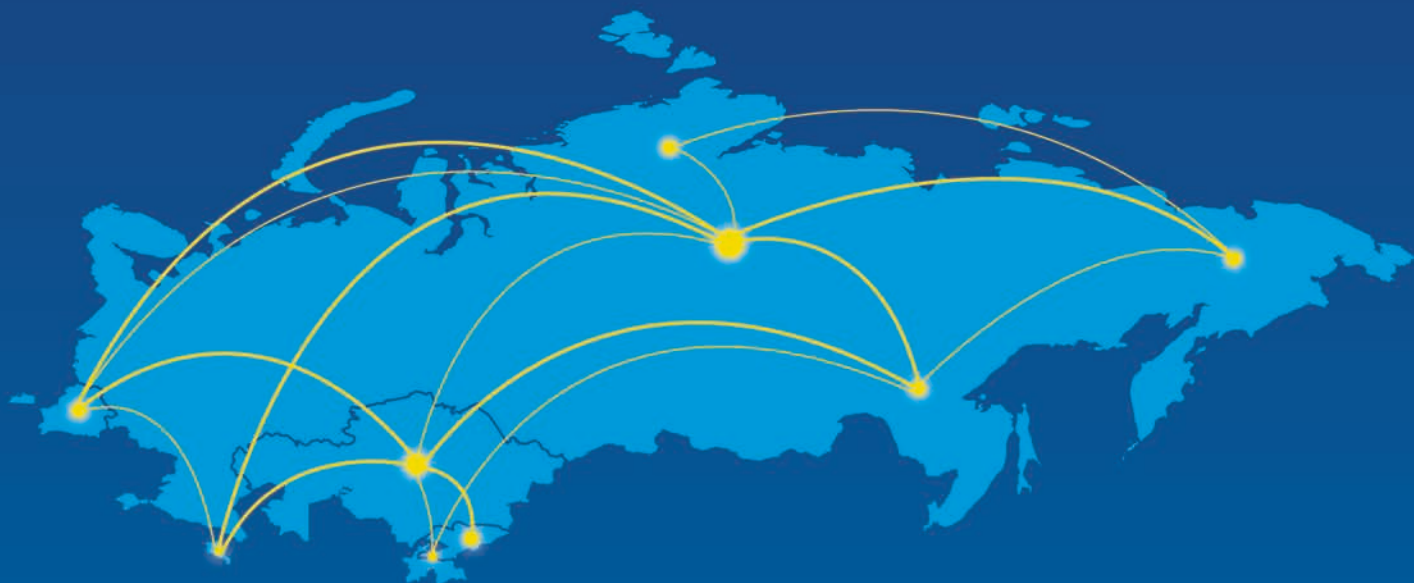


EDB MACRO REVIEW



10'2020

Republic of Kazakhstan

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INFORMATION DISCLOSURE

This Review includes a detailed description of the current domestic and external macroeconomic setting and a consistent set of forecasts that takes into account the interrelationships between the economies of the EDB operating region and the external sector.

The forecasts of the main macroeconomic indicators were prepared by the EDB jointly with the EEC using an integrated system of models based on a multi-country structural dynamic macroeconomic general equilibrium model. More detailed information about the structure of the integrated system of models, its main components, and its use for analysis of the macroeconomic situation and forecasting is contained in a joint EDB and EEC report entitled “Forecasting System for the Eurasian Economic Union”.

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LIST OF ABBREVIATIONS

BEA — U. S. Bureau of Economic Analysis

bbl — barrel

CDS — credit default swap

COVID-19 — Coronavirus disease

CPI — Consumer Price Index

ECB — European Central Bank

EDB — Eurasian Development Bank

EEC — Eurasian Economic Commission

ENONIA — Euro Overnight Index Average

EU — European Union

EURIBOR — Euro Interbank Offered Rate

Eurostat — The statistical office of the European Union

Eurozone — EU countries, that have adopted the euro as their primary currency and sole legal tender

FLBs — Federal Loan Bonds

FRS — Federal Reserve System of the United States

GDP — Gross Domestic Product

IRA — International Reserve Assets

ISM — Integrated System of Models

JSC — Joint-stock company

KZT — Kazakh tenge

LIBOR — London Interbank Offered Rate

MF RK — Ministry of Finance of the Republic of Kazakhstan

MIACR — Moscow Interbank Actual Credit Rate

NBRK — National Bank of the Republic of Kazakhstan

OECD — Organization for Economic Cooperation and Development

OPEC — Organization of the Petroleum Exporting Countries

PMI — Purchasing Managers' Index

pp — percentage point

Q — quarter

RF CB — Central Bank of the Russian Federation

RK — Republic of Kazakhstan

Rosstat — Federal State Statistics Service of the Russian Federation

SC MNE — Statistics Committee of the RK Ministry of National Economy

SSM — semi-structural macroeconomic models

TONIA — Tenge OverNight Index Average

U.S. or USA — United States of America

UK — United Kingdom

USD — United States Dollar

% — percent

% YoY — year-over-year growth rate

SUMMARY

The Kazakh economy faced challenging external economic conditions in the first half of this year. The COVID-19 pandemic resulted in an unprecedented decline in global economic activity and volume of international trade. Lockdown restrictions weakened consumer and investment demand considerably and fostered a slowdown in inflation along with a fall in energy prices. These conditions compelled monetary regulators in both developed and developing countries to ease their monetary policy, while fiscal bodies unveiled large-scale anti-crisis packages to help individuals and business.

June–July 2020 performance indicators heralded the beginning of a recovery in global economic activity amid an easing of lockdown restrictions and companies resuming work, primarily in the service sector. Due to differences in the epidemiological situation and government support across countries, this process has been gradual and varied. The EDB's baseline scenario assumes a slow recovery of the world's major economies with unused capacity at production facilities in 2020–2022 to drive only moderate external demand for Kazakh exports in the medium term. These conditions will lead to external inflationary pressure remaining weak.

Oil prices remained depressed by weakened global demand in the first half of the year, while the OPEC+ agreement to reduce oil extraction reached in April was instrumental in limiting their fall. The EDB's projections assume that oil prices will grow moderately as global economic activity gets back on its feet.

In such circumstances, the Kazakh economy contracted by 1.8% YoY in January–June 2020. Among the key factors influencing economic trends were the domestic health restrictions, reduced external demand and transportation difficulties, falling oil prices and slowing growth of production volumes under the OPEC+ agreements, increased uncertainty and a deterioration in business sentiment. That resulted in a considerable decline of consumption, investment and both individuals' and businesses' incomes. The aftermath of the coronavirus pandemic is now mostly embodied in a cyclical economic recession, although potential GDP growth rates have also decreased. We believe the negative output gap to have amounted to some 6–8% in 2Q2020.

According to the EDB's baseline scenario, the easing of lockdown measures in the second half of this year and continued support from expansionary monetary and fiscal policies will generate conditions fostering economic recovery. Government anti-crisis support is expected to continue in 2021; the funding volumes will start decreasing gradually from 2022, which will mitigate the pandemic's adverse effect on the economy. As a result, we expect GDP to decline by 2.5% over 2020 and to recover, at an

average of 4.7% per year, beginning in 2021–2022. However, we expect the process to be lengthy due to the increased uncertainty, social distancing, moderate external demand and weakened investment; a return to the pre-crisis production levels is expected in 2021–2022, while the output gap will remain negative for the entire forecast period.

In the first half of 2020, the Kazakh tenge weakened against the world's key currencies. The highest pressure was seen in the second half of March, when the coronavirus outbreak grew into a pandemic, while the OPEC+ countries failed to reach an agreement regarding the extension of oil production restrictions. In May–June, the tenge regained some of the lost ground and appreciated to 397 per U.S. dollar, which was encouraged by the beginning of economic recovery at home and abroad, as well as by oil price growth. In the second half of August–early September 2020 pressure on the tenge grew due to increasing geopolitical risks; should these risks remain, the national currency is unlikely to strengthen by as much as its potential. The exchange rate is expected to adjust to an equilibrium level during 2021 as the coronavirus spread slows and the geopolitical situation normalizes.

Consumer price index growth rates increased somewhat in the first half of this year due to the exchange rate pass-through effect, temporary feverish demand for certain products and increases in prices of fruit and vegetables. We expect the inflation rate to grow to 7.1% YoY by the end of 2020, mainly due to national currency depreciation and the fiscal momentum effect. Moderate domestic and foreign economic activity will be a considerable constraint on inflation in the medium term. As a result, if the exchange rate stabilizes, consumer price index growth will slow down to 5.6% YoY in 2021 and then keep within its target range (4–6%).

Monetary policy in the first half of the year aimed to maintain macroeconomic stability amid inflation overshooting its target, an economic growth slowdown and sharp tenge depreciation. The NB RK held six meetings on monetary policy, including two extraordinary ones. By the end of the first semester, the base rate was 9.5%, which, given the increased inflation, points to monetary policy's stimulative nature. According to our estimates, the indicator's decrease potential has largely been realized, and the rate will stay at the 9.0% level till the end of the current year.

The State budget posted a deficit of 2.9% of GDP in the first half of this year. Expenditures increased significantly, mainly due to two anti-crisis economic support packages totaling some 6 trillion tenge (about 8.7% of GDP). Income fell in January–June 2020, primarily owing to the fall in the prices and exports of hydrocarbons as well as reduced domestic economic activity. As a whole, fiscal policy was of a stimulative nature, thus limiting the scale of decline in production and demand. In the medium term, we expect a gradual weakening of the fiscal momentum as support for the economy decreases.

Heightened and negatively skewed risks to our forecasts remain, since the anticipated economic recovery is not of a stable nature, on the back of a potential second wave of the pandemic, increased tensions between the USA and China, and additional sanctions rhetoric regarding Russia, whose adverse effect may be transmitted to the Kazakh economy via trade and financial channels.

EXTERNAL CONDITIONS

Economic Activity

Unprecedented decline in global economic activity

The first half of this year was marked by a huge challenge — the COVID-19 pandemic. As the disease spread, government bodies in the majority of countries responded by taking measures intended to contain it, which then led to a disruption in global supplies and increased volatility in the financial and commodity markets and exerted an overall negative impact on a great number of key economic sectors. Lockdown measures resulted in a reduction of consumer and investment activity, real and business incomes, and increased unemployment.

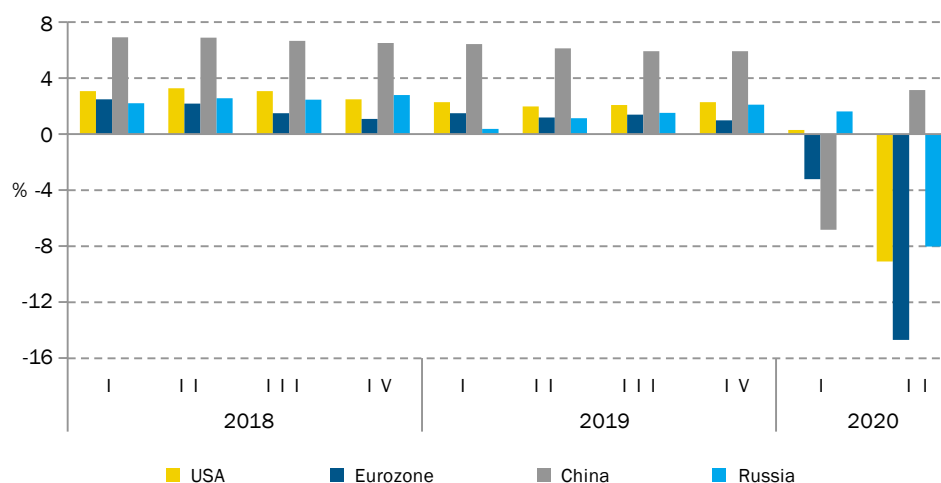
Among the world's largest economies, the biggest decline in business activity in 2Q2020 was observed in the Eurozone, where GDP declined by 14.7% YoY¹ (down 3.2% YoY in January–March 2020), which is the highest drop since the indicator was first calculated in 1995. GDP of the USA decreased by 9.1% YoY² (0.3% growth in Q12020) over the same period, which had not been at this level since 1947. China's GDP showed a positive trend in Q2: it increased by 3.2% YoY (down 6.8% YoY in January–March) upon the restrictions being eased in the spring.

