SigmaBleyzer

Kazakhstan Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

May 2011

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- **The economy grew by 6.6% in January-March, just below the 7.1% growth rate in the same quarter of 2010.**
- **In January-April, industry advanced by 6.1% on broad-based gains in manufacturing and mining.**
- **The state budget ended April with a small deficit of about 0.3% of projected full year GDP.**
- **In April, consumer prices grew by 8.4% in annual terms - down from 8.6% the month before.**
- **The first quarter current account surplus stood at $4.8 billion.**

Executive Summary

Exports and a resumption of consumer spending continue to sustain economic recovery in Kazakhstan. First quarter GDP growth stood at 6.6% with the service-providing part of the economy contributing over half of the overall economic expansion. The solid rebound of the service-providing sectors is underpinning growth momentum in Kazakhstan. Indeed, according to preliminary estimates, GDP increased by about 7% during the first four months of 2011 on solid gains in trade, transportation and telecommunications. Meanwhile, industry is growing thanks to broad-based gains in manufacturing and mining. Lastly, construction is starting to generate growth again. All told, the economy is regaining firmer footing, as the contribution of sectors that rely on domestic demand is getting stronger.

Equally important, companies feel more confident about expanding production – in January-April, fixed capital investments grew by 4.1% compared to an 8.7% decline a year ago. Although most of the business spending is still happening in the oil industry, recent data reveals increasing investment activity in service-providing sectors and manufacturing. All of this points to a genuine economic uptick and should add an extra layer of resilience to this year's GDP growth. Improving personal spending helps keep the economy on an expansion path as well. For example, brisk retail sales are strengthening business activity in complementary industries, such as transportation. Meanwhile, households are spending more on services, including air and auto transportation, wireless calls and Internet.

Although, this uptick in personal spending is sustained by healthy employment and wage gains, personal consumption still accounts for less than 45% of GDP. This means that business spending will remain a critical driver of GDP growth. In fact, investments are set to play a key role in the new government economic strategy, which targets 7% average annual growth in 2011-2015. Fixed capital investments are projected to grow even faster as the government will continue to liberalize the business environment to encourage growth of the non-oil part of the economy.

In the meantime, foreign investors and the public sector are likely to remain the major source of investments, as banks are still struggling under the weight of nonperforming loans. That said, the financial sector is gradually stabilizing - in April, bank credit posted its second annual gain thanks to a solid uptick in corporate borrowing and continued easing of consumer deleveraging. Companies are increasingly willing to apply for new loans, while households feel more confident to borrow again. Meanwhile, high liquidity in the banking sector and increasing competition for creditworthy borrowers are prompting lenders to loosen credit requirements. This should help cut corporate funding costs, encouraging firms to boost investments.

Domestic consumption and investments aside, foreign demand for energy and base metals is still a big part of the Kazakh growth story. Indeed, increasing crude oil shipments, partly boosted by higher exports to the EU due to the unrest in the Middle East, are bringing record forex revenues. At the same time, there are signs of a gradual release of pent-up demand for imports as a more stable economy and stronger currency are pushing households and businesses back into spending mode. Yet notwithstanding a recent uptick in imports, the current account surplus hit another quarterly high in the first quarter of 2011. As a result, appreciation pressures are gradually building up, while the central bank is stockpiling reserves.

In conclusion, recent gyrations in commodity prices as well as rekindled fears over the health of the U.S. economic recovery and the EU debt crisis point to risks from overexposure to export-led growth. With that in mind, it is reasonable to expect a slower growth of Kazakh exports in the second half of 2011. Still, the country has $34 billion more in foreign reserves and assets of the National Oil Fund compared to the beginning of the global economic recession three years ago. This is still a rather comfortable cushion to mitigate the impact of a sudden drop in energy prices

	2006	2007	2008	2009	2010	2011[f]
GDP growth, % change yoy	10.7%	8.9%	3.3%	1.2%	7%	6.5%
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	146.0

Where Opportunities Emerge.

