Kazakhstan

Kazakhstan comes in from the cold

Premium

Struggling oil producer tipped as emerging market investment hot spot

EM Squared

The transport ministry building (left) with the headquarters of state-owned oil and gas company KazMunaiGaz in the background, in Astana, Kazakhstan. © Bloomberg

YESTERDAY by: **Steve Johnson**

Kazakhstan is perhaps best known as home to a long-serving autocrat with a fetish for grand architectural statements and an economy that is unhealthily dependent on both Russia and oil.

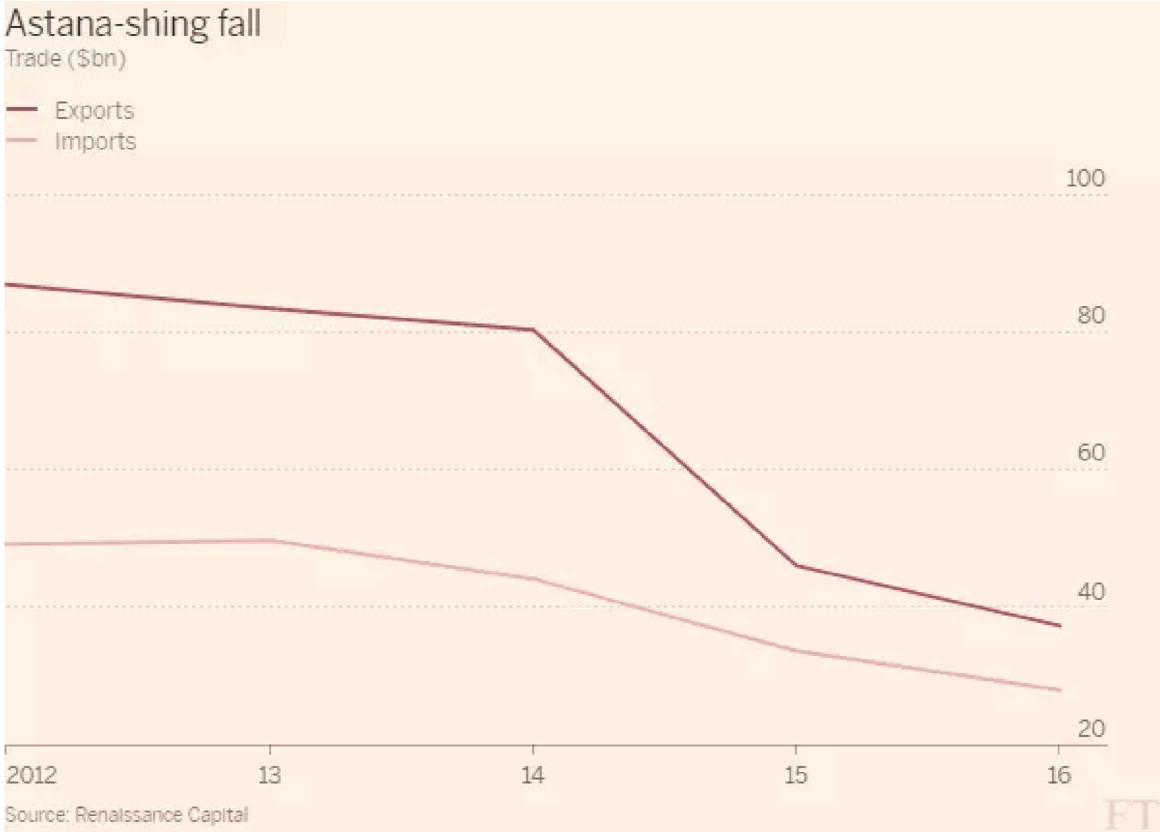
Yet analysts and investors seem to be queueing up to tip the vast central Asian republic — the size of western Europe — as one of the most attractive hotspots in the emerging world.

This comes despite President Nursultan Nazarbayev, who has maintained a firm grip on power since Soviet times, overseeing meagre economic growth of 1.1 per cent last year and gross domestic product, measured in nominal dollars, having fallen 39 per cent since 2014 to $134bn.

The dollar value of Kazakhstan's exports has slumped by 57 per cent since 2012, with imports down 43 per cent over the same period, as the first chart shows. Much of this was driven by the fall in world oil prices, but industrial production as a whole has declined for two years running.

The cost of servicing its debt has risen to 19.4 per cent of GDP, not helped by the tenge's 39.6 per cent plunge against the dollar since August 2015, depicted in the second chart. Two of three main rating agencies, Standard & Poor's and Moody's, have the country's sovereign debt on negative watch, despite downgrading it last year to the lowest notch of investment grade.

