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Research Report on Kazakhstan

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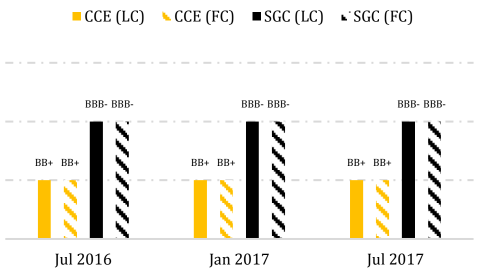
Ratings

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	2014	2015	2016
Gross gov. debt, LC bn	5752	8946	9640
Nominal GDP, LC bn	39676	40884	45732
Real GDP growth, %	4,3	1,2	1,1
Gross gov. debt/GDP, %	14,5	21,9	21,1
Deficit (surplus)/GDP, %	2,5	-6,3	-4,4
Inflation rate, %	7,4	13,6	8,5
Current Account Balance/GDP, %	-2,7	-3,0	-6,2
External debt, USD bn	-	-	163,7

Development indicators	2016
Inequality adj. HDI	0,71
GDP per capita, USD th	25,1

Default indicator	14.07.2017
5-Year CDS spread, Bp	141
10Y Gov Bond Yield, %	3,9

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

Summary

The confirmation of Kazakhstan's SGC ratings at BBB- and CCE ratings at BB+ is supported by prevailing low levels of government debt as well as by the continuous improvement in the effectiveness of the monetary policy which has been translated in increasingly stable inflation and exchange rate levels and, thus, causing dollarization levels to ease.

However, the troubled banking system remains the main risk for Kazakhstan since it has elevated the probability of implicit contingent liabilities materialization and poses a threat to economic stability. Moreover, credit to the economy has stalled and the external position continued to weaken in 2016; nevertheless, we expect it to recover going forward.

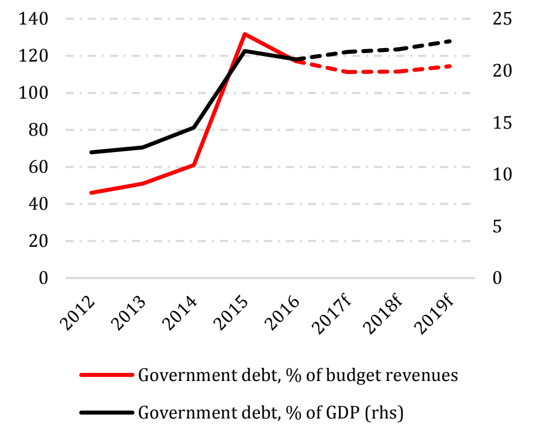
Economy set to pick up pace in 2017. GDP per capita in PPP terms increased to USD 25 154 in 2016 and is still one of the highest among its regional oil-producing CIS peers (see table 1). Real GDP grew at a 1,1% rate in 2016 driven by fiscal support, higher oil production and a pickup in mining output. Even though growth was lethargic for the second year in a row, it grew consistently in 1Q 2017 led by mining and manufacturing and we expect it to continue in an upward trend due to higher oil production in the Kashagan field. Despite this and given that the economy is still very dependent on commodities prices, the overall output will depend on the development of oil prices, which have been very volatile and have declined considerably in 2017. The non-oil sector growth also decreased in 2016 but we anticipate it to grow further in 2017.

Table 1: Peer comparison of oil-producing CIS countries for 2016*

	Kazakhstan	Azerbaijan	Russia	Uzbekistan
GDP per capita PPP (USD)	25 145	17 439	26 490	6 562
GDP growth (%)	1,1%	-3,8%	-0,3%	7,8%
Inflation rate (%)	8,5%	13,3%	5,4%	7,9%
Fiscal balance/GDP	-4,4%	-1,4%	-3,7%	-0,3%
Current account/GDP	-6,2%	-3,8%	1,7%	1,4%
Government debt/GDP	21,1%	37,7%	17,0%	11,6%

Source: RAEX (Europe) calculations based on data from the IMF and WB
* Some figures are estimations for the year.

Graph 1: Government debt dynamics



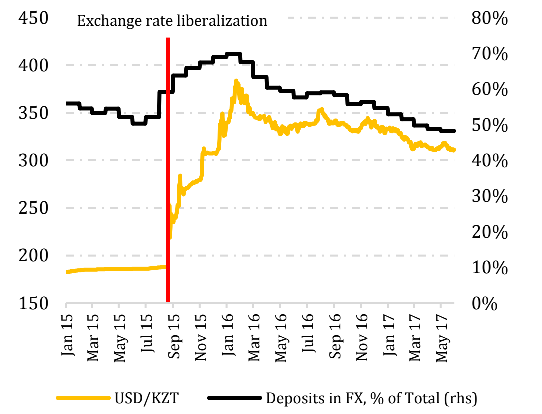
Source: RAEX (Europe) calculations based on data from the IMF

Government debt remains stable. Gross government debt stood at 21,1% of GDP, a decline of less than 1p.p. from a year ago, and 117,1% of budget revenues at the end of 2016. Going forward, we anticipate debt levels to remain stable due to the government's effort to consolidate the public budget (see graph 1).

