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Research Report on Kazakhstan

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Responsible Expert:

Hector Alvarez
Rating Associate

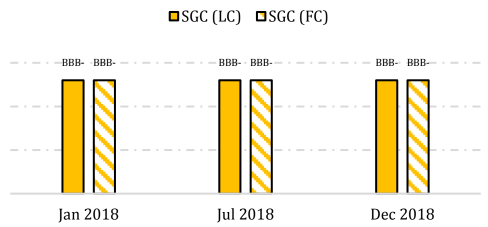
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

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	2016	2017	2018f
Gross gov. debt, KZT bn	9243	10805	10822
Nominal GDP, KZT bn	46971	51967	59790
Real GDP growth, %	1,1	4,0	3,7
Gross gov. debt/GDP, %	19,7	20,8	18,1
Deficit (surplus)/GDP, %	-5,3	-6,4	0,6
Inflation rate, %	8,5	7,1	6,2
Current Account Balance/GDP, %	-	-	-0,7
External debt, USD bn	-	-	164,4*

Development indicators	2017
Inequality adj. HDI	0,74
GDP per capita, USD th	26,3

Default indicator	21.12.2018
5-Year CDS spread, Bp	73,4
10Y Gov Bond Yield, %	2,5

Source: RAEX-Europe calculations based on data from the IMF, Cbonds, Ministry of Finance of the Republic of Kazakhstan and NBK.
* Figure for 2Q 2018 ** EUR-denominated bond

Summary

The confirmation of Kazakhstan's rating at 'BBB-' with a stable outlook shows the stability of most macro and fiscal metrics across the board. Lower government debt, positive fiscal balance, favorable GDP growth and inflation levels as well as a solid external position are among the factors supporting the creditworthiness of the sovereign.

Despite this, the lingering weakness of the banking sector continues to be the key issue in regard to the country's credit rating. A fragile banking system may cause contingent liabilities to materialize. Moreover, the economy continues to be highly dependent on the oil sector. Thus, the volatility of the oil market creates uncertainties towards economic growth and fiscal imbalances.

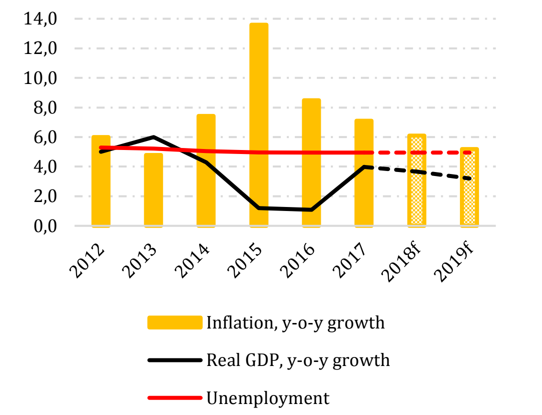
Economic growth expected to remain stable and oil dependent. We anticipate real GDP to continue growing at a stable pace at around 3,7% in 2018 as a result of higher oil prices for most of the year (see graph 1). Despite the economy remaining highly dependent on the oil sector, non-oil real GDP is expected to grow robustly in 2018 at around 3,9%.

As a result of higher real wages and a higher minimum wage in 2019, we expect consumption to remain strong and going forward. Moreover, despite the recent dip in oil prices, we still expect the average oil prices in 2019 to be slightly below the average of 2018; however, we also anticipate prices to be increasingly volatile. In light of this, we believe growth in 2019 will be quite stable but still highly dependent on external factors.

Government debt is anticipated to decline. As we previously anticipated, government debt is projected to decrease and stand at 18,1% of GDP in 2018 with a contraction of 1,3p.p. from 2017 (see graph 2). Moreover, the debt to budget revenues ratio is expected to decrease to 110%. At the same time short-term external debt almost doubled in the 1H 2018, mainly from debt securities of the Central Bank and trade credit and advances provided to the Central government. Despite the increase, we expect it to remain very low at 0,5% of GDP in 2018.

