Rabobank

Country report

KAZAKHSTAN

Summary

Kazakhstan's economy is recovering steadily and posted 7% growth in 2010. The main problems in the banking sector have been dealt with, but the sector remains a major weakness nonetheless. Kazakhstan's government finances remain one of the country's strengths, although government stimulus has led to increased budget deficits and public debt. The government's attitude towards investors is a concern, as is corruption. External debt is declining on the back of the banking sector's reduced external borrowing. The current account has improved on the back of higher international oil prices. President Nazarbayev has won April's snap elections, after failing to secure a term until 2020. However, Nazarbayev is 70 years old and no clear successor has been appointed. As a result, political unrest may increase when he is no longer able to fulfil his tasks.

Things to watch:

- International oil price fluctuations
- Economic diversification efforts
- Banking sector recovery

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Kazakhstan

National facts	
Type of government	Republic
Capital	Astana
Surface area (thousand sq km)	2,724
Population (millions)	16.0
Main languages	Russian (95%)
	Kazakh (64%)
Main religions	Muslim (47%)
	Russian orthodox (44%)
	Protestant (2%)
Head of State (president)	Nursultan A. Nazarbayev
Head of Government (prime-minister)	Kamir Masimov
Monetary unit	tenge (KZT)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	138	0.22
Nominal GDP at PPP	196	0.26
Export value of goods and services	64	0.34
IMF quotum (in mln SDR)	366	0.17
Economic structure	*2010*	*5-year av.*
Real GDP growth	7.0	6.8
Agriculture (% of GDP)	5	6
Industry (% of GDP)	34	32
Services (% of GDP)	56	56
Standards of living	*USD*	*% world av.*
Nominal GDP per head	8418	86
Nominal GDP per head at PPP	11933	102
Real GDP per head	4691	59

Social and governance indicators	rank / total
Human Development Index (rank)	66 / 169
Ease of doing business (rank)	59 / 183
Economic freedom index (rank)	78 / 179
Corruption perceptions index (rank)	105 / 178
Press freedom index (rank)	162 / 178
Gini index (income distribution)	30.92
Population below $1.25 per day (PPP)	2%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
China	17	Russia	37
Italy	16	China	13
France	7	Italy	5
Russia	8	Germany	6
Main export products (%)			
Mineral products			75
Metals			13
Chemicals			5
Food products			3
Main import products (%)			
Machinery & equipment			39
Chemicals			14
Mineral products			14
Metals			12
Openness of the economy			
Export value of G&S (% of GDP)			46
Import value of G&S (% of GDP)			30
Inward FDI (% of GDP)			7.5

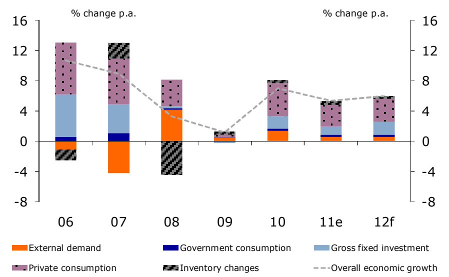
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Kazakhstan is geographically the largest of the former Soviet republics (save Russia) and the largest economy in Central Asia. With a nominal GDP of USD 138bn and 16 million inhabitants, GDP per capita amounts to USD 8,406. As such, Kazakhstan is classified as an upper middle income country by the World Bank. Kazakhstan's economic welfare is mainly derived from the country's vast endowment of natural resources, such as hydrocarbons and numerous types of minerals. Kazakhstan's economy is therefore highly dependent on extractive industries and on the oil sector in particular, which accounts for 60% of total exports and more than 25% of GDP. On the one hand, Kazakhstan's oil reserves will provide the country with income for years to come. Oil production is expected to double from today's level when the Kashagan Caspain Sea oil field comes online between 2015 and 2020. On the other hand, however, the wellbeing of the economy therefore hinges on developments in international commodity (oil) markets, leaving the country vulnerable to external shocks. Moreover, diversification efforts are undermined by symptoms of Dutch disease, which makes the non-oil and gas tradable sectors uncompetitive internationally. Also, a weak infrastructure and unreliable energy supply undermine the country's economic potential. The agricultural sector's contribution to GDP is relatively small (5% of GDP), but in terms of employment the sector is important, as nearly 30% of the labor force works in the agricultural sector. Industry contributes a relatively large 43% to GDP while the services sector accounts for the remaining 52%.

