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Research Report on Kazakhstan

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Main Economic Indicators of Kazakhstan

Macro indicators	**2012**	**2013**	**2014**
Gross pub. debt, bill KZT	3761	4537	5778
Nominal GDP, bill KZT	30347	35275	38033
Real GDP growth, %	5,0	6,0	4,3
Gross gov. debt/GDP,%	12,4	12,9	15,2
Deficit (surplus)/GDP,%	4,5	5,0	1,9
Inflation rate,%	6,0	4,8	7,4
Curr. Account balance/GDP,%	0,0	12,2	14,0

Development indicators	**2014**
Inequality adj. HDI	0,67
GDP per capita (Thou. of USD)	24,0

Default indicator	**07.08.15**
5-Year CDS spread (Bp)	271
10Y Gov Bond Yield, %	7,1

Sources: RAEX (Europe) calculations based on data from IMF, National Bank of Kazakhstan, Ministry of Finance of Kazakhstan.

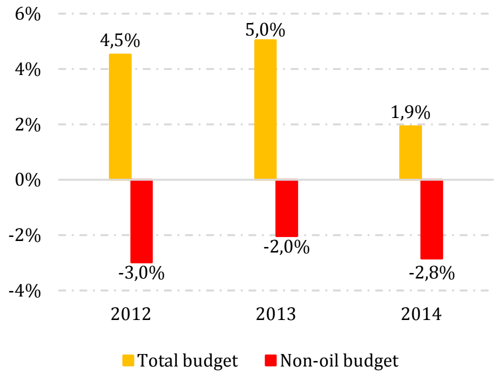
Introduction

The debt load and consolidated fiscal position of the Kazakh government remain sound. However, the non-oil fiscal balance (excluding transfers from the oil fund) showed negative figures over the past 3 years. The country's heavy dependence on volatile and unpredictable oil revenues raises concerns about future financing of the government in the face of the recent oil price decline. Worsened regional and global conditions motivated the president of the country to formulate a long-term development plan aimed at modernizing Kazakhstan's institutions and economy. Among the first steps of the initiative was unification and nationalization of the pension fund, whose overall performance improved significantly under the government management. Devaluation expectations and inflation rate volatility are still key drivers of dollarization. Performance of the banking sector improved as a result of transfer of NPLs to special purpose vehicles and the national bad-loans fund.

High commitment of the government to implement a modernization plan. The "Plan of the Nation", which was unveiled right after Mr. Nazarbayev's reelection earlier this year, is mainly aimed at reshaping Kazakhstan by strengthening the rule of law, industrializing the country and increasing transparency and accountability of the state. This ambitious plan is expected to be accomplished through 100 well defined steps and, if successful, will position Kazakhstan among the top 30 global economies by 2050, according to the authorities. The reform plan is not only a clear response to worsening regional and global conditions, but also decisive given the need for a successor to the long-time president. It is not a coincidence that these reforms are being proposed while the oil price (the main export commodity of Kazakhstan) has been dropping and expected to remain low in the near future. Additionally, the recent slowdown in the EU, Russia and China, Kazakhstan's main trade partners, requires alternative ways of propelling economic growth in the country.

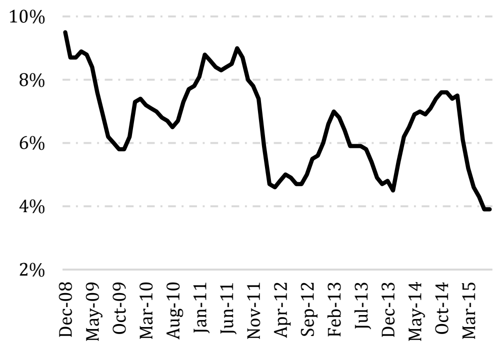
Debt load of the Kazakhstan government remains low. Total gross government debt of the Kazakhstan government was equivalent to 15,2% of GDP and 61,3% of budget revenues in 2014 and poses low risk for the country's economy. In a short-run perspective, the country bears little

Graph 1: Total vs. non-oil budget (as % GDP)