The Russian economy contracted by 8% YoY in 2Q2020 (down 3.4% YoY in the first half of the year). The deteriorating epidemiological situation resulted in a fall in consumer and investment demand, with reduced extraction under the OPEC+ agreement holding back exports further.

¹ Seasonally adjusted data. As per our estimates, the year-on-year decrease compared to the previous quarter (seasonally adjusted) amounted to some 40%.

² Seasonally adjusted data. The year-on-year decrease compared to the previous quarter (seasonally adjusted) amounted to 31.7%.

Figure 1.
GDP of the key trade partners
(year-on-year growth rate)



Source: CEIC Data, BEA, Eurostat, Rosstat

Big losses in the service sector

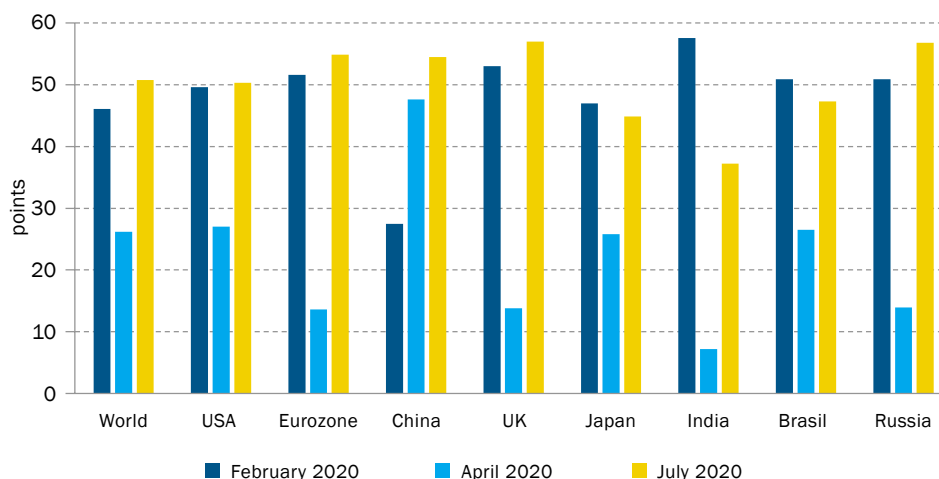
In terms of industry, the largest losses were incurred by businesses providing consumer services. This follows from PMI survey results³, evidencing a significant decrease in business activity in the tourism and hotel industries, as well as in the transport and real estate sectors. A significant deterioration in business sentiment affected technology and financial firms, along with the telecommunications services segment. An output decline was also caused in the manufacturing industry, primarily in mechanical engineering and automobile production. There was a lesser impact of the pandemic on the food and pharmaceutical industries.

Stabilization of the world economy at reduced levels in June–July

The maximum impact of the crisis (barring a second global wave of the disease or provided that its duration and consequences are not overly severe) is likely to have been passed in April–May, with the composite PMI at 26.2 (a record low) and 36.3 points, respectively. In June–July, the indicator increased to 47.7 and 50.8 points, respectively, which attests to a significant slowdown in the economic downturn after lockdown restrictions were eased. The composite PMI for Russia reached 56.8 points in July (13.9 in April 2020), 54.9 in the Eurozone (13.6 in April 2020), 50.3 in the USA (27 in April 2020), and 54.5 in China (27.5 in February 2020).

³ PMI is an indicator describing changes in business activity and the operating conditions of private companies in the manufacturing and service industries. This indicator is based on monthly surveys of purchasing managers. A PMI index reading of over 50 points indicates an increase in economic activity, while readings below 50 indicate a decrease. For more information, please see: <https://www.markiteconomics.com/Public/Release/PressReleases>

Figure 2.
Composite PMI



Source: IHS Markit

Economic sentiment improved in June–July both in the service sector (real estate operations, banking products, telecommunications) and in the manufacturing industry (production of construction materials, automobiles, chemical products, etc.). There was a significant slowing in the decline of new orders volumes, including exports. However, the recovery in global business activity is uneven due to differences in the epidemiological situation, and leading indicators overall signal the stabilization of global output at significantly lower levels than pre-crisis, which indicates the world economy is likely to be slow in returning to its “normal” state.

Inflation

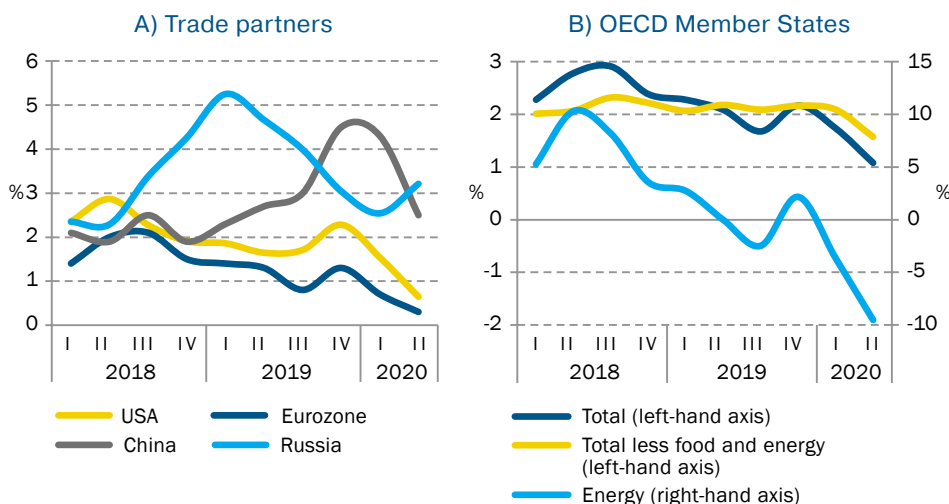
Weak inflation background

The decline in global economic activity resulted in a slowdown in the world’s inflationary processes. Inflation in the OECD countries fell to 1.1% YoY in June from 2.2% in December 2019; in the U.S., it fell to 0.6% from 2.3%; in the Eurozone, it fell to 0.3% from 1.3%; and in China, it fell to 2.5% from 4.5%. The fall in energy costs due to decreased demand acted as an additional disinflationary factor. Accelerated food price growth had an impact on consumer prices despite their decrease in the international market, which might be driven by temporary difficulties relating to transportation and feverish demand for certain products in late March–early April.

Russia retains a moderate price environment: inflation remained below the Bank of Russia’s target (4%) in August, amounting to 3.6% YoY, an increase from 3% YoY in December 2019. The increase in the indicator mainly stems

from the rise in the cost of food products due to the weakening of the national currency, the challenging transportation and logistics situation, as well as the low base effect in the fruit and vegetable segment. Core inflation amounted to 3.1% YoY in August, as in December 2019. Weakened domestic consumer demand curbed its movement.

Figure 3.
Foreign inflation
(the last month in a quarter vs. the last month of the same quarter a year before)



Source: OECD, RF CB

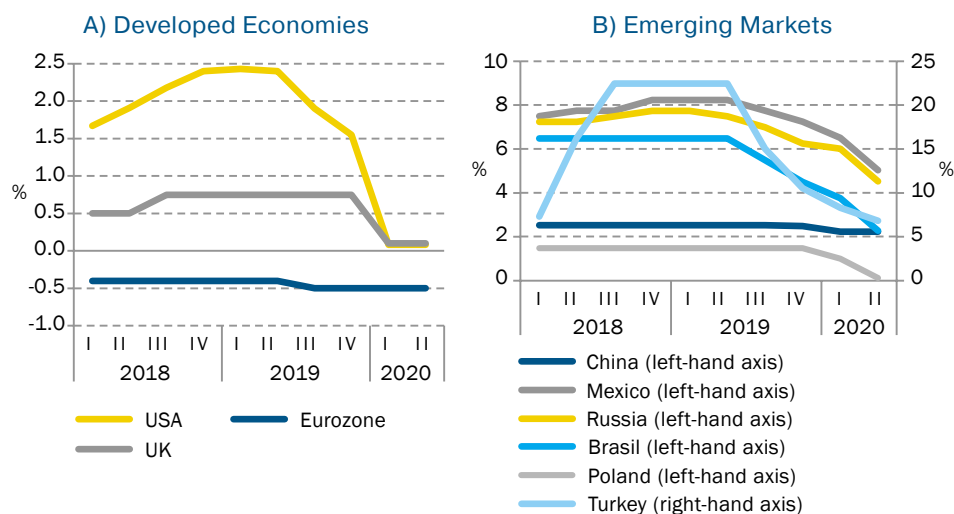
Monetary and fiscal policy

Easing of monetary policy

Active government measures taken to support the population, business and the financial sector were instrumental in limiting the scale of decline of the world’s largest economies. Monetary regulators eased monetary policy significantly in the first half of 2020 by lowering key interest rates and expanding asset purchase programs. In addition, top central banks announced their intention to maintain a soft policy in the medium term.

Monetary regulators in developing countries also lowered key rates, most actively in March–April 2020. As of the end of August 2020, the Bank of Russia key rate amounted to 4.25%, 2 pp lower compared to its level at the beginning of the year. The regulator’s actions are explained by a shift in the balance of risks in 2Q toward disinflation due to a deep drop in both domestic and external demand, which might cause inflation to drop below the 4% target in the medium term. Since the inflationary trend has proven to be rather moderate, we assess the Bank of Russia’s monetary policy as moderately stimulative.

Figure 4.
Key interest rates of foreign countries
(as at the end of period)

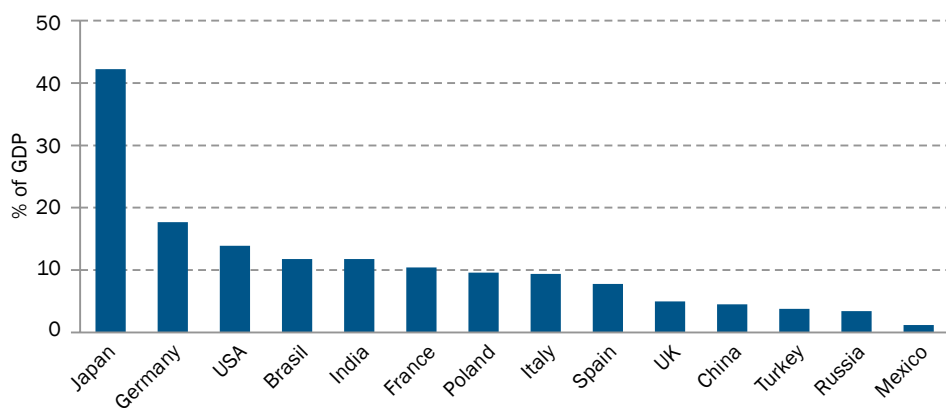


Source: CEIC Data

Stimulative fiscal policy

The volume of fiscal assistance was significantly expanded in the first half of 2020, since a need for anti-crisis measures arose, factoring in support for business and real incomes. According to the COVID-19 Economic Stimulus Index⁴ as of August 25, the volume of fiscal stimulus in Japan amounted to 42.2% of GDP; in the U.S., 13.9% of GDP; in Germany, 17.7% of GDP; in France, 10.4% of GDP; in Italy, 9.4% of GDP; in the United Kingdom, 5% of GDP; in China, 4.5% of GDP; and in Russia, 3.4% of GDP.

