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Research Report on Kazakhstan

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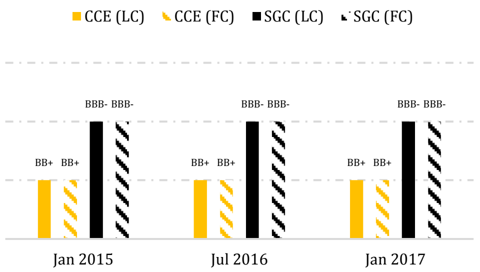
Ratings

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, KZT bn	5752	8946	9656*
Nominal GDP, KZT bn	40755	40878	45178*
Real GDP growth, %	4,3	1,2	-0,8*
Gross gov. debt/GDP, %	14,1	21,9	21,4*
Deficit (surplus)/GDP, %	1,7	-6,8	-5,6*
Inflation rate, %	7,4	12,0	8,5
Current Account Balance/GDP, %	-	-	-2,2*
External debt, USD bn	-	-	165,4**

Development indicators	2015
Inequality adj. HDI	0,69
GDP per capita, USD th	25,7*

Default indicator	20.01.2017
5-Year CDS spread, Bp	164
10Y Gov Bond Yield, %	3,6***

Source: RAEX (Europe) calculations based on data from the IMF, Deutsche Bank, Ministry of Finance of the Republic of Kazakhstan and NBK
* Forecast for 2016 ** Figure for 3Q 2016 ***Eurobond

Summary

The confirmation of both SGC and CCE ratings of Kazakhstan is based on the fact that, despite an improvement of some major indicators, most of them are generally consistent with our expectations in the previous revision of the rating.

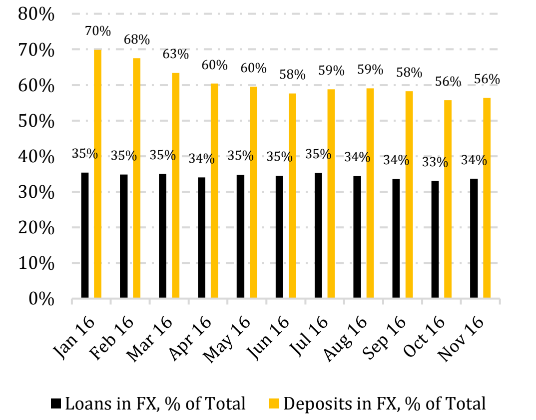
Government debt remains below our internal thresholds, inflation has slowed down and we expect it to remain stable for 2017 and the monetary policy introduced in 2015 has stabilized the exchange rate and inflation expectations, thus, causing a decline in financial dollarization. Furthermore, higher oil prices are expected to propel a rebound of the economy in the current year.

However, the financial system is still underdeveloped and fragile, inflationary pressures remain latent and the country still has an extremely high dependency on the hydrocarbon sector. Furthermore, the external position continues to deteriorate as the current account deficit and the negative Net International Investment Position (NIIP) have widened.

Economic growth set to rebound. GDP growth was lethargic in 1H 2016. In 1Q 2016 it contracted by 0,2% and grew by a mere 0,09% y-o-y by the end of 2Q 2016. However, the economy performed better than expected in 3Q 2016 showing a slight growth of 0,4% y-o-y by, driven by the agriculture, construction and services sector. Furthermore, we expect the economy to have ended 2016 with a positive growth in real terms (opposite to IMF expectations of a contraction) on the back of increased oil production in Kashagan and the recovery of world oil prices. We anticipate a further recovery in 2017 supported by increased oil production from the Kashagan field and the recovery of hydrocarbons prices.

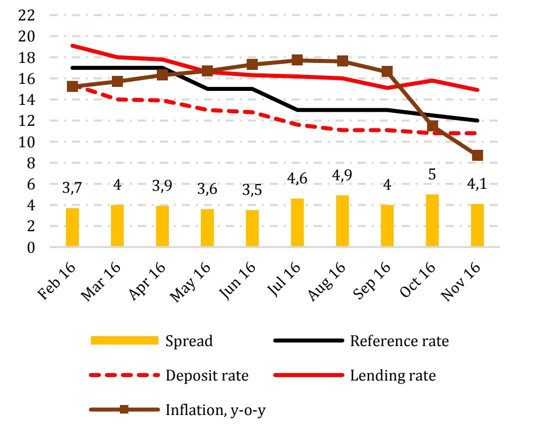
Monetary policy has stabilized price and exchange rate volatility. A steep depreciation of the KZT along with speculative moves by banks, a spike in inflation and NBK interventions followed the decision of National Bank of Kazakhstan (NBK) to free float the exchange rate and adopt an inflation-targeting policy in August 2015. However, along 2016 the exchange rate has reached an equilibrium and stayed stable, which has translated in lower dollarization (see graph 1) and stable price levels.

