NATIONAL BANK OF KAZAKHSTAN

Inflation Report

For the Third Quarter of 2017

Almaty, Kazakhstan

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-resouce 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 November 9, 2017.

CONTENTS

SUMMARY

The annual inflation has continued to decelerate and in September accounted for 7.1% as a result of a decrease in the contribution of the food component, which was previously at a high level. This was due to a temporary saturation of markets which was more expressed by seasonal decrease, and by deflationary trend in a separate segments of the food market. The core inflation rate excluding the volatile components (food products, energy and regulated tariffs) has continued to slow down and amounted to 6.6% by the end of September.

Weakening of an external inflationary background, and favorable internal environment of the agricultural markets, stability of inflationary expectations and also limited expansion of aggregate demand because of negative dynamics of real income became the major factors contributing the descending dynamics of inflation. The constraining factors for a more rapid deceleration of inflation were the increased volatility in the domestic energy markets against a reduction in supply, depreciation of the tenge exchange rate, and the persistently stimulative fiscal policy.

External demand on the part of the trading partner countries remained unchanged against the acceleration of economic growth in the EU and its slowdown in China and Russia. At the same time, a significant reduction in inflation in Russia and a moderate rate of price growth in China and the EU led to a further weakening of the external inflationary background.

Some pressure from inflation came from the foreign exchange market. At the time of favorable environment in foreign commodity markets, the situation in the domestic foreign exchange market was characterized by the increased volatility of the exchange rate as a result of the strengthening of devaluation expectations of the population and market participants.

Real GDP growth rates continued to recover in the domestic economy. In the economic sectors, the growth rate increased in the mining industry against the growth in the volume of raw materials extraction, and in the manufacturing industry as a result of an increase in the rate of growth in the production of metals. In the third quarter, there was an increase in the growth rate of retail commodity turnover, which, among other things, was supported by the EXPO international exhibition. At the same time, the negative pattern of the real cash income of the population, amid low growth of wages, limits the inflationary risks associated with consumer demand.

In the condition of slowing price growth rates, stable inflation expectations as well as the downward forecast for the inflation path in the medium-term, the monetary policy continued to ease. The base rate in August was lowered by 0.25 pp to 10.25% while maintaining the width of the interest rate band. The liquidity surplus caused the targeted rate to be at the lower boundary of the interest rate band. The excess liquidity in the money market was withdrawn mainly through the issuance of short-term notes of the National Bank. Measures for implementation of the Program for Increasing Financial Soundness of the Banking Sector served as a main factor, having influenced on the excess liquidity volume in the money market; they resulted in a reduction in negative balance from operations of the National Bank and behavior of monetary aggregates.

In the third quarter, weighted average interest rates on deposits in the domestic currency continued to decrease, just as weighted average interest rates on loans. Domestic lending, supported in large part by the activation of retail lending, continued to recover, also amidst the increasing growth rate of the corporate loan portfolio for financing of the working capital.

On the part of fiscal policy, there was an increase in transfers within the allocation of public funds for the capitalization of the JS «Problem Loan Fund» for rehabilitation of the banking system, which entailed an increase in the non-oil budget deficit. The increase in expenditures was

also due to the increase in social payments, which indicates that the stimulative focus of the fiscal policy persists.

With respect to the baseline scenario, the National Bank's approach remains conservative – oil price at the level of USD 50 per barrel is accepted as a baseline scenario. The prerequisites for external parameters have not changed significantly; a further recovery of external demand is still expected due to positive growth rates in countries - trading partners. In addition, no significant changes are expected in the external inflationary background. World prices of cereals will have a neutral impact on the development of prices in Kazakhstan given the increase in grain reserves.

Within the basic scenario estimates on rates of actual growth of economy in 2017 and 2018 in view of higher growth rates in the third quarter 2017 are reconsidered. So, the forecasts for 2017 have been raised to 3.5% (in previous Inflation report – 3.1%), and the forecasts for 2018 were changed towards a minor decrease of 2.8% (3%), due to the high base of the previous year. According to the updated estimates of the National Bank, the output gap in Kazakhstan in the short term will be weakly negative. However, it is expected that it will be closed in the second quarter of 2019, which, in turn, will have a neutral impact on the inflationary processes in the country.

Under the baseline scenario, inflation in the fourth quarter of 2017 will be closer to the upper boundary of the target band of 6-8%, and in 2018 it will start to gradually go into the target band of 5-7%.

The main risks for the inflation forecast still include the decline in prices of oil. If the scenario with the price of oil being at USD 40 per barrel realizes, higher inflation and moderate GDP growth rates are expected. In the baseline scenario as compared to the previous Inflation Report, the risks associated with the non-anchoring of inflation expectations and supply shocks have increased in the forecast horizon.

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

In the third quarter of 2017, the average price of oil (Brent) had been at USD 52.1 per barrel (Figure 1). As compared to the previous quarter, the price increased by 4.9%, and as compared to the corresponding quarter of 2016 the growth accounted for 13.8%.

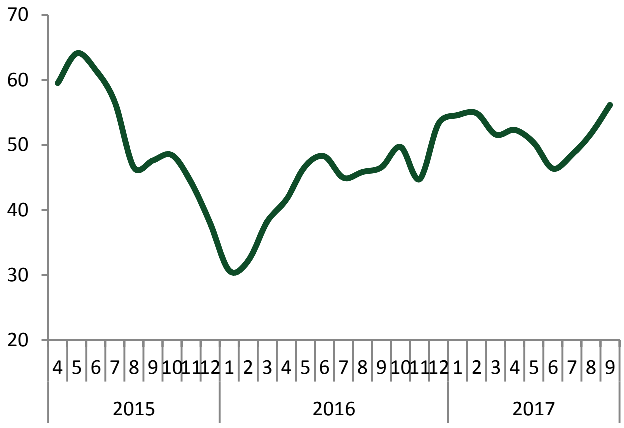
The market quotations of oil were increasing against the oil deficit which was persisting from the beginning of the year and was caused by accelerated growth rates of the global demand and the reduced growth rates of the oil supply (Figure 2). A negative balance between the global oil production and consumption was 0.49 million barrels a day, and the balance decreased by 32% as compared to the previous quarter.

Annual rates of growth in the global oil consumption slowed down because of a dramatic reduction in the demand from the USA as a result of Hurricanes Irma and Harvey. Oil consumption has also notably fallen in some European countries, Russia, and India. At the same time, a positive contribution to the growth in oil consumption was made by countries in Latin America, South-East Asia and China (Figure 3).

According to the U.S. Energy Information Administration, the global net production of oil somewhat accelerated. So, if in the second quarter of 2017 as compared to the corresponding quarter of 2016, the global oil production increased by 1.3%, in the third quarter of 2017 the growth accounted for 1.9%. The increase in the global oil production was driven by persistently high growth rates of oil extraction in the countries outside of OPEC as well as by a positive trend in OPEC countries (Figure 4).

