

Keynotes of NBK Deputy Governor Aliya Moldabekova on Tenge Exchange Rate and Development of the Emerging Markets: 2021 Preliminary Results and 2022 Prospects

2021 has not been the easiest year for the Emerging Markets despite optimism and expectations at the beginning of the year. However, early 2022 turned out to be a shock for the entire Kazakhstan and for its financial market. Under the emergency conditions, National Bank of Kazakhstan has managed to quickly restore banking services for the population, money and foreign exchange markets functioning.

About NBK measures to stabilize the situation on the money and foreign exchange markets in the conditions of state of emergency in the country

Since the first days of stabilization of the situation in the country, the National Bank has taken all the necessary measures to restore regular functioning of the financial markets.

First, starting from January 7, key banking services for the population were gradually restored.

Second, operations on the money and stock markets resumed on January 10. The National Bank resumed their daily operations with STBs to provide and withdraw liquidity. In order to prevent liquidity risks in the banking sector, the National Bank started providing liquidity on the repo and swap markets for longer periods: 7, 30 and 90 days.

Moreover, as the situation settles down, work is underway to uninterruptedly reinforce the market with cash in foreign and national currencies.

Third, trading on the foreign exchange market was launched on January 12. The National Bank expected an increased demand for foreign currency and its limited supply in the first days after the trading resumed. Therefore, the day before opening of the foreign exchange market, we stated our readiness, against the background of unprecedented events that had taken place, to carry out foreign exchange interventions in order to prevent speculative pressure on tenge.

Indeed, given almost week-long absence of foreign currency trade, an accumulated demand for foreign currency has formed both on the part of business and households. The situation was aggravated by the fact that against the background of the events that had taken place and uncertainty about the further movement of the tenge exchange rate, number of currency sellers was **drastically limited**. In order to prevent risks of financial stability and destabilizing fluctuations, the National Bank carried out foreign exchange interventions. For January 12 and 13 their volume amounted to USD 240 million or nearly 50% of the total trading

volume. From the beginning of the year until January 13, against the background of the increased demand for foreign currency, tenge depreciated by 0.5%, to 433.67.

Currently, operation of the financial market has been completely restored, transactions are made in a 'business-as-usual' manner.

About the main results of 2021 for financial markets and the factors that influenced the markets in December 2021

Investor expectations supported by optimism related to a widespread rollout of the vaccination process were quite upbeat in early 2021, especially in relation to EM countries. However, summing up results of the year, we can conclude that this optimism **failed** to meet expectations.

Unprecedented measures of monetary and fiscal support have become the key drivers for global economic growth and improvement in dynamics of financial markets. However, along with that, these measures have also become the factors of persistent and high inflation worldwide.

Moreover, the emergence of new coronavirus strains and also the slow pace of vaccination have entailed compulsory recurrent lockdowns and disruption of global supply chains, which also led to higher global prices and negatively affected dynamics of the assets of emerging markets in 2021. The MSCI Emerging Markets (EM) Index posted a 4.6% year-over-year decline, significantly lagging behind the developed markets.

One of the few asset classes that demonstrated significant growth in 2021 was the equity market of developed countries in conditions of continued large amount of liquidity due to fiscal and monetary support measures. The MSCI World Index soared by 22.4% for the year. Against the background of strengthening US dollar, returns of global government bonds indices of developed countries was negative and accounted to (-)3.5%, while the corporate bond index dropped by 3.1%.

Inflation in the United States in December 2021 reached 7% year-on-year, a record high over the past 40 years. Rising inflation in the United States has caused increased concerns about a more rapid curtailment of support measures by the US Fed and the transition to tightening of the monetary policy. Financial market participants expect the first US Fed rate hike in March. As a result, there was global strengthening of the US dollar and an increase in treasury bond yields. At the end of the year, the US dollar Index (DXY) showed a significant strengthening by 6.4%, which is the highest appreciation over the past 5 years. Emerging market currencies demonstrated an opposite trend with the EM Currency Index weakened by 9.25%.

Since the beginning of this year, there have been no major changes in the emerging market currency index. However, I would note that yesterday the exchange rate of the Russian ruble lost 2.2% of its value from 74.7 to 76.3 rubles per dollar after the negotiations between NATO and Russia on the situation in Ukraine ended with no results.

About the situation on the oil market and the key factors that influenced the price trend in 2021

In general, at the end of the year, dynamics of the oil prices revealed an impressive recovery, +50.2% for the year, a record growth since 2009. In 2020, the main driver in the ‘black gold’ market was the supply, in particular, the quotas of the OPEC+ alliance, meanwhile in 2021 the focus shifted to the demand side, due to a **gradual recovery** of the global economy, which became the key driver of growth.

