Kazakhstan
Macroeconomic Situation

SigmaBleyzer | THE BLEYZER FOUNDATION — Turning Transitions Into Prosperity

August 2011

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- **The economy grew by 7.1% in January-June 2011.**
- **In January-July, industry grew by 4.8% on slower expansion in mining.**
- **The state budget deficit stood below 0.5% of GDP in January-July.**
- **A draft budget envisions a reduction in the republican budget deficit to 1.3% by 2014.**
- **In July, consumer prices grew by 8.8% versus the same month a year ago.**
- **In the first half of 2011, the trade in goods surplus stood at $28.3 billion or $11.7 billion higher than in 2010.**
- **During the first eight months of 2011, Kazakhstan's forex reserves, including assets of the National Oil Fund, increased by $17 billion.**

Executive Summary

Kazakh GDP grew by 7.1% in the first half of 2011 versus 6.6% in the first quarter of this year on solid gains in the service-providing part of the economy. In fact, domestic trade has emerged as the single biggest driver of economic expansion, contributing over a quarter to overall GDP growth. Meanwhile, the role of goods-producing sectors is becoming less pronounced on slowing growth in mining and only a gradual recovery of the construction industry. In the first half of 2011, construction added just 1.5% to economic growth versus over a quarter during the peak of the building boom.

Slower expansion of the mining sector is limiting the upside potential for the economy as well. Indeed, in January-July, industry grew by 4.8% as output in mining increased by only 2.7%, significantly more slowly than during the same seven months of 2010. Meanwhile, the government expects that oil production will remain virtually flat in 2012-2013 and will resume growing thereafter, provided that there is no delay in the launch of commercial operations at the Kashagan oil filed.

Manufacturing saw smaller gains in July as well. On the upside, it is still growing on par with the precrisis trend thanks to continued recovery in metallurgy. Faster growth of capital investment in manufacturing compared to mining may partly explain this more resilient performance. For example, in January-July, fixed capital investments in manufacturing were up by 11%, while fixed capital investments in mining were 4% lower than a year ago.

That being said, reemerging worries over the health of the world economy are likely to weaken energy and metal prices – two staple commodities of Kazakh industry. This may reduce business activity in metallurgy and mining. Indeed, world oil prices fell sharply in August and remain highly volatile on lingering uncertainties over oil supply from the Middle East and concerns about the health of the world economic recovery. Still, the medium-term outlook for global commodity prices remains favorable. The convergence of energy consumption between emerging and advanced economies, as well as an increasing share of the developing economies in world GDP, will sustain global demand for oil. All of this is likely to keep oil prices on the rise when the global economic recovery regains momentum.

In the meantime, the Kazakh economy will be supported by booming consumer spending on continued increases in public sector pay, higher social welfare payments as well as the improving job market. During the first seven months of 2011, retail sales were up by 12.4% on a 15% gain in July alone. In fact, in July, the consumer sentiment index jumped to its highest level in over three years following a 30% increase of government wages at the beginning of the month. This helps sustain growth momentum in other consumer related sectors, such as passenger transportation and information. Improving consumer optimism may encourage stronger demand for housing as well. In July, home prices grew for the twelfth straight month, increasing by about 8-9% versus a year ago.

Finally, public expenditure on social welfare will continue to underpin personal consumption in Kazakhstan. After all, the budget deficit in January-July was below 0.5%, which offers sufficient fiscal space to boost spending. However, as tax revenues return to more normal growth rates, higher social spending risks widening the structural budget deficit. That being said, the government remains committed to policies that will reduce the budget deficit in the medium term – its draft 2012-2014 budget envisions a reduction of the republican budget deficit to just 1.3% in three years. In particular, as inflation abates, there is less pressure to adjust nominal social benefits, which are projected to grow significantly slower in 2012 than during 2011. As a result, the budget spending as a share of GDP is expected to stabilize at about 20%.

