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Macroeconomic report

4Q2018

Abstract

The main barometer of the state of Kazakhstan economy – oil prices increased by 30% in 2018 from an average of $54 per barrel to $70, while rising above $80 in autumn, but dropping to $50 by the end of the year. Such significant growth of the main item of Kazakhstan exports did not fail to have a positive impact on public finances and external accounts of the country where the movement toward balance was observed for the first time since 2014, when oil prices started to fall from $100 per barrel.

Even with the strong rise in oil prices, economic growth in 2018 has remained at the level of the previous year at 4.1% in 2017, indicating the lack of drivers for further acceleration. Thus, the peak of the growth in the current economic cycle had already passed. It also says about weak impact of economic policy of the State that continues to rely on the commodity sector.

An increase in oil production to the new maximum of 90 million tons in 2018 supported industry growth above 4%, for a similar amount increased activity in the transport sector (4.6%), construction (4.1%) in agriculture weaker growth at 3.4%.

Investment growth in 2018 peaked over the past 10 years, for most of the year held higher than 20%, with more than 40% of the investment growth in the extractive sector, where major volumes formed expanding capacity at Tengiz oilfield. Development mainly in the commodity sector reinforces the tendency of dependence on mineral resources and, as practice shows, even high prices of raw materials are not able to provide a stable inclusive growth of the economy with concomitant increase of welfare of population.

Consumer activity has grown significantly and has outstripped most industries with expanding retail sales above 6%. High growth of retail sales was partly financed by borrowed monies, consumer lending significantly outstripped growth in real wages – 5.9% versus 1.8% in 11M2018.

There was an increase in the demand for labor in 2018, the number of employed rose to 8.7 million in the 3rd quarter – the highest rate in history. The main increase occurred due to persons previously economically inactive and older people tha remained longer in the labor market. At the same time the main growth in employment occurred in low productive services sectors where the proportion of employed persons for increased by 1pp to 66% in the total.

Consolidation of budgetary expenditures with relatively high oil prices led to an improvement in public finances, however, the practice of tapping extra-budgetary funds (the NBRK, ENPF) constrains the consolidated budget balancing, resulting in the size of its deficit, though it fell 5 times in a year, but amounted to 1.3% of GDP in 2018. Due to the reduction in the use of funds of the National Fund asset accumulation again resumed last year after a continuous reduction since 2015, and their total volume is >40% of GDP.

Inflation in 2018 was unusually restrained, reaching the lows over the last 5 years at 5.3%, and ignored negative impact of weak tenge, record levels of inflation expectations, nominal wages growth above 7%, trade turnover of more than 8%, double-digit growth in investment, that all formed strong pro-inflationary picture.

Monetary conditions remained neutral, despite the base rate hike in 4Q2018 to 9.25%. The NBRK regularly reduced the base rate until 3Q2018 along with the decline in inflation. However, in the fourth quarter of 2018 the NBRK decided to raise the base rate while inflation ended the year at 5.3%. We believe that such a decision might be viewed by the market as a beginning of monetary policy tightening. In 2018, FX rate of the national currency weakened from 318 tenge to 384 tenge per US dollar as the end of the year, while RUBKZT FX rate was at 5.5-5.6 tenge per Russian Ruble.

External trade of Kazakhstan in 2018 increased due to energy prices recovery resulting in growth of nominal value of exports within 10 months 2018 by 41%. Trade balance widening improved current account deficit that radically decreased compared to 2016-2017 and amounted to less than 1% of GDP in 3Q2018.

KASE index showed upward growth from 2 155 to 2 325 at the end of December 2018. Such growth dynamics of KASE index was driven by on the one hand increase in commodity prices, and on the other hand, the continued tightening of Fed policy that caused the outflow of capital from emerging markets, as well as geopolitical uncertainty regarding Russian Federation and trade wars between United States and China.

Scenario forecast

At the end of 2018 under the influence of negative factors on external markets oil prices fell to $50 per barrel, although the average price of Brent oil amounted to $70 per barrel. At the beginning of this year, oil prices began to adjust upwards, and forecasts of oil prices stand at the level of $70 per barrel. In this regard, we have revised the forecast of oil prices this year toward a small decline to $68 per barrel on average.

Scenario projections of major macroeconomic indicators we implemented with symmetrical deviation from baseline scenario assuming average annual oil price of $68 per barrel in 2019 and 2020 (based on the assessment of the expectations of the international organizations and market participants and our more conservative approach to the evaluation of oil quotations). Pessimistic – the average annual price of $58 per barrel in 2019 and 2020 and optimistic – the average annual oil price of $78 per barrel in 2019 and 2020.

Kazakhstan's economy in 2019 we expect to grow by 3.6%. Oil prices since 2016 rose by almost 60%, their growth is limited by the growth of the world economy that reached the plateau. In our assessment, the average oil price will be $68 per barrel. In view of the slowing down of the extractive industries contribution of services to growth will moderately increase. The State budget will improve significantly, however, the use of funds of the National Bank and ENPF will retain the consolidated deficit within -0.5% of GDP in 2019.
Rise of the minimum wage will support a small increase in wages. Limited supply of workforce due to demographic factors will have a positive impact on employment.
Foreign trade conditions in 2019 will form favorably in general, because the cost of energy will be only slightly below 2018 ($68 per barrel).
In 2019 we expect a slight expansion of the current account deficit through increasing imports of investment goods for major oil projects, as well as due to deepening deficit accounts of primary income of foreign investors.
We believe that the level of exchange rate will stand at 375 per USD and follow the Russian ruble movements, which will suffer from the effects of sanctions and the budget rules.

Inflation will be closer to the middle of the NBRK target corridor at a level of 5.4% and will largely be determined by the delayed effect of the weakening of tenge in 2018, which did not materialize, though resulted in significant growth of inflation and devaluation expectations since last fall. The NBRK will keep monetary conditions at a neutral level in 2019, and by the end of the year will reduce the base rate to 9%.

Table 1. Main macroeconomic indicators

	2017	2018	Base		Pessimistic		Optimistic	
	Fact	Estimate	2019	2020	2019	2020	2019	2020
Oil BRENT, average, USD/bbl	54.0	70.0	68.0	68.0	58.0	58.0	78.0	78.0
Real GDP, % yoy	4.1	4.1	3.6	3.6	2.8	2.9	4.0	3.8
Exchange rate USDKZT, eop	332.0	384.2	375.0	375.0	393.7	394.5	357.9	361.5
Exchange rate USDKZT, average	326.0	344.7	371.5	375.0	391.0	394	366.6	360
CPI, % change yoy	7.1	5.3	5.4	5.0	5.6	5.2	5.4	5.0
Government debt, KZT bn eop	13.5	15.0	15.8	16.6	16.0	17	15.5	16.3
Government debt, % GDP	25.4	25.3	24.7	24.2	24.9	24.4	23.9	23.6
Budget balance consolidated, % GDP	-7.4	-1.3	-0.5	0.7	-0.8	-0.3	0.2	1.1
Current account, % of GDP	-3.3	-0.3	-0.9	-0.2	-1.0	-0.4	0.0	0.9

Economic sectors

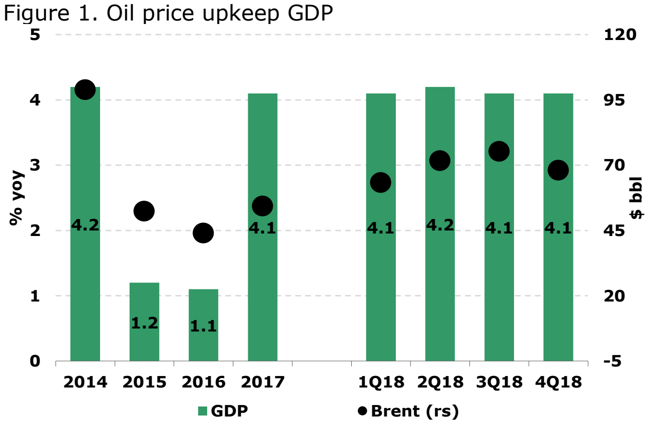
Economic growth in Kazakhstan amounted to 4.1% yoy in 2018, with nearly identical growth in each single quarter. Thus, the economy shows growth at 4.1% for two consecutive years after two years increase of 1% in 2015 and 2016 respectively (fig. 1), which indicates a degree of linearity of economic growth on "manual management". The cost of oil as the main barometer of the state of the economy, stood at $70 per barrel on average in 2018, and showed growth during most of the year, reaching $85 per barrel in October, but subsequently fell to $53 per barrel by the end of the year. In comparison with the previous year, Brent oil has risen by almost 30% from $54 per barrel in 2017 and almost 60% from 2016 level of $44 a barrel, indicating favorable conditions for the growth of the economy. However, it also indicates that further acceleration of growth hasn't happened and further capacity is limited.

