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# Kazakhstan's Oil Boom Is Driving Its Recovery

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## Kazakhstan's oil and commodity boom is driving a recovery from a severe banking crisis. As a result, Kazakhstan's sovereign creditworthiness and currency are likely to strengthen further.

The rise in oil prices and inflows of commodity-based capital have provided Kazakhstan's economy with the resources to recover from a severe banking crisis. The additional resources have catalyzed a recovery in growth centered on commodity-based sectors and led to substantial improvements in the balance of payments. The recovery has helped to restore confidence in the currency and banking system. As a result, Kazakhstan's creditworthiness continues to improve, and the currency is likely to strengthen this year.

Kazakhstan's real GDP grew by 1.2% in 2009, which is in line with average emerging market growth of 1.4% and well above the average contraction of 3.4% in the advanced economies. The cycle troughed last year, as growth was lower than the 3.3% recorded in 2008 and substantially less than the country's average annual growth of 10.2% from 2000 to 2007. But Kazakhstan's economy has performed far better than other countries that also experienced severe banking crises, such as Latvia, Lithuania, Romania, Ukraine and Hungary, where growth contracted by between 7% and 19% last year.

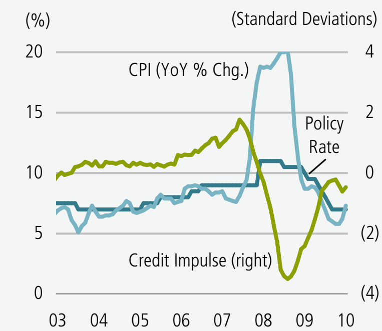
Kazakhstan's relative outperformance reflects several factors. Its banking crisis started in August 2007, a year earlier than the rest of the world, meaning that the economic impact of the credit shock was already advanced. The large stockpile of foreign currency reserves allowed the government to conduct stimulative fiscal and monetary policies without relying on market financing. And a conscious policy of attracting foreign investment to the commodity sectors from China, Russia, Korea, France and elsewhere helped to offset the reduction in domestic demand from a severe contraction in credit. Industrial production in the mining sector rose by 5.9% in 2009 compared with a contraction in manufacturing of 4.3%.

These trends are continuing this year, making the outlook for growth highly favorable. Real GDP growth is likely be two to three times higher than the consensus forecast of 2.7% for several reasons. First, the government is seeking to complete the restructuring of the major failed private banks—BTA, Alliance, Temir and Astana Finance—by April or May, thereby allowing the highly liquid banking system to focus on new lending.

Display 1

**The Central Bank Will Start to Tighten Only After Credit Recovers**

Policy Interest Rate, Inflation and Credit Growth




Source: Haver Analytics, National Bank of Kazakhstan and AllianceBernstein

Second, policy is likely to remain stimulative until new lending accelerates. Indeed, the central bank is now focusing more on credit growth than inflation as a leading signal of economic activity, which marks a significant change in policy orientation **(Display 1)**. The central bank believes that monetary and regulatory policy was too loose prior to the credit crisis, given the rapid expansion in loan growth.

Finally, the investment boom in the commodity sectors, especially oil, is likely to be sustained for at least the next several years until the Kashagan oil field project comes on stream in 2013 or 2014.

These trends are evident in balance of payments statistics. First, oil production volumes rose by 7.5% in 2009, and the government expects production to rise by another 5.3% this year **(Display 5)**. Thus, Kazakhstan stands out as one of the only major oil producers globally with rising production levels. As a result, oil export revenues are likely to grow from $27 billion to $40 billion, given the expected increase in average oil prices from $60 per barrel in 2009 to $75 this year. This increase, combined with export sales of wheat, uranium and ferrous metals, should support a reversal in the current account balance from a deficit of $2.8 billion (2.6% of GDP) in 2009 to a surplus of $4.7 billion (3.6% of GDP) this year.