These fiscal projections assume that the economy will grow by close to 7% over the next three years with GDP per capita approaching $15,000 by the end of 2014. Set against the slower expansion of mining, the economy will be increasingly driven by domestic investments and personal consumption. Indeed, loose fiscal policy boosts consumption, while public investments in social and industrial infrastructure (which are projected to stay close to 4% of GDP in 2012) will help revive the role of capital spending in economic development. Lastly, the government remains firmly committed to reforms to improve the business climate and investment attractiveness of Kazakhstan, which should provide an extra boost to balanced and sustainable growth in the future.

	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%	-2.0%
Governmet external debt (including NBK), % of GDP	2.9%	1.8%	1.6%	2.4%	2.6%	2.5%
Unemployment, end of period	7.8%	7.3%	6.6%	6.6%	5.8%	5.5%
Inflation, end of period	8.4%	18.8%	9.5%	6.2%	7.8%	9%
Retail sales, % change yoy	15.0%	10.7%	3.1%	-3.9%	12.3%	-
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	147.0

Where Opportunities Emerge.

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Economic Growth

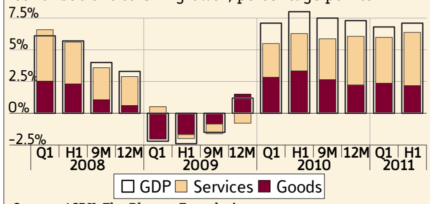
Kazakh GDP grew by 7.1% in the first half of 2011 versus 6.6% in the first quarter of this year on continued expansion in the service-providing part of the economy (see chart 1). In particular, wholesale and retail trade has emerged as the single biggest contributor to economic expansion, generating over a quarter of first half GDP growth. Meanwhile, the role of goods-producing sectors is becoming less pronounced on the back of a deceleration in mining (up by only 4.1% in the first half of 2011 versus an average annual growth rate of about 10% over the last decade) and a slow recovery of the construction industry. Indeed, over the first half of 2011, construction grew by a paltry 1.7% (compared to breakneck double digit growth at the onset of the financial crisis) and its share in GDP shrank to just 5.6% versus almost 10% five years ago (see chart 2). With construction adding just 1.5% to overall GDP growth in the first half of 2011 (versus over a quarter during the peak of the building boom), the economy is likely to grow below its precrisis trend of over 10% a year.

Slower expansion of the mining sector is limiting the upside potential for the economy as well. Indeed, the government expects that oil production remain virtually flat in 2012-2013 (see chart 3) and will resume growing thereafter, provided that there is no delay in the launch of commercial operations at the Kashagan oil filed. In fact, in January-July, industry grew by 4.8% versus over 10% a year ago, as output in mining increased by only 2.7% or twice as slow as during the same seven months of 2010. As a result, in July, the short-term economic indicator fell to its lowest level since October 2010 (see chart 4). Manufacturing saw smaller gains in July as well; yet its 8.1% growth, propped up by an 11% increase in metallurgy, remains on par with the precrisis trend - in 2002-2007, output in manufacturing grew on average by 8% a year. Faster growth of investment in manufacturing may partly explain this more resilient performance. For example, in January-July, fixed capital investments in manufacturing were up by 11%, while fixed capital investments in mining were 4% lower than a year ago. After all, both mining and manufacturing are capital-intensive industries, which rely on a steady flow of investments to sustain output gains.

That being said, reemerging worries over the health of the world economy are likely to trigger a correction in international energy and metal prices – two staple commodities of Kazakh industry. This may weaken business activity in metallurgy and mining. Indeed, world oil prices fell sharply in August and remain highly volatile on lingering uncertainties over oil supply from the Middle East and concerns about the health of the world economic recovery. On the upside, per capita energy consumption in developing nations is still well below energy use in advanced economies. China, for instance, still consumes about 5 times less energy per capita than the United States (see chart 5). As result, the convergence of energy consumption between developing and advanced economies will sustain global demand for oil. In addition, developing nations tend to use more oil to produce a unit of GDP versus advanced economies - energy intensity in China is four times higher compared to the U.S. (see chart 6). This may partly reflect less efficient use of energy as well as the smaller share of service-providing sectors in GDP, meaning that the energy intensity of emerging economies is likely to fall in the long-term. In the meantime, the increasing share of developing economies in world GDP will drive global energy demand. China is already expected to account for 60% of world crude oil consumption growth in 2011. Finally, crude oil consumption in the U.S. (which accounts for a fifth of world oil demand) is unlikely to fall as much as during the 2007-2009 recession (oil consumption in the U.S. fell by over 10% from 2007 to 2009)[1] given the limited scope for further reduction of demand. All of this is likely to keep oil prices on the rise when global economic recovery regains momentum.

