SigmaBleyzer

Kazakhstan
Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

July 2011

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- **First half GDP growth stood at about 7%.**
- **In January-June, industry increased by 5.8% on solid gains in manufacturing.**
- **Consumer prices rose somewhat slower in June – up by 8.4% versus a year ago.**
- **In the first half of 2011, the state budget deficit stood at 0.5% of full-year GDP.**
- **In January-June, the current account registered a surplus of $7.2 billion or $2.5 billion higher than a year ago.**

Executive Summary

High commodity prices and strengthening consumer demand are sustaining a robust pace of economic growth in Kazakhstan. According to preliminary estimates, the economy expanded by about 7%. Industrial output was 6% higher than a year ago on a solid gain in manufacturing led by metallurgy and machine building. Indeed, companies are spending more on machinery and equipment as investment activity in manufacturing, transportation and construction starts to pick up. Brighter business sentiment, stronger corporate earnings and more available credit are likely to support this trend through the rest of 2011.

Equally important, consumer retrenchment is easing as higher wages and more jobs are propping up personal spending. In addition, consumer deleveraging, which is a serious drag on economic recovery in many parts of the world, is a lesser constraint in Kazakhstan - the ratio of bank claims on households to personal income is less than 30%. As a result, consumers are more confident about loosening purse strings - in January-June, retail sales were up by 12%.

Increasing consumer buying power is fuelling growth in service-providing sectors of the economy as well, which should sustain economic growth in the second half of 2011. After all, services account for over half of the entire economy and provide close to two thirds of all jobs. As most services are produced and sold locally, stronger personal spending supports domestic employment and businesses. In contrast to service-providing industries, Kazakh goods producing sectors rely more on external demand, while a big portion of spending on consumer and investment goods is absorbed by imports. As a result, increasing local spending on goods may have a smaller impact on domestic production, as it is more likely to seep over the border via imports.

In addition, construction is recovering at a glacial pace as banks shy away from issuing new mortgages. Although banks issued 65% more new mortgages versus the first half of 2010 on improving demand for loans, the monthly volume of mortgage origination remains at a paltry 25%-30% of its peak during the construction boom. On the upside, residential investments are bouncing back, while home values are already stabilizing. All of this should help breathe life into the property market and sustain the recovery of the construction sector.

Meanwhile, new worries over the strength of the world economic recovery are cooling global demand for commodities. That being said, the ongoing correction of energy prices is unlikely to reach the scale of the adjustment experienced during the peak of the global finical crisis. Above all, big emerging economies are the key source of the new demand for energy and other staple commodities. Unlike many developed economies, where debt-laden government and consumers face a long period of deleveraging and weak growth, these countries remain on a healthier footing. Thus, solid demand for energy in these emerging economies should help support crude oil prices at a relatively comfortable level for Kazakhstan.

After all, strong commodity prices helped push Kazakh exports to record levels in the first half of 2011. According to advance estimates, the current account surplus widened to $7.2 billion in January-June (versus $4.7 billion a year ago) on a 38% surge of the trade in goods surplus. At the same time, strong consumer and investment demand appears to be pushing imports back to their precrisis levels. Indeed, the second quarter of 2011 saw the fifth consecutive gain of imports, which jumped by 39% to just a shade below the previous quarterly record. For example, imports of footwear and clothing nearly doubled on recovering personal consumption, while imports of passenger vehicles increased by 18% as households feel more confident about spending on big ticket items. At the same time, improving investment activity in industry, telecommunications, transportation and construction is fueling imports of construction materials, industrial machinery and electronic equipment.

	2006	2007	2008	2009	2010	2011[f]
GDP growth, % change yoy	10.7%	8.9%	3.3%	1.2%	7%	6.0%
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.

