Research Report on Kazakhstan

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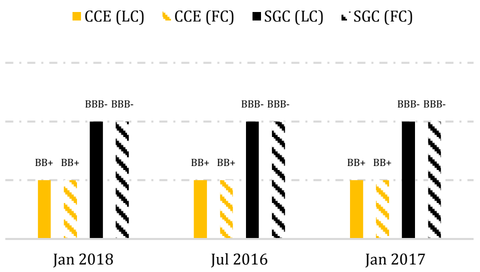
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Country Credit Environment (LC)	BB+
Country Credit Environment (FC)	BB+

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Kazakhstan

Macro indicators	2015	2016	2017
Gross gov. debt, KZT bn	8946	9586	11270*
Nominal GDP, KZT bn	40884	45732	51699*
Real GDP growth, %	1,2	1,1	3,3*
Gross gov. debt/GDP, %	21,9	21,0	21,8*
Deficit (surplus)/GDP, %	-6,3	-4,0	-6,5*
Inflation rate, %	13,6	8,5	7,1
Current Account Balance/GDP, %	-	-	-5,3*
External debt, USD bn	-	-	168,9**

Development indicators	2017
Inequality adj. HDI	0,71
GDP per capita, USD th	26,1*

Default indicator	12.01.2018
5-Year CDS spread, Bp	107,1
7Y Gov Bond Yield, %	3,43

Source: RAEX (Europe) calculations based on data from the IMF, Cbonds, Ministry of Finance of the Republic of Kazakhstan and NBK
* Forecast for 2017 ** Figure for 3Q 2017

Summary

Kazakhstan's SGC ratings at BBB- and CCE ratings at BB+ are underpinned, on the one hand, by the low level of government debt, sufficient fiscal buffers and the continued stabilization of the consumer price level as well as the exchange rate, which caused a steady decline in the amount of deposit dollarization. Additionally, the external sector has recovered as the trade and current account balances posted improved figures in 2017.

On the other hand, the ratings also reflect the persistent banking system risk which heightens the probability of contingent liability materialization for the Kazakh government. Furthermore, we continue to observe a stalled credit market, especially for corporations, as a result of the still high NPLs and restructured loans.

Solid GDP growth in 2017 driven by hydrocarbons production. As expected in our previous review, real GDP growth was strong in 2017 (projected to have grown by 3,3% y-o-y) underpinned by the hydrocarbon sector, where higher prices have improved the terms of trade and the production of crude oil and natural gas increased by around 10,5% y-o-y by November 2017. This, as a result, increased the level of exports from the country as the exports of hydrocarbons account for around 57% of total Kazakh exports (see graph 1). Moreover, even though consumption growth figures remain positive, they were lower than in 2016. This could be the result of a real income decline of individuals.

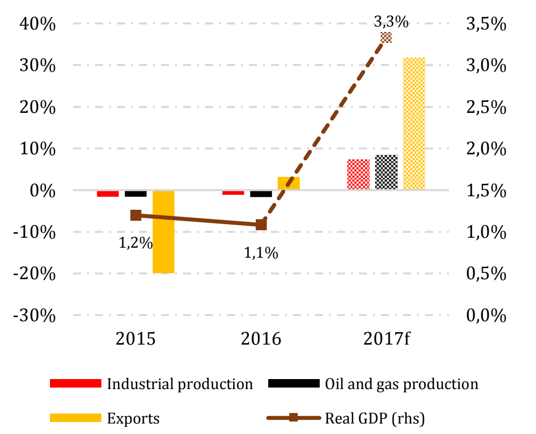
Furthermore, the non-oil sector also enjoyed a stable growth throughout 2017 as the overall industrial production increased steadily driven by the manufacturing, agriculture, transport, and trade sectors.

Going forward, we expect the stability of the country's output will depend on the results of the recent implementation of the structural reforms aimed at achieving a more diversified and less oil-dependent economy.

Government debt metrics remain low. We anticipate government debt to have been low in 2017 and to continue in the same trend in the following years. According to our estimates, government debt to GDP is set to finish the year at around 22% of GDP, a stable figure when compared to the readings from 2015 and 2016. Moreover, we expect this figure to remain steady 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 its efforts to consolidate the budget.