Figure 5.
Scope of fiscal support measures



Source: COVID-19 Economic Stimulus Index

⁴ For more information, see: Elgin C., Basbug G., Yalaman A. 2020. Economic Policy Responses to a Pandemic: Developing the Covid-19 Economic Stimulus Index. CEPR. Covid Economics, Vetted and Real-Time Papers. No 3. PP. 40–53.

Commodity markets

Low oil prices

The prices of most commodities were driven largely by global demand and expectations of its recovery. After falling in March and April, prices for oil, metals and food began to recover in the face of a revival in economic activity. The OPEC+ agreement also had a positive impact on oil prices, providing for a large-scale reduction in raw materials extraction from May 2020. As a result, the price of Brent rose to USD 42.8 per barrel in July (Urals rose to USD 43.9) from a multi-year low of USD 23.3 in April (Urals: USD 18.2), but remained much lower than before the crisis.

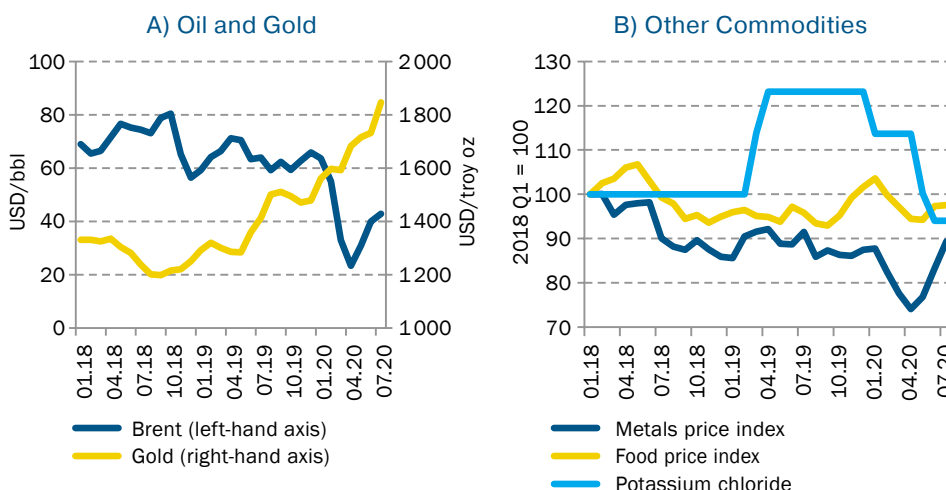
Resumption of growth in metal prices by the end of the first half of the year

The metal price index increased by 20.7% in July versus the April minimum, and exceeded the level of December 2019. This was largely influenced by the revival of economic activity in China. The weakening of the U.S. dollar against key world currencies, as well as the risk of reduced supply of industrial metals, including copper, caused by the spread of coronavirus in Latin America, also affected the rapid growth of the indicator in June–July. The food price index showed a similar trend: after falling in April–May, there was a recovery in June–July. The market for potash fertilizers and coal remains just weak.

Increase in gold prices

Amid increasing global uncertainty in the first half of this year, there was a significant increase in demand for protective assets such as gold, with its prices reaching an all-time high in July 2020, being almost 25% higher than in last December. The soft policy maintained by major central banks furthered the increase, accompanied by large-scale injections of liquidity.

Figure 6.
Commodity prices



Source: World Bank

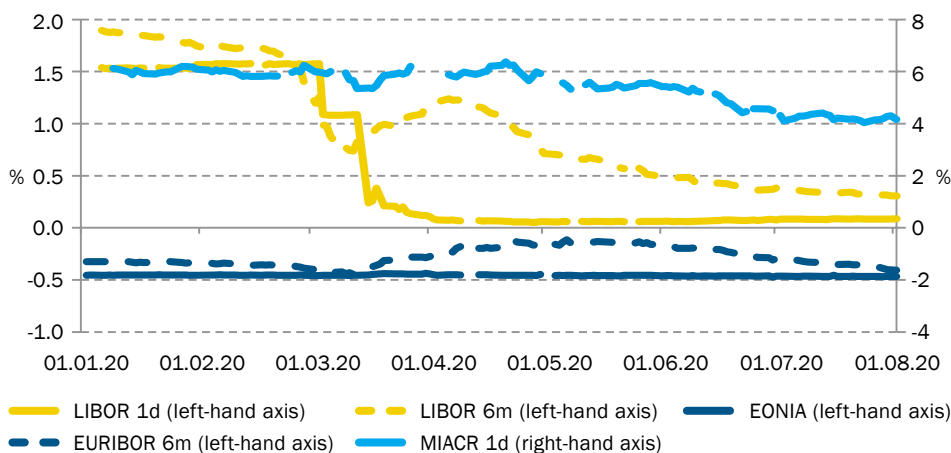
Financial markets

Lowering of interbank market rates

LIBOR rates in U.S. dollars, as well as indicators of the Eurozone money market, decreased in 2Q2020 after monetary regulators opted to ease monetary policy. Central banks' efforts to maintain financial markets liquidity and somewhat improved business sentiment amid stabilizing economic activity were instrumental in reducing spreads between rates on one-day and longer interbank loans, which had returned to pre-crisis levels after an upsurge in March.

The short-term interbank loan rates decreased in Russia over January–June 2020, staying near the policy rate, with a small negative spread resulting from a structural surplus of liquidity remaining in the banking sector. The yield on ruble FLBs also significantly decreased in April–July after an increase in March, propelled by the expectation of a key rate adjustment and the stabilization of the financial market after a period of increased turbulence around the middle of March.

Figure 7.
Money market rates

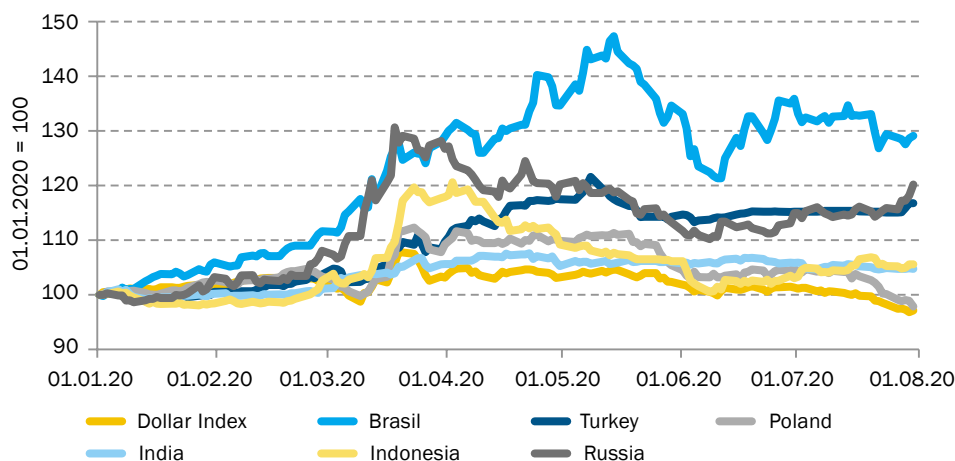


Source: CEIC Data

Weakening of the U.S. dollar against the currencies of developed countries

The U.S. dollar exchange rate against key world currencies weakened markedly in June–July after strengthening in March–April, when investors were exiting from risky assets. The decline in the value of the U.S. currency was caused by a number of factors, including the FRS's statements about its intention to support an extremely soft monetary policy in the medium term, a still high rate of coronavirus disease spread in the USA, and the EU countries' agreement to issue common bonds in July.

Figure 8.
Exchange rates
against the U.S. dollar



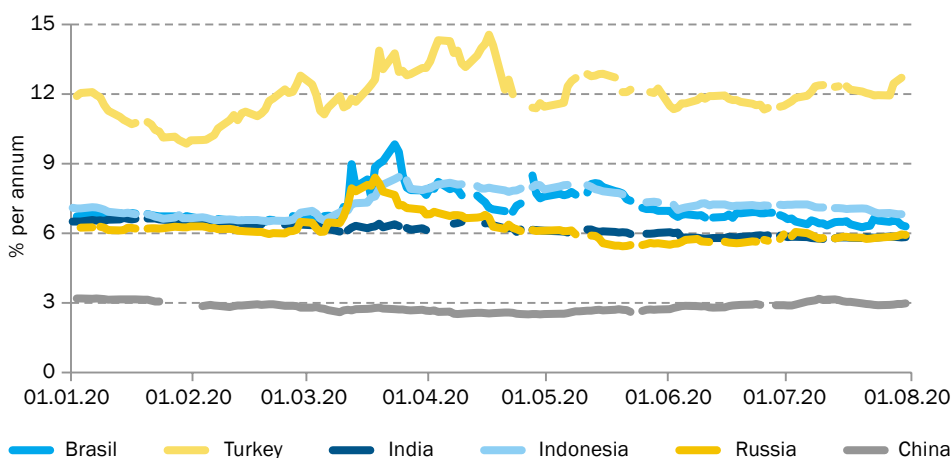
Source: CEIC Data, Investing.com

Volatility in emerging market currencies

The currencies of emerging market countries regained in 2Q2020 some of the ground lost against the U.S. dollar in March, largely driven by signs of recovery in economic activity. In addition, these movements were largely corrective, since the currencies were oversold amid the March panic. However, exchange rates remain volatile. In the wake of new COVID-19 outbreaks in late June and July and a deterioration in China–United States relations, emerging market currencies were again pressurized by increased concerns about a second wave of the pandemic and a decrease in investor interest in risky assets.

The yield on long-term government bonds of emerging market countries decreased in April–July after a significant increase in March; it basically returned to the levels observed prior to the start of the pandemic, if not lower. Both the reduction in key interest rates of central banks and the beginning of recovery processes across economies played a crucial role in this.

Figure 9.
Ten-year government
bond yield in emerging
markets

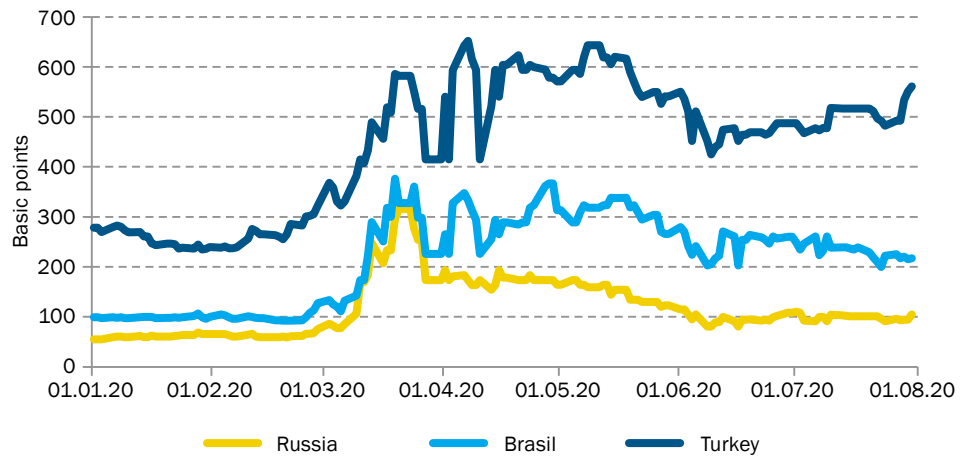


Source: Investing.com

Risk premium has stabilized at a heightened level

Risk premiums for developing economies in 2Q2020 decreased against the highs of March–April, as indicated by the CDS trends. Nevertheless, their indicators stabilized in June–July, at levels higher than those before the crisis, which might be driven by the remaining high uncertainty about the global economic outlook. Country risk premiums will likely remain high until the spread of coronavirus slows in a sustained fashion.