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Economic Growth

Strong exports and a resumption of consumer spending continue to drive the Kazakh economy. First quarter GDP growth stood at 6.6% - just below 7.1% in the same quarter of 2010. However, the composition of this year's growth is markedly different. Indeed, a year ago industry produced nearly half of the first quarter GDP growth, partly thanks to a robust rebound of exports of metals. Meanwhile, the service-providing sectors added only a fifth to the overall economic expansion, while declining output in construction continued to subtract from growth. This time, the service-providing part of the economy generated over 55% of the total GDP growth, while industry contributed just above 31%. Lastly, construction, which grew by 3.1% in January-March 2011, is starting to generate growth again (see chart 1). All told, the economy is regaining firmer footing as the contribution of sectors that rely on domestic demand (such as services and construction) is gradually increasing.

A solid rebound in the service-providing sectors is underpinning growth momentum in Kazakhstan. Indeed, according to preliminary estimates, GDP grew by around 7% during the first four months of 2011 (see chart 2). In January-April, trade, transportation and communication industries (which generate over a fifth of the country's GDP) increased by 14.2%, 6.5% and 15.6%, respectively. Meanwhile, industry advanced by 6.1% in January-April on broad-based gains in manufacturing and mining. In particular, factory output was up by 8.1% thanks to a sustained growth in key manufacturing sectors, such as production of construction materials (up by 18.2%), metallurgy (up by 12.8%) and machine building (up by 29%). Business sentiment in manufacturing remains bright as well, increasing by one percentage point in April.

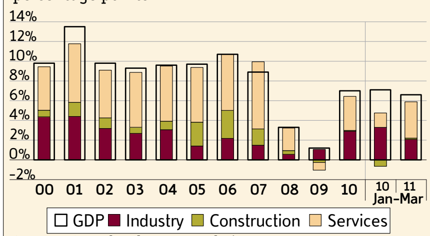
Equally important, businesses feel more confident in expanding production – in January-April, fixed capital investments grew by 4.1% compared to an 8.7% decline a year ago. True, most investments are absorbed by the energy sector – mining still accounts for over 40% of all business spending. In addition, increasing investments in transportation (up by 32.4%) may partly reflect spending on oil and gas pipeline infrastructure. But unlike a year ago, fixed capital investments saw a widespread gain across all major service-providing sectors and manufacturing. Fixed capital investments in manufacturing grew by 25.7%, investments in communication industry were up by 10%, 22% more were invested in real estate, business and professional services, while capital spending in the financial industry rose by 40%. All of this points to a genuine uptick in economic activity and should add an extra layer of resilience to this year's GDP growth.

Improving personal spending helped keep the economy on an expansion path as well. In January-April, retail sales grew by 11.8%, up from 10.9% a year ago. This strengthens business activity in complementary industries, such as transportation (see chart 3). Meanwhile, as households get richer, they are increasing their consumption of services. For example, passenger traffic was 26% higher than in January-April 2010 on growing volumes of air and auto transportation, while the communication industry grew by about 16% as households spent 69% more on communication services, primarily on wireless calls and internet.

This uptick in personal spending is supported by increasing consumer buying power on solid employment and wage gains. In the first quarter of 2011, payroll employment was 2.2% higher than a year ago, while the jobless rate stood at 5.5%, down from 6.2% in the first quarter of 2010. Meanwhile, real wages were nearly 12% higher in March 2011 than a year ago, thanks in part to public sector wage hikes in education and healthcare.

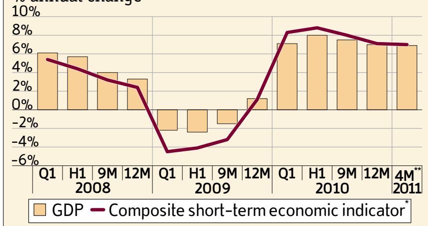
That said, consumer spending, which still accounts for less than 45% of GDP, has yet to emerge as a driver of sustainable economic growth. True, economic recovery last year was mostly driven by the rebound of personal consumption (see chart 4). However, fixed capital investments accounted for a big chunk of economic growth before the global financial crisis.

