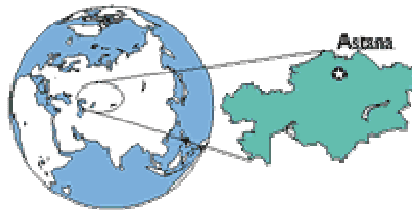


COUNTRY REVIEW

Kazakhstan



16 May 2011

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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.
- The National Fund of the Republic of Kazakhstan held assets of around USD36bn in April 2011.
- Low public debt.
- Rising oil export capacities over the next decade.

Weaknesses

- Authoritarian political regime.
- Increasingly interventionist and protectionist economic strategy.
- Regional instability in Central Asia.
- High vulnerability to world commodity prices.
- Recovery from 2007-2009 financial and systemic banking crisis still fragile.
- Weak monetary policy track record.
- High external debt burden.
- Exchange rate vulnerability to external shocks.
- A poor rule of law, perceived widespread corruption, vested interests and weak corporate governance dent the business environment.

Country Risk Assessment

Ratings	Kazakhstan		Median Grade C	Median Grade D	Peers	
	Latest	Previous			Argentina	Russia
Systemic Political Risk:	P3-	P3-	P3+	P3-	P2-	P3+
Systemic Economic Risk:	E5	E6	E5	E6	E6	E5
ME rating:	ME5	ME6	ME5	ME6	ME6	ME4
<i>Structure</i>	4.0	4.0	5.8	6.0	6.0	4.0
<i>Policy</i>	3.8	5.6	5.2	5.6	3.8	5.8
<i>Solvency</i>	6.0	5.5	3.3	4.3	5.1	3.9
<i>External Liquidity</i>	3.5	6.0	4.2	4.8	5.2	1.7
SBE rating:	SBE4	SBE5	SBE4	SBE5	SBE4	SBE5
COUNTRY GRADE:	D	D			D	C

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 Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Astana
Population:	15.568 mn (2009)
GDP:	USD 105583 mn (2009)
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: 2016

Major Industries (% of GDP at market prices, 2009)	Global Assumptions	2010	2011	
Services	56.1%	Real GDP grth (% yr/yr)	3.3	2.9
Trade	12.9%	Inflation (% av) *	1.2	1.4
Finance	4.9%	Dated Brent (USD/b)	80	115
Industry (incl. construction)	37.6%	* Major economies		
Agriculture	6.2%			

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Mineral products	72.2%	Machinery & equipment	40.2%
Metals	15.0%	Mineral products	16.6%
Food products	4.2%	Metals	15.6%
Chemicals	3.5%	Chemicals	10.3%
Lead Export Markets (% of total exports, 2009)		Lead Import Markets (% of total imports, 2009)	
China	16.4%	Russia	28.3%
France	9.2%	China	26.8%
Germany	8.3%	Germany	6.6%
Russia	6.9%	Italy	5.6%
Ukraine	5.5%	Ukraine	4.8%

Basic indicators

Selected economic indicators	2007	2008	2009	2010	2011f
Nominal GDP (USD mn)	102,833	135,553	105,584	121,140	141,199
Population (mn)	15.54	15.55	15.57	15.58	15.60
GDP per capita (USD)	6,619	8,716	6,782	7,773	9,052
Real GDP growth (% yr/yr)	8.9	3.2	1.2	7.0	6.0
Inflation (% eop)	18.8	9.5	6.2	7.8	8.2
Fiscal balance (% of GDP)	4.7	1.1	-1.4	1.5	1.8
Current account balance (% of GDP)	-8.1	4.7	-4.1	3.6	4.6
External debt/GDP (%)	94.2	79.6	107.3	98.4	92.1
External debt/Exports of goods & services (%)	186.6	141.3	235.1	183.2	173.3
Debt-service ratio (%)	48.9	41.6	62.9	33.4	30.1
Foreign exchange reserves (USD mn)	15,775	17,870	20,180	24,708	35,000
Import cover (months)	4.2	4.3	6.2	6.9	8.4
Exchange rate assumption, KZT:USD (av)	122.6	120.3	147.5	147.4	145.0
Exchange rate assumption, KZT:EUR (av)	168.0	176.9	205.7	195.4	199.7
f: CRU central forecast					

Sources: National sources, IMF, ADB, IHS Global Insight, Euler Hermes Economic Studies

Political Stability

Since its independence from the Soviet Union in 1991, Kazakhstan has been ruled by President Nursultan Nazarbayev. Executive, legislative and judicial powers are highly concentrated under his rule. The media is repressed, as are opposition parties that aim at policy reforms and potential succession candidates who appear to challenge the President. In April 2011 Nazarbayev was re-elected for a fourth term with 95.5% of the vote in an early election, with a turnout of 90%. There was no real competition from a weak opposition. As with previous elections, international observers from the OSCE criticised the latest poll as falling short of genuine democracy. For the time being, the regime appears secure and the main risk to political stability is probably the President's age (70)—although Nazarbayev has indicated that he will run again in 2016—as there is no obvious chosen successor. A change of government through a popular uprising appears unlikely as Nazarbayev remains generally popular thanks to the use of earnings from the country's abundance of raw materials to reduce social hardship.