Figure 10.
Five-year CDS in emerging markets



Source: Investing.com

STATE OF THE ECONOMY OF THE REPUBLIC OF KAZAKHSTAN

Economic Activity

Large-scale contraction of economic activity

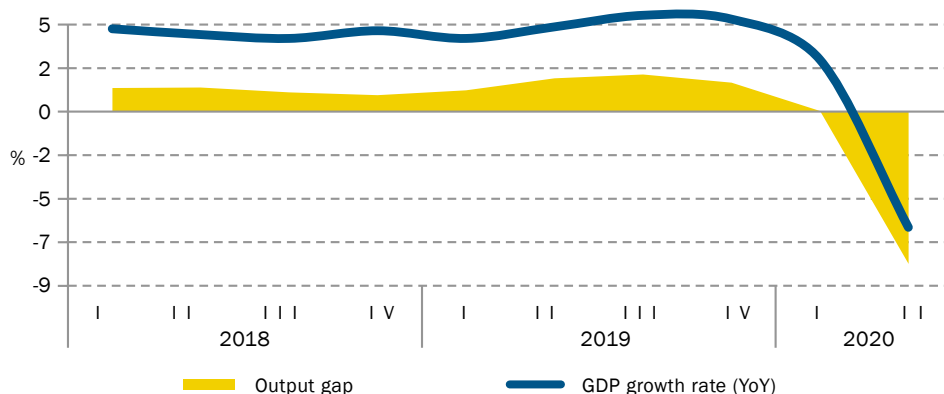
In the first half of 2020, the Kazakh economy suffered a large-scale shock caused by the COVID-19 pandemic. GDP decreased by 1.8% YoY in January–June 2020. The outbreak of the disease affected business activity in the country via two main channels:

- Deterioration of the external setting, in the form of weaker demand for Kazakh exports, the budget's and organizations' decreased revenues from commodity exports due to the price fall, disrupted global value chains, and worsened business sentiment.
- The effect of domestic health measures, primarily the lockdown imposed from mid-March till mid-May this year, that led to a large-scale decline in consumer and investment demand.

The pandemic hit the hardest in the 2Q, when output fell by 6.0% YoY. According to our assessment, its adverse effect manifested itself more as a cyclical decline, although potential GDP growth declined as well (according to EDB calculations, by 0.5–1.4 pp from its pre-crisis values, to 2.2–3.5% YoY) (*Box 1*).

The Government's fiscal, monetary and macroprudential support measures helped mitigate the negative economic and social impact of the challenging epidemiological situation.

Figure 11.
Economic Activity



Source: SC MNE, EDB and EEC calculations


Box 1. Impact of the COVID-19 Pandemic on Potential and Cyclical Economic Growth in Kazakhstan

The fallout from the COVID-19 pandemic may have a significant impact on trends in unobservable macroeconomic variables, such as potential GDP and the output gap. Whether monetary and fiscal policies will be effective is largely determined by several aspects: the correct identification of the state of the business cycle, the nature of monetary and fiscal policies, and the drivers of economic processes.

The EDB uses its ISM⁵ as the main tool for analyzing and forecasting the macroeconomic situation in the Bank's operating region. The system uses semi-structural models with monetary and fiscal sectors that permit an assessment of non-observable variables.

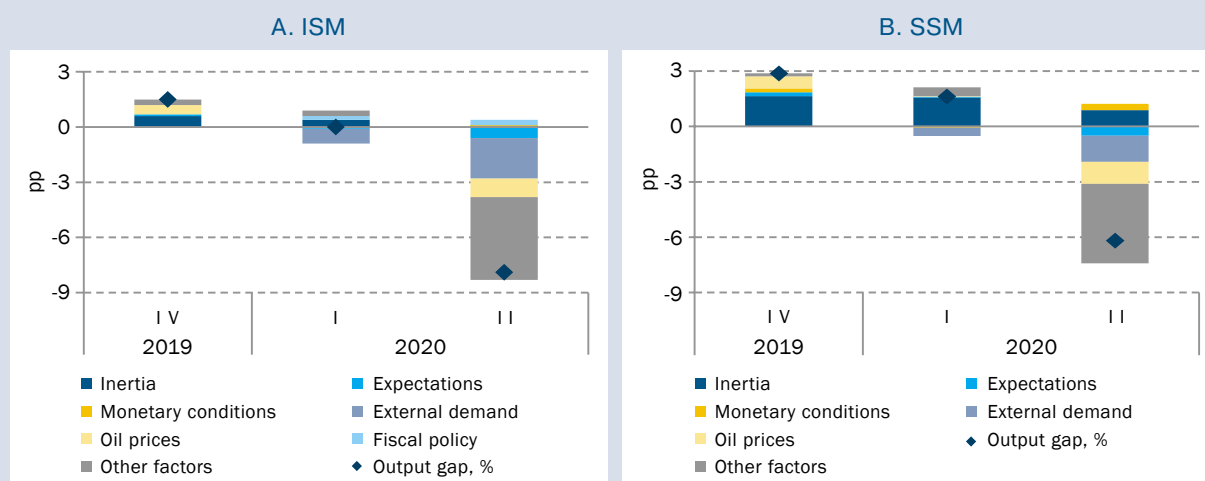
To verify ISM-based findings, the Bank has developed semi-structural macroeconomic models (SSMs)⁶ for every country in the Bank's operating region. They are distinguished from the ISM mainly by the method of determining the equilibrium interest rate: its level (instead of ISM-based uncovered interest rate parity) is linked to the growth of potential GDP, which is adjusted for the change in the real equilibrium effective exchange rate. This makes it possible to directly factor in how the impact of the production profit rate on the equilibrium rate, the impact of the economic convergence process and the return on foreign currency investments influence its movements.

The findings obtained showed that the COVID-19 pandemic resulted in a large-scale cyclical downturn in the Kazakh economy: the negative output gap, which shows the deviation of actual real GDP from its equilibrium (potential) level, was some 6–8% in 2Q2020, the lowest value in the past 16 years. This trend can be attributed to such key factors as contraction of external demand and the effect of domestic restrictive measures aimed at containing the coronavirus disease. In the decompositions included here (Figure B.1), the latter's influence is shown under other factors' contribution (demand shock). The fall in oil prices and energy commodities production reduced under the OPEC+ agreement (translating, like the health measures, into a demand shock) had a significant impact on the economic cycle. State support measures were crucial in limiting the scale of the downturn in business activity.

The growth rate of potential output decreased by 0.5–1.4 pp — to 2.2–3.5% YoY, which can be attributed to some businesses and organizations closing, to a decline in investment activity and increased uncertainty, as well as the impact of the OPEC+ agreements on limiting oil production. It should be noted that the COVID-19 pandemic may affect potential economic growth significantly more than the findings show, which will largely depend on how the epidemiological situation unfolds. 

⁶ For more information, see the Joint EEC and EDB Report entitled '*Forecasting System for the Eurasian Economic Union*' (2016).

⁷ For more information see the EDB Special Report entitled '*Estimation of Non-Observable Economic Variables in EDB Member Countries*' (August 2020).

Figure B.1. Decomposition of the Output Gap in Kazakhstan

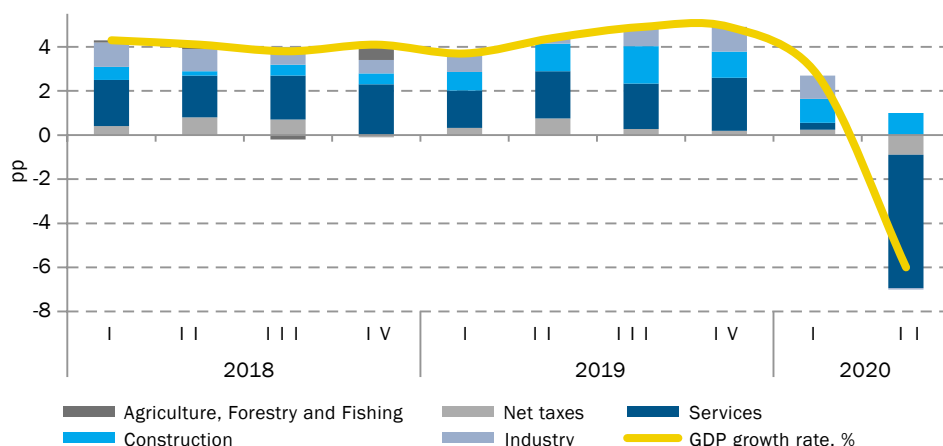
Source: EDB and EEC calculations

Service sector shrinks In terms of industry, the greatest losses in the first half of 2020 were incurred by service sector businesses, whose output fell by 5.5% YoY. The social isolation measures and the closure of some organizations had the greatest effect on the transportation and warehousing sector, and on wholesale and retail trade, which declined by 14.6% and 10.6% YoY, respectively. On the other hand, the lockdown boosted the development of telework and e-commerce, which increased demand for telecommunication services (by 9.0% YoY).

Construction driving growth Goods production retained a positive trend in the first half of 2020 (4.1% YoY), partly due to Government support. Thus, the volume of construction works increased by 11.2% YoY as a number of programs were implemented to expand the housing stock and make mortgages more affordable ('Nurly zher', '7-20-25', 'Bakytty otbasy' and others), as well as to create transport infrastructure ('Nurly Zhol'), while medical facilities were built with budget funds.

Industrial growth decelerates as OPEC+ deal is implemented Agriculture and the industries were much less exposed to the negative effects of the COVID-19 pandemic. Agricultural output increased at a steady rate (2.4% YoY) in the first half of 2020. The industrial sector's slowdown deepened in July 2020. In January to May 2020, crude oil output grew by 5.4% YoY against last year's low base. In June 2020, the country began implementing the OPEC+ treaty in full, which slowed down its energy resources production rate to 1.4% YoY over January-June 2020. The manufacturing industries increased output by 4.8% YoY in January-June 2020. Positive trends continued virtually in all key industries of this sector. The greatest growth was observed in the production of pharmaceuticals and metal products, as well as in machine-building.

Figure 12.
Decomposition of GDP Growth Rate
(year-on-year)



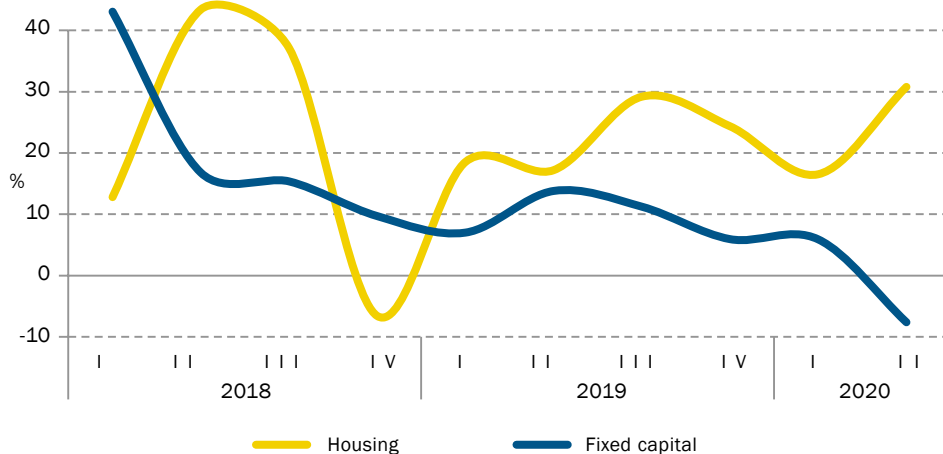
Source: SC MNE, EDB calculations

Investment activity weakens

Investment in fixed capital fell by 7.6% YoY in 2Q after 5.9% YoY growth a quarter before. Over the first half of the year, the figure declined by 2.9% YoY. The suspension of a major investment project on the Tengiz oilfield resulted in an 11.6% fall of investment in the mining industry compared with the first half of 2019. Investment in the gas supply sector decreased partly on account of the completion of the Saryarka gas pipeline, whose construction was in its active phase in 2019. The deterioration in businesses' finances and economic sentiment, limited domestic demand, disruption of supply chains and weakening of the national currency caused capital investments in the trade sector to fall by 49.2% YoY; in construction, by 49.3% YoY; in enterprises providing professional services, by 47.2% YoY; and in transport and warehousing organizations, by 4.8% YoY.

