



NATIONAL BANK OF KAZAKHSTAN

# Inflation Report

The Second Quarter of 2018

Almaty, Kazakhstan

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**The Inflation Report** is a quarterly publication of the National Bank which contains the analysis of key macroeconomic indicators affecting inflation as well as the forecast of macroeconomic parameters in the short- and medium-term horizon.

The Report is published in an electronic form on the official Internet-resource of the National Bank in the Kazakh, Russian and English languages.

The forecast of macroeconomic indicators was prepared on the basis of statistical information as at 16.08.2018.

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## SUMMARY

Since the time of the previous Inflation Report for the first quarter of 2018, the National Bank twice made the decision regarding the base rate. Each time the base rate was retained at 9.00% with the unchanged interest rate band of +/-100 basis points.

In August 2018, inflation in Kazakhstan was 6.0%, which corresponds to the mid-point of the target band of 5-7%. According to the National Bank's assessments under the baseline scenario which assumes the oil price (Brent) to be at USD 60 per barrel throughout the entire forecast horizon, the balance of risks shifted towards the surge of inflation factors. The most recent forecasts demonstrate a slower deceleration of inflation as compared to those expectations which were published in two prior issues of the Inflation Report. This poses the risks that inflation targets will not be achieved on the medium-time horizon in the environment of decreasing inflation targets for 2019 and 2020. Based on the results of the "August-September 2018" forecast round, under the baseline scenario the annual inflation in Kazakhstan in 2018 will be within the target band of 5-7%, and in 2019 – near the upper boundary of the interest rate band of 4-6%.

The adjustment of inflation assessments was driven by the impact of both internal and external factors.

From the second quarter of 2018, the situation in the global markets is characterized by the escalation of trade conflicts; the increasing tension had translated into the slowdown in the growth rates in trading partner countries, particularly in China and the EU. Amidst the escalation of trade conflicts and sanction wars as well as the expected tightening of the external monetary environment, currencies of trading partner countries were depreciating. As compared to prior assessments, the National Bank's assumptions regarding the external environment have not changed significantly and a positive growth pattern will be retained. However, the assessment of external inflationary background was revised upwards.

The exchange rate of the tenge is under the pressure of depreciation of the Russian ruble and other currencies of developing countries and of the tightening of external monetary conditions.

Perception of inflation and inflation expectations in Kazakhstan demonstrate a long-term downward trend. Based on the most recent assessment of August 2018, a quantitative value of inflation expectations was set at 5.9%. In the near term, they remain sensitive to the existing factors, and depreciation of the tenge in April and in August of this year served as such factor.

According to updated forecasts made by the National Bank, under the baseline scenario the growth of Kazakhstan's real GDP will account for 3.5% at the end of 2018. Assessment of the dynamics of economic activity in 2018 has not changed as compared to the previous forecast round. The consumer and investment demand will serve as the main growth factors on the near-term horizon. Positive dynamics of the consumer demand will be observed against the increasing cash income of the population and positive trends in the consumer lending. The upturn in the investment demand will be accompanied both by expansion of fixed capital investments given the project implementations in the mining industry as well as positive growth rates of investments in residential construction. The increase in production of oil and gas condensate in the Kashagan oil field will be conducive to the positive dynamics of exports.

In the medium term, the economy will be growing at a more moderate pace given the expected deceleration processes in the dynamics of consumer demand and exports. Under the baseline scenario, the economic growth in Kazakhstan at the end of 2019 will account for 2.6%.

The National Bank continues to assess the output gap as positive, which also explains a slower deceleration of inflation. In the medium term, the output gap will be in a weakly positive, disinflation zone till the end of first quarter of 2020.

Monetary conditions in Kazakhstan, according to the National Bank's assessment, remain neutral and do not affect the inflation and output gap. However, given depreciation of the tenge which was observed during the recent months as well as in the case if assessments about a slower deceleration of actual inflation as compared to its earlier forecast come true, the National Bank does not exclude possibility of tightening of monetary conditions before the end of this year with a view to minimize risks associated with the upsurge of negative expectations.

The upcoming decision regarding the base rate is expected on October 15. The next forecast round is scheduled for November and its results will be published in the next Inflation Report in December 2018.

## I. MACROECONOMIC ENVIRONMENT AND THE FINANCIAL SECTOR DEVELOPMENT

### 1. EXTERNAL MACROECONOMIC ENVIRONMENT

#### 1.1 Situation in the Global Commodity Markets

##### 1.1.1 Oil Market

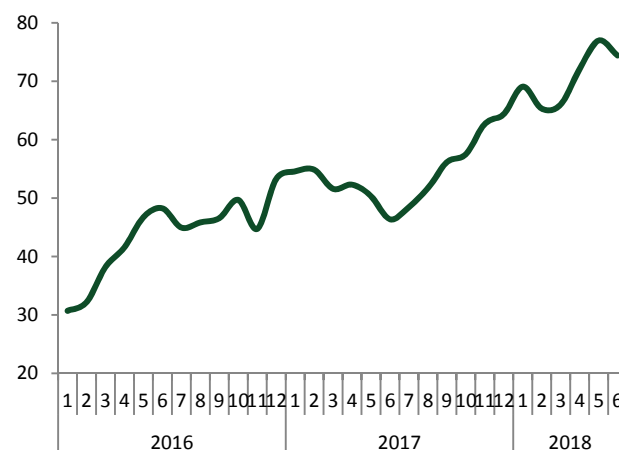
At the end of the second quarter, the average price of oil (Brent) had been at USD 74.5 per barrel (Figure 1). The price went up by 11.5% versus the previous quarter and one and a half times versus the corresponding quarter of 2017.

The oil pricing was setting at the above points amidst a minor rise in the global reserves which occurred because of the slowing growth rates of the global demand as well as the increasing volumes of crude oil production (Figure 2).

The growth rates of the global demand were slowing down due to the reduced consumption of oil in key importing countries, namely in the USA, China, the EU member countries and India. Many analysts correlate the main reason for the slowdown in the demand with a high oil price. Meantime, other factors were also under way. So, in China a slowdown in the demand was caused by the shutdown of some oil refineries as a result of technical maintenance and of strengthened control by the government in its effort to struggle tax evasion. In the USA, the demand slowed down because of the beginning of tropical storms in the south-east of the country. Analysts put together the slowing demand in the EU and in India and the decline in imports from Iran given the earlier sanctions imposed by the USA (Figure 3).

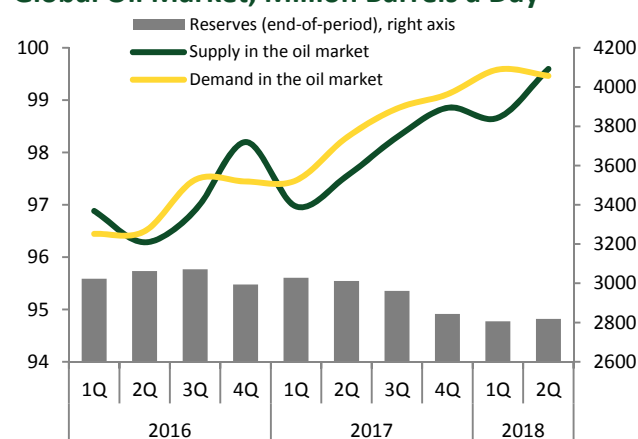
Volumes of the global oil production went up by 2.6% in the second quarter as compared to the corresponding quarter of the last year (Figure 4). The main contribution to the growth in the global production was secured by countries outside of OPEC where the overall oil extraction has risen by 4.3%. Since the second quarter of 2017, the highest oil production performance among countries outside of OPEC has been primarily retained in the USA and Canada. Along with that, from the late 2017 reduction in oil production was observed in the EU member countries because of depletion in Norwegian oil fields as well as due to repair

**Figure 1. Price of Oil (Brent), USD per Barrel, Monthly Average**



Source: U.S. Energy Information Administration (EIA)

**Figure 2. Demand, Supply and Reserves in the Global Oil Market, Million Barrels a Day**



Source: U.S. Energy Information Administration (EIA)

works performed there.

In OPEC countries, the supply of oil slightly increased given the ramp-up of oil output in Saudi Arabia and Russia. However, this effect turned out to be low since oil extraction in Venezuela dropped because of the deteriorating economic situation and in Libya and Nigeria oil extraction decreased amidst resurgent civilian riots. It should be also mentioned that sanctions imposed by the USA so far had not significantly affected oil extraction in Iran although a downward trend was outlined.

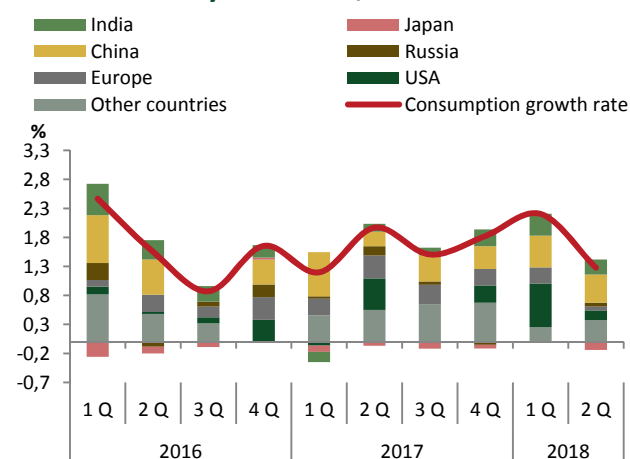
### 1.1.2 Non-Ferrous Metals Market

In the first half of 2018, negative dynamics was prevailing in the non-ferrous metals market that became aggravated because of the growing tension in the international trade as well as due to a poor performance in the Chinese industrial sector. The intra-quarter price dynamics of all non-ferrous metals was volatile. Meantime, in the second quarter of 2018, according to the National Bank's assessment, the price index of copper, aluminum, zinc and lead demonstrated the 1.2% growth (Figure 5).

The aluminum market again happened to be under the impact of the US protectionist measures. In the second quarter, metal price quotations went up by 8.3%. The recorded price upswing occurred from behind the drop in exports by a Russian company RUSAL, one of the world's largest producers of primary aluminum and red mud given the sanctions imposed by the USA. Prices were also supported by the declining output in one of the large aluminum production facilities in Brazil due to environmental problems. As a consequence of rising world prices of aluminum as well as a reduced supply on the part of Russia, China began to escalate exports of untreated aluminum and aluminum products. This prompted a gradual decline in prices of aluminum by the end of the second quarter.

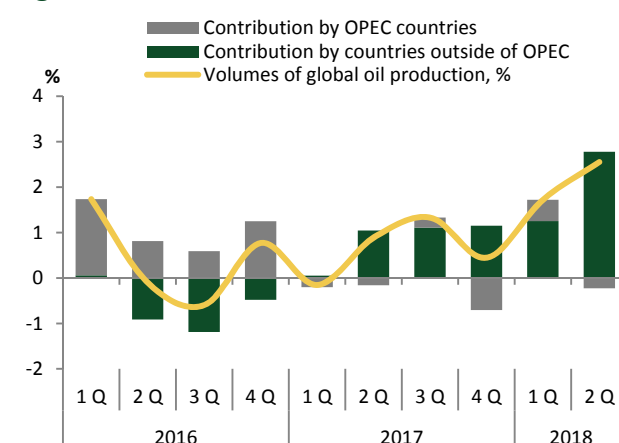
In the copper market, prices also went up by 2.5%. A slight depreciation of the US Dollar against the Chinese Yuan in April 2018 caused the price growth. Factors causing the decline in the metal price include: a strike in Escondita,

**Figure 3. Global Oil Consumption and Contribution by Countries, YoY**



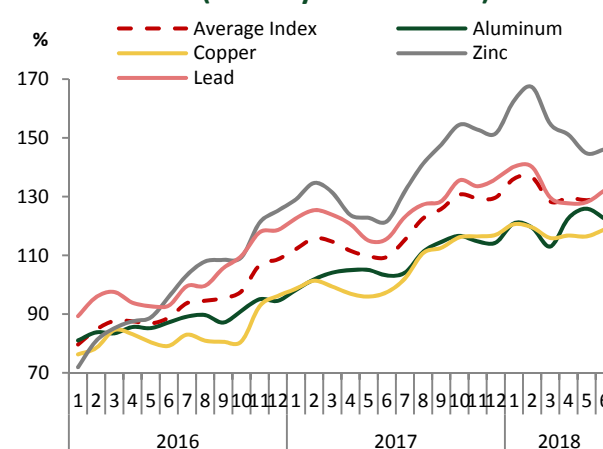
Source: U.S. Energy Information Administration (EIA)

**Figure 4. Global Oil Production, YoY**



Source: U.S. Energy Information Administration (EIA)

**Figure 5. Price Index of Copper, Aluminum, Zinc and Lead (January 2015=100 %)**



Source: NBRK's calculations based on data from Bloomberg

one the largest copper fields in Chile, by reason of negotiations regarding the raise of wages to workers; a slowdown in the growth rates of the Chinese industrial sector which consumes about 40% of copper in the world as well as the growing market concerns about escalation of trade conflicts between China and the USA.

In the zinc market, from February 2018 prices continued to actively go down; in the second quarter of 2018 the price decline accounted for 5.5%. The fall in prices was driven by the slowdown in the global demand, primarily on the part of China, where local producers set a course for reduction in the metal smelting given that metal quotations continue to go decrease. An additional impact on reduction in demand was made by environmental inspections in industrial enterprises as well as a shutdown of a number of large lead smelters for a scheduled technical maintenance. Depreciation of the Yuan against the US Dollar at the end of the second quarter of 2018 as a result of escalation of trade conflicts became an important factor causing a slowdown in the demand in China.

Lead quotations went up by 1.9% in the second quarter. Lead prices were supported by a significant drop in the stocks of metal in Shanghai. Along with that, a downward pressure on prices was made, firstly, by a slowdown in lead consumption by international battery manufacturers, and, secondly, by the decreasing demand in China where a number of “brownfields” were closed based on environmental inspections.

### 1.1.3 Food Market

According to the Food and Agriculture Organization of the United Nations, in June 2018 the FAO Food Price Index made up 175.3%; as compared to March 2018, prices went up by 1.3%, and as compared to June 2017, the FAO Index had not demonstrated any changes (Figure 6). The main driver for the price growth was the increase in prices of meat and dairy products. A negative contribution to the price index was made by the fall in prices of vegetable oils and sugar.

The cereal price index has grown up by



0.7% over the quarter. In April-May, the rise in prices of wheat and corn was recorded amidst expectations about a possible shortage of crops in a number of leading exporters. In July, prices demonstrated a decline in connection with the increased tension in trade relations. During the second quarter of 2018, world prices of oil went up, while the shortage of supply provoked the growth in prices of rice of the Japanese variety.

The price of dairy products in the global market had risen by 8.0% in the second quarter of 2018; as compared to June 2017, prices went up by 2.0%. The hike in price of dairy products is explained by the reduced supply in New Zealand which is a key exporter of dairy products and by the increased demand in the global market.

In June, meat prices demonstrated the 2% growth as compared to March 2018. The rise in prices is explained by a high global demand and the reduced supply of lamb meat by Oceanian countries. The surge in prices of pork meat was caused by a high domestic demand in the EU member countries.

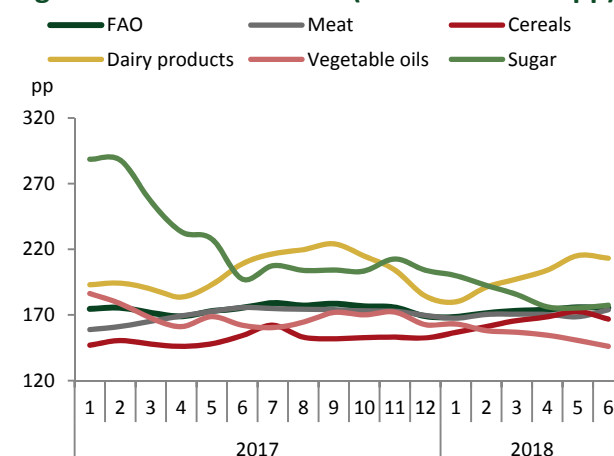
In the second quarter, the 4.4% drop in prices of sugar was recorded. It is explained by expectations about a high crop in Brazil and depreciation of the Brazilian real against the US Dollar. Measures taken by India and Pakistan to encourage exports of sugar also caused the decline in prices.

In June 2018, prices of vegetable oils demonstrated the 6.9% drop as compared to March 2018, being driven by a concurrent fall in prices of all types of oils. Prices of palm oil went down due to the absence of a steady demand. The increased stock reserves of soybean oil in a number of countries provoked a reduction in prices; quotations of sunflower oil dropped given the information about a good output in the EU and in Ukraine.