Contributions to GDP growth 1
percentage points



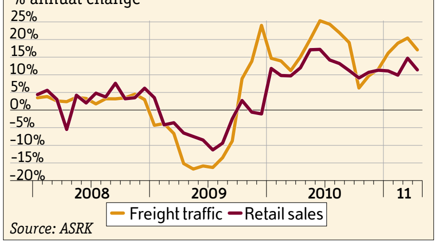
Source: ASRK, The Bleyzer Foundation

Economic recovery is stabilizing 2
% annual change



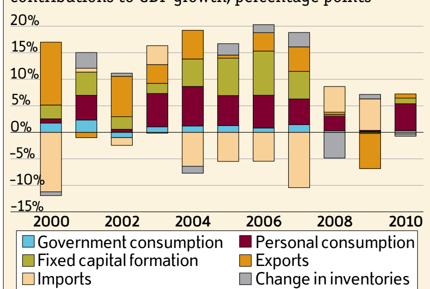
*The composite economic indicator tracks output of major sectors (i.e. agriculture, industry, construction, trade, transport, and communications), which account for over two-thirds of the Kazakh economy.
**Preliminary estimates
Source: ASRK

Improving trade fuels demand for transportation services 3
% annual change



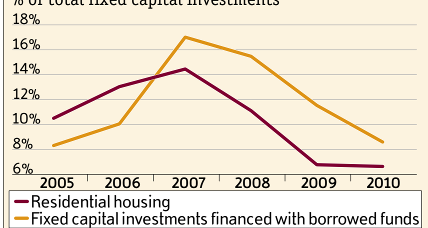
Source: ASRK

Consumers supported recovery in 2010 4
contributions to GDP growth, percentage points



Source: ASRK, The Bleyzer Foundation

Housing investments remain weak 5
% of total fixed capital investments



Source: ASRK

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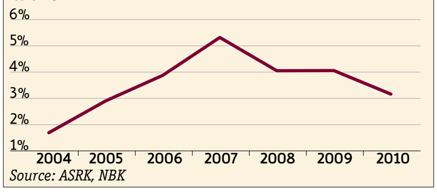
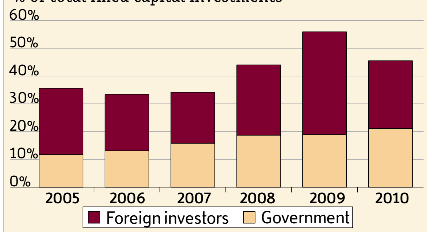
Residential construction, financed with borrowed funds, played a big part in this investment boom (see chart 5). With consumers remaining in deleveraging mode and banks being cut off from international funding sources, the outlook is for a rather slow and gradual recovery of mortgage lending (see chart 6). This means that the government and foreign investors (mostly in the mining industry) will play a more pronounced role in investment-driven GDP growth (see chart 7). After all, the mining industry still absorbs over a third of all capital spending. Meanwhile, investments in transportation and communications (such as roads and pipelines) account for up to a fifth of all fixed investments. At the same time, capital spending in both sectors is prone to sharp ups and downs due to commodity price fluctuations and the irregular nature of public spending on large infrastructure projects.

Mortgage debt outstanding 6
% of GDP



Source: ASRK, NBK

Foreign investors and the government are still the main sources of capital spending 7
% of total fixed capital investments



