HALYK RESEARCH

Macroeconomic report 2Q2020

August 14, 2020

The economy of Kazakhstan showed a decrease in GDP growth by 5.6% yoy in the second quarter, while the decrease in GDP for the first half of the year was -1.8% yoy. The service sector, represented by trade, transport and other industries, expectedly have gone into a deep slump due to quarantine restrictions, while the main support to the economy during this period was provided by the real sector: industry and construction. Growth in food prices remained at an elevated level in 1H2020, but overall inflation was moderate. Tightening of foreign currency regulation and the presence of the National Bank at the foreign exchange market allowed to extinguish the increasing volatility of the national currency and limit the speculative wave. External accounts dynamics was positive and the current account was formed with a surplus (1q2020 in $2.0 billion and 2q2020 in $96 million) due to the decrease in capital outflows of income on direct investments, as well as due to a relatively moderate reduction in the trade surplus balance. Despite the increased burden on the assets of the National Fund and the reduction in tax revenues, the country's consolidated assets decreased by only 0.1% due to the growth of the NBK IRs by 13.6% ytd.

Under pressure from the lockdown and low oil prices, the economy entered a recession. In the second quarter, the economy showed a decline of 5.6% yoy. The peak of the quarantine, together with the local minimum in oil prices and the exchange rate of the tenge, fell on April. In May and June, as a result of the easing of quarantine restrictions and the recovery of oil prices, accompanied by the strengthening of the tenge, there was some economic recovery.

The service sector has been hit harder than other sectors. At the end of the first half of the year, the trade and transport sectors experienced the largest decline, measured by double-digit figures of -11% yoy and -15% yoy. By contrast, construction and telecommunications maintained strong growth of 11% yoy and 9% yoy, respectively. The industry remained in the positive zone, while the planned recovery of oil production in the third quarter under the OPEC+ deal will support the industry.

In the first half of the year, inflation was 7% yoy. In the consumer market, food products (+11.1% yoy) were the main driver of price growth. At the same time, inflation in the second quarter was below the level of the first quarter – 1.9% versus 2.3%, as a result the rise in prices in 1H2020 amounted to 4.2%. The easing of inflationary pressures in the second quarter was facilitated by the stabilization of the situation on the foreign exchange market and the decrease in regulated prices for fuel and utility tariffs. In addition, there was a significant contraction in domestic demand as a result of the worsening economic situation.

NBK softened monetary conditions. After an abrupt reduction in the base rate from 12% to 9.5% in early April, the NBK no longer changed the rate during the 2q2020. However, in July, the NBK lowered the base rate from 9.5% to 9.0% and narrowed the liquidity window by 50 bps. The base rate cut was due to the stabilization of the money market situation, easing of inflationary pressure over the economy, de-dollarization of deposits and the decline in business, consumer and investment activity. The regulator is increasing monetary impulse in order to support the economy with cheaper lending.

FX rate of the national currency is to weaken. During the 2q2020, FX rate of the national currency strengthened against US dollar amidst the rising price of oil, strengthening of the currency of the trading partners, weakening of the US dollar itself, and, the most importantly, due to a significant increase in foreign currency supply by the National Bank as part of the conversion of transfers from the National Fund (70% of trade on the foreign currency market) with strict measures to limit the speculative stance at place. In 2H2020, sluggish foreign trade, relatively low oil prices, expected weakening of the Russian ruble, the reduction in currency sales by the National Bank from the National Fund and the expansion of the state budget deficit will put pressure on FX rate of the national currency to its weakening.

NBK's reserves are growing, the assets of the National Fund are shrinking. Amidst rising gold prices and an increase in the funds of commercial banks in foreign currency in the accounts of the NBK, the gross IRs of the NBK increased by 10.4% for the second quarter to $32.9 bn (13.6% ytd). Assets of the National Fund increased by 0.5% to $57.7 bn (6.5% ytd), despite an increase in transfers to the budget and a decrease in tax revenues by 31.2% yoy to T1.0 tn. ($2.6 bn). The growth of the National Fund's assets was due to an increase in investment income more than 6 times - to T2.6 tn or $6.3bn.

Current account deficit is expected to widen. In 1H2020, according to preliminary data of the NBK, the current account yielded a surplus of $2.1 bn or 1.3% of GDP. Originally, the current account surplus was the largest in the first quarter of 2020 at the amount of $2.0 bn, while in the second quarter it was reduced to $95 mn. The widening of the current account surplus in 1H2020 was facilitated by the deficit reduction of primary income balance by $5.2bn to to $6.3 billion (-45.2% yoy, deficit of $4.1 bn in 1q2020, deficit of $2.1 bn in 2q2020), slight reduction of the deficit of services balance by $15 mn to $1.8 bn (-0.8% yoy, deficit $879 mn in 1q2020, deficit in 2q2020 $921 mn), as well as the expansion of the surplus of balance of secondary income by $70 mn to $252 mn (38.2% yoy, surplus of $65 mn in 1q2020, surplus of $187 mn in 2020).

According to the preliminary statistics of the NBK's financial account, in 1H2020 there was an inflow of capital of $3.2 bn (inflow of $365 mn in 1q2020, inflow of $2.8 bn in 2q2020) against capital outflow of $3.5 bn last year for the same period (outflow of $3.5 bn in 1q2019, inflow of $12 mn in 2q2019). The positive dynamics of capital inflows in the financial account was facilitated by the expansion of capital inflows in 1H2020 on the account of portfolio investments of $3.5 bn (inflow of $1.8 billion in 1q2020, inflow of $1.9 mn in 2q2020) compared to an outflow of $4.2 bn last year (outflow of $3.3 bn in 1q2019, outflow of $922 mn in 2q2019).

In our opinion, this was due to the reduction of nominal holding of foreign assets by residents, as well as by reducing the foreign assets of the National Fund while increasing the obligations of the commercial sector of the Republic of Kazakhstan to non-residents. Sluggish foreign trade dynamics in 2H2020 will expand the current account deficit from 3.6% of GDP in 2019 to 5.1% of GDP in 2020.