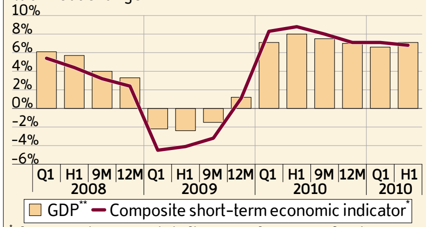
Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

Economic Growth

High commodity prices and strengthening consumer demand are sustaining a robust pace of economic growth in Kazakhstan. Indeed, according to preliminary estimates, the economy expanded by about 7% in the first half of 2011 (see chart 1). In particular, industrial output was 6% higher than a year ago on a solid 9% gain in manufacturing led by a 12% growth in metallurgy and a 26% increase in machine building. Above all, companies are spending more on machinery and equipment as investment activity in manufacturing, transportation and construction starts to pick up. Meanwhile, booming corporate earnings (the first quarter pretax corporate earnings were 45% higher than in the same quarter a year ago) and more available credit are likely to support capital spending through the rest of 2011. In fact, business sentiment in industry has returned to pre-crisis levels, which means that companies are more willing to expand production. This rebound in business investment should strengthen the resilience of the Kazakh economy. After all, during the boom years, fixed capital spending accounted for about two thirds of overall economic growth (see chart 2), while its share in GDP widened to close to 30%.

The short-term economic indicator 1

% annual change

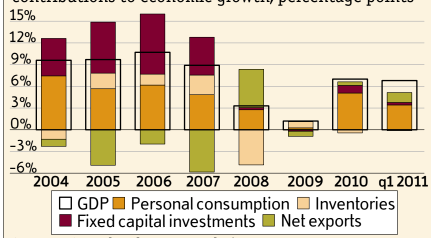


*The composite economic indicator tracks output of major sectors (i.e. agriculture, industry, construction, trade, transport, and communications), which account for over two-thirds of the Kazakh economy.
**Preliminary estimates, H1 2011
Source: ASRK

Equally important, consumer retrenchment is easing as higher wages (in May, an average inflation-adjusted wage was 4% higher than a year ago) and more jobs (in June, payroll at large and medium companies grew by 2.9% compared to the second quarter of 2010, while the jobless rate fell to 5.3%) are propping up personal spending. In addition, consumer deleveraging, which is a serious drag on economic recovery in many parts of the world, is a lesser constraint in Kazakhstan. Indeed, the ratio of bank claims on households to personal income is less than 30%. Meanwhile, inflation-adjusted personal income was up by over 6% in January-May. As a result, consumers are more willing to loosen purse strings – both consumer sentiment and the willingness to purchase durable goods have been on an uptrend recently. In fact, in January-June, retail sales were up by 12%, which also contributes to a surge in business activity in freight transportation and warehousing. Increasing consumer purchasing power is fuelling growth in other service-providing sectors of the economy as well. In the first half of 2011, passenger transportation was more than 25% higher than a year ago, while revenues in the telecommunication industry grew by 17% thanks to improving spending on wireless phone services (up by 13%) and internet (up by 62%). In fact, households, which bring in two thirds of all revenues in the telecommunication industry, increased spending on these services by over 41% versus the first half of 2010.

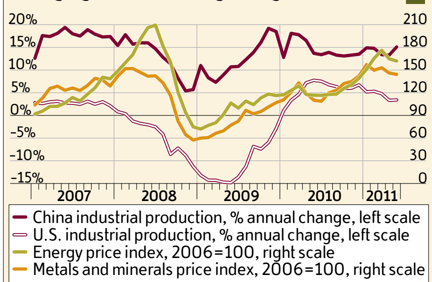
Investments still have to return as a driver of growth 2

contributions to economic growth, percentage points



Source: ASRK, The Bleyzer Foundation

Emerging economies are growing faster 3



Source: World Bank, Federal Reserve, National Bureau of Statistics of China

This robust uptick in the service-providing sectors of the economy should sustain economic growth in the second half of 2011 as well. After all, services account for over half of the entire economy and provide close to two thirds of all jobs. As most services are produced and sold locally, stronger personal spending supports domestic employment and businesses. In contrast to service-providing industries, Kazakh goods producing sectors rely more on external demand (for example, mining accounts for over 40% of all value added in goods producing sectors), while a big portion of spending on consumer and investment goods is absorbed by imports. As a result, increasing local spending on goods may have a smaller impact on domestic production, as it is more likely to seep over the border via imports.