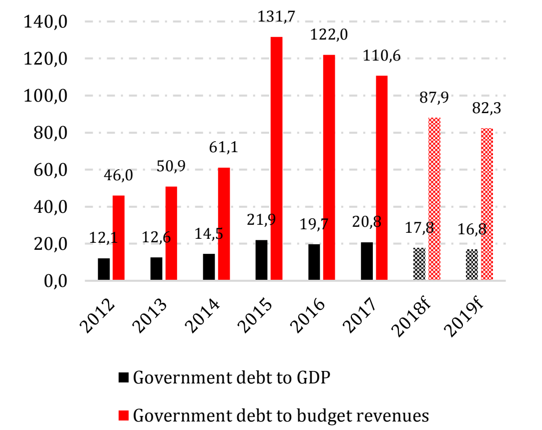
However, contingent liabilities remain high. The share of total assets owned by state and municipal corporations varies among 30-40% of GDP, which, alongside the banking system weakness, creates a latent risk of contingent liabilities' materialization. However, as a result of the national privatization program, the amount of SOE's will be decreased by 877

Graph 1: Macroeconomic indicators, %



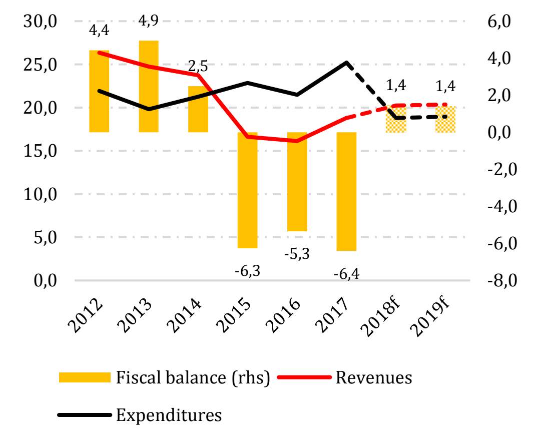
Source: RAEX-Europe calculations based on data from the IMF

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

entities. The fragile banking system and the indebtedness of public companies are the main threats from a potential materialization of contingent liabilities, which could impact public finances. The estimated financial support to public companies in 2018 is close to 1% of GDP.

Inflationary pressures caused the NBK to hike rates. As a result of the RUB depreciation and also a decline in oil prices, the KZT has been on a depreciation trend since the end of 1Q 2018. Moreover, food and fuel prices have increased causing the overall CPI index to grow by 6,1% in September. These factors contribute to the decision of the NBK to hike the base interest rate by 0,25p.p. up to 9,25% back in October.

We expect the inflation rate to reach around 6,2% by year-end 2018. At the same time, better economic activity, rising wages and the announcement that the minimum wage is to be increased in 2019, have increased inflationary pressures in the country.

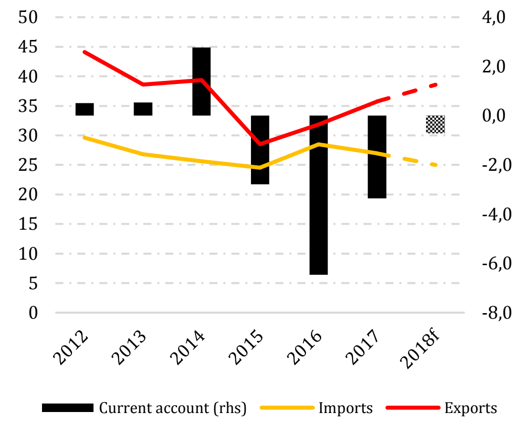
After the rate hike back in October a more stable exchange rate could be observed. In addition, at the last meeting in early December, the NBK decided to leave the rate unchanged.

In our view, the neutral monetary policy will continue, however, we could see more rate hikes in case if the exchange rate volatility were to persist combined with stronger pressure on prices. Also, we still believe that 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 balance turning positive. The overall fiscal balance is expected to be positive for the first time since 2014 and to achieve a figure of around 0,6% of GDP in 2018, primarily driven by recovering oil prices (see graph 3). Restructuring of the economy is progressing at a slow pace keeping budget revenues extremely dependent on extracting industries. The recently introduced tax policy stimulus affects mainly natural resource sectors, promoting further exploration, while important for social equality progressive scale of income tax is still under consideration. The non-oil fiscal balance will continue to be negative in 2018-2019, at around -6,9% of GDP, while oil fiscal revenues will form around 40% of the total budget income.