2020 forecast: GDP contraction by 1.1%, inflation 7.3%, KZT435 per dollar. As we expected, the second quarter of this year was marked by a serious decline in economic activity. The crisis peaked in April, after which some improvement was registered in May and June. The economic contraction in the third quarter will not be as deep, given the gradual recovery in oil production and the adaptation of the economy to the inevitable constraints caused by the pandemic. The continuation of the quarantine, albeit in a less stringent format, so far limits the full restoration of the service sector, where the bulk of all employed people are concentrated, and mainly small and medium-sized businesses. A noticeably faster recovery in economic activity in the near term will be facilitated by the reduction of restrictions around the world, which will positively affect the demand for Kazakhstani exports. Increased budget spending compared to last year and numerous forms of fiscal stimulus will provide an important boost to business recovery. Consumer inflation, in our opinion, will stabilize at around 7% in the second half of the year, although a moderate increase in inflationary pressure against the background of the expected weakening of the tenge is possible.

Main macroeconomic indicators	2018 Fact	2019 Fact	Base		Pessimistic		Optimistic	
			2020	2021	2020	2021	2020	2021
Oil Brent, average, USD/bbl.	71.6	64.2	40.0	45.0	36.0	35.0	46.0	55.0
Real GDP, % yoy	4.1	4.5	-1.1	3.9	-1.9	3.3	0.6	4.1
Exchange rate USDKZT, eop	384.2	381.2	435.0	445.0	456.0	465.0	415.0	420.0
Exchange rate USDKZT, average	344.7	382.8	415.7	440.8	420.0	461.7	406.5	418.3
CPI, % change yoy	5.3	5.4	7.3	6.5	8.1	7.4	6.9	6.1
Government debt, % GDP	24.9	23.7	27.9	28.8	28.8	29.3	27.0	27.0
Budget balance consolidated, % GDP	-1.3	-1.8	-3.4	-3.2	-3.7	-3.5	-3.1	-2.7
Current account, % of GDP	-0.2	-3.1	-5.1	-3.7	-5.3	-4.2	-4.7	-3.2

Economy entered a recession in the 2nd quarter of 2020

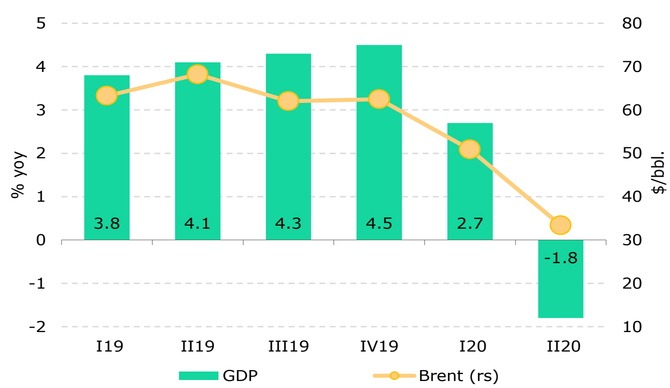
In the first half of this year, the economy of Kazakhstan showed a moderate decline of 1.8% yoy, taking into account the sum of all negative external factors. Growth in the first quarter of 2020 by 2.7% yoy was followed by a decline, according to our estimates, by 5.6% yoy in the second quarter. It is worth noting that the economy found itself in a negative zone for the first time since 2016, when a decline of 0.1% yoy was recorded in the first quarter, however, Kazakhstan has not experienced an economic decline of more than 5% in a quarter for more than 20 years. For comparison, the decline in the economy in neighboring Russia in the second quarter reached 9.6% yoy, (-4.2% yoy in 1H2020), in Azerbaijan and Belarus the figures for the decline in GDP are comparable to those of Kazakhstan. In China, which faced the pandemic earlier than other countries, the economic decline in 1Q 2020 was 6.8% yoy.

Judging by the monthly dynamics of GDP, when in April its growth sharply went into the negative zone to -0.2% yoy from +2.7% yoy in March and then stabilized in May and June at the level of -1.8% yoy, the strongest slump the economy experienced in April, the same month saw the most severe restrictive measures in relation with the coronavirus. At the same time, the lowest oil price in 2020 was formed at $23 per barrel (on average per month) with a daily minimum of $17 and the minimum average value of the tenge to dollar exchange rate at 434 (daily minimum of 448). In addition, in April, Kazakhstan experienced the deepest decline in retail sales – a decline of almost 45% yoy. Due to the factually synchronous effect of negative factors in April, it is still difficult to understand from what the economy suffered more – from the fall in oil prices, or from isolation measures.

In May and June, the economic downturn began to ease, which apparently prompted officials to announce that positive economic growth could be achieved this year. In particular, the minister and the vice minister of the Ministry of National Economy spoke about this potential outcome when discussing anti-crisis measures. Recall that the package of measures to stimulate the economy this year is estimated at about T6 trillion, not counting various fiscal and administrative supportive measures. The quarantine measures resumed in July were already less strict, so we expect a less significant impact on the results of the second half of the year.

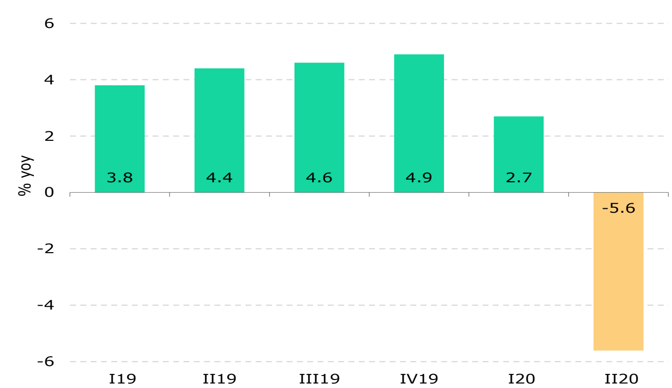
In the first half of 2020, the republican budget expenditures increased by 31.5% yoy. According to the plan, in the second half of the year, these expenses will increase by another 18.6% yoy. Such a significantly increased allocation of resources for the economy, combined with targeted quarantine measures of a less stringent nature, give reason to expect that the economic contraction may turn out to be minimal at the end of this difficult year.

