Kazakhstan

Macroeconomic Situation

SigmaBleyzer — The Bleyzer Foundation

September 2010

Sergey Kasyanenko, Edilberto L. Segura

- **Kazakhstan's economy grew by 8% yoy in January-June 2010.**
- **In January-August, industrial production grew by 10.9% yoy.**
- **The government intends to cut the republican budget deficit to 1.5% of GDP by the end of 2013.**
- **Inflation pressures remain subdued with consumer prices growing by only 6.5% yoy in August.**
- **BTA Bank has completed the restructuring of its $16.4 billion foreign debt.**
- **In January-July, the trade in goods surplus widened to $19.4 billion.**

Executive Summary

The economic recovery in Kazakhstan is gaining traction on booming exports and strengthening consumer spending. In fact, in August, the consumer confidence index remained at its highest level in over two years on a better economic outlook, improving job security and higher incomes. And stronger demand helped the economy to expand by 8% yoy in the first half of 2010 versus 7.1% yoy in the first quarter. Indeed, better performance of service-producing industries, which rely more on domestic consumption, helped offset slowing industrial recovery.

That said, growth momentum in industry, where recovery cooled in June, appears to be returning. Business sentiment is improving on higher estimated future production levels thanks to increasing sales and lean inventories. Meanwhile, industry saw a resumption of double-digit output growth in July and August supported by increasing production of ferrous and non-ferrous metals.

Industry accounts for one third of the economy and contributes 40% to GDP growth. Yet it remains vulnerable to fluctuations in foreign demand. And recent deceleration of the global manufacturing recovery does imply that Kazakhstan's industrial sector may grow more slowly through the rest of this year. Indeed, crude oil extraction and metallurgy remain the backbones of industry and manufacturing. However, weaker global economic data leads to wider swings in commodity prices, which may affect near-term output levels. That being said, long-term macro fundamentals still favor Kazakhstan as the resilience of large emerging market economies should sustain steady growth of the industrial sector.

The Government of Kazakhstan has approved the 2011-2013 draft budget. It assumes a 3% annual growth rate over the next three years, while the republican budget deficit is expected to shrink to 1.5% of GDP by the end of 2013. Continued reliance on large transfers from the National Oil Fund and a higher export duty on crude oil do imply that the oil sector remains the key to good fiscal performance.

Inflationary pressures continue to taper off thanks to a stronger local currency, more stable energy prices and seasonal declines of prices of foods. The risks of a repeat episode of spiraling food prices similar to 2008 remain low. Indeed, this year's harvest in Kazakhstan is sufficient to meet local demand, while the global grain supply is relatively high.

At the end of August, BTA Bank finalized the restructuring of its foreign debts, marking the conclusion of debt restructuring by the three Kazakh banks. This should add to the stability of the financial sector and reduce the risks of additional bank bailouts by the government.

Finally, China is becoming the biggest export market for Kazakhstan. This means that Kazakhstan's dependence on energy demand from developed economies is gradually easing. A strengthening of economic ties between Kazakhstan and China looks certain to bring more stability to Kazakh export revenues thanks to a better economic outlook for China compared to many other economies.

	2005	2006	2007	2008	2009	2010*
GDP growth, % change yoy	9.7%	10.7%	8.9%	3.3%	1.2%	2.0%
GDP per capita, $	3 754	5 262	6 757	8 398	6 710	7 600
Industrial production, % change yoy	4.8%	7.2%	5.0%	2.1%	1.5%	–
State budget deficit, % of GDP	0.6%	0.8%	-1.7%	-2.1%	-3.1%	–
Governmet external debt (including NBK), % of GDP	1.8%	2.9%	1.8%	1.6%	2.4%	–
Unemployment, end of period	8.1%	7.8%	7.3%	6.6%	6.3%	–
Inflation, end of period	7.6%	8.4%	18.8%	9.5%	6.2%	6-8%
Retail sales, % change yoy	13.5%	15.0%	10.7%	3.1%	-2.0%	–
Gross forex reserves of the NBK, $ billion, end of period	7.1	19.1	17.6	19.9	23.2	–
Assets of the National Oil Fund, $ billion, end of period	8.1	14.1	21.0	27.5	24.4	–
Current Account Balance, $ billion	-1.1	-2.0	-8.2	6.6	-3.4	2.0
External debt, $ billion	43.4	74.0	96.9	108.1	111.7	120.0
Exchange rate, tenge/$, annual average	132.9	126.1	122.6	120.3	147.5	145.0

