

Keynotes of the interview by Aliya Moldabekova, Deputy Governor of the National Bank on situation on the foreign exchange market in May, 2021

Inflation risks caused by unparalleled measures to support economies create new uncertainty for global markets regarding further steps of central banks in leading countries of the world. Recalibration of expectations of global investors is a volatility factor for all asset classes, including currencies of emerging markets.

Situation on foreign exchange markets

May demonstrated improvement in key statistics on the coronavirus pandemic. Number of confirmed cases of the infection worldwide declined by 20% versus April. Stable epidemiological situation in Europe and decreased incidence in India contributed to attenuation of the third wave of the pandemic. New cases in India plunged to 86,000 from a peak of 414,000 per day. Most European countries lift quarantine restrictions and open borders for vaccinated tourists.

Recovery of business activity continues worldwide as confirmed by Global Composite PMI, which in May continued to update its historic highs amid active recovery in the service sector.

Rising inflationary expectations and, as a consequence, concerns about tightening of monetary policy by global central banks influenced mixed dynamics of global stock indices and global foreign exchange market during the month.

Last month, foreign exchange markets were most sensitive to statements related to inflation and release of macroeconomic data, which could potentially affect further steps of the US Federal Reserve System. In particular, weak April report on the US labor market caused significant weakening of the USD, on May 7 the US dollar index against the basket of currencies of developed countries (DXY) lost 0.8% within one day. However, release of data on record inflation rates in April (+ 4.2% y-o-y, a maximum rate in more than 12 years) once again urged forward the USD exchange rate and on May 12 DXY index rose by 0.6%.

Concerns about rising inflationary expectations spur central banks in developed economies to revise their monetary stimulus programs. In addition to the previously announced decisions of the Bank of England and the Bank of Canada to diminish a volume of asset purchases, the US Federal Reserve System plans to launch discussions at its next meetings covering a gradual reduction in volumes of injections.

By the second half of May, active communications policy of the US Federal Reserve System helped mitigate concerns of investors about acceleration of inflation. A number of representatives of the regulator said that stable inflation was

unlikely to exceed the target, and, as a result, there was no need to turn to tightening the screws. As a result, DXY index lost 1.6% for the month, and yields on 10-year US treasury bonds also slightly declined (-3 basis points).

Most currencies of emerging markets moderately strengthened in May against the background of disillusioning US macroeconomic data: South African rand by 5.2%, Brazilian real by 4.0%, and Russian ruble by 2.5%. Growth of the Russian ruble was facilitated by mitigation of geopolitical risks on the eve of the scheduled meeting of the Presidents of the Russian Federation and the United States. Turkish lira lost 2.4% amid fears of investors about indecision of the Central Bank in conditions of increased inflation. Some economists (Goldman Sachs) predict that against the background of unchanged policy of the US Federal Reserve System and expansion of geography of economic recovery, weak dollar trend may persist, however, it should be indicated that risks of revising the rhetoric of Central Banks of the leading countries remain and they are key ones.

Dynamics of oil prices on the global market

In May, Brent crude oil quotations went up by 3.1% to USD 69.32 per barrel.

Upbeat statistics about the US economy, coupled with ongoing vaccination of population and easing of quarantine restrictions, allowed oil prices break through the level of USD 70 in early June, reaching their two-year peaks.

Extra positive is reported after extension of the current OPEC+ oil production agreement, according to which 2.1 million barrels daily will be returned to the market during three months from May to July. Also, the International Energy Agency in its May report predicts an increase in oil consumption by 5.4 million up to 97.7 million barrels per day in 2021, based on positive expectations amid extensive vaccination campaigns.

Market participants closely followed negotiations of Iran concerning a nuclear deal. In the second half of the month, oil quotations significantly sagged against the background of a statement of the Iranian President about an intention of the Western countries to lift sanctions: over three trading sessions Brent lost more than 6% in price. However, comments of representatives of the US Department of State about existing challenges in negotiations with Iran cast a doubt on an imminent return of Iranian oil to the global market, and the oil price was adjusted.

Since early June, oil price has demonstrated positive dynamics amid continuing recovery in demand for hydrocarbons. In early June, oil price surpassed USD 72 per barrel for the first time since May 2019 after negotiations on a nuclear deal with Iran were postponed for a week. Along with that, despite continuing disagreements between the parties, likelihood of making the deal in the near future remains high.

In recent days, a correction in oil prices was reported after a period of significant growth amid weak statistics on oil imports in China.

Trend of the exchange rate of the national currency against the background of rising oil prices

In May, tenge gained 0.1% up to 428.71 amid rising oil prices. Additional positive factors for tenge included a tax week and an increase in investments of non-residents: during the tax period, exporters traded nearly USD 290 million on the stock exchange, and inflow of non-residents into government securities of the Republic of Kazakhstan made almost KZT 100 billion.

Quite insignificant strengthening of the tenge against the background of all the above mentioned positive factors was associated with an increased demand for foreign currency to pay dividends. Every year after annual audited statements are formed, companies convene a meeting of shareholders with an agenda covering payment of dividends. 2021 was no exception, most banks and companies in March – April made decisions on distribution of 2020 dividends. Need for payments in foreign currency, in particular, by one of the largest local banks, was a factor that contributed to an extra demand from the market in May.

