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## **Kazakhstan: On track of steady recovery**

Kazakhstan's economy bounced off in the fourth quarter of 2009, which allowed the country to avoid recession and reach 1.2% real GDP growth that year. In the first quarter of 2010 the recovery continued and the economy grew by an astonishing 7.1% year-on-year (y-o-y). The biggest contributions to growth were made by manufacturing (18.7% growth y-o-y), mining (7.8%), and wholesale and retail trade (11.5%). At the same time, value-added continued to drop in financial services (-21.5%), construction (-8.7%), and the hotels and restaurants sector (-4.5%). The major factors behind the growth speed-up are increased commodity prices at the world markets and reviving internal demand (which is reflected in the growth of retail trade).

The oil sector will continue to be the most important source of growth during the forecast period as Kazakhstan plans to increase oil production and world demand is expected to be high. We forecast that in 2010, exports will grow by 34% in EUR terms, thus to a large extent offsetting the previous year's plunge by 36%. In 2011-2012, export growth will be moderate, as we do not envisage a significant surge of oil prices during this period.

Yet, we expect that internal demand will contribute increasingly more to the growth. We forecast that household consumption will grow by 3% in 2010 (after a 3% decline in 2009), and growth will speed up in the next years. The factors behind this trend will be faster growth in wages with a revival of the economy and an increase in public wages and social expenditures envisaged by the government (for example, starting from 1 April 2010, salaries of civil servants and students' scholarships were increased by 25%; the government plans to increase financing of active labour market policies). First signs of a revival of domestic demand can be seen in the improvement of consumers' expectations in the first quarter of 2010 (measured by the consumer confidence index). Restrained access of households to loans in the short run will limit the growth potential.

Inflationary pressures will remain relatively low during the forecast period, as growth of household consumption will be moderate and the tenge will slightly depreciate with respect to the US dollar. Thus, consumer price inflation will remain in the one-digit range (6-7% per

annum). The producer price index, by contrast, will rise quite dramatically in 2010 – by about 20% p.a. – reflecting the oil prices rebound. In 2011-2012, PPI growth is expected to be in the one-digit range as we assume that world oil prices will remain relatively stable.

The government is active in pursuing an economic diversification strategy by attracting investment into infrastructure development projects (besides the oil transport infrastructure). Recently the World Bank, the EBRD and IFC (as members of the Clean Technology Fund) agreed to provide USD 1.3 billion for the development of energy saving projects. The EBRD provided a USD 1 billion loan to support diversification projects. The effects of these efforts are not likely though to have a noticeable impact on the Kazakh economy in the short run.

We expect that by the end of 2010, when the effect of the lower base will be less pronounced, Kazakhstan's GDP will grow by 3%. In 2011, growth will speed up further to 5% and in 2012 it will slow down somewhat to 4.5%. This comes as the effects of the structural changes will not be profound yet and thus there will not be sufficient driving forces for a more rapid growth of the economy.

The 2010 budget was amended in March in order to account for increases in social expenditures, and the planned budget deficit was raised. We forecast that the 2010 budget deficit will reach its highest level in the past ten years, 4% of GDP. In order to finance the increased budget deficit, a USD 1 billion loan was taken from the World Bank. Later on, as the negative effects of the economic crisis will fade away, we expect the government's fiscal policies to become more prudent and the budget deficit gradually to decline to 2% of GDP in 2012.

According to our forecast, the current account will be positive in 2010 (1.1% of GDP), as imports are expected to recover more slowly than exports, reflecting different rates of growth of domestic and external demand. For the years to come, growth of imports will outpace that of exports, mainly due to increased investment demand. The current account is therefore expected to turn into a deficit of about 2% of GDP. Capital inflows, in particular FDI, will be high enough to finance the deficit. FDI, which has been directed primarily to the oil sector (exploration and extraction), turned out to be very resilient – in 2009, net FDI in euro terms decreased only by 12% y-o-y to EUR 9 billion (8.2% of GDP). We forecast that in 2010-2012 net FDI will be gradually increasing.

Government policy towards foreign investors in the oil sector may pose risks for the FDI forecast. After having muscled into the Kashagan oilfield project last year following a

dispute with the foreign investors, the Kazakh government continues to use the same instruments to obtain a stake in the Karachagank oil field, which remains the only major oil field in the country where the government does not have a stake yet. The companies participating in the Karachaganak Petroleum Operating (KPPO) consortium (BG, Chevron, Eni and Lukoil) have already faced a broad range of accusations including tax evasion, financial wrongdoing and environmental abuse. Recently, the accusations of fiscal fraud through an increase in costs by USD 1.3 billion have been dropped, however, two inquests still continue: one on unauthorized production of crude oil, and another one on violations of Kazakh regulations regarding employment of foreigners with threats to deport expatriate workers.