Oil production in 2018 due to Cashagan demonstrated growth for the second consecutive year, although slowed to less than 5% after 10.5% in 2017, production reached a new record at 90 million tons, underpinned by the growth in oil production also at Tengiz and Karachaganak, whereas other fields saw decline. Given that Kazakhstan within the framework of participation in the agreement to reduce oil production has committed itself to cut production by 40 thousand barrels per day in 2019, it can be expected that a serious increase in oil production this year will not happen, so much so that the Kashagan and Tengiz are expected to undergo maintenance works with suspension of production for several weeks.

Along with the gradual easing of the pace of industrial production and the growth of the service sector, the contribution of it in economic growth has increased (fig. 2). It is worth noting that the wholesale trade growth in 2018 for about 40% was formed at the expense of petrotrade. Thus, it has provided a significant contribution to GDP growth, albeit a purely "paper" in nature. Exchange rate of tenge, weakened by 15% from March 2018 that also did not affect the volume of retail trade, showing growth of 6.5% ahead of most indicators in the economy. Given oil trading increase, GDP growth still by more than half was formed by the commodity sector. In addition, the sharp slowdown in inflation despite strong pro-inflationary background could also contribute to the preservation of real economic growth at the level of 2017, as the lower the deflators/inflation, the higher real GDP growth, wages and other indicators. In the previous quarterly review, we have noted an unusual pattern, when every last month of quarter construction activity sharply goes up to a local peak that undoubtedly helped to maintain GDP growth above 4%. Thus, growth in the economy formally was stable, but the content and quality was low.

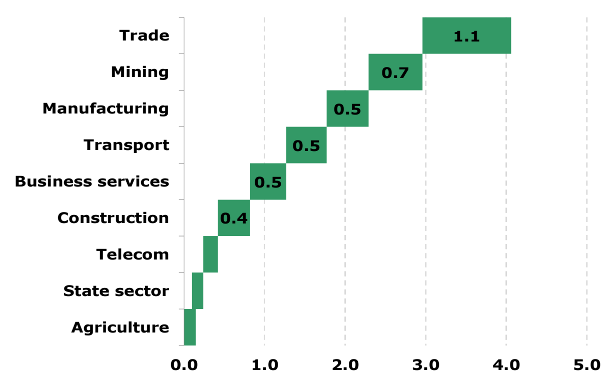
Throughout 2018 dynamics of economic indicators was quite stable. The partial slowdown became manifested during the second half of the year and was due to a deceleration in the industry to 4.1% yoy (5.2% yoy in 1H2018), in transport to 4.6% yoy (4.9% yoy in 1H2018). Rates dipped significantly in agriculture to 3.4% yoy (4.0% yoy in 1H2018), where there was a decrease in gross output. Acceleration occurred only in trade due to the wholesale trade. Dynamics of foreign trade exports followed oil prices movement and for the second consecutive year showed an increase of 30% with a much more modest pace of import growth. Investment is also rapidly expanded (+17% yoy) with twice as strong growth in investment in the primary segment.

Figure 1. Oil price upkeep GDP



Source: CS MNE, Halyk Finance

Figure 2. Contribution to GDP growth by sector



Source: CS MNE, Halyk Finance

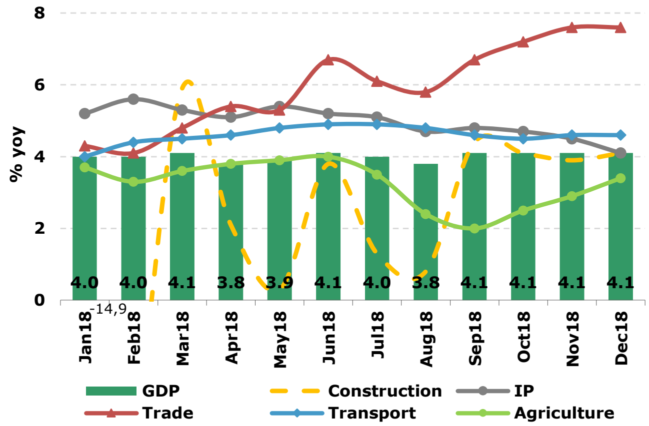
Industrial sector

Index of industrial production increased by 4.1% yoy in 2018 in December to December 2017 only +0.1%. Production growth in the mining industry amounted to 4.6% yoy (+9.3% yoy in 2017) and was defined mainly due to positive dynamics of crude oil output at 4.8% yoy, metal ores production at 4.7% yoy.

To 4% yoy (+5.1% yoy in 2017) growth in manufacturing contributed double-digit growth in engineering at 14.1% yoy, in refining at 8.8% yoy, in the chemical industry at 8.1% yoy. In metallurgy a modest growth at 2.2% yoy, with weak growth in the steel industry. High rates in engineering is due to low base last year, for example, assembly of cars amounted to 30 016 in 2018 that is almost twice 16 789 in 2017 in the same period. In addition, it is the best figure since 2014, for example in 2016 only 5.2 thousand vehicles were assembled. Among other sectors, it can be noted the increase in electricity production from 103.1 to 107.1 million kWh (+3.8% yoy), manufacture of accumulators from 2.1 to 2.6 million (+20.4% yoy), cement from 9.4 to 9.9 million tons (+5.5%), gasoline from 3 to 4 million tons (+29.8% yoy) by the way, gasoline production in 2018 was record in history, given the completion of the modernization of three oil refineries and plans to export surplus, diesel from 4.4 to 4.7 million tons (+7.4% yoy), which is also close to the historic high of 5 million tons in 1991. The decrease of production was evident in food, canned food, pasta, sugar, clothes and shoes, fertilizers, medicines, steel and flat-rolled products.

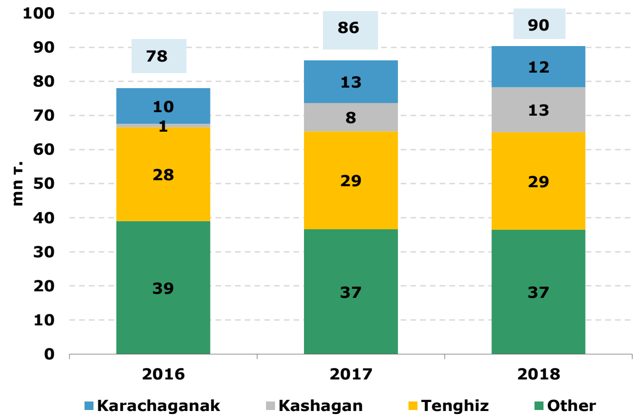
Oil production in 2018 for the second consecutive year achieved record volumes, though with some slowdown after high base in 2017, when it increased by about 10%. The main driver of growth, as in 2017 stands Kashagan, where production reached 13 million tons (fig. 4). Against the backdrop of stable volumes on major fields such as Karachaganak and Tengiz, and decline in old fields, entrance of Kashagan was implemented very timely and reversed downward oil production trend. Currently, the three largest fields mentioned above, account for more than half of all oil production in the country and their share will only increase. Thus not only the industry but also the entire economy, including the State budget, have become even more dependent on the commodity sector.

Figure 3. Acceleration only in trade



Source: CS MNE, Halyk Finance

Figure 4. Oil output growth slowed in 2018



Source: CS MNE, Halyk Finance

Investment

In 2018, there was strong growth of investment in fixed capital. For 11 months of 2018 it increased by 18.3% yoy and totaled T9.6 tn (fig. 5, 6). The rapid growth of investment was due to increased investment in the commodity sector at 42.9% yoy, resulting in the share of extractive sector accounting for 42% of all investments. Investment in manufacturing grew by 23.7%, in sum almost 60% of all investments were directed to industry. In its turn, almost half of all investment in manufacturing sector was achieved through investment in refineries, where the bulk of the expenses fell on Shymkent oil refinery. Among the industries we can mention the food processing, where the increase was 19.4% yoy, fivefold increase in textile, chemistry +27.1% yoy, in metallurgy +34.1% yoy in the manufacture of electrical equipment up three times. In real estate investment totaled 13% from all investments with increase by 23.7% yoy, 12% share of the transport sector with an increase of 6%, 3% was invested in agriculture with increase of 1.5% yoy.

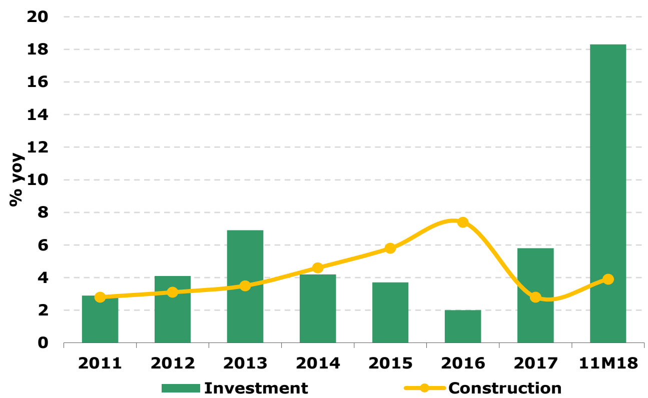
Construction

Construction industry demonstrated growth of 4.1% in 2018, at the same time there was an unstable dynamics of indicators within a year, for example, for 5 months this year, its growth was only 0.3% yoy. The bulk of the construction works – 86% fell on non-residential buildings, 14% on housing.

