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Research Report on Kazakhstan

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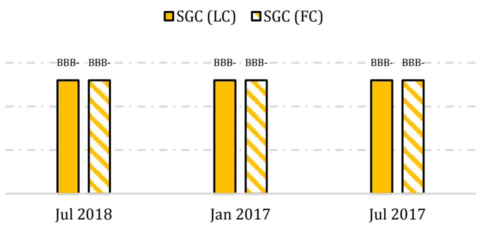
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Kazakhstan

Macro indicators	2015	2016	2017
Gross gov. debt, KZT bn	8946	9586	11107
Nominal GDP, KZT bn	40884	45732	52433
Real GDP growth, %	1,2	1,1	4,0
Gross gov. debt/GDP, %	21,9	21,0	21,2
Deficit (surplus)/GDP, %	-6,3	-5,5	-6,3
Inflation rate, %	13,6	8,5	7,1
Current Account Balance/GDP, %	-	-	-2,9
External debt, USD bn	-	-	167,4

Development indicators	2017
Inequality adj. HDI	0,71
GDP per capita, USD th	26,3

Default indicator	03.07.2018
5-Year CDS spread, Bp	93,28
7Y Gov Bond* Yield, %	4,23

Source: RAEX (Europe) calculations based on data from the IMF, Cbonds, Ministry of Finance of the Republic of Kazakhstan and NBK
* Maturity in 2025

Summary

The rating of Kazakhstan confirmed at ‘BBB-’ with a stable outlook reflects the acceptable amount of government debt, stabilizing inflation levels and declining financial dollarization. Moreover, fiscal buffers remain vast and the external position is solid and we expect it to continue in the same trend going forward.

However, the rating is negatively affected by the risk stemming from the banking system which increases the probability of contingent liabilities’ materialization. In addition, the highly dependent and concentrated economy in the oil sector augments the volatility of economic growth and reduces stability. Finally, resulting from still high NPLs and restructured loans, the growth in credit to the economy continues to be subdued.

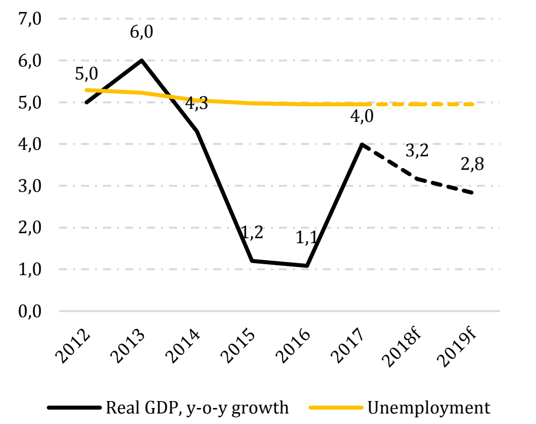
Economic growth remains dependent on the oil market dynamics. Real GDP grew at around 4% in 2017, slightly above than what we initially anticipated (see graph 1). Higher and more stable oil prices have had a positive impact on the economy. In this sense, the country remains mainly driven by the dynamics in the oil market. Additionally, higher oil prices have also caused exports to increase which augmented its share of impact in the overall output.

Moreover, the non-oil sector also enjoyed a stable growth throughout 2017 as the overall industrial production increased steadily driven by the manufacturing, agriculture, transport, and trade sectors. Investment in fixed assets continues to increase at a stable pace. We anticipate growth to remain robust going forward; however, still highly dependent on the oil market.

Government indebtedness in a good position. Gross government debt remains low in Kazakhstan. As of end-2017, debt to GDP was 21,2% and debt to budget revenues stood at 114%. In addition, short-term external debt, despite having increased, remained low at 0,5% of GDP in 2017 (see graph 2).

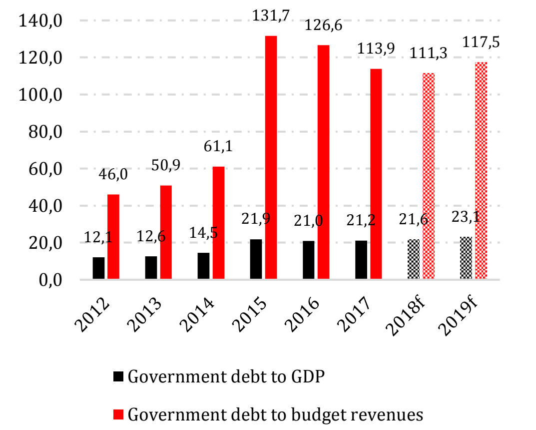
We still anticipate debt metrics to remain steady and low as the government’s fiscal position is well-anchored by financial buffers from the National Fund of the Republic of Kazakhstan (NFRK) and the authorities continue their efforts to consolidate the budget.

Graph 1: Macroeconomic indicators, %



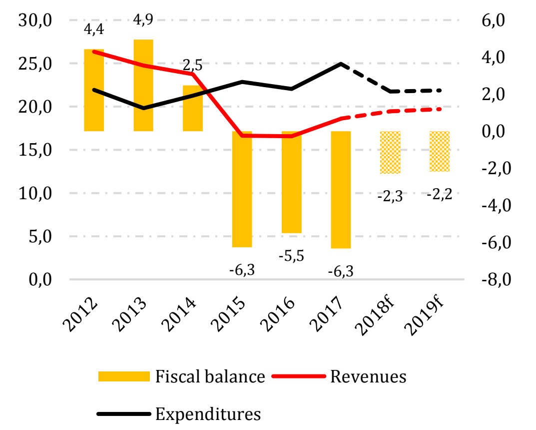
Source: RAEX (Europe) calculations based on data from the IMF

Graph 2: Government debt dynamics, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF

Graph 3: Fiscal budget dynamics, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF

Nevertheless, we still consider that the potential materialization of contingent liabilities remains a threat to the stability of public finances given the fragile banking system. However, the amount of SOEs has reduced slightly as a result of the government's privatization plan which has advanced substantially and the government has shown less potential support towards public companies in case of a distress situation.