Figure 1. GDP growth (cumulative ytd) and oil prices



Source: CS MNE, Bloomberg

Figure 2. GDP dynamics quarterly



Source: CS MNE, HF

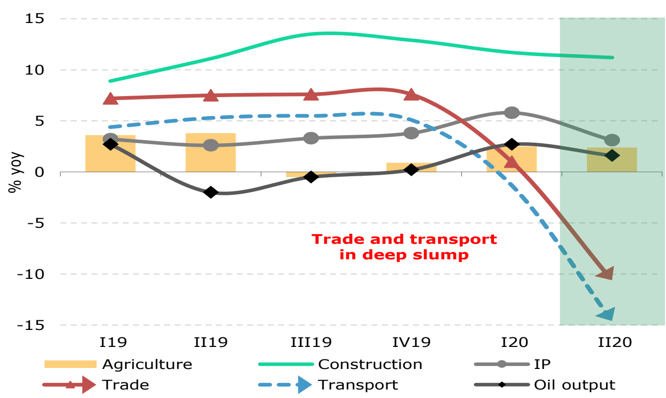
In June, the IMF again downgraded its estimate of global economic growth for 2020 to -4.9% from -3% in April. Accordingly, the forecast for economic growth in Kazakhstan was lowered from -2.5% to -2.7%. In turn, the World Bank expects the economy of Kazakhstan to fall at a close level of -3%, while it significantly worsened its April estimate of -0.8%. In our opinion, these assessments could have been realized, given the high dependence of Kazakhstan on the external sector. However, thanks to the rapid recovery in demand for hydrocarbons amid limited supply, sentiment in the global oil market quickly improved, which contributed to the return of quotations above $40 per barrel, while the IMF and other international organizations proceeded from the assumption that oil prices would be significantly lower, and the negative effect from the global lockdown far stronger. In addition, since May of this year, measures to counter the pandemic have been carried out in a much milder format, which reduces the negative impact of isolation measures on the economy, and it is also possible that additional measures of state support for the economy will be undertaken.

The decline in economic growth in the second quarter of this year was caused by the deterioration in the dynamics of a number of sectors, including industry, transport and trade. Industrial production growth, which amounted to 5.8% yoy in the 1st quarter, slowed down almost twice in the first half of the year - to 3.1% yoy (data for the 2nd quarter in a separate format has not yet been published). The slowdown in industrial growth was caused by the slowdown in the mining industry from 5% yoy in the first quarter to 2.2% yoy in the first half of the year, in the manufacturing industry from 8.8% yoy in the first quarter to 4.8% yoy at the end half a year, in the production and distribution of electricity from 1.2% yoy to 0.2% yoy.

In connection with Kazakhstan's participation in the OPEC+ agreement, oil production in May decreased by almost 8% mom, and in June – by more than 10% mom. It is expected that oil production will begin to gradually recover in August, but the situation with the development of the pandemic will play a decisive role in the dynamics of the recovery in world oil demand and, accordingly, in easing production restrictions. Based on the most up to date forecast of the Ministry of Energy, oil production in Kazakhstan in 2020 will amount to 84.5 million tons, down 7% yoy, while export revenues, taking into account lower prices, may fall by 30% yoy.

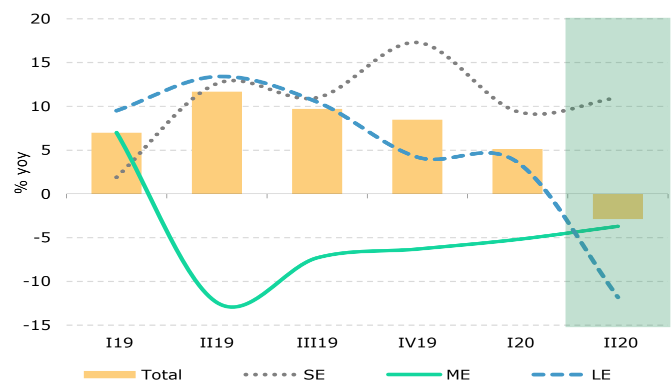
In our opinion, with the oil price at $40 per barrel and with a significant expansion of state budget expenditures by about 4ppt of GDP this year (23.6% of GDP) compared to last year's costs (19.6% of GDP), the economy of Kazakhstan could very well achieve positive growth. However, COVID-19 and countermeasures are largely leading to a contraction in business activity and, at the same time, creating an atmosphere of high uncertainty, which seriously complicates the situation. As we saw in April, tough quarantine measures lead to a serious economic downturn and reduced the confidence of businesses and the population in the future.

Figure 3. Industries dynamics



Source: CS MNE

Figure 4. Investment by size of enterprise



Source: CS MNE

Against the general negative background, the construction and telecommunications sectors demonstrated quite a good dynamics. In construction, volume growth in 1H2020 remained at double-digit level of 11.2% yoy, while telecoms recorded growth of 9% yoy. Both industries are well positioned to maintain positive growth rates. For construction, the growth drivers are the housing sector, infrastructure and the mining sector. In turn, the widespread use of contactless forms of work and online trade increases demand for telecommunications services.

In the first half of the year, investment activity avoided a collapse, but nevertheless went into negative territory by almost 3% yoy. In terms of the size of enterprises, one can see a decrease in investments of large enterprises by almost 12% yoy, which was the main reason for the overall decline in investments, since large enterprises form more than half of all investments in the economy. Investments of medium-sized enterprises continued to be in the negative zone, while small enterprises showed surprisingly high investment activity, demonstrating an increase of 11% yoy. The flexibility of small businesses due to the ability to work even under conditions of restrictions, in our opinion, predetermined such a high investment rate. At the same time, it is possible that the large unfinished construction volumes of last year, which were taken into account in the current year, perhaps played a role.

