

KAZAKHSTAN

GROWTH STIMULUS CHALLENGES STABILITY OF THE ECONOMY

The economy is receiving support from accelerated budget spending, but the effect is limited

GDP growth will likely decelerate to 3.8% yoy in 2019 on the back of a temporary decline in oil production, while consumer demand will likely suffer from an increased credit burden and higher inflation.

NBK needs to keep conditions tight (9.00%) leaving little chance of easing in the medium term

Although the inflation dynamics remain within the NBK target range, we see an upward trend in the CPI growth, with increased risks from accelerated retail sales and a weaker tenge. For this reason, the NBK will likely continue to limit secondary risks and keep conditions tight.

Loose fiscal discipline put pressure on the tenge

Increased social spending in the regional budget requires additional transfer from the NFRK, which undermines the stability of the tenge, already hit by global risks. We see USD/KZT at 395 by end-2019 and 400 in 2020.

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Growth stimulus challenges stability of the economy

- Kazakhstan's 1H19 GDP growth was surprisingly resilient at 4.1% yoy despite maintenance works on the main oilfields restraining industrial production growth. Economic growth was supported by accelerated consumption growth owing to increased social spending and intensified credit growth, which also accelerated the CPI growth. We expect the primary boost from the consumption surge to gradually fade away by year-end, while oil production should increase with the end of construction works. We see GDP growth at 3.8% yoy in 2019 and 3.4-3.5% yoy in 2020-2021.
- Political uncertainty in Kazakhstan eased with the election of new President Tokayev, who supports the existing Government policies and will likely continue outgoing president Nazarbayev's initiatives. In particular, the Government increased social spending by 10% to \$8.4bn in 2019, which will be financed by additional transfers from the NFRK. This decision undermines fiscal tightness and raises concerns about the stability of CPI growth and the FX market as the Government would prefer a weaker tenge in these circumstances.
- The current inflation dynamics create risks for monetary policy. While headline inflation remains within the NBK target range of 4-6% (5.4% yoy in July) owing to artificial low inflation of regulated tariffs, food inflation rapidly accelerated. The NBK suspended monetary policy easing and switched its forward guidance to a hawkish footing. We expect inflationary risks to dominate in the economy (SGe: CPI 5.6% yoy by year-end) owing to a weaker tenge and a revival in the consumer demand, so the NBK will have to keep tight conditions (9.0%). However, no hikes are needed given the environment of overall falling global rates.
- The tenge suffered both from loose fiscal policy and external background turmoil. The currency weakened against the ruble from 5.4 to 5.8 on the global EM market sell-off and the drop in oil prices, while the ruble was supported by internal factors. We see further weakening on the tenge to 395 by year-end and to 400 in 2020 against the dollar as eased fiscal discipline will outweigh external balances.

OUTLOOK – WHERE WE DIFFER FROM CONSENSUS

Annual	CPI % yoy						GDP growth % yoy						Unemployment					
	2018	2019	2020	2021	2022	2023	2018	2019	2020	2021	2022	2023	2018	2019	2020	2021	2022	2023
Consensus Economics	5.3	5.5	5.2	5.0	4.9	4.7	4.1	3.6	3.6	3.7	3.9	4.1	4.9	4.8	4.8	4.8	4.7	4.7
IMF (Jul'19)	5.3	5.7	4.8	4.7	4.2	4.0	4.1	3.8	3.9	3.7	3.3	3.3	4.9	4.9	4.9	4.9	4.9	4.9
Societe Generale	5.3	5.6	5.1	5.0	4.9	4.7	4.1	3.8	3.5	3.4	3.3	3.2	4.9	-	-	-	-	-

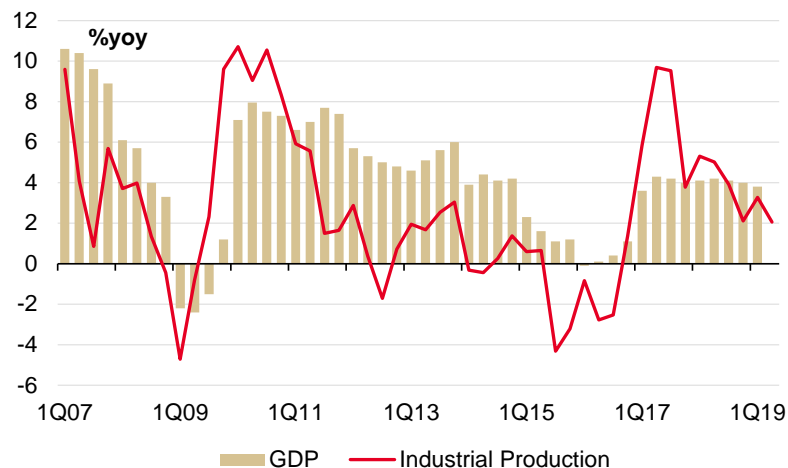
Quarterly	CPI					10Y				Bank Rate					USDKZT			
	2Q19	3Q19	4Q19	1Q20	2Q20	2Q19	3Q19	4Q19	1Q20	2Q19	3Q19	4Q19	1Q20	2Q20	2Q19	3Q19	4Q19	1Q20
Consensus Economics	5.4	5.7	5.5	5.8	5.5	-	-	-	-	9.00	9.00	8.89	8.88	8.75	381	380	384	385
Market*	-	-	5.3	-	-	-	-	-	-	-	-	-	-	-	381	391	394	395
Societe Generale	5.4	5.4	5.6	5.3	5.4	-	-	-	-	9.00	9.00	9.00	9.00	9.00	381	390	395	400