Source: RAEX (Europe) calculations based on data from IMF, Ministry of Finance of Kazakhstan

Graph 2: Y-o-Y monthly inflation rate



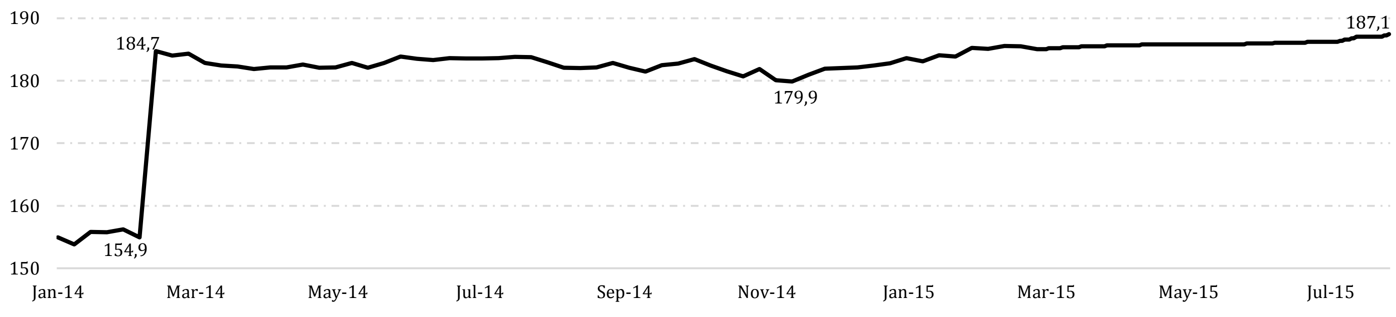
Source: RAEX (Europe) calculations based on data from Department of Statistics of Kazakhstan

risk as debt maturing in the next twelve months accounted for 1,2% of gross government debt as of the end-2014. Kazakhstan's low long-term exposure was evidenced by successful 10- and 30-year Eurobond issues for a total amount of 4 billion USD in mid-July 2015.

Total fiscal balance was positive during 2014 despite drop in oil prices. The Kazakh government has maintained a positive fiscal balance, despite sharp drop of oil prices since the second half of 2014 (see graph 1). Positive fiscal balance was achieved due to transfers from the National Fund of the Republic of Kazakhstan (NFRK) and prudent fiscal expenditure. However the non-oil fiscal balance has been negative for the last 3 years, demonstrating the country's high dependence on oil taxation. This situation imposes a high pressure on the financing abilities of the government in the face of the current drop in oil price.

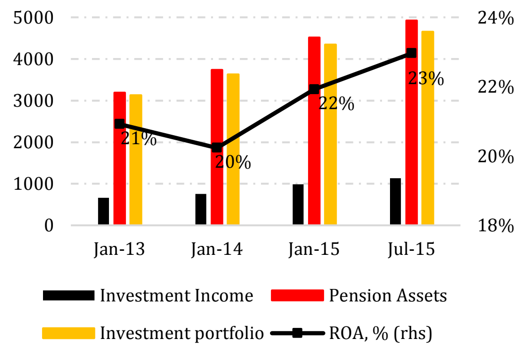
Dollarization levels are still fueled by devaluation expectations and volatile inflation. As of December 2014, banking deposits denominated in foreign currency represented about 55% of total banking deposits. The key driver of dollarization is mistrust in the Kazakhstani Tenge, which is mainly fueled by devaluation expectations and inflation rate volatility. Kazakhstan ended the year 2014 with an inflation rate of 7,4%, showing a clear reversion in the long-term trend of this variable, which had been negative during 2010-2013. Even though the recent drop in oil prices, combined with weak domestic demand and lower bank lending, should bring the inflation rate down by the end of 2015, volatility of monthly inflation rate remains high (see graph 2). Additionally, recent drop in the oil price increased the propensity for speculative currency attacks in the context of a tightly-managed exchange rate. Devaluation pressures during the first months of 2015 (see graph 3), pushed the National Bank of Kazakhstan (NBK) to expand the KZT to US dollar exchange rate corridor from the current 185+3/-15 to 185+13/-15 and to postpone plans to introduce an inflation targeting policy.