The pandemic had a lesser negative effect on investment in housing construction, whose output grew by 16.5% and 30.8% YoY in 1Q and 2Q2020, respectively.

Figure 13.
Investment
(year-on-year growth rate)



Source: SC MNE, EDB calculations

The Labor Market

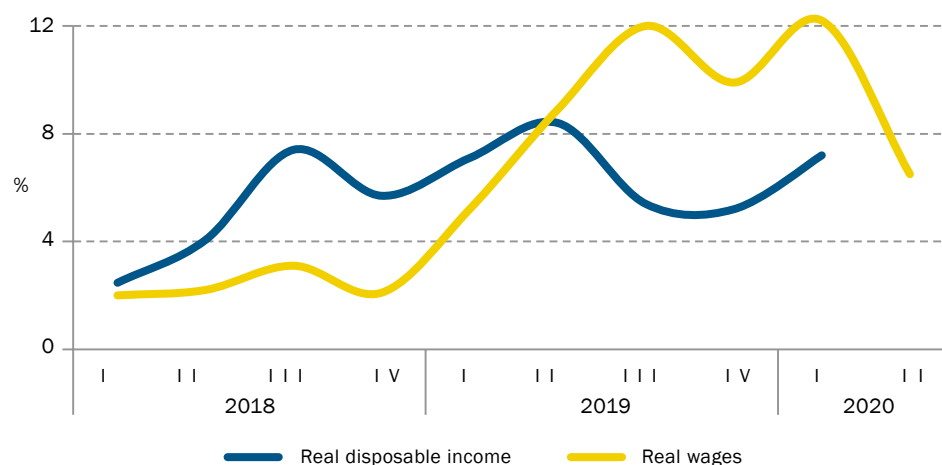
Households' incomes supported by government measures

Real wages continued growing at a positive rate in the first half of 2020 (9.3% YoY after 9.1% YoY in 2019). The rise of teachers' wages by 25%, cultural workers' by 35–50% and social workers' by 30–60% from 1 January 2020 helped increase households' incomes in 1Q2020. The negative impact of the crisis that peaked in 2Q was partially offset by the Government's support measures that included the exemption of entrepreneurs from individual income tax. Consequently, real wage growth decelerated to 6.5% YoY in 2Q2020 from 12.2% YoY the quarter before. In the hardest-hit sectors (financial and insurance activities; real estate transactions; arts, entertainment and recreation, and wholesale and retail trade) real wages declined by 1.1–8.6% YoY in January–June 2020.

The authorities' initiative to pay one minimal wage, 42 500 tenge, to those who lost employment as a result of the quarantine measures, must have had a positive effect on household income in the 2nd quarter.

Registered unemployment as of the end of 1Q2020 remained at 4.8%, unchanged from 2019.

Figure 14.
Labor Market Indicators
(year-on-year growth rate)



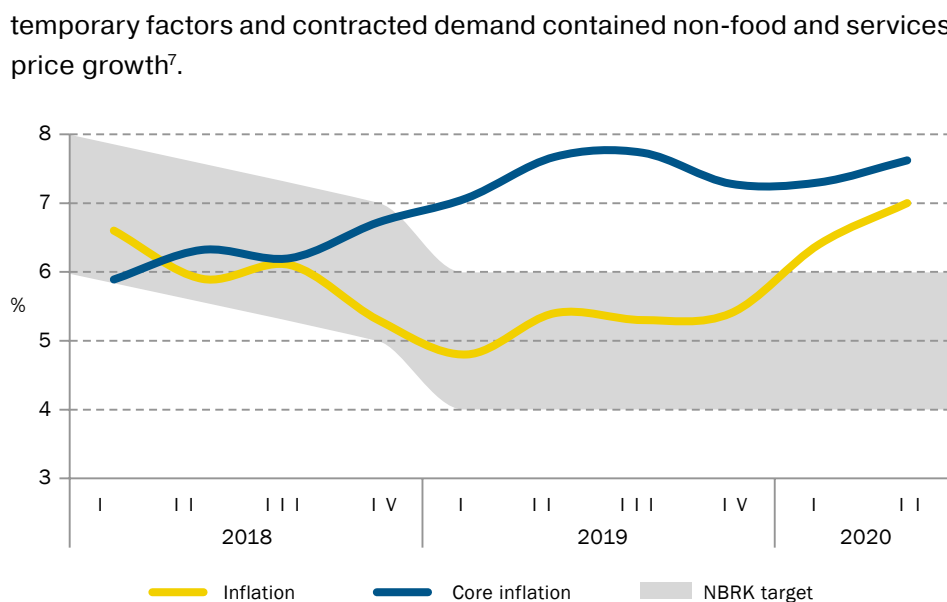
Source: SC MNE, EDB calculations

Inflation

Inflation above target range

In the first half of 2020 inflation accelerated to 7.0% YoY, from 5.4% YoY in December 2019, to overshoot the National Bank's target of 4.0–6.0%. Price growth accelerated mainly on account of the food component, while both

Figure 15.
Inflation
(the last month in a quarter vs. the last month of the same quarter a year before)



Source: SC MNE and NB RK

Accelerated price growth in necessities

Inflation accelerated in January and February 2020, driven by one-time factors, namely the rise in petrol excises and utility tariffs, that had been reduced a year before. Starting from March 2020, inflation came under the pressure of increased demand for prime necessities during the lockdown. That mainly applied to food, whose prices accelerated to 11.1% YoY in June 2020, from 8.9% YoY in February 2020. Thus, the prices of such goods as bread and bakery products, groats and pasta products grew in March to June 2020. Price appreciation of meat products, fruit and vegetables, as well as pharmaceuticals and medical services was also recorded.

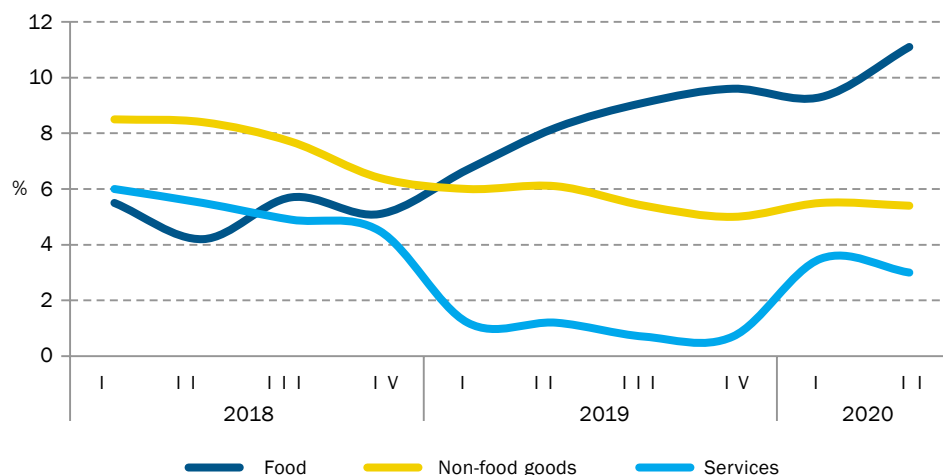
Non-food inflation remained stable, at 5.4% YoY in June 2020. The fall in economic activity in the country and the imposed restrictions caused domestic demand to contract and contained tenge depreciation pass-through to non-food prices.

The service sector's CPI performance was determined by one-time factors. The price index accelerated to 3.5% YoY in March 2020, from 1.4% YoY in January 2020 as the effect of the administrative reduction of regulated prices a year before petered out. To support households, the Government reduced utility tariffs from 1 April 2020 for the duration of the state of emergency. As a result, the service price index began slowing down again, to 3.0% YoY in June.

⁷ Core inflation, excluding the appreciation of fruit and vegetables, utility services, railway transport, communications, petrol, diesel fuel and coal, was 7.6% YoY in June 2020.

Figure 16.
Inflation Components

(the last month in a quarter vs. the last month of the same quarter a year before)



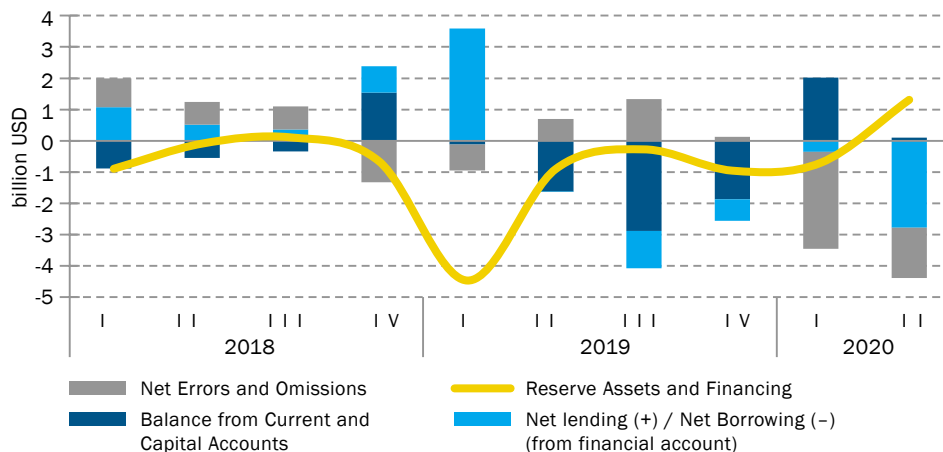
Source: SC MNE

The External Sector

Current account deficit expands

The first half of the year saw a current account surplus that the National Bank estimates at USD 2.1 billion (3.1% of GDP) versus a USD 1.7 billion deficit (2.4% of GDP) a year before. The indicator was driven by a decline in the primary income balance (as payments to foreign direct investors fell by 1.9 fold), while the goods and services balance also decreased. Financial account transactions (excluding IRAs) showed net borrowings of USD 3.2 billion from other countries in January–June 2020, versus USD 3.5 billion in net lending a year before.