*Bloomberg consensus

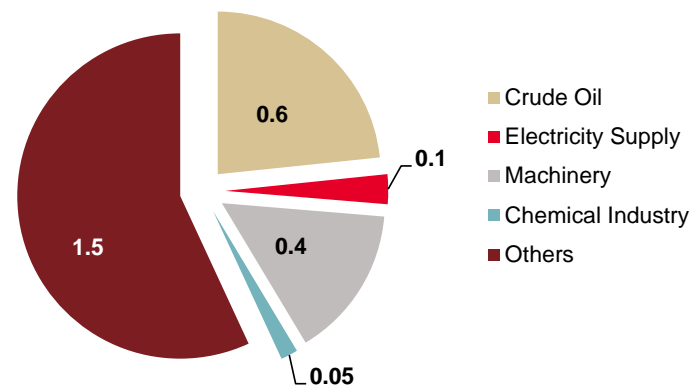
- All market participants expect GDP growth to decelerate in 2019. **We remain in the pessimistic camp** as accelerated consumer demand will have a limited effect, while the expected slowdown in the global economy will hamper oil production.
- **Inflation is expected to stay within the NBK target range** with an acceleration by year-end owing to risks from food prices and a weaker tenge. Our forecast differs marginally from the consensus.
- Against this background, **we expect a flat trajectory on the key rate over next 12 months, while the consensus is pricing one key rate cut in 2Q20**. We see this as hard to implement owing to loose fiscal policy.
- **Most see further devaluation of the tenge, but we expect this to happen faster than consensus**. We expect pressure both from global economy risks and pressure from the Government owing to increased transfers from the NFRK in 2019-2021.

Source: Bloomberg, Bank of Russia, IMF, Consensus Economics, Rosbank

RETAIL TRADE COMPENSATED FOR FORCED CUT IN OIL PRODUCTION



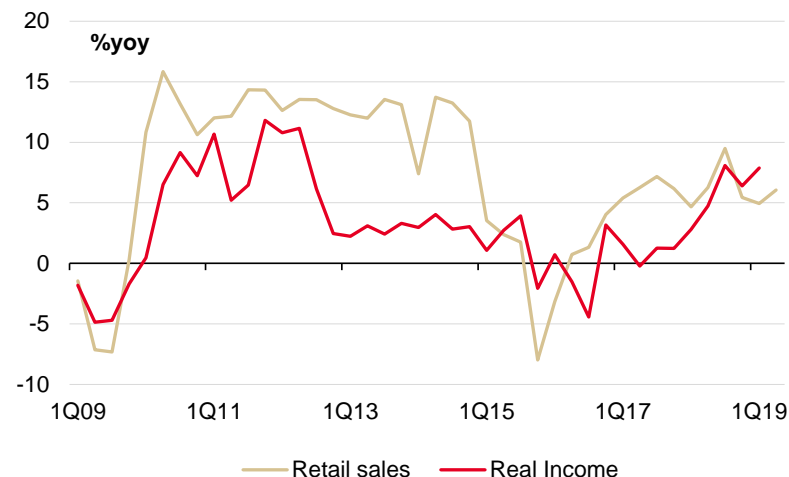
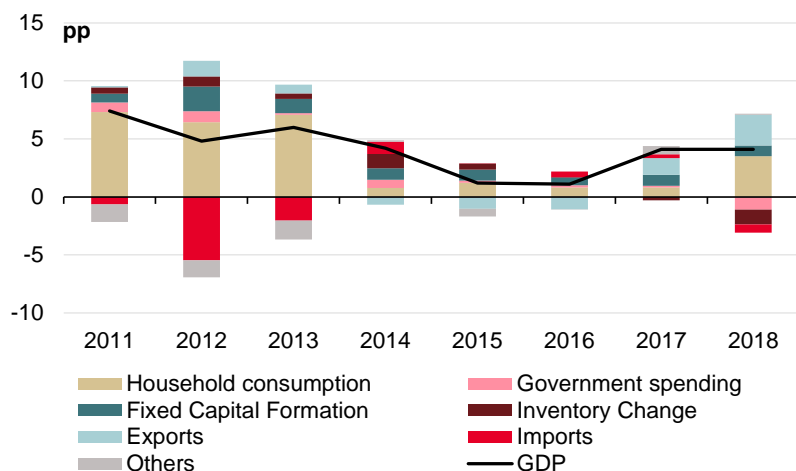
contribution to IP growth in 1H19, pp



