Kazakhstan
Macroeconomic Situation

June 2011

Sergiy Kasyanenko, Edilberto L. Segura

- **During the first five months of 2011, industry grew by about 6%.**
- **The state budget ended May with a small deficit of only 0.3% of projected full year GDP.**
- **In May, consumer prices grew by 8.3% as global food prices stabilized.**
- **During the first four months of 2011, the trade in goods surplus stood at nearly $20 billion.**
- **By the end of May, Kazakhstan had $74 billion in forex reserves.**

Executive Summary

Booming exports and an uptick in consumer spending are sustaining growth momentum in Kazakhstan. Indeed, the short-term economic indicator points to a steady GDP growth of about 6% in January-May. A continuing expansion in mining and manufacturing is a big part of this growth story. Having said that, the mining sector, which still accounts for a big chunk of Kazakh industry, appears to be slowing down. Cost and tax uncertainties at the two big oil fields (the Kashagan and Karachaganak projects) may be prompting foreign oil companies to delay investments.

On the upside, whereas production is expected to flatten out in many oil-producing countries as existing oil supply capacity matures, Kazakhstan still has large untapped oil reserves. However, it may be more challenging to sustain the expansion of the oil industry at past rates as higher energy prices are boosting capital and operating costs. In fact, adjusted for capital costs, investments in oil production barely grew in 2010. Meanwhile, cost overruns and delays continue to plague the Kashgan oil venture – Kazakhstan's largest oil development project. Thus, increasing costs and higher uncertainty may continue to hold back investments in the mining sector, contributing to slower industrial growth in the medium-term.

Still, the oil and gas sector aside, the economy remains strong on solid gains in metallurgy and machine building. Improving investment and consumer demand are supporting a manufacturing recovery. Looser lending standards, growing corporate earnings and more upbeat business sentiment are prompting a resumption of private-sector-led capital spending, which adds strength to the Kazakh economic recovery. Overseas demand for Kazakh goods is playing a crucial role in the Kazakh manufacturing rebound as well. In particular, metallurgy is growing thanks to booming consumption of nonferrous metals in emerging markets. Exports of Kazakh ferroalloys are sustained by a strong manufacturing recovery in Germany and a return to growth in Japan. The chemical industry is enjoying record high exports of uranium to China. Lastly, a construction boom in neighboring Central Asian economies is fueling demand for Kazakh building materials.

Despite the impact of higher prices of groceries and gasoline on consumer sentiment, personal consumption is posting healthy gains. Indeed, in January-May, retail sales were up by nearly 12% compared to a year ago. Household spending on services is improving as well. In January-May, consumer spending on telecommunication services jumped by over 50% thanks to booming demand for wireless phone services and internet provision. Meanwhile, the same five months saw a 25% gain in passenger traffic and a 14% increase in freight traffic. As a result, a consumer-driven growth in trade and transportation (which jointly account for over a fifth of GDP) should sustain economic growth in 2011.

Expansionary fiscal policy is boosting consumer demand as well. Indeed, although the state budget deficit remained relatively small in the beginning of this year thanks to a rebound of tax collections, it is set to widen in the second half of 2011 on a 30% hike in public sector salaries on July 1st. Still, with public wages absorbing just 16% of state budget revenues, higher payroll spending can hardly make a major dent in the country's finances. In addition, wages in the public sector are still some 16%-40% lower than the national average, while this sector provides over a quarter of all nonfarm jobs in Kazakhstan. Thus, higher public sector wages should strengthen the role of consumer spending, which is smaller as a share of GDP in Kazakhstan compared to other large CIS economies.

Finally, consumer prices grew by 8.3% in May as monthly inflation calmed thanks to more stable global food prices. After all, food prices in Kazakhstan saw a 12.4% annual gain in May due to a surge in world prices of staple crops in the second half of 2010. Imports of essential foods still account for a big portion of consumption in Kazakhstan, and this provides a channel through which global food inflation is transmitted to local prices. On the upside, in May, base inflation (which excludes more volatile prices of foods and fuels) fell to its lowest monthly rate in 2011. After all, bank credit, while posting a modest annual gain for the third straight month, is still struggling to regain its precrisis strength. This implies that monetary sources of inflation are relatively well contained in the near-term.