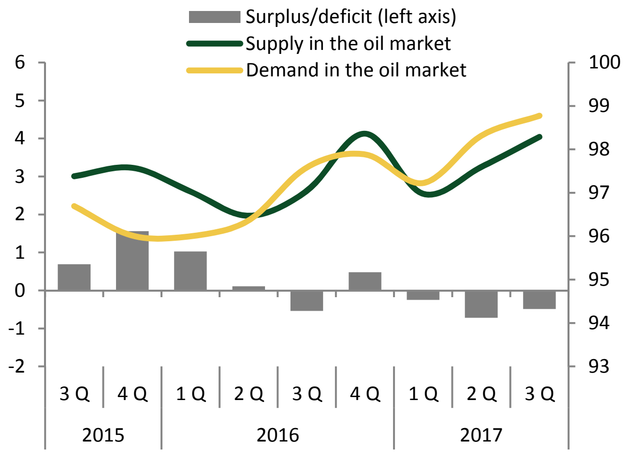
As compared to the corresponding quarter of the previous year, the growth rates of oil extraction in countries outside of OPEC increased by 2.8%; as compared to the previous

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



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

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



Source: U.S. Energy Information Administration (EIA) quarter, the growth accounted for 0.85%. The main sources for such growth were the USA, countries in the Central and South America as well as Russia. Acceleration in the oil production volumes in the USA occurred because of the previous year's low base and in Russia – as a result of commissioning of new oil wells. A negative contribution to the oil production in countries outside of OPEC was made by Canada, Latin American countries and China. In Canada, the oil extraction reduced mainly because of the reduced demand on the part of the USA coupled with the technical maintenance works performed in the oil fields. In Latin America, the oil extraction also dropped due to depletion of existing oil fields and also because of attacks against oil pipelines by rebels. It is worth mentioning that at the beginning of the third quarter of 2017, reduction in the oil production was also observed in Europe as a result of a fire in one of the largest oil refineries belonging to Shell Corp.

The volume of oil production in the OPEC countries due to the Algerian Agreement, aimed at reducing oil production, remains at low levels. The contribution of these countries to the overall global oil production amounted to 36%.

A significant reduction in oil extraction in the reporting quarter was noted in Saudi Arabia, Kuwait, UAE and Venezuela, which was offset by the increased production in Libya, Nigeria and Iraq.

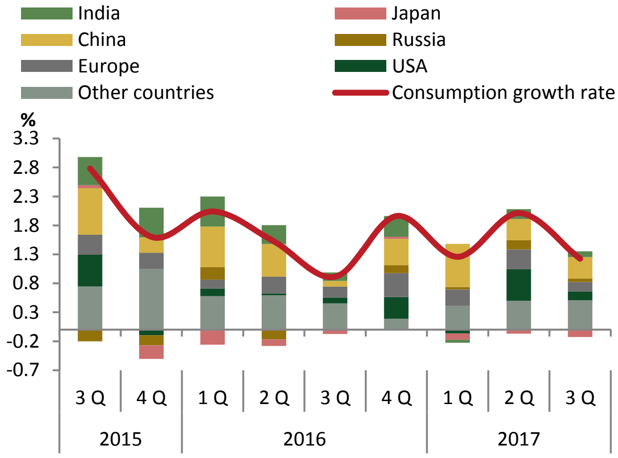
1.1.2 Non-Ferrous Metals Market

In July-September 2017, world prices of non-ferrous metals had a continuing upward trend (Figure 5).

The growth in prices of copper was caused by the increased demand from China; it is associated with new infrastructure projects and residential construction. At the same time, the growth in copper quotations was also supported by reduction in the volumes of cathode copper reserves in China and reduction in the supply of copper scrap.

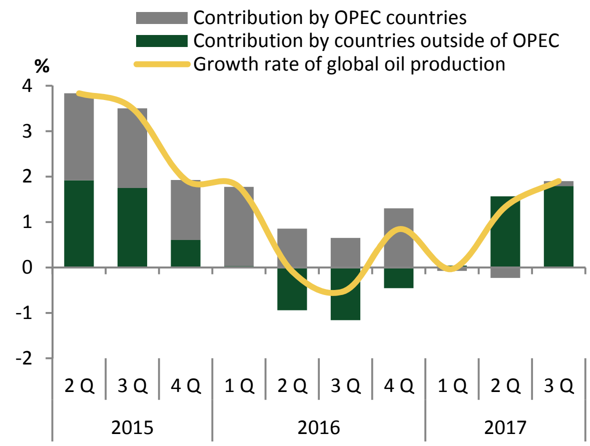
Prices of lead are increasing due to the

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



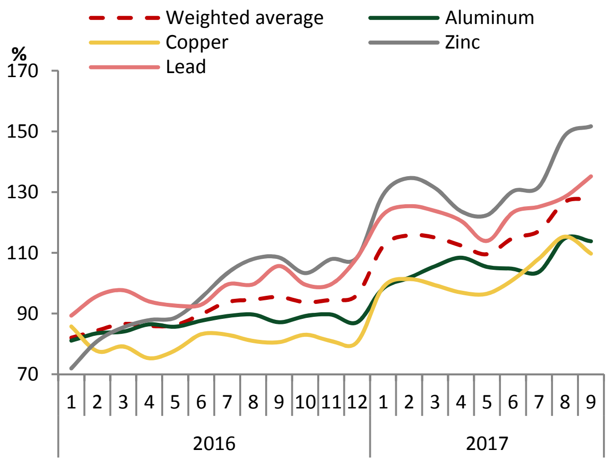
Source: U.S. Energy Information Administration (EIA)

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 growth in demand by car manufacturers and producers of motorcycle batteries and also because of the reduced world stocks of the raw material.

Prices of zinc continue to grow amidst the global curtailment of production and reduction in reserves. Apart from that, an additional reason for the growth in the market price was the shutdown of a significant part of zinc ore production capacities in China because of a high level of environmental pollution. As a result of the increased environmental requirements to the Chinese producers, the price of aluminum in the reviewed period also increased.

1.1.3 Food Market

In September 2017 as compared to June, the FAO Food Price Index increased by 1.9%, at the same time prices of certain goods (sugar, cereals and meat) were decreasing (Figure 6).

Prices of sugar have been declining since the beginning of the year; such decline was caused by the excessive supply in the global markets with a concurrent slowdown in the demand.

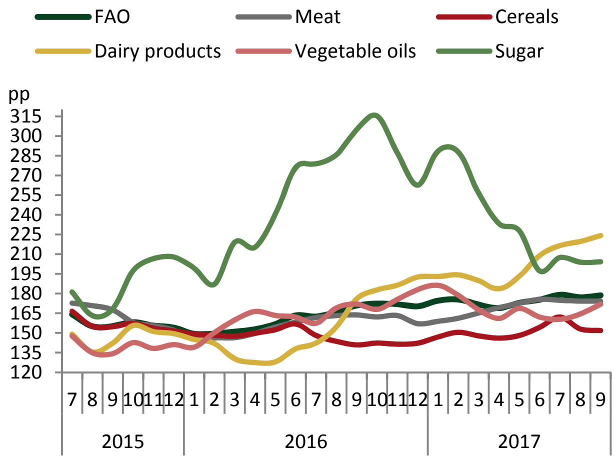
Favorable forecasts regarding the wheat crops in the EU an in Russia as well as of corn in China and South America contributed to the decline in prices of cereals in the global markets.