- In 1H19, **GDP growth remained at 4.1% yoy**. Construction works on the key oilfields have become the main reason for this moderate economic performance.
- However, **accelerated social spending** (+10% vs the previously planned level), introduced by former president N.Nazarbayev in February 2019, boosted consumer activity and supported the relatively robust economic growth. The contribution of retail trade to GDP growth increased from 1.0pp to 1.2pp.
- With the end of reconstruction works in 2Q19, **oil production is expected to rise by c.15%**, prompting further acceleration in economic growth. However, the decelerating global economy, as well as limited capacity for further trade growth after the rapid primary effect, will limit the potential for full-fledged acceleration.
- We expect GDP growth at **3.8% yoy in 2019** and deceleration to **3.4-3.5% yoy in 2020-2021**.

Source: Committee on statistics in RK, CEIC data, Rosbank

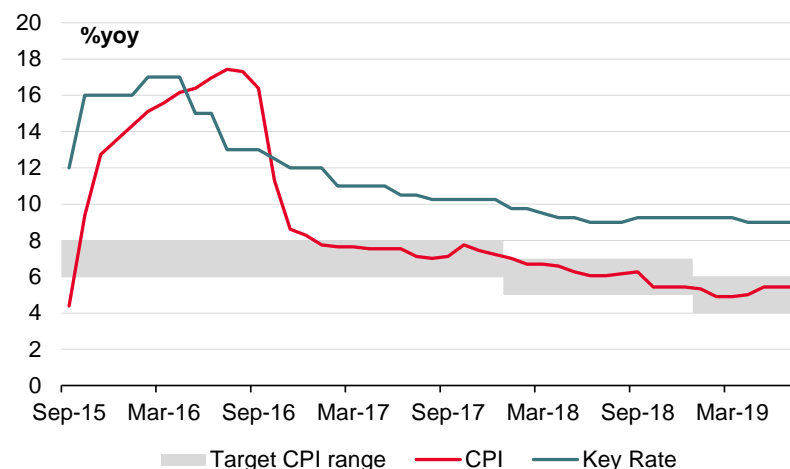
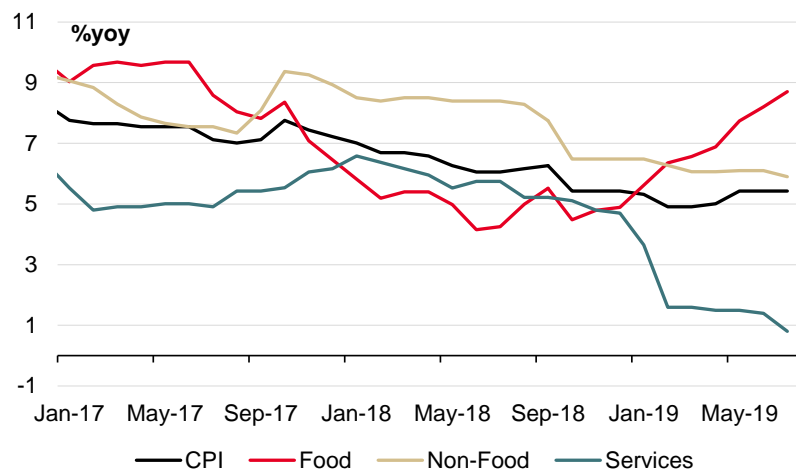
CONSUMPTION BOOSTED BY INCREASED GOVERNMENT SPENDING



- **Household consumption has found a new growth driver in social spending.** According to the Republican budget amendments, the Government is going to spend KZT3.2tn in 2019 on social items vs the previously planned KZT2.9tn. At the same time, consumer credit activity has continued to intensify. Retail lending rose by 20.7% yoy in Jan-May 2019. In this context, real disposable income growth accelerated to 7.9% yoy in 1Q19, while retail sales growth jumped by 4.9% yoy and 6.1% yoy in 1Q19 and 2Q19, respectively.
- **We adjusted our expectations of real income growth for the increased social spending from 3% yoy to 5% yoy in 2019.** Certainly, growing public wages and pensions will support an upward trend. Nevertheless, rapid lending growth since 2018 has led to a growing credit burden and has limited consumer potential. In addition, lower oil prices can limit wage growth in the mining sector, which is the largest contributor to the overall pay-out.
- We believe that income growth will continue to support consumer demand. We expect **household consumption growth at 5.0% yoy** in 2019, which could be limited by poor global demand and unstable inflation and FX dynamics.