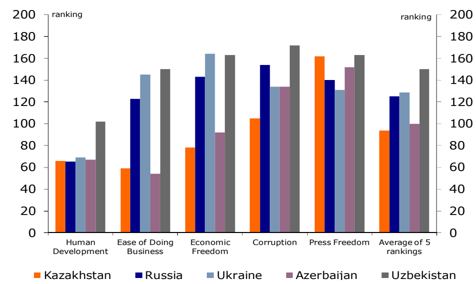
The global credit crunch and subsequent economic downturn worldwide strongly and negatively affected Kazakhstan's economy, as capital inflows slowed drastically and international oil prices plummeted. Banks' balance sheets weakened as a result of the economic slowdown and problems on the real estate market, combined with a strong devaluation of the tenge that strongly increased the banking sector's external debt burden in tenge terms. A large fiscal support program, amounting to some 7.5% of GDP, supported the banking sector and measures were taken to support economic activity as well. As a result, a positive growth rate (1.2%) could be maintained in 2009. In 2010, Kazakhstan's economy recovered mainly on the back the global economic recovery and resulting higher commodity prices, although ongoing government stimulus and investment also added to the recovery. Fixed investment and private consumption rebounded and grew by 7% and 7.5% last year, respectively, and the external sector contributed positively to growth again. In all, Kazakhstan's economy grew 7% in real terms last year. In the coming years, increasing oil, gas and mineral output, and the government's investment program will continue to support growth. However, at the same time, economic activity will be subdued by nearly stagnating credit growth as the banking sector remains weak. As a result, economic growth is expected to fall to between 5 and 6 percent in the coming years.

Chart 1: Growth performance



Source: EIU

Chart 2: Social indicators



Ranking: a higher ranking implies a worse performance. Source: see factsheet

The banking sector experienced major problems during the global economic downturn and continues to be one of Kazakhstan's major weaknesses. With the banking sector borrowing heavily abroad while exposure was concentrated in the nontradables sector, the reduction of foreign capital inflows led to a domestic credit crunch at a time that the domestic economic environment was weakening. As the banking sector's weaknesses were exposed, three major banks needed restructuring (BTA, Alliance and Temir) and the country's national development agency, Samruk-Kazyna, took equity stakes in four large banks. The price for foreign creditors was high, as they had to accept a major haircut. The restructuring effort, the government support (including a USD 9bn capital injection and USD 4bn in refinancing and loan support programs), a more stable exchange rate and the economic recovery have supported the banking sector since and, at the moment, signs of stabilization are visible. Even so, total non-performing loans (NPLs) remain high, reportedly at 26% of total loans in November last year, and credit conditions remain weak, as annual credit growth remained marginal at 7% in 2010 and an expected 9.6% in 2011, compared to 65% in 2008. Further government support seems unnecessary though, as the banking system's capital adequacy ratio is around 18% (not taking into account the restructured banks) and provisions are relatively sound at 17.2% of the loan stock. In addition, the banking sector's domestic deposit base has strengthened following an increase of public sector deposits (amounting to 20% of total liabilities) and a contraction of lending in foreign currency. In October 2010, the share of foreign currency lending fell to around 53% of total loans. However, to structurally reduce the financial sector's vulnerabilities, which include risky lending practices and weak governance, regulation and supervision have to be improved.

