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Kazakhstan: inflation back under control, but growth prospects worsen

Banking crisis, aggravated by housing bubble burst, turns out to be more profound

Banking sector problems remain central to Kazakhstan's economic development. Kazakh banks are burdened by external debt worth over EUR 26 billion (about 50% of the country's total external debt), EUR 7.7 billion of it being due in 2008, while they still face difficulties with access to external financing.¹ In order to diversify sources of financing, banks have been making efforts to attract more deposits at the domestic market by offering higher interest rates: in March 2008, deposits increased by 25% year-on-year. However, this influx of deposits is not large enough to compensate for the lost sources of external financing – by the end of March 2008, the total stock of deposits was only EUR 22 billion or 57% of total loans.

At the same time Kazakh banks have faced a worsening in their assets quality, particularly in the construction and real estate sector, where they are exposed as lenders both to home buyers and property developers. The situation in these sectors and related ones (such as advertising or construction materials production) deteriorated dramatically due to the bursting of the housing bubble. Construction output increased only by 3.3% y/y in January-February 2008, while production of construction materials fell by 21.7% y/y in the first quarter of 2008. There is already anecdotal evidence that labour shedding in these sectors has been taking place.

The six largest banks in terms of assets announced credit losses of about EUR 0.8 billion; the share of losses in total retail loans reached 8% in April 2008, while the share of loans with delayed payments increased by 2.5 times to 2% as compared to June 2007, with the corresponding shares in construction and industry reaching 6.7%. This made the banks more cautious in providing loans and they increased loan interest rates significantly – by about 3 percentage points against July 2007 (the revision of interest rates has been made in the existing loan contracts as well). Together with the lack of funds and stricter banking regulation and supervision, this situation resulted in virtual stagnation of loans: during September 2007 to April 2008, total banking loans increased by 2% only.

On the positive side, the government has sufficient financial resources to withstand the crisis. The country's foreign assets (both forex reserves and the oil fund) exceed EUR 28 billion (more than 40% of GDP) and have been increasing regardless of considerable expenditures to fight the current

¹ Starting from the beginning of 2008, there were only two cases of major external borrowing by Kazakh banks – ATF and Halyk. In particular, in April 2008, Halyk bank issued bonds with a coupon rate of 9.25%, which is 2 percentage points higher than a year ago.

crisis. The government made generous efforts to support the ailing banking system by creating a USD 4 billion stabilization fund aimed at mitigating liquidity constraints and offloading some of the loans on Kazakhstan's state mortgage company. Banking regulation and supervision has also been tightened in order to reduce possibilities of too risky behaviour of banks.

The most likely scenario for overcoming the consequences of the crisis and the medium-term development of the Kazakh banking system embraces an increase in the foreign ownership of banks, which has been the lowest in the region so far. The process has already started with Unicredit buying a strategic stake at ATF, the fifth biggest bank, for USD 2.2 billion, and a South Korean bank buying a 30% stake in the sixth largest bank CenterCredit. The three largest Kazakh banks BTA, Kazkommerzbank and Halyk (the former state savings bank) are reluctant at the moment to sell their strategic stakes as valuations are low, but the situation is likely to change in the near future.

Inflation outlook improved on the back of efficient policies

In January-April 2008, consumer prices increased by 3.4% (year-on-year, the CPI reached 19.1% in April). Inflation was driven primarily by food prices, which accelerated by 27.5% y/y. Though these figures are high, they are still significantly lower than in Ukraine, and do not differ noticeably from the previous year's dynamics. By the end of 2008 the annual average CPI should reach 11%, and gradually decelerate further to 9% in 2010.

We have revised our inflation forecast downwards, primarily due to higher efficiency of the government's anti-inflationary policy which has included a broad spectrum of measures. First, monetary policy has been quite restrictive. Starting from December 2007, the National Bank of Kazakhstan raised the refinancing rate by 2 percentage points to 11%. During January-April 2008, the money supply (M3) increased by only 4.8% as compared with 8.2% during the same period in 2007 (22% y/y growth in April 2008 versus 72% y/y growth in April 2007).