	2006	2007	2008	2009	2010	2011f
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

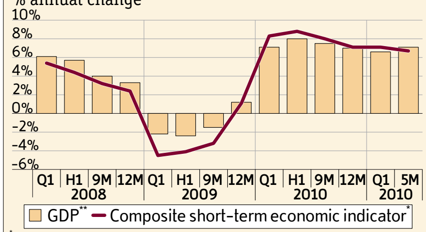
Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

Economic Growth

Increasing exports and a robust uptick in consumer spending continue to support economic recovery in Kazakhstan. In January-May, the short-term economic indicator was 6.7% higher than a year ago (see chart 1) pointing to a steady GDP growth of about 6%. In particular, during the first five months of 2011, industry grew by 5.8% as mining and manufacturing gained 4% and 8.7%, respectively. Having said that, the mining sector (which still generates nearly 65% of all industrial output) appears to be slowing down (see chart 2) on modest increases in crude oil extraction. Indeed, in January-May 2011, crude oil production (excluding gas condensate) increased by only 2.2% versus 9.3% growth during the first five months a year ago. Lingering uncertainties over the two biggest oil fields (the Kashagan and Karachaganak projects) may be partly blamed. In particular, tighter regulations on costs, taxes and fees in the oil sector may be prompting foreign oil companies to delay investments. For example, a dispute over the Karachaganak project, which dates back to 2009, threatens to put off the third phase of the field development. On the upside, there are signs that tensions over this project are gradually subsiding. The Karachaganak Petroleum Operating Group[1] is negotiating a transfer of a 10% stake to the state-owned oil and gas company Kazmunaigas, which should help resolve issues of the third expansion phase. Lastly, the Chevron-led joint venture, Tengizchevroil, which is developing the Tengiz oil field, has recently announced a plan to invest up to $20 billion by 2016 to raise its production by 40%.

The short-term economic indicator 1

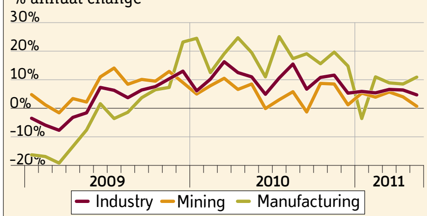
% annual change



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

Monthly industrial production 2

% annual change

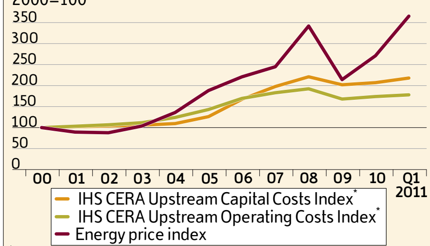


Source: ASRK

Still, it may be more difficult to sustain the expansion of the oil industry at previous rates as higher energy prices are boosting capital and operating costs (see chart 3). Indeed, adjusted for capital costs, investments in oil production barely grew in 2010 (see chart 4). On the upside, unlike Russia and Azerbaijan, where oil production is expected to flatten out as existing oil supply capacity matures,[2] Kazakhstan still has substantial untapped oil reserves. In fact, the latest energy outlook of the U.S. Energy Information Administration puts crude oil production in Kazakhstan 12.5% higher in 2012 than in 2010 versus a flat output in Russia. For example, the first development phase of the giant Kashagan offshore oil field[3] is expected be completed by the end of 2013. Its projected production capacity of about 450,000 barrels per day will be roughly equivalent to the Tengiz oil field - currently Kazakhstan's largest producing oil field. However, cost overruns and delays continue to push the second development phase of this project even further behind.[4] As a result, increasing costs and higher uncertainty may continue to hold back investments in the mining sector, contributing to slower industrial growth in the medium-term.