Prices of meat products slightly declined given the increased supplies of pork from Brazil. Since the supply of beef and poultry remained at a sufficient level, prices of these meat products remained virtually unchanged. An additional pressure on prices of meat products, lamb in particular, was made by a significant growth in the global demand.

Prices of vegetable oil showed upward dynamic, first of all as a result of the growth in prices of palm oil due to lower than expected crops in the South-East Asia.

The growth in prices of dairy products was driven by the increased import purchases from the Asian countries and a limited supply from Australia, New Zealand and the European Union.

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



Source: UN FAO

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

In the third quarter of 2017, the USA was battered by violent Atlantic hurricanes Irma and Harvey. As consequence of hurricanes, several states were flooded; a significant damage was incurred by oil companies as well as by the agricultural producers. In addition, the growth of unemployment as well as the growth in prices of fuel was noted in the regions which had suffered from the hurricane.

Despite the demolishing hurricanes, according to the Bureau of Economic Analysis, in the third quarter of 2017 versus the corresponding quarter of the previous year, the US economy achieved the 2.3% growth (Figure 7). Notably, such growth turned out to be the most intensive since the third quarter of 2015.

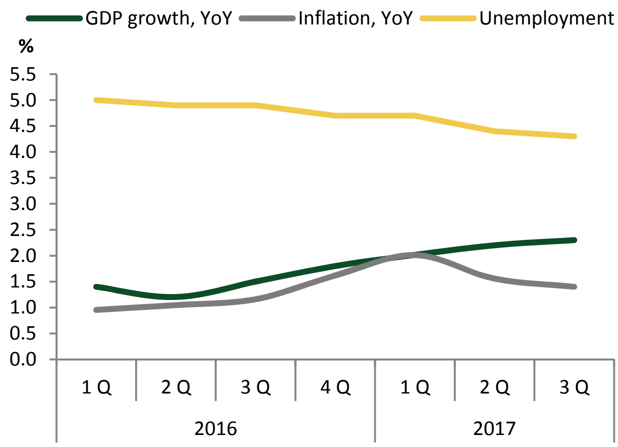
Acceleration in the GDP growth rate in the USA was driven, first of all, by the growth in consumer spending which accounts for over 70% of the US GDP. The increased investments in production, the growth in financial services and in the healthcare services as well as the increased export volumes also became the growth drivers. Despite the slowing growth rates of imports, they exceeded the growth rates of exports thus serving as constraining factors for the GDP growth.

In September, the annual inflation was slowed down up to 1.4% (Figure 7). The fall in prices of some foodstuffs such as dairy products, meat, fruits and vegetables was conductive to such decline. A significant increase in energy prices as well as of the cost of rented housing prevented a further deceleration of inflation.

In the third quarter of 2017, according to the Bureau of Labor Statistics, the labor market showed positive trends. So, the unemployment decreased to 4.3% (Figure 7) as compared to 4.4% in the second quarter of 2017. The number of Americans who used to receive an unemployment benefit decreased to a record-low level.

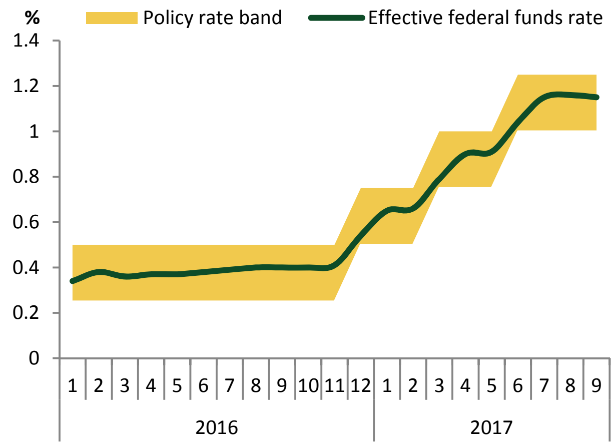
The session of the US Fed which took place on November 1 this year, decided to keep the target interest rate band in the range from 1%

Figure 7. US Economic Performance



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

Figure 8. US Rates



Source: Reuters

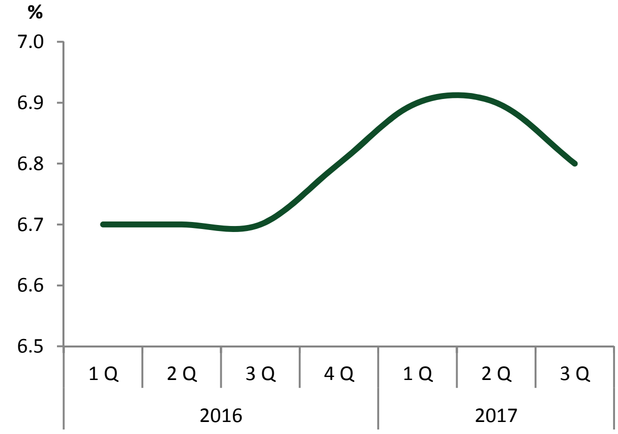
to 1.25%, taking into account positive trends in the labor market and in inflation rate (Figure 8). According to the Fed's forecasts, the median value of the policy rate in 2018 will be 2.1%, in the long term - 3.0%.

1.3 Economic Situation in Countries – Kazakhstan's Trading Partners

1.3.1 China

In the third quarter of 2017, contrary to the market expectations, the Chinese economy showed the 6.8% growth, and a minor slowdown is observed as compared to the previous quarter (Figure 9).

Figure 9. China's Real GDP Growth, YoY

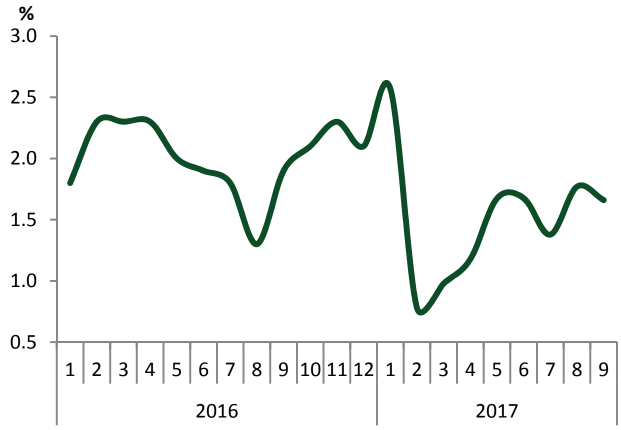


Source: Bloomberg

Negative factors which stifle acceleration of the economic growth include an overgrowth of lending, the increasing debt burden of the corporate sector and households, and also redundant capacities in different sectors of the economy.

In China, the main drivers of the economic growth included a significant increase in retail sales (especially sales by the Internet) as a result of the growth in consumption; the growth in the industry and in the transport sector as well as the increased fixed capital investments and the development of the country's infrastructure. Fixed capital investments are still financed by the government to a larger extent, while the share of investments by the private sector remains relatively low. External risk factors still include a possible deterioration in trade relations with the USA in the environment of the protectionist policy as well as a slowdown in the EU economy.