### 1.2 Economic Situation in the USA and the Fed's Rate

Current macroeconomic parameters in the USA are smoothly drifting to the planned target of the annual economic growth of 3%. So, at the end of the second quarter of 2018, the economic growth accounted for 2.8% (Figure 7). According to some analysts, a tax reform which

**Figure 6. FAO Price Index (2002-2014=100 pp)**



Source: UN FAO

was implemented last year as well as a progressing trade war amidst the advancing protectionist measures had given a strong impetus to the US economy growth. Meantime, as the data from the U.S. Bureau of Economic Analysis with the US Department of Trade showed, the increased consumer spending became the main driver for the economic growth in the first instance, particularly expenses related to car purchases, healthcare services, utilities as well as food and housing. Along with that, the growth in consumer spending, apart from reduced taxes, was significantly influenced by the labor market with the increase in the number of jobs and the decreasing unemployment which had reached the minimum values since the beginning of 2000s.

Positive dynamics in the growth of the US GDP was also supported by the expansion of fixed capital investments, the increased government spending as well as high exports. Some analysts view a sharp spike in exports not as much as a sign of the strong economic growth but as an endeavor of local producers to build up exports before the rise in duties by trading partners given the trade wars.

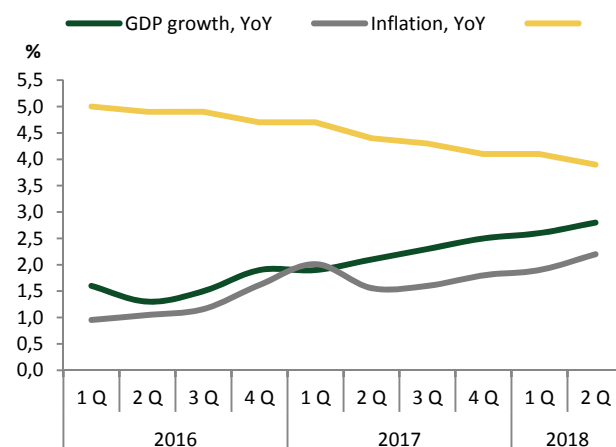
The constraining effect on the further growth of the US economy is made by sluggish performance in the housing market expressed in the reduced investments into residential construction as well as by a limited supply of a qualified labor force in the labor market.

The annual inflation reached the US Fed's target. Acceleration of inflationary processes was caused by a sizeable surge in prices of energy carriers as well as by a high domestic demand against the growing wages and personal disposal income of the population.

In June 2018, the US Fed raised its policy rate by 25 basis points to 1.75-2%. The decision made is explained by a positive performance of the labor market, steady growth of the business activity and by attainment of a long-term inflation goal.

On its June session, the US Fed changed its posturing towards a tighter monetary policy. The policy rate is expected to be changed at least twice before the end of 2018, and three

**Figure 7. US Economic Performance**



Sources: U.S. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics (BLS)

times – in 2019. In 2020, the Fed's policy rate will be 3.4%, and in the long run – 2.9%.

### 1.3 Economic Situation in Countries – Kazakhstan's Trading Partners

#### 1.3.1 Aggregate External GDP

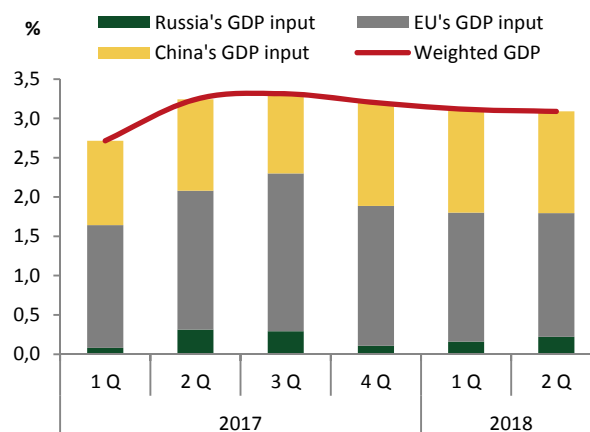
Aggregate external GDP which is calculated on the basis of the data about Kazakhstan's international trading structure and is characterizing the demand for Kazakhstani exports slightly decreased as compared to the previous quarter of this year (Figure 9). The reduction was caused by a slowdown in the rates of economic growth of the EU member countries and China, which was offset by the growth of the Russian economy (Figure 10).

In the second quarter, the Chinese economy showed a slowdown from 6.8% to 6.7%. Major external factors for such decline include, apart from the growing tension in trade relations with the USA, the global expansion of protectionism and market volatility associated with the strengthening of the US economy and a dramatic appreciation of the US Dollar. Among domestic factors, the following had a downward pressure: tough fight with high arrears of state-owned enterprises and local authorities, an overheated real estate market as well as a downturn in the manufacturing industry due to the enhanced clean environment programs which were accompanied by a shutdown of a number of large manufacturing plants and curtailment of production.

A positive impact on the Chinese economy's growth was made by positive dynamics in the mining industry which progressed amidst the rising world prices of oil, growing investments and on-line retail sales as well as stable performance in the labor market.

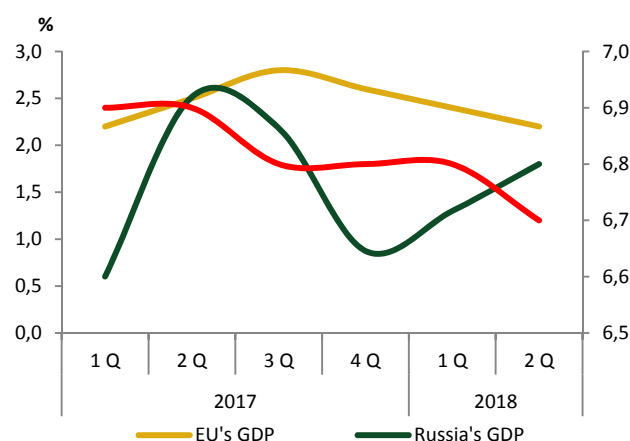
According to the Eurostat, in the reporting period the economic growth in the EU given the slowing activity in Germany, France and Italy became more moderate, accounting for 2.2% versus 2.4% in the previous quarter. A direct negative effect on the economy was made by the industrial sector where the production volumes decreased. However, the construction market as well as the increased retail sales given the growing employment and availability

**Figure 9. External Weighted GDP , YoY**



Source: NBRK's calculations

**Figure 10. Real GDP Growth in China, EU and Russia, YoY**



Source: Bloomberg, Eurostat, Rosstat

of credit resources supported the growth. Unemployment in the EU member countries keeps going down steadily having reached the lowest value for the last 10 years.

According to the assessment made by the Ministry of Economic Development of Russia, in the second quarter of 2018 the growth rate of the Russian economy accelerated to 1.8%. A positive impact on the macroeconomic development was made by the improved production activity in such sectors as construction, retail trade, freight turnover, industrial production.

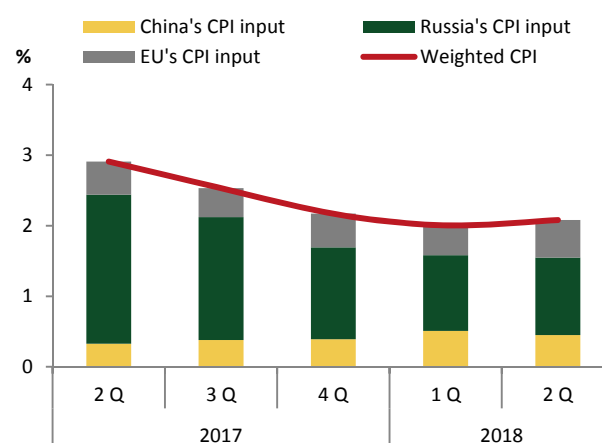
### 1.3.2 Aggregate External Inflation

Aggregate external consumer price index which is calculated based on the share of main trading partners in Kazakhstan's imports, in the second quarter of 2018 showed a minor growth after a long-run decline (Figure 11). Such increase was driven by the growing inflation in Russia and in the EU (Figure 12). The growth of the indicator serves as a sign of the increasing external inflation pressure on consumer prices in Kazakhstan.

Inflation in China, after reaching its maximum in the middle of the first quarter of 2018 (2.9%), had dropped to 1.9% at the end of the second quarter. Deceleration of inflation is explained by a seasonal decline in prices of vegetables and fruits; prices of tobacco and alcohol products were also decreasing. In addition, a rise in prices of energy carriers, meat products, pork meat in particular, was observed.

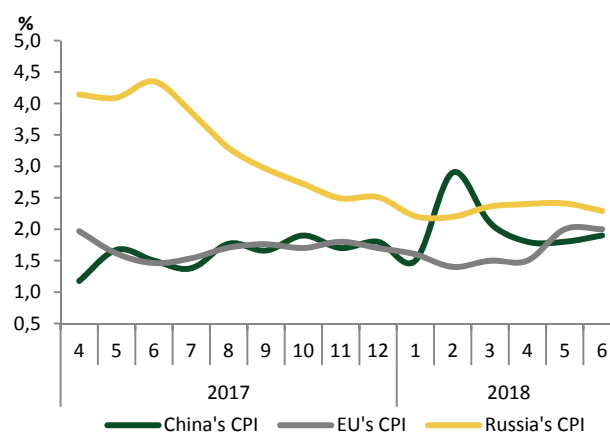
Inflation in the EU member countries has been moving approximately along the same path since the mid of 2017, with no significant fluctuations. Meantime, in May 2018 the price of oil had reached its historical maximum since 2014 because of aggravation of trade relations between the USA and Iran. Such development resulted in acceleration of growth rates of inflationary processes worldwide, including the EU member countries. According to the Eurostat, inflation in the EU accelerated from 1.5% in March to 2% in June, having reached the ECB's target. Acceleration of inflationary processes was also affected by the increase in

**Figure 11. Weighted External CPI, YoY**



Source: NBRK's calculations

**Figure 12. Inflation in China, EU and Russia, YoY**



Source: National Bureau of Statistics of China, Reuters, Eurostat

price of the US alcohol beverages and tobacco products as a result of escalation of a trade war with the USA, as well as for some types of services.

After a minor growth in annual inflation in Russia to 2.4% in April-May 2018, in June this indicator decreased to 2.3%. Such deceleration of inflation to a larger extent was caused by the decline in prices of fruit and vegetable production. For the first time in the modern history of Russia, the annual deflation on foodstuffs was observed.

It should be mentioned however that acceleration of the consumer demand in view of the persisting positive dynamics of wages, depreciation of the ruble as a consequence of new sanction restrictions imposed by the USA as well as indirect impact from the rise in prices of gasoline in May 2018 represent the risks of increasing inflation pressure in the near term.

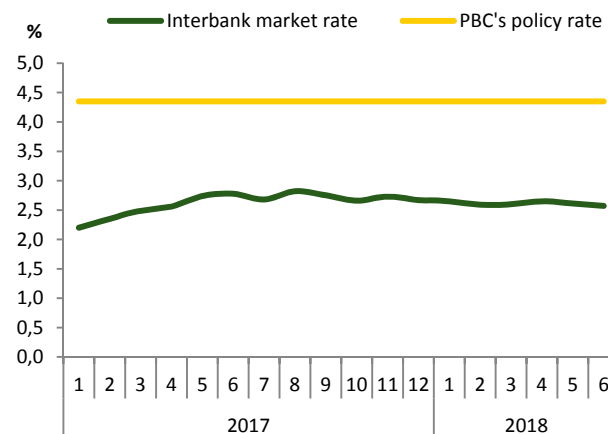
### 1.3.3 Money Market Rates

The People's Bank of China, despite the upward pattern of the US Fed's rate, retained its policy rate unchanged (Figure 13). The average monthly over-night SHIBOR also decreased from 2.61% in May to 2.57% in June 2018.

The ECB's Governing Council, during its most recent session, decided to retain its official interest rates at the existing level at least till the summer of 2019, despite the growing inflation (Figure 14). Also, it was announced that before October 2018 the volume of asset purchases will be cut from EUR 30 bln. to EUR 15 bln.; in doing so, the quantitative easing program will be terminated already in December 2018.

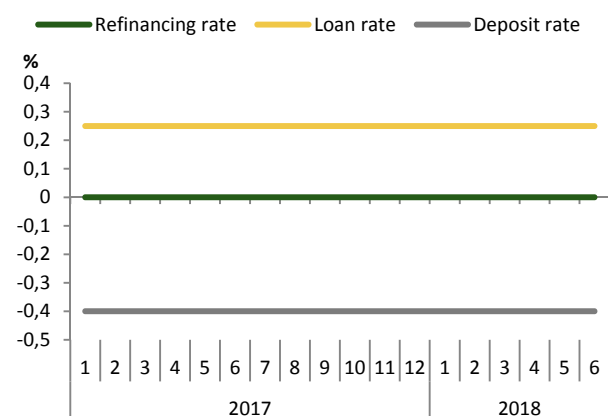
In June 2018, the Bank of Russia made the decision to retain its key rate at 7.25%. Given the existing inflation risks, the Central Bank of Russia revised its inflation forecasts upwards. So, according to the CBR's forecasts, at the end of 2018 the annual inflation will account for 3.5-4% instead of 3-4% as declared earlier. In 2019, a short-term acceleration of inflation rate to 4-4.5% is anticipated, followed by a gradual fitting into the 4% target at the beginning of 2020 (Figure 15).

Figure 13. Rates in China



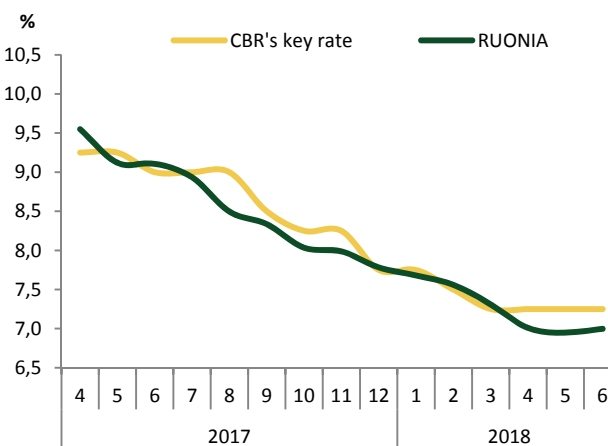
Source: Reuters

Figure 14. ECB's Rates



Source: Reuters

Figure 15. Rates in Russia



Source: Central Bank of Russia

### 3.4 Foreign Exchange Rates

The average monthly exchange rate of the Yuan against the US Dollar depreciated from CNY 6.297 in April to CNY 6.465 per 1 USD in June 2018 (Figure 16).

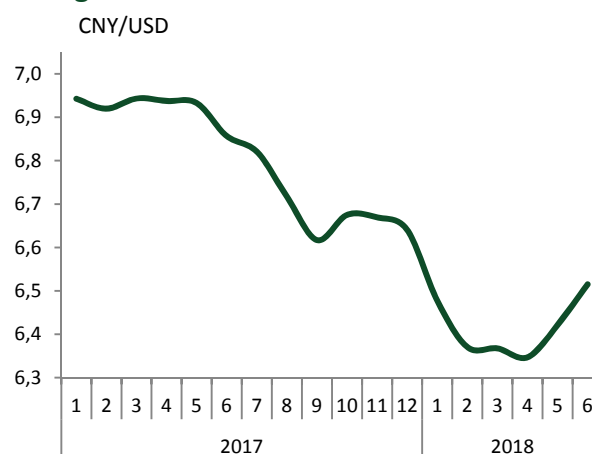
Depreciation of the Chinese local currency was first of all determined by the introduction of import duties by the USA in respect of some products exported from China. A negative impact was also related to the repayment of external loan debt by the Chinese enterprises and the change in preferences of foreign investors in connection with the increasing fluctuations in the Chinese stock market.

During the reviewed period, the European currency quotation weakened from 1.227 on average in April 2018 to USD 1.167 per 1 EUR on average in June 2018 (Figure 17). Escalation of the trade war with the USA also affected depreciation of the European currency.

The Russian ruble had been demonstrating a depreciation trend against the US Dollar throughout the quarter. Such dynamics was to a larger extent determined by imposition of sanctions against Russia by the USA; this resulted in an outflow of non-residents from the federal loan bond market (Figure 18).

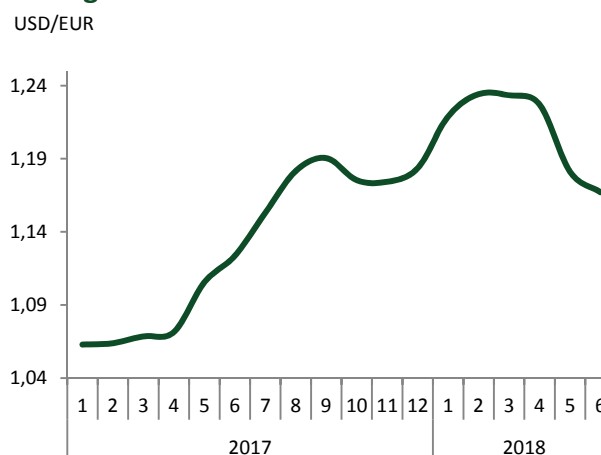
In June, the average monthly exchange rate of the ruble depreciated by 10% versus March 2018 making up RUB 62.9 per 1 USD. The average exchange rate of the ruble against the US Dollar was RUB 61.9.