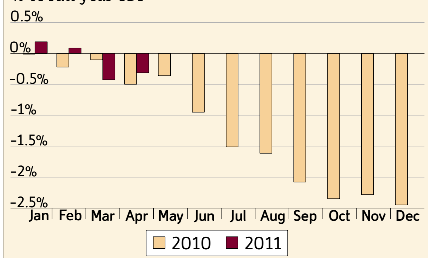
Source: ASRK

Still, investments are set to play a key role in the new government economic strategy, which targets a 7% average annual growth in 2011-2015. Indeed, fixed capital investments are projected to grow by over 9.5% a year on average as the government will continue to liberalize the business environment to encourage growth of the non-oil part of the economy. In particular, Kazakh authorities intend to reduce the number of licenses and permits by 30%, merge all permits into a single law on business regulation, simplify issuing procedures and gradually shift all business licenses online. In addition, enforcement and inspections will be simplified to reduce compliance costs for businesses, especially for small companies. Judging by the past track record, this goal appears feasible. In fact, according to the World Bank, last year Kazakhstan improved business regulation more than any other country and moved up 15 spots in the rankings on the ease of doing business – to 59th out of 183 economies. Still, sustaining global competitiveness requires more ingredients, such as better infrastructure, more reliable utilities and an improving quality of human capital. The new economic strategy does confirm the government's commitment to continue investing in transportation, infrastructure and education. This will provide an extra boost to the medium-term economic outlook thanks to higher investment demand and, more importantly, due to the development of a solid foundation for future productivity growth.

Fiscal Policy

During the first four months of 2011, the state budget deficit stood at about $0.5 billion – roughly 0.3% of projected full year GDP (see chart 8). Booming tax revenues (up by 47% in January-April 2011 versus the same four months a year ago) are adding strength to public finances and point to the fact that an economic recovery is gaining traction. As a result, the share of tax revenues in total budget revenues widened to nearly 80% from 68% a year ago (66% in January-April 2009). Meanwhile, the share of transfers from the National Oil Fund in state budget revenues narrowed to just 20% from 29% a year ago. However, the government is still relying on oil exports to fund budget programs. Indeed, revenues from an export duty on crude oil and petroleum products stood at nearly $1 billion in the first quarter of 2011, amounting to over 15% of all tax revenues.[1]

State budget balance 8
% of full year GDP



Source: Ministry of Public Finance, ASRK

Meanwhile, state budget expenditures grew by 19.5% on rapid growth of public spending on social welfare programs. At the beginning of 2011, pay-as-you-go pensions were increased by 30%, a monthly state retirement pension[2] was raised by 34%, while social benefits (for example, disability and survivors' benefits) grew by about 9%. In addition, state stipends and wages in the public sector are 25% higher than year ago. As a result, spending on education, social assistance and healthcare widened to nearly 60% of all government expenditures, compared to 56% a year ago. In fact, thanks to public sector wage hikes and increasing pensions, current expenditures of the state budget (which includes wages, social transfers as well as government purchase of goods and services such as medicine) is growing faster than overall budget spending and now absorbs over 70% of all spending versus 64% in 2010.

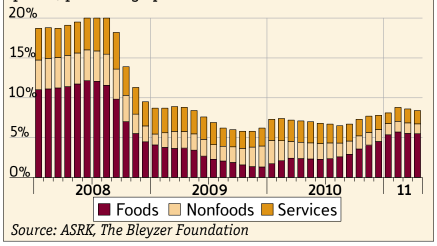
Monetary Policy

Slower growth of food prices and unchanged service tariffs helped keep consumer prices relatively stable in April compared to the first two months of 2011. In particular, the consumer price index grew by only 0.5% compared to March as food prices increased by 1% on a monthly basis versus an average monthly increase of 2.5% in January-February. As a result, in April annual inflation dropped slightly to 8.4% from 8.6% the month before. Still, food prices continue to contribute the most to overall inflation due to their high weight in the consumer basket (an average household still spends over 40% on foods). In particular, during the first four months of

[1] A duty on crude oil exports was reintroduced in August 2010 at $20 per ton and was raised to $40 per ton starting January 2011.
[2] Paid to individuals who reached official retirement age.

