

*Keynotes of NBK Deputy Governor
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Regarding Dynamics of Tenge Exchange Rate
and the Recent Trends in the Financial Markets*

The key events that affected dynamics of foreign markets in July

July was a month of new record highs and lows in financial markets. Inflation in the US hit a 40-year high again, making 9.1% y/y in June. As a result, risks of a faster rate hike by the US Fed, coupled with investors' fears about a global recession, supported USD dominance on foreign exchange market until mid-July. In these conditions, in the first half of the month, the Euro briefly reached values below parity for the first time in two decades, the Japanese yen fell down to the 1998 levels, and EM currencies also sustained pressure.

However, by the end of the month, a meeting at the US Fed which decided to raise the rate by 75 bp to 2.25–2.5% was one of the turning points for the USD dynamics. Rhetoric during J.Powell's speech was perceived by global investors as relatively 'soft', which supported the risk sentiment, caused an increase in risky assets and weakened the USD growth. As a result, the MSCI (Emerging Markets Currency Index) fell by 2.4% for the month. The stock market showed a strong positive trend in July, while the global MSCI index rose by a significant 7.9%, which is a maximum increase since November 2020.

Another notable event in July was the ECB meeting resulting in raising the rate by 50 bp. Thus, the regulator ended the era of negative rates, which had been going on since 2014. However, a shift from negative rates is complicated by serious risks of economic crisis in the region. Despite positive growth of the eurozone economy in the second quarter (+0.7% q/q), business activity indicators signal deterioration in the outlook for the EU economy. Thus, aggregate PMI fell to 49.9. In the US, released data on negative economic growth for the second quarter in a row by (-)0.9% q/q provoke an enormous controversy about whether the current situation may deem a recession. In China, Purchasing Managers' Index in manufacturing industry fell to 49 points, which also indicates a transition from growth to decline.

As a result, increased concerns about the global economy in July had a negative impact on the commodity market, including oil. Oil prices declined by 4.2% for the month, losing most of the gain caused by the geopolitical conflict between Russia and Ukraine. For the first time since April, the oil price on some days fell below USD 100 per barrel.

In early August, prices for 'black gold' fell below USD 95 again amid the concerns about prospects for fuel demand. Following a meeting on August 3, the OPEC alliance decided to increase production by 100,000 barrels per day in total, the delegates voiced their concern about a potential recession in the US and China's quarantine restrictions.

The key factors of influence on tenge exchange rate and situation on the foreign exchange market

According to the results of the month, the tenge exchange rate moderately weakened by 1.5% to 477.07. Both external and internal factors contributed to these dynamics.

It is necessary to indicate declining oil prices for the second month in a row. Moreover, aggressive rate hikes in the US continue to put pressure on the national currency, as well as on the EM currencies.

As for internal factors, the ongoing period of holidays and dividend payments by companies facilitated an increase in demand for foreign currency during the month. Thus, the average daily trade volume rose in July to USD 118.6 million against USD 96.4 million in the previous month. By the end of July, the tenge slightly recovered and reduced the weakening pace thanks to tax payments from exporters. The exchange rate was supported throughout the month by sales of quasi-public sector entities in the amount of USD 543.9 million, as well as sales of foreign currency to secure transfers from the National Fund of the Republic of Kazakhstan in the amount of USD 599.2 million. The National Bank did not make foreign exchange interventions.

The dynamics of international reserves

According to preliminary data, volume of gold and foreign exchange assets in late July amounted to USD 32.8 billion with a USD 835 million increase for the month. In July, we witnessed an expansion in the foreign currency part of the international reserves due to a gain in volume of correspondent accounts of second-tier banks with the National Bank, which served as a main factor for growth of gold reserves. Gold prices partially leveled off this effect. Thus, due to a 3% decline in a price for the precious metal from USD 1,814 to USD 1,759 per ounce, the 'gold portfolio' declined. It is necessary to indicate that during the month, gold price reached USD 1,687 per ounce.

We are accustomed to perceive gold as a defensive asset, demand for which emerges when the risk sentiment of global investors worsens, which is caused by escalation of geopolitical and macroeconomic risks. However, currently, gold has come under pressure from a number of equally important factors, including tightening of monetary policy by a number of central banks against the background of accelerating global inflation.

