

# The Good, the Bad and Where the Kazakh Economy is Heading To?

2009 was a hard year for export-reliant Kazakhstan. With commodity prices much lower than in the pre-crisis times, the Government of Kazakhstan had to adjust the economic policy accordingly. Strong government support and a thorough package of anti-crisis measures laid foundation for recovery, and now, with the global economic situation continues to improve, the economy of Kazakhstan economic development gains momentum. There are, however, some challenges yet to be addressed to facilitate sustainable long-term growth.

**Dominic Lewenz**, Director Oil and Gas Research at Visor Capital in Kazakhstan and **Jean-Christophe Lermusiaux**, Managing Director and Head of Research, share their opinion on the present state and future prospects of the country's economy.

**What tasks does the Kazakh Government see as the priority ones for supporting economic growth in the country? What are the main problems and challenges at present?**

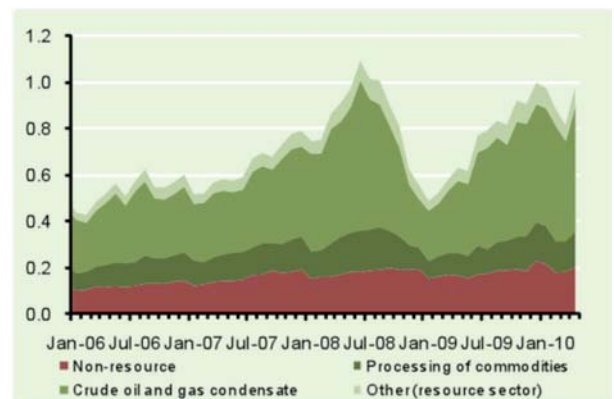
With an 80% share of national industrial production, and over 90% share in exports, continued development of the commodities sector remains a priority for Kazakhstan. The main drivers of the oil sector are several key projects like Kashagan, where the pace of development is partly driven by factors exogenous to the country.

The key local development challenges are likely to be political, administrative including sanctity of contract and tax stability, agreement on routes of hydrocarbon export, speed of administrative or regulatory approvals, and the availability of suitable labour and materials. Providing Kazakhstan can continue to achieve its goals, and commodity prices remain supportive, Kazakhstan can expect overall

continued strong growth. While facilitating Kazakhstan's rapid growth and development, the commodity sector has also caused difficulties associated with both the pace of its development, and the lack of diversification in the economy. In fact, in our view, the Government often exerts even more effort towards tackling these imbalances than it does to the primary projects. One of the earliest successes in this regard was the establishment of an oil fund, which attempts to reduce potential cyclical impacts of reliance on commodities markets.

The Government has, therefore, also set a goal of diversifying the economy, and encouraging the industrial sector. It is important to understand that, despite