The customs union of Kazakhstan with Russia and Belarus has to be launched on 1 July 2010. Russia announced in May that it would proceed with launching a customs union with Kazakhstan only, as the issue of export duties on oil and oil products has not yet been resolved with Belarus. However, even for Russia and Kazakhstan the customs union will not be fully operational starting from July; several technical regulations and procedures still remain to be defined and adopted.

Kazakhstan managed to agree with Russia on the solutions of a number of sensitive issues: there will be a transitory period granted for imports of passenger cars and airplanes during which import duties will not be raised; and decisions in the regulatory body (Commission of the Customs Union) will be made on a consensus basis, with Kazakhstan having equal representation as Russia. However, the overall increase in import duties is still in place, bringing them mostly in line with Russia's level. These changes will have a negative impact on the Kazakh economy, creating trade diversion and hampering diversification of the economy. In total, according to calculations of ATF Bank, a Kazakh subsidiary of the Unicredit group, the non-weighted average import tariff of Kazakhstan increased from 5.8% to 9.5%, while for the weighted average import tariff the increase will be more moderate – from 4.2% to 5.4% (as duties will not be imposed on goods imported from Russia, a major trading partner of Kazakhstan). Under the new customs regime rates of 75-100% reappeared, whereas previously the maximum import duty rate in Kazakhstan was 30%. The highest increase in tariffs will be for investment goods. For example, import duties on trucks have been raised dramatically and reach up to 90% now. This increase in import duties was decided on to serve the interests of two truck producers in Russia and Belarus (KamAZ and Minsk automotive factory). Kazakh transport companies mostly import trucks from outside the newly created customs union, as Russian and Belarusian trucks do not come up to EURO 4 and EURO 5 emission standards.

The potential benefits of the customs union for Kazakhstan may be linked to increased FDI as the country has the most favourable tax regime among the three and thus can be an attractive destination for foreign investors looking for better market access opportunities. However, the overall economic effect of entering the customs union is likely to be negative for Kazakhstan, and it appears that political motives are the major reason for the country's participation in the union.

The issue of the restructuring of the two major banks (BTA and Alliance Bank) appears to be solved and the problem banks are not going to be a drag on the banking system. Nevertheless, the banking sector still faces problems as banks continue to accumulate losses because of poor asset quality. The share of non-performing loans (NPLs) in their portfolios has been growing. There are different measures of NPLs in the available statistics, but even the most moderate indicator of bad debts increased from 1% at the beginning of 2008 to 21% in March 2010. If a broader definition of NPLs is used, with certain categories of doubtful loans being considered non-performing, the share of NPLs even reaches an estimated 30%. The share of doubtful loans in total loans is estimated at 44%, which gives grounds to expect the share of NPLs to further slightly increase, as banks will proceed with admitting more bad loans in their portfolios.

Given the prevalence of high-risk assets at the market, banks have been very reluctant to issue new loans. In March 2010, the amount of loans issued was 45% lower than a year earlier, with the decline in loans to the corporate sector being even more profound. The total stock of loans in March 2010 was 6.7% lower than in March 2009. We expect that in 2010, Kazakh banks will still be licking their wounds and there will be no significant revival in credit market activity. In 2011-2012, the loans market will start growing again, though not at as high a rate as prior to 2008.