In the last month of the year, oil prices somewhat won back the November slump, oil price recovered by 10.2% month-to-month, to USD 77.78 per barrel. Reports of milder symptoms of the new Omicron strain as well as declining U.S. oil inventories have exerted a positive impact on oil prices.

In January 2022, prices in the oil market continued their rise. The OPEC+ alliance has decided to follow the previously agreed production increases of +400,000 bpd. However, investors expect production growth to lag behind the approved limits, with countries such as Libya, Nigeria and Russia failing to meet production quota gains in previous months. In this conditions, oil prices are at a high level of USD 84 per barrel.

About the key factors that affected tenge exchange rate in 2021 and the situation on the currency market in December 2021

From late November until the first days of December, against the background of news about the Omicron strain and the collapse of oil prices down to USD 65.7 per barrel, tenge was under strong pressure from non-residents, increased demand from the population and legal entities. In December, trading volume reached record high of USD 4.26 billion.

Against the **background of a global outflow of capital** to developed countries, the exit of foreign investors from tenge carry positions intensified in December and was reflected in a higher demand for foreign currency. Over the month, investments by foreign investors shrank by significant 200 billion tenge (about USD 452 million). Thus, according to our calculations, for the last two months of 2021, volume of demand for foreign currency from non-residents to close the positions in tenge accounted to USD 1.1 billion.

Boosted activity in the foreign exchange market in December was also caused by a growing demand from enterprises and households. By the end of the year, companies were in the active phase of budget development, payments, which supported demand for imports, and, consequently, for foreign currency. Demand for foreign currency in cash from the population, according to our calculations, in December totaled at least USD 30 million daily.

Situation on the foreign exchange market on certain days of December was featured by a high demand and extremely **limited** supply. We have already indicated the interventions by the National Bank in early December. On December 2 and 3, in order to stabilize the situation in the foreign exchange market against the background of significant demand from non-residents, the National Bank conducted foreign exchange interventions. Also, on the last day of December, against the background of growing demand and absence of foreign currency sellers, in order to prevent destabilizing tenge fluctuations, the NBK made foreign exchange interventions. Overall, the National Bank interventions in December 2021 amounted to USD 252 million.

On the other hand, tenge was supported in December by operations to convert funds of the National Fund with a view to allocate transfers to the budget and the sale of foreign currency by the quasi-public sector. Supply of foreign exchange was also supported by exporters' sales during the December tax week. At the end of the month, tenge rate moderately appreciated to 431.80 or by 0.6%.

In general, in 2021, tenge depreciated by 2.6%, despite the increase in the oil prices. I will focus on key reasons for growing demand for foreign currency.

1) The main reason is the growth of imports amid pent-up demand and recovery of the economic activity. Key pressure on the foreign exchange market is exerted by imports of consumer goods. According to preliminary data, for 11 months of this year, imports of consumer goods increased by USD 2 billion or +22% as compared to 11 months of 2020 and by USD 2.4 billion or +27% versus the same period of pre-pandemic 2019.

Imports of intermediate goods and capital goods are partly financed by foreign investments. Therefore, its impact on the foreign exchange market is less significant.

2) Growth of the monetary base. Expansion of the monetary base increases the money supply through consumer lending, which ultimately leads to an increase in imports of consumer goods. Against the background of the allocation of funds as part of the anti-crisis measures and concessional lending programs, the monetary base expanded by 1.6 times since the beginning of 2020, to 11.0 trillion tenge, the growth amounted to 4.1 trillion tenge.

3) Implementation of an initiative of the Head of State on early withdrawal of pension savings has allowed a lot of citizens to improve their living conditions and settle the previously taken mortgage loans. However, it should be noted that final recipients of these funds, particularly construction companies and individuals who sold real estate, directed on average about 40-50% of the funds received (USD 2.5-3 billion) for imports and foreign currency. In case of construction companies, this included import of building materials and equipment, and in case of individuals, this is consumer imports and purchase of foreign currency.

4) Growth in dollar deposits. Despite the fact that the level of dollarization at the end of 11 months of 2021 remained practically unchanged and is at the level of 37.2–37.3%, there is an increase in the volume of foreign currency deposits by 1.4 trillion tenge. At the same time, about 250 billion tenge was currency revaluation due to depreciation of the exchange rate in the reviewed period. Real increase in deposits in foreign currency was 1.1 trillion tenge, or USD 2.6 billion.

5) Pressure against tenge was exerted by tightening of the monetary policy in developed countries, the strengthening of US dollar and outflow of capital from emerging markets. As I have already mentioned, the EM currency index weakened by 9.25% in 2021.

