Research Report on Kazakhstan

13 December 2019

Responsible Expert:

Hector Alvarez
Associate Director

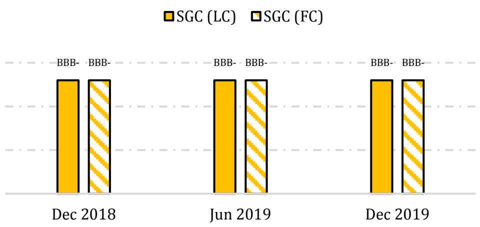
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00 ext. 1213
E-mail: alvarez@raexpert.eu
www.raexpert.eu

Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Kazakhstan

Macro indicators	2016	2017	2018
Gross gov. debt, KZT bn	9243	10805	12524
Nominal GDP, KZT bn	46971	53101	59614
Real GDP growth, %	1,1	4,1	4,1
Gross gov. debt/GDP, %	19,7	20,3	21,0
Deficit (surplus)/GDP, %	-4,5	-4,4	2,7
Inflation rate, %	8,5	7,1	5,3
Current Account Balance/GDP, %	-	-	-2,2
External debt, USD bn	-	-	158,3

Development indicators	2018
Inequality adj. HDI	0,74
GDP per capita, USD th	27,7

Default indicator	13.12.2019
5-Year CDS spread, Bp	63
10Y Gov EuroBonds Yield,%	0,89**

Source: RAEX-Europe calculations based on data from the IMF, Cbonds, Ministry of Finance of the Republic of Kazakhstan and NBK.
* Figure for 2Q 2019 ** Maturity in 2028 (ISIN: XS1901718335)

Summary

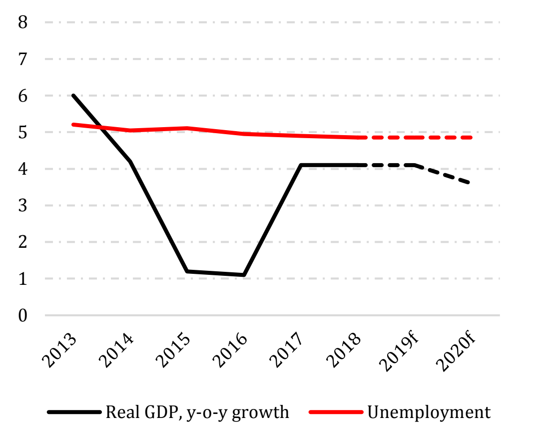
The affirmation of our credit ratings of Kazakhstan at 'BBB-' with a change in outlook from stable to positive is mainly related with resilient economic growth, especially in the non-oil sector, as well as satisfactory and continuously stable management of public finances. Moreover, the external position remains solid and inflation has remained within the target of the Central Bank.

However, weaknesses in the banking sector continue to present the largest threat to the creditworthiness of the country. The system remains quite fragile with subdued credit growth, high level of concealed NPLs and potentially substantial needs of further capitalization for some banks. This, combined with the still strong footprint of the state in the economy, elevate the risk of materialization of contingent liabilities. Finally, even though the transition to a more balanced economy away from hydrocarbon dependence is on its way, we still consider that it remains highly depend on the oil sector making the economic performance and public finances highly dependent on oil production and prices dynamics.

Economic growth has been strong and expected to remain so. As of 3Q 2019, the economy has shown a favorable performance driven by the industrial sector (9% y-o-y growth in nominal terms), as oil production declined, but it was still better than anticipated despite maintenance works in the main oil fields, while trade services (13,4% y-o-y growth in nominal terms) and construction (14,5% y-o-y growth in nominal terms) also saw an important uptick. On the other hand, despite growing, private consumption saw a decline as compared to the first half of 2019. The above reflects a strong and improved contribution of the non-oil sector of the economy, which is a key reason for our change in the rating outlook. Finally, the overall growth of the economy in the aforementioned period stood at 4,3% y-o-y and we expect the rate to stand around 4,1% by year-end 2019 (see graph 1).