**Figure 16. CNY/USD Exchange Rate, Monthly Average**



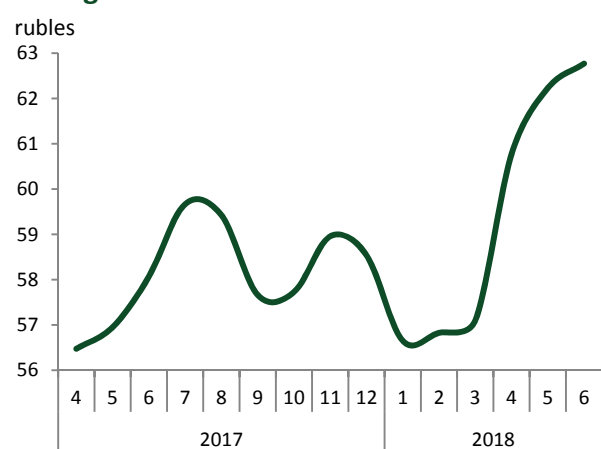
Source: Reuters

**Figure 17. USD/EUR Exchange Rate, Monthly Average**



Source: Reuters

**Figure 18. RUB/USD Exchange Rate, Monthly Average**



Source: Central Bank of Russia

### 1.4 Kazakhstan's Balance of Payments

In the first quarter of 2018, the current account deficit which was partially financed by operations on the financial account secured a positive overall balance of payments of USD 0.9 bln. (Figure 19 and Figure 20).

As compared to the first quarter of 2017, the current account deficit fell by 2.4 times and amounted to USD 0.6 bln. or 1.6% of GDP (Figure 20).

The rise in world prices of oil furthered the increase in exports of goods. Export of oil and gas condensate went up by 35.5% due to the growth in contractual prices and the increased volumes of physical supplies. Export of ferrous metals increased by 8.4%, and of non-ferrous metals – by 8.5%. Export of cereals nearly doubled.

Imports of goods continued to demonstrate a strong growth which was observed among all major commodity groups. Imports of consumer goods increased by 13.4%, of investment goods – by 24.9%, and of interim industrial goods – by 9.9%.

The value of exports of goods grew up to a larger extent versus the value of imports resulting in the increased balance of trade surplus.

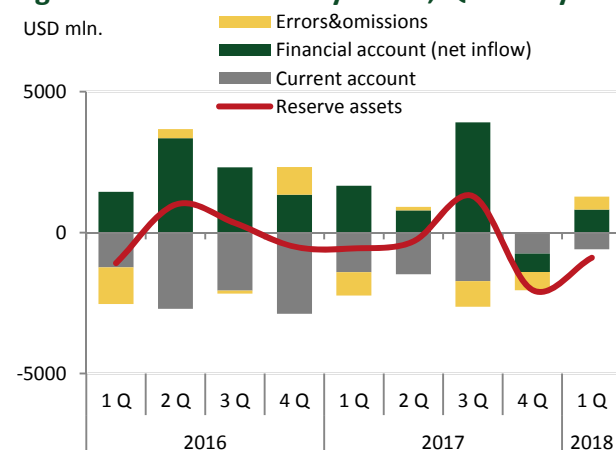
The deficit of the balance of international services decreased insignificantly because of the 3.4% growth of exports. The run up in the exports of services was secured mainly by the growing expenditures of non-residents related to trips to Kazakhstan.

A minor rise in the imports of services (by 1.3%) was caused by the growing volumes of other business services which are associated with the involvement of non-residents in implementation of large infrastructure projects within the territory of Kazakhstan and transport services of non-residents related to freights (Figure 21).

The financial account (excluding reserve assets) showed up a net capital outflow. The capital inflow on direct investments was virtually offset by an outflow on portfolio and other investments.

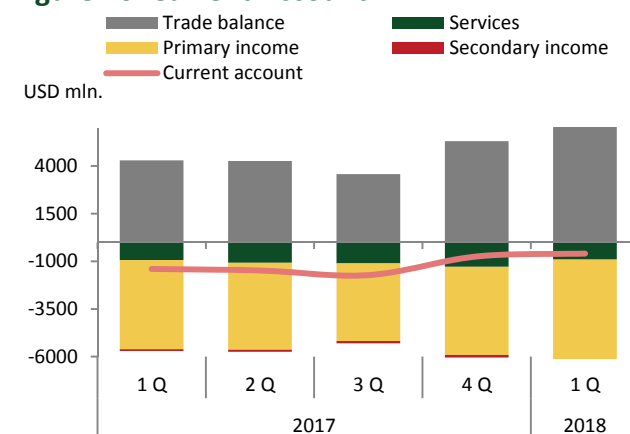
Foreign direct investments (FDIs) in the first quarter showed up a net inflow which was

**Figure 19. Balance of Payments, Quarterly**



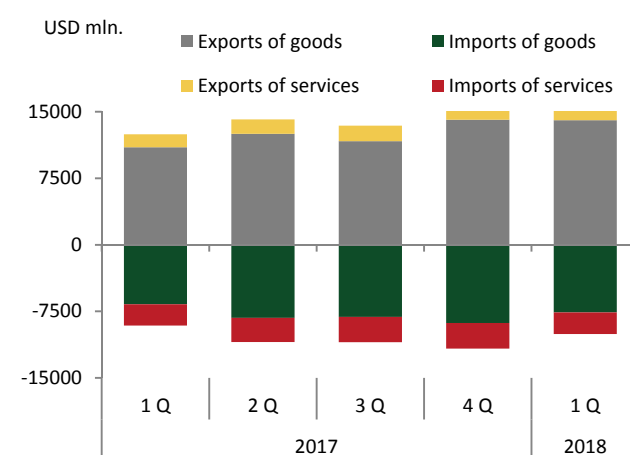
Source: NBRK

**Figure 20. Current Account**



Source: NBRK

**Figure 21. Exports and Imports of Goods and Services**



Source: NBRK



mainly secured by reduction in assets from direct investment operations as a consequence repayment of liabilities to Kazakhstani enterprises by foreign affiliated companies as well as in connection with large dividend payments to residents of Kazakhstan. Key foreign direct investments were transferred to finance enterprises in the oil and gas sector, metallurgical industry and wholesale and retail facilities.

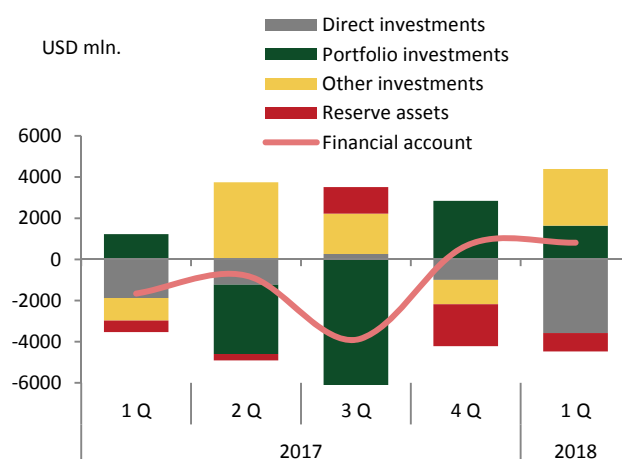
A surplus (a net outflow) on portfolio investments occurred as a result of a significant reduction in liabilities within portfolio investments with a minor increase in assets on such investments. The buildup of financial assets on portfolio investments is stemming from the growth of investments in foreign securities, primarily assets of the “UAPF” JSC.

A surplus on other investments in the first quarter of 2018 was primarily related to the growth in assets of residents on foreign accounts, the increase in receivables of non-bank organizations and in foreign cash in hand (Figure 22).

At the end of the first quarter, the real effective exchange rate index of the tenge appreciated by 1.7% versus the fourth quarter of 2017 and made up 77.9% of the benchmark competitiveness index of December 2013.

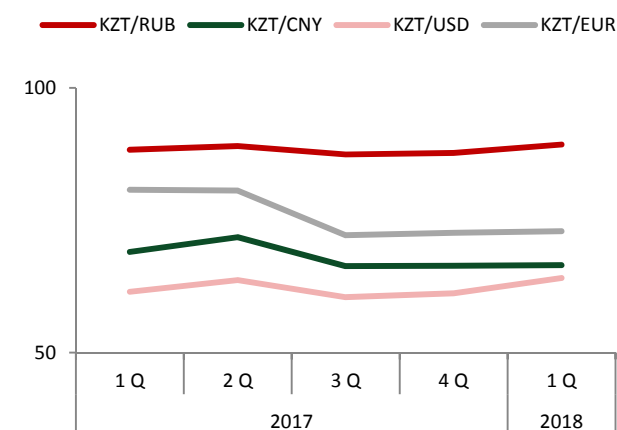
Indices of bilateral real exchange rates of the tenge against currencies of countries – main trading partners were demonstrating a unidirectional trend. In the first quarter of 2018 versus the fourth quarter of 2017, the tenge appreciated in real terms against the ruble by 1.8%, against the US Dollar – by 4.6%, against the Euro – by 0.4% and against the Yuan – by 0.2% (Figure 23).

**Figure 22. Financial Account**



Source: NBRK

**Figure 23. Real Effective Exchange Rate Index (December 2013 = 100%)**



Source: NBRK



## 2. DOMESTIC ECONOMY

### 2.1 Monetary Policy and the Financial Sector Development

#### 2.1.1 Money Market and Operations of the National Bank of the Republic of Kazakhstan

There was still a structural liquidity surplus in the tenge in the money market. The National Bank conducted operations to withdraw excess liquidity with a view to limit potential realization of inflation risks. The bulk of excess liquidity was withdrawn via the National Bank's short-term notes (Figure 24). In doing so, at the quarter-end the volume of short-term notes decreased from KZT 4.2 trln. in March to KZT 3.6 trln. in June, including the share held by non-residents (from 12.2% to 6.3%). Along with that, reduction in volumes of short-term notes was offset by the growth in bank deposits at the National Bank. Hence, there was no significant change in the balance on the National Bank's operations.

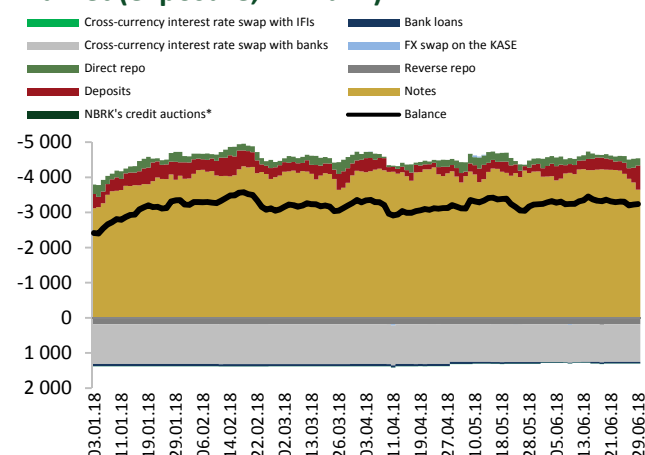
Given favorable oil prices and inflation forecasts in countries-main trading partners that were in line with their targets as well as due to subsiding inflation expectations, monetary conditions were eased further. The base rate was reduced twice (from April 17 and June 5) by 50 bp in total. Generally, monetary conditions were maintained at a neutral level. The TONIA rate was mainly maintained at the lower boundary of the interest rate band throughout the quarter and was building around 8.51% at the end of the period (Figure 25).

Owing to a high volatility of swap rates at the Kazakhstan Stock Exchange, from April the National Bank resumed standing facilities operations with FX swap in the overnight market.

The Money Market Index has been moving within the range of 7.82-9.53%. At June 29, 2018 the index made up 7.82% (Figure 26).

The shape of the yield curve continues to normalize. Lower yields in the segment over 6 years reflect a higher demand for longer-term securities (Figure 27).

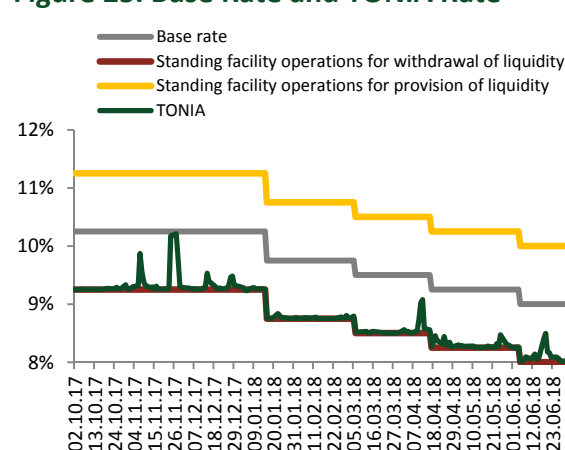
**Figure 24. NBRK's Operations in the Domestic Market (exposure, KZT bln.)**



\* NBRK's securities buy/sell back auction

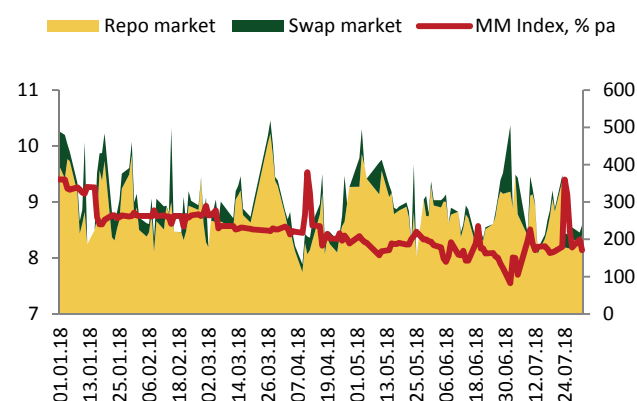
Source: NBRK

**Figure 25. Base Rate and TONIA Rate**

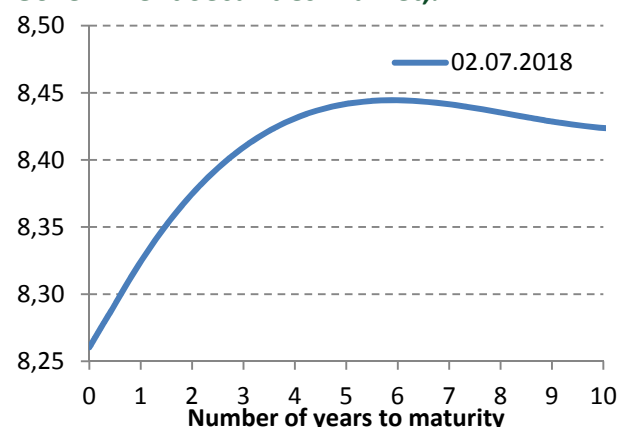


Source: NBRK, KASE

**Figure 26. Changes in the MMI and the Volume of Transactions (KZT bln., right axis)**



Source: KASE

**Figure 27. Risk-Free Yield Curve in the Government Securities Market, %**

Source: KASE

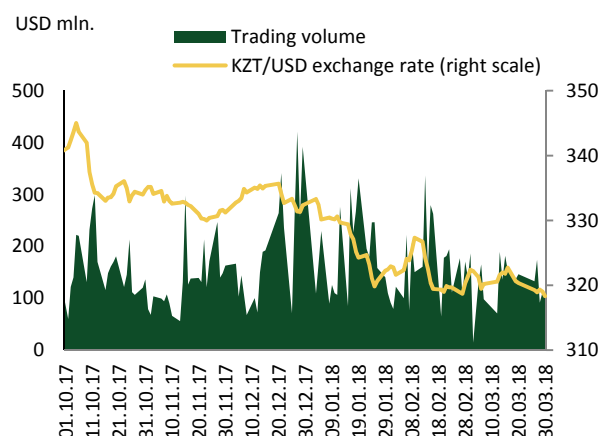
### 2.1.2 Foreign Exchange Market and Foreign Exchange Operations of the National Bank of the Republic of Kazakhstan

The foreign exchange market was demonstrating volatility. Dynamics of external fundamental factors of the exchange rate of the tenge was divergent. Depreciation of the tenge was in the first instance associated with appreciation of the US Dollar against currencies of developing countries and a capital outflow from developing markets given the increased US Fed's interest rates. Besides, volatility of the tenge in April started to react to depreciation of the Russian ruble as a result of the US sanctions against Russia. A persisting pricing environment in foreign commodity markets created prerequisites for decreasing the amplitude of exchange rate movements.

The tenge was fluctuating between KZT 319.2-341.3 per 1 USD. At the quarter-end, the KZT/USD rate on the stock exchange depreciated to KZT 341.08 or by 7.2% (Figure 28).

The National Bank's net participation in the domestic foreign exchange market was equal to zero.