In almost all regions of the country there has been a positive dynamics, the exceptions were only Akmola and Pavlodar, Zhambyl oblasts, but the main decrease occurred in Astana (-13.4% yoy) in 11M2018, where the proportion of construction works decreased to 14% out of Republican volume (17.3% for 11M2017). However, the Capital holds second place after Atyrau region with a share of 16.8%.

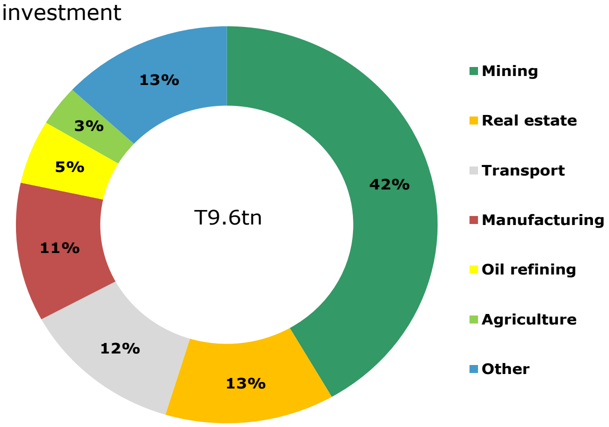
Investment in housing construction exceeded T1 tn (+18.4% yoy) for 11M2018, which is comparable volume of investment for the whole 2017. High activity of housing construction is supported by state programs, due to this fact the pace of construction per capita in Kazakhstan spiked to 0.6 sq. m. and by this indicator outrun many other countries. Amid lack of purchasing power of population, declining real prices and the cost of renting of real estate, further active stimulation of housing construction by the State carry risks of a drop in demand for housing and a decline in the industry.

Figure 5. Investment and construction dynamics



Source: CS MNE, Halyk Finance

Figure 6. Mining and oil refining are main attractors of investment



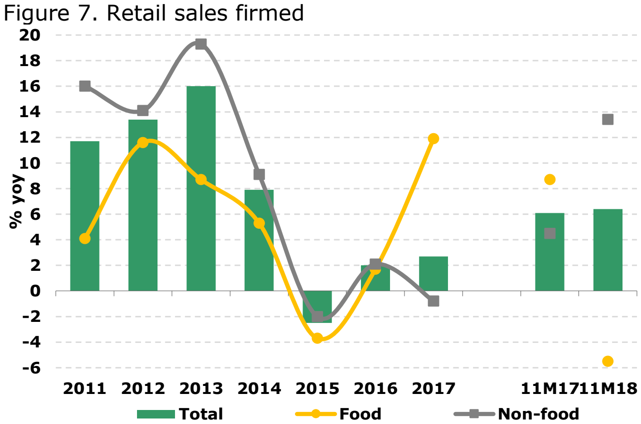
Source: CS MNE, Halyk Finance

Trade

The situation in the sphere of trade continued to improve accompanied by an increase in the incomes of the population, the expansion of consumer credit, restoring growth of larger share of sectors of the economy. Since the beginning of 2018 real wages started to trend up after the cumulative fall by 5% in 2015-2017. This nascent growth is partly attributable to the low base last year, and an unusually low inflation of 5.3%. However, higher wages build more favorable environment for consumer demand. So, for 11M2018 retail trade turnover grew by 6.4% yoy, mainly driven by non-food items +13.4% yoy, while foodstuffs fell by 5.5% yoy. The reduction in turnover of foodstuffs was due to Almaty, where it fell by nearly 26% yoy, while sales of household goods, by contrast, grew by nearly 33%, providing half of the total growth in this segment. In addition to Almaty, contradictory dynamics was observed in the Kyzylorda oblast, where groceries tumbled by 28% yoy and grew by 24% yoy for non-food items, in Akmola oblast on the opposite, the realization of food products increased by 73% yoy, but fell by 22% yoy for non-food items. Such significant inconsistencies in the figures of dynamics of trade make doubtful the reliability of the statistics.

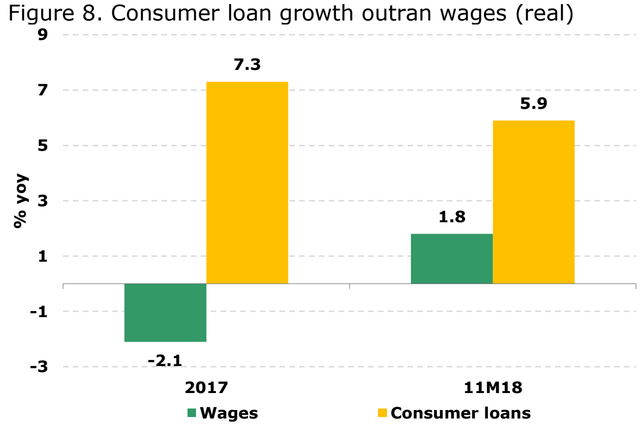
The trade sector situation definitely has improved significantly, with growth ahead of the overall growth of the economy, as well as income growth that can be attributed to the improvement in consumer sentiment, given the growth of wages and accompanying expansion of consumer lending (fig. 8). As a negative factor stands the weakening of tenge by 15% since the beginning of the second quarter of 2018 owing to the National Bank policy of weak tenge.

Figure 7. Retail sales firmed



Source: CS MNE, Halyk Finance

Figure 8. Consumer loan growth outran wages (real)



Source: CS MNE, NBRK

Labor market and incomes of population

According to data the number of employed population amounted to 8.7 million in the third quarter of 2018 and increased by 1.8% over the same period last year. At the same time, the number of self-employed has decreased slightly from 2.2 million to 2.1 million, or 24.2% of the total employed population (fig. 9), the unemployment rate in the same period fell from 4.9% to 4.8%.

Breakdown by branches of economy show that the first place firmly took the trade sector with the number of employed at 1.4 million with a share of 16%, the second highest number of employed was in agriculture with 1.3 million and a share of 14%, third-fourth places fall on industry and education, employing 1.1 million each. In the span of 3Q18 from 3Q17 the number of employed persons declined in agriculture by 116 thousand, in extractive industry by 8 thousand, in construction

(-32 thousand). The decline in employment in agriculture go constantly and from 2010 reached 1 million, though there are doubts that there were employed as many people all these years due to weak accounting. For comparison, in Russia, with a similar proportion of agriculture in GDP of about 4% with employees at less than 7% of the total. In the mining industry decline comes amid falling oil production in Mangistau, Kyzylorda and Aqtobe oblasts. Reduction in employment in construction is due to the decline in construction work after the completion of construction of the EXPO 2017. In turn, employment grows almost entirely at the expense of the services sector, dominated by such weak for economic development industries as trade, real estate operations and other services. Surprisingly, despite the decrease in the number of banks and insurance companies, the number of employed in the financial services increased by 10%.

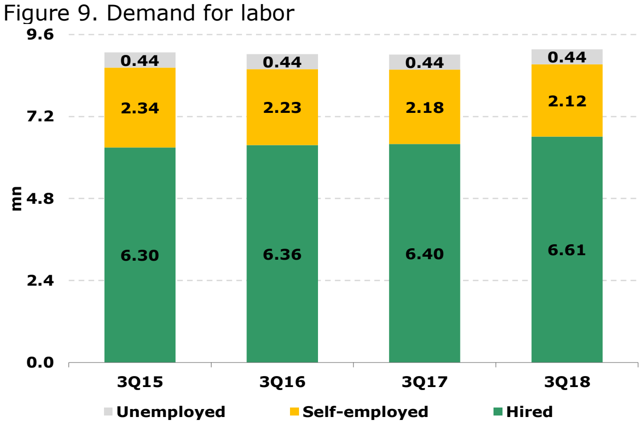
Judging by dynamics of emigration (30 thousand on average per year), the sustained trend of significant population outflow in excess of inflow is firm, with the "brain drain" keeping high share in outflows.

