

Growth story with oil as the leading part



S&P downgrades Kazakhstan

The rating agency S&P decided on 7 October to downgrade Kazakhstan. Foreign-currency bonds now have a rating of BBB- and local-currency bonds BBB. The country is thus still in investment grade (BBB-). There are no prospects of further downgrades. Moody's rates foreign-currency bonds to A2 and local-currency bonds to Baa1 (Baa3 is the lowest investment-grade rating).

S&P's decision is mainly based on conditions in the Kazakhstan banking sector. The banking sector is highly dependent on foreign capital, and liquidity has fallen in the international lending market. This has already affected lending and is likely to put a damper on growth in 2008.

In our view, the financial crisis is not over yet, and if it flares up, Kazakhstan will be hit hard.

We maintain our recommendation on selected bonds in the banking sector

We acknowledge that the Kazakhstan banking sector has been hit by the financial crisis, but we believe that S&P's downgrade is mainly a reaction to past events, and we still believe that the major banks hold potential. The president's promise of support for the banking sector worth USD 4bn substantiates that the government - together with the central bank - support the banks. We therefore maintain our BUY recommendation of bonds issued by Bank Turanalem, the second-largest bank.

Bank Turanalem has a Baa3 and BB rating from Moody's and S&P, respectively. The bank has seen a very strong development in earnings and profit which will contribute to limiting the risks. The most interesting bonds from the bank are:

B01656 6.25% EUR 2011 at 90.50 = 9.22%

B01950 7.125% GBP 2009 at 92.50 = 11.16%

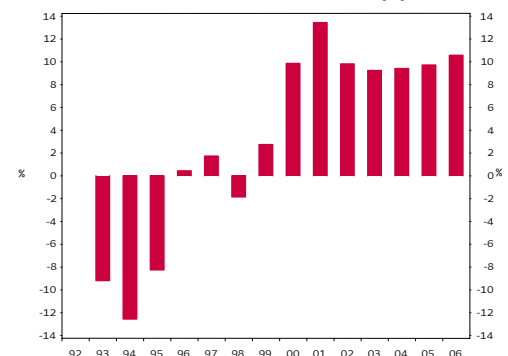
B02097 FRN USD 2009 at 94.75 = 11.06%

Impressive growth

Kazakhstan has seen impressive growth since the dissolution of the Soviet Union. Since 2000, the economy has grown by an average of 10% a year. The population has seen a major increase in wealth. In the period since the turn of the century, real wages and the purchasing power have more than doubled and unemployment has fallen from 13% to 7%. GDP per capita has increased fivefold since 1999.

The positive development can mainly be ascribed to the fact that Kazakhstan has plenty of natural resources such as minerals, metals, natural gas and not least oil. The high oil prices - and commodity prices in general - have meant that there has been an inflow of money to the country and oil is one of the prime movers behind the growth adventure which Kazakhstan has seen in recent years. This also means that Kazakhstan is very dependent on oil (and oil prices), both directly through exports and investment but also indirectly through the massive liquidity flowing into the country.

Kazakhstan: Growth in real GDP, y/y



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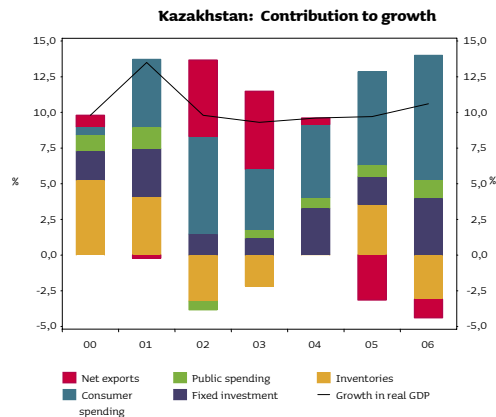
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To reduce Kazakhstan's vulnerability to swings in the oil price, an oil fund, the National Fund of the Republic of Kazakhstan (NBRK), has been established, which collects money in the form of taxes on oil exports. In September 2007, the fund held almost USD 18bn.