* Projections

Source: ASRK, NBK, Ministry of Finance of Kazakhstan, IMF, Economist Intelligence Unit

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

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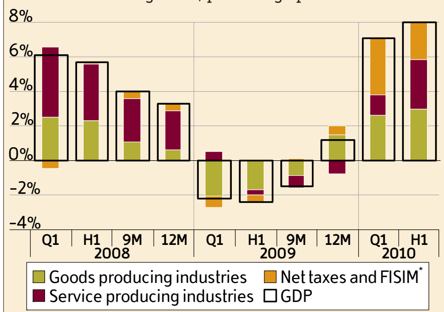
Economic Growth

The economic recovery in Kazakhstan is gaining traction on booming exports and strengthening consumer spending. Indeed, GDP grew at a faster rate in the second quarter of 2010, advancing by 8% yoy in January-June versus 7.1% yoy in the first quarter. Improving economic activity in service-producing industries, where growth accelerated to nearly 5% yoy versus a modest 1.8% yoy gain in the first quarter of 2010, helped offset slowing industrial recovery (see chart 1). This is important because unlike goods-producing sectors, which rely mostly on the overseas markets, services are more closely linked to domestic demand. More than that, a robust uptick in the wholesale and retail trade industry contributed over 60% to the overall expansion in the service-producing part of the economy. In particular, trade (roughly one eighth of GDP) expanded by 13% yoy compared to 11.5% in the first quarter of 2010, as consumers are becoming more eager to spend. The monthly volumes of retail trade grew on average by over 15% yoy in the second quarter of 2010, versus only 10% yoy the quarter before. That said, the average monthly growth in retail trade decelerated somewhat in the first two months of the third quarter to about 14% yoy. Still, it remains sufficiently high to sustain a solid recovery of the service-producing industry. Lastly, business and professional services reported stronger growth in the second quarter as well, while losses in finance and insurance narrowed to only 6.4% yoy in the first half of 2010 versus over 15% yoy in January-March.

There are also signs that the recovery in consumer demand is becoming more self sustained. In August, the consumer confidence index remained at its highest level in over two years as a less uncertain economic climate, improving job security (in August, the unemployment rate fell to 5.7% versus 6.3% a year ago) and increasing purchasing power (thanks to growing real household incomes) helped release pent-up demand. In particular, in January-July, personal income was up by 4.6% in real terms, while real wages were 5.9% higher than a year ago. And more public spending on social welfare programs (for example, in the second quarter of 2010 the average pension was 24% higher than a year ago) help support consumer demand as well.

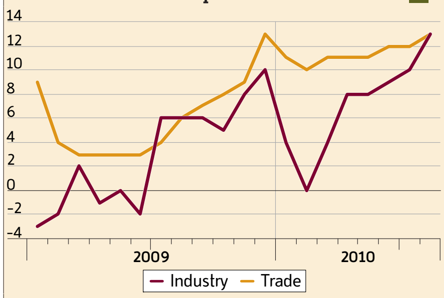
Equally important, growth momentum in industry, where the recovery cooled in June following heightened uncertainties over the world economic outlook, is returning. Business sentiment (both in trade and industry) is getting better on brighter estimates of future production levels thanks to increasing sales and lean inventories (see chart 2). Meanwhile, industry saw a resumption of double-digit output growth in July and August (up by 11.3% yoy and 10.1% yoy versus only 6.5% yoy in June (see chart 3)) supported by increasing production of ferrous and non-ferrous metals.

Kazakhstan's economic recovery accelerates 1
contributions to growth, percentage points



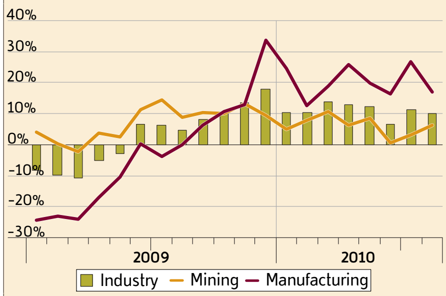
* FISIM - Financial intermediation service indirectly measured, which is an estimate of the value of the services provided by financial intermediaries, such as banks, for which no explicit charges are made; instead these services are paid for as part of the margin between rates applied to savers and borrowers.
Source: ASRK, The Bleyzer Foundation