Salaries increased nominally by 9.3% yoy in the third quarter, to T162 thousand, in real terms up by 3.1% yoy meanwhile, real wage growth moderated to 1.8% yoy in January-November. In industry, construction, trade real wages grew by 5%-6% for 9 months of the year, in the State administration up by 4%. While in education increase was only 1.7% and in health recorded a decline of 2.8%. The highest growth was observed in administrative office services and support at 16%, in finance at 10%. It should be noted that in financial sector employment also increased by 10%, which can be interpreted as a growing demand for workers in the financial sector stimulated the growth of salaries, despite consolidation in the banking and insurance sector. Wage growth is unstable for now, wages continued to fall in agriculture (-3.8%), in Telecom (-1.6%), in real estate (-1.8%). Summarizing, we can say that the real wage growth reflects the rising cost of oil and other raw materials over the past two years and reduced official figures for inflation, but real changes affecting the improvement of the economic structure, in not observed.

The wage growth in 2019 will be influenced by an increase of minimum wage by 50%. Given moderate economic growth it is not excluded that employers will compensate for the increased cost of raising the minimum wage by freezing pay in total, given that the private sector will have to send sizable sums on raising the minimum wage. Wage growth in the next year, we see at about 7 per cent in nominal terms and within 1% for real wages. Note that raise in the minimum wage is implemented with the assistance of the administrative resource, State organs establish a special headquarters for monitoring progress in wages increases, but without improving the competitiveness of enterprises and reducing the share of the State in the economy this wage hike will have only a short-term effect. In comparison with Russia and Belarus, even with the increase, the minimum wage in Kazakhstan will be approximately 40-50% lower.

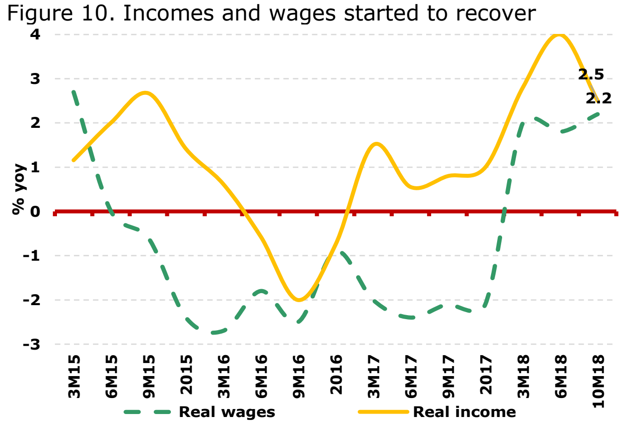
From 2019, single aggregate payment for individuals engaged in small business activities that imply the self-employed is stipulated. The size of the monthly payment is set at a very low level at 1 minimum calculated indicator for cities and 0.5 in the countryside. According to the plan of the State authorities this measure will contribute to the exit of self-employed population from the shadow and ensure their social guarantees. In our view, this initiative will have a weak effect in the medium term, as the incentives for the population with unstable incomes to declare self-employment is lacking. For example, the scope of voluntary pension savings is approximately 70% of the employed population. Withdrawal of the State from the labor market since the beginning of mass privatization in the 90's without regard to the underdevelopment of the non-commodity sector, which is the main source of employment, will affect the labor market and social protection of population upon retirement in the long run. Not investing in efficient employment today, the government would be obliged to spend moneys on welfare of people in old age. For example, in China the population with incomes of less than RMB5000 per month (T275 thousand) are exempt from income tax this year while the minimum wage varies from RMB1150 to 2420 (T63 to T133 thousand), thereby increases disposable income of low income population and personal consumption that stimulates economic growth, and also supports the competitiveness of the economy. On the contrary, in Kazakhstan State support oftentimes does not focus on the end-users, but on private and public companies that discourage them to improve their efficiency.

Figure 9. Demand for labor



Source: CS MNE, Halyk Finance

Figure 10. Incomes and wages started to recover



Source: CS MNE, Halyk Finance

Fiscal policy

State budget in Jan-Nov 2018

State budget revenues (excluding transfers to the National Fund) rose by 17.1% yoy and totaled T7.4 tn in January-November 2018. Tax revenues in the State budget grew 18.5% yoy to T7.1 tn or 92% of the plan. Income from CIT grew by 9% yoy, individual income tax by 11.3% yoy, social tax by 6.6% yoy, VAT up 27% yoy, for excises up 21.7% yoy. Transfers from the National fund fell by 37% yoy, but excluding transfers of T2.1 tn to rescue banks in 2017, increased by 27% yoy, while the entire volume of guaranteed transfer T2.6 tn was used in 10 months. Thus, the income of the State budget by 26% were formed due to transfers that were above 20% (excluding a transfer of T2.1 tn to rescue banks in 2017) in the corresponding period of 2017.

Budget expense rose more moderately in comparison with incomes at 10.6% yoy (excl. T2.1 tn to support banks in 2017) and totaled T10.1 tn (90% of the plan) in January-November 2018. By 26.7% yoy increased the costs on defense, other State services decreased by 6% yoy. As authorities increased pensions and benefits, spending on social security increased by 19.6% yoy. By 6% yoy increased expenses on the economy: transport, industry, agriculture, etc. Debt servicing costs have increased by 30% yoy, that can be associated with a weakening of tenge in the current year, as external borrowings accounted for one third of the total debt. Note that after an absence of external capital markets from 2015, Kazakhstan has placed Eurobonds totaling EUR1.05 billion, the placement of Eurobonds denominated in euros was the debut.

State budget balance was in deficit of T365 bn in January-November 2018 (-T1.245 bn for 11M2017) a planned deficit is T883 bn in 2018 or 1.5% of GDP, which reflects the positive changes that occurred during the year (-2.7% of GDP in 2017).

National fund

Revenues of the National fund from oil and gas sector grew by 60% yoy to T3.2 tn (T2 tn in 2017). Two and a half times increased income from the share of the RK in the agreements under production sharing, income from the rent tax on export earnings and bonuses doubled, CIT increased by 76% yoy. Income from MET showed a decline by 26% yoy.

The size of the expenditure from the National Fund has fallen by 40% yoy to T2.6 tn, but excluding transfer of T2.1 tn to support banks in 2017, there was an increase by 12%. As the guaranteed transfer in the amount of T2.6 tn was used up in October, tax revenues have exceeded outflow by T257 bn in November and by T583 bn in December, the assets of the National Fund in the foreign currency switched to growth since November. Thus the accumulation of assets in the National fund resumed last year after a continuous reduction since 2015, while their total volume is more than 40% of GDP, but so far below peak level of 50% of GDP in 2015.

Consolidated budget

Oil prices increase during January-November 2018 along with the growth of oil exports had a positive impact on the flow of oil revenues of the consolidated budget that has grown by 34% yoy. Concurrently the share of oil revenues in the consolidated budget income had risen to 37% from 31% in the same period of 2017. Non-oil income increased only by 2% yoy to T6.4 tn (fig. 11).

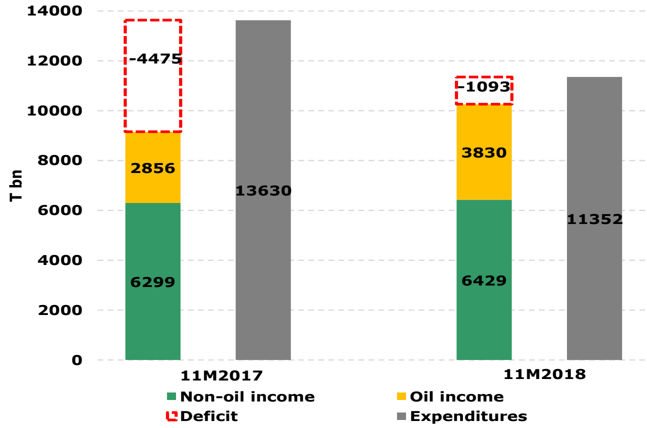
Consolidated budget expenditures fell by 17% compared to the corresponding period of 2017. General government deficit decreased to T1.1 tn from T4.5 tn in January-November 2017, the deficit in our assessment will amount to 1.3% of GDP in 2018 and drop from -7.4% of GDP in 2017.

Non-oil deficit of consolidated budget amounted to T4.9 tn in 11M2018 in comparison with -T7.3 tn in 11M2017. In relative terms, due to nominal GDP growth, non-oil deficit declined to 8.2% from -13.8% for 11M2017. It should be noted that investment income of T1.8 tn was taken into account in the official consolidated budget income, and thus official consolidated balance of the budget was positive in 11M2018, but this revenue reflects the exchange currency changes and in accordance with the IMF's ruling on State finances should have been taken into account in estimation of the assets of the National Fund, rather than artificially inflating non-oil revenues to balance the budget and lower non-oil deficit.

Increased revenues of State budget in view of higher oil prices and the effect of weaker exchange rate of tenge are the basic drivers of improvement of public finances. However, financial authorities allocated funds of the National Bank for the needs of the banking system at the amount of T950 bn, T600 bn is planned from the joint funds of the National Bank and ENPF in 2019 and T85 bn for investment from ENPF for «Saryarka» gas pipeline construction. In accordance with the rules of the IMF on government finances, these sums are consolidated in the budget expenditures, resulting in non-oil consolidated budget deficit potentially reaching -8.4% of GDP and significantly exceeds threshold of -7.4% of GDP for the current year in the Concept on the formation and use of funds of the National Fund as applied to the Republican budget. The following year, also has a probability of non-oil deficit to exceed the -7.2% of GDP threshold.