Political and social situation

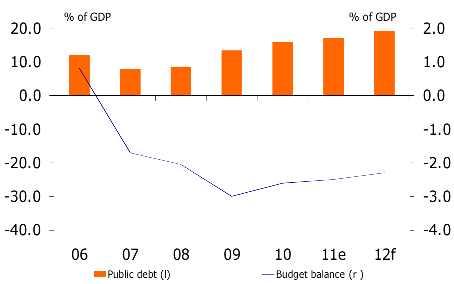
President Nursultan Nazerbayev is the first and only ruler of Kazakhstan since the country became independent from the USSR in 1991. In the past 20 years, Nazarbayev has solidified his power base and, through changes of the constitution, established an authoritarian political regime that effectively guarantees his rule forever. Political opposition is weak and support for Nazarbayev in Kazakhstan's parliament is very strong, as exemplified by the fact that it has given Nazarbayev the title "Leader of the Nation" (which exempts him from legal prosecution for life) in June last year. However, Kazakhstan's authoritarianism differs somewhat from that in neighboring countries such as Belarus and Uzbekistan, as it relies less on coercion and allows for some (economic) freedom. However, press freedom is strictly limited, reflected by the press freedom ranking of 162 (out of 178 countries), and corruption remains a major problem with Kazakhstan ranking 105th out of 178 countries on Transparency International's corruption perception index. An "independent" group of citizens tried to propose a referendum that would allow Nazarbayev to remain in office until 2020, thereby circumventing two elections. While 55% of the electorate supported this proposal, it was deemed unconstitutional by Kazakhstan's Constitutional Court. In response to the decision, Nazarbayev brought forward the upcoming presidential elections, which had been scheduled for December 2012, to April 2011. As expected, Nazarbayev secured a victory with more than 90% of the vote and extended his rule until 2016. With Nazarbayev at the helm, Kazakhstan's political environment has been very stable in the past decades and this will remain as long as he is in change. The recent unrest in the Middle-East has not spilled over into Kazakhstan and the risk that it will do so in the future seems small. Succession, however, is a potentially large problem. Nazarbayev is 70 years old and there is no clear successor. This is partly due to the fact that Nazarbayev himself seems oblivious to the problem, as he stated he will run again in the 2016 elections. However, with no clear successor, an untimely death of the Leader of the Nation could lead to increased political instability, as it may lead to infighting amongst the Kazakhstani elite. The importance of China in Kazakhstan's international relations has increased in the past years, particularly after the global economic downturn, and maintaining good relations with China is currently a top-priority in Kazakhstan's foreign policies. Both countries stand to benefit, as China is willing to invest heavily in Kazakhstan to secure access to its energy reserves while Kazakhstan wants to secure new export routes. Economic links to Russia will also remain strong as a result of the customs union between Kazakhstan, Belarus and Russia, which has been in place since January 2010 and will expectedly lead to a single economic space by early 2012. WTO accession is being pursued, but will also depend on the progress regarding WTO membership of the other customs union members, although each country is negotiating its membership with the WTO separately.

Economic policy

Kazakhstan's economic policies are rather prudent and the government finances are one of the country's strengths. However, the government's attitude towards foreign investors and creditors is cause for concern, which reflects negatively on the business climate, as there have been many examples in which foreign investors and creditors were left in the cold in times of trouble. Foreign creditors were forced to accept a large haircut during the restructuring of the banking sector, despite earlier statements that this would not be the case. In addition, Kazakhstan's government has taken a tougher stance towards foreign oil companies in recent years, making use of environmental laws to force them to accept changes to earlier agreements. An export duty on crude oil and petroleum products was reintroduced mid-2010 (the initial duty introduced in May