The increase in volumes of trading in the USD/KZT currency pair as compared to the first quarter of 2018 accounted for 10.8% – to USD 10.5 bln. (in the first quarter of 2018 – USD 9.5 bln.). Such growth was mainly associated with the increasing volumes of trades in the KZT/USD currency pair because of volatility in Russian markets in April 2018.

**Figure 28. Exchange Rate Behavior and the Trading Volume in the Foreign Exchange Market**

Source: KASE

### 2.1.3 Deposit Market

At the end of the second quarter of 2018, the deposit volume amounted to KZT 17.8 trln., having increased by 4.1% over the quarter.

Deposits in the domestic currency increased by 5.2%, and foreign currency deposits decreased by 4.0% in the US Dollar equivalent (Figure 29). As a result, overall dollarization level went down to 44.5% (in March – 45.0%).

Over the second quarter of 2018, the weighted average interest rate on deposits in the domestic currency had decreased by 0.2 pp from 7.6% in March to 7.4% in June. The dynamics of the weighted average interest rate is fully determined by the rate on time deposits (Figure 30).

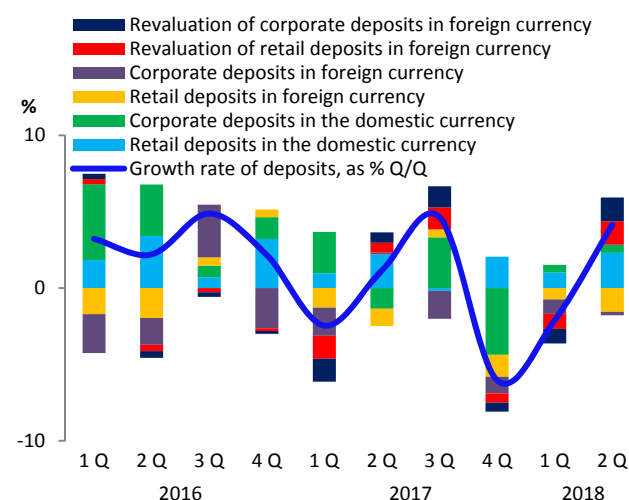
In the structure of time deposits in the tenge, interest rates for corporate entities are going down more significantly than for individuals (Figure 31). Among attracted deposits of corporate entities, super short-term deposits (up to 1 month – more than 91% of the volume attracted over the period) prevail; this is explained by operating activities of this group of depositors. Ultimately, banks are more actively reacting to reduction in the base rate by reducing interest rates on deposits of corporate entities. Deposits of individuals are less mobile but are more sensible to the level of interest rates. Therefore, banks are more limited in their capacities to reduce interest rates for the population.

Besides, the existence of marginal interest rates on retail deposits established by the “Kazakhstan Deposit Insurance Fund” JSC at a flat rate does not allow banks to deviate from the established “cap” without the risk of losing a market share.

From October 1, 2018 the approach to setting marginal rates is going to be changed. Their level will be determined both based on a deposit maturity and on the terms and conditions providing a possibility of withdrawal and replenishment of a deposit. In doing so, market rates on deposit products of banks will serve as the basis for calculation.

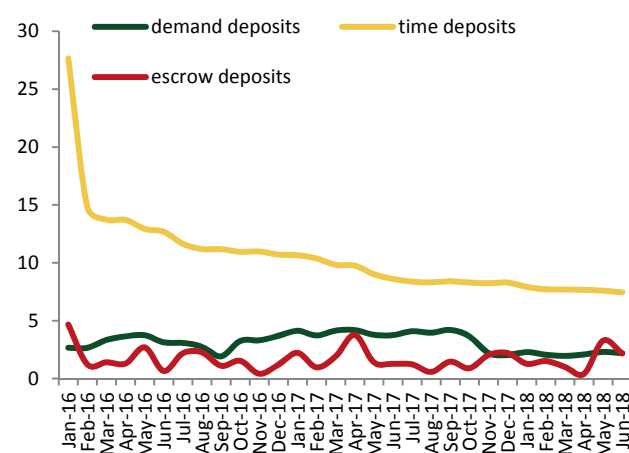
Rates on deposits in freely convertible currency remain at fairly low levels. In June,

**Figure 29. Contribution of Components to the Growth in Deposit Volumes**



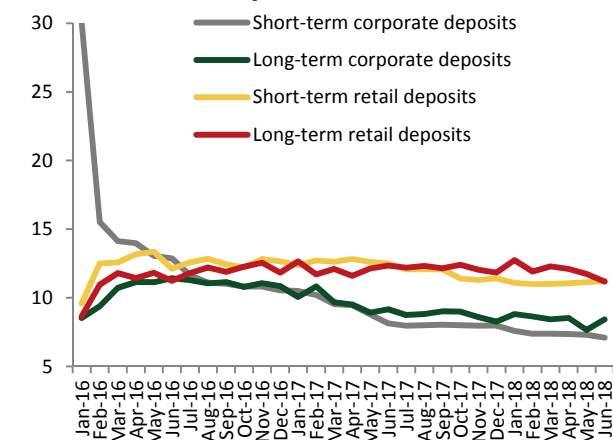
Source: NBRK's calculations

**Figure 30. Interest Rates on Deposits in the Tenge, by Deposit Types, %**



Source: NBRK

**Figure 31. Rates on Time Deposits in the Domestic Currency, %**



Source: NBRK

short-term foreign currency deposits were taken at 0.3% for corporate entities and at 0.9% for individuals. Interest rates on long-term deposits in June were 2.1% and 2.0%.

### 2.1.4 Credit Market

During the second quarter of 2018, the volume of bank loans increased by 2.1% to KZT 12.8 trln. Excluding banks whose license was revoked or suspended as well as those that write off their assets as a result of the balance sheet cleanup, the loan portfolio growth is assessed to be 14.1% on a year-on-year basis.

The loan portfolio in the tenge increased by 2.8%, and the foreign currency portfolio decreased by 6.6% in the US Dollar equivalent.

In the corporate segment, the loan portfolio demonstrated a minor quarterly growth of 0.1% to KZT 8 trln. due to revaluation of a foreign currency component. The retail loan portfolio went up by 5.7% owing to loans in the tenge – the growth accounts for 6.5% or KZT 280.3 bln. (Figure 32).

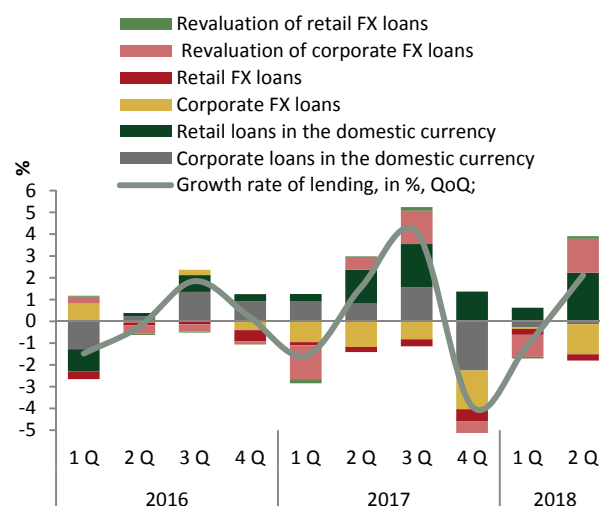
Over the quarter, the weighted average interest rate on loans in the domestic currency went down from 15.3% in March to 15.0% in June 2018 (Figure 33).

In the structure of interest rates on loans provided to corporate entities availability of long-term loans increased; in all likelihood, this fact reflects the National Bank's decisions to reduce the base rate in the first quarter of 2018. Interest rates on such loans decreased from 14.2% to 13.2% while volumes of loans with maturities over one year grew by 13.2%.

Interest rate on retail loans in the tenge is still high; this is explained both by the persisting demand for borrowed resources for consumer purposes at such rate of return and by a level of credit risk for banks. Relatively low interest rates which are comparable with interest rates on corporate loans are available for long-term lending only, mainly on mortgage loans; however, volumes of lending at such maturities remain insignificant.

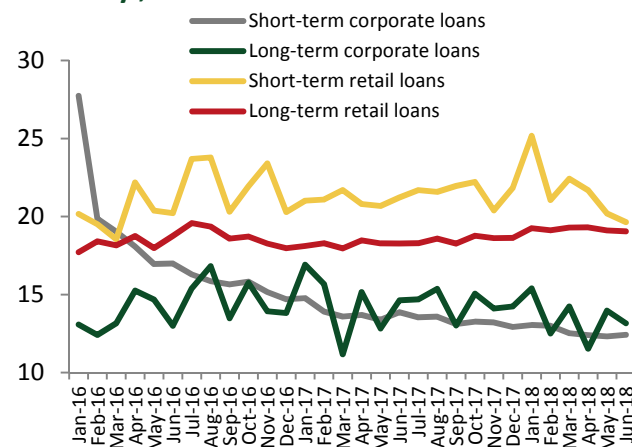
According to the poll on lending conducted

**Figure 32. Contribution of Components to the Growth in Loan Volumes**



Source: NBRK

**Figure 33. Rates on Loans in the Domestic Currency, %**



Source: NBRK

among banks based on the second quarter of 2017<sup>1</sup>, banks, being influenced by the competition, continued to ease terms and conditions for the corporate sector, SMEs in particular. Given reduction of interest rates and the increased maturity, the demand for loans on the part of businesses continued to grow. According to the poll conducted by the National Bank among enterprises in the real sector of the economy, businesses in their turn also mention the easing of lending terms in all sectors.

### 2.1.5 Monetary Aggregates

The second quarter was characterized by expansion in all monetary aggregates (Figure 34). The 25.6% expansion of the reserve money over the quarter (or by 10.8% over the year) mainly occurred because of reduction of notes in circulation securing 9.7% out of 25.6% of the change as well as contraction of claims from the Government (a contribution to the change in the reserve money – 4.3%). The establishment of the National Bank's subsidiary, "Baspana" JSC, secured a 4.5% expansion of the reserve money.

The factors which provided for expansion of the reserve money also affected the rise in the money supply (by 5.1% over the quarter). Apart from that, a positive contribution to the formation of money supply was made by the increase in net foreign assets (mainly due to revaluation of the exchange rate of the tenge) as well as by the growth in credits to the economy (Figure 35).

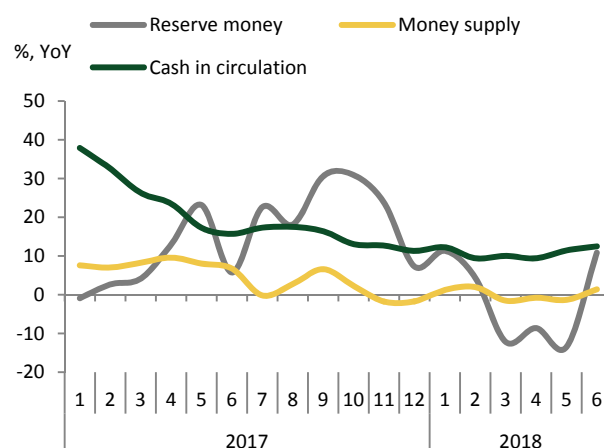
## 2.2 Prices and Inflationary Processes

### 2.2.1 Prices in the Consumer Sector

In the second quarter, the annual inflation was building up closer to the middle of the target band of 5-7%, having dropped to 5.9% in June from 6.6% in March (Figure 36).

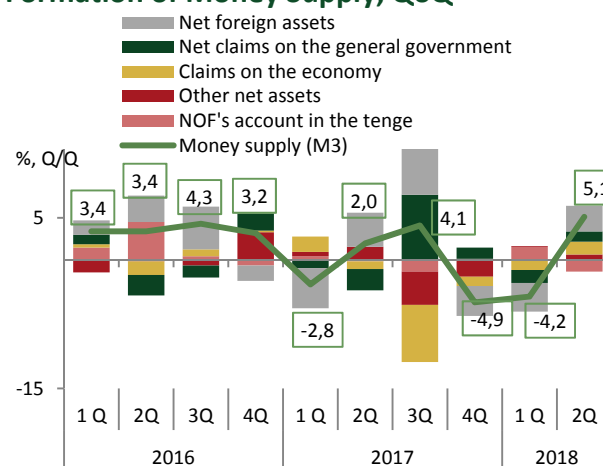
Inflationary pressure continued to go down as a result of a downward trend of the food component driven by an eased pricing policy of agricultural producers as well as by the high base effect of the last year as supply shock in the vegetables market that was observed in the same period of the last year was cancelled out

**Figure 34. Growth in Monetary Aggregates, YoY**



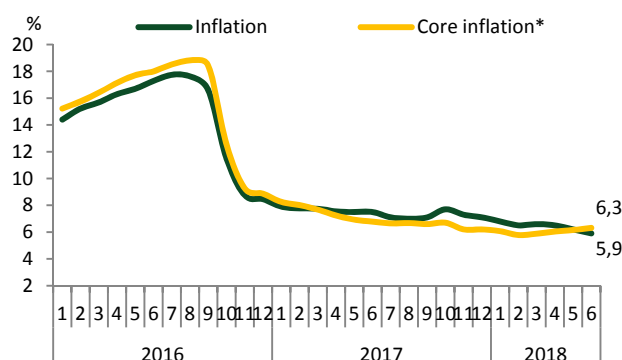
Source: NBRK

**Figure 35. Dynamics of Sources to the Formation of Money Supply, QoQ**



Source: NBRK

**Figure 36. Annual and Core Inflation Dynamics, YoY**



Source: CS MNE RK

\* excluding prices of fruits and vegetables, utilities, railway

<sup>1</sup> <http://nationalbank.kz/?docid=3535&switch=russian>

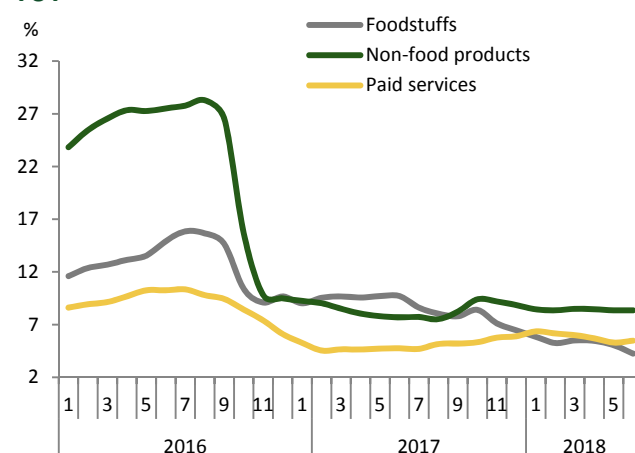
(Figure 37). The slowdown in the price growth was favored by the decline in agricultural producer prices for fresh vegetables due to the development of the domestic production as well as by the increased volumes and reduced cost of imported products (including from China and Uzbekistan). At the same time, food prices slightly increased, excluding fruit and vegetable production (Figure 38); this fact translated into a minor acceleration of the core inflation.

Depreciation of the exchange rate of the tenge and recovery of real income of the population had a constraining effect on deceleration of inflation. Commodity items with a high share of imports in their consumption demonstrated some appreciation in cost (clothes, footwear, fruits, etc.). At the same time, the impact made by depreciation of the tenge was limited since prices of the majority of durable non-food products slowed their growth rates. Perhaps, during this period enterprises had a reserve to retain the existing prices taking into account the level of demand and prior orders.

A more moderate indexation of tariffs for utilities as compared to the last year was also conducive to reduction of inflationary background.

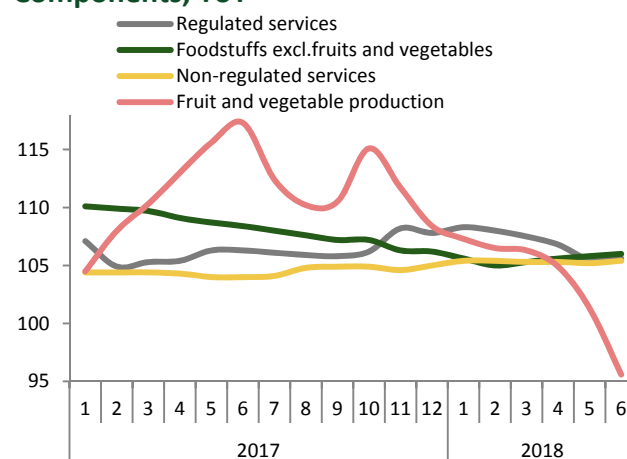
*transport, communication, gasoline, diesel fuel and coal*

**Figure 37. Dynamics of Inflation Components, YoY**



Source: CS MNE RK

**Figure 38. Dynamics of Individual CPI Components, YoY**



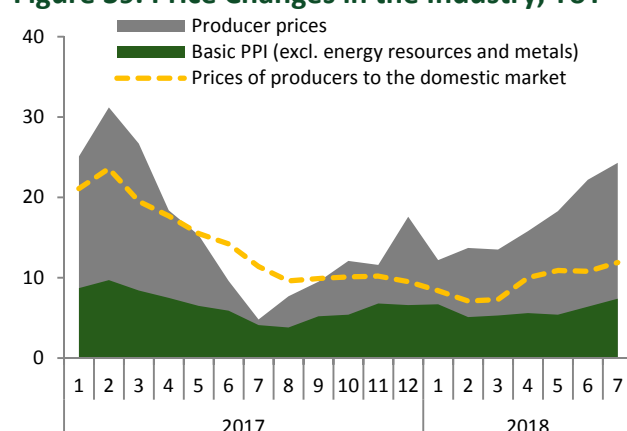
Source: CS MNE RK

### 2.2.2 Prices in the Real and External Sectors

In the second quarter, inflationary pressure on the part of expenditures somewhat increased. Annual rates of growth of producer prices in the industry were going up while in agriculture they were slowing down. At the end of the reporting period, cargo transportation tariffs were raised (24%) because of the railway transport. However, the growth in prices of electricity slowed and the change in water supply fees remained moderate.