Graph 1: Financial dollarization



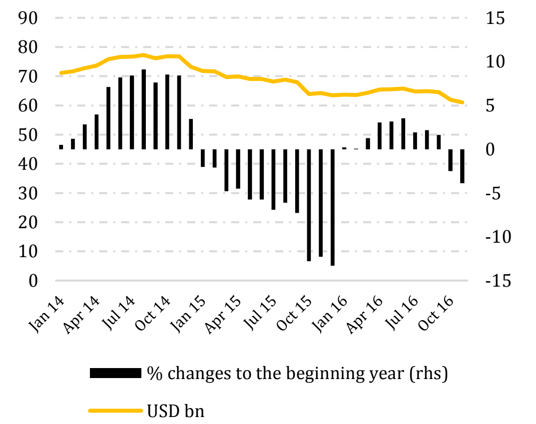
Source: RAEX (Europe) calculations based on data from the NBK

Graph 2: Monetary policy transmission, %



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

Graph 3: Dynamics of the NFRK



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

Since adopting an inflation-targeting policy, the NBK has consistently reduced the base rate, reflecting lower inflation expectations, slower pace of price increases (CPI rose by as low as 8,5% y-o-y by December 2016 mainly due to a base effect) and de-dollarization of the economy. At the same time, the monetary transmission mechanism has improved and the spread between deposit and interest rates has remained stable and consistent (see graph 2).

Nonetheless, inflationary pressures remain in place given an expected increase in services' tariffs, recent increase in food prices and higher domestic fuel prices as a result of the world oil price recovery.

Fiscal position improved by the end of 2016. Kazakhstan is set to post a fiscal deficit of around 5% in 2016, the country's second in a row given dismal economic conditions and depressed oil prices during most of part of 2016. However, towards year-end 2016 fiscal results were positive. Government revenues (excluding transfers from the National Fund of the Republic of Kazakhstan (NFRK)) increased by 31,8% through November 2016 as compared to the same period last year, propelled by the collection of an additional 38% in corporate tax and 59% in value added tax. Additionally, expenses showed a 16,6% increase in the same time span. Finally, transfers from the NFRK increased by 25,8% reducing the fund by an additional USD 2,5 bn in 2016 (see graph 3).

For 2017, we expect a tighter fiscal policy with lower government spending aiming towards consolidation. In addition, privatization plans continue to materialize in Kazakhstan which would bring additional revenues for the government and reduce contingent liabilities. Companies such as Kazatomprom, Kazpost and Samruk-Energy set to be partially privatized between 2017 and 2018.

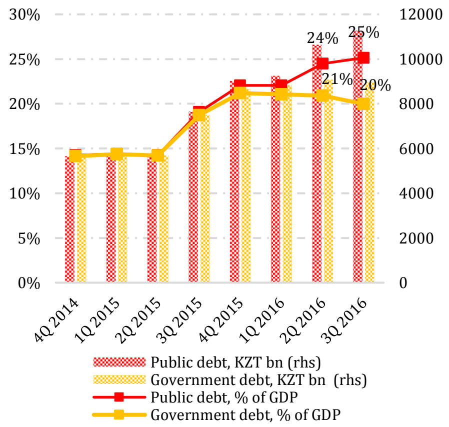
Government debt stabilized in 2016. Government debt remained stable throughout 2016 (estimated to have finished the year at around 21,4% of GDP) and it is expected to continue in the same trend for 2017. Government debt stood at 20% of GDP in 3Q 2016; however, total public debt[1] grew by 3p.p. up to (25,1% of GDP) from 2015 to 3Q 2016 due to an important increase in debt from the NBK (see graph 4). Government debt to budget revenues is projected to end 2016 at 133,9%, 2p.p. higher than 2015.