Source: Committee on statistics in RK, BIS data, CEIC data, Rosbank

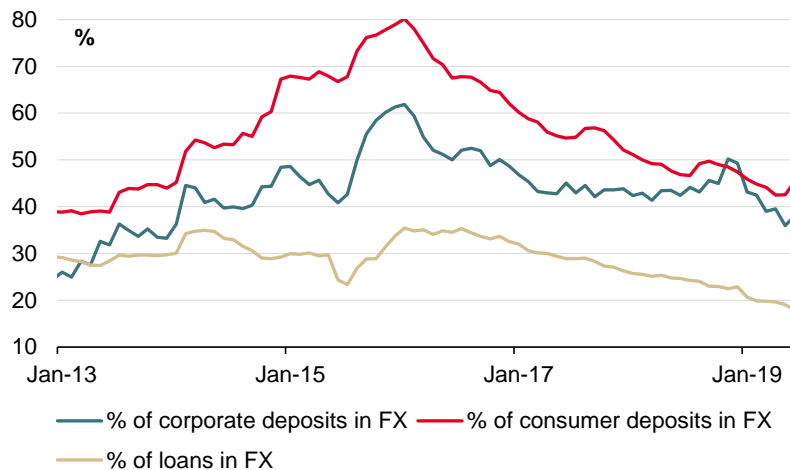
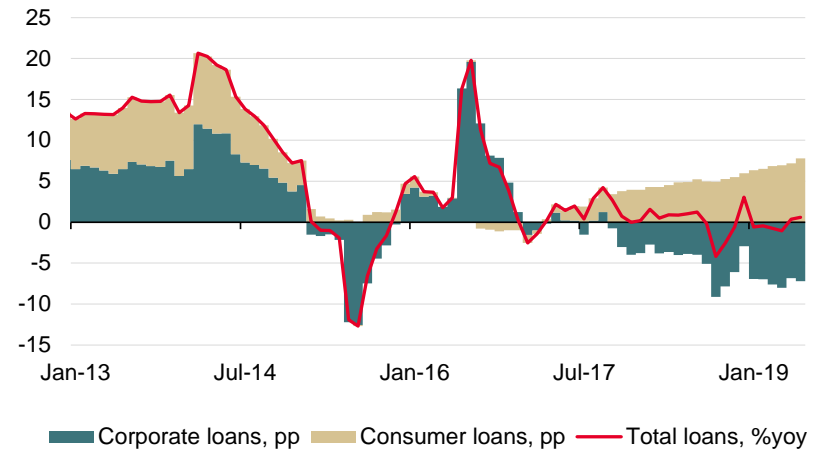
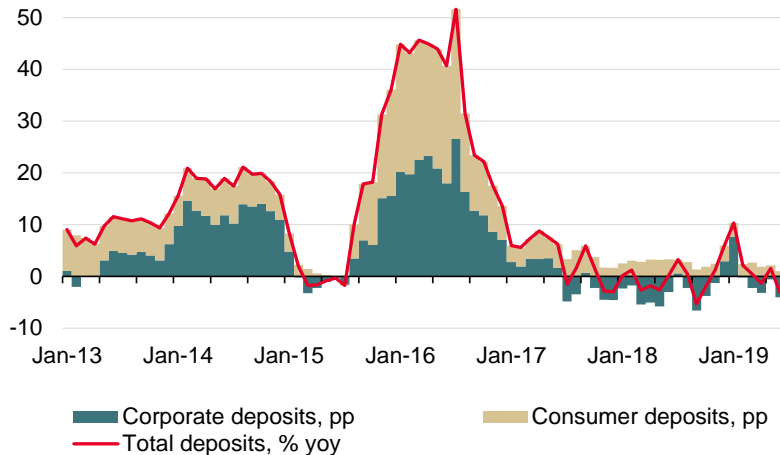
MONETARY POLICY: NBK NEEDS TO KEEP HAWKISH STANCE