Business sentiment improves 2



Source: ASRK

Industrial recovery continues 3
% annual change



Source: ASRK

In particular, in January-August, industrial production grew by 10.9% yoy thanks to 6% yoy growth in the mining industry and a 19% yoy gain in manufacturing. Crude oil extraction (over 80% of the mining sector) continues to provide the foundation for the mining industry. And booming demand for iron ore is helping the sector as well. Indeed, iron ore extraction jumped by 20% on surging exports and improving demand from local steelmakers. Metallurgy (up by 15.5% yoy) plays a key role in manufacturing recovery as well. Output in ferrous and nonferrous metallurgy (accounting for 19% and 24% of all manufacturing, respectively) bounced back by 13.5% yoy and 17.3% yoy thanks to growing exports of ferroalloys as well as higher world prices of aluminum, zinc and copper. In addition, manufacturing of products for the local market (such as foods and construction materials) is posting robust growth as well. This testifies to stronger consumer spending and improving conditions in construction. Indeed, in January-August, the volume of construction works stayed roughly the same as a year ago (versus a decline of 10% yoy in 2009), while investments into residential construction fell by less than 2% yoy (compared to a drop of 43% yoy in January-August 2009). Lastly, weaker currency (see chart 4) has been supporting local manufacturers as well. In fact, imports of foods and consumer products continue shrink, while local production is growing thanks to the improved competitiveness of Kazakh producers.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Almaty Office, Kazakhstan
286-V Zharokov Street,
Almaty, 050060
Tel./fax +7 (727) 258-5570/71
E-mail: office@sigmableyzer.kz

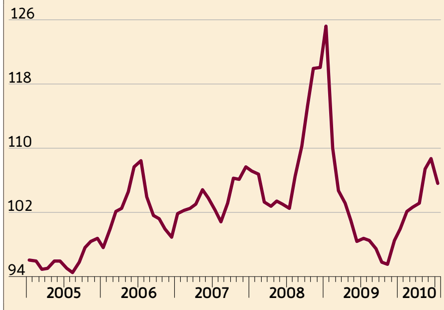
That said, industry, which accounts for roughly one third of the economy and contributes 40% to GDP growth, is still very sensitive to fluctuations in foreign demand. Recent inconclusive output trends in global manufacturing (with a deceleration in the U.S., China and Japan, and somewhat stronger performance in the Eurozone, albeit largely thanks to the weaker Euro) does imply that Kazakh industry may grow more slowly through the rest of this year. Above all, ambiguous economic data and unparalleled fiscal policy challenges faced by developed countries undermine confidence in the strength of the global economic recovery, which leads to wider swings in commodity prices and dampens investor sentiment. All of this may exert pressure on the near-term economic outlook of Kazakhstan because of heightened downside risks to world economic growth. However, the long-term macro fundamentals still favor Kazakhstan. After all, crude oil extraction and metallurgy remain the backbones of Kazakh industry and manufacturing. And the global demand for these commodities will stay strong as emerging economies continue to outperform developed nations. Indeed, China, which is already the world's second biggest economy, will be consuming more energy and industrial metals. This resilience of large emerging market economies, which fueled a robust industrial recovery in Kazakhstan in the first half of 2010, should sustain steady industrial growth in the future.

Fiscal Policy

The Government of Kazakhstan has approved the 2011-2013 draft budget. This document assumes that the economy will grow at about 3% annual growth over the next three years, while the republican budget deficit will narrow to 1.5% of GDP by the end of 2013 (see chart 5). The oil industry will continue to be an important source of budget revenues. In particular, transfers from the National Oil Fund to the republican budget were set at $8 billion, while a higher crude oil export duty (up to $40 per ton from the current $20) is anticipated to bring an extra $2.8 billion (roughly 11% of total budget revenues). Meanwhile, social welfare payments (with the state pension program accounting for more than 70%)[1] will remain the key expenditure item, growing by over 20% yoy. As a result, the share of social protection and benefits in the republican budget will grow to 24% from 21% in 2010 (see chart 6).