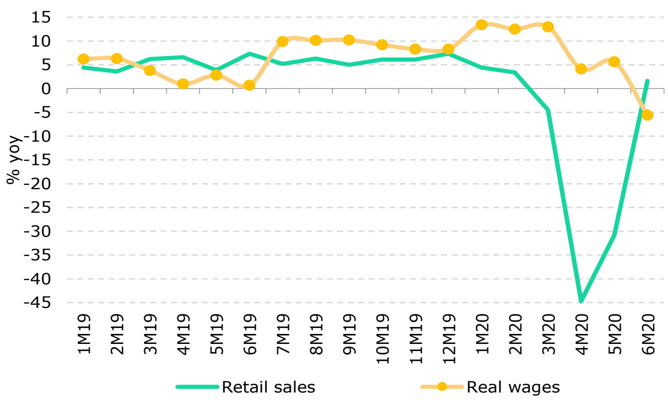
Recovery of retail trade and decline of real wages in June

The manifestations of the economic downturn are increasingly reflected in the consumer market and in the wages of the population. After hitting a bottom in April this year, retail turnover went into positive territory with a 1.6% yoy rise in June, although the decline reached almost -45% -31% yoy at the peak of isolation measures in April and May.

This rapid trade recovery looks surprising against the backdrop of weak growth in retail lending – up 2% YTD, compared to 10% growth in January-June 2019. Household deposits, on the other hand, grew by almost 6% over six months, indicating a trend towards saving income rather than spending it. Some explanation for the increase in trade turnover can be provided by the growth of real wages, which averaged almost 10% in January-May, which was replaced by a decline in June (-5.6% yoy). The rush on the eve of the resumption of quarantine measures due to the worsening situation with the pandemic in the second decade of June can also be considered as a driver of growth in retail, and especially in the food segment.

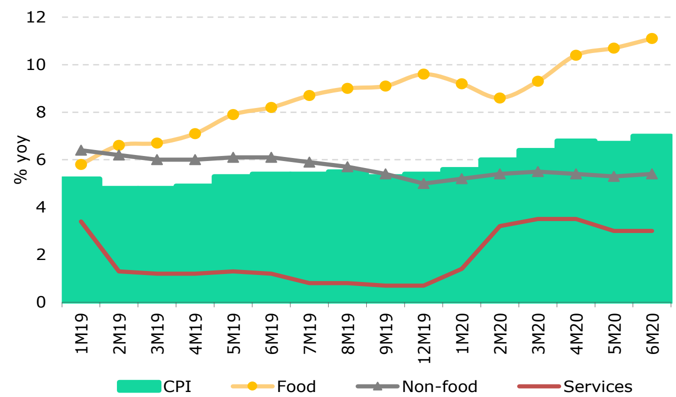
The increase in public sector wages, the indexation of pensions and benefits, social assistance payments in the amount of T42.5 thousand, together with measures to limit inflation, certainly supported the restoration of trade turnover within a limited period. However, in the second half of the year, stagnation and even a certain drop in the trade sector is likely. At a time when the private sector has suffered significantly from restrictions of its activities and lost income, only the state can provide the main support for growth. At the same time, the public sector provides jobs for only about 20% of the employed population and cannot be the only driver of income growth. As a result, while the private sector is in decline, consumer activity will remain weak, holding back economic growth. It should be noted that the official unemployment rate remained unchanged at 4.8% and continues to ignore the economic crisis.

Figure 5. Retail trade and wages (real)



Source: CS MNE

Figure 6. Inflation and main components



Source: CS MNE

Inflation in June 2020 showed a slight but slowdown for the second month in a row. Compared to the first quarter, the rise in prices in April-June slowed down from 2.3% to 1.9%; in total, in the first half of the year, the rise in prices amounted to 4.2% (2.6% in 1H2019). The annual inflation rate rose as expected to 7%. At the same time, food products showed the highest growth – bread went up by 10.5% yoy, cereals – by 35.5% yoy, flour – by 21.5% yoy, meat – by 14% yoy. In part, the high growth in food prices was formed due to their rise in prices last year following the rise in food prices in the world market. In turn, this year the rise in prices was caused both by a sharp depreciation of the tenge in March and April, and by heightened inflationary expectations. Prompt intervention by government agencies in the pricing of housing and communal services and fuel prices had a direct effect in May and June, which eased inflationary pressures and with a seasonal decline in prices for fruits and vegetables led to a normalization of prices in the last two months of the second quarter.

Taking into account the beginning of the recessionary processes in the economy, accompanied by a drop in household income and an increase in unemployment, we expect inflation to stabilize near the 7% level in the second half of this year. Against the backdrop of continued slowdown in price growth, moderate expectations of a weakening of the national currency, we revised our previous forecast for inflation growth downward from 8.7% yoy to 7.3% yoy at the end of this year, while we do not exclude a more noticeable decrease in inflationary pressure due to suppressed domestic demand.

Interest rate policy - NBK softened monetary conditions

The interest rate policy of the NBK in 2q2020 was marked by the easing of its monetary policy. In early April, the regulator reduced the base rate from 12% to 9.5%, with the liquidity window unchanged at 2%. During the 2nd quarter, the NBK did not change it, as inflationary pressure on the economy continued to increase. At the end of July, the NBK cut the base rate by 50 bps to 9% with the narrowing of the window to +/-1.5pp. Monetary easing took place amidst a strong decline in business activity and the tightening of quarantine measures in Kazakhstan. Inflation and inflation expectations as per the regulator's projections were formed in accordance with its forecasts of 8%-8.5% at the end of the year. The regulator expects the growth of the disinflationary effect resulting from a significant decline in consumer and investment activity. The main risks of inflation regulator links with fiscal and quasi-fiscal impulses, as well as with the increase in import prices amidst weakening of the national currency.