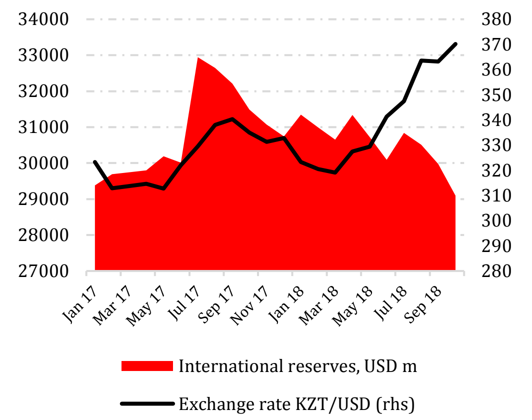
External exposure remains high but position is stable. The current account deficit is forecast to shrink substantially in 2018 to about -0,7% of GDP as compared to -3,4% of GDP in 2017 as there was a substantial increase in exports of oil and gas as a result of higher production and favorable price dynamics (see graph 4). We anticipate the hydrocarbon exports to increase by around USD 10,5 bn from 2017 to 2018.

Graph 4: External sector indicators, % of GDP



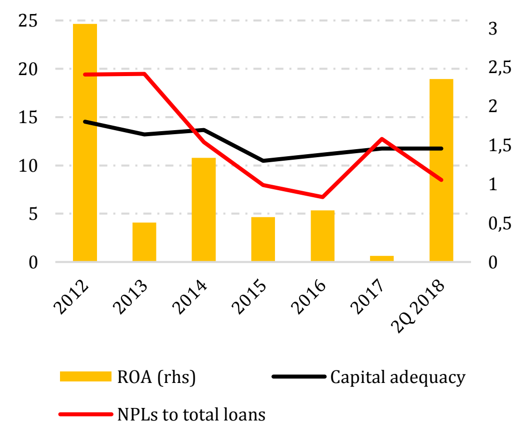
Source: RAEX-Europe calculations based on data from the IMF and NBK

Graph 5: International reserves and exchange rates



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

Graph 6: Financial soundness indicators, %



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

At the end of 2018, the oil price slumped down to around 50 USD per barrel affecting exports and the exchange rate as the KZT lost around 2% against USD since July 2018. The depreciation of the KZT led to a decrease in the level of international reserves; however the NBK's gross reserves remained above the suggested adequacy range for a country with a floating exchange rate in the amount of USD 29,2 m as of October 2018. These reserves cover about 8 months of import of goods and services and cover around 2x the short-term debt (see graph 5).

The banking system is still weak with uncertainties. Credit to the economy remains subdued, corporate credit has grown by a mere 1%. The key constraints of credit growth are limited availability of long-term funding and insufficient demand by creditworthy borrowers. In order to develop the capital markets, the government developed and recently inaugurated a second stock exchange under the Astana International Financial Center (AIFC) project.

Main indicators of commercial banks keep restraining the creditworthiness of the sovereign. The real value of problem loans in the system is still hard to estimate and it is expected to be higher than the official NPLs at 8,5% in November 2018 (see graph 6). Moreover, the recent liquidity struggles of Tsesna bank (the second largest bank accounting for around 7% of total assets) have triggered an injection of funds by the government representing around 0,8% of GDP and have exerted further pressure in the system. On the other hand, profitability indicators significantly improved in 3Q 2018 as ROA reached 2,35% and ROE 19,01% increasing by 2,52p.p. and 20,61p.p. from the same date last year respectively. Taking under consideration all the restructuring efforts of the authorities (the NBK withdrew licenses of several medium-sized and small banks that were in violation of prudential requirements), the official NPLs ratio declined further however remained high. The level of financial dollarization continues to be significant in 2018. More than 47% of total deposits were placed in foreign currency, considering that the interest rate for local currency deposits is at least 5 times higher for all terms in 2018.

Seeking for lower interest rates and expanding new currency for borrowing, Kazakhstan issued a EUR-denominated sovereign bond after 20 years of USD dominance. It was sold with a discount and less 2p.p. higher coupon rate than German government security with identical maturity. Such low spread (around 2p.p., as of December 2018) indicates relatively small risk level making it attractive for investment.

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_21.12.2018.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.