Graph 3: KZT/USD exchange rate



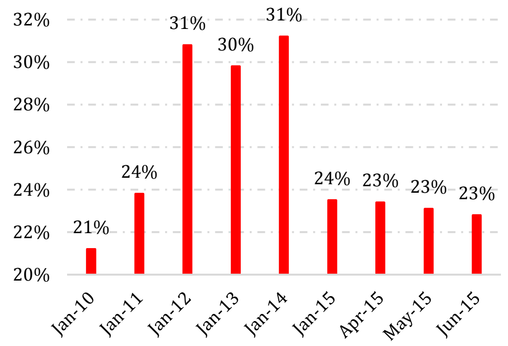
Source: RAEX (Europe) calculations based on data from Department of Statistics of Kazakhstan

Graph 4: Performance of the Kazakh pension system



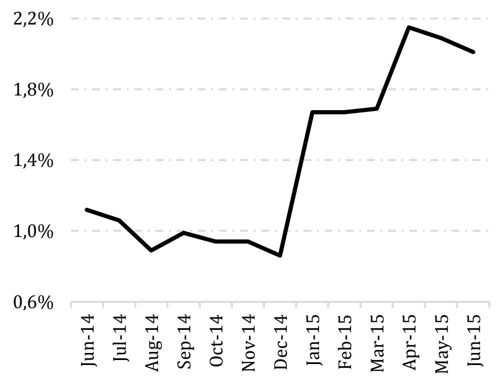
Source: RAEX (Europe) calculations based on data from National Bank of Kazakhstan

Graph 5: NPL (% of total loans)



Source: RAEX (Europe) calculations based on data from National Bank of Kazakhstan

Graph 6: ROA of Kazakh Banking Sector



Source: RAEX (Europe) calculations based on data from National Bank of Kazakhstan

Performance of the Integrated Accumulative Pension Fund (IAPF) remains sound. More than a year ago on March 26th 2014, when the country's pension funds were merged under the IAPF, the general public was anxious about skills of the government officials and the National Bank of the Republic Kazakhstan (NBRK) to manage the fund. The first evidence of sufficient management skills of the state control arrived by the end of 2014 (see graph 4), when the reported ROA was 22% (2% higher than in 2013) and investment income amounted to 756 billion KZT (13% higher than in 2013). As a result, the fund has reverted a negative trend in profitability. The positive trend achieved in 2014 has continued in 2015 with the ROA for the first half of the year at 23% while investment income grew to 1 132 billion KZT.

Profitability of the banking sector improved in the first half of 2015. As a result of bad loans transfers to special purpose vehicles (subsidiary banks) and the bad-loan fund created by the NBRK in 2012, the country's banks have been able to write-off non-performing loans (NPLs) from their balance sheets. This helped reduce the level of NPLs to 22,8% of total loans in June 2015 from about 31% at end-2014. Such a reduction in NPLs (see graph 5) was the main driver of the higher profitability in the banking sector of Kazakhstan, which reported a ROA of 2% in June 2015 and reverted the negative trend demonstrated in 2014 (see graph 6). However, the banks have transferred their risks to own subsidiaries (through transfers to SPVs) and the government (through the bad-loan fund). For the policy of improving the banking sectors' quality of assets to succeed, the government will ultimately have to take care of NPLs.

Conclusion

The overall position of Kazakhstan remains highly influenced by the country's heavy dependence on oil revenues. Recent decline in oil price, combined with slowdown of Kazakhstan's main trade partners stand as key sources of risk for the country. Even though inflation rate is expected to decline by the end of 2015, devaluation expectations keep fueling dollarization in the country. However, low government debt provides strong resilience to potential crises. In the face of worsening regional and global conditions, the Kazakh government is showing evident commitment at reshaping the institutional framework and the economic position of the country as pledged by Mr. Nazarbayev. Unification of the pension fund and steps taken to improve the banking sectors' high share of NPLs have resulted in positive outcomes. However, longer time frame is needed to fully assess success of the government initiatives.