Capital costs in the oil industry are growing 3

2000=100

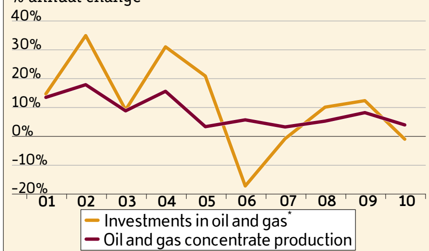


*These indices track the costs of equipment, facilities, materials, and personnel in the oil and gas industry.
Source: The World Bank, IHS Cambridge Energy Research Associate

The oil and gas sector aside, Kazakh manufacturing remains strong (up by about 9% in January-May) on solid gains in metallurgy and machine building (up by 13% and 29%, respectively). Growing exports as well as improving investment and consumer demand are supporting manufacturing recovery. In particular, although fixed capital investments grew by only 0.6% in January-May on lower public investments and falling capital outlays in the mining industry (mostly by foreign companies), investments financed with profits and borrowed funds continued to grow. In fact, capital spending funded with bank loans was up by over 24% (in real terms) following an 18% decline a year ago. After all, lending standards are getting looser, while companies remain upbeat about the strength of business activity - in May, sentiment in industry stood at its highest level in 2011 for the second straight month. As a result, businesses feel more confident about investing, while growing corporate earnings are contributing to stronger business spending.[5] That being said, with fixed capital investments accounting for over a quarter of GDP, a resumption of private-sector-led capital spending adds strength to the Kazakh economic recovery.

Investments in oil and gas production, exploration and development 4

% annual change



*Adjusted for the IHS CERA Upstream Capital Costs Index.
Source: ASRK, The Committee of Geology and Resource Exploitation, IHS Cambridge Energy Research Associate

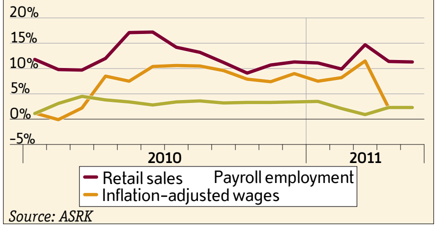
[1]The group members include Italy's Eni, Britain's BG Group (each holds 32.5%), Chevron with 20%, and Russia's Lukoil with 15%.
[2]Source: International Energy Association.
[3]The Kashagan field is the fifth biggest in the world in terms of reserves and is estimated to hold about 11 billion barrels of oil – over a third of the country's total recoverable oil reserves. Source: Oil and Gas Journal.
[4]The second phase may increase crude production at Kashagan to nearly 1 million barrels per day.
[5]According to the ASRK, the first quarter pretax earnings of medium and large companies in the non-mining sector were 52% higher than in the same quarter of 2010.

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

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

Sturdy overseas demand for Kazakh goods is a big part of the Kazakh manufacturing rebound as well. In particular, metallurgy is growing thanks to booming consumption of nonferrous metals (for example, copper) in emerging markets, especially in China. Exports of ferroalloys are sustained by strong manufacturing recovery in Germany[6] and a return to growth in Japan as tsunami-inflicted supply chain disruptions are gradually easing[7]. The chemical industry is enjoying record high exports of uranium to China. Lastly, a construction boom in neighboring Central Asian economies (for example, soaring investments in mining and manufacturing in Kyrgyz Republic and growing residential construction in Tajikistan) is fueling demand for Kazakh building materials – this sector grew by nearly 18% in January-May.

Growing wages and employment sustain retail sales 5
% annual growth



Source: ASRK

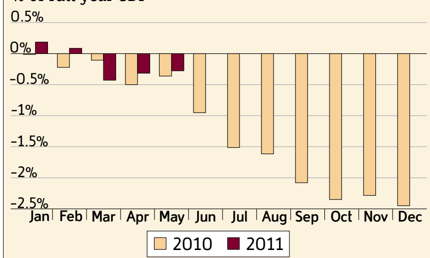
Lastly, notwithstanding a slight deterioration of consumer sentiment on the back of higher prices of groceries and gasoline, personal consumption is posting healthy gains. Indeed, in January-May, retail sales were up by nearly 12% compared to the first five months a year ago. Meanwhile, May was the seventeenth straight month of inflation-adjusted annual gains in retail sales, which averaged 11.7% during the first five months of 2011. Higher wages and welfare benefits and solid employment gains are contributing to stronger buying power (see chart 5).