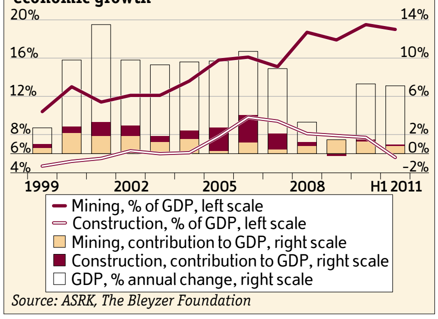
In the meantime, the Kazakh economy will be supported by booming consumer spending on continued increases in public sector pay, higher social welfare payments as well as the

Services are sustaining economic recovery 1
contributions to GDP growth, percentage points



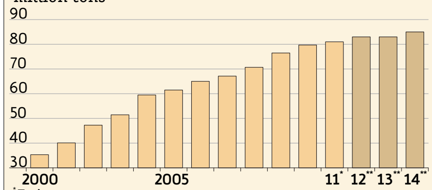
Source: ASRK, The Bleyzer Foundation

Construction is yet to regain its past role in economic growth 2



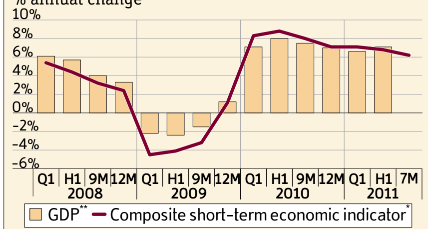
Source: ASRK, The Bleyzer Foundation

Crude oil production 3
million tons



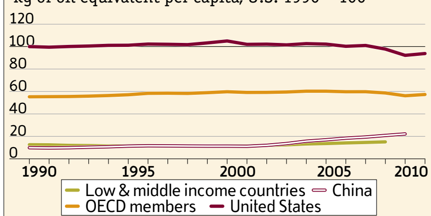
**Estimate*
***Projections from the 2012-2014 draft budget*
Source: ASRK, The Ministry of Finance

The short-term economic indicator 4
% 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

Energy use 5
kg of oil equivalent per capita, U.S. 1990 = 100



Source: World Bank, OECD

[1]Source: The U.S. Energy Information Administration.

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improving job market. Indeed, during the first seven months of 2011, retail sales were up by 12.4% on a 15% gain in July alone. In fact, in July, the consumer sentiment index jumped to its highest level in over three years following a 30% increase of government wages at the beginning of the month. And this helps sustain growth momentum in other consumer related sectors, such as passenger transportation and information. Improving consumer optimism may encourage stronger demand for housing as well. In July, home prices grew for the twelfth straight month, increasing by about 8-9% versus a year ago (see chart 7).

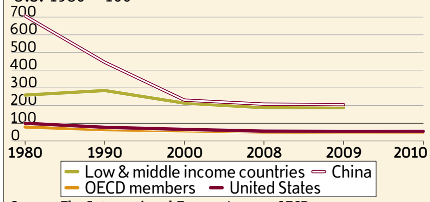
Fiscal Policy

Increasing spending on social welfare remains the principle focus of fiscal policy in Kazakhstan. Indeed, the share of education, healthcare and social security in total spending is at its highest level in nearly 10 years, reaching 54% in January-July 2011 – up from 47% three years ago. After all, with the state budget deficit in January-July shrinking below 0.5% (or three times smaller as a percentage of GDP versus a year ago, see chart 8) the government has sufficient fiscal space to boost spending in an effort to offset somewhat weaker global demand for Kazakh exports. Indeed, as corporate profits bounce back and VAT revenues surge on growing consumption, tax revenues are booming – up by nearly 50% in January-July (although a substantial portion of this gain was generated by the export duty on oil) or well above a 17% increase in budget spending.