Table KZ

## Kazakhstan: Selected Economic Indicators

	2006	2007	2008	2009 <sup>1)</sup>	2009 1st quarter	2010	2010	2011	2012
							Forecast		
Population, th pers., average	15308	15484	15674	15880	15814	16049	16000	16100	16200
Gross domestic product, KZT bn, nom.	10214	12763	16053	16100	3055	3882	19400	21600	23900
annual change in % (real)	10.7	8.7	3.3	1.2	-2.2	7.1	3	5	4.5
GDP/capita (EUR at exchange rate)	4200	4900	5800	4900	.	.	6700	7400	7800
GDP/capita (EUR at PPP - wiiw)	8200	9000	9300	9100	.	.	.	.	.
Consumption of households, KZT bn, nom.	4547	5468	6871	7200	1629	.	7900	8800	9700
annual change in % (real)	12.7	11.0	6.3	-3	0.3	.	3	5	4
Gross fixed capital form., KZT bn, nom.	3084	3857	4309	4541	625	.	5600	6100	6800
annual change in % (real)	29.7	17.3	1.0	1.9	-11.4	.	3	6	6
Gross industrial production									
annual change in % (real)	7.0	4.5	2.1	1.7	-4.6	11.5	7	5	4
Gross agricultural production									
annual change in % (real)	7.0	8.4	-5.6	13.8	3.6	2.4	4	8	5
Construction industry									
annual change in % (real)	28.6	5.7	1.8	-4.9	-4.2	-8.7	1	5	8
Employed persons - LFS, th, average	7403.5	7631.8	7857.2	7903.4	7830.4	8029.3	8060	8140	8180
annual change in %	2.0	3.1	3.0	0.6	0.9	2.5	2	1	0.5
Unemployed persons - LFS, th, average	625.4	578.8	557.8	554.5	583.1	526.2	.	.	.
Unemployment rate - LFS, in %, average	7.8	7.3	6.6	6.6	6.9	6.2	6.2	6	6
Reg. unemployment rate, in %, end of period	1.1	0.8	0.7	0.6	0.8	1.0	.	.	.
Average gross monthly wages, KZT	40790	53238	60734	67639	62671	67839	.	.	.
annual change in % (real, gross)	10.3	17.8	-2.5	3.8	3.9	0.9	.	.	.
Consumer prices, % p.a.	8.6	10.8	17.1	7.3	8.7	7.6	7	6.5	6
Producer prices in industry, % p.a.	18.4	12.4	36.9	-22.2	-28.7	45.5	20	3	6
General governm.budget, nat.def., % GDP									
Revenues and grants	27.9	22.6	25.1	21.8	.	.	.	.	.
Expenditures and net lending	20.4	24.3	27.2	24.8	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	7.5	-1.7	-2.1	-3.1	.	.	-4.0	-3.0	-2.0
Public debt, nat. def., in % of GDP	11.3	7.2	8.3	10.1	.	.	9	8	7
Base rate of NB % p.a., end of period	9.0	9.0	10.5	7.0	9.5	7.0	.	.	.
Current account, EUR mn <sup>2)</sup>	-1525	-5355	4742	-2400	-900	2100	1200	-2500	-2800
Current account in % of GDP	-2.4	-7.0	5.2	-3.1	-5.3	11.1	1.1	-2.1	-2.2
Exports of goods, BOP, EUR mn <sup>2)</sup>	30881	35309	48905	31500	6300	9800	42300	43600	47500
annual growth rate in %	35.8	14.3	38.5	-36	-40.6	55.6	34	3	9
Imports of goods, BOP, EUR mn <sup>2)</sup>	19216	24288	26128	20636	4700	3900	24300	28100	31200
annual growth rate in %	33.1	26.4	7.6	-21	-4.1	-17.0	18	16	11
Exports of services, BOP, EUR mn <sup>2)</sup>	2237	2596	2978	3100	700	700	3400	3600	3900
annual growth rate in %	25.0	16.1	14.7	4	16.7	0.0	10	6	8
Imports of services, BOP, EUR mn <sup>2)</sup>	6947	8491	7474	7219	1600	1700	8900	9600	10400
annual growth rate in %	15.4	22.2	-12.0	-3	0	6.3	23	8	8
FDI inflow, EUR mn <sup>2)</sup>	4958	7440	9882	9000	2000	2100	10700	10800	10600
FDI outflow, EUR mn <sup>2)</sup>	-309	2369	2590	2200	200	200	2400	2300	2300
Gross reserves of NB excl. gold, EUR mn	14525	11970	13711	16184	14603	20146	.	.	.
Gross external debt, EUR mn	56252	65436	76417	77881	79326	.	.	.	.
Gross external debt in % of GDP	87.2	86.0	84.3	99.5	104.9	.	.	.	.
Average exchange rate KZT/EUR	158.27	167.75	177.04	205.67	180.88	204.86	182	182	189
Purchasing power parity KZT/EUR, wiiw <sup>3)</sup>	81.24	91.09	110.40	111.09	.	.	.	.	.

1) Preliminary. - 2) Converted from USD with the average exchange rate. - 3) Based on ICP benchmark results 2005 and wiiw estimates.

Source: National statistics (National Bank, Agency of Statistics etc). Forecasts by wiiw.