

## **Keynotes of the interview by Akylzhan Baimagambetov, the NBK Deputy Governor on the results of forecast round for May – June 2021: acceleration of inflation, the reasons to retain the base rate, and improved forecast for the Balance of Payments**

### **Situation in the economy and the pace of its recovery**

The recovery processes in the real sector of the economy are observed very clearly, and I would not say they are slow, they are rather dynamic. After a significant decline in January – February 2021, positive economic growth rates were reported in March – April. Real GDP growth in January – April, 2021 has shown 0.7% in annual terms.

Accelerating growth rates are reported in manufacturing industry, which has grown by 7.7% year-on-year due to increased output in metallurgical industry, food production, mechanical engineering and pharmaceutical industry. Positive contribution to the economic growth was also made by information and communication sectors against the background of continued remote working and online learning (an increase of 11.1%, year-on-year), construction (12.5%, year-on-year) and agriculture (3.5%).

In the service sector, there is a recovery in trade and transport, which is facilitated by easing of quarantine restrictions and a gradual recovery in external demand. In January – April 2021, growth rate in trade was 5.7% (year-on-year), rate of decline in volume of transport services slowed down to (-) 9.0% (y-o-y).

Along with that, decline in the mining industry (down by 6.3% y-o-y) continues to exert negative effect due to falling production of crude oil and gas condensate as part of the OPEC+ agreement to limit oil production amid a high base at the beginning of last year.

Recovery in consumer demand is facilitated by growth in real wages amid improved business activities in economic sectors, as well as growth in budget spending on pensions and scholarships. At the end of quarter 1, 2021, growth of real incomes of the population made 3.4% in annual terms. Expansion of consumer demand is also traced in accelerated dynamics of retail trade, a significant increase in consumer imports, in particular in non-food products, and high growth rates of retail lending. Large-scale vaccination and easing of quarantine restrictions have a positive effect on demand.

Despite declined investments in mining industry in the 1<sup>st</sup> Quarter, 2021, investment activities in other economic sectors remain in a positive zone. Significant acceleration of investments was indicated in chemical industry (2.3-fold),

metallurgical industry (by 54.1%), communications (by 62.7%), and agriculture (by 54.8%).

Dynamics of investments in housing construction maintain high growth rates, which is supported by implementation of government mortgage lending programs and implementation of the initiative of the Head of State to enable early withdrawal of the pension savings above the established threshold in order to improve housing conditions.

Given faster economic recovery, the National Bank has improved its forecasts for economic growth. Faster recovery in business activities is expected as well as an increase in household income, which will contribute to expansion of cumulative demand, which will trigger off economic growth. Along with that, restraining influence on GDP dynamics will be exerted by restoration of imports. Export recovery is expected in the second half of this year as a result of an increase in oil production since OPEC+ restrictions are softened and external demand for Kazakhstan's export goods grows. Moreover, budget expenditures were revised upwards this year. In turn, a more positive fiscal impulse will contribute to recovery of domestic demand, thereby exerting an upward influence on both economic growth and inflationary processes.

Compared to forecast round for February – March 2021 we have revised oil price in the base-case scenario. Thus, currently, global prices for Brent crude oil are above USD 70 per barrel, which is due to recovering global oil demand in conditions of mass vaccinations and operation of the OPEC+ agreement to cut oil production. However, as global production gradually increases, oil price will fall from its current values, and the National Bank considers price of Brent crude oil USD **60** per barrel in 2021 – 2022 as a base-case scenario, which is consistent with forecasts of international organizations.

In line with the base-case scenario, with the specified oil price in 2021, economic growth of Kazakhstan is expected at **3.6 – 3.9%**, with a further improvement up to **4.0 – 4.3%** in 2022.

### **Changes in forecast round and the realized forecast risks thereof**

A number of risks associated with higher actual inflation have come true. Thus, rising prices for fuel and lubricants and electricity, further growth in prices for food products, higher consumer demand against the background of an increase in real incomes of the population and a recovery in consumer lending, and an increased inflationary background from Russia contributed to accelerating inflation up to **7.2%** in May 2021.

Due to occurrence of these factors as well as increased budget expenditures in 2021, we have revised inflation forecasts in 2021 – 2022 upward.

Compared to a previous forecast round, risk profile has slightly deteriorated, which indicates that inflation risks deviating from the base-case scenario are at a higher level.

Among external risks, I would like to mention plummeting oil prices due to a worsening epidemiological situation in the world, growing food prices and an abrupt switch to tighter monetary conditions in developed countries. Among the internal risks, there are risks from inflation in demand and supply, implementation of which may entail a significant acceleration of inflation both in the short and medium term.

### **The key factors for inflation**

After some stabilization early this year, in May there is an acceleration of inflationary processes to 7.2% in annual terms. Significant increase in prices for non-food products and paid services was partially offset by disinflation of a food component.

Annual growth in prices for food products continued to slow down and made 9.3% in May, which is associated with an exit from calculation of high monthly inflation data in 2020. Despite disinflationary processes, the trend of price growth persists in some commodity markets (sunflower oil, sugar, lamb). In January – May 2021, growth in food prices was 4.9%. Additional pro-inflationary pressure is exerted by growing global food prices amid recovery in demand and limited supply.

Annual non-food inflation speeded up to 6.7% in May as a result of continued growth in prices for fuel and lubricants, clothing and footwear. Rise in the cost of fuel and lubricants is attributed to increasing production costs (production and transportation), recovery in economic activities and delayed effect of changes in an excise rate in 2020. It is also necessary to mention a differential of prices for gasoline with neighbor countries since a level of gasoline prices in Russia and Kyrgyzstan is much higher than in Kazakhstan. Acceleration of an annual growth rate of prices for clothing and footwear takes place amid rising import prices and a gradual recovery in consumer demand.