Second, the government has been quite active in introducing administrative measures. In particular, on 15 April Kazakhstan imposed a ban on wheat exports until 1 September (the country being the fifth largest exporter of grain and the largest wheat exporter in the world); a ban on oil products exports valid until 1 September was introduced starting from 1 June.

Besides, fiscal policy has been quite tight, with the budget balance being kept positive. The government has been attempting to squeeze more resources from the oil sector – thus, an export duty on crude oil (USD 110 per ton) was introduced, which is anticipated to increase budget revenues by about EUR 0.6 billion in 2008. The duty is currently applied to only about 50% of crude oil produced, as the (mostly foreign-owned) companies which secured tax stability in their contracts are exempt from paying this duty (thus the duty is applied primarily to the state oil company KazMunaigaz Exploration and Production). However, it is expected that the exemptions from the oil export duty will be eliminated in two years.

On the expenditures side, the country has been balancing between the need to support people who are the most vulnerable to food price increases, and struggling with inflation. The first step in subsidizing the most vulnerable ones will be made in July 2008, when social payments will be raised. More targeted government subsidies to stimulate household consumption are expected to be introduced in the future.

GDP growth slows down, but remains still high thanks to rocketing commodity prices

We have reduced our forecast of the GDP growth due to more severe problems resulting from the banking crisis. According to our new forecast, GDP will increase by just 5.5% in 2008; in 2009 and 2010 growth will speed up to 6.5% and 7% respectively.

The current economic growth has primarily been determined by the mining industry, which is in a favourable position owing to rocketing world commodity prices. In the first quarter of 2008, the extraction industry increased its output by 6.8% y/y, while manufacturing industry faced a decline of real output by 1.2% y/y. Diversification came to a halt: the mining industry will remain the biggest contributor to economic growth during the forecasted period, and also cause a swift increase in merchandise exports.

Investment growth will remain double-digit, as the booming FDI in the mining sector is expected to continue, and FDI in the financial sector is likely to speed up soon, thus imports of investment goods and also services should continue to grow. However, high inflation, slowdown in wage growth and deteriorated access to consumer credit will cause less fast increases in private consumption, and consequently in imports. Thus, the trade balance is expected to improve during the forecasting period from a surplus of EUR 5.2 billion in 2007 to EUR 8.6 billion in 2010. Nevertheless, the current account balance will remain negative (though declining), mostly due to the high level of investment income being directed out of the country.

The exchange rate of the Kazakh tenge remains de facto fixed to the US dollar since October 2007; however, the National Bank is likely to return to a more flexible exchange rate policy when the crisis is over. Strong growth of export revenues in 2009 and 2010 should result in gradual appreciation of the tenge.