In regard to the debt structure, short-term debt was low at 0,3% of GDP and around 1% of total debt by 3Q 2017. Moreover, the external debt of the government as a percentage of total debt decreased to about 46,5% where 53% of the total government external debt was issued by international financial institutions.

Graph 1: Industrial production, exports and real GDP, y-o-y growth

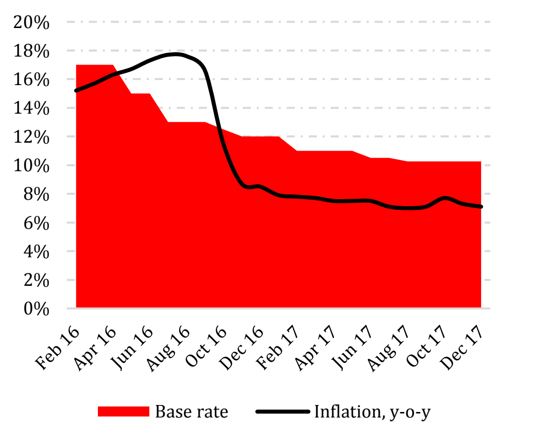


Source: RAEX (Europe) calculations based on data from the IMF, NBK and the National Statistics Office

Effective monetary policy and exchange rate regime. The new inflation-targeting monetary policy, coupled with the free-float exchange rate regime continues to show effectiveness according to the reported figures. We have observed sustained and consistent stability in both the inflation rate and the exchange rate, which has resulted in lower levels of deposit dollarization.

Along 2017, the average exchange rate was 326,2 KZT per USD and showed very low volatility as compared to previous periods. This has been favorable for the local currency as it has increased people's confidence in the KZT. Evidence of this can be seen in lower levels of deposits in foreign currency which stood at 48% by November 2017 as compared to 56% a year before. Besides this, the recent slight appreciation of the KZT/USD was due to improving oil prices towards year-end 2017.

Graph 2: Base rate vs Inflation rate



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

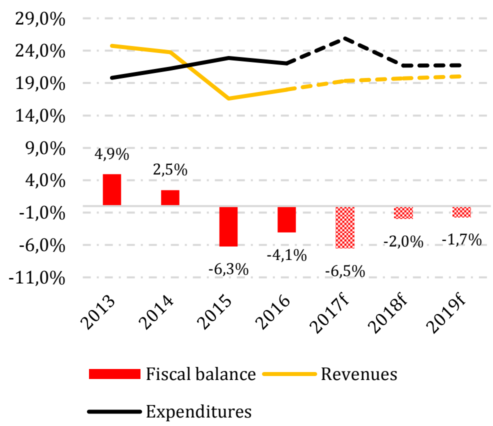
The inflation growth in the economy has also been stable and in a downward trend and within the NBK target (between 6% and 8%) for 2017 when inflation grew by 7,1% y-o-y by year-end. As a result of the declining trajectory of the price level, the NBK decided to trim its base rate by 25 b.p. to 10,25% in August 2017 (see graph 2). Even though energy prices have hiked, the declining level of inflation can be partly explained by lower consumption as a result of lower real wages of individuals. Due to the latter, we could expect lower levels of inflation going forward which may cause additional easing by the NBK in order to maintain inflation in its newly introduced target for 2018 (between 5% and 7%).

Fiscal metrics expected to recover in 2018 after wide deficit posted in 2017. By 3Q 2017 government expenditures had a substantial hike of 11,2% y-o-y, in contrast, the increase in revenues was only 8,2% y-o-y. These dynamics were driven by the supportive policy of the government as most of the increase in expenditures is connected with the implementation of the Nurly Zhol program and capital injection in the banking system. Moreover, expenditures of the NFRK in the form of transfers increased by about 94% in the same period.

Thus, we expect the fiscal deficit to have posted a figure of around 6,5% of GDP in 2017, as previously anticipated (see graph 3). Even though the government has made strides to reduce the budget dependence on oil, the non-oil deficit is expected to have also widened in 2017.

However, we expect the authorities to further reduce the use of funds from the NFRK going forward as a result of the introduction of rules[1] that will aim at maintaining strong buffers and reducing dependence on oil, ultimately stabilizing transfers from the NFRK.