However, as tax revenues return to more normal growth rates (see chart 9), higher social spending risks widening the structural budget deficit. In fact, a draft of the 2012–2014 republican budget envisions that budget revenues (excluding transfers from the National Oil Fund, which will still account for about 4% of GDP in 2012) will gradually shrink below 12% of GDP by 2014, implying that nominal GDP will grow faster than budget revenues. On the upside, budget spending is projected to increase at an even slower pace, with its share in GDP narrowing from about 19.5% in 2011 to below 17% in 2014. For example, minimum pensions will be raised by just 9% in 2012 compared to a 30% hike in 2011. Since government spending on pensions accounts for two thirds of all social welfare, expenditure on social benefits is projected to grow by just 10% in 2012 or twice as slow as this year. After all, previous pension increases were partly motivated by the intent to raise pensioners' living standards[2] (see chart 10). As inflation decelerates, there is less pressure to adjust nominal social benefits. Thus, on the back of slower growth of spending, the budget deficit is projected to drop to just 1.3% in three years (see chart 11).

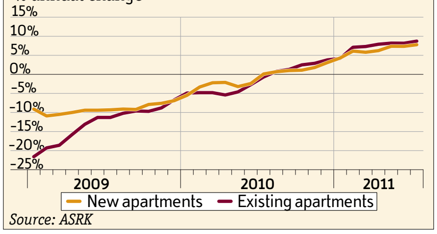
These fiscal projections assume that the economy will grow by close to 7% over the next three years with GDP per capita approaching $15,000 by the end of 2014 or 32% higher than in 2011. That said, the government's outlook for world oil prices remains rather conservative – the Brent crude oil price is expected to average $80 per barrel in 2012 and $70 per barrel in 2013 and 2014. In fact, even if GDP growth slows below 2% in the developed world over the next three years and falls to 5% in the developing economies, crude oil prices may stay above budget projections (see chart 12). Having said that, the government expects crude oil extraction to remain virtually flat in 2012 and 2013, which, together with the cautious projection of oil prices, implies that the share of exports in GDP will shrink to 34% in 2014 from over 40% this year. This means that economic growth will be driven by private consumption and investments (see chart 13). This is exactly what the government attempts to achieve with its fiscal policy. Indeed, higher social spending boosts consumption, while public investments in social and industrial infrastructure (which are projected to stay close to 4% of GDP in 2012) will help revive the role of capital spending in economic development.

Energy intensity 6
energy use per unit of GDP in constant 2000 prices, U.S. 1980 = 100



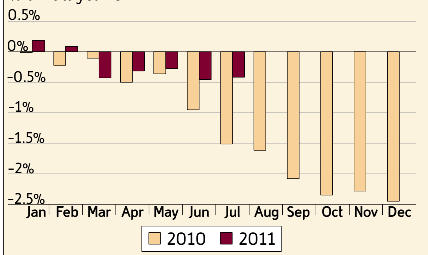
Source: The International Energy Agency, OECD

Home values are recovering 7
% annual change



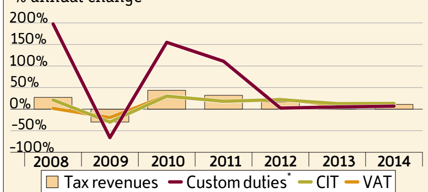
Source: ASRK

State budget balance 8
% of full year GDP



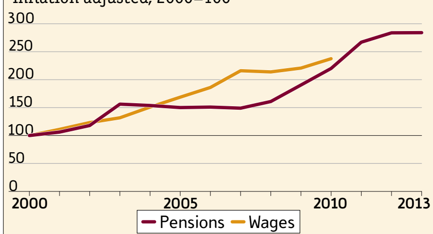
Source: Ministry of Public Finance, ASRK

Republican budget tax revenues 9
% annual change



**Kazakhstan introduced an export duty on crude oil in May 2008. It was abolished by January 2009 and reintroduced in July 2010 at $20 per ton. In January 2011, this duty was raised to $40 per ton.*
Corporate income tax (CIT), VAT and custom duties generate over 90% of all tax revenues of the republican budget
Source: Ministry of Finance