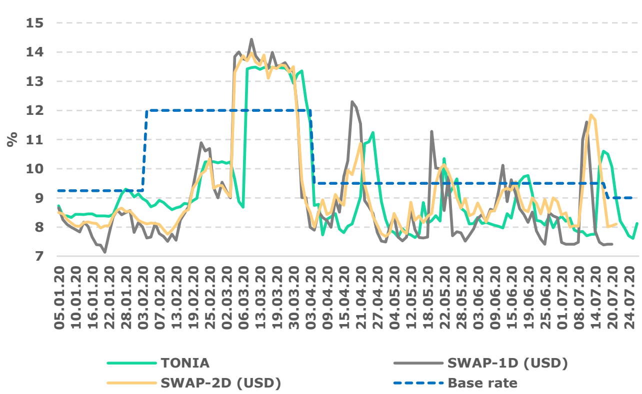
The base rate cut was due, on the one hand, to the stabilization of the situation on the money market, the adaptation of the economy to external shocks, the de-dollarization of deposits and the decline in business, consumer and investment activity. On the other hand, the regulator intensified the monetary impulse to support the economy with cheaper lending in the coming recovery phase of the economy. In our opinion, Kazakhstan's economy will be under the depressed conditions of the external and domestic demand. Under these conditions, fiscal easing will not be enough, so in 2H2020 we do not exclude further monetary easing by the financial authorities.

Money market rates during the 2q2020 under the uncertain environment reacted sensitively to the changes of FX rate of the national currency. Thus, the weakening of USDKZT on 21-24 April at 2.2% affected the value of cash in the money market by increasing rates from 8.0% to 11.2% (TONIA), 8.5% to 12.3% (one-day USDKZT swaps) and from 8.75% to 10.87% (two-day USDKZT swaps).

On 22 of May, when the FX rate of KZT strengthened by 0.5% for the day, there was a jump in rates from 8.21% to 10.35% (TONIA), from 7.66% to 11.28% (one-day USDKZT swaps) and 8.37% to 10.14% (two-day USDKZT swaps). A similar dynamic of the money market was observed on 16-17 of June when the tenge against the US dollar strengthened by 0.3% in a few days.

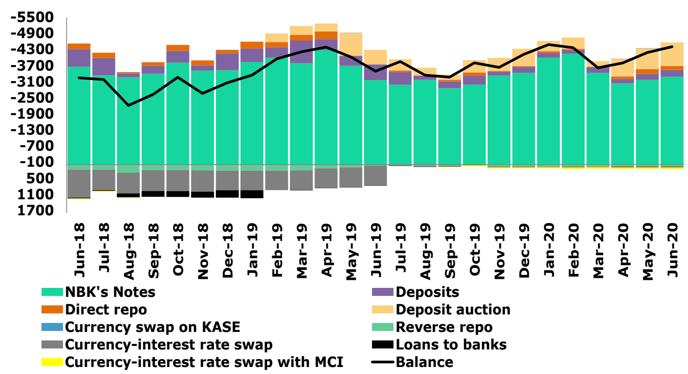
The rate on automatic repo operations (TONIA) at the end of June 2020 was at 8.25% (9.04% at the end of June 2019) with an average value of 8.76% (8.16% in 2q2019). Automatic Repo transactions increased by 13.0% yoy in 2q2019 and amounted to T19.0 tn, with the average value of daily transactions T306 bn (T271 bn in 2q2019). Maximum daily transaction of automatic repo occurred in the very first days of June 2020 and amounted to T448.1 bn (T485.3 bn in May 2019).

Figure 7. Money market rates eop



Source: NBK, Halyk Finance

Figure 9. Excessive liquidity sterilization



Source: NBK, Halyk Finance

One-day USDKZT swaps in 2q2020 increased by 28.1% yoy to T1 573 bn. In 2q2020, the rate on one-day USDKZT swaps made at the level of 7.59% (7.09% at the end of the 2q2019) with an average of 8.87% (7.18% in 2q2019). The maximum trade of one-day USDKZT swaps occurred in mid-May 2020 and amounted to T115.1 bn with the average quarterly value of T25.8 bn (T71.0 bn on the last day of June 2019, the average quarterly T20.8 billion). Two-day USDKZT swaps in 2q2019 fell by 86.6% yoy. 8.45% (7.89% at the end of 2q2019) at an average quarterly value of 9.02% (7.28% in 2q2019). The maximum trade volume of two-day swaps was in mid-May and made T32.4 bn with the average quarterly value of T14.1 bn (T149.1 bn in the last days of June 2019, the average quarterly T107 bn).

From the beginning of the year up to June, there has been a 3.9% decrease in the volume of liquidity withdrawn with the help of NBRK notes. At the same time, the effective yield on the NBK notes in circulation in June 2020 was 10.4% (9.02% in June 2019 and 9.77% in December 2019). Effective rate of initial placement of NBK's notes in February 2020 amounted to 10.5% with the volume of placement of T1 091 bn against the rate 10.15% and the volume of the initial placement in T1 970 bn at the beginning of the year. The yield of NBK's notes for 182-364 days in June 2020 was 9.99% and 10.68%, respectively. Thus, in the second quarter of this year, the money market was dominated by increased volatility in response to the rapidly changing situation in FX markets.

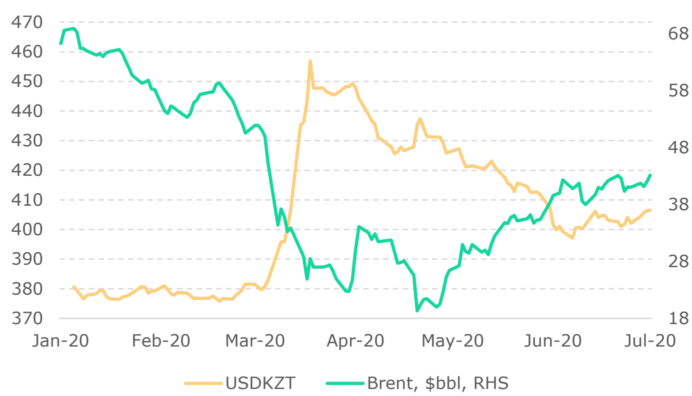
FX rate - expected to weaken

In the second quarter of this year, there was a significant strengthening of the national currency by 11.4% to 397.3 tenge per U.S. dollar (-9.9% qoq to 403.8 tenge per U.S. dollar at the end of 2q2020). This strengthening of the FX rate was facilitated by the decline in demand for foreign currency as a result of the downturn business activity, falling retail lending and the National Bank's restriction of speculative FX currency demand. At the same time, there was an increase in the supply of the foreign currency as a result of the conversion into tenge of foreign currency funds as part of the transfer from the National Fund (about 67-70% of all transactions on the market) and the sale of currency by quasi-state companies.