Figure 10. Inflation in China, YoY



Source: National Bureau of Statistics of China

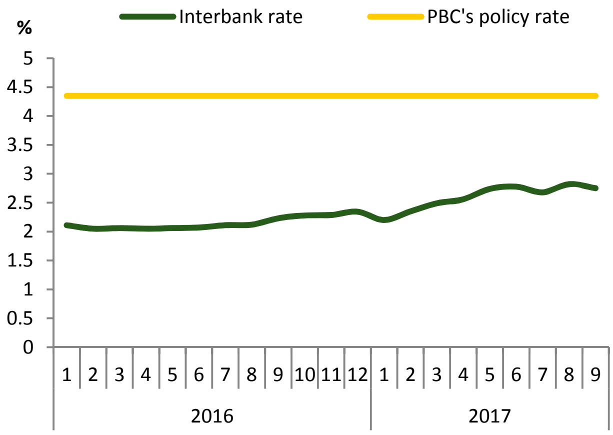
Within the quarter, the inflation pattern was divergent; however, by September annual inflation rates decreased to 1.6% against 1.8% in August (Figure 10) because of the decline in prices of some foodstuffs (pork, vegetables, fruits, tobacco, and alcohol). The factors which curb deceleration of inflation include the growth in prices of all groups of services and also of clothes and footwear. Besides, given the improved internal demand and the limited supply because of shrinkage in capacities and the tightening of environmental requirements, there was the price growth in the industry.

In the third quarter of 2017, the People's Bank of China was implementing a generally neutral monetary policy, while retaining its policy rate at the existing level (Figure 11). In order to manage a high debt burden of the Chinese enterprises, to reduce the risks of a significant growth in housing prices as well as with a view to prevent the capital outflow from the country, interbank borrowing rates slightly decreased. So, the average monthly over-night SHIBOR rate slightly decreased from 2.78% in June to 2.75% in September 2017.

Based on the export stimulation policy pursued by the People's Bank of China (easing reserve requirements to financial entities for forward trading against the Yuan), appreciation of the Euro and depreciation of the US Dollar in the global market, the average monthly rate of Yuan to US Dollar appreciated from CNY 6.7708 in June to CNY 6.5669 per 1 USD in September (Figure 12).

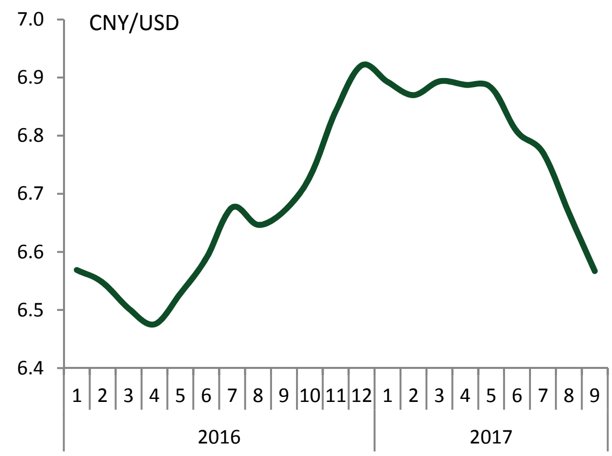
A further appreciation of the Yuan was driven by the fact that the international rating agency S&P lowered the sovereign credit rating of China from A+ to AA- because of increased economic and financial risks as well as by the US Fed's decision to keep its interest rate unchanged.

Figure 11. Interest Rates in China



Source: Reuters

Figure 12. USD/CNY Exchange Rate, a Monthly Average



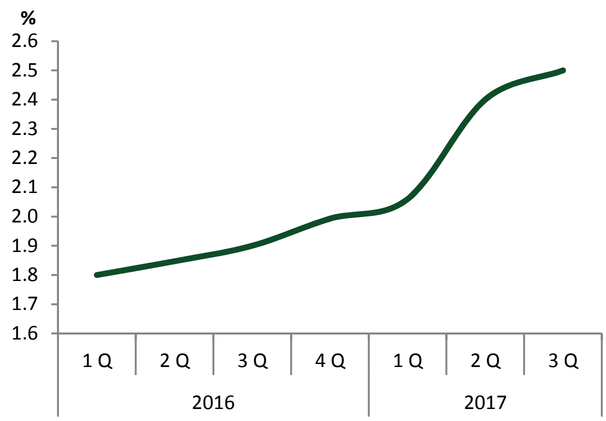
Source: Reuters

1.3.2 European Union

According to an initial estimate of the Eurostat, the economic growth in the EU in the third quarter of 2017 accelerated and accounted for 2.5% versus the respective period of the last year (Figure 13). Acceleration of growth was observed in all key countries of the EU.

Meantime, according to the most recent estimations made by the Eurostat, in the second quarter of 2017 the economic growth in the EU countries accounted for 2.4% (in the first quarter of 2017 –2.1%), being driven by stable growth rates of consumer and investment demand as well as by acceleration of the global trade. Favorable financing terms as well as the steadily decreasing unemployment will be

Figure 13. EU's Real GDP Growth Rate, YoY



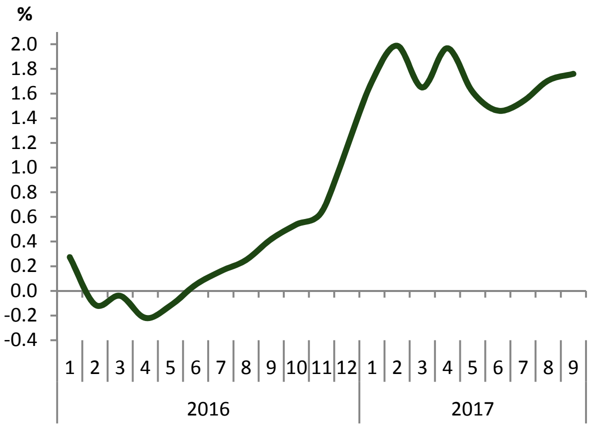
Source: Eurostat

supporting the economic growth further; however, a high government debt and a high percentage of non-performing loans in the banking sector's assets of some countries may serve as a constraining factor for the GDP growth in the EU.

In the reporting quarter, the inflation rate increased from 1.5% in June to 1.8% in September 2017 due to the growth in prices of energy commodities as well as due to the policy implemented by the ECB and aimed at the monetary stimulation of the economy and owing to the decreasing unemployment rate (Figure 14). However, a feeble growth of real wages serves as a constraining factor for the inflation to be anchored near its target of 2%. Since the inflation was below the target, the ECB left key market rates unchanged (Figure 15). In addition, the regulator made the decision that the monetary stimulus program will be extended to September 2018 provided that the steady inflation trend persists, while the asset purchases will be reduced from EUR 60 bln. to EUR 30 bln. a month.