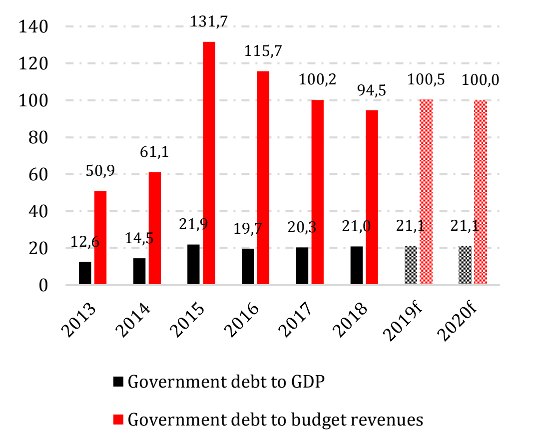
In our view, economic growth will remain strong going forward, as the execution of planned reforms should contribute to increase investments. Moreover, we anticipate exports to grow slightly, but we also expect the external position to be challenged by oil price volatility and trade tensions. On the positive side, the non-oil sector appears to be developing positively

Graph 1: Macroeconomic indicators, %



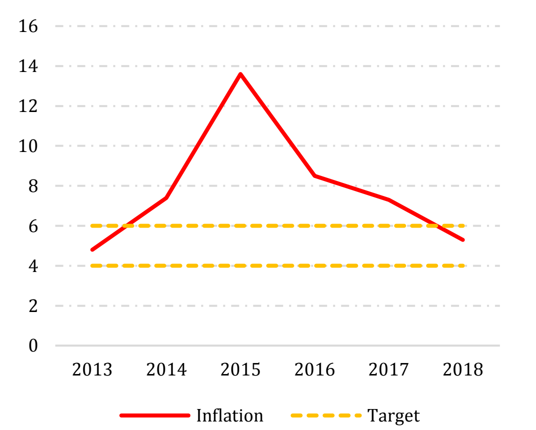
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the IMF

Graph 3: Target vs inflation rate, %



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

and the presidential transition towards the new President Kassym-Jomart Tokayev, signals a continuation of policies.

Government debt levels remain consistent. Government debt levels are expected to remain balanced in 2019 at 21% of GDP and 99% of budget revenues (see graph 2). Both readings show a stable development of government debt as compared to the last four years and we expect this stability to continue in the mid-term perspective as the authorities have committed to cap debt levels in the new budget law. In terms of the structure of debt, it is not favorable in regard to the level of external debt, as it accounts for 46% of total debt; however, the structure remains positive as referred to the level of short-term debt, which is still low and covered 24x by international reserves, while the amount of concessional debt stands at 42% of the total external debt.

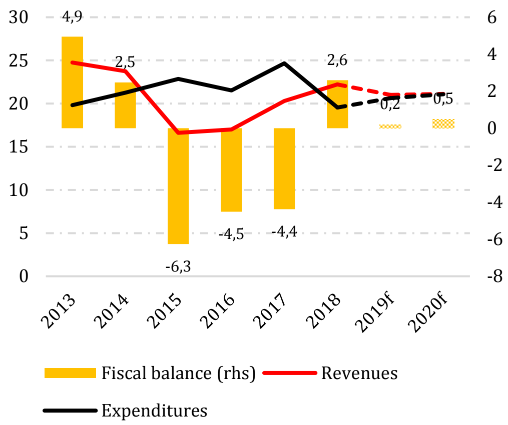
The materialization of the contingent liabilities' risk still lingers. The combination of the amount of assets where the government still has a stake, with the persistent needs of the banking system from government capital, make contingent liabilities high. However, the amount of state-owned companies has been gradually declining as the privatization process has continued despite some delayed IPOs. In fact, the government recently announced that in 2020 it is planning to partially privatize large companies, such as KazMunayGaz, Air Astana and Kazakhtelecom.

The Central Bank is focused on price stability. After trimming the base rate back in April 2019 due to inflation spiraling down, the National Bank of Kazakhstan (NBK) increased the rate by 25b.p. in September 2019 as a result of increasing inflation and inflation expectations, showing its commitment to achieve price stability. So far in 2019, the inflation rate has remained within the target of the NBK between 4% and 6%. As of November 2019, the y-o-y inflation stood at 5,4% and we expect the metric to finish 2019 at around 5,6%, showing a fine level of stability and remaining within the NBK threshold (see graph 3).