In general, situation on the foreign exchange market was balanced, the National Bank did not conduct interventions in foreign currency market. In order to make transfers to the budget, USD 553 million were traded on the foreign exchange market, sales volume of the quasi-public sector amounted to nearly 340 million USD.

In June, KZT exchange rate continues its upward trend. Since the beginning of the month, the currency has gained 0.5% from 428.71 to 426.70 against the background of peak oil prices.

Condition of the international reserves

Gold and foreign exchange reserves at the end of May amounted to USD 36.5 billion, up by USD 2.2 billion since the beginning of the month. The increase in gold reserves is attributed mainly to a growth of the gold portfolio by USD 1.9 billion in conditions of recovery of the gold price from USD 1,769 to USD 1,892 per ounce (or up by 7%). Share of gold in reserves reached 67.7%. Rise in prices for the precious metal was triggered off by a decline in yield on US government securities and depreciation of the USD on a global scale.

Assets in freely convertible currencies soared by USD 311 million, including due to an increase in funds on deposits and accounts with the NBK by USD 297 million.

Dynamics of foreign exchange assets of the National Fund

According to updated data, at the end of May, foreign exchange assets of the National Fund amounted to USD 58.5 billion, up by USD 800 million for the month.

Growth of foreign exchange assets of the National Fund over the past month was associated with an increase in foreign exchange inflow and positive investment income. Foreign exchange inflow in May totaled USD 720 million. Significant level of income to the Fund is connected with recovering oil prices this year and period of large tax payments in May.

Due to continuing positive trend on the stock market, recovery of bond and gold values, investment income of the National Fund in May made around USD 660 million or 1.15%.

Along with that, in order to allocate guaranteed and targeted transfers in May in the amount of 251 billion KZT, the National Bank sold foreign exchange assets of the Fund for an amount of USD 553 million (equivalent to 237 billion KZT). At the same time, a part of the transfers was covered using balances on the KZT account and KZT inflows.

The measures to enhance role of the National Fund as a future generations fund

One of the core functions of the National Fund is to ensure accumulation of funds for future generations of Kazakhstan. In order to eliminate risks of ‘eating up’ the Fund, Concept of Formation and Use of Assets of the National Fund has prescribed a minimum threshold of resources at the Fund at the level of 30% of the GDP, i.e. in case of a decrease in assets of the National Fund below the threshold value, amount of transfers must be cut for a relevant amount.

One of sources of accumulation of resources for future generations at the National Fund is return on investments with a balanced level of risk of asset allocation. As I have already said in one of my previous interviews, during the crisis 2020 year the National Bank took measures to preserve invested assets of the Fund, in particular, prescription of a minimum threshold in stabilization portfolio of the National Fund as a ‘safety cushion’ for an amount of USD 5 billion and extension of a transition period from conservative to balanced asset allocation, avoiding investing in risky classes of assets at an unfavorable point of time.

Today, the National Bank continues its efforts to switch to balanced asset allocation and increase a share of more profitable asset classes. Since the beginning of 2021, investments in government securities of developing countries have been increased by USD 1.3 billion and investment-grade corporate bonds by USD 500

million. According to preliminary data for 5 months of this year, return on assets of the National Fund is USD 1.64 billion or 2.84%.

Moreover, the Government of the Republic of Kazakhstan and the National Bank have developed extra mechanisms to help ensure a saving function of the National Fund. Thus, starting from 2023, amount of a guaranteed transfer will be determined based on countercyclical budget rule.

The impact of early withdrawal of pension savings on the quality of investment portfolio of the Unified Accumulative Pension Fund

First of all, I would like to indicate that during the first five months of this year, profitability of pension assets was 5.3% with inflation of 3.5%. Thus, the return of 1.8% above inflation is provided for the UAPF depositors.

In line with instructions of the Head of State, the UAPF depositors have been granted the right to use a part of their pension savings before retirement to improve housing conditions, have medical treatment or to transfer to private investment management companies. As of May 31, 2021, volume of the early withdrawals totaled 1.4 trillion KZT.

Since the start of the early withdrawal of pension savings, we have seen a decrease in volume of monthly withdrawals: 643 billion KZT in February, 302 billion KZT in March, 283 billion KZT in April, and 179 billion KZT in May this year.

These withdrawals do not affect quality of the UAPF investment portfolio since it is mainly carried out at the expense of accumulated funds received from redemption of financial instruments and contributions from depositors.

Meanwhile, the National Bank continues active work to transform a foreign exchange portfolio, which at the end of May this year accounted to 32% of pension assets or nearly USD 9.5 billion. As part of the completed work, operations with foreign exchange financial instruments are carried out in order to bring structure of the current foreign exchange portfolio in line with prescribed strategic target distribution of assets, providing for an increase in investments in more profitable classes of assets. In particular, it is planned to invest up to 25% of the foreign exchange portfolio in equity instruments on global markets, up to 25% in bonds on emerging markets, and up to 20% in corporate bonds of investment grade.

Overall, the shift of the foreign exchange portfolio to the prescribed strategic distribution of assets will improve structural diversification by expanding geography of investment and range of financial instruments, as well as improve quality of the investment portfolio, its liquidity and profitability of pension assets in the long term.