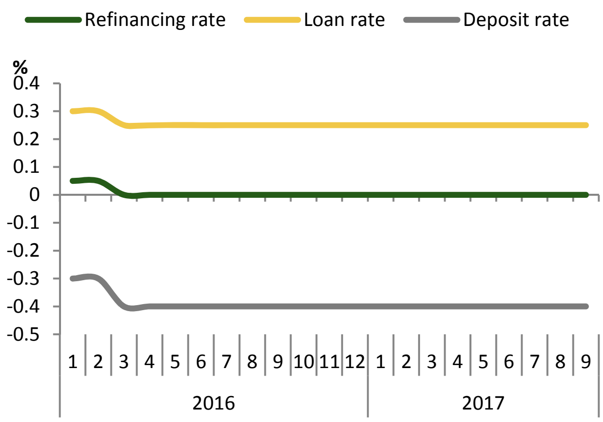
Over the reviewed period, the Euro appreciated from USD 1.1236 in March to USD 1.1905 per 1EUR in September (Figure 16). The main reasons for appreciation of the Euro have been the increased certainty among the market participants about a possible reduction in monetary stimuli in 2018 given the accelerating growth rates of the economy as well as smaller concerns regarding the outcomes of elections in Germany. Nonetheless, a cautious posturing of the ECB regarding the tightening of its monetary policy in the medium term coupled with anticipated further increase in interest rates in the USA limits a further appreciation of the Euro. Also, a negative impact on the Euro may be made by the actual implementation of Brexit and unfavorable developments in Catalonia.

Figure 14. Inflation in the EU, YoY



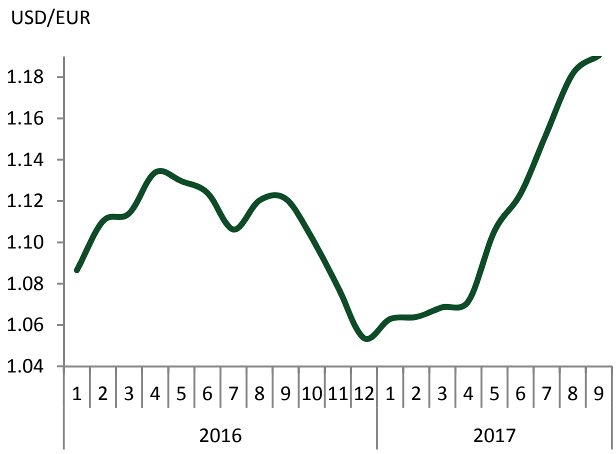
Source: Eurostat

Figure 15. ECB's Rates



Source: Reuters

Figure 16. USD/Euro Rate, a Monthly Average



Source: Reuters

1.3.3 Russia

According to the initial assessment by Rosstat, in the third quarter of 2017 the growth rates of the Russian economy slowed down and accounted for 1.8% as compared to 2.5% in the previous quarter in annual terms (Figure 17). The decrease in the GDP growth was caused by a downturn in the mining sectors as well as a downward revision of estimates regarding trends in the construction sector.

Nonetheless, the growth in agriculture due to a record-high crop of cereals and recovery in the wholesale and retail trade, transport and communication sector served as positive factors.

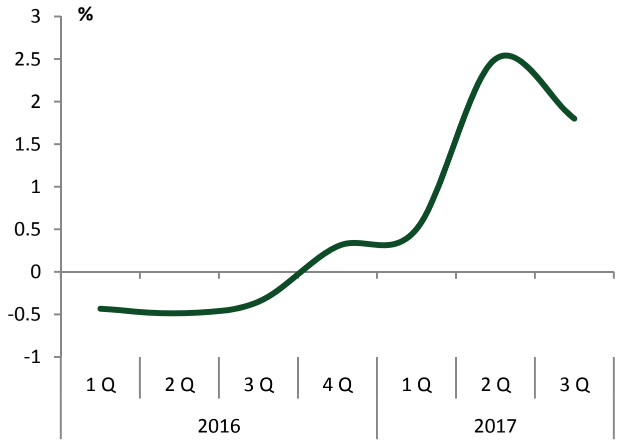
The risk factors which can slacken economic growth in future may include a possible unfavorable behavior of oil prices as well as the upping of US sanctions in the energy sphere.

After some acceleration of the annual inflation rate to 4.4% in June 2017, in September 2017 it slowed to 3.0% (Figure 18). Such a change in the inflation pattern was caused by the drop in food prices (from 4.8% in June to 2.0% in September), in which structure prices of almost all goods item showed a slowdown or a decrease.

Given a downward pattern of inflation and inflation expectations that are observed since the beginning of the year, in September the Bank of Russia lowered its key rate from 9.0% to 8.5% (Figure 19). Nevertheless, still there are risks that inflation will go slightly above the target in the medium-term; such risks are related to possible price fluctuations in the global raw material and commodity markets, in the first instance, and to the growth in real wages at such pace which exceeds the productivity growth rates, in the second instance, and with the change in the household behavior pattern associated with a significant decrease in propensity to save, in the third instance.

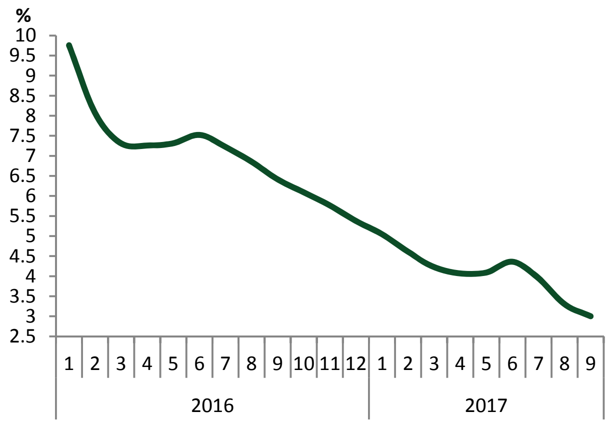
The exchange rate of the Russian ruble against the US Dollar was showing a divergent behavior during the third quarter (Figure 20).

Figure 17. Russia's Real GDP Growth, YoY



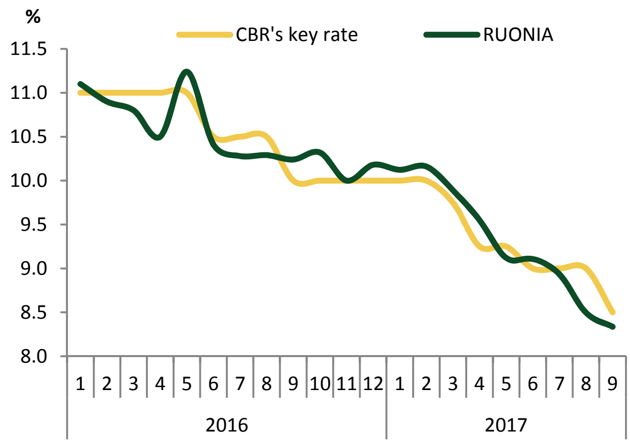
Source: Rosstat

Figure 18. Inflation in Russia, YoY



Source: Reuters

Figure 19. Rates in Russia

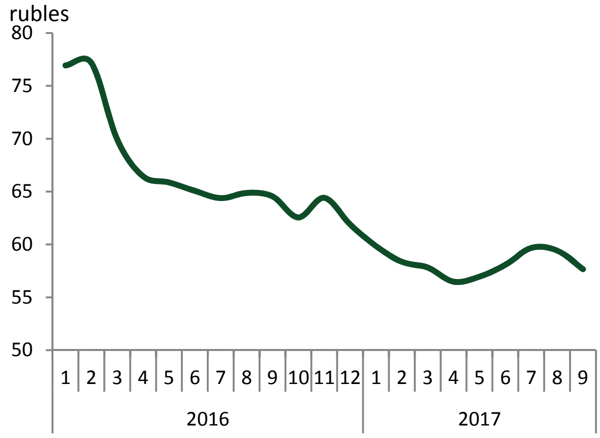


Source: Reuters

So, in July the average monthly exchange rate of the ruble depreciated versus June 2017 by 2.8%, in September it came back having appreciated to 57.66 rubles per 1 US Dollar. Such appreciation was driven to a larger extent by the oil price behavior, by the growing attractiveness of Russian assets given the economic recovery and the narrowing spread between interest rates in Russia and in the USA.