The annual price growth in the industry accelerated from 13.5% in March to 22.2% in June (Figure 39, 40). In the mining industry, a rise in prices of crude oil and metals which are sold domestically and are exported was

**Figure 39. Price Changes in the Industry, YoY**



Source: CS MNE RK



observed. In the manufacturing industry, prices of foodstuffs were going up after the period of their decline from the end of the last year.

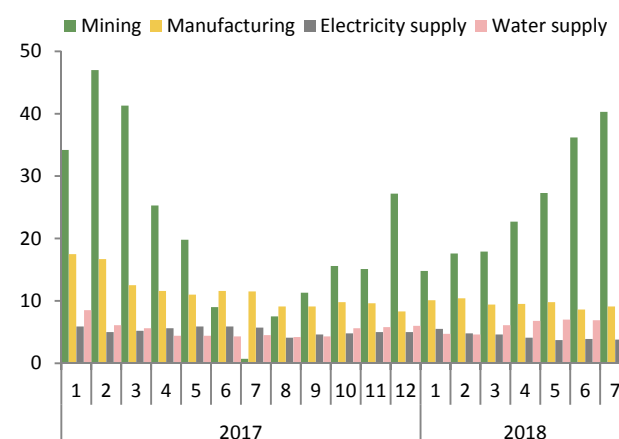
The trend when prices of the domestically manufactured consumer goods were slowing their growth from mid-2016, changed for a minor acceleration. The growth in prices of interim goods accelerated significantly.

The annual growth rates of agricultural producer prices continued to slow because of the plant production (Figure 41) as a consequence of declining cereal prices. Cereal stocks at the beginning of July remained at a higher level than a year before (by 5%). However, there were no overstocks of oil-bearing crops, thus causing a slowdown in the upward trend of their prices. Over a year-half, the drop in prices was demonstrated among all kinds of vegetables except cabbage; and the price of plant products growth under cover declined to the largest extent. To this end, the annual growth in prices of fresh vegetables decreased significantly.

In the animal production sector, there was an increase in prices of meat, namely poultry, that was connected with the growing price of the poultry feed in the global market and the ban for imports of Russian products.

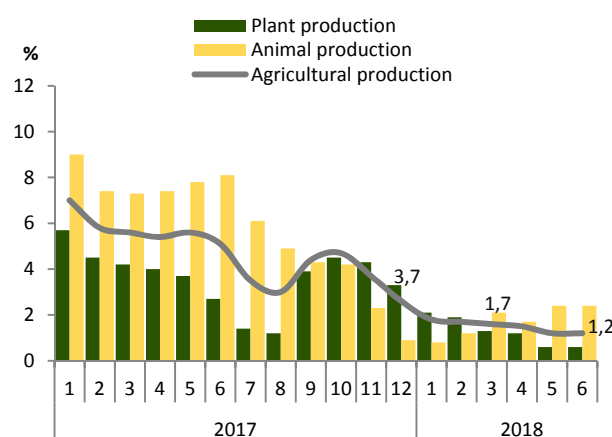
The enterprise poll outcomes show that in the second quarter enterprises observed the growth in prices for final products. Along with that, a more rapid increase in prices of raw materials and supplies was observed versus that for final products (Figure 42).

**Figure 40. Price Changes in the Industry by Types of Economic Activities, YoY**



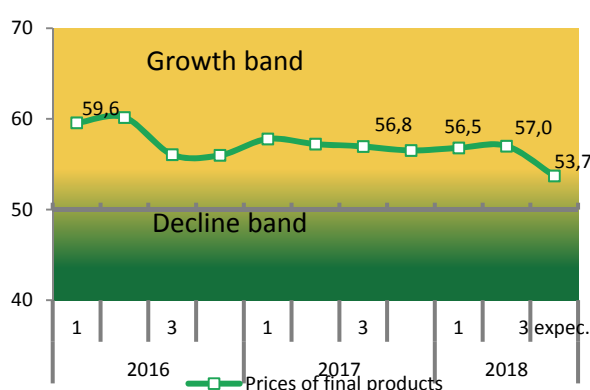
Source: CS MNE RK

**Figure 41. Price Changes in Agriculture, YoY**



Source: CS MNE RK

**Figure 42. Outcomes of the Enterprise Monitoring Survey by the NBRK**



Source: NBRK

\* The higher (lower) from 50 the DI (diffusion index) is, the higher (lower) the rates of growth (decline) of the indicator, and where the DI=50 it means the absence of a change

### 2.2.3 Inflation Expectations

The public poll outcomes show that in the second quarter of 2018 no significant changes in the level of expected inflation were observed. Along with that, perceived inflation decreased significantly.

The percentage of respondents who anticipate that inflation rates will remain unchanged within next 12 months, at the end of the quarter decreased to 41% of the total number of respondents (Figure 43) despite mixed intra-quarterly dynamics.

In general, inflation expectations of the population regarding the prospects of price changes of foodstuffs, non-food products and paid services remain at a stable level in the second quarter.

A quantitative assessment of expected inflation<sup>2</sup> for the coming year at the end of the quarter accounted for 6.0% (Figure 44), staying at the level of actual inflation.

Perceived inflation<sup>3</sup> which is generated based on the subjective basket of goods of an individual continues its long-term downward trend. At the end of the second quarter this indicator notably decreased from 17.5% in March to 15.8% in June following actual inflation.

## 2.3 Real Sector Development

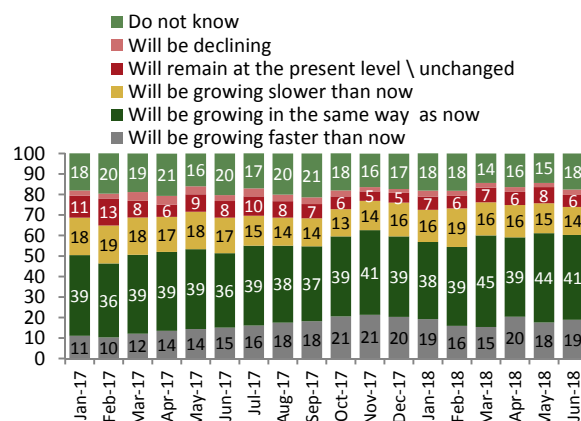
### 2.3.1 Domestic Demand

In the first quarter of 2018, the economic activity kept demonstrating a positive pattern amidst a favorable external pricing environment in the global energy markets. The GDP growth was accompanied by a positive contribution of all key components: net exports, consumer and investment demand.

At the end of the first quarter of 2018, the real GDP by the final consumption method increased by 4.1% given a significant positive contribution by net exports and consumer demand (Figure 45). Investment demand was also demonstrating a positive pattern.

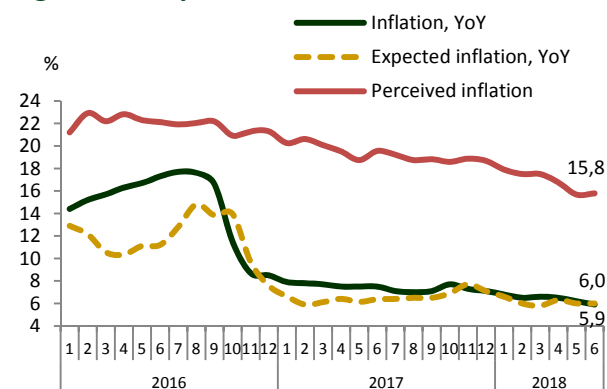
### Figure 43. Assessment of the Price Growth in a Year

In your opinion, how much generally will prices of foodstuffs, non-food products and services change in the next 12 months?



Source: GfK Kazakhstan

### Figure 44. Expected Inflation





The increase in net exports was accompanied by a sizeable growth in exports of goods and services (by 10.7%). Overall export volumes were going up amidst expansion in exports of crude oil and gas condensate as well as against a rise of world oil prices. In the first quarter of 2018, the growth of average oil prices accounted for 23.7% versus the same period of the last year.

For the first time since the first quarter of 2014, imports turned positive. The increase in real volumes of imports was observed against the growing consumer and investment demand.

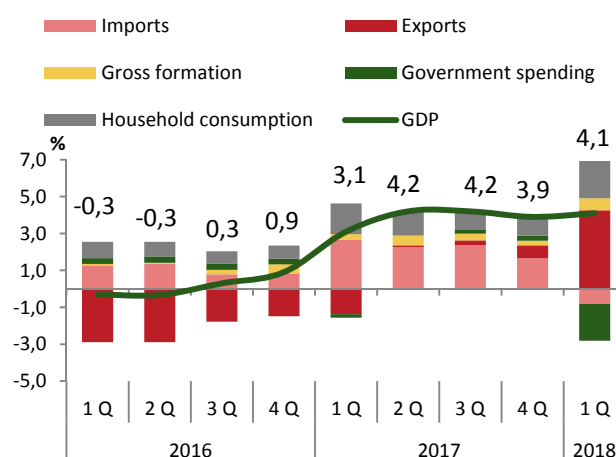
The 2.7% upturn in gross formation was accompanied both by implementation of government economic stimulus programs and by significantly accelerated growth rates of fixed capital investments.

At the end of the first quarter of 2018, the growth rates of consumer demand accelerated and accounted for 3.9% (Figure 46). The increasing real cash income of the population, on the one hand, and expansion of the consumer lending given deceleration of inflationary processes, on the other hand, served as a stimulus for the consumer demand.

In the first quarter of 2018, the government spending decreased significantly (by 16.4%). Such decline occurred because of curtailment of budget resources for purchases of goods and services based on the Government's plans to cut the state budget deficit.

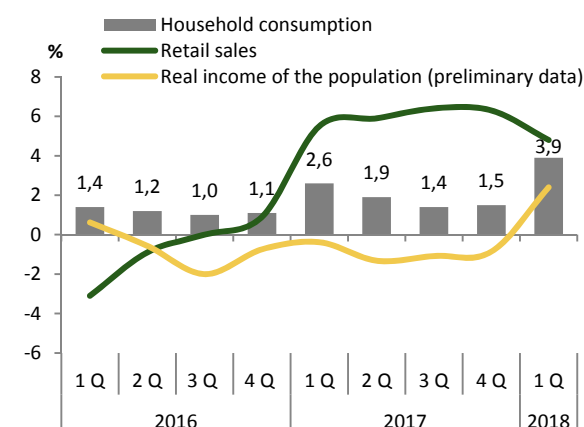
In the first quarter of 2018, the growth in nominal consumer household spending accelerated and reached 11.6%. Such acceleration was aided by the increased positive contribution to the growth in consumption of foodstuffs and paid services. However, contribution of non-food products continues to gradually go down (Figure 47).

**Figure 45. Decomposition of the GDP Components by the Final Consumption Method, YoY, year-to-date total**



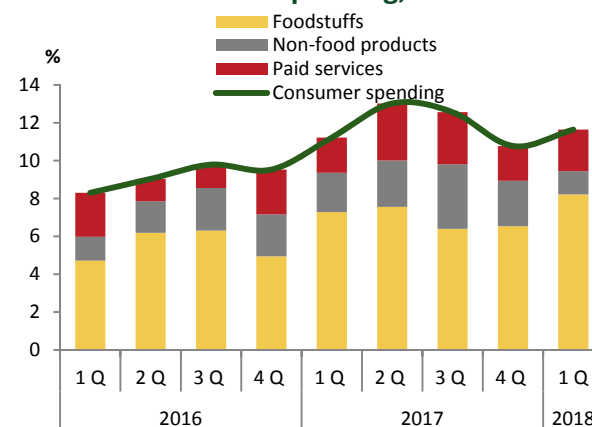
Source: CS MNE RK, NBRK's calculations

**Figure 46. Household Consumption, Household Real Cash Income and Retail Sales, YoY, year-to-date total**



Source: CS MNE RK

**Figure 47. Structure of Growth in Household Nominal Consumer Spending, YoY**

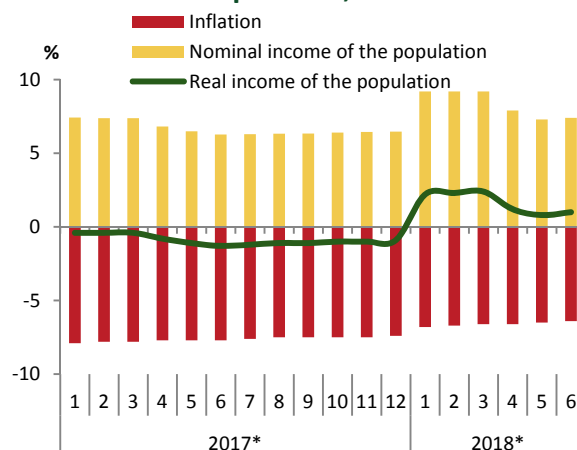


Source: CS MNE RK, NBRK's calculations

### Income of the Population

In the second quarter of 2018, real cash income of the population continued to grow after turning up positive in the first quarter of 2018 (Figure 48). The main reason for a positive growth in real cash income of the population had been the rise in their nominal values. In its turn, the nominal cash income was growing as a result of higher growth rates of real wages which increased by 2.2% in the second quarter. In addition, deceleration of inflationary processes to 5.9% in the second quarter also promoted the growth of income in real terms.

**Figure 48. Structure of Growth in Real Cash Income of the Population, YoY**



\*-preliminary data

Source: CS MNE RK

### Investments

At the end of the second quarter of 2018, the investment activity of enterprises in the real sector remained high. So, the expansion of fixed capital investments accounted for 25.8% as compared to corresponding period of the previous year (Figure 49).

In the industry-based breakdown, the largest contribution to the growth in investments was made by the mining industry (the annual growth of 49.7%) stemming from the increased capacities of oil extraction in the Tengiz oil field. The extension of the pipeline system for transportation of oil was conducive to the 30.1% growth of investments in the transport and warehousing sector.

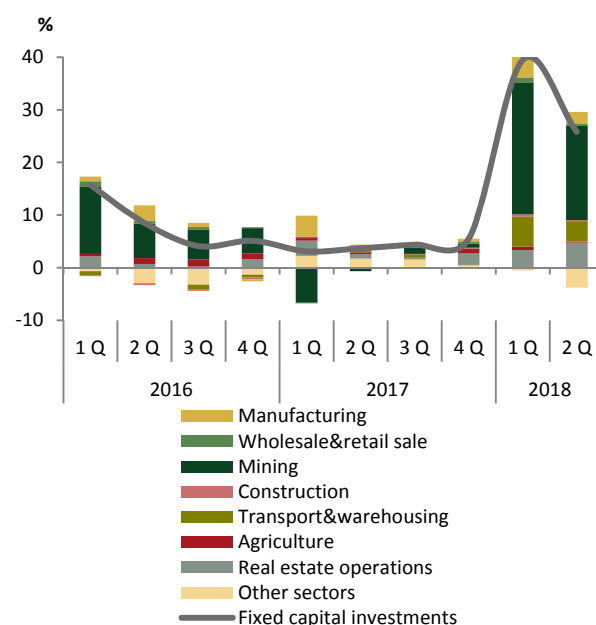
In the manufacturing industry, the 18.2% expansion is driven by modernization and reconstruction of Shymkent petrochemical plant.

In addition, a positive trend of growth in investments into real estate operations is keeping up owing to expansion in construction of residential buildings in the cities of Astana and Almaty.

In the second quarter of 2018, other sectors made a moderate contribution to the growth in investments.

As before, own funds of enterprises still represent the main source of investment financing (about 73.6%). In the second quarter of 2018, the share of domestic investments in

**Figure 49. Fixed Capital Investments, by Types of Economic Activity, Contribution, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

total investments accounted for 70.6%, and the share of foreign investments – for 29.4%. During the first quarter of 2018, gross inflow of foreign direct investments amounted to USD 6.7 bln. and it increased by 24.1% as compared to the corresponding period of the previous year. Non-residents were most actively investing into the mining and manufacturing industries.

### 2.3.2 Domestic Production

In the first half of 2018, the real GDP growth by the production method accounted for 4.1% versus the corresponding period of the previous year (Figure 50).