After a two-fold monthly decline in April, in May FX trading on the foreign exchange market decreased by an additional 7.0% mom (-24.3% yoy) to $1.6 bn. National Bank's share at the FX market jumped from 21% in January to 70% in May. In June, there was an increase in the volume of trading however, despite the growth of the foreign exchange market, the regulator's share remained significantly higher than at the beginning of the year.

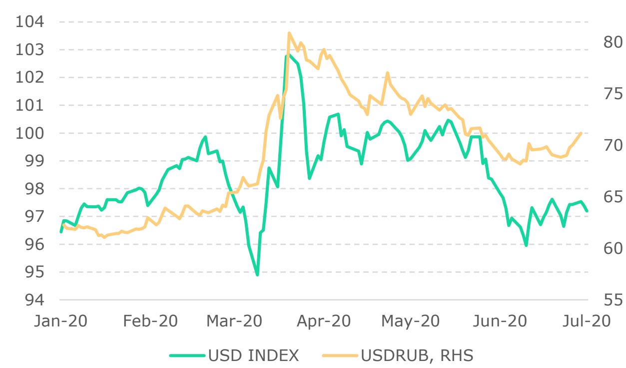
Thus, in June, according to the National Bank, the sales the National Fund's foreign currency as part of the guaranteed transfer to the budget was $1.4 bn (28.7% mom), which amounted to 68.5% of the total volume of the country's foreign exchange market. Thus, if in 1q2020 the NBK sold the currency for the National Fund at $1.8 bn, then in the second quarter sales amounted to $3.4 bn.

Figure 11. USDKZT vs Brent



Source: Bloomberg, Halyk Finance

Figure 12. USDRUB vs DXY



Source: Bloomberg, Halyk Finance

The increase in the tenge FX rate was also affected by a significant increase in oil prices in response to the extension of the terms agreement on reducing oil production at the OPEC meeting in early June. The meeting ended with the agreement to maintain the current decline in oil production by 9.7 mn barrels per day until the end of the July, which, with the exception of Angola and Nigeria, was respected by all parties to the agreement. In addition, the market energy resources began gradually to get balanced as the world economy came out of quarantine. Thus, according to short-term forecasts of the Energy Information Administration (EIA), the oversupply of oil decreased from 5.1 mn barrels per day in May to a deficit of 1.8 mn barrels of deficit in June.

Another factor in strengthening of the national currency was strengthening of the Russian ruble FX rate (-9.2% from 78.42 rubles U.S. dollar at the end of June). In addition to the rise in oil prices, the rise of the ruble against the US dollar contributed to the implementation of the budget rule, under which at the oil price below $42.4 per barrel the Ministry of Finance of the Russian Federation actively sold foreign currency on the FX market. Thus, sales of FX currency from the FNB (National Welfare Fund) in the period from May 13 to June 4 were increased threefold to 193.1 bn rubles (11.4 bn rubles daily) compared to the period from April 7 to May 12 (77.8 bn rubles or 3.5 bn rubles a day).

Strengthening of the national currency was also helped by weakening of the dollar against a basket of the world's leading currencies. Thus, the index (DXY) adjusted by -1.7% for 2q2020 to 97.39 by the end of the second quarter. During the second quarter, the dollar index momentarily reached the value of 95.96. This weakening of the global reserve currency was facilitated by the strengthening of the euro on the news that the CME will expand the volume of purchases of private and public sector securities due to the pandemic emergency (PEPP - Pandemic Emergency Purchase Program) from 750 bn euros to 1.35 tn euros and will extend the buyback program until June 2021. In addition, the unrest in America had also contributed to the depreciation of the US dollar not only against the euro, but also against the currencies of other countries.

Foreign trade and changes in FX rate of trading partner countries are external factors of the weakening of the tenge

We believe that with the average Brent price of $40 (-37.7% yoy) per barrel in 2020 there will be a significant reduction in Kazakhstan's exports proceeds. In addition, consumer demand for imported consumer goods will recover amidst of gradual economic recovery, which together with "sluggish" exports will affect the reduction of the trade balance surplus. Along with the slump in FX capital inflow under the foreign trade, we expect an increase in the income withdrawal by non-residents under their direct investment in Kazakhstan. This will affect the reduction in re-invested income as it was observed in 2008 (-48% yoy) and in 2015 (-101.5% yoy). Thus, the current account deficit in 2020 will widen from 3.6% of GDP in 2019 to 5.1% of GDP in 2020, which will put pressure on the tenge rate to weaken.

In 2H2020, the risks of weakening the Russian ruble against the US dollar increase due to the gradual decline in foreign investors' interest in the FLBs (federal loan bond) due to a fairly dynamic reduction in the key rate of the regulator (from 6% to 4.5% in 2q2020), which makes interest arbitration on carry trade transactions less attractive. It should be reminded that at the moment about 30% of all FLBs belongs to non-residents. In addition, dividends are planned to be paid to non-resident shareholders of Sberbank, Lukoil, Rosneft and Nornickel in the second half of this year. Converting the dividends paid by Russian rubles into FX currency and bringing it abroad will also lead to increased demand for FX currency and pressure on the Russian ruble.

Additional pressure on the Russian ruble FX rate will also be exerted by the implementation of the budget rule, under which at the cost of Brent oil above $42.4 per barrel, the Ministry of Finance of the Russian Federation and the Central Bank of the Russian Federation will gradually resume the purchase of FX currency. Note that since the end of June the Brent price does not fall below $43 per barrel of Brent.