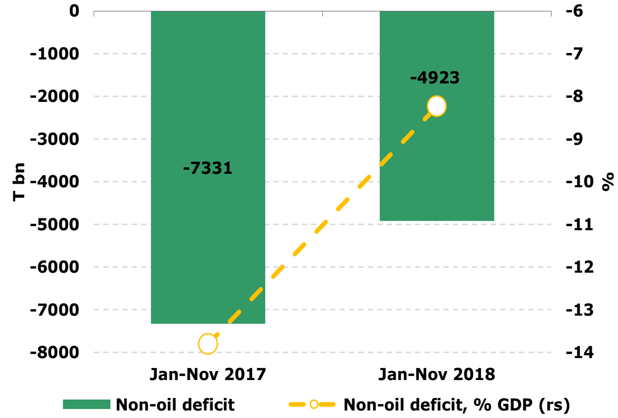
As already noted, the economic growth in 2017-2018 was due to the recovery in the prices of mineral resources and the accompanying rise in the commodity economy, which contributed to the growth of State budget incomes dependency on oil revenues. Increased oil revenues have brought the State budget to balance, but another disbursement of funds for the banking system through extra-budgetary funds led to the preservation of consolidated budget and non-oil deficits despite declared objective of bringing public finances to balance.

Figure 11. State budget (consolidated)



Source: Minfin RK, Halyk Finance

Figure 12. Non-oil deficit 11M2018



Source: Minfin RK, Halyk Finance

Inflation

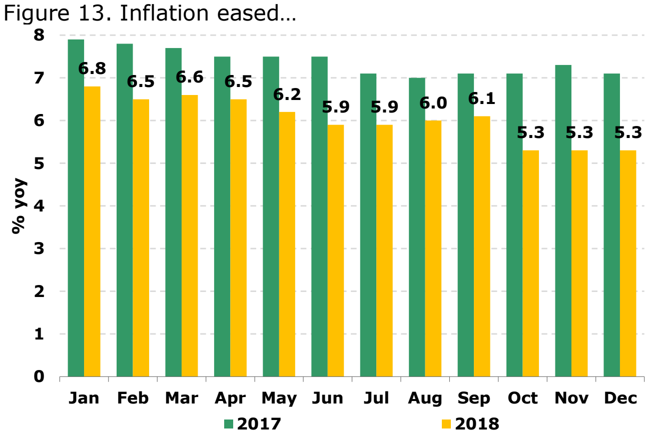
According to the Committee on statistics, inflation in December 2018 slowed in comparison with the previous month to 0.7% (0.9% in November), the annual inflation remained at the level of October and November at 5.3% (7.1% in 2017), an annual average was 6% (7.4% in 2017). The main contribution to annual price increases have provided food and non-food products +1.9 pp each, services +1.5 pp, in 2017 nonfood products had the higher impact +2.7 pp groceries +2.5 pp and services +1.9 pp.

Inflation in 2018 has been unusually low-key and ignored the negative impact of weak tenge, which depreciated for most of the year. Annual average exchange rate amounted to 344 per US dollar (15% fall from late March 2018), i.e. the level of 2016, when there was 2-digit inflation, inflation expectations reflected adverse changes in exchange rate – a record number of respondents 28% expected an acceleration of growth in prices in September, but once again inflation disregarded this factor. It is known that the impact of the weakening of tenge on inflation is asymmetric, i.e. inflation with a slight lag translates into prices, but half-heartedly responds to the strengthening of tenge. However, in the past year, inflation behavior was such like tenge hadn't dropped from 318 to 384 per US dollar, with accompanying high volatility. In addition to these factors, wages for 10 months, 2018 increased by 2% in real terms, trade turnover by more than 7%, investment by nearly 20% in 11 months, which bears the pro-inflationary background. However, inflation steadily didn't react to these changes that evokes the feeling of a managed process of understating inflation since the end of 2017.

In our opinion, the main threat to inflation in 2019 are increase of excise duties on fuel in Russia, with domestic prices likely adjusting to prices in the neighboring country, continued high inflation expectations, and some increase in wages, primarily by increase in the minimum wage. In our opinion, the weakening of tenge in 2018 not yet fully passed into current prices. Despite the fact that the budget expense declined, the national fund transfers are replaced by means of extra-budgetary funds – National Bank and ENPF, including at the expense of national holdings. As a result, we expect inflation at 5.4% in 2019.

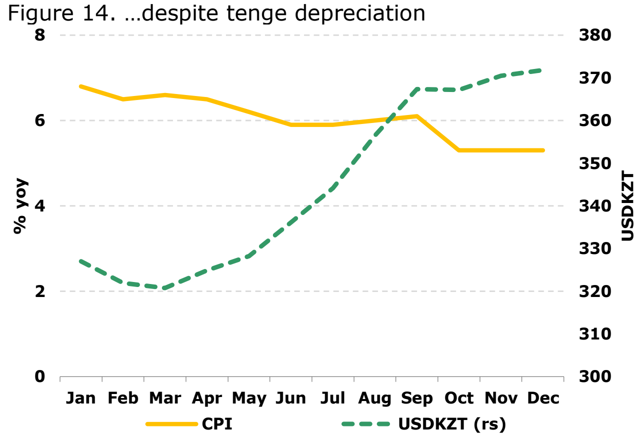
At the same time, it is highly likely that this year's price growth will continue to be managed, as a result, inflation could easily go below 5% as is known the reduction in inflation automatically leads to an increase in real wages, incomes, and many other macro-aggregates which State bodies have started to pay much attention to in 2017. At this point we note that inflation is moving ahead into the boundaries of new NBRK corridor of 4-6% in 2019.

Figure 13. Inflation eased…



Source: CS MNE, Halyk Finance

Figure 14. …despite tenge depreciation



Source: CS MNE, Halyk Finance

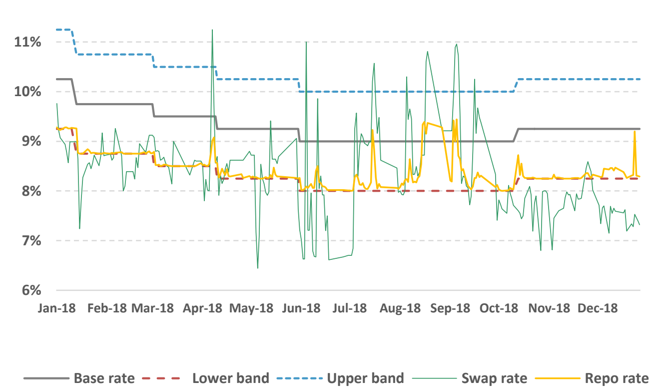
Monetary Policy

Interest policy

In mid-October 2018 the regulator increased the base rate to 9.25%. The base rate remained unchanged within the rest two months of the fourth quarter. According to the official data, in October-December of the last year there was observed noticeable decline of inflation rate to 5.3% y/y that was one of the reason to keep the base rate unchanged. However, the regulator mentions the pro-inflationary risks related to oil prices that evinced a downtrend in early October and lasted to the end of December of the last year (Brent future contracts prices slumped from $86.3 to $53. 8 per barrel). Among other pro-inflationary risks mentioned stands the acceleration of inflation in the trade partner countries of Kazakhstan.
Internal pro-inflationary risks encompass business activity growth, increase of internal demand due to increase of real income of the population as well as increase of the consumer lending by 12.9% ytd as of October. The NBRK in its own analysis of the monetary policy mentions that inflation rated slowed amidst of weakening of the national currency from 318 in February to 384.2 tenge per US dollar in December. We have repeatedly mentioned that transmission through interest channel is limited since inflationary processes are non-monetary by nature. Repo rates in 4Q2018 ranged within 8-9% averaging at 8.28%. As the period end Repo rate amounted to 8.29%. The maximum Repo amount reached KZT478bn (KZT405bn in 3Q2018). As the end of 2018, Repo operations amounted to KZT193bn while quarter average volume was KZT245bn (KZT257bn in 3Q2018). Repo operations decreased in 4Q2018 by 2.9% q/q.