In recent years, growth has solely been driven by domestic demand, notably by strong consumer spending. Oil revenue has also given rise to higher public spending. The budget showed a small surplus of 0.8% of GDP in 2006. Higher public spending on for instance infrastructure will contribute to changing the surplus into a small deficit in 2007.

The banking crisis will most likely put a damper on growth in 2008. The effect of the crisis on the real economy depends very much on the length of the financial crisis and how much support the banking sector will receive from the government.

Rich in commodities

Kazakhstan is very much a commodity country since it has the largest oil reserves in the region around the Caspian Sea (includes both Azerbaijan and Turkmenistan). The oil field Kashagan is the largest outside of the Middle East and is the world's fifth largest in terms of oil reserves. Kazakhstan is assessed to have oil reserves of up to 40bn barrels. This corresponds to 3.3% of the world's total oil reserves (in comparison Saudi Arabia has more than 20%). It is also assessed that the country has natural gas corresponding to 1.7% of the world's total reserves. Kazakhstan also

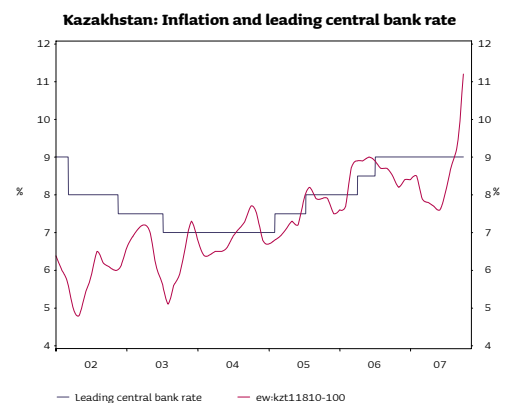
has some of the world's largest gold and silver deposits, a fourth of the world's uranium and the world's largest coal mine.

In recent years, the government has increasingly become involved in the oil sector through the ownership of the oil and gas company KazMunaiGaz. Since 2005, KazMunaiGaz must own at least 51% of all new oil projects and joint, and there have been imposed restrictions on foreign ownership of strategic sectors, including oil.

Dilemma over the monetary policy

A high inflow of liquidity, strong growth, higher public spending, high wage increases and high food prices have meant that inflation has increased markedly over the past months from 7.6% y/y in May to 11.2% in September. Inflation has thus risen above the central bank's (NBK) target of 8.2%–9.2% in 2007.

The NBK has held interest rates at 9% throughout 2007 but after the recent development in inflation the bank may be forced to react and raise interest rates if the inflation target should be met this year. For the longer term, the fall in lending and lower growth will have a dampening effect on inflation.



Another possibility is to allow the currency to appreciate. The argument against this is that inflation is notably driven by temporary factors. The current account has deteriorated over the past months and a stronger currency will only cause the deficit to rise further.

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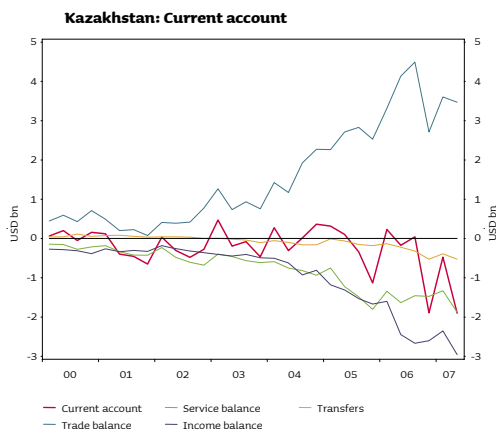
A large inflow of foreign capital has meant that the currency (KZT, Kazakhstan Tenge) has strengthened both in nominal and relative terms in recent years. Both the government and the IMF have expressed concern that Kazakhstan will be hit by the 'Dutch disease', i.e. that the competitive power in non-oil sectors deteriorate so much that no investment is made in these sectors.