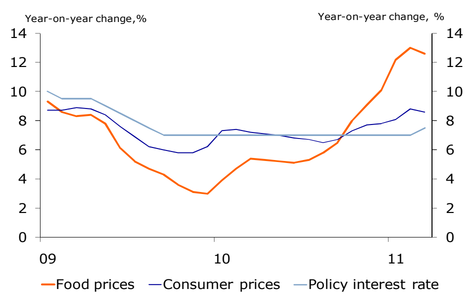
2008 was set at zero in January 2009). Besides increasing government revenues from the oil and gas sector, the new approach is also meant to force oil companies to contribute to Kazakhstan's diversification drive, forcing them to cooperate with the government's industrialization program and requiring them to use more local labor. In March 2011, the government adopted a law that details the procedure for nationalization of property. The law states that this can only be done in case of a threat to national security and that any actions taken by the state in this regard will be on a non-discriminatory basis and prompt and adequate compensation will be made. However, given Kazakhstan's authoritarian political environment, there is a risk that these law will be used arbitrarily.
As the oil and gas sector was developed in the past decade, Kazakhstan's government has seen a dramatic increase of government revenues from the oil and gas sector. These currently account for around 40% of total government income. At the same time, expenditures remained more or less steady around 22% of GDP, except in 2005 and 2007 when expenditures increased to nearly 27% of GDP. The extra oil-related income was used to lower public debt and to build up the National Oil Fund (NFRK). The NFRK was set up in 2000 to reduce the economic impact of volatile oil prices and to save part of Kazakhstan's oil income for future generations. It holds around USD 30bn in assets (end-2010), all of which are invested abroad. In response to the economic slowdown in 2009 and problems in the domestic banking sector, the government implemented a large support program for the banking sector, tax cuts for the non-extractive industry and increased expenditures on pensions, public sector wages and social benefits. The total fiscal support effort is estimated at 4.5% of GDP (7.5% of GDP when off-budgetary spending is taken into account), partly financed by drawing on the NFRK and partly by increased public debt. The fiscal support in combination with lower revenues led to a widening of the budget deficit from 2% of GDP in 2008 to 3% of GDP in 2009, while public debt increased from 9% of GDP in 2008 to 16% of GDP in 2010. A gradual improvement of the fiscal balance, as expenditures will continue to grow steadily while revenues will increase more rapidly on the back of relatively strong GDP growth, is estimated to lead to a balanced budget by 2014. Public debt, meanwhile, will increase to nearly 20% of GDP by 2013 before starting to decline thereafter.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation



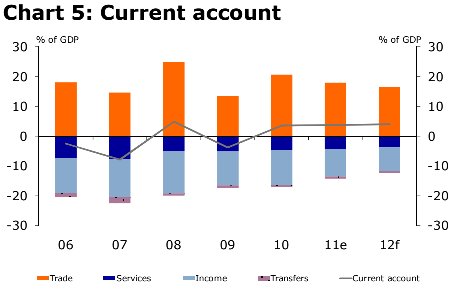
Source: Reuters EcoWin

Inflation fell sharply during the global economic downturn, from a very high 17% in 2008 to slightly over 7% in 2009 and 2010, as falling demand and lower commodity prices reduced price pressures. This allowed the National Bank of Kazakhstan to embark on a monetary easing cycle to support the economy. Interest rates were lowered to 7% by September 2009 and remained equal in the following 18 months. However, rising food and fuel prices are now starting to push up inflation. In February 2011, inflation accelerated to 8.8% year-on-year and the central bank responded the first rate increase in three years, raising the policy interest rate by 50bp to 7.5%. Inflation is expected to peak in 2011 at 8.5% before easing to around 6% in 2012. In spite of officially abandoning the trading corridor of the tenge, the central bank's exchange rate policies are still aimed at maintaining a stable exchange rate of the tenge vis-à-vis the US dollar. The downside, however, is that dollarization is high at 43% (in 2009). Following sustained downward pressure on FX-reserves, the central bank devalued the tenge by around 20% from 120 KZT/USD to nearly 150 KZT/USD in 2008. At the moment, however, there is an appreciating pressure on the tenge, as the global recovery and higher oil prices have improved market sentiment towards Kazakhstan's currency. As inflation has increased, the central bank is allowing some appreciation to help reduce imported inflation, and the tenge is expected to appreciate to slightly below 140 KZT/USD by 2012 as a result. A structurally more flexible exchange rate would benefit Kazakhstan, as this would help to absorb external shocks and enhance the effectiveness of monetary policies. Given the current dependence of Kazakhstan's economy on the oil and gas sector, economic diversification is important to guarantee sustainable economic development in the (very) long term. In this regard, the government is implementing a broad economic development program intended to improve the country's infrastructure and develop the non-oil sector. In 2010 alone, around USD 10.5bn will be spent on 200 projects and a total of USD 55bn will have been spent by 2020. Main sectors targeted under diversification program are pharmaceuticals, telecommunications and petrochemical and food processing.