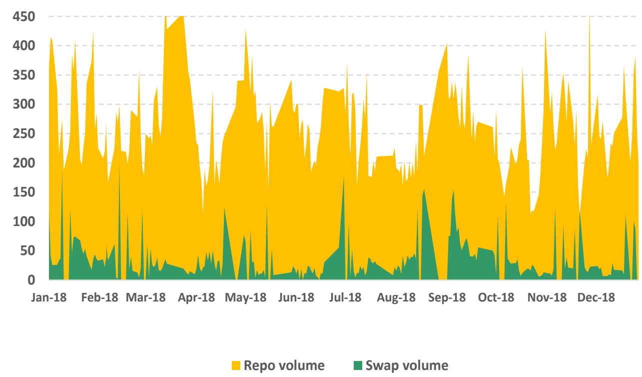
Swap rates in 4Q2018 ranged within 6.80%-8.59% and averaged 7.46% in the period. Swap volume peaked KZT132bn while the average volume was KZT34bn. In 4Q2018, there is a quarterly decline in swap volume by 36% q/q.
Excessive liquidity persisted in the Republic and is sterilized by the NBRK by short-term notes. As last year end, excessive liquidity increased by 12.6% q/q and amounted to KZT4.3 tn. Sterilization of the liquidity by the notes as the year end amounted to KZT3.5 tn and increased on 4% q/q. Effective yield of the notes in October and November amounted to 8.59%.

Figure 15. Money market rates



Source: NBRK, Halyk Finance

Figure 16. KASE trade volume



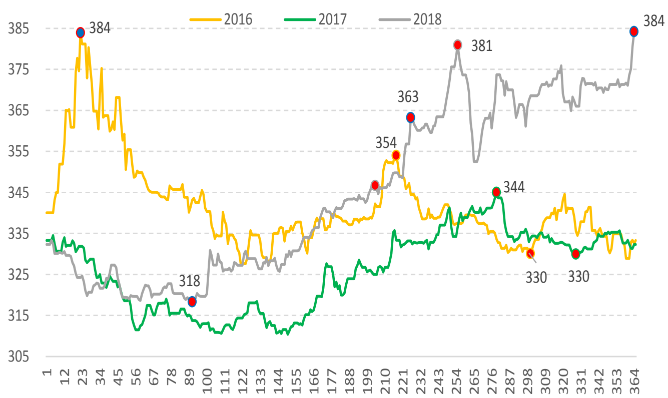
Source: NBRK, Halyk Finance

FX rate policy

In October 2018 oil quotes were at record highs at the global markets peaking $86 per barrel of Brent. Starting from the mid-October uptrend of quotes shifted to a regular downtrend and as of the end of the month plunged to $53 per barrel. Oil prices downtrend relayed itself at FX rate of the national currency that weakened from 363.07 tenge in the beginning of October to 384.2 tenge per US dollar as the end of the quarter (5.8%). The same weakening evinced the Russian ruble that weaken by 7.3% and amounted to 69.7 rubles per US dollar.
Therefore, oil quotes changes as one of the fundamentals of the resources economies produced the most noticeable impact on the Russian Federation rather than that of Kazakhstan. In addition FX rate was under the influence of the further tightening of the FED monetary policy. However, it happened rather due to global strengthening of US dollar (EURUSD strengthened from 1.8 to 1.15 as of the end of 4Q2018) than to foreign capital outflow from the sovereign debt of Kazakhstan since the nominal hold of the debt decreased by KZT30 bn.
Weakening of the national currency resulted from the policy of the weak tenge that was conducted by the NBRK in 2018. Fundamentally, USDRUB FX rate must have been a way higher if "budget" rule had not been applied amidst oil quotes uptrend during 3 quarters of last year. FX rate of the Kazakh tenge from 318-327 tenge per US dollar with Brent price averaging $67.17 per barrel plunged down to 384.2 tenge per US dollar with Brent price averaging $68.59 per barrel in October - December 2018. Hence, we believe that in 4Q2018 the national currency FX rate quotes were under the USDRUB exchange rate market movement. In the 4Q2018, RUBKZT FX rate averaged 5.56 tenge per the Russian ruble, furthering its weakening from 5.43 tenge per ruble in 3Q2018.
Weakening of the national currency from 318 to 384 tenge per US dollar played a remarkable role at the rise of devaluation expectations. In 4Q2018, 66.4-70.1% of the respondents (October - November) believed that there would be the FX rate

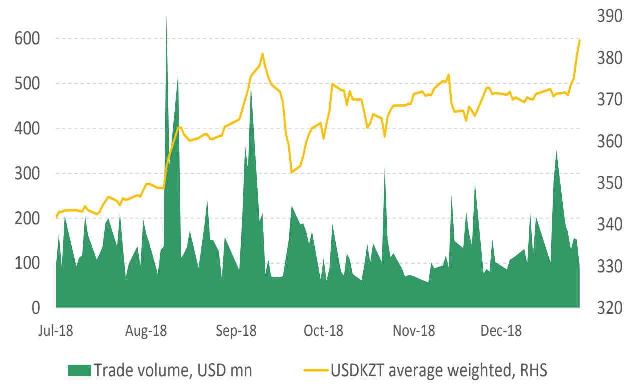
appreciation of tenge to US dollar. We believe that observed weakening of the national currency at the KASE will give higher rise in devaluation expectations. Real effective exchange rate (REER) analysis of the major trade partners evidences that as of November of 2018 KZTRUB decreased from 93.8% in August to 91.4% in November 2018. KZTUSD also evidences decrease from 58.2% in August to 57.1% in November. Yearly data analysis shows that KZTEUR and KZTUSD were at the yearly lows. KZTRUB REER, on the contrary, demonstrates an increase from the beginning of the year from 88% up to 91.4%.
In 2018, the trade balance surplus widened further by 64.2% y/y (9 months data). We believe that the surplus will continue to widen in 4Q2018 since the oil quotes on average were not less than in 1Q2018, moreover yearly oil exporters increased by 2.4% y/y. In 2018, foreign currency inflow in Kazakhstan from the extremal trade was more than in 2017 that should have resulted in strengthening of the national currency however such a strengthening had not occurred. The fact proves that there was a policy of the weak tenge conducted in the country.

Figure 17. KASE USDKZT quotes change



Source: NBRK, Halyk Finance

Рисунок 18. USDKZT and KASE trade volume



Source: KASE, Halyk Finance

External accounts

External trade in January-October 2018 (according to the latest data of the Committee on Statistics and the State Revenue Committee)

Exports from Kazakhstan in January-October 2018, according to the latest data from the Statistics Committee, continued to demonstrate rapid growth (+ 29.3% y/y) and amounted to $50 bn compared with imports (+ 11.7% y/y), the volume of which amounted to $26.8 bn. Expansion of foreign trade turnover for 10 months accounted 22.6% y / y and amounted to $76.8 bn. The geographical structure of exports in January-October 2018 was represented mainly by Italy (20%, 18.5% in January-October 2017), France (6.2%, 6.1% in January-October 2017), the Netherlands (10.5%, 10.0% in January-October 2017.) By China (9.6%, 11.7% in January-October 2017) and the Russian Federation (8.5%, 9.9% in January-October 2017). The geographical structure of imports was represented mainly by the Russian Federation (37.5%, 39.6% in January-October 2017), China (16.9%, 15.8% in January-October 2017), Germany (5.3%, 5.1% in January-October 2017) and Italy (4.8%, 3.2% in January-October 2017).

Exports analysis from Kazakhstan showed that in January-October 2018, the share of mineral products increased from 68.6% a year earlier to 74.8%. In nominal terms, mineral products exports grew by 41% yoy and amounted to $37.4 bn. According to the State Revenue Committee of Kazakhstan as of January-October 2018, mineral products exports grew by 4.1% y/y amounted to 52.7 mn tons.

The major importing countries of Kazakhstan, according to the data of the State Revenue Committee of the Republic of Kazakhstan for January-September 2018, were Italy with a share of oil imports from Kazakhstan in 30.8% (31.7% in January-September 2017) and total worth of $8.6 bn (+ 38.8% y / y), the Netherlands with a share of physical oil imports of 14.3% (14.7% January-September 2017) and a total value of $4.0 bn (+42, 6% y / y), France with a share of physical oil imports of 9.3% (10.7% in January-September 2017) and a total value of $2.6 bn (+ 25.1% y / y), Spain with a share of physical oil imports of 5.0% (5.0% in January-September 2017) and about the total cost is $1.4 bn (+ 44.4% y / y), China with a share of physical oil imports of 1.9% (3.2% in January-September 2017) and a total value of $471 mn (-17, 1% g / g). In January – September 2018, the Republic of Korea continued to increase the volume of imports of mineral products by 3.1 times to 3.4 million tons. Imports of oil in nominal terms increased by 4.7 times compared to the same period last year and amounted to $1.9 bn.