**Industrial production by sector (KZTtr/m)**

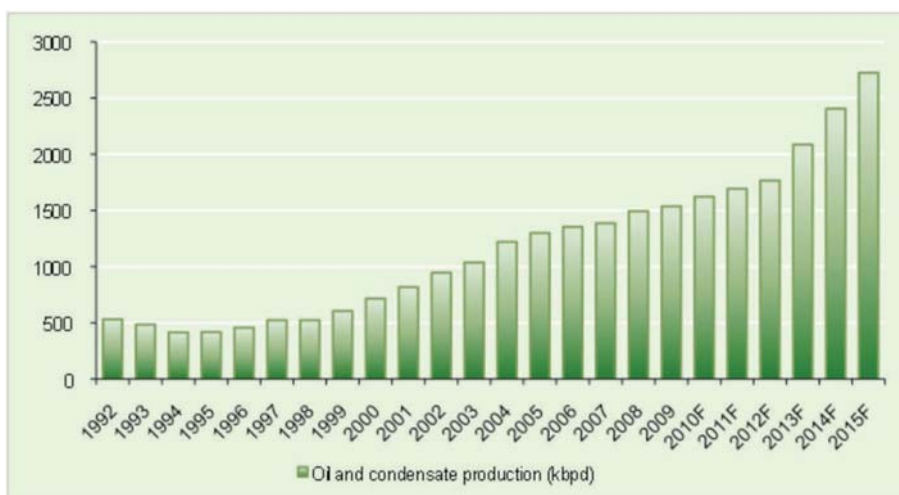


Source: Kazakhstan Statistical Agency, Visor Capital estimates

being the principal driver of GDP growth in Kazakhstan, the oil industry is not a large employer relative to its share of GDP. A vibrant industrial sector could also decrease the country's dependence on imports, and decrease sensitivity of Government tax revenues to commodity prices. The principal mechanism to support the development of the manufacturing sector has been the adoption of its *Accelerated Industrialisation Programme*, which partially focuses on targeting development of the resource processing sector, including the production of industrial goods. Industry currently employs 650k people out of the total labour force of ca 7.6m. One of the key tools in promoting this rebalancing of the economy has been the Government's moves to increase the share of the tax burden in recent years for the commodities sectors and away from other sectors.

Other key supply-side constraints that affect both the development of the commodity and industrial sectors of Kazakhstan, relate to its relatively small population of 16m people. We think that a relative lack of experience in the key oil & mining sectors, in addition to

**Kazakhstan's oil production (1992-2015F) (kbpd)**



Source: National dispatching office, Visor Capital estimates

limited success in educating sufficient numbers of technical specialists, presents a challenge. Other issues typical of emerging economies include a lack of infrastructure, sometimes opaque decision making, and a lack of domestic long-term investors.

**Reliance on the raw materials export: what risks does it bring for Kazakhstan's economic stability?**

Even if the Government is successful in its diversification efforts, the expected expansion of the oil and mining industries over the next decade is expected to ensure the extractive industries remain the dominant sector. With commodities taking a 90% share of exports, Kazakhstan's Government finances and the macroeconomic environment are highly reliant upon the price of a few key products, particularly oil, which accounts for 75% of exports. A further 15% of exports come from the even-more-volatile metals sector.

The reliance upon such volatile commodities inevitably brings risks, problems and issues for the macroeconomy, including Government financing, currency and balance of payment problems, inflation, asset bubbles, Dutch disease, and potential sharp swings in employment patterns during recessions.

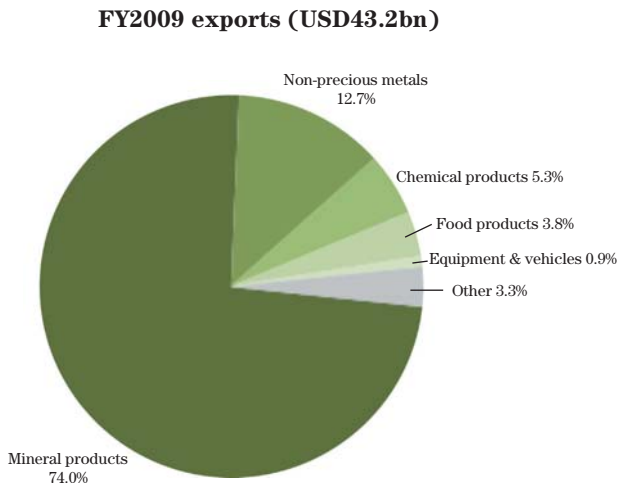
Such problems are not unique to Kazakhstan, which has aimed to copy best practices of countries like Norway. Kazakhstan's key policy tool, the National Oil Fund, is a Norwegian-style reserve that helps smooth out some of the cyclical gyrations and to sterilise some of the inflation problems. Nonetheless, problems are still likely to hit the wider economy. For example, the boon in oil prices from 2005 helped to stoke property bubbles in Almaty and Astana.