- After a rapid deceleration in CPI growth to 4.8% yoy in February owing to tariff regulations, **headline inflation returned to an upward trend and speeded up to 5.4% yoy by end-July**. The main reason behind this acceleration is the rapid jump in food prices by 8.7% yoy in July backed by both the tenge depreciation and increased consumer demand. At the same time, non-food price growth also remained at elevated levels (6.1-6.3% yoy).
- The National Bank of Kazakhstan (NBK) has set an inflation targeting policy with the CPI target in the range of 4-6% yoy. Since the beginning of the year, the NBK has delivered 25bp in cuts to 9.0% as inflation sustainably remained within the desired range. However, the CPI risks intensified in 2H19 owing to the tenge weakening and increased social spending. **The NBK has now switched its forward guidance to a hawkish wording.**
- We **expect CPI growth to accelerate to 5.6% yoy by year-end** as inflationary risks gain momentum. Moreover, at the beginning of next year, headline inflation has every chance of reaching 5.8-6.0% owing to base effect in services. Against this background, **we do not expect any easing from the NBK in 2H19 or 1H20** as the CPI dynamics may undermine target levels. Nevertheless, the global wave of rate cutting, including the Central Bank of Russia, creates an environment in which an additional increase in the Kazakhstan key rate is not needed.

Source: NBK, Committee on statistics in RK, CEIC data, Rosbank

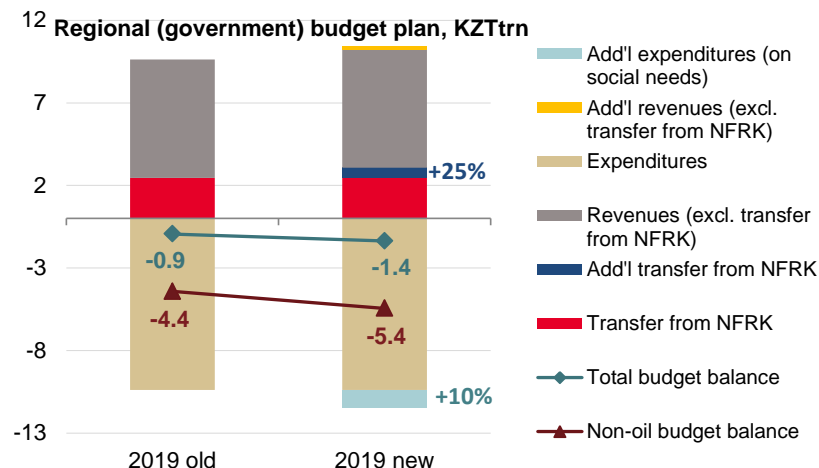
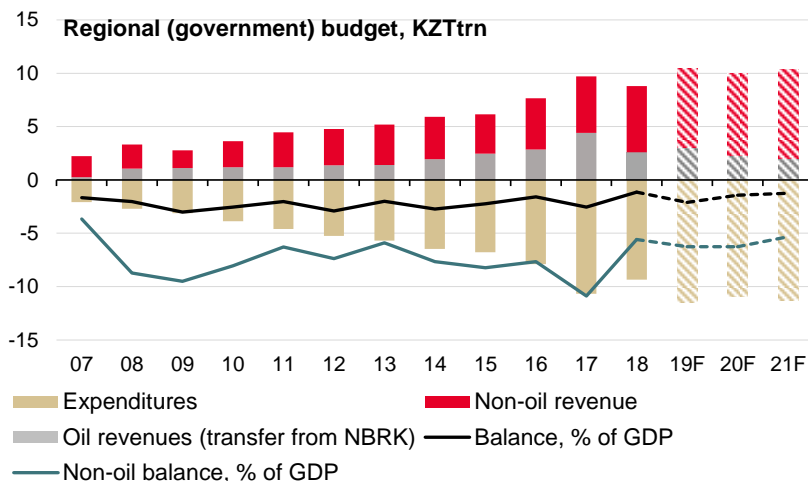
BANKING SYSTEM FACED WITH OLD PROBLEM OF DOLLARIZATION



- **Unstable tenge dynamics put pressure on the banking system.** The share of FX deposits returned to growth in June – the combined FX deposit ratio of corporates and individuals edged up to 41.6% from 39.1% over May, increasing instability and vulnerability of the banking system.
- **Consumer loans growth continued to accelerate rapidly** to 20.7% yoy as of 1 June 2019, while **corporate loans fell significantly** by 11.6% yoy, keeping the overall growth around zero (+0.6% yoy).
- Increased credit growth in the retail sector makes the banking system fragile as **NPLs are growing in the environment of slower nominal wage growth compared to lending growth**. In addition, there is still a huge surplus of tenge liquidity owing to a low loan-to-deposit ratio (75%), which will require coordinated action by the NBK to absorb liquidity.