The structure of the debt has remained consistent since our last review. Short-term debt, despite being all external, accounts for as low as 0,9% of the overall debt. The amount of external debt was around 50% of total debt with 26% being concessional and 24% represented by a Eurobond issuance.

However, potential implicit contingent liabilities materialization risk arising from the banking sector recapitalization needs, represents a threat to the stability of the government's public finances.

Graph 2: Exchange rate effect on dollarization

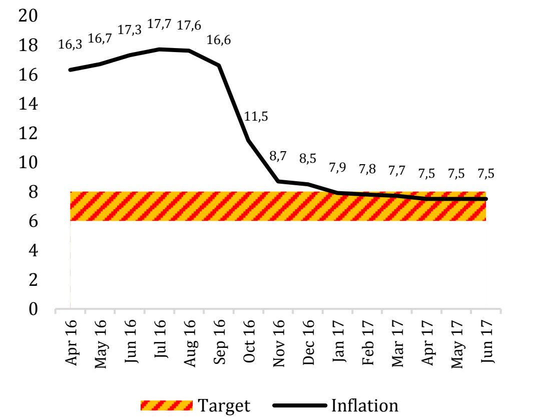


Source: RAEX (Europe) calculations based on data from the NBK

Monetary policy showing signs of effectiveness. The liberalization of the exchange rate and the switch of the National Bank of Kazakhstan (NBK) toward an inflation-targeted monetary policy has brought many benefits to the economy, namely, stability of the exchange rate and inflation levels as well as an improved transition mechanism.

Since the currency was let to free-float in mid-2015 we have observed a more stable USD/KZT exchange rate which contributed to a steep decrease in the levels of deposits denominated in foreign currency; from January 2016 until May 2017, deposit dollarization has decreased by as much as 22p.p. (see graph 2). Despite the decline, the level of FX deposits is still considered very high and a source of risk for economic stability.

Graph 3: Inflation dynamics, y-o-y %



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

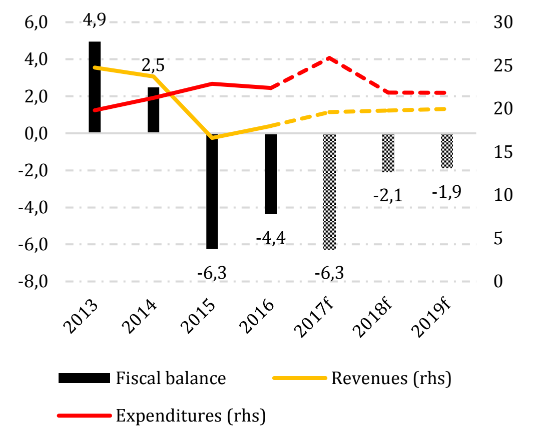
On the other hand, inflation has substantially decreased and, even though we still consider the overall level as high according to our internal thresholds, it has lately reached levels within the target band of the NBK. As of June 2017 it posted a 7,5% y-o-y increase while the NBK target stands between 6% and 8% (see graph 3). Moreover, in the wake of lower inflation expectations, the NBK has continued to ease policy in order to maintain the inflation target. Since March 2016, when the base policy rate was 17%, the NBK has trimmed it six times, reaching 10,5% as of July 2017. Furthermore, as mentioned in our previous review[1], the spread between the deposit and lending rate remains stable and consistent.

Nonetheless, risk of higher inflation remains in place due to possible food supply shocks, KZT depreciation and lower oil prices.

Fiscal metrics to deteriorate in 2017 but to strengthen in the long run. The government has been propelling economic growth by investing

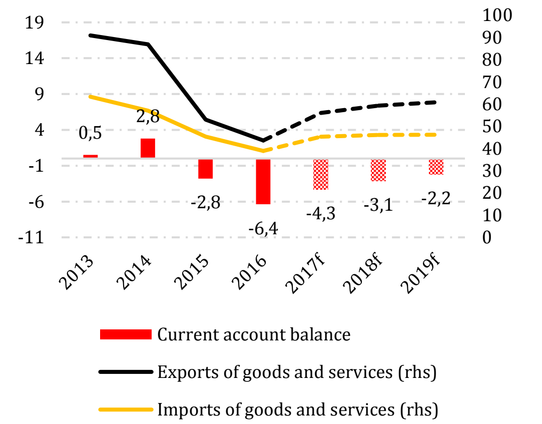
[1] Research report on Kazakhstan from 20 January 2017 (https://raexpert.eu/reports/Research_report_Kazakhstan_20.01.2017.pdf).

