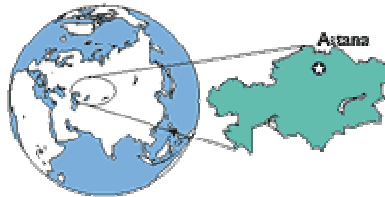


COUNTRY REVIEW

Kazakhstan



13 July 2009

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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Abundance of raw materials, in particular hydrocarbons
- Establishment of the National Fund of the Republic of Kazakhstan in 2001 which held assets of around USD23.6bn in June 2009
- Low public debt (8.6% of GDP at end-2008)
- Rising oil export capacities over the next decade

Weaknesses

- Authoritarian, centralised political system
- Increasingly interventionist and protectionist economic strategy inhibits development of a functioning market economy and threatens foreign investors
- Regional instability in Central Asia
- High vulnerability to world commodity prices
- Excessive credit boom until 2007, the reversal of which continues to be painful
- Banking sector crisis
- Soaring gross external debt
- Vulnerability of the tenge, which is pegged to the USD, to external shocks
- Administrative inefficiency, a poor rule of law, widespread corruption, vested interests, weak corporate governance, and anti-business policies reflect a weak structural business environment

KEY RISKS

- **Systemic banking sector crisis (more or less already underway)**
- **Inability to refinance large amounts of maturing external debt, potentially resulting in insolvencies or debt restructurings of banks (already underway) and companies**
- **Exchange rate risk (with respect to external debt repayments due as well as foreign trade credits)**
- **Risks stemming from low/falling commodity prices (including oil)**
- **Recession in 2009, with the number of insolvencies to rise sharply**

Country Risk Assessment

Ratings	Kazakhstan		Median Grade D	Georgia	Peers Serbia	Argentina
	Latest	Previous				
Systemic Political Risk:	P3-	P3+	P3-	P3-	P3-	P3+
Systemic Economic Risk:	E6	E5	E6	E6	E6	E6
ME rating:	ME6	ME5	ME6	ME6	ME6	ME6
<i>Structure</i>	4.0	4.0	6.0	6.0	5.7	5.7
<i>Policy</i>	5.6	4.8	5.6	6.0	5.2	4.2
<i>Solvency</i>	5.5	5.5	4.3	5.5	6.0	5.2
<i>External Liquidity</i>	6.0	4.6	4.6	4.3	4.8	6.0
SBE rating:	SBE5	SBE5	SBE6	SBE4	SBE4	SBE4
COUNTRY GRADE:	D	C		D	D	D

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Astana
Population:	15.52 mn (2008)
GDP:	USD 126803 mn (2008)
Currency:	Tenge (KZT)
Form of state:	Presidential republic
Head of government:	President Nursultan Abish-uly NAZARBAYEV (since 1991)
Next elections:	Legislative: 2011 (Senate), 2012 (Majilis) / Presidential: 2012

Major Industries (% of GDP at market prices, 2007)		Global Assumptions		2008	2009
Services	60.0%	Real GDP grth (% yr/yr) *	1.0	-0.6	
Trade	11.2%	Inflation (% av) *	3.4	1.5	
Finance	5.7%	Dated Brent (USD/b)	98	55	
Industry (incl. construction)	34.8%	* Major economies			
Agriculture	5.2%				

Main Exports (% of total, 2007)		Main Imports (% of total, 2007)	
Mineral products	69.7%	Machinery, appliances, electric. equip	26.9%
Base metals and articles thereof	17.1%	Transportation equipment	17.4%
Food products	4.3%	Base metals and articles thereof	13.3%
Chemical products	3.9%	Mineral products	13.1%
Pearls, precious stones and metals	1.5%	Chemical products	6.5%
Lead Export Markets (% of total exports, 2007)		Lead Import Markets (% of total imports, 2007)	
China	15.3%	Russia	34.1%
Germany	11.8%	China	22.4%
Russia	11.4%	Germany	8.3%
Italy	7.4%	Turkey	3.3%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	81,419	103,440	126,803	103,889	112,039
Population (mn)	15.30	15.41	15.52	15.63	15.74
GDP per capita (USD)	5,321	6,713	8,170	6,647	7,119
Real GDP growth (% yr/yr)	10.7	8.9	3.2	-1.5	1.5
Inflation (% eop)	8.4	18.8	9.5	7.0	8.0
Fiscal balance (% of GDP)	0.5	-1.7	-2.1	-4.0	-3.0
Current account balance (% of GDP)	-2.5	-7.9	5.5	-4.3	-3.8
External debt/GDP (%)	90.9	93.7	85.0	101.1	89.3
External debt/Exports of goods & services (%)	178.0	186.7	141.2	222.8	203.3
Debt-service ratio (%)	28.5	48.3	40.8	61.1	48.0
Foreign exchange reserves (USD mn)	17,750	15,775	17,870	15,000	15,000
Import cover (months)	6.5	4.2	4.3	4.5	4.8
Exchange rate assumption, KZT:USD (av)	126.1	122.6	120.3	147.8	150.0
f: CRU central forecast					