Taking into account the fact that the demand for Russian exports in the second half of this year will be relatively weak, support for the Russian ruble under foreign economic activity will also be insignificant. Considering that the share in foreign trade of the Russian imports to Kazakhstan is about 40% of the total, the weakening of the Russian ruble will immediately affect the FX rate of the tenge.

Reducing NBK's share in the foreign exchange market and budget execution are internal factors of the tenge weakening

Until the end of this year, the National Bank will continue to sell FX currency for the needs of the National Fund, however, as per our expectations, the sales will decrease. We estimate the FX currency supply on the FX exchange for the remaining 5 months at $2.2 billion. Distributed evenly, this will amount to about $450 mn, which is much less than FX currency sales by the National Bank in the first half of the year. As soon as the USDKZT trade on KASE is restored to $2.4 bn per month (the average monthly FX currency trade in 2019), the market monthly absorption of the FX currency at the amount of $450 mn will occur without significant impact on the FX rate of the tenge. Thus, the share of the exchange operations of the National Bank, which in 2H2020 amounted to 67-70% of the market capacity, will be reduced to 19-20%. However, support for the FX rate of the tenge will be provided by the mandatory sale of export proceeds by quasi-state companies that will be valid until the end of this year.

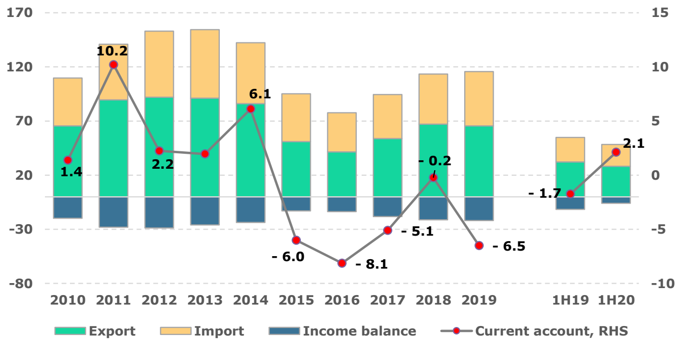
This year, the guaranteed transfer to the budget from the National Fund is planned at T4.8 tn ($10.8 bn at the budgeted average annual rate of 440 tenge per U.S. dollar). At the same time, the republican budget in 2020 is planned to be reduced to a deficit of T2.4 tn (-3.5% of GDP). At the current average FX rate of budget deficit will be T2.7 tn or -3.9% of GDP, hence a weaker rate the tenge will technically solve the problem of fulfilling the revenue part of the budget. Thus, given external and internal conditions, we expect a weakening of the national to 435 tenge per dollar in the second half of this year.

Current account recorded a surplus in 1H2020.

The current account of the Republic of Kazakhstan in 1H2020, according to the preliminary data of the NBK for 2q2020, has recorded a surplus of $2.1 bn (deficit of $1.7 bn for 2019). Basically, the current account surplus was formed in 1q2020 and amounted to $2.0 billion, while in 2q2020 there was a decrease to $95 mn.

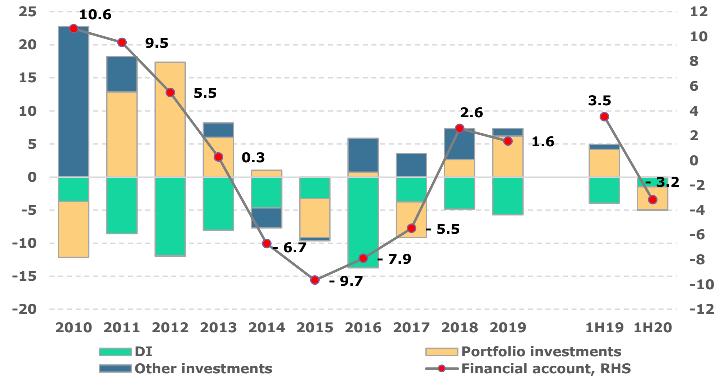
The expansion of the current account surplus in 1H2020 was facilitated by a significant reduction in the deficit of primary income balance by $5.2 bn (-45.2% YoY) to $6.3 bn (deficit $4.1 bn in 1q2020, deficit $2.1 bn in 2q2020, a slight reduction in the service balance deficit by $15 mn (-0.8% yoy) to $1.8 bn (deficit of $879 mn in 1q2020, deficit in 2q2020 $921 mn), as well as the expansion of the secondary balance surplus by $70 mn ($38.2% yoy) to $252 mn (surplus of $65 mn in 1q2020, a surplus of 2q2020 $187 mn). At the same time, narrowing of the trade surplus occurred by $1.4 bn (12.3% yoy) to $9.9 bn (a surplus in 1q2020 $7.0 billion, a surplus in 2q2020 $2.9 bn) due to a reduction in exports by 10.7% yoy to $25.6 bn ($13.9 bn in 1q2020, $11.7 bn in 2q2020), and imports by 9.7% yoy to $15.7 bn ($6.9 bn in 1q2020, $8.7 bn in 2q2020). Under the primary income balance was also observed a deficit reduction by 45.2% yoy to $6.3 bn.

Figure 13. Current account surplus widening, $bn



Source: NBK, Halyk Finance

Рис. 14. Financial account inflow, $bn



Source: NBK, Halyk Finance

Narrowing of the account balance was due to income fall form direct investments by 48.4% yoy to $5.4 bn ($4.1 billion in 1q2020, $1.1 bn in 2q2020). Narrowing of the services balance deficit in H2020 by 0.8% yoy to $1.8 bn occurred due to a reduction in the imports of international services by 16.0% yoy to $4.5 bn ($2.4 bn in 1q2020, $2.1 bn in 2q2020) and 23.9% yoy to $2.7 bn ($1.6 bn in 1q2020, $1.1 bn in 2q2020). Secondary income balance surplus increased by 38.2% yoy to $252 mn ($65 mn in 1q2020, $187 mn in 2q2020). Thus, the notable narrowing of the secondary income deficit and the relatively a slight reduction of the trade surplus led to a widening of the current account surplus. The current account surplus to GDP for 1H2020 was 1.3% ($2.1 bn), increased from a deficit of -1.0% ($1.7 bn) for the same period of 2019.