Key risks for depreciation of the ruble are the decline in oil prices, a possible strengthening of US sanctions against the Russian energy sector as well as the growth of imports amidst the recovering demand of businesses and the population.

Figure 20. RUB/USD Exchange Rate, a Monthly Average



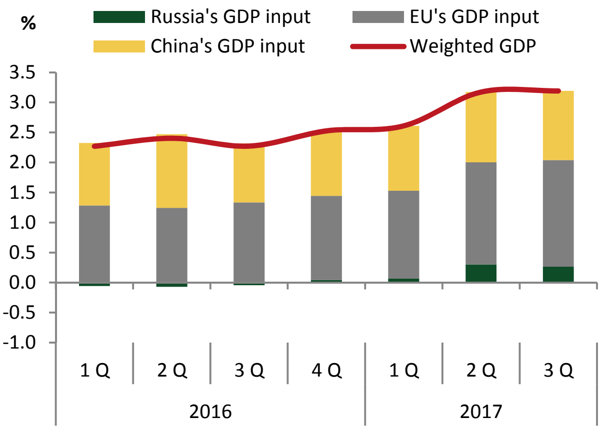
Source: Reuters

1.3.4 Aggregate External GDP and Inflation

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 remained unchanged in the reviewed period as compared to the second quarter of 2017 (Figure 21). The reasons for that were the growth of the Russian economy and moderate GDP growth rates in the EU and China.

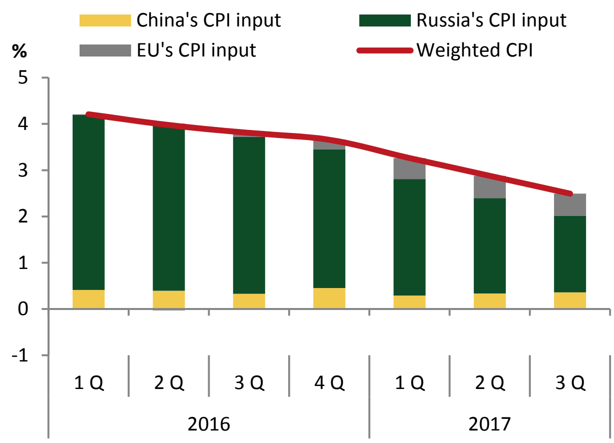
Aggregate external consumer price index which is calculated based on the share of main trading partners in Kazakhstan's imports demonstrated a decline of 39 basis points (Figure 22). Such decline is caused by deceleration of annual inflation in Russia in the third quarter of 2017 and a moderate inflation rate in China in the EU. Thus, the decline in the indicator speaks of the weakening pressure of external inflation on the Kazakh consumer market.

Figure 21. Weighted External GDP , YoY



Source: NBRK's calculations

Figure 22. Weighted External CPI , YoY



Source: NBRK's calculations

2. DOMESTIC ECONOMY

2.1 Monetary Policy and the Financial Sector Development

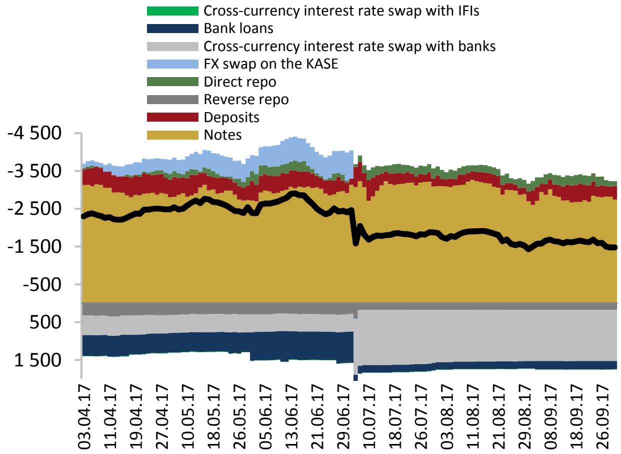
2.1.1 Money Market and Operations of the National Bank of the Republic of Kazakhstan

The situation in the money market was characterized by a structural surplus of the tenge liquidity in the money market. As before, the main liquidity volume was withdrawn with the help of the National Bank's short-term notes with maturities ranging from 7 days to 1 year. In July, a negative balance decreased as a result of operations related to the disbursement of loans by entering into a one-year cross-currency interest rate swap (as part of support to a systemically important bank[1]). These operations resulted in the repayment of the banking sector's loans to the National Bank and reduction in the volumes of the National Bank's operations on the KASE (Figure 23).

In the conditions of stabilization of the inflation rate in a target range and the decreasing inflation expectations, the National Bank continued to ease monetary conditions. On August 21, 2017 the base rate was lowered from 10.5% to 10.25% while retaining the band of +/-1%.The TONIA rate had been primarily at the lower boundary of the interest rate band throughout the quarter. However, in September it was going below the lower boundary of the base rate band due to the increased supply of the tenge liquidity on the part of the non-bank sector in the automatic repo sector (Figure 24).

The Money Market Index was moving within the range of 9.13%–10.88%. At September 30, 2017, the MMI was 9.32%. The major portion of transactions in the market belongs to automatic repo sector (Figure 25).

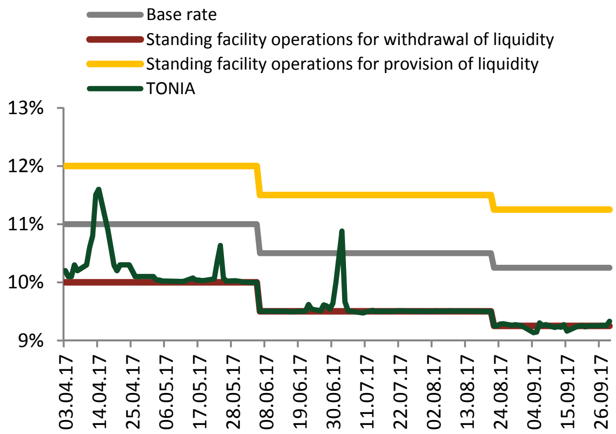
Figure 23. NBRK's Operations in the Domestic Market (exposure, KZT bln.)