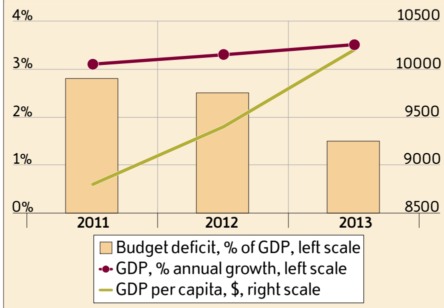
In January-August, the state budget deficit stood at $2.4 billion or about 2% of projected full year GDP (see chart 7). State budget revenues (about $18.4 billion) grew by 15% yoy on a robust rebound of tax revenues, which jumped by 26% yoy. In particular, proceeds from the corporate income tax and personal income tax bounced back by 37% yoy and 20% yoy. And the value added tax brought 22% yoy more revenues this year, mostly thanks to more taxes paid by local producers of goods and services. Indeed, the share of Kazakh producers in VAT collection widened to 37% from 23% a year ago due to a continued retrenchment in demand for imports. Meanwhile, budget expenditures increased by 18% yoy on growing social welfare payments and higher wage bills in the public sector.[2] In addition, this year the government allocated more funds to support agriculture (the national holding company "KazAgro" received a loan in the amount of over $500 billion) and injected more capital into state-owned entities. As a

Real Effective Exchange Rate 4
December 2000=100



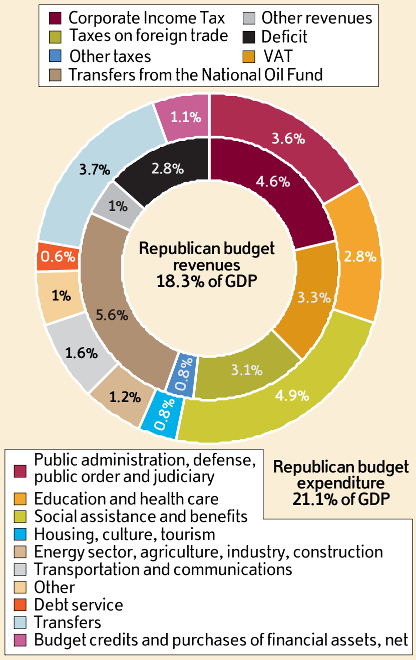
Source: NBK

2011-2013 budget projections 5



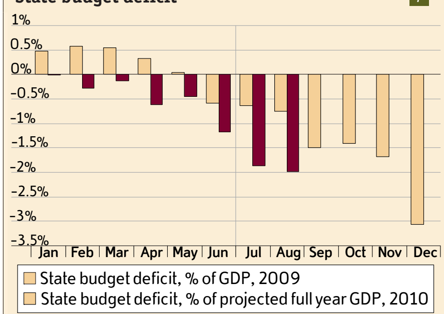
Source: The Government of Kazakhstan, The Bleyzer Foundation

The 2011 Republican Budget 6
% of GDP



Source: The 2011-2013 Republican Budget Draft Law

State budget deficit 7

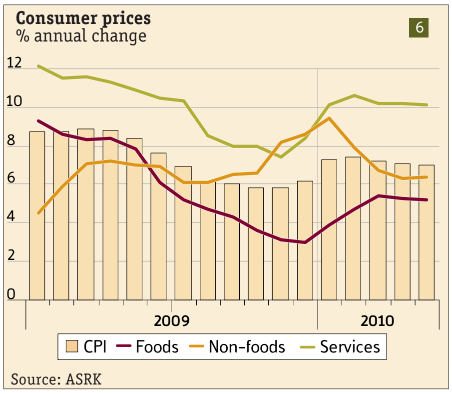


Source: The Ministry of Public Finance

[1] According to the 2011-2013 budget, minimum pensions will be raised by 30% in 2011.
[2] Starting April 1st, stipends and wages in the public sector were increased by 25%.

result, net lending and purchases of financial assets more than doubled to about $2 billion or 9% of total budget expenditures (compared to only 5% a year ago).

Monetary Policy



Inflationary pressures continue to taper off in Kazakhstan with the annual increase in consumer prices (CPI) slipping to 6.5% yoy in August from 7.4% yoy in February (see chart 8). Stronger local currency (the Tenge strengthened by 2.3% versus August 2009), more stable energy prices and cheaper agricultural products (due to seasonal factors) are contributing to slower inflation. That said, a recent uptick in the global prices of grains (due to the supply disruption brought by bad weather conditions in Russia and Pakistan) may prevent further reduction of inflation in Kazakhstan. Indeed, foods still account for over 40% of the consumer basket, which means that inflation in Kazakhstan is particularly sensitive to the large fluctuations of prices of basic agricultural commodities.[3] However, at present, risks for a repeat episode of spiraling food prices remain low. First, according to the Ministry of Agriculture of Kazakhstan, the 2010 grain harvest (albeit smaller than a year ago due to less favorable weather conditions) will be sufficient to meet local demand and export about 7-8 million tons (or over half of this year's output). Second, global grain stockpiles (which hit a 25-year low at the end of 2006) have been rebuilt thanks to 2009 bumper crops and the efforts of many countries to improve their food security. Finally, the lower harvest in Europe is likely to be offset by growing output in the North America.