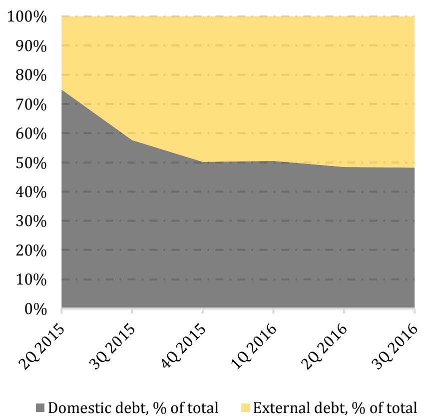
Furthermore, the structure of the government obligations remains satisfactory. As mentioned in our previous report[2], external debt spiked in 3Q 2015 since the Eurobond issuance and by 3Q 2016 represented 51,8%

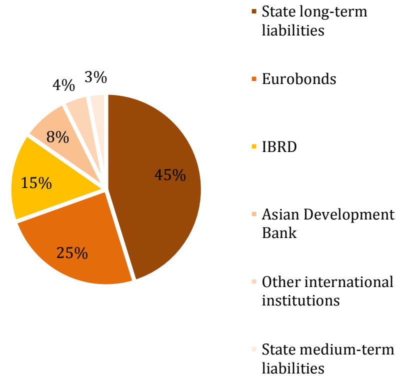
[1] Public debt includes obligations issued by the NBK.
[2] Research report on Kazakhstan from 22 July 2016 (http://raexpert.eu/reports/Research_report_Kazakhstan_22.07.2016.pdf).

of total government debt. Despite this, 53,1% of the total external debt is concessional and 93,6% of the domestic obligations have long-term maturities (see graphs 5 and 6).

Graphs 4, 5 & 6: Government and public debt statistics



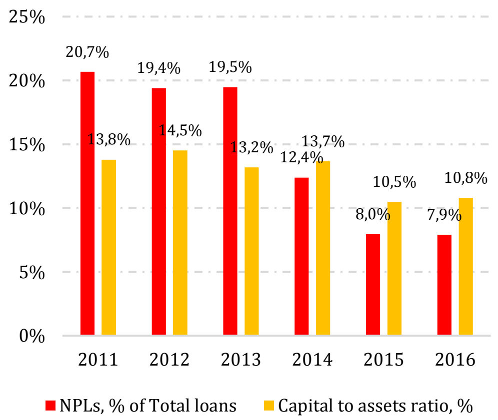




Source: RAEX (Europe) calculations based on data from the Ministry of Finance of the Republic of Kazakhstan and the NBK

Banking system facing potential distress. Credit to the economy picked up slightly in 2016. We estimate that bank assets and private debt to GDP were around 59% and 45% respectively last year. The increase is due to the excess liquidity in the banking sector. Furthermore, given the stability of the exchange rate and the gap between interest rates in KZT and foreign currency, levels of deposit dollarization decreased by 13p.p. from January 2016 to November 2016 while loans in FX remained practically flat in the same period.

Graph 7: Financial soundness indicators



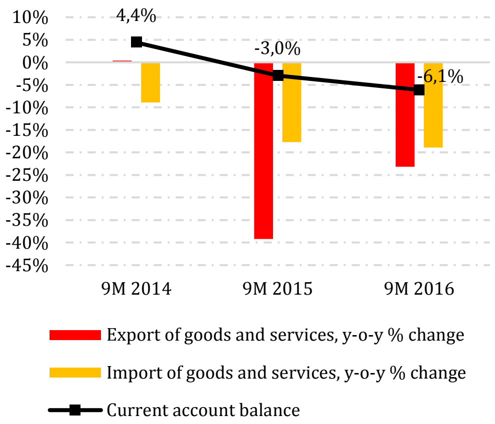
Source: RAEX (Europe) calculations based on data from the NBK

Despite the adverse condition in the banking system, it remains well capitalized having posted a capital to assets ratio of 10,8% in 2016, a stable indicator over the past six years. Additionally, the NPLs to total loans ratio declined to 7,8% in the same year (see graph 7). Nonetheless, the amount of restructured loans has also increased substantially and many of these may represent hidden NPLs.

Furthermore, the recent struggle of Kazkommertsbank, Kazakhstan's biggest bank, whose assets have substantially deteriorated, may bring additional shocks to the financial system given a potential bailout from the government.

External position continued the negative trend. The external position of Kazakhstan continued to deteriorate in 2016 as previously expected by the Agency. By 9M 2016 exports and imports of goods and services declined by 23% and 19% respectively given lower oil prices and reduced

Graph 8: Current account dynamics, % of GDP



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

domestic demand. As a result, the current account deficit is set to increase up to 6,1% of GDP in the same period (graph 8).

In addition, net direct investment was USD 12,2 bn in 9M 2016, the highest in the last eight years mainly due to the investments in the oil sector. However, the NIIP of Kazakhstan has deteriorated and stands at USD -44,9 bn in 9M 2016.

International reserves have remained stable throughout 2016 (USD 29,8 bn by November 2016). We expect that by year-end 2016 reserves covered gross government debt by 1,1x and external debt by 2,2x.

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:

http://raexpert.eu/reports/Press_release_Kazakhstan_20.01.2017.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.