Sources: National Bank, Statistics Agency, Ministry of Finance, ADB, IMF, Euler Hermes Country Risk Unit

Political Stability

Since independence from the Soviet Union in 1991, Kazakhstan has been ruled by President Nursultan Nazarbayev, who was re-elected with 91% of the vote in December 2005. Executive, legislative and judicial powers are highly concentrated. Based on constitutional changes and election outcomes since 2006, President Nazarbayev appears to have further strengthened his firm grip on political powers and is expected to retain them for several more years. However, he will have to manage factional struggles within the political and economic elite which have recently re-emerged, and have been reflected in a wave of high-profile arrests and a crackdown on several top politicians and managers of prominent business concerns, which has dented foreign investors' confidence. There is also a growing risk of social tensions in the wake of the economic recession underway.

Foreign policy is shaped by the country's geopolitical position, by regional sensitivities and the large oil resources of the Caspian Sea, which Kazakhstan shares with four other countries (Azerbaijan, Iran, Russia, Turkmenistan)—the partitioning of which is not entirely clear. In recent years, relations with the West have been somewhat tense as a result of Western criticism of human rights abuses, while economic relations with Russia and China have improved. In June 2009, Kazakhstan suspended WTO accession talks in favour of pursuing joint membership of the global trade body together with Russia and Belarus as part of their customs union. Nonetheless, Kazakhstan's commitment to the Baku-Tbilisi-Ceyhan oil pipeline (BTC)—a non-Russian route enabling direct delivery of Caspian oil to the Mediterranean, opened in 2005 and fully operational since mid-2006—has reduced its dependence on Russia as a transit country and increased its bargaining power in the oil relationship with Moscow. It should also improve relations with the West, which strongly supported the BTC.

Economic Stability

Kazakhstan possesses substantial crude oil and natural gas reserves, as well as plentiful supplies of other minerals and metals. It also is a large agricultural producer, mainly livestock and grain. Surging commodity prices supported a strong economic performance in 2000-2007, reflected in average annual growth of real GDP of 10.1%. On the demand side, growth had been increasingly driven by private consumption and private sector investment, which had been fuelled by strong wage expansion and a credit boom, with the latter increasingly funded by large-scale foreign borrowing of Kazakh banks. However, dependence on high commodity prices and rapid credit growth made the economy highly vulnerable to external shocks, as has become evident over the past two years.

Credit growth had become excessive and unsustainable, reaching 110% yr/yr in mid-2007, with much of the credit denominated in foreign currency and directed to real estate, contributing to a property bubble. As a result the global credit squeeze led to difficulties in rolling over maturing external debt of banks, causing liquidity problems in the banking sector. Swift support by the National Bank of Kazakhstan (NBK, the central bank), which provided substantial short-term funding to troubled banks, and massive stabilisation measures by the government (including emergency funding, purchasing stakes in the four largest banks and taking over some of the banking sector's distressed assets) helped avert an immediate systemic banking sector collapse. Large windfall oil revenues in previous years that had contributed to the accumulation of substantial foreign exchange reserves had enabled the comprehensive support. However, the sharp drop in world prices for oil and other commodities since mid-2008 as well as the intensification of the global financial crisis in September 2008 dented growth prospects and raised some questions about the authorities' ability to sustain stabilisation measures, resulting in several sovereign and bank downgrades by the major rating agencies.

In February 2009, the banking sector was largely nationalised as the government took control of BTA (the largest bank) and Alliance Bank (the fourth largest bank). However, both banks, as well as Astana Finance (an investment bank) have since defaulted on their foreign debt repayments and are seeking a restructuring. Crucially, in March 2009 the government changed its earlier stance and announced that it would no longer provide guarantees for banking sector debt. The policy shift may reflect government concerns over the country's fiscal position as the National Fund of the Republic of Kazakhstan (NFRK, the oil stabilisation fund) lost 20% or USD5.6bn of its reserves in February 2009 alone and, with low oil prices at that time, there was little prospect of swift recovery. Fiscal stimulus is forecast to increase the budget deficit from 2.1% of GDP in 2008 to 4% in 2009. Public debt is expected to rise from 8.6% of GDP in 2008 to 14% this year which, however, is still low.