In addition, money supply, which more than doubled from 2005 to 2007, grew by only 12.5% since the beginning of this year. This helps cool inflationary pressures as well. In fact, banks continue to shy away from extending new loans, which restrains money supply. Indeed, during the first eight months of 2010, bank lending to households and the corporate sector shrank by 2.5% or down by over 7% versus August 2009. First, tight access to foreign credit markets and a reduction of forex denominated loans on banks' balance sheets (as banks write off bad loans and repay forex-denominated liabilities) led to a 19% drop of loans issued in foreign currencies. As a result, the share of these loans fell to 45% from 52% in August 2009. Second, a narrow pool of creditworthy borrowers and continued deleveraging by households resulted in a 9% reduction of loans issued to households. And a high share of non-performing loans (which stood at 20% of all loans issued by commercial banks, excluding BTA Bank, Alliance Bank and TemirBank) does imply that the banking sector still has to go through a period of prolonged restructuring. This means that the non-oil sector of the economy, which relies more on bank lending unlike cash-rich resource-extracting companies, may grow more slowly (or require more state support) as the supply of bank lending remains constrained.

On the upside, three Kazakh lenders - BTA Bank, Alliance Bank and TemirBank - have already completed the restructuring of their foreign liabilities. In particular, at the end of August, BTA Bank finalized the restructuring of its $16.7 billion foreign debt. The total liabilities of the bank were reduced by $12.5 billion, while the maturity of the remaining debt was lengthened to 8-20 years. All told, a conclusion of the debt restructuring by three Kazakh banks, which played a key role in the precrisis credit boom, should add to the stability of the financial sector and reduce the risks of additional bank bailouts by the government. However, many structural problems in the banking sector remain, including a high concentration of assets and liabilities and a slow resolution of bad loans. The government, which owns large stakes in the restructured banks, still has to outline its exit strategy, which further clouds the outlook for the banking sector. All of this means that the banking sector will be playing a smaller role in economic development as it's unlikely to restore its precrisis capacity to channel foreign funds into the Kazakh economy.

International Trade and Capital

During the first seven months of 2010, exports of goods from Kazakhstan grew by 64% yoy to $34.4 billion on stronger crude oil and metal prices. Exports to China (which is already the biggest export market for Kazakhstan, accounting for over 16% of all exports) nearly doubled to $5.4 billion.[4] In particular, China has been aggressively buying Kazakh energy materials, metal oars and ferrous and nonferrous metals to support its rapid industrial growth. And a global manufacturing recovery boosted demand for Kazakh ferroalloys (exports of ferroalloys were up by 80% yoy). Indeed, exports of ferroalloys to Germany, Korea, USA, and Japan (or 60% of all exports of Kazakh ferroalloys) jumped by 5, 4, 8, and 1.8 times, respectively. Meanwhile, demand for imports continued to shrink with imports decreasing by 4% yoy to $15 billion. As a result, the trade in goods surplus stood at $19.4 billion or 3.6 times higher than in January-July 2009.

[3] Indeed, from October 2007 to August 2008, prices of foods in Kazakhstan grew on average by 27%. As a result, the CPI soared by over 20% in August 2009 (from less than 8% in the first half of 2007). During the same period, global food prices grew by over 40% on historically tight supply and booming demand soy-based biodiesel and corn-based ethanol.
[4] Booming exports of Kazakh goods to China generated over a fifth of the exports growth in January-July 2010.

True, this return to precrisis levels of the trade surpluses largely reflects a recovery of energy and metal prices. Yet, several factors point to a structural shift in foreign trade flows as well. First, currency devaluation and weaker consumer demand have considerably cooled willingness to buy imports. And tight bank credit and a depressed housing market reduced consumer demand for durable goods. Furthermore, the struggling construction industry has cut back on purchases of building supplies, which, with the exception of basic materials, are mostly shipped from abroad. Second, China is becoming the biggest export market for Kazakhstan. This means that Kazakhstan's dependence on energy demand from developed economies is gradually fading. That said, a strengthening of economic ties between Kazakhstan and China looks certain to bring more stability to Kazakh export revenues thanks to a much better economic outlook for China compared to many other economies.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Almaty Office, Kazakhstan
286-V Zharokov Street,
Almaty, 050060
Tel./fax +7 (727) 258-5570/71
E-mail: office@sigmableyzer.kz