Balance of Payments

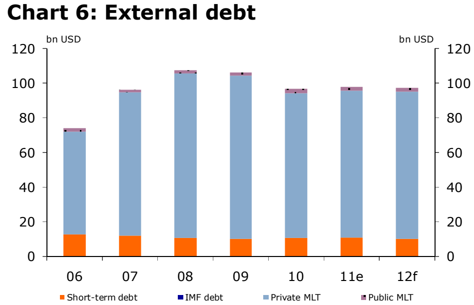
Supported by commodity exports, which account for nearly 90% of total exports, Kazakhstan's trade account generally shows a large surplus of between 14 and 20 percent of GDP. As trade decreased strongly in 2009, the trade surplus narrowed to USD 15bn (13.6% of GDP), which pushed the current account back into a deficit. In 2010, on the back of an improved external backdrop exports rebounded strongly and the trade surplus widened to USD 29bn (20.6% of GDP). In the coming years, the trade surplus is expected to continue to hover around USD 30bn, but will decline as a percentage of GDP (to around 16.5% in 2012) as nominal GDP increases. In spite of the substantial trade surplus, the balance on the current account is subdued by large deficits on the services and income accounts due to the many foreign companies that are active in Kazakhstan. After the current account deficit of 3.8% of GDP in 2009, it recovered in line with the trade surplus and registered a surplus of 3.7% of GDP in 2010. In the coming years, the current account will show a steady surplus of around 4% of GDP.

Chart 5: Current account



Source: EIU

Chart 6: External debt



Source: EIU

FDI inflows slowed in the past years, as Kazakhstan's economic outlook deteriorated, from nearly USD 16bn in 2008 to around USD 10bn in 2010. At the same time, outward direct investment increased. As a result, net investment inflows decreased sharply from USD 15bn in 2008 to only USD 2.8bn in 2010. A recovery of net investment inflows to around USD 12bn is foreseen by 2012, as investor confidence returns slowly and the second stage of the Kashagan Caspain Sea oil field will start to be developed. Meanwhile, the strong net portfolio outflow seen in the years before the global economic downturn slowed from USD 15bn in 2007 to USD 2.5bn in 2010, and even turned into a net inflow briefly in 2009, but will increase steadily again in the coming years. The problems in the banking sector, a heavy external borrower, is reflected in the amount of debt inflows. Whereas a strong net debt inflow of nearly USD 15bn was registered in 2008, this amount fell sharply to around USD 3.4bn in 2009 and 2010. A small net debt outflow is anticipated in the coming years, as foreign liabilities of the banking sector are further reduced. In the coming years, FDI inflows, with those originating from China expected to grow in importance, and bilateral government lending will support the capital account in the coming years.

External position

Even though external debt is currently below its peak of USD 107bn in 2007, total external debt, consisting mainly out of private sector debt, was still relatively high at nearly USD 96bn (70% of GDP) in 2010. Only around 10% of the total external debt is short-term debt, but the debt service ratio is nonetheless rather high at 45% of current account receipts. However, Kazakhstan's external position is not an immediate reason for concern. FX-reserves are large, amounting to USD 25bn in 2010 and are expected to increase to USD 32bn by end-2011. The reserves cover 100% of debt service due and 8.6 months of imports in 2011. Moreover, Kazakhstan's liquidity ratio is sound at 126% in 2010 and an estimated 132% by end-2011.Furthermore, these figures do not take into account the foreign currency saved in Kazakhstan's National Oil Fund, which amounted to an estimated USD 30bn end-2010.