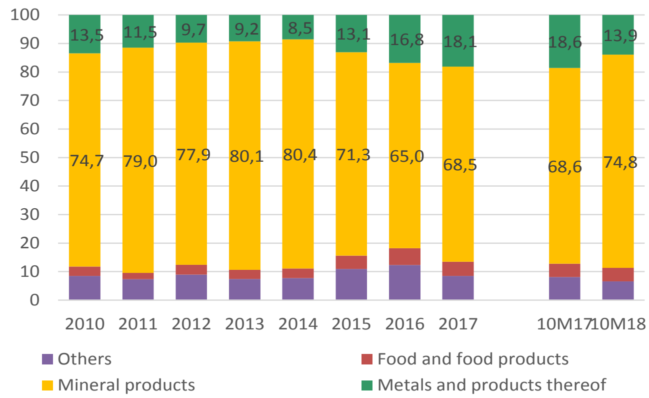
Metals and products from them take the second position in the structure of exports of Kazakhstan. According to the Statistics Committee, there is a decrease in their share from 18.6 in January-October 2017 to 13.9% in the same period last year. In nominal terms, exports decreased by 3% y/y and amounted to $7 bn. According to the data of the State Revenue Committee of Kazakhstan for January-September 2018, nominal value of Kazakhstan's exports of ferroalloys decreased by -2.6% y/y to $1,4 bn, with a simultaneous increase in physical volume of 2.6% y/y. There is a significant reduction in the volume of exports under the item "other ferrous metal products" position by -60% yoy and -14.4% in value terms to $8 bn.

Those two categories of exports, in January-October 2018 increased its combined share from 87.2% a year earlier to 88.7% due to the increase in the physical volume of exports of fuel and energy products, as well as due to the upward trend of oil prices at the global markets until 10 of October 2018 with the subsequent downtrend.

Products of animal and vegetable origin, finished food products are the third largest export item in Kazakhstan, whose share in January-October 2018 did not change compared to the same period of the last year and amounted to 4.7%. At the same time, in value terms, exports increased by 28.7% to $3.4 bn. Thus, over 10 months of 2018, the increase in the physical exports of wheat and oilseeds increased by 66.5% y/y and amounted to 4.1 million tons and reached 630 million US dollars (66.5% y/y).

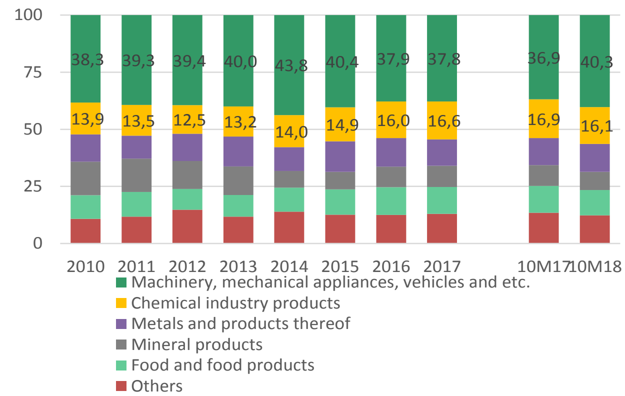
The main importers of Kazakh wheat in January-October 2018 were Uzbekistan with a share of 38.7% of total exports in the amount of $188 mn (+ 49.5% y/y), Tajikistan with a share of 16.7% and the amount of $101 mn (-5.7% y/y) and China with a share of 10.2% and the amount of $72 mn (+ 68.1% y/y).

Figure 19. Exports structure



Source: CS MNE, Halyk Finance

Figure 20. Imports structure



Source: CS MNE, Halyk Finance

Imports' structure analysis, according to the Committee on Statistics, showed that in January-October 2018, Kazakhstan increased imports of machinery, equipment, vehicles, instruments and apparatus by 22% y/y and its share rose from 36.9% in January –October 2017 to 40.3% in the same period of 2018. Chemical products and its related industries (including rubber and plastics) decreased to 16.1% in 10 months of 2018 from 16.9% for the same the period of 2017. In nominal terms, an increase was 6.4% y/y or $4.3 bn. of goods contributed to the rise in price of oil and, as a consequence, petrochemical products. Import of metals and products from them to Kazakhstan expanded from 11.9% to 12.2% in January-October 2018 and amounted to $3.2 bn (14.4% y/y).

Imports from the Russian Federation in January-October 2018 showed that motor gasoline imports amounted to 373 thousand tons. August 2018 was the last month when Kazakhstan imported motor gasoline. In September and October, there was no imports of the item. Decrease of imports of gasoline in physical terms was by 53.1% y/y.

We believe that the observed decline in imports of mineral products with a gradual increase in their exports will further improve the trade balance. The weakening of the national currency in 2018 will also contribute to the expansion of the volume and export nomenclature of the republic, thereby expanding the country's trade balance surplus.

We believe that the observed decline in imports of mineral products with a gradual increase in their exports will further improve the trade balance. The weakening of the national currency in 2018 will also contribute to the expansion of the volume and export items of the republic, thereby widening Kazakhstan's trade balance surplus still further.

Balance of Payment for 9 months 2018 (as per the NBRK data)

Trade balance

Exports of goods in 9M2018 increased by 28.3% y/y and amounted to $45.4 bn. Expansion of export resulted from, first of all, the upward dynamics of oil quotes, the cost of which in average in January-September 2018 was about $ 72.7 (+ 38.4%) dollars against $52.51 dollars per barrel of Brent for the same period last year. Along with the change in prices for hydrocarbons, the positive dynamics of nominal volume of mineral products was influenced by the increase in physical volumes of exports of crude oil by 4.0% y/y to 52.7 mn tons for 3 quarters of 2018 (according to TradeMap statistics).

Trade balance in 9M2018 reached $19.9 bn (+ 64.2% y/y). Expansion of trade surplus in9M2018 was primarily due to the outpacing dynamics of exports (+ 28.3%), growth of which particularly accelerated in the third quarter of 2018 to + 35% y/ y over imports (+9, 6% y/y), the dynamics of which in the third quarter were at the level of 11% y/y.

Current account

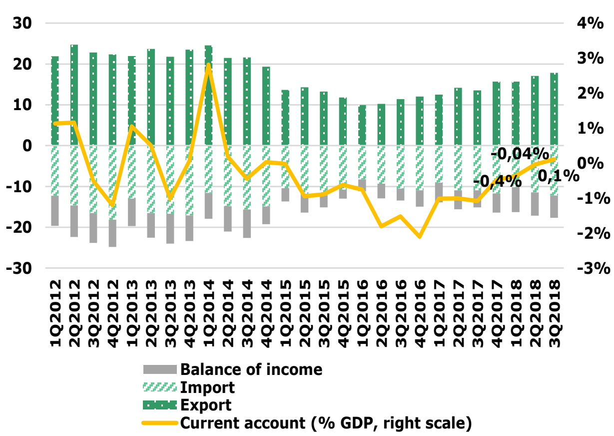
According to the updated data of the NBRK, current account of Kazakhstan in 9M2018 was formed with a negative balance of $488 mn, which is $4.1 bn less than in 9 months of last year. Unlike last year, in 3Q2018, current account was formed with a surplus of $180 mn (the last time current account surplus was observed in Q4 2014). The improvement in current account balance was facilitated, on the one hand, by expansion of trade account with a positive balance 64.2% y/y, the prevailing service account surplus ($8.9 mn versus a deficit of $ 324 mn last year), on the other hand, a reduction in the negative balance of the service account (-0.3% y/y). Capital outflows on the primary income account in 9 months of 2018, on the contrary, showed a significant increase (+ 29.8%) and account deficit reached $17.2 bn, which is comparable to the annual size of the account deficit in 2017 ($17.9 bn). The growth of income from direct investments by 31.8% y/y in the amount of $16 bn contributed to the expansion of the primary income account deficit.

Item-by-item analysis of current account showed that trade balance remains the main balancing item of current account, despite the positive balance of the secondary income account. In relation to GDP, current account deficit decreased from -3.0% in 9M2017 to 0.1% in 3Q2018.

Financial account (w/o reserve assets of NBRK)

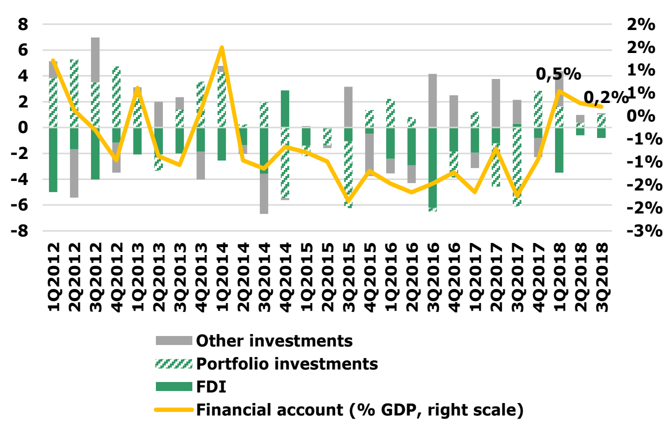
According to the updated statistics of the NBRK, outflow of financial resources amounted to $1.7 bn in 9 months of 2018 against inflows of $6.6 bn in the same period last year. The outflow of financial resources for 9 months of the current year resulted from outflow of portfolio investments in the amount of $ 3 bn against inflows of $ 8.2 bn in the same period of 2017 and other investments in the amount of $3.4 bn against $4.4 bn in 9M2017. The observed outflow of portfolio investments in the account is associated with a gradual reduction in the nominal holding of sovereign debt of Kazakhstan by non-residents from T464 bn in April to T141 bn in September.