Monetary policy remains neutral. Inflation levels in a declining trend and inflation expectations pointing downwards have motivated the National Bank of Kazakhstan (NBK) to cut the base rate once again in June down to 9%. So far the rate has been trimmed by 75b.p. since the year started. As mentioned previously, the inflation targeting policy implemented by the NBK has stabilized inflation and the exchange rate. However, we still believe that inflationary pressures remain given the exposure of the economy to external factors as well as volatility in food and fuel prices.

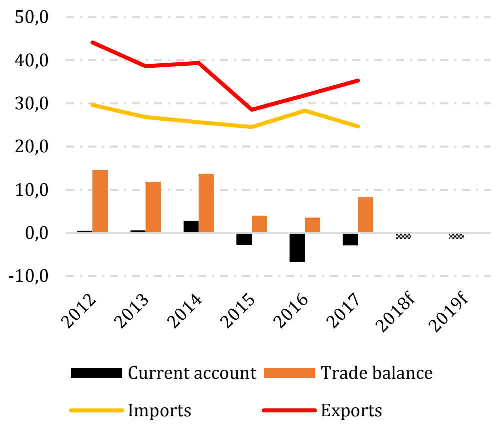
Even though monetary policy has become more efficient with the free-float exchange rate; the policy direction is still quite unpredictable and not completely independent from the central government.

Fiscal deficit widened, but expected to narrow going forward. In 2017, the fiscal deficit increased by almost 1p.p. as a result of a continued increase in expenditures which grew at a higher pace than revenues (see graph 3). The same trend was observed in 1Q 2018 when revenues increased by only 1,4% while expenses hiked by 13,5% y-o-y as spending on education, public health care and social security followed a steady upward trend. In fact, social transfers from the budget have continued to increase and represent a substantial share of budget expenditures. Other expenditures are also related to the Nurly Zhol program. Transfers from the National Fund of the Republic of Kazakhstan (NFRK) were about KZT 1 tn as of May 2018. This figure is on pace to meet the authorities' target of KZT 2,6 tn transfers by end-2018.

As mentioned in previous reviews, the government continues to make efforts to reduce the budget dependence on oil; however, the non-oil deficit is also expected to have widened in 2017. Furthermore, the recent announcement by a court in Brussels in regard to the lift of the freeze of USD 22,2 bn held by the National Fund, mitigates the risk of a potential disruption of day-to-day operations and the government's public finances.

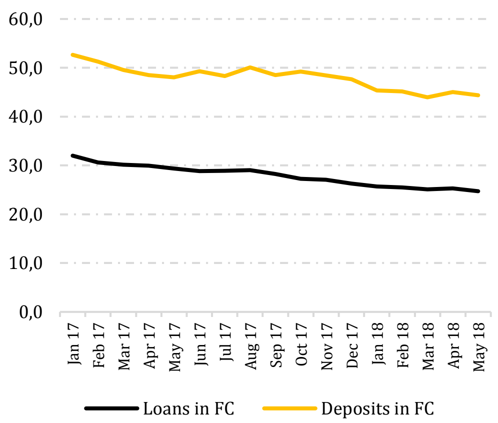
External sector remains resilient. The exchange rate appreciated at the beginning of 2018 reflecting the hike in the prices of oil and higher foreign investment in financial instruments; however, it depreciated sharply after

Graph 4: External sector indicators, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF and NBK

Graph 5: Financial dollarization, % of total



Source: RAEX (Europe) calculations based on data from the NBK

1Q 2018 mainly due to the introduction of additional sanctions against Russia.

After a deep fall in 2H 2017, international reserves have increased slightly and remained stable in 5M 2018. Even though FX reserves declined, assets from the National Fund increased. The level of international reserves is well-positioned covering external debt by 2x and gross government debt by 1x.

The current account deficit declined in 2017 and stood at around 2,9% of GDP. Also, the trade balance surplus increased up to 8,3% of GDP in the same period as a result of surging exports given higher oil output (see graph 4). Nevertheless, in the current year, exports have shown a slower pace of growth.

The banking sector in Kazakhstan remains fragile. Despite having sound balance sheet indicators, restructured loans and lack of credit growth remain a concern. Moreover, Qazaq Bank, Bank of Astana and Eximbank suffered extensive deposit withdrawals after president Nursultan Nazarbayev criticized the way the institutions operate. However, financial soundness indicators remain stable. By April 2018, capital adequacy remained high at 16,9%, NPLs have declined consistently down to around 9% (this, without considering restructured loans and NPLs from SPVs) and ROA was positive at 0,4%. Finally, due to the restructuring efforts of the banking system, it remains concentrated in a few institutions.

Credit to the economy has remained stagnant, banks assets to GDP declined by 10p.p. in 2017 down to 46% of GDP and domestic credit also declined by 3p.p. down to 41,5%. The absolute level of bank's assets and loans remained practically unchanged from the beginning of the year until April 2018. Furthermore, deposit dollarization levels continued to decline slightly down to 44% as of May 2018; while FX loans have slightly declined down to 25% as of the same date. However, the still high level of financial dollarization remains a risk for the economy and the stability of the financial system (see graph 5).

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Kazakhstan_06.07.2018.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.