The National Fund

It is no secret that in 2000, when the National Fund was established, the Norwegian experience was taken as a reference. The Norwegian Fund, like the National Fund of Kazakhstan, is funded by oil excess profits, and funds are invested worldwide. Particularly, Government Pension Fund of Norway today exceeds the USD 1 trillion mark and remains a benchmark not only for the National Fund, but also for most sovereign funds around the globe.

Purpose of the National Fund is to ensure social and economic development of State through accumulation of financial resources for future generations, as well as

to reduce reliance of economy on the oil sector and on adverse external factors. Accordingly, the functions of the National Fund are saving and stabilization.

Implementation of the stabilization function involves provision of transfers to the republican budget. Regular transfers, in turn, require maintaining a high level of liquidity in portfolio. Consequently, assets of the stabilization portfolio are invested in money market instruments, mainly short-term US Treasuries.

Saving function implies saving and preserving funds for future generations. Along with that, due to volatility in the financial markets, current value of assets of the National Fund may fluctuate. Accordingly, the purpose of savings portfolio is to provide long-term returns with a moderate risk level.

For a long time, strategic allocation of assets of the savings portfolio has contained 80% bonds of developed countries and 20% shares of companies in developed countries, which is very conservative in the context of global practice.

Since 2019, the National Bank has undertaken a switch to a new balanced asset allocation designed to improve long-term investment returns with a moderate risk level. The new allocation involves an increase in shares up to 30%, as well as building of portfolios of gold and alternative investment instruments up to 5%. Moreover, it is planned to increase asset diversification in the bond portfolio by investing in the investment-grade corporate bonds up to 10% and in the EM bonds up to 21%.

This transition is expected to be completed by the end of 2022. As a result, we expect potential average annual return of the National Fund to grow by 1% over the long term.

The factors affecting the volume of foreign exchange assets of the National Fund in July

According to preliminary data, in July, volume of foreign currency assets of the National Fund totaled USD 53.1 billion, growing by USD 1.2 billion for the past month.

Last month, 518 billion KZT were allocated from the National Fund to the republican budget as transfers. Part of the transfers was allocated using balances in tenge account of the National Fund as well as the tenge receipts to the fund. Moreover, assets worth USD 599.2 million were sold on the domestic foreign exchange market, equivalent to 288 billion KZT.

Currency receipts to the fund in June made USD 582 million.

Last month's results reveal that investment income of the National Fund was positive and totaled USD 1,240 million, mainly due to partial recovery of the stock market. At the same time, long-term profitability of the National Fund since its establishment is 3.17% in annualized terms.

The further prospects for development of situation in the financial markets

In July, we witnessed a convincing reversal of the USD dynamics on the global currency market after the Fed's meeting, which once again stresses the importance of signals from the US regulator. During the July meeting, the Federal Reserve governor stated that the committee would make decisions depending on incoming

data without clear instructions on further steps, while indicating the possibility of slowing down the rate hike at the next meetings. Along with that, Jerome Powell pointed out that the Dot Plot of committee members is the 'best guide' for the interest rate trajectory. Therefore, judging by recent June Dot Plot, rates are expected to get another 100 bp, to 3.25-3.5%, by the end of 2022 during the remaining 3 meetings.

As for recession, release of GDP data for the second quarter probably marked the onset of a technical recession in the US – negative economic growth for two or more consecutive quarters. However, a lot of US officials disagree with this thesis, including the president, Fed governor and secretary of treasury, since the official definition of recession implies a subjective judgment about decline in economic activities, which is noticeable in dynamics of several indicators (GDP, employment, real income, industrial production, etc.). However, since 1948, all 10 cases of two consecutive negative economic growth indicators were later declared as recessions in the US. As a result, a self-contradictory situation took place, in a sense similar to Schrödinger phenomenon, when two opposite facts can coexist.

Under these conditions, the fears about growth of global economy and further rate hikes by the US Fed do not add optimism regarding the prospects for risky assets and EM currencies, which may also put pressure on tenge.