** NBRK's securities buy/sell back auction*

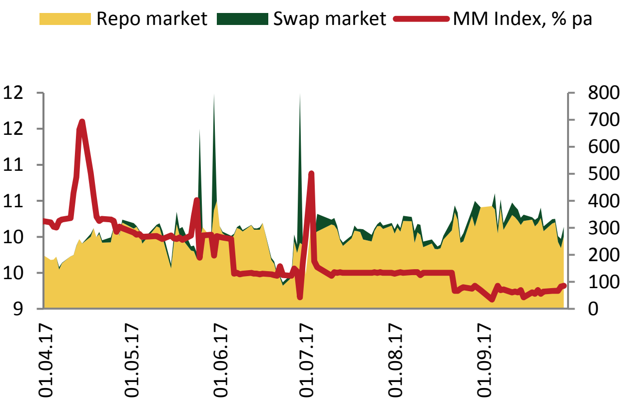
Source: NBRK

Figure 24. Base Rate and TONIA Rate



Source: NBRK, KASE

Figure 25. Changes in the MMI and the Volume of Transactions (KZT bln., right axis)



Source: KASE

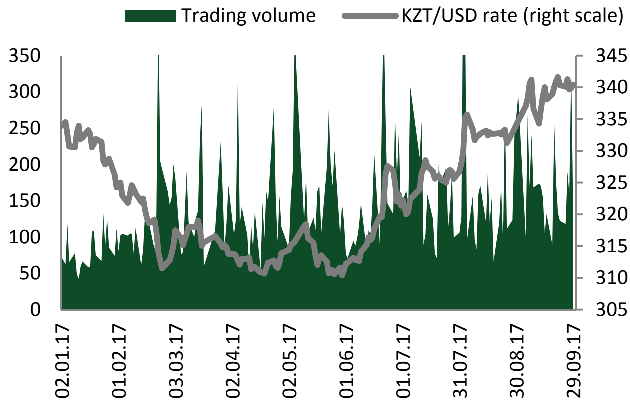
[1] first block of the Program for Increasing Financial Soundness of the Banking Sector

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

The situation in the domestic foreign exchange market was characterized by a gradual depreciation of the tenge against foreign currencies. Domestic factors led to depreciation of the tenge (devaluation expectations of the population). At the same time, external factors (oil prices and the exchange rate of the Russian ruble) were demonstrating a trend which had an opportunity to influence the tenge towards its appreciation.

The exchange rate of the tenge was fluctuating within the range of KZT 320.00-341.61 per 1 USD. At the quarter-end, the official exchange rate of the tenge against the US Dollar depreciated from 322.73 to 341.19 or by 5.5% (Figure 26).

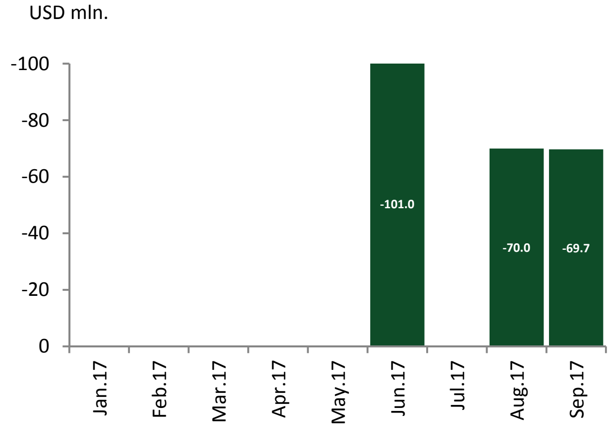
Figure 26. Exchange Rate Behavior and the Trading Volume in the Foreign Exchange Market



Source: KASE

The share of the National Bank's participation in the domestic foreign exchange market was insignificant (0.5% at the quarter-end). The National Bank's participation in FX trading was obliged by an excessive demand for foreign exchange caused by the growing devaluation expectations of the population and the market participants. During August-September 2017, the National Bank sold foreign exchange worth USD 139.7 mln. (Figure 27).

Figure 27. NBRK's Interventions



Source: NBRK

In the reviewed period as compared to the previous quarter, volumes of on-exchange and off-exchange trades in the KZT/USD currency pair increased slightly by 8.6% and 9.7%, respectively.

2.1.3 Deposit Market

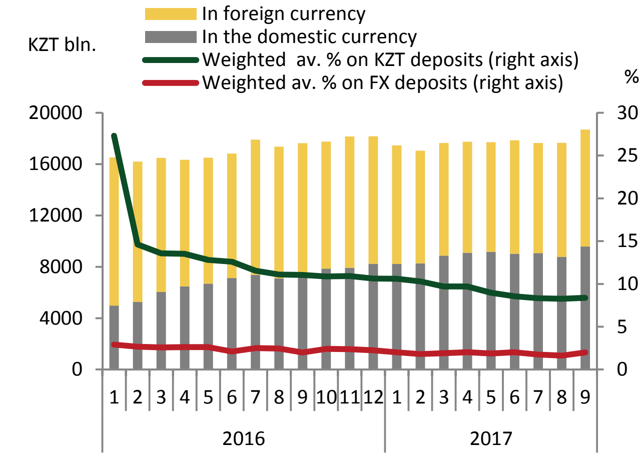
In the environment of growing inflation expectations, the outflow of the tenge deposits was observed in the third quarter; at the end of the quarter such growth was offset by the increase in transferrable deposits owing to capitalization of the Kazakhstan's Sustainability Fund – the National Bank's subsidiary established as part of the bank support program. So, during the third quarter of 2017, deposits in the domestic currency increased by

6.2% and foreign currency deposits – by 3.1%. In general, in the third quarter of 2017 as compared to the second quarter, the volume of bank deposits increased by 4.7% and amounted to KZT 18.7 trln. The volume of the tenge deposits still exceeds that of foreign currency deposits. At the end of September, the level of deposit dollarization was 48.7% (49.5% in the second quarter of 2017).

Corporate deposits in foreign currency decreased by 1.7%, against the 10.8% growth of the tenge deposits, thus resulting in the decrease in the percentage of corporate deposits in foreign currency from 45.5% in June 2017 to 42.5% in September 2017. In terms of the currency structure of retail deposits, the growth in dollarization of deposits was observed during the same period – from 54.7% to 56.8% as a result of the 8.2% increase in foreign currency deposits and the 0.9% decrease in the tenge deposits.

The weighted average interest rate on deposits attracted in the domestic currency decreased from 8.5% in June 2017 to 8.4% as at the end of September(mainly due to a decrease in the rates of time deposits of individuals from 12.4% to 12.1%), the interest rate on foreign currency deposits remained at 2.0% (Figure 28).