The main contribution to the growth of goods production (by 5.0%) was made by branches of the industry owing to extraction of mineral resources and production of industrial goods. Positive contribution to the growth in the service production (by 3.7%) was secured by sectors of wholesale and retail trade, transport and warehousing.

Performance of key economic sectors demonstrates positive development trends. So, in the first half of 2018 a short-term economic indicator went up by 5.2% as compared to the same period of the previous year (Figure 51).

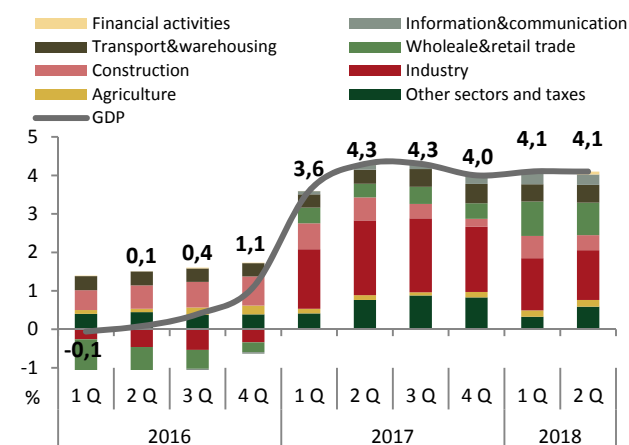
Actual overfulfillment of plan for crude oil extraction in large oil fields of the country (Tengiz and Kashagan) as well as stable rates of growth in volumes of extraction of natural gas, iron ore and non-ferrous metal ores sparked the 5.5% growth of the mining industry in the first half of 2018 (Figure 52).

Given a favorable external market environment, production activity in the manufacturing industry was persisting, being secured both by the increased production of interim goods (metallurgical industry and oil refinery) and of consumer goods.

The growth in the manufacturing industry accounted for 5.2% as compared to the corresponding period of the previous year (Figure 53).

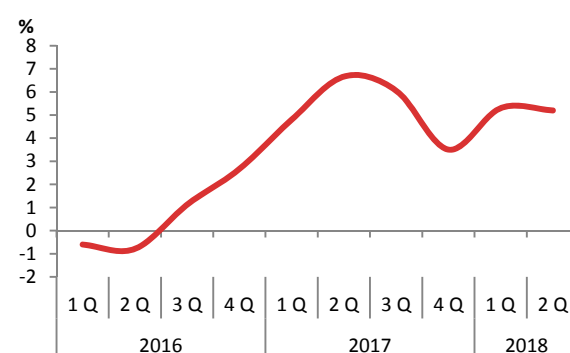
In the metallurgical industry the growth slowed down to 3.4%; this was mainly caused by deceleration in production in the non-ferrous metallurgy: output volumes of refined silver and pure copper declined.

**Figure 50. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

**Figure 51. Short-Term Economic Indicator, YoY**



Source: CS MNE RK, NBRK's calculations

The ferrous metallurgy boosted by 5.0% owing to the increased production of ferroalloys, rolled products and fixtures.

The growth in production of petrochemicals given the increased oil extraction accounted for 4.4%.

In the structure of consumer goods production, the growth was observed in the following sectors: in the food industry (5.2%), light industry (2.4%), in production of tobacco (14.2%) and paper products (12.0%).

A significant advancement of 17.2% is observed in the engineering industry. Such advancement was secured by the increased production of motor vehicles (68.3%), electrical equipment (55.1%) and computers, electronics and optics (47.1%).

In the first half of 2018, gross output in the agricultural sector accounted for 4.0%, owing to the increased output of animal products. There was an increase in the volumes of cattle and poultry slaughtering on a live weight basis, yield of raw cow milk and in the quantity of chicken eggs.

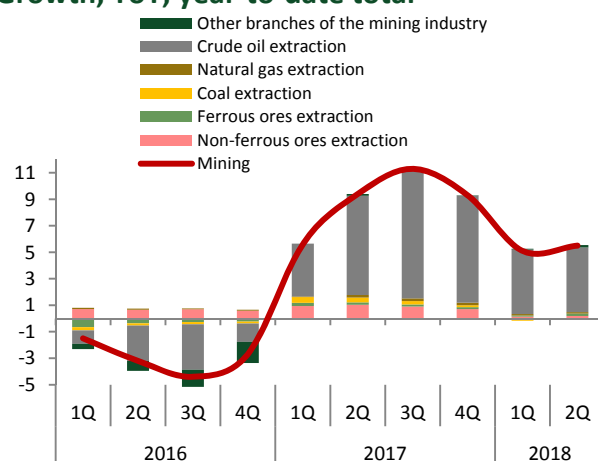
The growth in the volume of construction works slowed down to 3.8%, which is related to reduction in construction and assembly works (by 1.8%) and a significant increase in works on major overhaul and regular maintenance (Figure 54).

Reduction in construction and assembly works is associated with a high base of the first half of 2017 due to sizeable volumes of construction of EXPO-2017 facilities, and the increase in repair works – with reconstruction of industrial facilities, highways and railways thus reflecting on the structure of commissioned facilities.

The rise in real cash income of the population was conducive to the 5.6% growth in volumes retail sales (Figure 55). In the structure of retail sales, the share of non-food products increased significantly; this is an evidence of the growing consumer demand. At the same time, the sales of foodstuffs decreased by 6.3%.

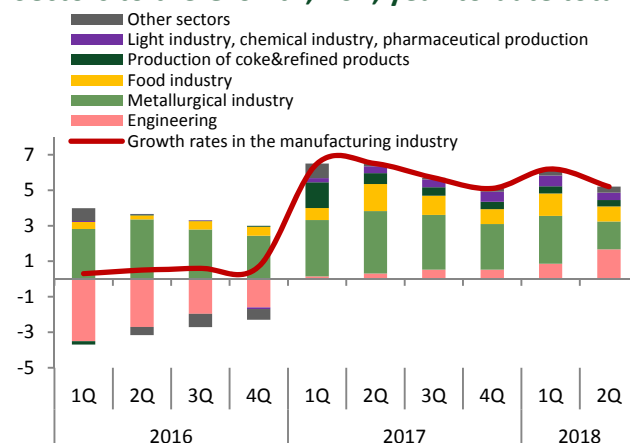
The growth of wholesale turnover slowed down to 6.1% as a result of decline in wholesale trading of non-food products and capital goods.

**Figure 52. Decomposition of the Mining Industry. Contribution by Sectors to the Growth, YoY, year-to-date total**



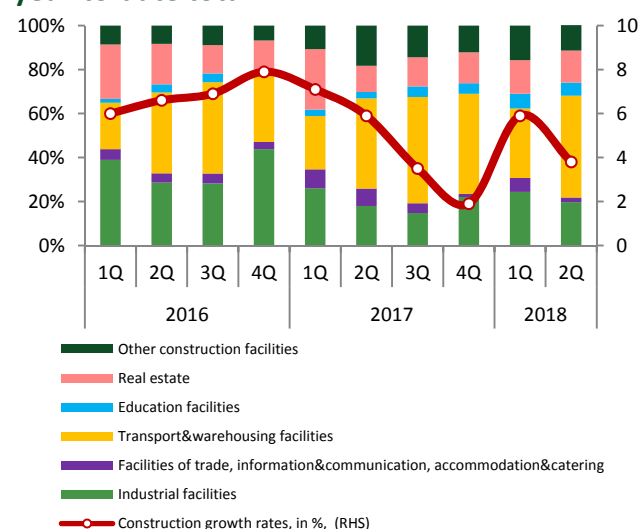
Source: CS MNE RK, NBRK's calculations

**Figure 53. Decomposition of the Manufacturing Industry. Contribution by Sectors to the Growth, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

**Figure 54. Growth Rates of Construction and a Relative Share of Commissioned Facilities, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

Implementation of infrastructure projects, positive trends in the industry and trade help to increase the volumes of transport and warehousing services. So, in the first half of 2018 the growth in the sector accounted for 4.9%, with a significant contribution made by cargo transportations by railways (11.4%), by pipeline transport (9.4%) and motor transport (6.4%).

During the first half of 2018, the growth in the information and communication sector accounted for 5.9% mainly due to the increased volume of the Internet services (7.6%), mobile communication (2.4%), postal and express mail services (4.1%).

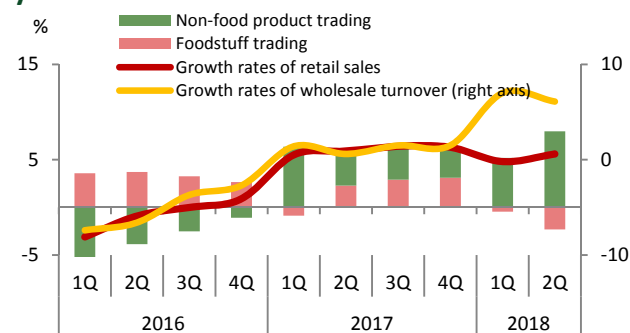
The composite leading indicator, which summarizes the assessment of the existing situation as well as expectations of CEOs of companies in the real sector of the economy, in the second quarter of 2018 keeps staying in the positive zone which indicates that the business activity in the real sector continues to recover. A favorable environment in the global oil market as well as the recovering domestic consumption amidst the growing real cash income generally had a positive effect on the demand for final products. So, the interviewed enterprises (industry, agriculture, transport, trade, and construction) record the increase in the average return on sales, reduction of average interest rates on loans in the tenge, a slowdown in the price growth for raw materials and supplies. The output gap, for the first time since 2014, has turned positive indicating the existence of a feeble pro-inflationary pressure in the economy (Figure 56).

### 2.3.3 Labor Market and Unemployment

In the second quarter of 2018, real wages continued their growth which accounted for 2.2%. The increase in real wages was furthered both by retention of growth rates of their nominal values (8.5%) and by deceleration of inflation (Figure 57).

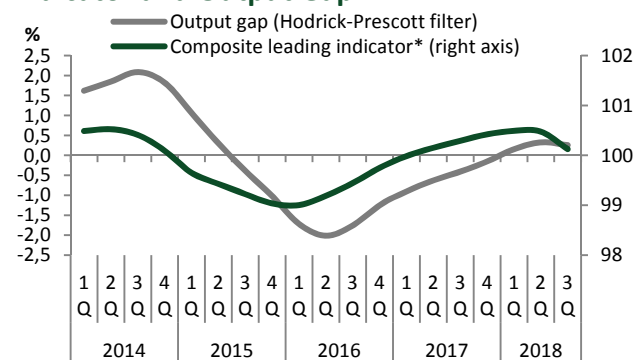
In the industry-based breakdown, the growth in real wages was observed in activities in the area of administrative and ancillary service (by 15.7%), in the construction sector (by 8.4%), in the mining and the manufacturing

**Figure 55. Growth Structure of Retail Sales and Growth Rates of Wholesale Turnover, YoY year-to-date total**



Source: CS MNE RK, NBRK's calculations

**Figure 56. Behavior of the Composite Leading Indicator and Output Gap**



Source: NBRK

\* the calculation of a composite leading indicator was revised based on the OECD methodology

industry (by 6.5% and 4.6%, respectively), and trade (by 3.3%).

At the same time, real wages were decreasing in the healthcare sector (by 4.5%) and real estate operations (by 5.2%).

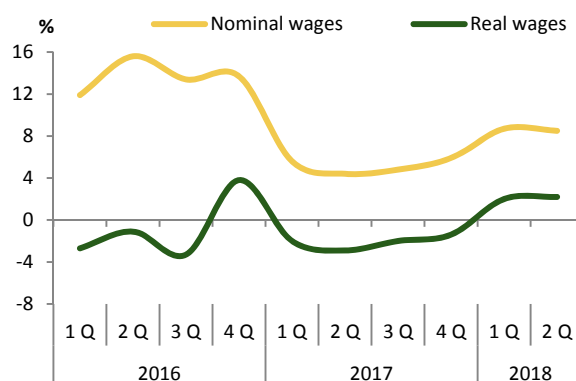
At the end of the first quarter of 2018, the growth in labor productivity decelerated and accounted for 3.7%. Such deceleration happened after a steady acceleration of productivity beginning from the third quarter of 2016. Positive dynamics of labor productivity in the economy as a whole was accompanied by retention of significant growth of productivity in the sectors engaged in the production of goods (by 7%). In the industry, the labor productivity increased by 5.4% mainly due to the increased productivity in the mining industry (by 9.9%), and the labor productivity in the manufacturing industry decreased by 1.2%. In agriculture and construction, the labor productivity went up by 4.2% and 12.2%, respectively.

The labor productivity in the service sector in the fourth quarter of 2017 shifted to a positive zone, after a significant downturn which had lasted since the end of 2014. In the first quarter of 2018, the positive dynamics continued and the growth made up 2.3%. The growth of labor productivity in the service sector was observed against its increase in the financial and insurance activities (by 21.1%), transport (by 5.8%), professional, scientific and technical activities (by 5.6%), accommodation and catering services (by 3.2%), and communication (by 2.8%). At the same time, the productivity decreased in real estate operations (by 29.5%), and activities in the area of administrative and ancillary service (by 11.9%).

The dynamics of unit labor costs turned positive for the first time since the first quarter of 2015. At the end of the first quarter of 2018, the growth in unit labor costs made up 0.35%. Such increase was observed amidst acceleration of growth rates of nominal wages (Figure 58).

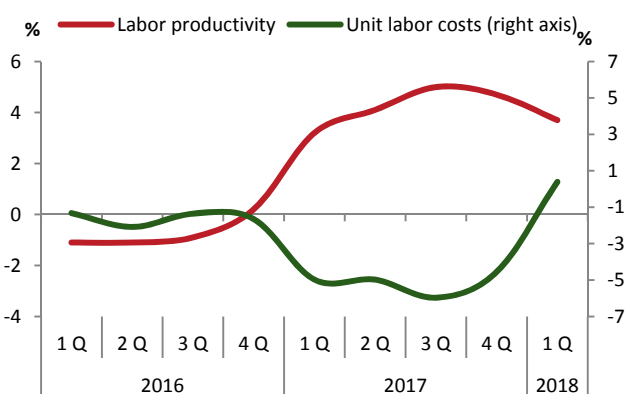
In the second quarter of 2018, the situation in the labor market was generally positive. The unemployment rate has not changed and accounted for 4.9%. A steady unemployment rate is observed against the persisting positive dynamics in the economic activity in majority of

**Figure 57. Nominal and Real Wage Indices , YoY**



Source: CS MNE RK

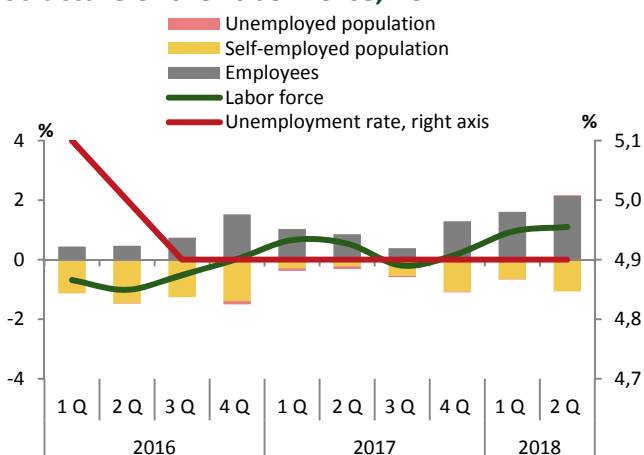
**Figure 58. Labor Productivity and Unit Labor**



Costs, YoY, year-to-date total

Source: CS MNE RK, NBRK's calculations

**Figure 59. Unemployment Rate, Growth Structure of the Labor Force, YoY**



Source: CS MNE RK, NBRK's calculations



economic sectors. In addition, implementation of the government programs of employment and infrastructure development coupled with the expansion project at the Tengiz oil field also helps to create additional jobs.

In the second quarter of 2018, the labor force increased by 1.1%, first of all owing to the employed population. The growth in the employed population is caused by the increase in the numbers of employees. However, the self-employed population has been decreasing for four years in a row (the decline of 2.8%), first of all, because of the unproductively employed people. The number of the unemployed population slightly increased (Figure 59).

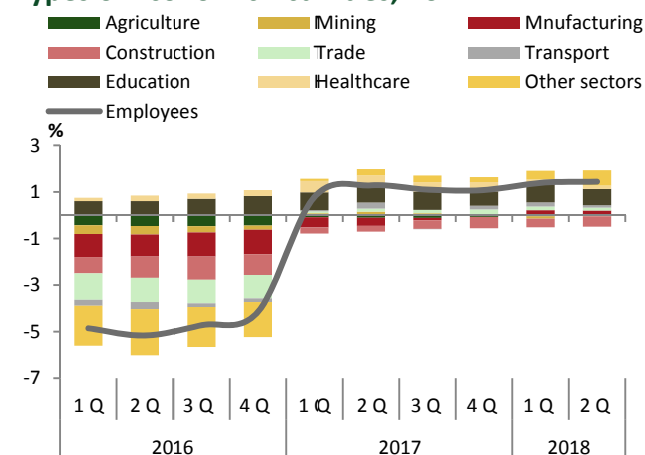
In the second quarter, the number of employees increased by 1.4% (Figure 60). The growth was observed in the professional, scientific and technical activities (by 2.7%), education (by 2.6%), the manufacturing industry (by 2.6), trade (by 2.5%), transport (by 1.7%), and communication (by 1.6%). At the same time, reduction was observed in such sectors as real estate operations (by 9.3%), the mining industry (by 0.6%), and electricity supply (by 0.3%). The trend of reduction in the number of employees in agriculture (by 0.5%) and in construction (by 8.9%) was persisting against the growth in labor productivity in these sectors.