Oil prices would need to fall to below $55 per barrel for a significant period of time to pose serious risks to this scenario. The sensitivity of Kazakhstan's current account position to oil prices is less than in neighboring Russia. Kazakhstan's relatively open development model, which is based on the significant involvement of foreign firms, means that roughly 70% of oil export proceeds leave the country in the form of worker payments, construction services, dividends and foreign investments by the country's National Oil Fund (NOF). Estimates put the equivalent figure for Russia at approximately 50%. Thus, our calculations suggest that the oil price would need to fall to $55 before Kazakhstan's currency account fell into deficit.

Second, net capital inflows to the commodity-based sectors are likely to remain high at $13.9 billion (10.8% of GDP) in 2010 following inflows of $14.4 billion (13.4% of GDP) in 2009. These inflows have provided the Kazakh economy with the foreign exchange necessary to service its banking sector debt without destabilizing the exchange rate or undermining domestic depositor confidence. Kazakhstan's external debt has remained stable at approximately $110 billion **(Display 2 and Display 5)**, but the mix has shifted. This year, banking sector debt is likely to decline another $16 billion, including an expected $11 billion write-down in the debts of restructuring banks held by foreign creditors.

Importantly, capital inflows to the commodity-based sectors are more sustainable than inflows to the banking sector. Commodity-based inflows are invested in export-oriented industries that over time will generate export revenues to service external debt and equity investments. Much of the banking system inflows were channeled to the domestic real estate and trade sectors, which do not generate foreign exchange.

Overall, Kazakhstan's large balance of payments surplus (the current account plus financial account) suggests that foreign currency reserves, including the NOF, are likely to rise to $63 billion (49% of GDP) this year, from $48 billion in 2009. This improvement will bolster Kazakhstan's sovereign creditworthiness, and is likely to be reflected in a further narrowing of credit spreads.

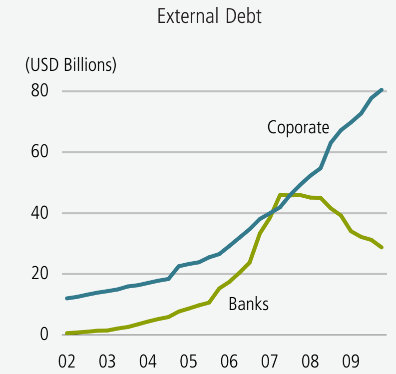
## Currency Appreciation

The factors we have outlined—a recovery in growth, balance of payments surpluses and completion of the banking system restructuring—are likely to strengthen Kazakhstan's currency (the tenge). The tenge has remained stable in real terms as compared with the Russian ruble over the past decade **(Display 3)**. Given the growth in Kazakhstan's economy and the rise in real oil prices over that period, we would have expected the tenge to appreciate. This divergence suggests the currency has substantial room to appreciate.

The central bank acknowledged the risk of a strengthening currency when it announced this month's change in the exchange rate band within which it will attempt to maintain the tenge against the dollar. The asymmetric move from a range of 145.0 to 155.0 to a band of 127.5 to 165.0 allows scope for greater strengthening than weakening from the current rate

Display 2

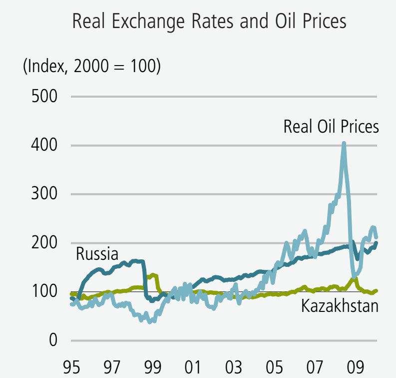
**Corporate Inflows Have Financed Bank Repayments**