In the past, monetary policy has mainly focused on exchange rate stability. As a result, inflation was relatively high (averaging 10.8% in 2007 and 18.9% in 2008) and credit growth was allowed to reach the excessive 110% yr/yr recorded in mid-2007. Fearing a currency crisis since the onset of the banking sector problems in H2 2007, the NBK reinforced its target of exchange rate stability, maintaining a de facto peg of the tenge (KZT) against the USD at around 120 KZT/USD until January

2009. While this reduced exchange-rate risk for banks and companies that had borrowed in foreign currencies, it also cost at least USD10bn of foreign exchange (FX) reserves (USD6bn alone from September 2008 to January 2009 according to the NBK). With the prospect of lower foreign exchange earnings in 2009 because of weaker oil and export revenues, the NBK in early February 2009 devalued by 25% and allowed the KZT to trade in a 3% band around KZT150:USD1, a move aimed at reducing downward pressure on FX reserves. Our central forecast is that the new currency peg will hold in 2009. However, risks to this scenario are more to the downside because of ongoing banking sector problems and the still fragile global economic outlook.

As a result of sharply decelerating credit growth and rapidly falling commodity prices, real GDP growth declined markedly from 8.9% in 2007 to 3.2% in 2008. The downturn continued in Q1 2009 when GDP declined by 2.2% yr/yr. We expect a modest recovery in H2 2009 and 2010—as oil prices may stabilise at USD50-70 per barrel—and forecast full-year GDP to shrink by 1.5% this year and to increase by 1.5% next year.

Following a deficit of 7.9% of GDP in 2007, the current account balance shifted to 5.5% surplus in 2008, largely because of high oil revenues in H1. We expect the current account to move back into deficit of about 4.3% in 2009 as a result of lower average oil prices and the weak external environment. In Q1 2009, exports of goods and services plummeted by a much steeper 46% yr/yr than imports which fell by 12%. The large-scale foreign borrowing of Kazakh banks to mid-2007 has increased gross external debt to critical levels relative to GDP (85% at end-2008) and export earnings (141%). Even the fact that around one third of external debt is intra-company debt is not comforting. The debt service ratio was a hefty 41% in 2008 and will probably rise to 60% or more in 2009 (mainly because export earnings will fall sharply). Short-term debt and principal repayments due in 2009 are estimated to be more than double the level of the NBK's current foreign exchange reserves of about USD16.4bn. Moreover, the 25% devaluation of the KZT has increased the cost of external debt repayments for Kazakh companies and banks, such that further defaults are to be expected.

Structural Business Environment

The Structural Business Environment is well below average in our assessment overall, with serious impediments to the conduct of commercial transactions. Areas of particular weakness include administrative inefficiency, a poor rule of law, perceptions of corruption, protection of vested interests, weak corporate governance and an increasingly interventionist and protectionist economic strategy of the government. In recent years, lawmakers have passed a series of measures and laws that are undermining foreign investment, for example, by easing nationalisation, increasing risks of acquisitions and increasing the tax burden of industries in which foreign investors already have a large share. Reportedly there is a continued trend in favour of domestic and also Russian companies, particularly. The government's tendency towards economic nationalism was underscored by amendments to the natural resource law in 2007, which empowered the government to annul or revise contracts "damaging Kazakhstan's economic security". This followed the escalation of a dispute between the government and a foreign consortium led by ENI (Italy) developing the giant Kashagan oilfield in the Caspian Sea over repeated production delays and cost overruns in mid-2007. Work at Kashagan was temporarily halted because of alleged environmental violations and customs tax evasion by the consortium. The issue was only resolved at end-2008 by an agreement that doubled the stake and raised the responsibilities of Kazmunaygaz (Kazakhstan's national oil company) in the project, stripped ENI of its leading role and included compensation payments by the foreign consortium.

Banking sector risk has further increased following the default on foreign debt repayments of three major banks (see Economic Stability section). The expected recovery rate is very low. Alliance Bank has reportedly agreed on a restructuring with its creditor committee that imposes a 77.5% loss on bondholders. Although the government has managed the defaults without sparking sustained domestic deposit outflows, the banking crisis can be regarded as systemic in the meantime. Kazakh banks continue to face very restricted access to international financing which makes refinancing their large foreign debts difficult. The NBK has reported the banks' external debt repayments due in 2009 at USD12.8bn. Exchange rate risk is another problem for banks. The 25% KZT devaluation in February has further affected banks' ability to generate revenue to pay back external loans. Moreover, some 30-50% of total bank lending was given to the construction sector and for mortgages. As Kazakhstan is in the midst of a serious property bust, the share of non-performing loans in total loans has reportedly tripled to almost 30%. Private sector credit growth decelerated sharply to 4.5% yr/yr in Q3 2008 as a result of the global and domestic financial crises but, surprisingly, it has picked up again thereafter and stood at 14.4% in May 2009. This raises additional concern with regard to the already weak position of banks.

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Charts