In May 2021, annual growth in prices for paid services rose up to 5.1%. The acceleration of service inflation was attributed to an increase in electricity tariffs and an increase in prices for certain services amid increased demand in conditions of easing quarantine restrictions and mass vaccination of the population.

I would like to point out that amid a rapid recovery in consumer demand and increasing prices for certain consumer goods and services, according to our estimates, this year inflationary processes will slow down at a slower pace. In this regard, the National Bank has revised its short-term and medium-term inflation forecasts.

A further slowdown in food inflation is expected, which will be associated with withdrawal from calculations of high values of 2020. At the same time, non-food and service inflation will continue to accelerate amid recovery growth in domestic consumer demand and a slight increase in external inflationary background. These factors are not yet stable and depend on epidemiological situation worldwide and in Kazakhstan, the National Bank closely monitors dynamics and nature of these risks. Thus, given the occurred jump in gasoline prices, growing electricity prices, stronger fiscal stimulus and heightened inflation expectations, **inflation by the end of 2021 will form slightly above the target range.**

During 2022, inflation will continue to decelerate, staying closer to the upper bound of 4 – 6% during 2022. Its slowdown will take place against the background of weakening of external inflationary pressure as a result of failure of inflation in China and the EU to reach their target levels and formation of inflation in Russia close to the target level. Gradual decline in global food prices is also expected after their significant growth in recent months.

### **The influence of external factors, including possible tightening of monetary conditions in developed economies, particularly the FED, due to a risk of a more stable nature of inflationary processes**

An increased inflationary background is currently reported worldwide. Acceleration of inflationary processes is taking place not only in the United States but also in many other countries. For example, in China, Producer Price Index, which is a main focus when deciding on monetary policy, after negative dynamics last year in April 2021, rose up to 6.8% (y-o-y). Consumer price growth in Europe accelerated to the target value of 2.0% in April 2021 (y-o-y) from 0.2% in December 2020. Along with that, an increase in price surge was reported in almost all large European countries (Germany, Italy, France).

Against the background of ongoing active vaccination and easing of the quarantine measures, economic situation in developed economies is recovering. The US economy, after a last year's drop in the first quarter of 2021, grew up by 0.4% (y-o-y). In May 2021, business activities in industry and services reached all-time high values. Situation on the US labor market as a whole also demonstrates positive indicators. Since the beginning of the year, unemployment rate has dropped from 6.3% to 5.8%.

Recovery in the US consumer demand is creating pro-inflationary pressures. Consumer inflation accelerated to 4.2% y-o-y from 1.4% at the beginning of the year.

In conditions of recovery of business activities and acceleration of inflationary processes, central banks of developed economies are signaling a possible reduction in monetary stimulus. Thus, within the framework of the forecast round for May – June 2021, gradual withdrawal of stimulus measures by large central banks and a smooth transition to a neutral monetary policy were laid down as preconditions for external monetary conditions.

### **The reasons to retain the base rate unchanged despite certain opinion of experts to increase it**

Currently, the effect of pro-inflationary factors in the economy really prevails. External inflationary pressure is attributed to the rise in global food prices and acceleration of inflation in trading partner countries of Kazakhstan. In the domestic sector, main influence on acceleration of inflation is exerted by growing prices for fuel and lubricants and increase in tariffs of energy generating organizations.

In this connection, these pro-inflationary factors in conditions of instability of inflationary expectations increase likelihood of secondary inflationary effects, causing an increase in the general inflationary background, which may slow down decline in inflation.

Nevertheless, next year we expect that effects of internal pro-inflationary factors will exhaust and external inflationary pressures will weaken.

Thus, the National Bank has decided to retain the base rate at 9%. This level of the base rate still allows maintaining control over inflation and ensuring its systematic reduction in the mid-term.

I would like to highlight that the National Bank closely monitors situation in the external sector and the domestic economy and, and if there is more sustained pressure from pro-inflationary factors in the future and slower disinflation compared to forecast estimates, the NBK is ready to raise the base rate.

### **Improvement in the structure of foreign trade against the background of deficit in Balance of Payments**

Trends in the external sector indicate an improvement in the balance of payments indicators for this year. We expect that the current account deficit with an oil price

of USD 60 per barrel will almost halve from USD 6.3 billion in 2020 to USD 3.6 billion in 2021. With an average annual price of USD 65 per barrel, the deficit, according to our estimates, will be further reduced fourfold down to USD 1.5 billion in 2021. Keeping oil prices at USD 65 per barrel and above next year will result in a near-zero deficit by the end of 2022.

Improvement of the situation during this year is mainly due to growing exports of goods. According to our base-case forecasts, merchandise exports will increase by 20.2% to USD 56.2 billion. Increase in the export of goods will be ensured by growing prices for key products of Kazakhstan's export (oil, ferrous and non-ferrous metals, gas, uranium, grain) due to recovery in the global demand.

We expect that recovery in economic activity, as well as implementation of large investment projects, mainly in mining and manufacturing industries, will support import of interim and investment goods. Recovery in purchasing power will also contribute to growth of import in consumer goods. Collectively, import will rise by 5.3% up to USD 38.1 billion.

Economic transformations intended to diversify domestic production will contribute to positive shifts in changing a structure of foreign trade.

As per the Balance of Payments, it is vital to reach the goals and objectives of building up non-resource exports and reducing dependence on imports as set out in three-party Agreement for 2021 – 2023 signed between the Government, National Bank and Agency for Regulation and Development of the Financial Market. We look forward to successful implementation of these measures since the potential effect on trade balance can drastically improve the current account of Balance of Payments in the medium term.