Meanwhile, new worries over the strength of the world economic recovery are cooling global demand for commodities. That being said, the ongoing correction of energy prices is unlikely to reach the scale of the adjustment experienced during the peak of the global finical crisis. Above all, big emerging economies are the key source of the new demand for energy and other staple commodities. And unlike many developed economies, where debt-laden government and consumers face a long period of deleveraging and weak growth, these countries remain on a healthier footing (see chart 3). True, macroeconomic policies in developing countries have been recently tightened to contain overheating and inflation risks. For example, in July, China raised interest rates for the fifth time in eight months, while the main rate of the Reserve Bank of India was increased for the eleventh time since March 2010. In addition, Brazil raised interest rates for the fifth time in 2011. Although this policy tightening will restrain commodity price gains, it came as a response to booming local demand. The resiliency of this demand should provide some support to the world energy and metal prices.

Lastly, construction (which at the onset of the global financial crisis delivered over half of the entire growth in Kazakh goods-producing industries, while accounting for just a fifth of that part of the economy) is recovering at a glacial pace as banks shy away from issuing new mortgages (despite returning to growth in the first quarter of 2011, the output in construction was still more than 10% lower than three years ago). Indeed, although banks issued 65% more new mortgages versus the first half of 2010 on improving demand for loans (see chart 4), the monthly volume of mortgage origination remains at a paltry 25%-30% of its peak during the construction boom. On the upside, residential investments are bouncing back (up by over 24% in the first half of 2011) which should add strength to future construction activity. In fact, home values are already stabilizing (see chart 5) as increasing confidence about economic prospects helps release pent-up demand for housing. This should help breathe life into the property market and will sustain the recovery of the construction industry.

Fiscal Policy

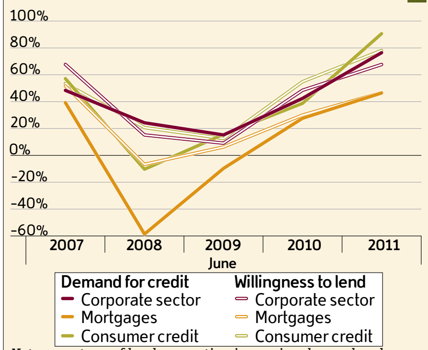
Recent public-sector wage hikes are making a big contribution to domestic demand as well. Indeed, the public sector (including education, healthcare and the government) provides over a quarter of all non-farm jobs; however, public-sector wages are still lower than the national average. As a result, the share of the public sector in the national labor income is below 15%. Thus, a series of pay increases (the most recent 30% wage hike came on July 1st) will help push the share of wages in GDP, which, in turn, will make personal consumption a more potent source of future growth. Furthermore, the public-sector wage bill accounts for only a fifth of state budget revenues (excluding transfers from the National Oil Fund). Meanwhile, in the first half of 2011, the state budget deficit stood at just 0.5% of full-year GDP versus 1% a year ago (see chart 6). This means that higher wages are unlikely to pose a serious threat to the sustainability of public finance. In fact, booming tax revenues (up by nearly 50% during the first half of 2011) are lessening the reliance of budget programs on the oil sector – in the first half of 2011, the state budget received $600 million less from the National Oil Fund compared to the first half of 2010. As a result, the share of transfers in total budget revenues narrowed to just 24% from 35% a year ago. Having said that, the oil industry continues to exert a large impact on public coffers. Indeed, transfers from the National Oil Fund to the state budget account for about 3% of full-year GDP, while close to 13% of all tax revenues are generated by the crude oil export duty. On the upside, a trivial amount of the government debt (external severing debt, excluding foreign claims on the central bank, stood at just 3.8 billion at the end of the first quarter of 2011) and a relatively modest size of the public sector (state budget spending is projected to remain at just 23% of GDP in 2011) help keep public finances of Kazakhstan on a healthier footing versus many other economies. As a result, fiscal austerity, which at present threatens economic recoveries in many parts of the world, is a rather remote possibility in Kazakhstan.