Kazakhstan

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	10.7	8.9	3.3	1.2	7.0	5.4	6.0
Consumer prices (average % change pa)	8.6	10.8	17.1	7.3	7.1	8.4	6.2
Current account balance (% of GDP)	-2.5	-8.0	4.9	-3.8	3.6	3.8	4.0
Total foreign exchange reserves (mln USD)	17751	15777	17872	20720	25239	32410	35060
Economic growth							
GDP (% real change pa)	10.7	8.9	3.3	1.2	7.0	5.4	6.0
Gross fixed investment (% real change pa)	29.7	17.4	1.0	-0.8	7.0	5.0	7.5
Private consumption (real % change pa)	12.7	10.9	6.3	0.6	7.7	4.8	5.2
Government consumption (% real change pa)	7.8	14.6	3.5	4.0	4.0	3.6	4.5
Exports of G&S (% real change pa)	6.5	9.0	0.7	-11.6	9.5	6.5	7.4
Imports of G&S (% real change pa)	12.2	25.9	-11.5	-16.0	6.5	6.0	7.5
Economic policy							
Budget balance (% of GDP)	0.8	-1.7	-2.0	-3.0	-2.6	-2.5	-2.3
Public debt (% of GDP)	12	8	9	13	16	17	19
Money market interest rate (%)	4.8	6.0	6.5	2.4	1.4	3.3	3.2
M2 growth (% change pa)	77	24	29	19	22	21	12
Consumer prices (average % change pa)	8.6	10.8	17.1	7.3	7.1	8.4	6.2
Exchange rate LCU to USD (average)	126.1	122.6	120.6	147.5	147.4	143.4	138.2
Recorded unemployment (%)	7.8	7.3	6.6	6.3	5.5	4.2	5.2
Balance of payments (mln USD)							
Current account balance	-1999	-8226	6596	-4248	4953	6260	7580
Trade balance	14642	15091	33519	15159	28499	30010	31110
Export value of goods	38762	48351	71971	43972	59405	63390	66100
Import value of goods	24120	33260	38452	28813	30906	33390	34990
Services balance	-5942	-8072	-6616	-5778	-6507	-7080	-7180
Income balance	-9491	-13086	-19323	-12729	-16090	-15500	-15060
Transfer balance	-1207	-2160	-985	-900	-949	-1160	-1300
Net direct investment flows	6663	7968	14783	9525	3063	10350	12350
Net portfolio investment flows	-10720	-14827	-9013	2549	-2511	-3200	-4520
Net debt flows	30254	20452	10568	3319	3432	-410	-280
Other capital flows (negative is flight)	-12140	-6864	-20692	-7797	-3868	-5580	-12540
Change in international reserves	12057	-1498	2243	3348	5070	7420	2590
External position (mln USD)							
Total foreign debt	74230	96347	107595	106406	96679	97730	97210
Short-term debt	12661	11959	10637	9982	10684	10650	9820
Total debt service due, incl. short-term debt	22683	40184	45394	30942	30218	32460	32210
Total foreign exchange reserves	17751	15777	17872	20720	25239	32410	35060
International investment position	-28965	-44317	-39674	-44084	n.a.	n.a.	n.a.
Total assets	59426	77611	92444	96586	n.a.	n.a.	n.a.
Total liabilities	88391	121928	132118	140670	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	18.1	14.6	24.8	13.6	20.7	18.0	16.5
Current account balance (% of GDP)	-2.5	-8.0	4.9	-3.8	3.6	3.8	4.0
Inward FDI (% of GDP)	7.8	10.8	11.7	11.3	7.7	7.7	7.6
Foreign debt (% of GDP)	92	93	80	95	70	59	51
Foreign debt (% of XGSIT)	169	171	133	206	145	138	129
International investment position (% of GDP)	-35.8	-43.0	-29.4	-39.6	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	52	71	56	60	45	46	43
Interest service ratio incl. arrears (% of XGSIT)	5	7	5	7	4	3	3
FX-reserves import cover (months)	6.5	4.2	4.3	6.4	7.2	8.6	8.9
FX-reserves debt service cover (%)	78	39	39	67	84	100	109
Liquidity ratio	118	94	108	116	129	134	139

Source: EIU