More positively, Kazakhstan has produced strong macroeconomic indicators in recent years, despite a substantial banking crisis and a 38% drop in the average oil price in 2009. The Government was able to offset these problems by using reserves from the National Fund, and through the strength of the commodity sector, highlighted by 9% oil production growth. Aside from the macro factors, regional

factors are particularly important in Kazakhstan because of the country's sparsely distributed population. Small regions or cities are often tied to one company or product, leaving them potentially exposed to acute effects when a specific product market declines.

funds and commercial banks, with residual amounts coming from abroad. Kazakh pension funds have historically been one of the main buyers of local sovereign debt, with ca USD2.0bn of new funds for the domestic market per annum. In addition, commercial banks have increasingly become important

investors for Government bonds due to a situation of excess liquidity at certain banks that have not been lending due to persistent concerns over loan quality of borrowers. These factors allow the Government to borrow inexpensively. The demand of commercial banks (which now accounts for 50-80% of Government bond sales) has contributed to a significant decline in Government bond yields – to 2.0% for 1-year bonds, and to 6.0% for long-term bonds.



Source: Visor Capital based upon data from Statistical Agency of Kazakhstan

**Kazakhstan budget: how the deficit will be financed? What measures the Government plans to take to solve the deficit problem? What is the situation with the reserves?**

Based upon most international measures, Kazakhstan is currently in a position of budget surplus. Using Ministry of Finance data, we estimate that Kazakhstan's YTD consolidated budget (incorporating National Fund revenues, national, and regional budgets' revenues) showed a net surplus of USD1.2bn or around 2.2% of GDP in 1H2010.

As the Government excludes National Fund revenues in its definition however, we estimate that of the USD12.7bn in revenues from the resource sector, around 37% are likely to remain in the National Fund, even after the annual fiscal transfer to the state budget. As no significant moves to reduce spending have been made, and taxes increased only on the oil sector this year, we expect the Kazakh Government to have a primary budget deficit of ca USD4.7bn in FY2010, to be funded from borrowings.

We believe that the majority of these funds will come from internal borrowing, principally from the pension

We note that the Ministry of Finance recently announced that the Government had abandoned its plans to issue USD500-700m Eurobonds in FY2010, which we attribute to increased confidence the debt can be financed domestically, given the excess liquidity in certain Kazakh banks. The Government retains other options, such as potentially increasing transfers from the National Fund to the Budget, or Sovereign borrowing from Russia, China or elsewhere.

We expect long-term growth from commodities to continue to drive Government revenues higher. The Government has also announced that it intends to reintroduce a Customs Export Duty on oil from August 2010 and on metals from 2011. Unlike the majority of oil taxation, such revenues would go directly to the Ministry of Finance, bypassing the National Fund. The Government expects the duty to raise KZT60bn (ca USD408m) for the budget in 2010, and KZT177bn (ca USD1.2bn) in 2011. We note that the revenue from this measure is still subject to some uncertainty due to the potential for legal disputes, and lack of clarity on how it will be imposed on the mining sector.

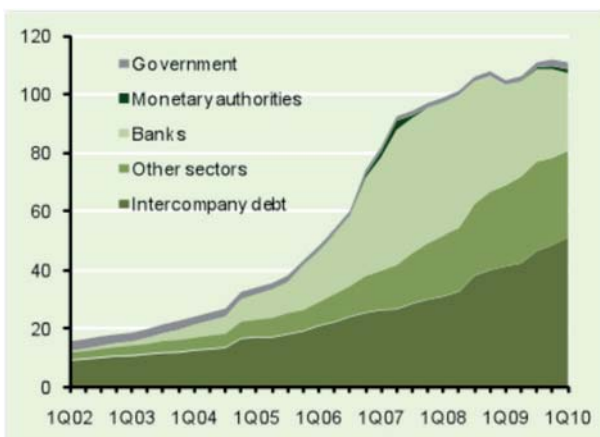
The return to health of commodity markets has allowed Kazakhstan to continue to add to overall reserves, particularly through its oil fund. As can be seen in the chart below, with reserves of USD54bn, we believe Kazakhstan remains in a strong position.