However, I would like to point out that in general, 2021 was marked by a slight net increase in interest of non-residents in Kazakhstan's securities. Thus, the share of non-residents in government securities of the Republic of Kazakhstan increased from 3.13% to 4.26%. Volume of their investments surged from 413 billion tenge in early 2021 to 863 billion KZT in October 2021, with a further decrease in November-December to 595.5 billion KZT.

About the impact of interventions on the volume of gold and foreign exchange reserves of NBK in December 2021

Gold and foreign exchange reserves in late December amounted to USD 34.4 billion, which is USD 1.1 billion down since the beginning of the month.

The gold portfolio, which in 2021 exceeded 400 tons for the first time reaching 402.4 tons, or USD 23.5 billion. A slight increase in gold prices in December by 1.3% to USD 1,820 per ounce was a result of fears of accelerating inflation in the US. However, the Fed's rhetoric and accelerated tapering of the asset purchase program limited further increase in value of the precious metal.

As a result, gold reserves contracted due to a foreign exchange part of the assets, which diminished by 1.1 billion because of payment of the sovereign debt obligations, operations on government accounts and correspondent accounts of the National Bank clients as well as carrying out our foreign exchange interventions.

About the factors that affected the volume of gold and foreign exchange reserves in 2021

According to preliminary data, at the end of 2021, the foreign exchange assets of the National Fund made **USD 55.3 billion** demonstrating an increase by USD 404 million in December.

First of all, it should be indicated that in November 2021 there was a significant market correction due to discovery of a new Omicron strain. However, as early as in December, market participants were **more optimistic** amid a move away from practice of large-scale lockdowns. As a result, at the end of December, there was a recovery in the financial markets. Investment income of the National Fund in December was positive and totaled USD 916 million.

Simultaneously, in order to allocate guaranteed and targeted transfers in the amount of 368 billion KZT, assets worth USD 839 million were sold on the foreign exchange market last month.

Overall, against the backdrop of withdrawals of transfers to the republican budget, assets of the National Fund in 2021 decreased by USD 3.4 billion.

Last year, in order to ensure allocation of transfers to the budget for 4.5 trillion KZT, foreign exchange assets worth 9.6 billion dollars were sold from the National Fund. Foreign currency inflows to the fund for the year amounted to USD 3.9 billion.

About the market expectations in 2022

Future situation with COVID-19, trajectory of the monetary policy of the US Fed and other central banks, accelerating inflation worldwide are the main factors to determine dynamics of the markets in 2022.

The recovery of global economy **continues**, with the OECD expecting global GDP growth of 4.5% in 2022. According to the December forecast of the National Bank of Kazakhstan, the economy of Kazakhstan will grow by 3.9–4.2% this year with an average annual oil price of USD 70 per barrel.

I would also emphasize the factors that have a direct impact on our foreign exchange market. First, one of the fundamental factors for tenge is the oil price, dynamics of which continues to be sensitive to the situation with COVID-19. According to most analysts, the prospects for the oil market remain positive: gradual recovery in demand will continue, which, given the observed slight shortage of oil supply, means a surge of prices for ‘black gold’. An important role will be played by further policy of the OPEC+ countries and the pace of increasing production. However, the risks of worsening situation with COVID-19 and lifting

of the US embargo on export of the Iranian oil remain crucial for the energy market.

Second, future policy of the US Fed remains one of the essential topics in the global financial markets. As previously mentioned, after the last meeting, expectations for an early rate hike have increased **significantly**. The market is already considering forecasts of not three but four rate hikes in 2022.

The US Fed's rate hike is a negative factor for emerging markets which entails the strengthening of US dollar and, as a result, capital outflow and an increase in the cost of borrowing for the EM countries. But on the other hand, some analysts indicate that global USD improvement in 2021 has already set expectations for the scenario of a faster-than-expected rate hike scenario. Therefore, we do not expect significant strengthening of US dollar provided that the current background persists on the financial markets.

The determining internal factors for tenge will be further dynamics of de-dollarization/dollarization of deposits and a state of the balance of payments. Despite the fact that the oil prices have risen and they boost Kazakhstan's exports, imports also continue to grow and **put the pressure** on tenge. Dependence on imports is one of the reasons that limit the de-dollarization of the population and business.

I would like to underline that Head of State pays special attention to make the monetary policy more efficient and clearly highlighted an important role of ensuring stability on the foreign exchange market for sustainable economic growth. Joint efforts of the Government and the National Bank in 2022 and in the medium term will be focused to mitigate import dependence, stabilizing and reducing inflation to a level of the target corridor, which will contribute to balance and stability on the foreign exchange market.