We still expect the NBK to concentrate on price stability. Nevertheless, we still consider that monetary policy effectiveness is still weak and the transmission mechanism remains affected by high level of dollarization and subsidized lending.

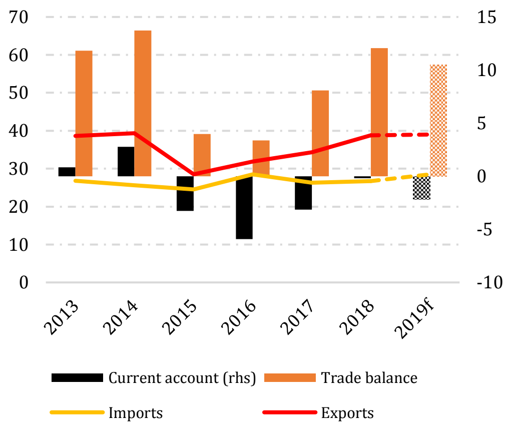
Fiscal policy to remain supportive in the mid-term horizon. We anticipate the fiscal surplus to shrink down to 0,4% at the end of 2019 since, as expected, we have seen a surge in social spending. Spending in items such as education, social assistance and social security and public health care, grew by 18,2%, 25,5% and 10,4% y-o-y respectively as of

Graph 4: Fiscal budget dynamics, % of GDP



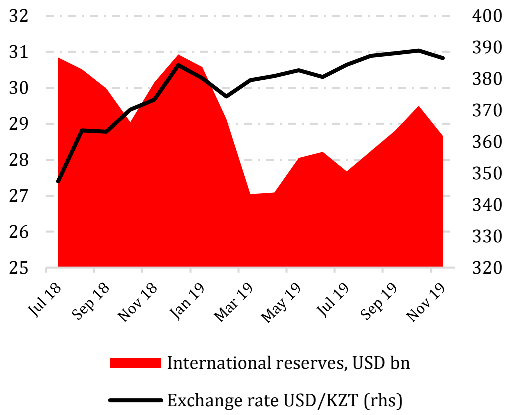
Source: RAEX-Europe calculations based on data from the IMF

Graph 5: External sector indicators, % of GDP



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

Graph 6: International reserves and exchange rate



Source: RAEX-Europe calculations based on data from the NBK

October 2019. In contrast, budget revenues only hiked by 4,3% as of the same date as a result of improved tax collection (see graph 4).

Going forward, we expect public finances to remain stable and, in the mid-term view, face a downward pressure resulting from a loose stance in order to carry out the second phase of the "Nurly Zhol" and the commitment to increase social spending and public sector wages, among other supportive policies. However, we expect the government to continue to seek fiscal consolidation in the long-term perspective.

In regard to the non-oil fiscal deficit, we anticipate it to remain wide at around 6,9%; however, we have also seen a stronger development of the non-oil sector which has already translated in higher revenues. We expect this trend to continue and to be reflected in narrower deficits going forward.

In general we consider the fiscal policy and its management to be prudent despite constant transfers from the National Fund of the Republic of Kazakhstan (NFRK) to the budget, for which the level has not been depleted since mid-2017 and we expect it to remain stable going forward.

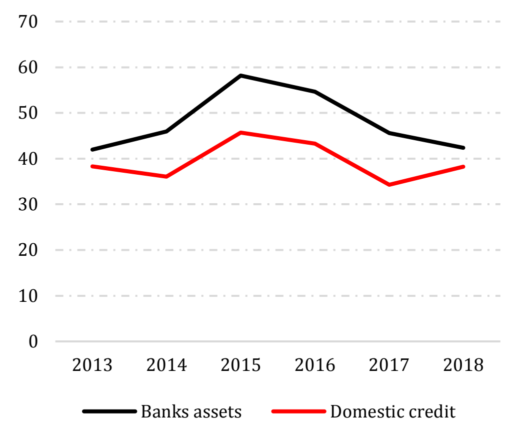
Finally, the recent woes in the banking system may require additional aid from the government which we calculate could be at around 2% of GDP.