## 2.4 Fiscal Policy

In the second quarter of 2018 as compared to the same period of the previous year, budget revenues decreased by 3.9% and amounted to KZT 2.6 trln. or 22.1% of GDP (Figure 61). The main reason for reduction in revenues is the 35.2% drop in the volume of guaranteed transfers received from the National Fund. Non-tax revenues also decreased (by 36.2%).

Tax revenues went up by 15.9% given the improved macroeconomic situation in the country. The main contribution to the increase in tax revenues was made by such items as the VAT and the tax on international trade and foreign operations. The growth in receipts from the tax on international trade is mainly associated with the use of an incremental ECD

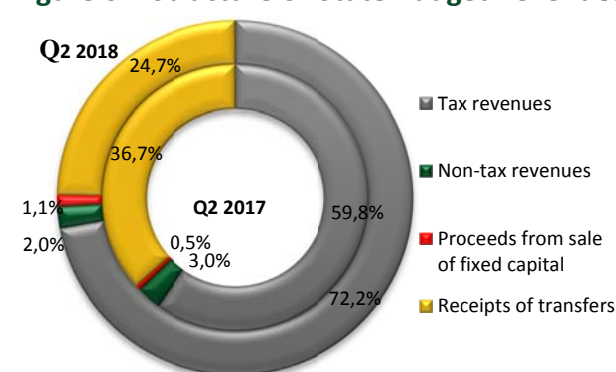
**Figure 60. Employee Growth Structure\*, by Types of Economic Activities, YoY**



Source: CS MNE RK, NBRK's calculations

\*- excl. small businesses engaged in entrepreneurship

**Figure 61. Structure of State Budget Revenues**



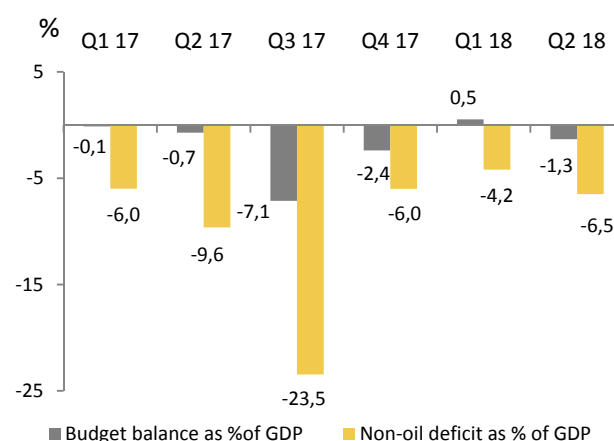
Source: Kazakhstan's Ministry of Finance

rate on export of crude oil as a result of a higher price of oil.

The state budget spending increased by 6.4% and amounted to KZT 2.7 trln. (22.9 % of GDP).

As a result, the state budget showed up a deficit of KZT 167.3 bln. or 1.3% of GDP (Figure 62). The main portion of the budget deficit was financed through the issue of long-term government securities.

**Figure 62. Change in the Overall Balance and Non-Oil Balance of the State Budget**



Source: Kazakhstan's Ministry of Finance



## II. FORECAST OF KEY MACROECONOMIC INDICATORS AND FURTHER MONETARY POLICY GUIDELINES

*The forecast of macroeconomic indicators was prepared on the basis of statistical information as at August 16, 2018*

### 1. KEY ASSUMPTIONS FOR EXTERNAL FORECAST PARAMETERS

As compared to assessments provided in the previous Inflation Report, forecasts made by information agencies, international financial institutions and private companies regarding the oil price were revised upwards in the environment of increased global consumption of oil as well as higher existing price levels. The averaging of updated forecasts demonstrates that in 2018 the price of oil (Brent) will make up USD 70.1 per barrel on average and in 2019 it will be somewhere close to USD 70 per barrel (Table 1).

However, there are a number of risks which, if realized, could have a negative effect on the dynamics of oil prices. Reduction in the global demand as well as the arising excess in the world oil reserves against a high supply may have a downward effect on the oil price. To this end, the National Bank in designing its forecasts of macroeconomic variables for the short-term (to the first quarter of 2019) and medium-term (to the first quarter of 2020) periods set the price of oil (Brent) at USD 60 per barrel as its baseline scenario. As compared to the previous forecast round, the baseline scenario for the price of oil had not changed.

In its forecasts, the National Bank additionally considers a risk scenario which assumes that the price of oil (Brent) will drop and will be staying at USD 40 per barrel over the forecast horizon.

The National Bank's assumptions regarding the terms of trade related to the demand for Kazakhstani export commodities on the part of Russia, EU and China, which accounted for 74% of the total foreign trade turnover of goods in the first quarter of 2018, had not undergone dramatic changes as compared to previous forecasts presented in the Inflation Report for the first quarter of 2018.

According to expectations which take into

**Table 1**  
**Forecasts of Oil Price (Brent) in USD per Barrel**

Source	2018	2019	Date of the Forecast Release
International Monetary Fund	72.5	71.2	July 2018
World Bank	67.1	67.1	April 2018
Thomson Reuters	72.8	72.5	June 2018
Consensus Economics	72.8	73.7	July 2018
Bloomberg	65.1	63.2	July 2018
Average	70.1	69.5	-

Source: prepared by the NBRK

account assessments of international organizations, external demand will be demonstrating positive dynamics with a minor deceleration by the end of the medium-term horizon. First of all, external demand will be slowing down as a result of lower growth rates of the economic activity in China and the EU. However, the growth of Russia's GDP will be close to its potential level (Figure 63).

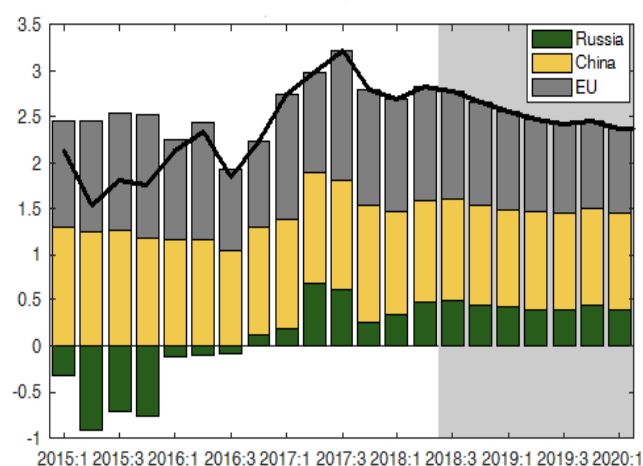
The forecast of external inflationary background expressed via the weighted inflation in main trading partners based on their shares in Kazakhstan's imports (Figure 64) was revised upwards due to higher inflation forecasts in Russia where inflation may go above the target in the forecast period. At the same time, inflation in China and the EU is expected to demonstrate stable dynamics in the reviewed quarter.

In the short term, according to projections made by the Food and Agriculture Organization of the United Nations (FAO), the demand in the global cereal market will be prevailing over its supply. Therefore, world cereal stocks are expected to go down in the agricultural season of 2018-2019<sup>4</sup>.

According to the National Bank's assessments, under the baseline scenario, in the medium term prices in the global food market will demonstrate an upsurge in view of lower expectations about cereal crops as compared to 2017. In turn, low expectations regarding the worldwide crops were determined by the risks that the wheat production in the EU will go down and the harvesting of wheat, corn and barley in the Russian Federation and in Ukraine will also drop. There is an assumption that by the end of 2019 the world cereal prices will be having a moderately upward effect on the dynamics of food prices in Kazakhstan.

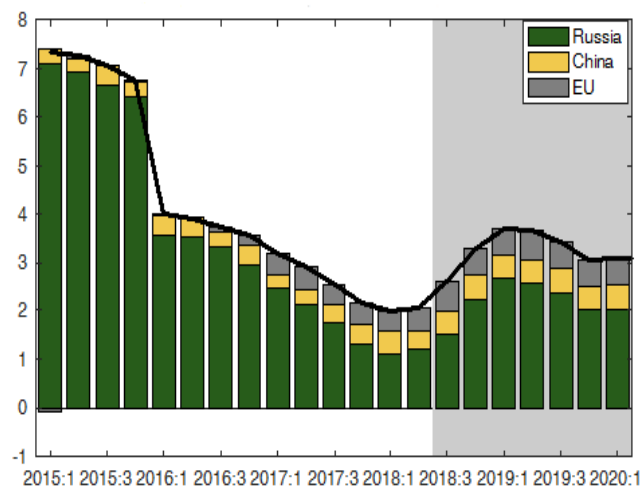
As for the external monetary conditions, they are expected to deteriorate in the medium term being driven by a tighter posturing of the US Fed regarding the prospects that interest rates will be raised.

**Figure 63. External GDP Decomposition Broken Down by Kazakhstan's Main Trading Partners, %, YoY**



Source: NBRK's calculations

**Figure 64. Weighted Inflation Broken Down by Kazakhstan's Main Trading Partners by Shares in Imports, % YoY**



Source: NBRK's calculations

Russia; China; EU

<sup>4</sup> <http://www.fao.org/worldfoodsituation/csdb/en/>

## 2. FORECAST UNDER THE BASELINE SCENARIO

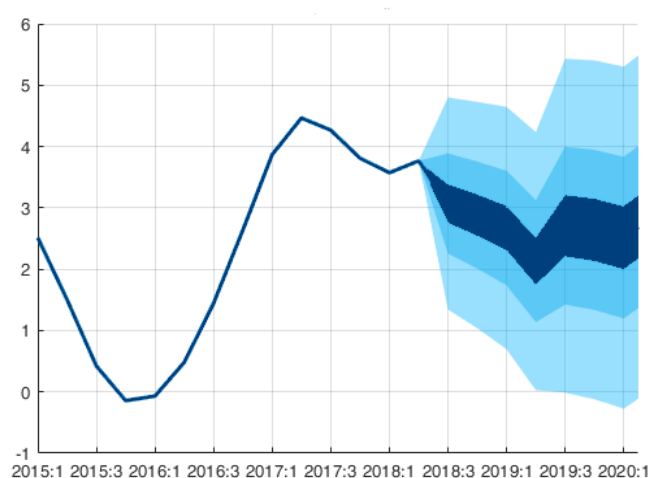
According to updated forecasts of the National Bank, under the baseline scenario Kazakhstan's real GDP growth at the end of 2018 will account for 3.5% (Figure 65). Assessment of the dynamics of economic activity in 2018 has not changed as compared to the previous forecast round. In the short term, the consumer and investment demand will act as key growth factors. Positive dynamics of the consumer demand will be observed amidst the growing real cash income of the population and a positive trend in the consumer lending. The increase in investment demand will be accompanied both by the expanded fixed capital investments given implementation of projects in the mining industry and by positive growth rates of investments into residential construction. A positive trend in exports will be promoted by the increased extraction of oil and gas condensate in the Kashagan field. The Government's plans to gradually cut the budget deficit assume that the general government spending will be demonstrating weak dynamics.

In the medium term, the economy will be growing at a more moderate pace because of anticipated deceleration processes in the pattern of consumer demand and exports (see the Current Account Forecast in Annex 1). Under the baseline scenario, at the end of 2019 the economic growth in Kazakhstan will account for 2.6% versus the corresponding period of the last year.

According to the National Bank's updated assessments, in the short term the output gap will be positive and will be putting a slight pro-inflationary pressure. In the medium term, the output gap will be in a weakly positive zone up to the end of the first quarter of 2020.

Annual inflation forecasts as compared to the previous forecast period were adjusted towards a minor growth, thus increasing the risks that the target for 2020 will be overrun (below 4%). This was caused by the observable depreciation of the domestic currency exchange rate given depreciation of the Russian ruble and other currencies of developing economies, by

**Figure 65. GDP, Quarter to the Corresponding Quarter of the Previous Year, %**

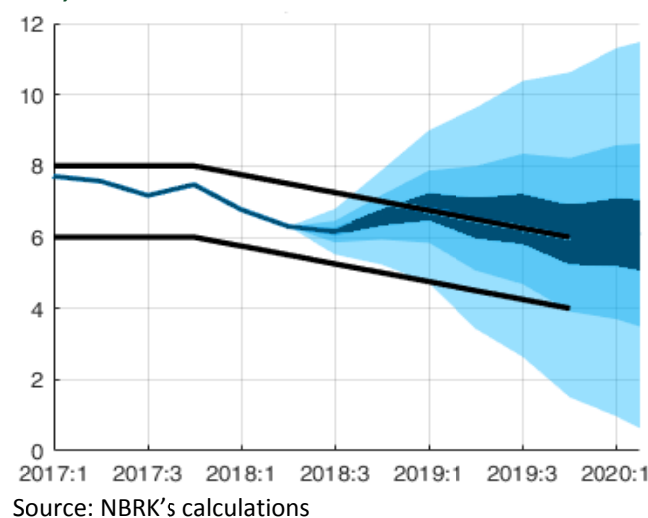


Source: NBRK's calculations

deteriorating external inflationary background, tightening monetary conditions as well as by persistently high rates of surge in prices in the manufacturing industry (in annual terms).

According to forecasts, under the baseline scenario the annual inflation in Kazakhstan in 2018 will be within its target band of 5-7%, and in 2019 – near the upper boundary of the interest rate band of 4-6% at the year-end (Figure 66).

**Figure 66. Inflation, Average for the Quarter, YoY, %**



### 3. RISKS IN THE MEDIUM TERM

Changes in the external economic environment motivated the National Bank to revise its assessment of risks in the medium term forecast (Figure 67). At the same time, the probability of realization of internal risks as compared to the previous forecast round remained unchanged but is still at a fairly high level.

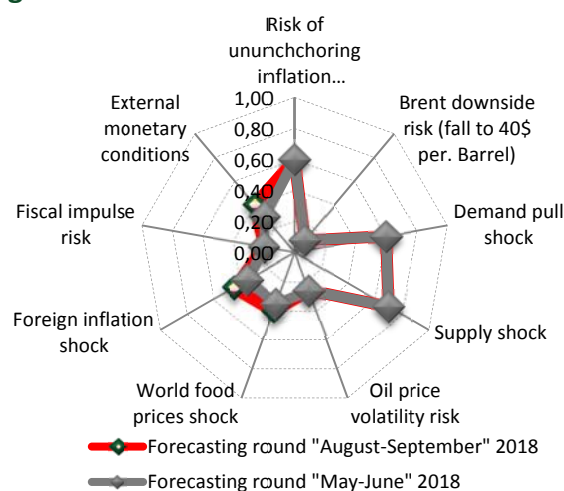
Acceleration of the domestic demand given the increase in wages, a significant growth of retirement benefit payments from July 2018 as well as a positive pattern in the consumer lending, serves as one of key risks for acceleration of inflation in the medium-term period.

In the environment of persistently high growth rates of producer prices, there is still a substantial probability for realization of supply-pull shocks which may significantly affect the inflation forecast.

The non-anchoring of inflation expectations of the population is another risk for the price stability and it may significantly change the dynamics of forecasts. Inflation expectations of the population are still adaptive and demonstrate a high degree of sensibility to the change in internal and external factors.

As compared to the previous forecast round, the risks of rise in world food prices slightly intensified given the forecasted drop in the worldwide stocks and the growth in the

**Figure 67. Risk Map Based on the Expert Judgment**



global consumption.

Risks of deterioration in external monetary conditions intensified as a result of a heavier posturing of the US Fed on raising the policy rate. This factor as well as the growing tension in the trade relations between the world's leading economies (the USA, China, European Union) may increase the capital outflow from developing markets, weaken their local currencies and accelerate inflationary processes. Besides, given the higher forecasts regarding inflation in Russia and its temporary overrunning the target in 2019, the risk of import of external inflation increased. Nonetheless, a stable situation in the oil market where risks of the price upsurge or drop are generally balanced should be viewed as a positive external factor. So, the increased worldwide production of slate oil and a possible downturn in the global economy amidst uncertainty in trade relations between countries may lead to the fall in oil prices and a sluggish production of oil in Venezuela and Iran may result in its upsurge. Therefore, the risk of oil price falling to USD 40 per barrel remains low. A probability of realization of risks of fiscal impetus and volatility of oil prices also remained unchanged.