Figure 17.
Balance of Payments



Source: NB RK

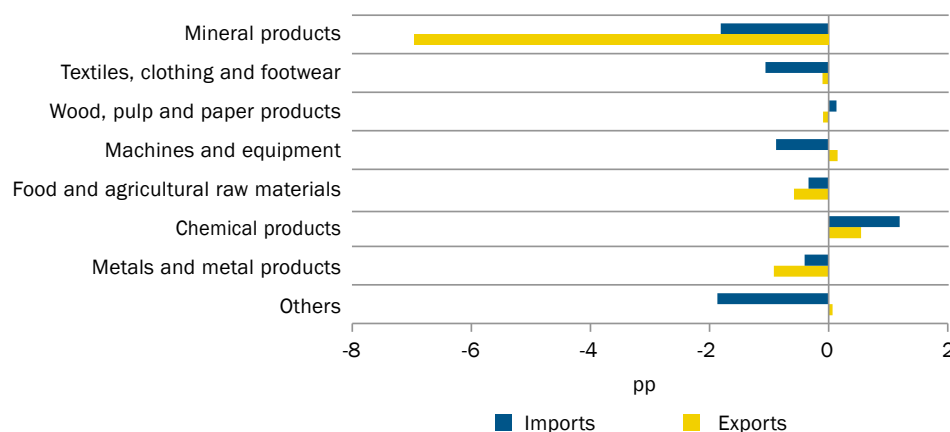
Goods exports decline The trade balance surplus equaled USD 9.9 billion in January–June 2020, USD 1.4 billion less than in the same period last year. The decrease in Kazakh goods exports (by USD 3.1 billion, or by 10.7% YoY) was the key factor behind the decline in the foreign trade balance.

The indicator's change was mainly driven by the decline of oil and gas exports in US dollar terms, largely attributable to weakening external demand, the slowdown in oil production under the OPEC+ agreement, and the decline of hydrocarbon prices.

Exports of most other key product groups also declined in the first half of the current year — including metals and metal products, foodstuffs, wood and textiles. The deterioration in the trade balance was held back by expanding exports of chemical products, machines and equipment.

Figure 18.
Product Groups'
Contribution to Goods
Exports and Imports
Growth

*(January–June 2020
vs. January–June 2019)*



Source: State Revenue Committee of the MF RK, and EDB calculations

Imports decline amid restrictive measures

The decline of domestic economic activity, transportation and logistical difficulties⁸ and tenge weakening affected goods imports, which declined by USD 1.7 billion (or by 9.7% YoY) in January–June 2020. There was a fall in imports of most aggregated product groups that culminated in April and May. According to the State Revenue Committee of the MF RK, an import growth recovery was observed in June, possibly due to a revival of domestic demand after the social isolation measures were eased.

Services and income balance in deficit

The services balance posted a deficit of USD 1.8 billion in the first half of 2019, unchanged from the same period of 2019. The fall in Kazakh transport

⁸ As estimated by the National Bank, the closure of the Khorgos International Center for Border Cooperation located on the border between Kazakhstan and China nearly halved imports by individuals in 1Q2020.

companies' revenue was compounded by a decline of residents' spending on foreign travel. The income balance deficit was USD 6.0 billion in January–June 2020, USD 5.2 billion less than in the same period last year. The key factor behind the balance improvement was a USD 5.0 billion decrease in interest payments and dividends on liabilities owed to foreign direct investors.

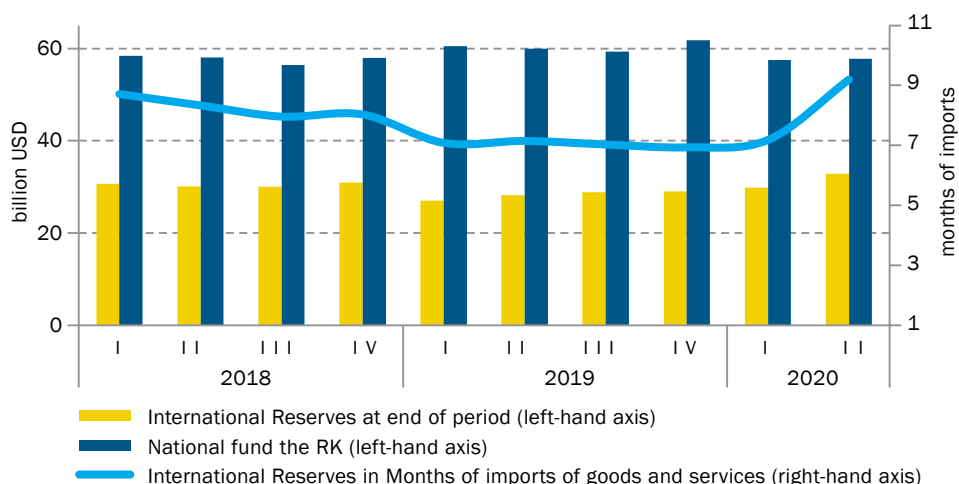
Financial account balance negative

The negative financial account balance (excluding IRAs) was USD 3.2 billion, versus a USD 3.5 billion surplus a year before. A net capital inflow emerged on account of a buildup of liabilities owed mainly to foreign direct investors and a decreasing share of foreign securities in Government authorities' and banks' portfolios.

Consolidated international reserves decline

The consolidated international reserves⁹ amounted to USD 90.6 billion as of the end of June 2020, a 0.1% decline since the beginning of the year. The RK National Fund's assets decreased in their structure by 6.5%, while gross international reserves grew by 13.6% compared with 2019. The former's trend was determined by growing transfers to the State budget, decreasing tax revenues from the oil sector and growing investment income. The second component was influenced by growing gold prices and by commercial banks' foreign exchange transactions on National Bank and State authorities' accounts involving foreign debt repayment. As of 1 July 2020, the country's reserve assets were estimated at USD 32.9 billion, which we consider sufficient to cover 9.2 months' worth of Kazakh imports of goods and services.

Figure 19. International Reserves and Assets of the RK National Fund



Source: NB RK

⁹ These comprise international reserves of the RK National Bank and assets of the National Fund.

The Fiscal Sector

Budget deficit grows over semester

In January–June 2020, the State budget posted a deficit of 0.8 trillion tenge, equivalent to 2.9% of GDP (0.1 trillion tenge, or 0.4% of GDP, a year before). The situation with public finances results from the growth in expenditures (24.7% YoY) outrunning income growth (14.0% YoY).

Greater transfers from the RK National Fund

The increase in the State budget's incomes was driven by the growth of transfers by 72.3% YoY. The latter accounted for 44.5% of all revenues (vs. 29.4% a year before). Non-tax revenues were an additional contributor, as public corporations generated more dividends. Tax collection and fixed capital sale revenues declined by 10.8% and 36.5% YoY, respectively, in the first half of 2020. The figures deteriorated as economic activity was constrained by the measures taken to curb the spread of the coronavirus infection (the state of emergency imposed and closed borders) and by the program adopted to support businesses and households (exemption from taxes and other mandatory payments for three to six months). The decline in world prices of Kazakh commodity exports had a contractive effect as well.

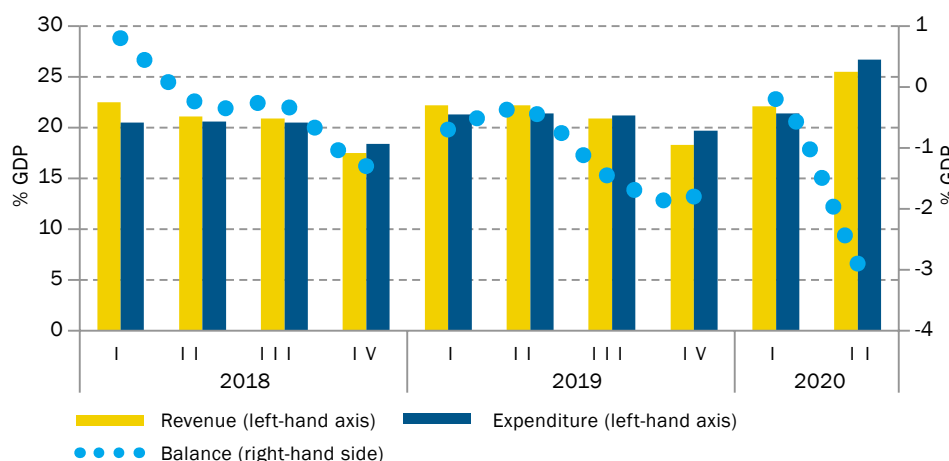
Expenditures grow

An increase in public expenditures in the first half of 2020 was observed in all budget categories. Growing spending on education was the key contributor (35.5% YoY) as teachers' salaries were raised. The growth of health expenses by 44.8% YoY resulted from counter-epidemic measures, including additional payments to personnel involved, the construction of treatment facilities and purchase of medical supplies. Social spending increased as pensions, benefits and targeted assistance were adjusted for inflation, the minimum wage was paid to citizens who lost their incomes during the lockdown, and utility payments were reimbursed.

Government support at 8.7% of GDP

Overall, two packages of anti-crisis measures, with funding of 5.9 trillion tenge (8.7% of GDP), were enacted to mitigate the consequences of the pandemic and facilitate post-crisis recovery. The social support measures were complemented by preferential lending to business via expanded public programs entitled 'Business Roadmap 2025', 'Economics of Simple Things' and 'Yenbek, Development of Productive Employment and Mass Scale Entrepreneurship', and also in the form of preferential lending by the NB RK.

Figure 20.
The State Budget
(year-to-date)



Source: MF RK and EDB calculations

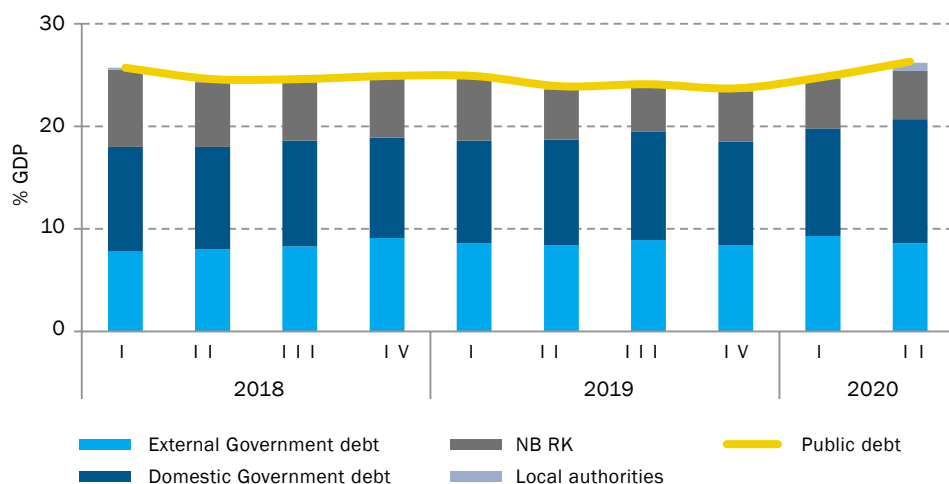
Public debt grows

Kazakhstan’s public debt increased to 26.2% of GDP as of 1 July 2020, from 23.7% at the beginning of this year, on account of domestic borrowings attracted as the budget’s deficit expanded — mainly through an issue of long Government treasury bonds that increased debt on these instruments by 49.4% compared with the beginning of the year. In May 2020, the fiscal authorities began issuing short-term securities. By the end of June, the liabilities on those grew to 277.1 billion tenge. On account of a Eurobond placement, external public debt grew by 1.2% in the period, while debt on other foreign loans decreased.

Sovereign credit ratings confirmed

Fitch and Standard & Poor’s kept Kazakhstan’s sovereign ratings at BBB and BBB- investment levels, respectively. Despite the shocks caused by the fall of oil prices and the coronavirus pandemic, Kazakhstan still has low public debt and a considerable volume of fiscal reserves, sufficient for mitigating external shocks.

Figure 21.
Public Debt



Source: MF RK and EDB calculations

Monetary Conditions

Monetary policy focused on macroeconomic stability

In the first half of 2020, the RK National Bank took six base rate decisions, of which two were extraordinary. In early February, amid mounting inflation risks, the regulator kept the rate at 9.25% with ± 1 pp liquidity provision and withdrawal band. On 10 March, the National Bank took an extraordinary decision to raise the rate to 12.0% and expand the band to ± 1.5 pp amid the global spread of the coronavirus infection and a rapid fall in world oil prices. The tightening of monetary conditions aimed to protect tenge assets and mitigate the impact of the external shock on the economy.