Source: NBK, Committee on statistics in RK, CEIC data, Rosbank

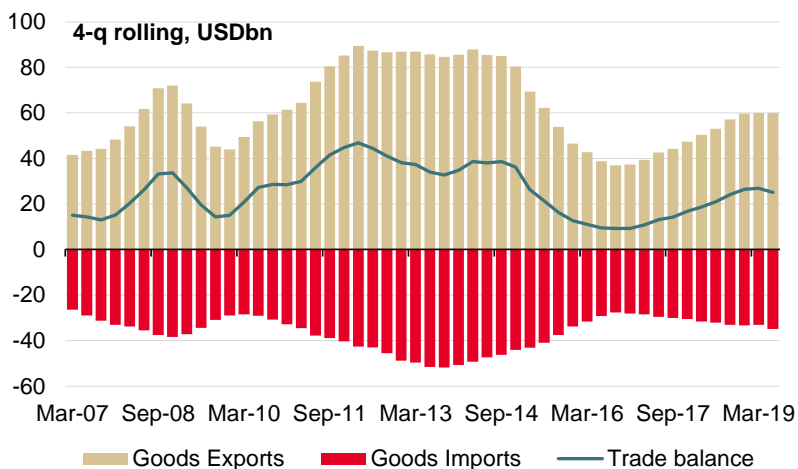
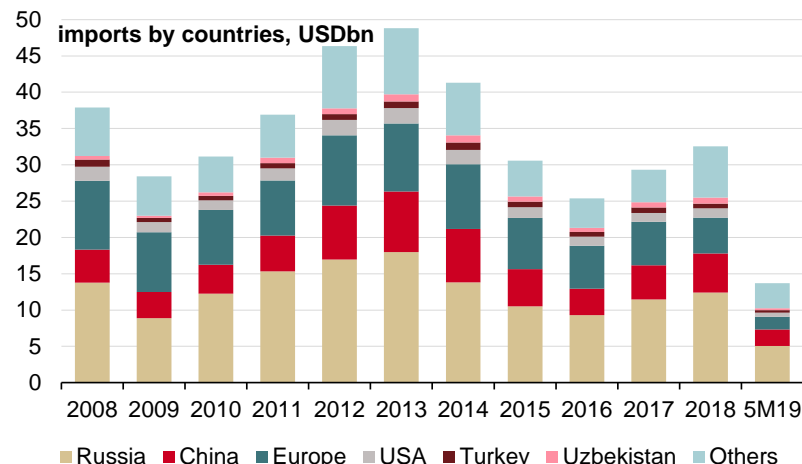
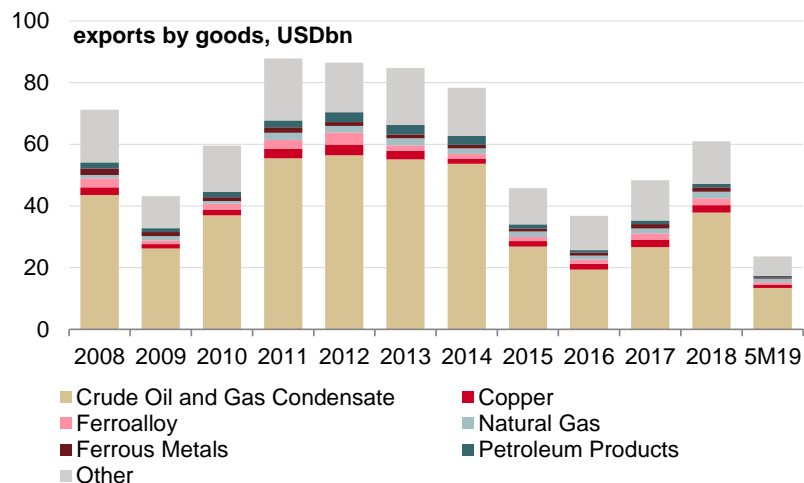
FISCAL DISCIPLINE IS GETTING LOOSE AS SOCIAL SPENDING INCREASED



- **The National Bank of Kazakhstan supported the FX market in 1H19, spending FX reserves.** Even though the NFRK increased by \$2bn to \$59.9bn, the overall international reserves dropped by \$1bn to \$87.6bn. Nevertheless, the current level of reserves (53% of GDP) supports the solid fiscal footing.
- **The Government revised the regional budget for 2019 and increased spending on social needs by 10%** (wages, pensions, compensations) owing to decrees by ex-President Nazarbayev, which will be financed via increased transfers from NFRK (+25%).
- Over the first five months, the budget performed worse than in the previous year as accelerated expenses significantly outstripped revenues. But the regional budget deficit is expected to widen only to 2.1% of GDP in 2019 (vs. 1.2% of GDP in 2018), which is still a relatively low level.
- In general, **fiscal changes do not undermine the stability of the system**, but lead to **negative consequences for CPI growth and FX dynamics**.