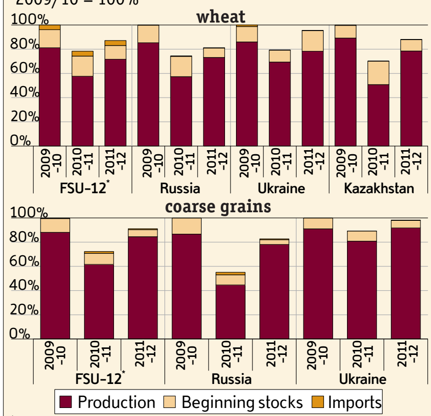
2011, food inflation was responsible for 65% of the total increase in consumer prices – an even higher contribution than during the 2008 food crisis (see chart 9). A recent retreat of energy prices as well as a deceleration of global food inflation should help ease inflationary pressures in Kazakhstan. That said, world prices of staple foods are still highly volatile due to lower expectations of the 2011/12 wheat harvest in the U.S. (due to the slow pace of planting, lower expected harvested area and yields) and increasing demand for corn as high crude oil prices are encouraging more corn use for ethanol. At the same time, wheat and coarse grains[3] harvests are projected to be much better in the CIS region (see chart 10). Thus, since local food prices are more sensitive to local supply conditions (after all, the governments of the CIS countries readily intervene to curb grains exports when supply tightens), it is reasonable to expect less food price volatility in Kazakhstan during the coming harvest season.

Costly foods are a major source of inflation 9
contributions to the annual growth of consumer prices, percentage points



Source: ASRK, The Bleyzer Foundation

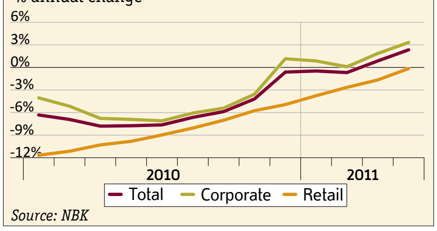
Grains supply in the CIS region 10
2009/10 = 100%



*FSU – Former Soviet Union
Source: United States Department of Agriculture, World Agricultural Supply and Demand Estimates (May 2011)

The banking sector is gradually stabilizing, as companies are increasingly willing to apply for loans to finance fixed capital investments, while households feel more confident in borrowing again. In April, bank credit posted its second annual gain thanks to a solid uptick in corporate borrowing and continued easing of consumer deleveraging (see chart 11). In particular, according to the latest NBK loan officer survey on bank lending practices, Kazakh lenders pointed to steadily improving demand for mortgages and a healthy rebound in consumer lending. After all, consumer sentiment remains on an uptrend, which boosts credit use – retail credit grew at about 1% monthly rate in April – the second straight monthly gain. Meanwhile, high liquidity in the banking system and increasing competition for creditworthy borrowers is prompting a gradual loosening of credit requirements for consumer loans. During the first quarter of 2011, 80% of banks were more willing to expand consumer lending compared to the quarter before, while 40% reported some easing of credit requirements (compared to 53% and 23%, respectively, at the end of 2010).[4] At the same time, foreign-owned banks are competing more aggressively for clients thanks to easier access to cheaper funding from abroad. This means that consumer credit is likely to become more accessible and affordable, providing an extra boost to personal consumption and, thus, economic growth. In fact, nearly 40% of Kazakh lenders are planning to loosen credit requirements in the next quarter compared to just 21% at the beginning of this year.