Household spending on services is improving as well. In particular, in January-May, consumer spending on telecommunication services (households generate about 70% of all revenues in telecommunications) jumped by over 50% thanks to booming revenues in wireless phone services and internet provision (up by 14% and 61%, respectively). Lastly, January-May saw a 25% gain in passenger traffic and a 14% increase in freight traffic. As a result, a consumer-driven growth in trade and transportation (which jointly account for over a fifth of GDP) should sustain a healthy economic expansion in 2011.

Fiscal Policy

A continuing rebound of industrial activity and trade is boosting public finances as well. In January-May, the state budget revenues grew by 20% thanks to a rebound of tax collections, which jumped by 46%. In particular, proceeds from the corporate income tax and VAT (both taxes generate nearly half of all tax revenues) grew by 25% and 24%, respectively. In fact, these trends reflect higher corporate profits (on growing exports) and a solid rebound of personal consumption – two key attributes of the ongoing economic recovery. Yet, unlike a year ago, a rebound in imports emerged as the biggest contributor to stronger VAT revenues. Indeed, in January-May 2010, VAT paid on locally produced goods and services nearly tripled to 40% of all VAT proceeds. However, during the first five months of 2011, VAT on local producers grew by only 4% and now account for just a third of all VAT revenues. Meanwhile, VAT on imports from Russia surged by 65% to about 28% of all VAT revenues (versus only 21% a year ago). After all, this year taxes on foreign trade brought 21% of all tax revenues compared to just 6% a year ago. True, over 12% (or $1.6 billion) of all tax revenues came from export duties on crude oil and petroleum products. Still, proceeds from customs duties on other goods were up by over 70% on growing import duties.[8] Finally, payroll taxes are increasing at double-digit rates as well. Thus, revenues from the personal income tax improved by 19% thanks to a declining jobless rate (in May, the unemployment rate fell to 5.4%) and an 18% jump in per-capita personal income in January-April 2011. On the revenue side, the state budget spent 15% more in January-May 2011 versus a year ago. Still, the state budget remained essentially balanced, with a deficit of only 0.3% of projected full year GDP (see chart 6).

State budget balance 6
% of full year GDP



Source: Ministry of Public Finance, ASRK

That said, as current state budget spending (which includes wages, welfare benefits as well as purchases of various goods and services) is growing faster than overall public expenditures, the deficit is likely to get wider in the second half of 2011. In particular, during the first five months of 2011, current spending of the state budget grew by 22% on increasing payroll in the public sector and higher social benefits (such as pensions and stipends). Although the public-sector wage bill was only 13% higher than a year ago, it is set to grow faster in the second half of 2011 due to a 30% hike in public sector salaries on July 1st. Still, with public wages absorbing just 16% of state budget revenues, higher payroll spending can hardly make a major dent in the country's finances. In addition, wages in the public sector (which includes public administration, education, healthcare and social services) are still some 16%-40% lower

[6] One of the key applications of ferroalloys is the production of stainless steel, which is used in a wide range of manufacturing processes - from the production of household utensils to the aerospace industry. Germany is home to the largest stainless steel company in Europe and is the seventh biggest steel producer in the world. According to the World Steel Association, crude steel production in Germany jumped by over 34% in 2010. Meanwhile, the International Stainless Steel Forum estimates that world stainless steel production grew by 8.6% in the first quarter of 2011 following a 25% annual gain in 2010. All of this helps sustain foreign demand for Kazakh ferroalloys.

[7] According to the Ministry of Economy, Trade and Industry of Japan, in May industry posted the second consecutive monthly gain.