Growing government spending on social protection boosts consumer demand as well. In particular, welfare payments, which represent about a quarter of all budget expenditure, grew by 25% in the first half of 2011. Above all, this helps shield the most vulnerable groups of the population against rising prices of staple foods as the share of foods in total consumer spending widened to nearly 50%.

Monetary Policy

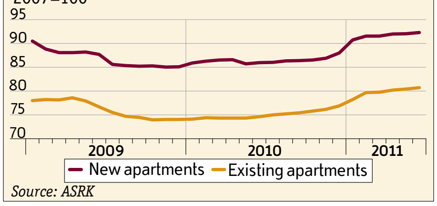
In June, consumer prices were 8.4% higher than a year ago on a 12.6% hike of food prices (see chart 7). And with foods accounting for a big chunk of household spending, higher food prices pose a material risk to a sustainable expansion of personal consumption. On the upside, in June, the monthly rate of food inflation fell to its lowest level since August 2010. Stable conditions on the global food markets (the FAO Food price index - see chart 8 - grew by just 0.9% in the second quarter of 2011 versus 4% in the first) and more upbeat projections on this year's supply of grains (the USDA projects wheat production in Kazakhstan to improve by two thirds in 2011/12 marketing year) are contributing to this trend. In addition, policy

Demand for credit is returning 4



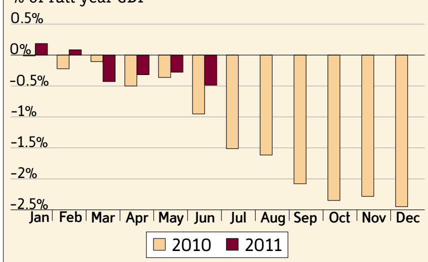
Net percentage of banks reporting improving demand and increasing willingness to lend
Source: NBK - Loan Officer Opinion Survey on Bank Lending Practices

Apartment prices firmer, yet recovery has a long way to go 5
2007=100



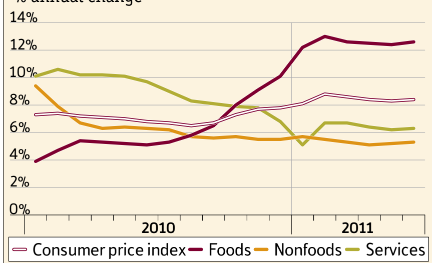
Source: ASRK

State budget balance 6
% of full year GDP



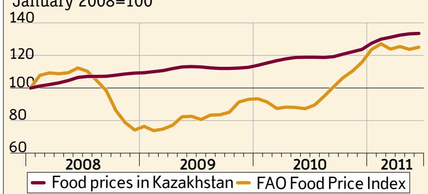
Source: Ministry of Public Finance, ASRK

Consumer prices 7
% annual change



Source: ASRK

Global food prices 8
January 2008=100



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

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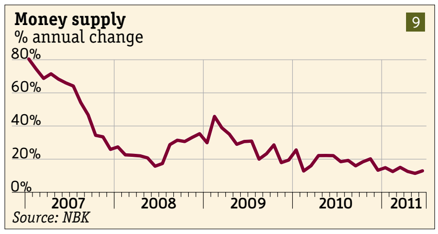
tightening in large emerging markets helps calm global food inflation as well. Lastly, on July 1st, Russia (which is a big player on the regional grain markets, accounting for over a half of the regional output) abolished a ban on grain exports. This will help keep grain prices at bay; in fact, wheat futures on the ETS Commodity Exchange in Almaty fell in July.

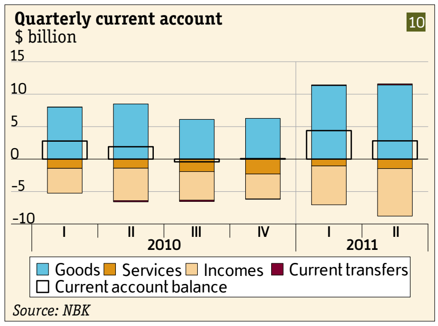


In addition, the global economic recovery appears to be slowing down on worries over the fiscal situation in developed economies and, in particular, the festering European sovereign debt crisis. In fact, the latest data from China and Germany point to the cooling of economic activity to its lowest level in two years. This should help keep a lid on global inflation, lowering import prices in Kazakhstan, which still buys most of its investment and consumer durable goods from abroad.

