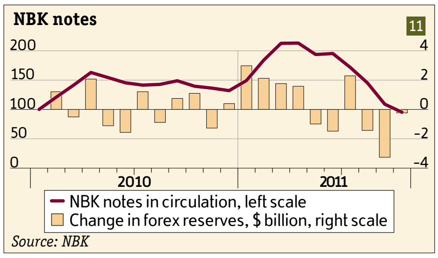
11). More importantly, although corporate and retail lending is inching up (see chart 12), commercial banks remain cautious about extending new credit. Indeed, according to the latest loan officer opinion survey on bank lending practices, most banks are maintaining a rather conservative lending policy, as few creditworthy borrowers, tight long-term funding and mounting nonperforming loans are discouraging lenders from expanding their credit portfolios. In fact, despite growing by over 11% since the beginning of the year, the quality of banks' loan portfolios has kept deteriorating - by the end of October over 22% of all loans were nonperforming – up from 20% ten months ago. In addition, currency mismatch between banks' assets and liabilities is still substantial - over 43% of all banks' liabilities are denominated in foreign currencies, yet nearly two thirds of all outstanding loans are issued in national currency. All this implies that the currency and credit risks in the Kazakh banking system remain relatively high, which leaves local banks exposed to unfavorable exchange rate fluctuations and an economic slowdown. On the upside, only a fifth of all liabilities are owed to foreigners compared to 45% at the beginning of 2009. In addition, according to the central bank, foreign debt repayments by commercial banks should not exceed $3 billion in 2012, while the total external debt of Kazakh lenders is now $20 billion lower than three years ago. This means that banks are much less vulnerable to external shocks (for example, to a withdrawal of foreign capital from emerging markets on sovereign debt worries in the Eurozone) compared to the 2008 finical crisis. That being said, a strong rebound in bank lending is unlikely in 2012, as banks will continue to muddle through, struggling to access long-term funding and clean up their balance sheets.

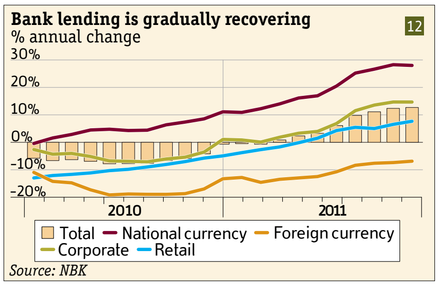
International Trade and Capital

High commodity prices (see chart 13) as well as increasing energy shipments to emerging markets helped push Kazakh exports up by 48% during the first ten months of 2011. As a result, the trade in goods surplus widened to $42.3 billion, or 45% higher than a year ago. Thanks to this, Kazakhstan is reporting a record high current account surplus – preliminary estimates place the current account surplus at $9.3 billion during the first three quarters of 2011, three times bigger than in all of 2010. This adds an extra layer of resilience against possible external shocks. That being said, the current account surplus is likely to narrow in the medium term – it was just $113 million in the third quarter of 2011 (see chart 14). First, strong economic activity is sustaining a recovery in imports (see chart 15). During the first ten months of 2011, imports of cars, trucks, and machinery and equipment jumped by 38%, 76%, and 29%, respectively. Second, a likely slowdown of the world economy in 2012 will, at the very least, stall the growth of commodity prices. Thus, Kazakh exports are set to grow more slowly.

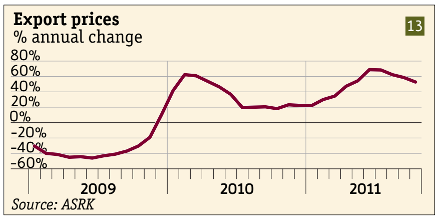
In the past, a swing of the current account into deficit coupled with debt repayments led to the loss of NBK forex reserves (see chart 16). This time, Kazakhstan's total forex reserves, including assets of the National Oil Fund, stayed at over $75 billion or nearly $30 billion higher than at the beginning of 2009. As a result, the country has a significant capacity to absorb negative terms-of-trade shocks. Increasing net foreign assets (see chart 17) is yet another sign of improved economic resilience. In particular, most of this improvement is due to a much stronger sovereign balance sheet: net foreign assets of the government may exceed 41% of GDP this year – up from 37% a year ago. Partly thanks to this, Fitch has recently upgraded the Kazakh sovereign rating to BBB- with a positive outlook, putting Kazakhstan on par with much bigger neighboring Russia.



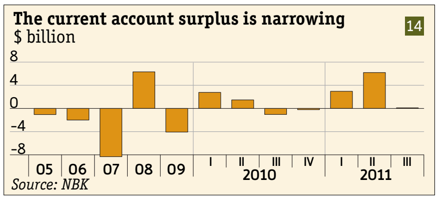
NBK notes
Source: NBK



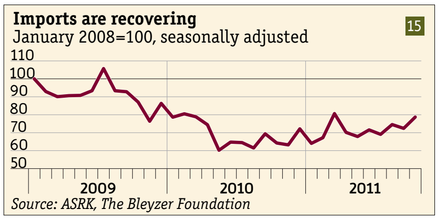
Bank lending is gradually recovering
Source: NBK



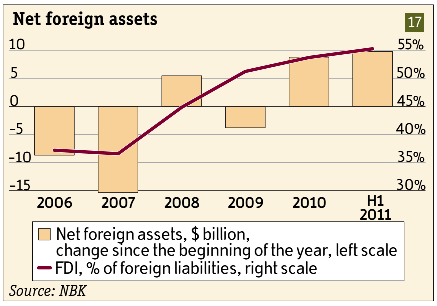
Export prices
Source: ASRK



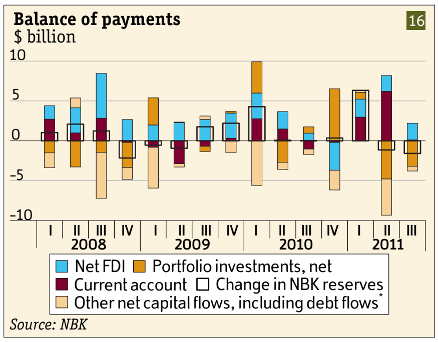
The current account surplus is narrowing
Source: NBK



Imports are recovering
Source: ASRK, The Bleyzer Foundation



Net foreign assets
Source: NBK



Balance of payments
Source: NBK

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