**Kazakhstan's foreign reserves (USDbn)**



Source: Visor Capital based upon data from the National Bank of Kazakhstan

**External debt of Kazakhstan (USDbn)**



Source: Visor Capital based upon data from the National Bank of Kazakhstan

**The Kazakh Government is expected to continue to remain the country's main infrastructure investor. How these investments will be financed and what sectors will be the priority ones for investments?**

We expect Kazakhstan to continue to invest substantially into infrastructure. However, as some of Kazakhstan's biggest projects are pan-regional, much of the funding comes from abroad, particularly from international institutions and Chinese sources, and is usually given on favourable terms. For example, for the Kazakhstan section

of the *Western Europe – Western China* road, the Government plans to borrow funds from abroad. The total cost of Kazakhstan's part of the project is USD5.6bn, of which the principal part (USD2.9bn) of the funds is being provided by international institutions:

from the International Bank for Reconstruction and Development (USD2.1bn); EBRD (USD180m); Asian Development Bank (USD527m); and Islamic Development Bank (USD170m). An additional USD1.9bn is expected to come from private investors, with only USD920m from Kazakhstan's Budget. We understand, the Government is already close to signing loan agreements for USD660m of this amount in 2010.

The one sector to fall outside this general pattern has been in oil and gas, where China has paid for the bulk of pipelines travelling east, whilst western oil majors put up the bulk of routes heading west. Other infrastructure investment (for example in power generation and distribution) is expected to come from the Government's overall budget.

**Has the situation in the banking sector improved? What are the main challenges at present? How soon will the banks be able to resume operations at the pre-crisis level?**

While there have been some positive developments in terms of the successful debt restructurings of major banks, and rising liquidity levels at stronger banks, we have not seen strong evidence of a broad and balanced recovery of the banking sector of Kazakhstan.

After the crisis of the late 1990s, Kazakh banks grew with a CAGR of over 50% until 1H2007. The later part of that growth was largely fuelled by

international wholesale funding markets, which helped to finance a significant real estate bubble in Astana, the capital, and Almaty, the main financial hub and largest city.

The Kazakh banks suffered quickly and acutely when foreign debt markets began to freeze due to the subprime crisis. After the world crisis deepened in 3Q2008, and the real estate bubble had substantially deflated, the Government injected capital into the four largest banks to prevent further problems.

Despite the successful Government interventions, overdue amounts continue growing, indicating continued problems with asset quality. While there have been signs of improving credit quality stability at certain banks, much of the sector appears to be getting worse. Fresh monthly lending remains at ca 20% of peak volumes in mid-2007, with no substantial growth in the sector's loan portfolios. In our view, this stagnation suggests not only that peak lending was too high for the size of non-resource part of Kazakhstan's economy in 2005-2007, but also that banks currently remain fearful about credit quality. We do not expect a return to pre-crisis activity levels in the medium term.

Kazakh banks generally have little direct exposure to the parts of the economy that have recovered the most: oil & gas, and metals & mining. While that may sound unfortunate, it makes a lot of sense, because the banks do not want to be taking exploration risks, which is often the capital constrained portion of these sectors. Resources companies with production on the other hand, present a source of cash, placing their excess liquidity into the banks.

However, when they need to borrow, many of these companies can tap cheaper international debt markets. This has meant the banks are more exposed to the parts of the economy for which the recovery has been slower, with the most troublesome segment being construction and real estate, in the aftermath of the real estate bubbles in the largest cities.

Now, with the last of three banks expected to emerge successfully from debt restructuring by September, and the macroeconomic recovery well under way, the sector appears ready to move in the right direction. As this sector has been a drag on the overall economy, such a move could prove to support even further macroeconomic growth.