By the beginning of the 2nd quarter, the risks of a decline in economic activity had grown and led the authorities to adopt a set of anti-crisis measures in order to support business activity. To coordinate fiscal and monetary policy measures, the National Bank reduced the base rate to 9.5% at its extraordinary meeting on 3 April 2020 and expanded the interest rate band to ± 2 pp. Those monetary conditions existed till the end of June 2020.

Interbank market rates declined by early July 2020

In the first half of 2020, the TONIA rate varied within the base rate's target range, usually closer to its lower limit, in the presence of a liquidity surplus. Increased demand for tenge liquidity in March caused the interbank market rate to rise to its upper limit. After the money and foreign exchange markets stabilized in April, the growing liquidity surplus continued to exert downward pressure on the TONIA rate, which mainly stayed in the lower segment of the interest rate band until the end of June.

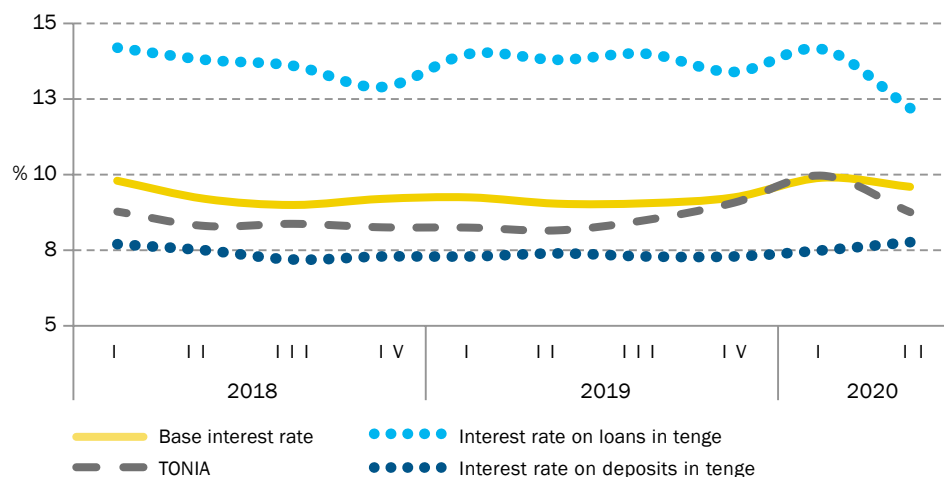
Lending declines...

The price of borrowed resources decreased by the end of the first semester, partly on account of the implementation of preferential lending programs by the Government and National Bank. Slower growth of the loan portfolio mainly resulted from a decrease in consumer and trade borrowing. The share of non-performing loans in the banks' loan portfolio was 9.0% as of 1 July 2020, up from 8.1% at the end of 2019.

...while deposit interest rates grow

The base rate increase in March led the banks to raise the interest rate on new deposits. That stimulated the growth of tenge deposits in 2Q2020. A considerable increase of foreign exchange deposits in the 1Q, mainly resulting from revaluation after the tenge weakened in March, gave way in April to a decrease in deposits denominated in foreign currency.

Figure 22.
Interest Rates
(the period's average)



Source: NB RK and EDB calculations

Tenge weakens against U.S. dollar

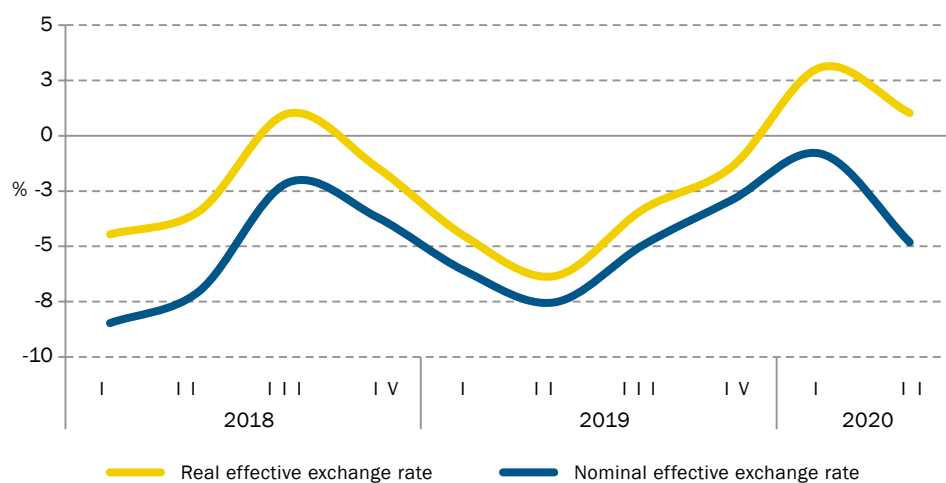
The Kazakh tenge weakened significantly against the world’s major currencies in the first half of 2020. The main blow was seen in the second half of March: the coronavirus outbreak turned into a pandemic, while the OPEC+ countries failed to reach an agreement on extending oil production restrictions. In that period, the depreciation of the national currency was contained by measures taken by the Government and National Bank, that included mandatory sale of part of foreign currency export revenues and tighter requirements for foreign exchange purchases/sales by legal entities. To limit speculative transactions, in 1Q2020 the RK National Bank made exchange rate interventions totalling USD 1.6 billion net and also used the Frankfurt auction mechanism.¹⁰ In 2Q, the tenge regained some lost ground and strengthened to a peak of 397 per USD, assisted by the start of economic recovery in the country and abroad and by growing oil prices.

Real effective tenge exchange rate undervalued

The Kazakh tenge’s real effective exchange rate weakened in line with the nominal one in the first half of the year. We believe that this resulted in the undervaluation of the national currency. On the one hand, inflation was affected, but on the other, the price competitiveness of domestic producers was maintained. According to our calculations, the coronavirus pandemic caused the equilibrium real effective rate of the Kazakh tenge to weaken at a faster rate.

¹⁰ A tool used by Kazakhstan Stock Exchange JSC during its trading sessions to prevent any destabilizing influence of external factors on the domestic foreign exchange market.

Figure 23.
Tenge Exchange Rates
(year-on-year growth rate, + = tenge strengthening)



Source: NB RK

ECONOMIC OUTLOOK: REPUBLIC OF KAZAKHSTAN

Background

Trade partner economies to gradually recover in medium term

The baseline scenario involves a further easing of lockdown restrictions in the world's largest economies (the US, the Eurozone and China) in the second half of 2020, that, along with stimulative fiscal and monetary policies, will be instrumental in a gradual recovery in consumer and investment activity, as well as international trade. However, due to the increased uncertainty, deterioration of the labor market, disruption of existing value chains, and anticipated changes in consumer habits (social distancing, higher savings rates, etc.), the return to pre-crisis production levels will be slow and is unlikely to be completed until 2022.

External demand constrained

The negative output gaps in the trade partner countries will close gradually while remaining in negative territory for the entire forecast period (2020–2022) as their economic activity will recover at moderate rates. As a result, external demand for Kazakh exports is expected to stay depressed in the medium term.

Moderate oil price growth

Under the EDB baseline scenario, oil prices will grow at a moderate pace in 2020–2022, encouraged by a recovery in global economic activity. Nevertheless, we are quite conservative in our expectations of the increase in energy commodity prices, which will stay affected by the uncertain global outlook.

Low foreign inflation

External inflation will remain weak in the medium term. We expect the growth rate of the consumer price index in Russia, the Eurozone and the USA to remain below the RF CB, ECB and FRS targets in the wake of moderate demand.

The country risk premium for Russia will remain heightened in 2020–early 2021 due to high uncertainty over the development of the pandemic and the global economic recovery, as well as a geopolitical factor (the threat of anti-Russian sanctions expanding). In the future, as the situation normalizes, we expect it to return to pre-crisis levels.

Fiscal policy parameters revised due to pandemic impact

In April 2020, the parameters of the State budget were revised due to the adverse effect of the coronavirus pandemic on economic activities and the restrictive measures imposed. The new document provides for higher public spending on social payments, transfers to local budgets that compensate for tax losses caused by a lower tax burden, reimbursement of utility payments, and higher funding for health and public order services. The budget's income side envisages lower tax revenues and a 2.1 trillion tenge increase in the transfer from the RK National Fund that will now reach 4.8 trillion tenge. As a result, the expected 2020 budget deficit is expanded to 3.5% of GDP, from 2.1% of GDP previously planned.

Fiscal momentum to weaken in medium term

The authorities intend to continue supporting the economy in 2021 and to gradually reduce anti-crisis funding in the following years, with the budget deficit to be reduced to 2.1% of GDP in 2023, from 3.4% in 2021.

Potential growth will begin to gradually recover in 2021–2022, assisted by State development programs aiming in particular to boost investment activity.

Table 1. Forecasts of Key Foreign Economic Indicators

	Average annual Urals oil price (USD per barrel)	Metals price index, 2010=100	Russia's real GDP growth rate,%	Eurozone real GDP growth rate,%	China's real GDP growth rate,%
2020	42.4	74.8	-4.2	-8.4	1.5
2021	48.9	78.3	3.2	5.5	8.3
2022	52.7	78.5	2.7	3.7	5.6

Source: EDB and EEC calculations

Economic Activity

Economic activity to gradually recover in second half of 2020

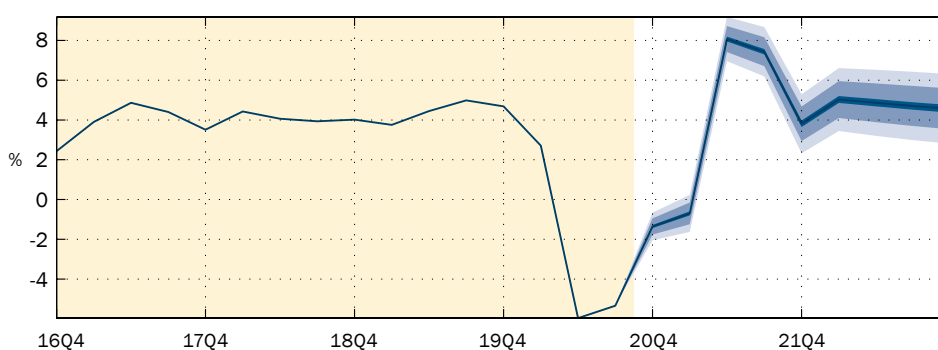
The easing of lockdown restrictions abroad since the end of the first half of this year is generating conditions for the recovery of economic activity in the country. We expect a gradual recovery in consumer and investment demand, which will stay supported by stimulative monetary and fiscal policies in 2020. Increased business activity abroad and the weakening of the national currency will help limit the decline in non-energy exports. The implementation of the OPEC+ agreements will continue to restrain oil

production: according to our calculations, factoring in the impact on related industries, this may cost about 0.7% of the country's GDP this year.

The repeated lockdown measures imposed in early July 2020 were lighter than those of the spring, while State support for businesses and households continued. Consequently, the summer restrictions had a more moderate effect on business activity.

We believe that quarterly GDP (seasonally adjusted) will begin to grow from 3Q2020, which will result in a slower decline in annual indicators and a gradual reduction in the negative output gap. The GDP contraction rate is estimated at 2.5% over 2020.

Figure 24.
Real GDP¹¹
(year-on-year growth rate)



Note: seasonally adjusted data.