[8] As a member of the customs union with Russia and Belarus, Kazakhstan shares all import duty revenues imposed on goods entering this customs union. In particular, the shares of Kazakhstan, Belarus and Russia are 7.33%, 4.7% and 87.97 %, respectively.

than the national average. At the same time, public administration, education and healthcare provide over 27% of all nonfarm jobs in Kazakhstan. Thus, this public sector wage hike falls within the government strategy to improve living standards. In addition, it should help boost consumer spending, adding resilience to economic recovery. Indeed, consumer spending in Kazakhstan as a share of GDP is smaller compared to other large CIS economies, partly because wage and salary disbursements represent a less significant portion of the economy (see chart 7).

Monetary Policy

In May, consumer prices grew by 8.3% as monthly inflation stabilized at 0.5% - the same rate as in the previous two months. Still, food prices posted a 12.4% annual gain in May driven by higher global prices of staple agricultural commodities (see chart 8). After all, imports of essential foods, with the exception of wheat and flour, still account for a big chunk of local consumption in Kazakhstan (see chart 9). This is a channel through which global food inflation is transmitted to local prices. On the upside, in May, base inflation (which excludes more volatile prices of foods and fuels) fell to its lowest monthly rate in 2011. This implies that inflationary pressures are still relatively mild.

After all, bank credit, although posting a modest annual gain for the third straight month in May, is still struggling to regain its precrisis strength. Although, credit to households posted its first 12-month gain since the beginning of the crisis in May (see chart 10), it was still more than 16% lower than the peak of consumer credit boom in late 2007. All of this means that monetary sources of inflation remain well contained as banks, beset by the large portfolio of bad loans, are cautious to step up issuing new loans. Indeed, at the end of May, over a fifth of all loans in the banking system were nonperforming.

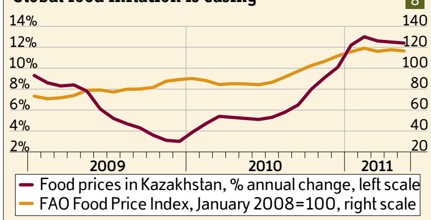
International Trade and Capital

A surge in global commodity prices is fueling a rebound of Kazakh export revenues. In January-April, exports grew by 47% to $27 billion. Meanwhile, local demand for imports is gradually improving on stronger consumer and investment spending. Thus, during the first four months of 2011, imports jumped by 26% to $9.7 billion, which puts the trade in goods surplus at nearly $20 billion. As a result, the record inflow of foreign currency earnings is boosting the forex reserves of Kazakhstan – by the end of May, the country had $74 billion in central bank reserves and assets of the National Oil Fund, or $15 billion more than at the beginning of this year. These forex reserves are equivalent to 60% of the country's external debt (compared to just 40% at the end of 2007) and are nearly 10 times higher than the total payments on foreign debt in the second half of 2011.

Personal consumption is still less than half of GDP 7

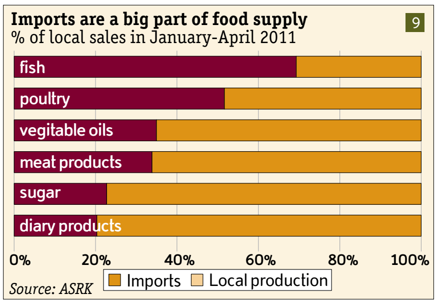
Source: ASRK, National Statistical Offices

Global food inflation is easing 8



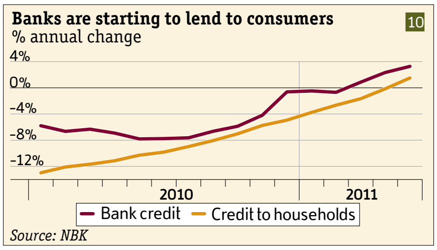
FAO - Food and Agriculture Organization of the United Nations
Source: ASRK, FAO

Imports are a big part of food supply 9



Source: ASRK

Banks are starting to lend to consumers 10



Source: NBK

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

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