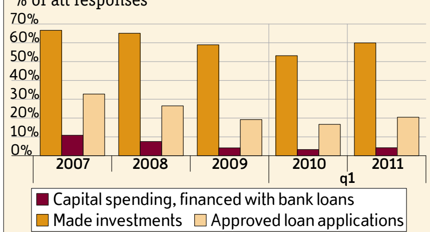
Credit outstanding 11
% annual change



Source: NBK

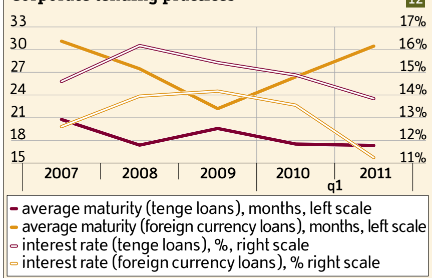
Similar trends are observed for corporate lending – over two thirds of all banks were willing to lend more to businesses in the first quarter of 2011 compared to just 58% at the end of 2010. Meanwhile, roughly 15% of lenders introduced some easing of credit requirements in January-March versus only 3% in the last quarter of 2010. This means that companies have access to cheaper loans with longer maturities (chart 12), which helps boost investments. Indeed, thanks to better availability of credit (around 1 in 5 companies was able to secure a bank loan in the first quarter of 2011 versus only 16% during the same quarter a year ago), an increasing number of nonfinancial businesses are resuming capital spending (see chart 13). Still, demand for corporate credit remains well below its precrisis levels – just a quarter of all firms turned to banks for funds in January-March, compared to nearly 40% in 2007. As a result, at present, bank loans fund a much smaller portion of total capital spending (just 4% in the first quarter of 2011 versus over 10% in 2007).

Companies are resuming capital spending 13
% of all responses



Source: NBK's Survey of Nonfinancial Businesses, Q1 2011

Corporate lending practices 12



Source: NBK's Survey of Nonfinancial Businesses, Q1 2011

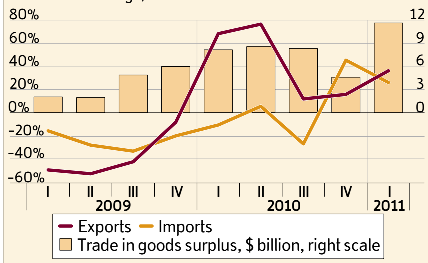
International Trade and Capital

During the first quarter of 2010, the trade in goods surplus was \$11.6 billion or 43% higher than a year ago (see chart 14). In particular, exports jumped by 36% to over \$18 billion thanks to increasing energy exports to the EU, boosted by high commodity

[3]Corn, sorghum, barley, oats, rye, millet and mixed grains.
[4]Source: NBK.

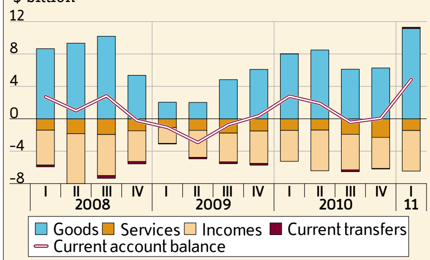
prices and the unrest in the Middle East. Thus, exports to Italy and the Netherlands (these two economies purchase nearly a quarter of all Kazakh exports) jumped by 57% and 177% respectively. Meanwhile, foreign demand for Kazakh ferroalloys remains strong thanks to a continued manufacturing rebound in Germany and Japan (although the first quarter data does not reflect the impact of the earthquake in Japan). Lastly, solid demand for nuclear power in China is sustaining exports of Kazakh uranium.

Quarterly foreign trade flows 14
% annual change, left scale



Source: ASRK

Current account balance 15
$ billion



Source: NBK

Turning to imports, there are signs of a healthy turnaround in consumer and investment demand – in January-March, imports of goods were 26% higher than a year ago (although still lower than in the first quarter of 2008). At the same time, imports saw broad-based gains across a wide range of products – from foods and furniture to trucks and machinery. This points to a gradual release of pent-up demand for imports as a more stable economy and stronger currency are pushing households and businesses back into spending mode. Imports of services show signs of life as well, though they grew by only 2.8% in the first quarter of 2011. Demand for foreign construction services, which accounted for over a third of all imports of services just before the economic downturn, remains weak due to a slow recovery of the housing market. As a result, the trade in services deficit (about $1.44 billion) stood at the same level as a year ago. In addition, profits withdrawn by foreigners (which, among other things, include the earnings of international oil companies and debt payments by Kazakh banks) are growing slower than exports thanks to last year's cancelation of nearly $8 billion of foreign debt. Thus, preliminary estimates place the first quarter current account surplus at a record high $4.8 billion (see chart 15). These large forex inflows add to appreciation pressures – the exchange rate has strengthened by 1.4% against the US dollar since the beginning of the year. Meanwhile, the central bank is accumulating reserves – gross international reserves of Kazakhstan grew by 31% during the first four months of 2011 to $37 billion and are now nearly $20 billion higher compared to the beginning of the global economic recession (December 2007).

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