Source: EDB and EEC calculations

Compared with our previous projection,¹² the estimate has been downgraded by 1.5 pp, mainly to account for the longer duration of the restrictive measures than was expected in early April¹³ and their slow easing, as well as for the pandemic's stronger negative impact on economic activity abroad.

Risks of aggravation of the economic situation

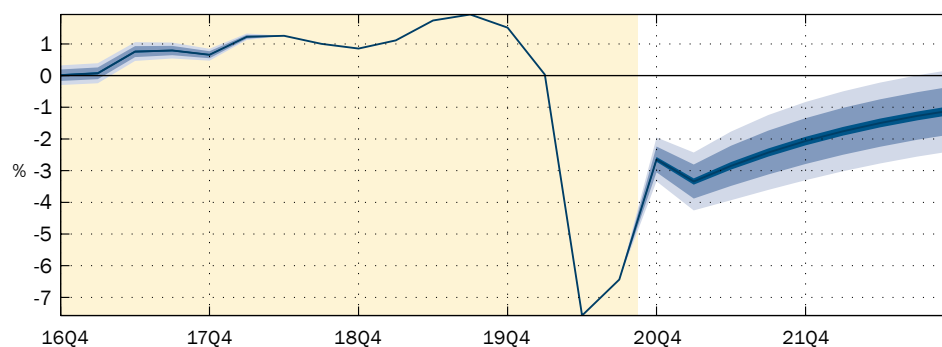
The short-term risks have shifted towards a greater GDP decline due to the ongoing challenging epidemiological situation in the world and to the risks of a large second wave of the pandemic in the coming fall and winter.

¹¹ Here and elsewhere the chart ranges correspond to the 10%, 50% and 75% confidence intervals.

¹² See EDB Macroeview. April 2020. 'Outlook Update'.

¹³ The April projection assumed the lockdown to last for one month and did not anticipate its re-imposition in July 2020.

Figure 25.
Output Gap



Source: EDB and EEC calculations

Economic activity to gradually recover in 2021–2022

In the 2021–2022 baseline, we expect GDP growth to continue to recover by an average of 4.7% per year as the situation in the global economy and commodity markets stabilizes, domestic structural reforms are implemented, and monetary policy support continues. However, the EDB forecasts assume that this will be a slow process due to the long-term weakening of investment activity amid the increased uncertainty, a number of service-related organizations closing down and changing consumer habits (social distancing and weakness of the tourist and air transport industries). In addition, fiscal support is projected to decrease in 2022–2023 as the fiscal momentum from the current anti-crisis measures weakens.

As a result, we expect that the pre-crisis (4Q2019) level of GDP can only be reached in mid-2021. Slow recovery will result in a negative output gap remaining throughout the forecast period, indicating that the economy will operate with incomplete production capacity.

Lingering risks to economic growth

The risks to the medium-term forecasts have shifted to the downside. The development of the epidemiological situation is still uncertain. Should it aggravate globally, we might expect greater losses of potential GDP than assumed in the base case scenario, due to a protracted decline of investment and innovation activity. There is still a probability of stronger geopolitical tension and stricter sanctions against Russia, which may have a considerable negative effect on the Kazakh economy via trade and financial channels. In addition, there is again an increased risk of global trade protectionism growing, which may hinder global economic recovery.

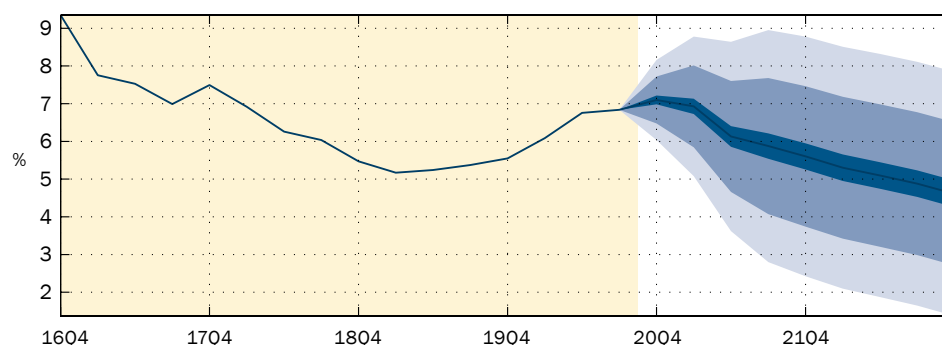
Inflation

Inflation to accelerate in second half of 2020 The EDB projects inflation to amount to 7.1% YoY by the end of 2020, exceeding the National Bank’s target of 4.0–6.0%. Increased volatility in the regional markets in the wake of harsher sanctions rhetoric against Russia, growing fiscal stimulation of the economy and rising service tariffs will affect prices in the second half of the year. Moderate domestic demand for non-food goods, especially durables, will be instrumental in limiting the scale of inflation acceleration.

Inflation to decrease in 2021–2022 Domestic demand will exert its biggest impact on CPI in 2021, which, together with the weak price situation in the major trading partner countries and the projected normalization of the Kazakh tenge exchange rate movements, will cause the consumer price growth rate to slow down to 5.6% YoY in 2021.

A gradual recovery of economic activity will help reduce the disinflationary impact of domestic demand during 2022. However, assuming a consistent monetary policy, we believe there will be some decrease in inflation expectations, leading to an inflation rate within the target range.

Figure 26.
Inflation
(the last month in a quarter vs. the last month of the same quarter a year before)



Note: seasonally adjusted data.

Source: EDB and EEC calculations

Risks of higher inflation

A number of proinflationary risks persist in the medium term. These are due to the threat of long-term and serious disruption of supply chains and shortages of individual goods in the event of a widespread second wave of the pandemic. In addition, should an unfavorable scenario occur, volatility in the foreign exchange market may experience a significant increase again, which will affect the prices of imported goods and the expectations of economic agents.

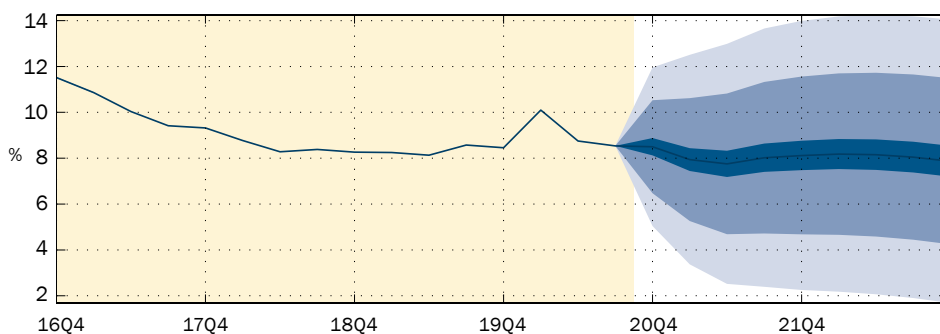
Monetary Conditions

Rate to remain at 9% till end of 2020

We believe that the base rate reduction potential is limited by the inflation risks, and it will remain at 9.0% till the end of this year, which will foster a recovery of economic activity with the authorities able to return inflation to its 4–6% target range.

In the medium term, the prevalence of disinflationary risks may necessitate further easing of monetary conditions, that will remain in place till 2022.

Figure 27.
TONIA Rate
(the period's average)



Source: EDB and EEC calculations

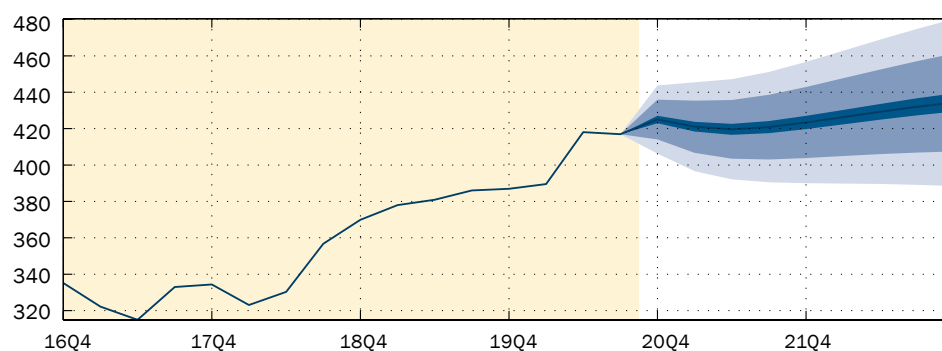
Geopolitical risks limit leeway for tenge to strengthen in second half of 2020

In the second half of August–early September 2020 the regional financial markets grew more volatile due to harsher sanctions rhetoric against Russia, which caused the tenge to weaken to about 427 per U.S. dollar. This factor is likely to remain influential during the rest of the year, which will hinder the full strengthening of the national currency. As a result, in 2020, the average annual exchange rate of the Kazakh tenge vs. the U.S. dollar is thus projected to be around 412 per USD.

Exchange rate to adjust to equilibrium level in 2021

The exchange rate is expected to adjust to its equilibrium level during 2021 assuming that the coronavirus spread is brought under control and the geopolitical situation normalizes. In this scenario, the Kazakh currency will depreciate in 2021–2022 at a rate that creates no imbalances in the economy. The weakening of the exchange rate in nominal terms will be due to a higher growth rate of consumer prices in Kazakhstan compared to the U.S.

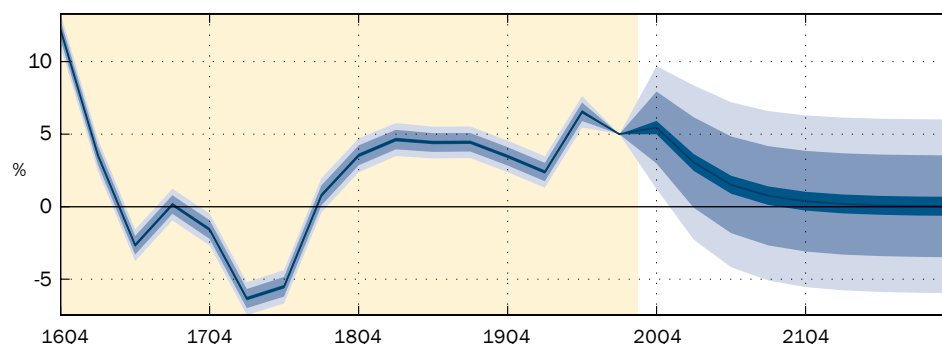
Figure 28.
Nominal Kazakh Tenge
Exchange Rate
(KZT per USD)



Source: EDB and EEC calculations

The main risks to the exchange rate still emanate from the external sector. A remaining possibility of deeper negative trends in the global economy may trigger a fall in the prices of key Kazakh exports. The Western countries' policy of sanctions against Russia also remains a risk factor that may be transmitted to the RK economy via trade and financial channels.

Figure 29.
Real Kazakh Tenge
Exchange Rate to USD
Gap
(+= the tenge is undervalued)



Source: EDB and EEC calculations

Table 2. Key Macroeconomic Indicators of the Republic of Kazakhstan

Indicators	2017	2018	2019	2020P	2021P	2022P
GDP in constant prices (% growth YoY)	4.1	4.1	4.5	-2.5	4.6	4.8
Consumer price index (% growth in December to previous year's December)	7.1	5.3	5.4	7.1	5.6	4.6
TONIA rate (the year's average % per annum)	9.9	8.4	8.4	9.0	8.0	8.1
Nominal Exchange Rate , KZT per USD (the year's average)	326.0	344.7	382.8	412.4	421.2	430.5

Note: P = Projected.

Source: EDB and EEC calculations



Eurasian Development Bank

**RESEARCH DEPARTMENT,
EURASIAN DEVELOPMENT BANK**

Your comments and suggestions concerning this review
are welcome at: pressa@eabr.org