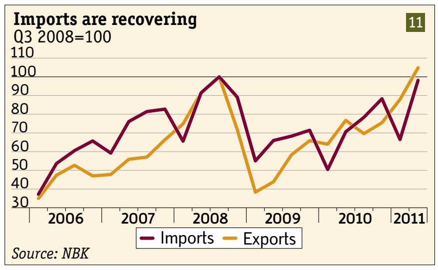
Finally, sluggish growth of credit (the loan portfolios of commercial banks barely grew over the past 12 months, increasing by only 2.5% versus the first half of 2010) helps curb inflationary pressures as well. Although banks are in better shape[1], a substantial level of nonperforming loans (close to one third of all loans) and tight lending standards makes them reluctant to extend new credit. As a result, the annual growth of money supply cooled to just 13% on average in the first half of 2011 compared to over 50% at the onset of the global financial crisis (see chart 9).

International Trade and Capital

Strong commodity prices helped push Kazakh exports to record levels in the first half of 2011. In January-May, exports posted a 44% gain and the trade in goods surplus widened to $21.5 billion or $7.6 billion more than in the same five months a year ago. These booming export revenues are piling up in the country's forex reserves – gross reserves of the National Bank and the assets of the National Oil Fund surpassed $73 billion at the end of the first half of 2011, $14 billion more than at the beginning of the year.



Meanwhile, according to advance estimates, the current account surplus widened to $7.2 billion in the first half of 2011 (versus $4.7 billion a year ago) on a 38% growth of the trade in goods surplus (see chart 10). At the same time, strong consumer and investment demand appears to be pushing imports back to their precrisis levels. Indeed, the second quarter of 2011 saw the fifth consecutive gain in imports, which jumped by 39% to just a shade below the previous quarterly record (see chart 11). For example, imports of footwear and clothing (mostly from China and Turkey) nearly doubled in the first half of 2011 on recovering personal consumption. Imports of passenger vehicles (primarily from Japan) increased by 18%; however, they are still only a third of automobile imports three years ago. At the same time, improving investment activity in industry, telecommunications, transportation and construction is supporting imports of construction materials, industrial machinery and electronic equipment.



With exports accounting for close to half of Kazakh GDP, the economy remains vulnerable to fluctuations of global commodity prices. Meanwhile, worries over debt problems in the U.S. and Eurozone, a moderation of economic growth in China and emerging overheating risks in other emerging markets are raising a fresh wave of concerns over the strength of the global economy. As a result, weaker global economic activity may push commodity prices down, limiting the growth of Kazakh export revenues. Crude oil prices (the biggest exports of Kazakhstan) have held up relatively well (up by about a half compared a year ago) on supply disruptions in Libya. However, as recent debt deals in America and Europe failed to calm markets due to a disappointing batch of economic data, oil prices dropped by about 8% in the first week of August alone. Above all, uncertainty over fiscal policy and job creation in developed economies is damping investors' risk appetite and leads to increased commodity price volatility. Having said that, emerging markets are gradually increasing their role in the world economy and global commodity consumption. According to the latest projections by the U.S. Energy Information Administration, China will account for half of all new demand for crude oil in 2011 as its total oil consumption almost doubled over the past decade (versus a 3% drop in the U.S.). The International Energy Agency estimates that total oil consumption in China, India and Brazil will surpass U.S. oil consumption by the end of this decade. Thus, solid demand for energy in these emerging economies should help support crude oil prices at a relatively comfortable level for Kazakhstan.

[1]Following debt repayments and the restructuring of external loans in 2010, foreigners' claims on Kazakh lenders shrank from $46 billion in 2007 to just $20 billion in the first quarter of 2011; meanwhile the share of liquid assets, such as cash, deposits and notes with the central bank, in total domestic assets is 23% or twice as high as at the end of 2007.

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