Source: National Bank of Kazakhstan and AllianceBernstein

Display 3

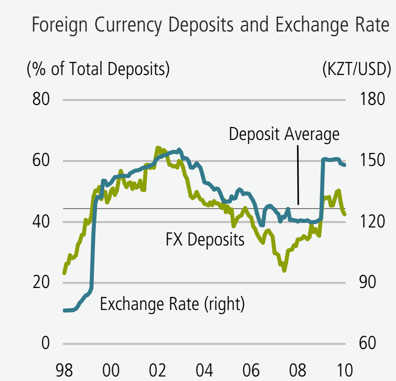
**Kazakhstan's Currency Is Undervalued**




Source: Haver Analytics, JP Morgan, National Bank of Kazakhstan and AllianceBernstein

Display 4

**Local Demand for Tenge Deposits Should Reinforce Currency Strength**




Source: Bloomberg, National Bank of Kazakhstan and AllianceBernstein of 147.4. In our view, the exchange rate could be 135 by the year end.

A strengthening currency has historically encouraged stronger demand for the tenge, thereby reinforcing the appreciation trend. This pattern is evident in the strong relationship between local depositor preferences for tenge deposits and the spot exchange rate **(Display 4)**. Expectations of currency strength have also attracted foreign inflows. The central bank estimates that local currency deposits have risen by $6 billion since November in anticipation of a stronger currency, comprising $4 billion from local depositors and $2 billion from nonresidents.

The central bank welcomes both the shift by local depositors into tenge deposits and any medium-term capital inflows by nonresidents. However, it does not view short-term foreign inflows favorably, and is prepared to use a number of policy tools to neutralize these flows. It plans to purchase foreign currency reserves against these flows to prevent a rapid pace of currency appreciation. It also plans to publish these reserves as a separate item to highlight its view that these short-term inflows may reverse as quickly as they came. It may also issue central bank bonds to sterilize the rise in the monetary base as a result of reserve purchases. As a last resort, the government could impose a short-term tax on inflows, as in Brazil.

Display 5
Oil Boom Underpins Balance of Payments Surpluses

Selected Economic Data, US$ Billions

| | 2007 | 2008 | 2009 | 2010F |
|---|---|---|---|---|
| **Nominal GDP** | **105.0** | **133.5** | **107.4** | **129.2** |
| Exchange Rate (KZT/USD) | 120.8 | 120.2 | 149.8 | 135.0 |
| **Current Account Balance** | **–8.2** | **6.6** | **–2.8** | **4.7** |
| % of GDP | 7.8 | 4.9 | –2.6 | 3.6 |
| Merchandise Trade Balance | 15.1 | 33.5 | 15.2 | 27.8 |
| Goods Exports | 48.4 | 72.0 | 43.9 | 63.4 |
| YoY % Change | 24.7 | 48.9 | –39.0 | 44.5 |
| Oil | 29.5 | 45.5 | 26.9 | 40.4 |
| Goods Imports | –33.3 | –38.5 | –28.7 | –35.6 |
| YoY % Change | 37.9 | 15.6 | –25.4 | 24.3 |
| **Financial Account** | **8.4** | **3.0** | **5.6** | **6.7** |
| **Foreign Currency Reserves (EOP)*** | **36.6** | **44.7** | **47.6** | **63.1** |
| % of GDP | 34.8 | 33.5 | 44.3 | 48.8 |
| **External Debt** | **96.9** | **108.1** | **111.4** | **106.7** |
| % of GDP | 92.3 | 81.0 | 103.8 | 82.5 |
| Oil Production (BPD) | 1,348 | 1,419 | 1,526 | 1,606 |
| % Change | 3.3 | 5.3 | 7.5 | 5.3 |
| Urals Crude Price (US$/bbl) | 68 | 98 | 60 | 75 |

*Includes National Oil Fund
Source: Bloomberg, Haver Analytics, National Bank of Kazakhstan and AllianceBernstein

The expected strengthening in Kazakhstan's sovereign creditworthiness and currency are positive developments, which reflect fundamental improvements in the country's resource-based economy. Importantly, Kazakhstani asset prices in general remain cheap, given the stigma associated with the banking system defaults. In our view, this combination represents an attractive investment opportunity in sovereign and quasi-sovereign credits. ■