Source: MinFin, Committee on statistics in RK, CEIC data, Rosbank

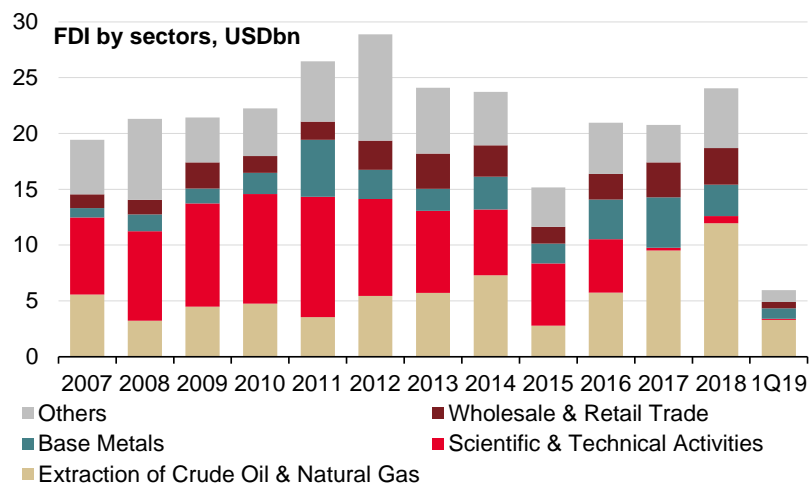
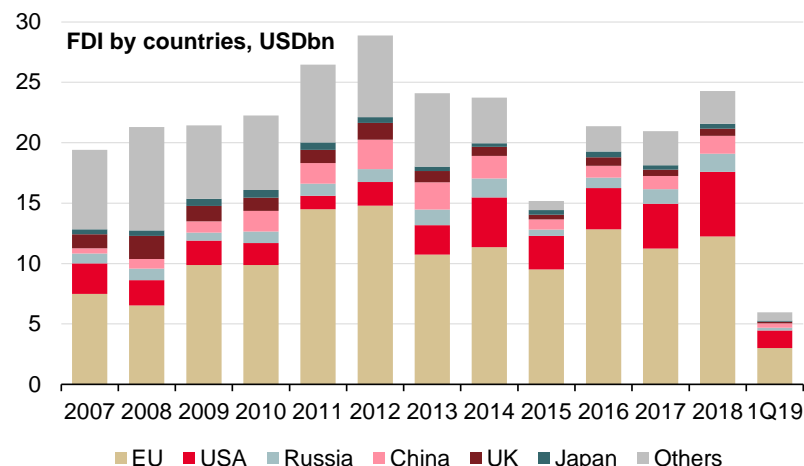
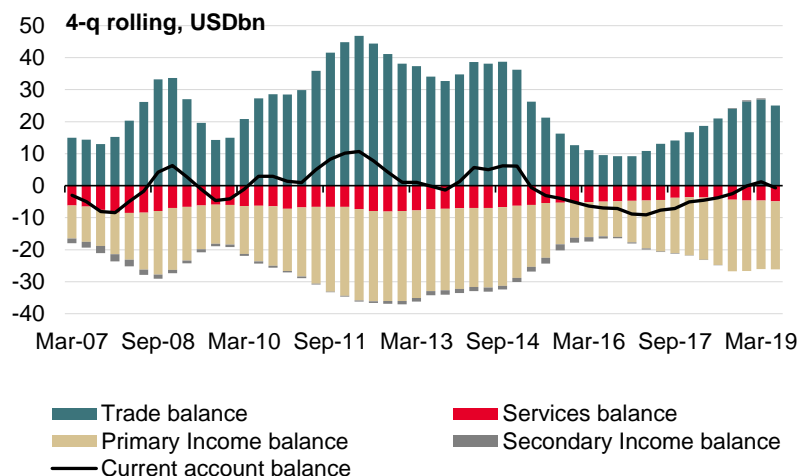
TRADE BALANCE UNDER PRESSURE FROM INCREASED IMPORTS



- **The trade balance deteriorated slightly to \$4.5bn in 2Q19** (vs. \$6.4bn in 2Q18), which was due to accelerated imports of equipment probably related to reconstruction works on the oilfields. At the same time, exports remained unchanged.
- Poor local production means **the Kazakhstan economy depends heavily on imports**. Russian goods account for 37% of total imports, followed by Chinese on 16%. Even though the tenge weakened in 1H19, imports still rose by 10.2% yoy.
- In an environment of relatively low oil prices combined with a revival in consumer demand, incl. import goods, the **trade balance should gradually get squeezed going forward**.