Figure 21. Current account deficit narrows



Source: NBRK, Halyk Finance

Figure 22. Capital outflow of financial account



Source: NBRK, Halyk Finance

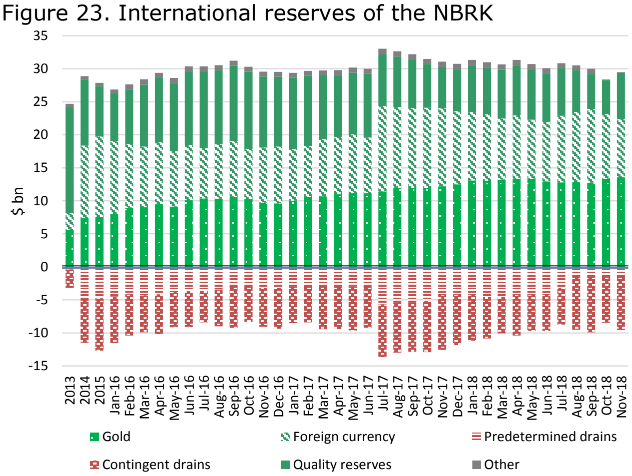
Direct investment account shows an inflow of financial resources in the amount of $4.9 bn (+ 69.4% y/y). The maximum inflow on this item of the balance is also observed in 1Q2018 and amounts to $3.5 bn (+ 78.8% y/y), while in 2Q inflows of the financial resources decreased to $593 mn. In 3Q 2018, there was a slight increase in inflows to $804 mn. Within the direct investment account, there is an inflow of $3.1 bn in debt instruments. In connection with the placement of Kazatomprom securities, it is expected to expand the participation of foreign direct investors in the capital of Kazakhstan direct investment enterprises in the 4Q2018.

Hence, outpacing reduction in acquisition of the liabilities over the acquisition of the assets resulted in capital outflow under financial account in the amount of $1.7 bn without taking into the account of the reserve assets of the NBRK and in the amount of $800 mn with them.

Consolidated international reserves

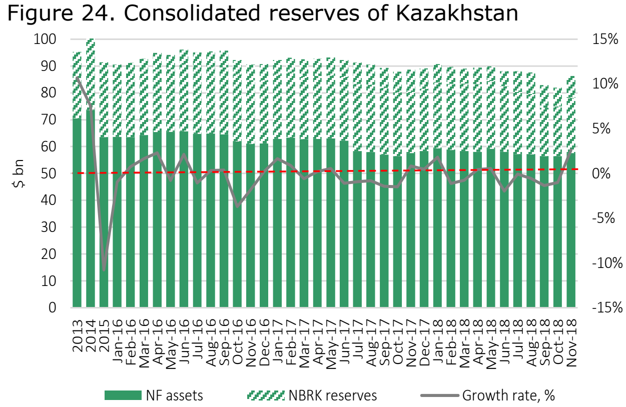
Consolidated international reserves as of 11 months of 2018 amounted to $87.7 bn. Since the beginning of the year there is a decrease of the consolidated reserves by 1.7% and 1.0% y/y. In 11 months gross international reserves of the NBRK decreased by 2.7% or by $851 mn, whilst the assets of the National Fund by 1.21% since the beginning of the year (0.1% y/y) or by $706 mn. In the NBRK assets structure, reserves in foreign currency decreased by $1 907 mn down to 16.6bn (-10.3% ytd). Decrease of the NBRK assets in foreign currency resulted from the change of the swap open balance of the NBRK with the commercial banks in the mid of June at KZT200bn ($595mn). Since June to November 2018 the swap balance remained unchanged at KZT800 bn. Intervention at the amount of $520.6 mn that were conducted by the regulator in September of last year also depleted the reserves. In 3Q2018, the NBRK cancelled its external obligations at the amount of $306 mn.
Gold holdings, on the contrary, increased by 8.45% or by $1.1 bn since the beginning of the year and amounted to $13.5 bn. From April to August 2018, gold quotes evidenced a downtrend that almost plateaued at $1,200 per t oz in August and mid-November. As of the end of the year spot prices levelled at $1,283 per ounce. Since the beginning of the year, the NBRK continued to increase the physical holdings of gold that in November 2018 reached 11,11 mn t oz or 345.2 tons (299.8 tons as of the end of the last year).

Figure 23. International reserves of the NBRK



Source: NBRK, Halyk Finance

Figure 24. Consolidated reserves of Kazakhstan



Source: NBRK, Halyk Finance

In 2018, there is observed the negative growth dynamics of the Fund's assets despite the income growth from oil trade, cancellation of the targeted transfer and limited guaranteed transfer in the budget at the amount of KZT2.6 tn. Since June to October 2018, there was the negative monthly dynamics of Fund's assets growth and only in November 2018, the assets evidenced the positive monthly dynamics since in October the budget had drawn completely the allocations of the guaranteed transfer.

Banking sector

Banking sector is comprehensively analyzed in the publication dedicated to this topic: [November 2018]

Stock market

KASE index showed upward dynamics from 2 164 points at the beginning of the year until the middle of the year, when the index reached the maximum annual value at 2 532 points at the end of May. Subsequently, the index showed downward momentum to the minimum value of 2 150 points in September. Starting from September 2018 index has risen up to 2 305 points at the end of December 2018, however, yielding to 1H2018 levels. The main pressure on 2H2018 reading of KASE index provided substantial downward correction of KazMinerals (-35% for 12 months).

Representative list of KASE index at the end of 2018 included 7 companies – Bank Centercredit JSC, Halyk Bank, KAZMinerals, Kcell, KazTransOil, Kazakhtelecom, KEGOC. In May 2018 shares of JSC Bank Astana (review license) and JSC KMG EP» (delisting) were excluded from the representative list of the index. Shares of all companies in the list, except for securities of KAZMinerals demonstrated increase since the beginning of the year.

Weighted average price of JSC «KazMinerals» shares decreased by 35% in a year and amounted to T2 530 per share. KAZminerals shares were down due to acquisition of Chukotka Baimskoe deposit, given its remote launch and substantial capital costs and the declining value of copper (in early 2018 copper prices dropped by ~18%), shares of KazTransOil showed growth of 0.4% and their value amounted to T1 342 in 2018. Shares of Kaztransoil and KEGOKa grew on the expectations of annual dividends. Shares of "Kcell" showed an increase from T1 730 per share at the beginning of the year to T1 850 at the end (+6.9%). shares of KEGOC JSC increased by 15.3% and amounted to T1 601 per share. Shares of Kazakhtelecom and Kcell has increased as Kazakhtelecom acquired controlling stake in Kcell (discount ~31% to the market), that will lead to the consolidation of the main part of the mobile segment of the republic and the possibility of substantial reductions in operating/capital costs of companies.
Shares of Halyk savings bank of Kazakhstan showed growth of 22% and their value amounted to T100 a share. Growth in the value of the shares occurred as a result of the implementation of the merger transaction with JSC «Kazkomerts bank» and rather good results of the Bank's activities in 2018. Shares of JSC "Bank Center credit" increased by 19% and their value amounted to T234. Significant cost growth occurred at the beginning of the year and is associated with adjustment in the prices to the estimated cost of the buyout of Tsesnabank JSC share in "Bank Center credit". During the year, there was a gradual adjustment of the value of these shares with the announced purchase of shares from minority shareholders at a lower price, as well as market expectations for additional placement of shares of JSC "Bank Center credit".
Shares of JSC "KazTransOil" showed a slight increase of 0.2% and their value amounted to T1 342. The main increase of KZTO shares took place in the 1H2018, when on anticipation of annual dividends quotes have grown by 19% (up to T1 600/share). In 2H2018 shares, corrected after the dividend fixing, traded at an average of T1 346/share at the end of the year.
Shares of "Kcell" showed an increase from 1 784 per share since the beginning of the year to T1 848 at the end (+3.6%).
Shares of KEGOC JSC increased by 15.9% over the year. During 2018 KEGOC has demonstrated strong financial performance and increased the interim dividend, which, inter alia, reflected in the growth of quotations from T1 384/share at the beginning of 2018 up to T1 601/share at the end of the year.

Indices of developing countries were under pressure, on the one hand, due to the ongoing tightening of the FED policy that caused the outflow of capital from emerging markets, on the other hand, due to geopolitical uncertainties with regard to the Russian Federation, and also because of trade wars between the United States and China.

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