Meantime, alongside with the baseline scenario, a riskier scenario which assumes that the price of oil would fall below USD 40 per barrel was considered by the National Bank. If this scenario is realized, inflation would go beyond the upper boundary of its target band in 2018-2019, and the GDP growth rates would slow down to 1.3% in 2019. A possible reaction of the National Bank would be the tightening of its monetary policy, and conditions in which the monetary policy is implemented would be changed from neutral to contracting ones. In future, in its assessment of the balance of risks, the National Bank will take into account not only external and internal factors described above but also the decisions regarding the government's fiscal and pricing policy since such decisions may significantly affect the inflation and GDP dynamics.

## Annex 1

## Forecast of the Balance of payments Current Account

According to the theory of macroeconomic interrelations, the state of the current account is a visible indicator of a country's economic security. The current account of the balance of payments demonstrates the sufficiency of domestic savings necessary to maintain the level of investment essential to ensure economic growth.

Positive current account balance provides high levels of domestic savings and creates a base for foreign expansion of domestic capital, leading to domestic currency strengthening. In the case of negative current account, the lack of domestic funds is covered by attracting foreign capital or external borrowings, or is covered by accumulated reserves of the state. In this regard, balance of payments forecasting plays an important role in economic policy implementation.

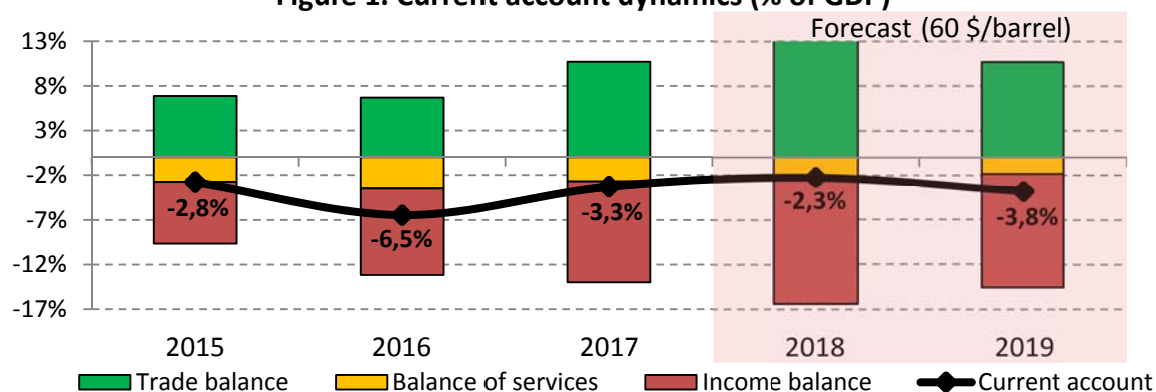
Current account forecasts are carried out on quarterly basis within the framework of "forecasting rounds" of the National Banks of the Republic of Kazakhstan (NBK) and the forecast results are used in the monetary policy decision making process. Assumptions of the NBK, the Government of the Republic of Kazakhstan and international analytical agencies are used as initial parameters of the forecast. The base scenario of the most recent forecasting round has Brent oil fixed at \$60 per barrel starting from the 4th quarter of 2018 (the average price in 2018 is \$70.9; in 2019 – \$60).

## Forecast

The balance of the current account in Kazakhstan is determined by the dynamics of the trade balance and income balance. The dynamics of the balance of services is stable and its impact on the current account indicators is limited (figure 1). By the end of 2018, the current account is expected to improve to a level of (-)2.3% of GDP. In 2019, the deficit is anticipated to increase to (-)3.8% of GDP due to lower average annual price of oil.

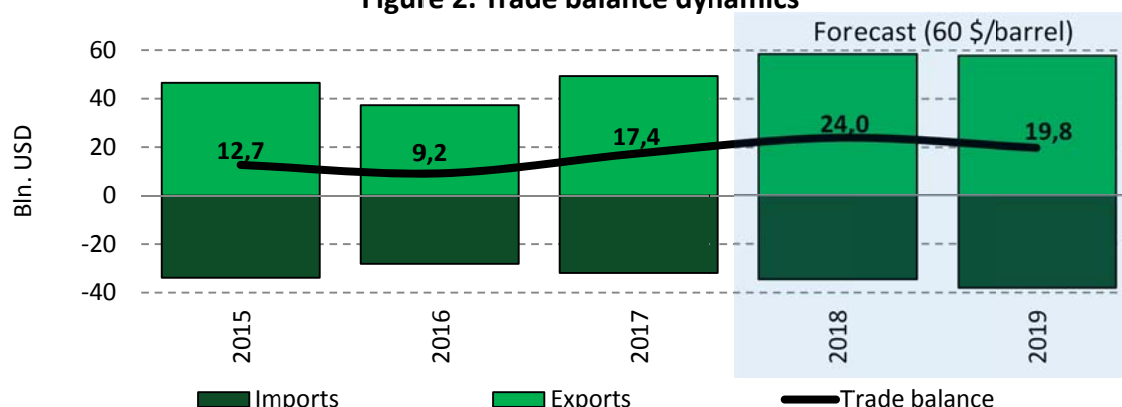
Increase in imports of equipment and pipes due to the launch of investment projects in the oil and gas sector, as well as increase in payments to foreign direct investors as a result of realization of joint investment projects are offsetting potential current account improvements.

**Figure 1. Current account dynamics (% of GDP)**



In 2018, rapidly rising export of goods, that outpace growing imports, is expected to contribute to increasing surplus of the trade balance. At the same time, in 2019, lower oil prices combined with increase in the volume of imports of goods necessary for the implementation of large-scale infrastructure projects in the oil and gas industry is expected to lead to a decrease in the trade surplus (figure 2).

Figure 2. Trade balance dynamics



*Note: Exports and imports are presented using the balance of payments methodology*

Export of goods is the key component determining the state of the current account. The main export goods are oil and gas condensate (in 2017 – 59.8%), ferrous metals (8.7%) and non-ferrous metals (10.1%).

The production of oil and gas is expected to reach 91 million tons this year and 93 million tons in 2019. Favorable environment on the world commodity markets remains. Stable growth of the economies in the key export markets of Kazakhstan is expected. In 2018, export of goods is expected to increase by 37.4%. In the scenario of oil prices dropping to \$60 per barrel in 2019, exports are projected to decline by 1.1%.

Further increase in import of goods is expected within the forecasting horizon. Under the baseline scenario, an increase in domestic demand will boost import of goods by 8% in 2018 and 10% in 2019.

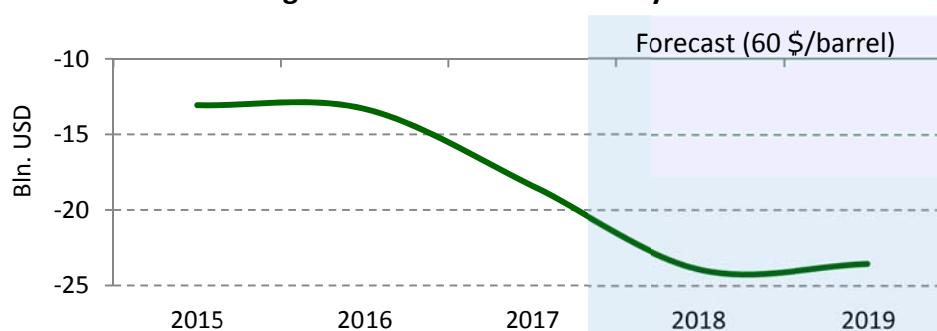
Import of consumer goods (27.3% of total import of goods in 2017) is the most sensitive component of imports. Changes in import of consumer goods are explained by exchange rate fluctuations and dynamics of consumer loans.

At the same time, the dependence of intermediate and investment imports on the exchange rate is relatively low. This is due to the fact that a significant proportion of those goods are imported for oil and gas investment projects. The implementation of such projects does not depend on changes in the exchange rate.

The income balance reflects the flows of income from investments, labor remuneration and transfers. The negative balance of income shows that the income to be paid to foreign investors exceeds the income to be received by domestic economic entities.

Under the forecasting period, the widening of the deficit of income balance is expected. Such a dynamic is explained by growing income of foreign investors in the commodities sector of Kazakhstan, which, in turn, is ensured by the stabilization of oil prices and the growth of oil production (figure 3).



**Figure 3. Balance of income dynamics**

According to the results of the forecasting round "August 2018", the following is expected:

- In 2018, the current account deficit is expected to shrink, indicating a reduction in economic imbalances;
- Rising oil prices and increasing production in the oil and mining industry is expected to lead to the current account improvement;
- Further increase in imports is expected across all product groups. The main factors of growth are increase in domestic demand and continued implementation of large-scale investment projects;
- Further improvement of the current account is being prevented by growing income of foreign investors.



## BASIC TERM AND DEFINITIONS

**Core Inflation** – means the inflation which excludes transitory uneven price changes subject to certain factors of administrative, event-related and seasonal nature.

**Base Rate** is a key monetary policy instrument of the National Bank that helps to regulate nominal interbank interest rates in the money market. By setting the level of the base rate, the National Bank determines a target value of the targeted interbank short-term money market rate in order to achieve the goal of ensuring price stability in the medium term

**Gross Fixed Capital Formation** – is the growth in non-financial assets which have been used in the process of industrial production for a long time. Gross fixed capital formation includes the following components: a) acquisition, less retirement, of new and existing fixed assets; b) costs for major improvements of tangible produced assets; c) costs for improvement of tangible non-produced assets; and d) expenses in connection with the transfer of title for non-incurred costs.

**FX Swap** – means a foreign exchange transaction which involves the concurrent purchase and sale of a certain amount of one currency in exchange of another currency with two different value dates.

**Gross Domestic Product** is an indicator that reflects the market value of all final goods and services (i.e. designated for direct consumption) produced during a year in all sectors of the economy within the territory of the country for consumption, exports and saving, irrespective of the national identity of the used production factors.

**Money Base (Reserve Money)** includes cash issued in circulation by the National Bank, other than cash at the cash departments of the National Bank (cash outside the National Bank),

transferrable and other deposits of banks, and transferrable deposits of non-bank financial organizations and current accounts of government and non-government non-financial organizations in the tenge at the National Bank.

**Money Supply (M3)** is determined on the basis of consolidation of balance sheet accounts of the National Bank and banks. It consists of cash in circulation and transferable and other deposits of non-bank legal entities – residents and households in the domestic and foreign currency.

**Dollarization of the Economy** means the situation where a foreign currency (largely – the US Dollar) starts to be used for transactions within a country or in certain sectors of its economy, pushing out the domestic currency from the domestic money turnover, and acting as the means of saving, measure of value and the legal tender.

**Inflation** – is an increase in the general price level of goods and services. In Kazakhstan, inflation is measured with the use of consumer price index.

**Consumer Price Index (CPI)** – the change in the overall level of prices for goods and services purchased by the population for consumption. The consumer basket of Kazakhstan for calculation of inflation reflects the structure of household expenditures and includes goods and services which represent the largest relative share in the consumption of population. The CPI is calculated as the ratio of the cost of a fixed set of goods and services in current prices and its cost in the prices of the previous (base) period. The index is calculated by the Committee on Statistics of the Ministry of National Economy of the Republic of Kazakhstan.

**Inflation Targeting** – is a monetary policy regime which is oriented at achieving a target inflation rate.

**Composite Indicator** – is a generalizing indicator which is used to reflect short-term trends in the development of the real sector of the economy. Composite indicator as possessing the forward-looking feature is used to reflect a cyclical change and to identify turning points when recovery and downturns in the economy occur and change. A composite indicator is built on the basis of survey findings among enterprises which participate in the market research conducted by the National Bank.

**Short-term economic indicator** is calculated with a view to ensure efficiency and is based on the change in the output indices by key sectors: agriculture, industry, construction, trade, transport and communication accounting for over 60% of GDP. The indicator is built without recalculations for the unobservable economy and without other macroeconomic adjustments.

**Credit Auctions** mean the National Bank's auction for the securities buy/sell back.

**Minimum Reserve Requirements (MRRs)** mean the mandatory share of bank's liabilities which a bank is to keep in the form of cash in its cash department and monies on correspondent accounts with the National Bank in the domestic currency (reserve assets). The volume of reserved liabilities of banks is regulated by the MRR ratios.

**Nominal Anchor for Monetary Policy.** It is a certain indicator including a macroeconomic indicator which helps the National Bank to influence the ultimate monetary policy goal.

**Reverse Repo** is the purchase of a security with the commitment to sell it after a specific period of time and at a specific price. The

National Bank conducts reverse repos with a view to provide the tenge liquidity to banks against the pledge of securities in line with the National Bank's list of collateral.

**Open Market Operations** are regular operations of the National Bank in the form of auctions for liquidity provision or withdrawal in the money market with a view to set interest rates around the base rate.

**Standing Facilities** refer to monetary policy instruments for adjustment of volumes of liquidity, which resulted from the open market operations. Standing facilities are provided as part of bilateral arrangements where the National Bank is one party to the transaction. Such operations are conducted at the initiative of banks.

**Transferrable Deposits** refer to all deposits which: 1) can be converted into cash at face value at any moment in time without any penalties and restrictions; 2) are freely transferable through a check, draft or endorsement orders; and 3) are widely used for making payments. Transferable deposits represent a part of the narrow money.

Other deposits primarily include savings and time deposits that only can be withdrawn on expiration of a certain period of time, or can have different restrictions which make them less convenient for use in the ordinary commercial transactions and, mainly, meet the requirements established for saving vehicles. In addition, other deposits also include non-transferable deposits and deposits denominated in foreign currency.

**Potential Output** reflects the level of output in the economy that can be reached subject to full utilization of inputs and full employment. It reflects the volume of production which can be manufactured and realized without creating prerequisites for the change in the price growth rates.

**Consumer Basket** means a sample of goods and services which characterizes the standard level and the structure of monthly (annual) consumption of an individual or a family. Such sample is used to calculate the minimum subsistence level, based on the cost of the consumer basket in current prices. The consumer basket also serves as a comparative basis for estimated and real consumption levels and also as the basis to determine the purchasing capacity of currencies.

**Interest Rate Channel** of the monetary policy transmission mechanism is the transmission mechanism channel which describes the impact of the central bank on the economy through the interest rate regulation.

**Direct Repo** is the sale of a security with the commitment to repurchase it after a specific period of time and at a specific price. The National Bank conducts direct repos with a view to withdraw excess liquidity in the tenge.

**Free Floating Exchange Rate.** According to the current classification of the International Monetary Fund, under the floating exchange rate framework a central bank does not establish any pegs including operating ones for the level or the change in the exchange rate, allowing the exchange rate to be determined by the market factors. In doing so, the central bank reserves the opportunity to periodically intervene in the foreign exchange market in order to smooth out the volatility of the domestic currency exchange rate or to prevent its dramatic changes as well as to ensure the financial system stability.

**Output Gap (GDP Gap).** Deviation in GDP expressed as a percentage of a potential output. Expresses the difference between an actual GDP and potential GDP for a certain time frame. Serves as an indicator which reflects the effectiveness of resources utilized in the country. If an actual output exceeds the potential one (a positive output gap), other

things remaining equal, the trend of acceleration in the price growth rates would be anticipated because of the overheating of the economy. The presence of a negative output gap indicates an expected slowdown in the price growth rates due to low economic activity. Output fluctuations around its potential level reflect business cycles in the economy.

**Real Exchange Rate** refers to a relative price of a commodity produced in two countries: the proportion of commodity exchange between countries. The real exchange rate depends on the nominal rate, relation between exchange rates of currencies, and prices for goods in the domestic currencies.

**TONIA Rate** – (Tenge OverNight Index Average) represents a weighted average interest rate on one-day repo opening transactions made on the stock exchange with government securities in the automatic repo sector.

**Monetary Policy Transmission Mechanism** is the process, by which monetary policy tools influence final macroeconomic indicators such as the economic growth, inflation.

**Narrow Reserve Money** is the reserve money excluding other deposits of banks at the National Bank.

**NDF** – non-deliverable forwards used to hedge foreign exchange risks.

**LIST OF KEY ABBREVIATIONS**

GDP – Gross domestic product  
GPIID – Government Program for Industrial and Innovation Development  
EU – European Union  
ECB – European Central Bank  
CPI – consumer price index  
PI – price index  
CS MNE RK – Committee on Statistics of the Ministry of National Economy of the Republic of Kazakhstan  
KASE – Kazakhstan Stock Exchange  
NBRK – National Bank of the Republic of Kazakhstan  
VAT – value-added tax  
OPEC – Organization of Petroleum Exporting Countries  
UN FAO – Food and Agriculture Organization of the United Nations  
RK – Republic of Kazakhstan  
REER – real effective exchange rate  
USA – United States of America  
FAO – UN Food and Agriculture Organization  
ΦPC – Federal Reserve System  
MMI – Money Market Index  
bln. - billion  
mln. - million  
thous. – thousand  
USD – dollars