Source: NBK, Committee on statistics in RK, CEIC data, Rosbank

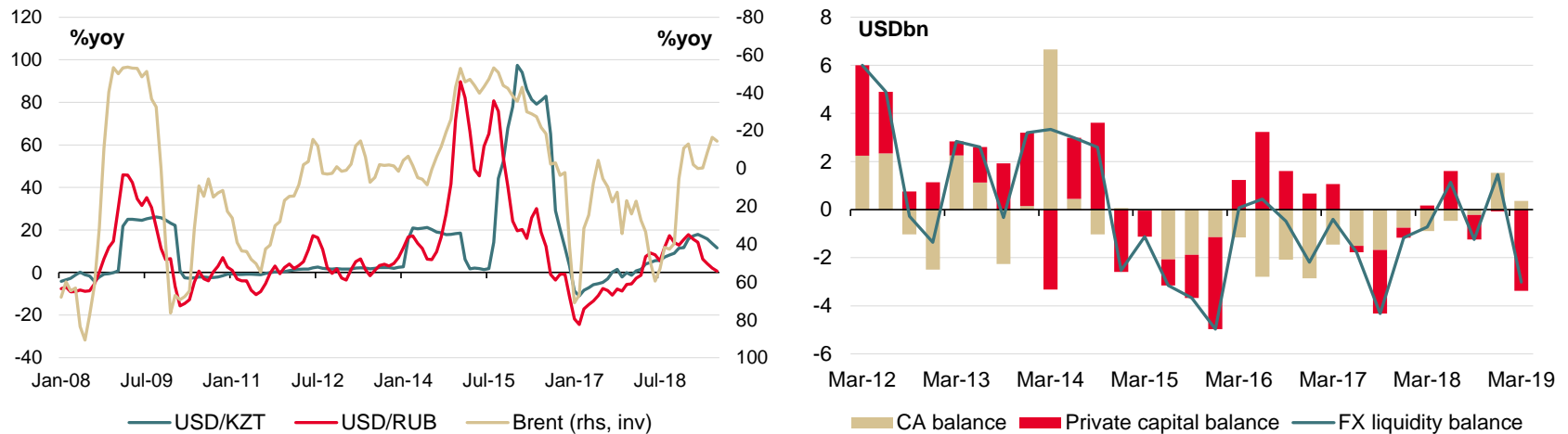
CURRENT ACCOUNT DEPRIVED OF STIMULUS TO IMPROVE



- **The current account (CA) balance returned to a significant deficit of \$2.3bn in 2Q19**, the worst result in 10 quarters. This negative result was mainly due to a weaker trade balance owing to a growth in imports of \$1.8bn yoy. In addition, payments abroad remained high (c.35% of export revenues) as the Kazakhstan oil industry is mainly financed abroad (70% of all FDI).
- We expect the drop in imports to slow as most of the reconstruction works have been already implemented. This should mean the **current account balance will improve slightly in 2H19, but will be unlikely to exceed zero by any meaningful margin over the next three years.**

Source: NBK, Committee on statistics in RK, CEIC data, Rosbank

FX: TENGE IS ON A DEPRECIATION TRAJECTORY



- **The tenge came under pressure from both domestic and external sides.** Firstly, political tension at the beginning of the year intensified capital outflows from the economy. Even though the arrival of new President Tokayev has served to ease the political risk by supporting existing policies, the **increased social payments have raised concerns as the increased transfers from the NFRK could force the authorities to keep a weaker tenge** through the indirect mechanism of FX liquidity management.
- Secondly, the risks of global recession exacerbated by the US-China trade conflict resulted in a sell-off on the EM FX markets and caused oil prices to drop. **The impact on the tenge was amplified by oil and the overall negative EM sentiment.** All in all, USD/KZT increased to 387 by mid-August.
- Even though Kazakhstan is a satellite economy of Russia, **the tenge was not supported by the strong positions of the Russian ruble** in June-July as the ruble appreciated owing to strong demand from foreign investors (RUB/KZT increased from 5.4 to 5.8 over the year).
- **We revised USD/KZT forecast up from 375 to 395 by end-2019** as we do not see strong support for the tenge from the fundamental factors: fragile CA surplus and lack of stimulus for capital inflows. In 2020, we expect USD/KZT at 400 as loose fiscal policy will further weigh on fundamentals.

Source: NBK, Bloomberg, CEIC data, Rosbank

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