Financial account (excluding NBK reserve assets)

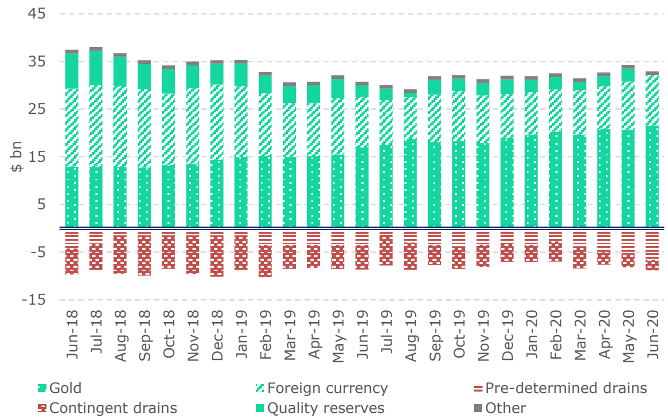
According to the preliminary NBK statistics, the financial account in 1H2020 evidenced capital inflows in the $3.2 bn (inflow of $365 mn in 1q2020, inflow of $2.8 bn in 2q2020) vs. capital outflow $3.5 bn (outflow of $3.5 bn in 1q2019, inflow of $12 mn in 2q2019) last year at the same period. The positive dynamics of capital inflow on the financial account was facilitated by the expansion of inflow of capital in 1H2020 under the portfolio investments account at $3.5 bn (inflow of $1.8 bn in 1q2020, inflow of $1.9 mn in 2q2020) compared to an outflow of $4.2 bn (outflow of $3.3 bn in 1q2019, outflow $922 million in 2q2019) last year. In our view, this was due to a decline in the nominal holding of foreign assets by the residents of Kazakhstan, as well as by reduction of foreign assets of the National Fund, along with a simultaneous increase of the liabilities of Kazakhstan's commercial sector to non-residents. Under the account of medium-term and long-term investments in 1H020 there was an inflow of $96.8 mn (outflow of $965 mn in 1q2020, inflow of $1.1 bn) vs. an outflow of $719.5 mn (outflow of $654 mn 1q2019 and $65 mn in 2q2019) last year. Direct investment account evidenced a decline of capital inflow of 62.5% yoy to $1.5 bn (inflow of $1.4 bn in 1q2020 and $108 mn in 2q2020). Under the other short-term capital flows in 1H2020 there was a decrease of 26.3% yoy to $1.9 bn (outflow of $1.9 bn in 1q2020, inflow of $24 mn in 2q2020).

Financial inflows under the financial account to GDP, according to our estimation, increased from an outflow of 2.1% ($3.5 bn) in 1H2019 to an inflow of 1.9% ($3.2 bn) in 1H2020.

Consolidated international reserves - growth at the expense of NBK

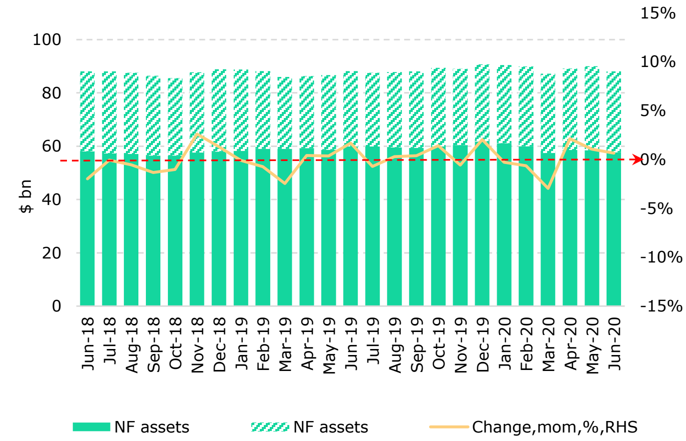
Consolidated international reserves as of the end of June 2020, according to the NBK, amounted to $90.6bn. Since the beginning of the year, the consolidated reserves have increased by 3.9 qoq (-0.1% ytd, +2.8 yoy) per National Fund's 0.5% qoq asset growth to $57.7 bn (-6.5% ytd, -3.7% yoy), while the NBK's gross IRs increased by 10.4 qoq, +16.5% yoy). Within the reserves of the NBK, there has been an increase in FX currency assets by 12.2% qoq to $11.3 bn (+12.5% ytd, 1.4% yoy). The growth of assets in FX currency was due to an increase in the amount of funds in the foreign currency accounts of the commercial banks in the National Bank. The amount of funds in FX currency and the deposits in FX currency, according to the IMF, decreased by 5.9% qoq (+3.4% ytd) and amounted to $4.2 bn. The securities holdings increased by 30.7% qoq (+21.4% ytd) to $6.4 bn. According to the monetary review of the NBK, FX currency in cash as of the end of June increased by 24% ytd and amounted to T140 bn ($348 mn) in structure of the NBK's gross international assets. At the same time, the share of assets in FX currency as the end of June 2020 decreased within a year from 39.6% to 34.5% due to the increase in the share of gold.

Figure 15. International reserves of NBK



Source: *IMF, Halyk Finance*

Figure 16. Consolidated reserves of Kazakhstan



Source: NBK, Halyk Finance

According to the Ministry of Finance, revenues of the NF in January-June increased by 85% to T3.6 tn ($8.9 bn). Direct tax receipts from the oil companies decreased by 31.2% yoy to T1.0 tn ($2.6 bn). Increase in revenues of the fund was due to the T2.6 tn or $6.3 bn of investment income from fund's assets management. In 6M2020, the fund's expenses increased by 72% yoy and amounted to T3.4 tn or $7.8 bn in January-June 2020. The amount of the guaranteed transfer to the state budget, due to which there was an increase in the amount of expenditures, increased by 116.2% yoy to T3.1 tn or $7.8 bn, with FX currency sales at $5.2 bn. For January-June 2020, the fund's revenue balance was positive at T463.5 bn ($1.1 bn).

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