Table KZ

Kazakhstan: Selected Economic Indicators

	2004	2005	2006	2007 ¹⁾	2007 1st quarter	2008	2008 Forecast	2009 Forecast	2010 Forecast
Population, th pers., end of period	15074.8	15219.3	15396.9	15571.5	.	.	15880	16200	16520
Gross domestic product, KZT bn, nom.	5870.1	7590.6	10139.5	12763.2	2536	3144	15900	19000	22300
annual change in % (real)	9.6	9.7	10.6	8.7	10.6	6.0	5.5	6.5	7.5
GDP/capita (EUR at exchange rate)	2313	3029	4185	4914	.	.	5500	7100	8600
GDP/capita (EUR at PPP - wiiw/WDI)	6520	7360	8260	8850	.	.	.	.	.
Gross industrial production									
annual change in % (real)	10.4	4.8	7.0	4.5	9.6	3.7	6.5	7	8
Gross agricultural production									
annual change in % (real)	-0.5	7.3	7.0	8.4	3.7	3.7	7.5	9	11
Construction output total									
annual change in % (real)	17.9	47.4	28.6	15.3	.	.	7	12	14
Private consumption, KZT bn, nom.	3054	3686	4547	5468	.	.	6400	7500	8900
annual change in % (real)	14.1	10.9	12.7	11.0	.	.	6	8	10
Gross fixed capital form., KZT bn, nom.	1472	2123	3084	8948	.	.	11500	14300	17600
annual change in % (real)	22.5	28.1	29.7	17.8	7.1	16.1	10	12	14
LFS - employed persons, th, avg.	7181.8	7261.0	7403.5	7631.8	7490	7876	.	.	.
annual change in %	2.8	1.1	2.0	3.1	2.8	2.9	.	.	.
Reg. employees in industry, th pers., avg.	869.6	891.8	904.5	940	.	.	.	.	.
annual change in %	1.7	2.6	1.4	3.9	.	.	.	.	.
LFS - unemployed, th pers., average	658.8	640.7	625.4	578.8	.	.	.	.	.
LFS - unemployment rate in %, average	8.4	8.1	7.8	7.0	.	.	7.5	7	6
Reg. unemployment rate in %, end of period	1.6	1.3	1.1	0.8	.	.	.	.	.
Average gross monthly wages, KZT	28329	34060	40790	53238	50910	58599	.	.	.
annual change in % (real, gross)	14.6	11.7	10.3	17.8	.	1.5	.	.	.
Consumer prices, % p.a.	6.9	7.6	8.6	10.8	6.3	13.4	11	9.5	9
Producer prices in industry, % p.a.	16.7	23.7	18.4	12.4	12.2	20.8	18	12	9
General governm.budget, nat.def., % GDP									
Revenues and grants	24.6	28.1	27.9	22.6	.	.	.	.	.
Expenditures and net lending	22.1	22.3	20.4	24.3	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	2.5	5.8	7.5	-1.7	.	.	1.2	1.5	1.7
Public debt in % of GDP	3.9	9.3	11.3	7.2	.	.	.	.	.
Refinancing rate of NB % p.a., end of period	7.0	8.0	9.0	9.0	7.0	11.0	.	.	.
Current account, EUR mn ²⁾	269.9	-848.1	-1525.3	-5245.9	-321.2	.	-3600	-4400	-4300
Current account in % of GDP	0.8	-1.8	-2.4	-6.9	-2.1	.	-4.1	-3.8	-3.0
Gross reserves of NB excl. gold, EUR mn ²⁾	6810	5965	14525	11970	16305	12434	.	.	.
Assets of the National Oil Fund, EUR mn ²⁾	4129	6486	11227	15340	12127	15442	.	.	.
Gross external debt, EUR mn	24013.1	36643.3	56252.3	65435.6	61943.2	.	.	.	.
Gross external debt in % of GDP	69.1	79.9	87.8	86.0	.	.	.	.	.
FDI inflow, EUR mn ²⁾	3345.6	1583.5	4958.2	7492.0	1802.3	.	.	.	.
FDI outflow, EUR mn ²⁾	-1029.3	-117.2	-308.7	2308.1	429.9	.	.	.	.
Exports of goods, BOP, EUR mn ²⁾	16581.0	22733.5	30880.8	35307.1	7764.8	.	44100	52000	61400
annual growth rate in %	41.4	37.1	35.8	14.3	36.6	.	25	18	18
Imports of goods, BOP, EUR mn ²⁾	11120.2	14442.2	19216.1	24250.6	4982.9	.	29800	35800	42200
annual growth rate in %	31.3	29.9	33.1	26.2	58.8	.	23	20	18
Exports of services, BOP, EUR mn ²⁾	1617.0	1790.1	2236.7	2593.9	546.8	.	3000	3500	4000
annual growth rate in %	6.6	10.7	25.0	16.0	24.0	.	17	15	15
Imports of services, BOP, EUR mn ²⁾	4110.7	6021.2	6946.7	8414.4	1551.7	.	9800	12000	14600
annual growth rate in %	23.6	46.5	15.4	21.1	5.6	.	17	22	22
Average exchange rate KZT/USD	136.04	132.88	126.09	122.50	124.85	120.45	120.5	118.1	116.9
Average exchange rate KZT/EUR (ECU)	169.04	165.42	158.27	167.75	163.49	180.36	180.8	165.3	157.8
Purchasing power parity KZT/USD, wiiw ³⁾	50.44	57.61	67.42	75.95	.	.	.	.	.
Purchasing power parity KZT/EUR, wiiw ³⁾	59.95	68.11	80.19	93.17	.	.	.	.	.

1) Preliminary and wiiw estimates. - 2) Converted from USD. - 3) Based on ICP benchmark results 2005 and wiiw estimates.

Source: National statistics; World Bank; wiiw forecasts.