Pensions and wages 10
inflation adjusted, 2000=100



Source: NBK, ASRK, The Ministry of Finance, The Bleyzer Foundation

Lastly, the government remains committed to reforms to improve the business climate and investment attractiveness of Kazakhstan. For example, a 3-year moratorium on inspections of new small and medium businesses – the backbone of the local service-providing economy and job creation – is to be introduced in Kazakhstan. Earlier this year, the government launched an electronic service that

[2] About 10% of population receives state pensions.

allows business owners to check the status of inspections, which helps reduce corruption and prosecute inspectors demanding bribes. According to the World Bank and Transparency International, Kazakhstan already does better than most of its CIS peers (except Georgia) in terms of costs of doing business and the level of corruption. This faster pace of institutional and regulatory reforms will provide an extra boost to balanced and sustainable growth in the future.

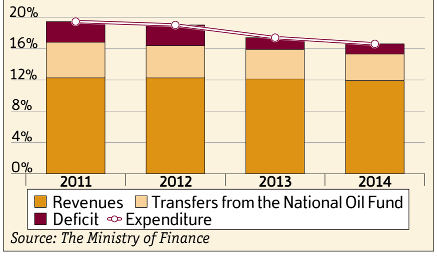
Monetary Policy

In July, consumer prices grew by 0.5% versus the month before, posting an 8.8% annual gain. Higher prices of foods (up by 12.8% compared to July 2010) continue to be the main source of inflation (see chart 14). At the same time, monetary sources of inflation, which remained relatively muted at the beginning of this year, may be gradually reemerging – money supply and domestic credit grew faster in summer, with annual growth rates accelerating in July to 16% and 10%, respectively. Recovering business activity and increasing wages may add to inflationary expectations as well. On the upside, a recent fall of commodity prices as well as a more upbeat outlook for this year's harvest[3] will help keep inflation in 2011 close to the central bank's upper target of 8%.

International Trade and Capital

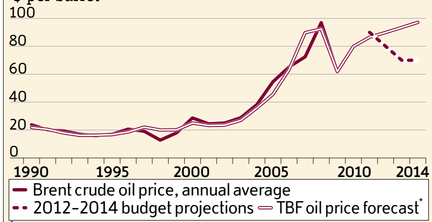
Improving economic activity and personal consumption is fueling demand for imports. Indeed, June saw the 14th consecutive annual increase of imports, although June's imports were still 15% lower than three year ago. At the same time, a much faster recovery of exports (in June, exports reached another monthly record of about $10 billion) is boosting Kazakh forex revenues – in the first half of 2011, the trade in goods surplus stood at $28.3 billion or $11.7 billion higher than a year ago. This provides an extra buffer against slower growth of foreign demand – by the end of August, Kazakhstan had $76.4 billion in forex reserves (including $40.4 billion in assets of the National Oil Fund) or $17 billion more than at the beginning of 2011.

Republican budget – 2012-2014 projections 11
% of GDP



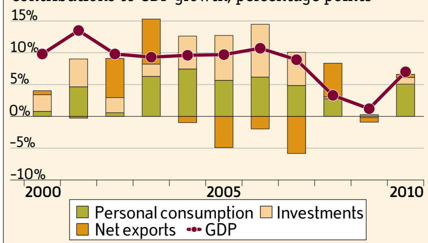
Source: The Ministry of Finance

Crude oil prices 12
$ per barrel



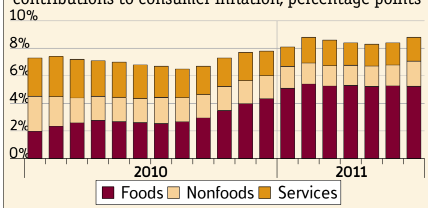
*Based on a relationship between the Brent oil price and growth rates in the advanced and emerging economies.
Source: The Ministry of Finance, The U.S. Energy Information Administration, The Bleyzer Foundation

Sources of economic growth 13
contributions to GDP growth, percentage points



Source: ASRK, The Bleyzer Foundation

Sources of inflation 14
contributions to consumer inflation, percentage points



Source: ASRK, The Bleyzer Foundation

[3]According to the Ministry of Agriculture, this year's grain harvest is expected to total 19 million tons or 55% higher than a year ago.