External stance still strong, but exposure remains. As of 3Q 2019, accumulated exports showed a decline of 1,4% y-o-y while imports increased by 7% as of the same date. These dynamics have been a reflection of lower exports of goods, especially commodities due to lower prices, combined with solid domestic demand which caused imports to hike. As a result, we anticipate the trade surplus to remain positive at around 10% of GDP in 2019, 2p.p. lower than in 2018, while the current account deficit will widen up to 2,2% of GDP. Going forward, we anticipate the current account deficit to remain wide as a result of moderate oil prices and a continued rise in domestic demand (see graph 5).

The level of international reserves stood at USD 28,7 bn by the end of November 2019, which, despite having declined due to debt repayments and portfolio outflows, still exceeds the IMF recommended reserve adequacy level for countries with a floating exchange rate, as the ratio of reserve calculated by the IMF stands at 1,7 (see graph 6). In addition, international reserves are equivalent to 90,5% of gross government debt and a little more than 7 months of imports of goods and services.

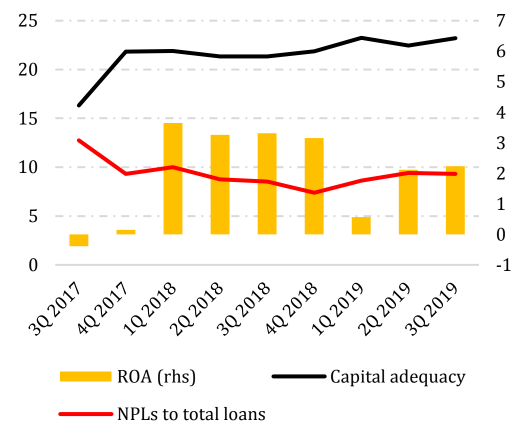
The banking sector still facing challenges. As expected in our previous revision, the assets in the banking system have continued to decline in 2019, as the metric of banking sector assets to GDP is forecast to stand at around 41% in 2019, a decline of about 2p.p. as compared to last year. This

Graph 7: Credit to the economy dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the WB and NBK

Graph 8: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the NBK

decline has been mostly propelled by a reduction in credits to corporations and individual entrepreneurs which shrunk by 6% y-o-y as of September 2019, while consumer loans hiked by 23% y-o-y as of the same date. The above is partly worrisome as we have not seen credit growth toward the producing sectors of the economy, instead, we have continuously observed hikes in the non-productive sphere (see graph 7).

In regard to the quality of the banking system, the ratio of NPLs to total loans stood at 9,1% as of October 2019. Nonetheless, if we account for the history of hidden bad debt in the system, we expect the real level of NPLs to be much elevated; thus, we are cautious when taking into account officially reported figures for our assessment. However, we expect metrics to reflect levels closer to reality once the NBK finalizes its asset quality review cycle, which is expect to be over by the end of 2019. After this review, we also anticipate additional fund injections from the authorities in order to support troubled banks, which, in our calculation, are set to amount to around 2% of GDP. Moreover, the level of dollarization in the banking system remains elevated but has consistently decreased. As of the end of 3Q 2019, the share of loans stood at 17,3%, while the share of deposits was 44,7%.

Profitability of the system remained strong as ROA and ROE stood at 2,2% and 18,2% respectively by the end of September 2019. As of the same date, the banks' level of capitalization has also remained favorable as the capital adequacy ratio was 23,2%. Liquidity in the system remains abundant which has produced problems of surplus liquidity since the amount of creditworthy borrowers remains insufficient to extend credit. Due to the above, the NBK has introduced better measures to manage liquidity in the system (see graph 8).

Finally, the underdevelopment of capital markets in Kazakhstan continues to drag the creditworthiness assessment as reflected by the low level of market capitalization, which slightly increased up to around 24% by 3Q 2019. Despite this figures, as mentioned in our previous review, the development of the capital markets is underway as the Astana International Financial Centre (AIFC) continues to evolve the Kazakh financial market, including the development of Islamic and green finance.

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_13.12.2019.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.