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 Kazakhstan has improved economic relations with Russia and China. 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 which entered into force in July 2010. However, 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 an excessive credit boom, with the latter increasingly funded by large-scale foreign borrowing of Kazakh banks. However, the 2007-2009 global financial crisis clearly demonstrated vulnerabilities arising from inadequate economic diversification and heavy dependence on international financial flows.

The global credit squeeze that started in July 2007 suddenly made rolling over maturing external debt difficult for Kazakh banks, causing liquidity problems in the banking sector and revealing its high vulnerability to global financial market turbulence. Despite massive support by the National Bank of Kazakhstan (NBK, the central bank) and the government, a systemic banking crisis occurred in 2009. The banking sector was largely nationalised and four major banks had to restructure their external debt. Moreover, the support measures and the NBK's initial attempt to maintain the then de facto exchange rate peg of the tenge (KZT) against the USD, combined with lower foreign exchange (FX) earnings since mid-2008 because of weaker oil and export revenues, led to a considerable decline in official FX reserves and in the assets of the National Fund of the Republic of Kazakhstan (NFRK, the oil stabilisation fund). In February 2009 the NBK eventually gave in to the ongoing downward pressures on the KZT and devalued the currency by 25%.

As a result of sharply decelerating credit expansion and rapidly falling commodity prices, real GDP growth declined markedly from 8.9% in 2007 to 3.2% in 2008 and 1.2% in 2009. Growth recovered to 7% in 2010, supported by the rebound in oil prices and external demand. Base effects also played a role, reflected in an easing of growth in H2. A preliminary estimate for Q1 2011 shows real GDP expansion of 6.6% yr/yr. A return to the high pre-crisis growth rates is unlikely in the near term. We expect around 6% growth in 2011 as a whole.

In the past, monetary policy of the NBK has mainly focused on exchange rate stability. As a result, inflation has been relatively high (averaging 10.8% in 2007 and 18.9% in 2008) and credit growth was allowed to reach the critical level of 110% yr/yr recorded in mid-2007, thereby significantly contributing to the domestic financial crisis. In its Monetary Policy Guidelines for 2011, the NBK has indicated a gradual transition to inflation targeting but has also stressed its continued "responsibility to promote the domestic currency stability". In February 2011, as a consequence of renewed upward pressures

on the KZT thanks to the surge in commodity prices, the NBK returned to a managed floating exchange rate regime, abandoning the 3% trading band around the KZT150:USD1 rate it introduced two years earlier. However, although the probability of renewed downward pressure on the KZT has dwindled in the near term, it cannot be completely ruled out, for example if banking-sector instability re-intensifies or if commodity prices fall again rapidly. Meanwhile, annual inflation has picked up from 7.8% at end-2010 to 8.4% in April 2011 and we expect it to remain around 8% for the rest of the year. Credit growth entered negative territory in the course of 2010 and has remained subdued.

The fiscal account shifted to a small deficit of 1.4% of GDP in 2009 but swung back to a 1.5% surplus in 2010 thanks to transfers from the again well-performing NFRK. We expect a fiscal surplus of about 1.8% of GDP in 2011. Public debt rose slightly to 11.4% of GDP in 2010, but this is still a very low and unproblematic level.

The current account balance shifted also from a deficit of 4.1% of GDP in 2009 to a 3.6% surplus in 2010, thanks to the rebound in oil prices and external demand. A preliminary estimate shows a further improvement of the current account in Q1 2011 and we forecast a 4.6% surplus for the year as a whole. The rebound in the external balance has also shored up official FX reserves from about USD20bn at end-2009 to USD33bn in April 2011, sufficient to cover around eight months of imports. During the same period, the assets in the NFRK increased from about USD24bn to USD36bn.

The large-scale foreign borrowing of Kazakh banks until 2007 had rapidly increased gross external debt to critical levels in relation to GDP (around 100%) and export earnings (180%), the reduction of which will take time such that the external debt burden will continue to be a threat to a sustained economic recovery. Even the fact that around 40% of external debt is intra-company debt is not comforting. The debt service ratio will remain a hefty 30% in 2011. Short-term debt and principal repayments due in 2011 are estimated to be close to the level of the NBK's current foreign exchange reserves. The refinancing of maturing external debt could still be difficult for some banks and companies.

Structural Business Environment

The Structural Business Environment is below average in our assessment overall, with serious impediments to the conduct of commercial transactions. Areas of particular weakness include the legal environment, perception of widespread corruption, protection of vested interests, weak corporate governance and an increasingly interventionist and protectionist economic strategy of the government.

The banking sector survived the systemic crisis in 2009 without a complete collapse including a bank run thanks to relatively adequate public sector support, external debt restructuring and improvements in supervision. The sector now appears to be stabilising, though restructuring is not yet complete and financial risks remain. Persistent problems have remained, for example, in form of high non-performing loans (26% of total loans in mid-2010) and weak asset quality (lack of adequate asset diversification in the case of some banks). As a result, risk aversion by banks is high and domestic credit growth is likely to remain subdued for some time. There is still some potential for instability in the banking sector to intensify again in the event of another shock.

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Charts