Concerns about the banking sector have prompted the population to demand dollar. The NBK therefore had to intervene by selling dollar over the past month so KZT is not weakened too much. The NBK has accumulated a large amount of dollar reserves (about USD 20bn) and can therefore intervene for quite some time yet, but a longer crisis will put pressure on the currency and result in current-account problems.

Trade balance in black, current account in red

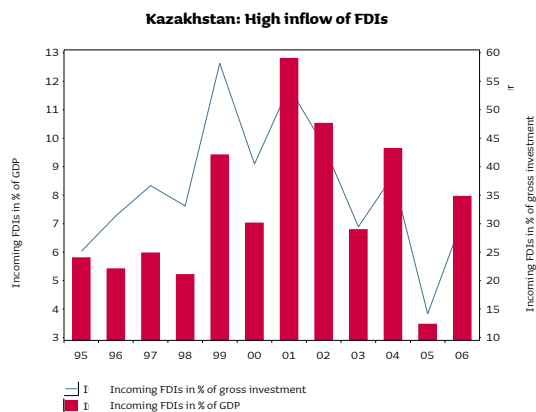
The surplus on the trade balance in 2006 was almost 20% of GDP. The reason behind is high commodity prices. In 2006 oil, oil products and gas accounted for almost 70% of total exports. Metals accounted for about 20%. This is notably due to a price effect and much less to a volume effect.

Soaring imports due to strong domestic demand (and a strong currency) have meant that the surplus has fallen in 2007.



The current account, on the other hand, is in the red. The reason behind is mainly a large and rising deficit on the income balance.

Kazakhstan has seen a very high inflow of foreign direct investment (FDI), and it is payment of dividend and profit to foreign investors and payments from Kazakhstan banks (which have borrowed money abroad) which have led to a deficit on the income balance - and also will in future.



However, it is positive that Kazakhstan is still an attractive country for foreign investors, and in view of the current situation the current-account deficit will therefore also this year be more than covered by FDIs.

However, President Nazerbayev has recently criticised foreign investors' involvement in the Kashagan oil project. More comments of this kind may mean that investors grow concerned which may dampen investment.

The political situation: stable but not democratic

The political situation is stable. President Nazerbayev is popular since he has brought growth and prosperity to the broad population, and he is therefore likely to remain in his seat until his term expires in 2012.

But there is no full democracy. The elections in Kazakhstan are generally criticised for not being free, and there are reports of irregularities in connection with counting of votes. The president also controls a large part of the media so that the opposition cannot speak. Kazakhstan is also one of the most corrupt countries in the world - it ranks 150 along with countries such as Sierra Leone and Belarus.

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Nazerbayev has been president since Kazakhstan became an independent state, and there are no indications that he will leave the seat in his lifetime. Throughout the years, he has successfully increased his influence and has special privileges for life. Recently, the parliament adopted a reform which means that Nazerbajev can run an unlimited number of times against previously twice. Critics say that in reality this means that he can be 'president for life'.

The opposition has so far been weak but may at some time find a base in the growing middle class and the many private entrepreneurs who do not like bureaucracy and the government's (excessive) interference in society.

Facts about Kasakhstan



Independent state since 16 November 1991

Population: 15.2m

Area: 2,727,300 km²
(9th largest country in the world, larger than Western Europe)

Capital (since 1997): Astana (means capital in Kazakhstan, 577,300 inhabitants)

Largest city: Almaty (1,186,000 inhabitants)

Official languages: Kazakhstan, Russian

Religion: Mainly Muslims, Russian orthodox, Protestants.

Government: Republic (the president is very influential)

President: Nursultan Nazerbayev (in power since 1989)

Prime Minister: Karim Masimov

Currency: Tenge (KZT)

GDP per capita in 2006: USD 5,016

GDP per capita (adjusted for purchasing power) in 2006: USD 9,410

2000: The first of the former Soviet countries to repay all its debt to the IMF

March 2002: Declared market economy

September 2002 Investment grade status as the first of the former Soviet countries.