Yet some are warming to a reform programme that German Gref, chief executive of Sberbank, Russia's largest bank, says is comparable to that of Singapore.



Also voicing approval is Chris Weafer, senior partner at Macro Advisory, a Moscow-based consultancy. "After spending several years trying to mitigate the impact of the currency collapse and economic slowdown, the government has adopted a radical programme to try and revive the economy and attract a bigger volume of inward investment," he says.

Among the key planks of this reform agenda, Mr Weafer lists higher budget spending and a manageable budget deficit equivalent to 3 per cent of GDP (up from 2 per cent last year), funded by debt and the National Fund, a $62.5bn sovereign wealth fund; the creation of a bad bank to relieve the banking sector of non-performing loans; tackling high-level corruption; and constitutional changes aimed at calming concerns over Mr Nazarbayev's eventual successor.

Oleg Kouzmin, chief Russia economist at Renaissance Capital, a Moscow-based investment bank, says investors are displaying a degree of "rational scepticism" about the reform agenda "given that Kazakhstan is an oil-producing country with the same economic structure as Russia and traditionally strong presidential power".

Nevertheless, Mr Kouzmin says Renaissance is “more optimistic than pessimistic on reforms,” given the progress so far “and our belief that reforms and privatisation are needed to strengthen the country’s institutions to ensure smooth transitions of political power in the long term,” leaving room for investors to be positively surprised.

Charles Robertson, global chief economist at RenCap, points out that Kazakhstan rose six places to 35th in the World Bank’s 2017 Ease of Doing Business report, one of the biggest jumps in the report, thanks to measures that made it easier to start a business, obtain a building permit and exports goods, alongside legislation to liberalise the labour market and strengthen shareholders’ and creditors’ rights.

“Perhaps surprisingly, compared to regional peers, Kazakhstan’s institutional strength is travelling in the right direction,” says Theo Holland, co-manager of Kames Capital’s Emerging Market Bond fund, who lists the country alongside Sri Lanka and Mexico as the most attractive emerging markets at present.

Mr Robertson’s two prime reasons for favouring Kazakh assets at this juncture, though, are its “cheap” currency and accelerating economic growth.

The IMF forecasts that growth will pick up from 1.1 per cent in 2016 to 2.5 per cent this year and 3.4 per cent in 2018, as the third chart shows, among the fastest rates of acceleration expected in any frontier market, alongside Argentina, Morocco, Nigeria and Tunisia.

RenCap's forecasts are a touch lower, based on oil prices remaining around today's levels, but Mr Robertson still believes "growth acceleration this year and next can attract investor interest".

Likewise he believes another draw is a currency that is 10 per cent cheaper than its long-term average, at a time when few frontier currencies are below fair value, by RenCap's calculations.

The tenge is the third cheapest frontier currency, RenCap suggests (after the Serbian and Tunisian dinars) but the one most likely to strengthen.

"In expensive emerging Europe, Kazakhstan stands out as a good credit opportunity at this time," says Mr Holland. "Its low government debt ratio [19.9 per cent of GDP] and strong fiscal backstop give us confidence that it can navigate the challenges of commodity price volatility."

In particular, Mr Holland lauds Astana's help for its troubled banks, which "for many years have acted as a drag on the economy"; the re-launch of oil production from the giant Kashagan field, after output at the much-delayed project was suspended in 2013 due to a series of internal pipeline leaks; and the likelihood of a round of privatisations.

Mr Weafer notes that the central part of the privatisation plan, to float eight to 10 major state corporations on the stock market, has been delayed to 2019, but believes the government remains committed to the project, which has the overall aim of privatising 1,000 state enterprises.

He also sees scope for the central bank to cut interest rates to 9.5 per cent by the end of the year, from 11 per cent at present and a high of 17 per cent last year as inflation, which spiked to 17.7 per cent in July 2016 in the wake of the tenge's tumble, has fallen back to 7.5 per cent.

Even geography, which has long worked against the world's largest landlocked country, which sprawls across the central Asian steppe, could finally start to work in its favour.

Mr Robertson says Kazakhstan's location has deprived it of a natural investor base, unlike say the Gulf states that have a lot of local money or those in Africa, which see a steady stream of foreign investors focused on the continent.

But neighbouring China may now be set to fill that void, Mr Weafer believes. "Kazakhstan has a huge competitive advantage in that it is a key transit corridor for China's One Belt, One Road programme. This means it will be better able to export a wide range of goods both to China and to Europe using the railway system," he argues.

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