Graph 3: Public finances, % of GDP

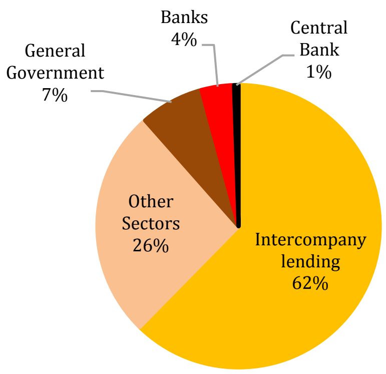


Source: RAEX (Europe) calculations based on data from the IMF

External sector recovered in 2017. Exports grew at an average of 31,8% y-o-y in the first 3Q 2017 propelled by strong industry production and increased activity with its main trading partners. In contrast, imports grew by only 16% in average over the same period. As a result, we expect the trade surplus to have widened up to around 6,8% of GDP in 2017 and the current account deficit to narrow slightly to about 5% of GDP despite the increase on primary income payments along the year. Going forward, we expect the same trends to continue and, thus, the current account and trade balances to present favorable figures.

The structure of the gross external debt remained practically unchanged where around 88% of the total gross external debt is owned by the private sector in the form of loan, securities and intercompany lending, among others (see graph 4). We project that by year-end 2017, the level gross external debt was around 110% of GDP, which would represent a 10p.p. reduction from a year before in part due to the stability of the exchange rate. Moreover, the net international investment position (NIIP) declined further and stood at USD -51,1 bn as of 3Q 2017; however, we project it to have declined to around 34% of GDP in 2017, 3p.p. lower than a year before.

Graph 4: Structure of external debt as of 3Q 2017



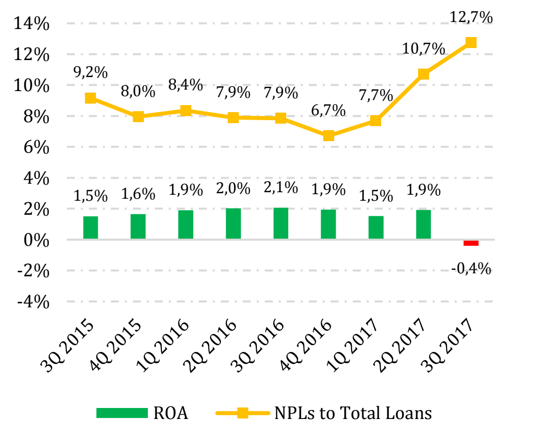
Source: RAEX (Europe) calculations based on data from the NBK

The level of international reserves has slightly declined towards end-2017 after the spike in July due to conversion operations from transfers of the NFRK. However, they remain quite high at USD 31 bn as of November 2017 covering FX-denominated debt by 2x and gross government debt by 1x.

The banking sector remains fragile. Despite persisting adequate official capitalization metrics, the official NPLs to total loans ratio was as high as 12,7% as of 3Q 2017 after having decreased substantially in 2016. However, the actual figure of troubled loans is higher when considering restructured loans and NPLs from SPVs. In this sense, we expect the authorities to continue to inject funds in order to improve the system. Furthermore, profitability in the sector was negative for the first time since the aftermath of the 2008 financial crisis posting a ROA of -0,4% (see graph 5). In our view, the aforementioned metrics reflect the increasing

[1] See our previous Research Report for a short description of the mentioned rules. Research report on Kazakhstan from 14 July 2017 (https://raexpert.eu/reports/Research_report_Kazakhstan_14.07.2017.pdf).

Graph 5: Financial soundness indicators



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

risk in the banking system; thus we still consider a potential materialization of contingent liabilities a key threat to the stability of the government finances.

Credit to the economy remains stagnant. We expect the volume of private credit to GDP to have declined in 2017 to around 44%. Moreover, we also anticipate a decline in the overall banks' assets to GDP ratio by around 10p.p. from 2016. The still high amount of troubled loans in the system and the potential to further increase this metric and hurt capitalization have caused limited credit growth, especially for the corporate sector. Furthermore, as mentioned above, deposit dollarization levels remain stable at 48% as of November 2017; while FX loans have slightly declined down to 27% as of the same date.

The takeover of KKB by Halyk Bank took another step as they recently agreed to merge operations and the new institution is expected to account for 40% of the market. On the one hand, this may stabilize the system; however, it increases concentration and may hurt competition.

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_12.01.2018.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.