Graph 4: Public finances, % of GDP



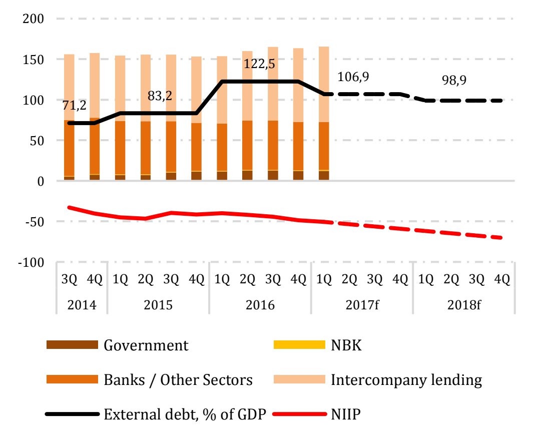
Source: RAEX (Europe) calculations based on data from the IMF

Graph 5: Current account dynamics, % of GDP



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

Graph 6: External debt and NIIP, USD bn



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

in construction, infrastructure, industry and entrepreneurship through the Nurly Zhol initiative, a government fiscal stimulus program representing around 3% of GDP. Moreover, increases in current spending also took place in 2016 while other expenditures were reduced. In the revenues side, non-oil related revenues increased along with interest income from the National Fund of the Republic of Kazakhstan (NFRK). These factors combined produced a reduction in the fiscal deficit of 2p.p. from 2015 to stand at 4% of GDP. The narrowing of the balance was due to the fact that part of the stimulus was performed off-budget.

We expect this year's fiscal deficit to widen once again given the government stimulus plan to clean up the banking system of bad debt. The government has planned to inject around KZT 2 tn in the Problem Loans Fund (PLF) financed by bonds and transfers from the NFRK. Nonetheless, after this one-off effect and given the government's commitment towards consolidation of the public finances, we anticipate the metric to resume a downward trend from 2018 (see graph 4).

The Agency also considers as a positive signal for the diversification of the economy the introduction of rules that will aim at maintaining strong buffers and reducing dependence on oil, ultimately stabilizing transfers from the NFRK. The rule will stipulate non-oil deficit targets of 7% by 2020 and 6% by 2025, as well as gradual reduction on the fund's transfers and a minimum amount of assets in relation to GDP levels (30%).

External position expected to recover. The external position of Kazakhstan deteriorated further in 2016. The current account presented a wider deficit mainly due to the worsening of the trade balance surplus as a result of a 20% y-o-y decline in exports and 18% y-o-y decline in imports (see graph 5). Moreover, the overall level of external debt stayed high by end-2016 at around 120% of GDP given the KZT depreciation effects; however, 65% of GDP is related to intercompany lending and public sector-related debt is only 26,5% of GDP. The net international investment position (NIIP) continues to decline and stood at USD -50,6 bn as of 1Q 2017, representing around 37% of GDP (see graph 6). In addition, FDI increased to 6,6% of GDP in 2016 due to investment in the oil sector.

Despite this, we anticipate a recovery in the current account and a reduction on external debt given expected higher prices of oil and increased production. Furthermore, we believe that the NIIP will continue to deteriorate in absolute terms but we expect it to stabilize in relation to GDP. Nevertheless, the recovery in the external position will largely depend on the recovery in the prices of oil which, as mentioned previously, have been highly volatile and challenging to predict.

The banking system poses the biggest threat to economic stability. The troubled and underdeveloped banking system remains the key risk for Kazakhstan's creditworthiness. Despite posting favorable official figures such as a capital adequacy ratio of 16,3% and NPLs to total loans at 6,7% as of end-2016, the system's capitalization is not as strong and off-balance sheet NPLs[2] and restructured loans are substantial. In addition, credit to the economy has stalled (private credit was around 45% of GDP, the same figure as in 2015) and there is an excess of liquidity in the market which the NBK has swept through short-term instruments.

In this regard, as mentioned before, the authorities have planned further capital injections of about KZT 2 tn to the PLF to continue sweeping the system of bad debt; however, public funds placed in the banking system are already around KZT 5 tn. Additionally, Halyk Bank has taken over the troubled Kazkommertsbank in order to strengthen the sector. Even though the acquisition will further consolidate Halyk Bank as the major player in the market (40% of market share) it will be a challenge to handle the takeover of a substantially weak bank. Moreover, sector concentration and lack of diversification could hurt competition and the stability of the financial system.

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_14.07.2017.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.

[2] According to IMF estimations official NPLs plus off-balance sheet bad loans account for about 40% of total loans.