Figure 28. Volumes and Interest Rates on Deposits in the Tenge and in Foreign Currency



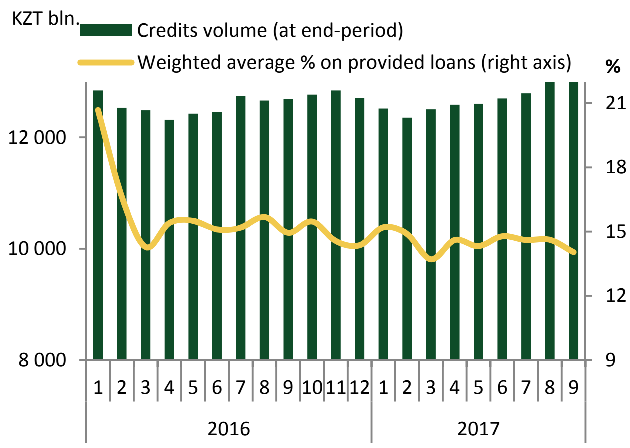
Source: NBRK

2.1.4 Credit Market

In the third quarter of 2017, banks became more active in providing loans. Apart from retail loans which have been the growth driver for the bank loan portfolios since the first quarter, loans to businesses also increased. So, retail loans increased by 5.5% to KZT 4.4 trln., and corporate loans increased by 3.4% to KZT 8.8 trln. As a result, during the quarter the total volume of bank loans increased by 4.1% to KZT 13.2 trln. (Figure 29).

In the corporate lending segment, there was a greater positive contribution of loans to industrial enterprises and individual entrepreneurs in the “Others” sector, which increase the borrowing for financing of working capital. The contribution of loans provided to the trade sector had shifted to the positive zone

Figure 29. Loan Volumes and Interest Rates



Source: NBRK

by the end of the quarter. Thus, loans to all sectors of the economy make a positive contribution to the growth in the lending portfolio of businesses. This is secured by stabilization of oil prices and the demand for metals, the growth in profits following the improvement in the financial condition of enterprises in these sectors.

In retail lending, the growth rate of consumer lending is increasing, and mortgage lending is gradually recovering.

In the third quarter of 2017, the weighted average interest rate on loans in the domestic currency decreased to 14.4% (in the second quarter – 14.6%). Weighted average interest rates on corporate loans in the domestic currency slightly decreased – to 13.5% from 13.8% in the second quarter of 2017.

2.1.5 Monetary Aggregates

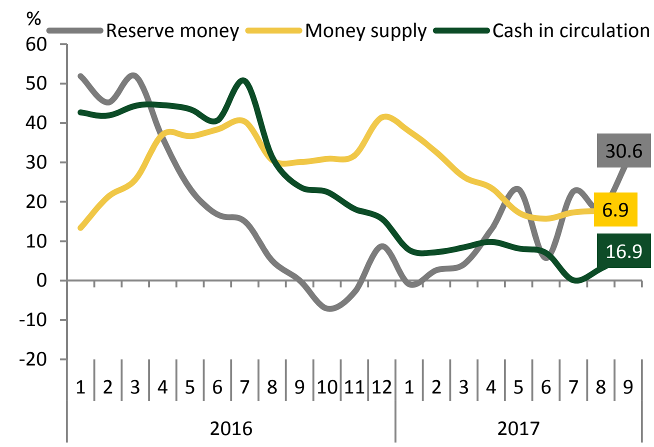
At end-September, the annual growth rate of the money supply accounted for 6.9% (Figure 30). Along with that, in July-September the money supply increased by 4.2%, reserve money expanded by 17.3%, and cash in circulation decreased by 0.8%.

In general, measures taken by the National Bank as part of the Program for Increasing Financial Soundness of the Banking Sector influenced the building up of monetary aggregates in the reviewed period.

A major positive contribution to the formation of money supply was made by the growth in net foreign assets and net claims on the general government within domestic assets. A positive contribution on the part of foreign assets was made as a result of conversion of an allocated targeted transfer from the National Fund[2] funded with the National Bank's international reserves. In addition, the growth in gold prices also resulted in the increase in international reserves.

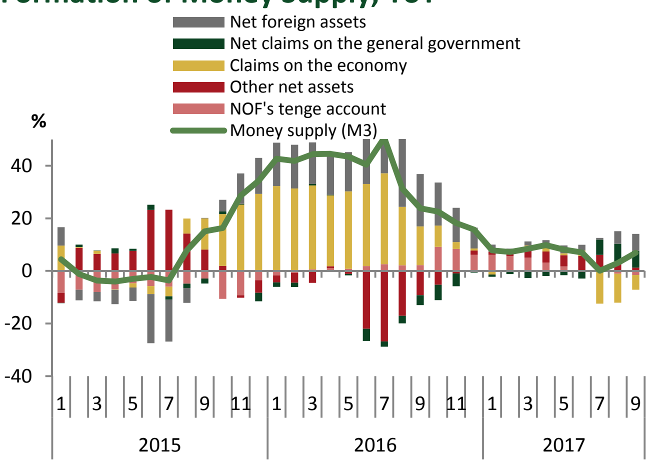
A negative contribution to the formation of money supply was made by the decrease in domestic assets, particularly the decreased

Figure 30. Growth in Monetary Aggregates, YoY



Source: NBRK

Figure 31. Dynamics of Contributions to the Formation of Money Supply, YoY



Source: NBRK

[2] *to accomplish the transaction between the People's Saving Bank of Kazakhstan and Kazcommertsbank. See the NBRK's newsletter of August 9, 2017*

claims on non-bank financial organizations as a result of BTA's debt to Kazcommertsbank (Figure 31). At the same time, it was partially offset by the increase in the banking system's claims on the central government as a result of a government securities issue by the Ministry of Finance of the RK which is worth KZT 1 trln.

A positive contribution to the behavior of the reserve money was made by the growth in gross international assets and the increased claims on the Government and non-bank financial organizations. Claims on non-bank financial organizations increased as a result of establishment of Kazakhstan's Sustainability Fund in order to support the banking system.

2.2 Prices and Inflationary Processes

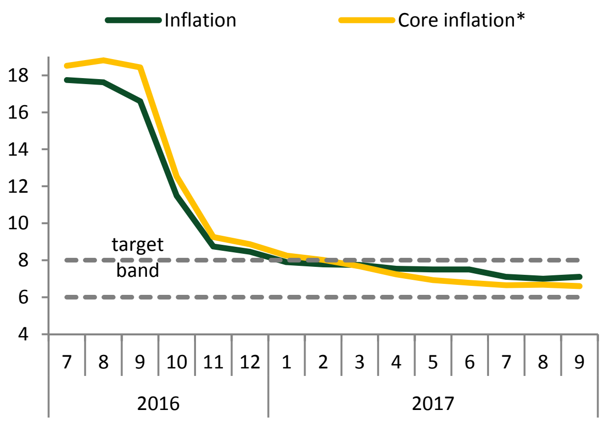
2.2.1 Prices in the Consumer Sector

In September, the annual inflation decelerated to 7.1% due to a sizable decrease in the contribution of the food component. Core inflation excluding prices of fruit and vegetable production, energy resources and regulated services decreased from 6.8% to 6.6%; this happened primarily as a result of decline in prices of a number of foodstuffs against significant reserves of primary produce and the increase in production (Figure 32).

So, annual growth rates of food prices excluding prices of fruits and vegetables slowed down from 8.4% to 7.2%. Alongside with large carry-over stocks and this season's yield, deceleration of food inflation was also promoted by a decline in domestic producer prices, and the reduced cost of the imported plant products. In general, the annual food inflation has decreased from 9.7% to 7.8% over the quarter, including due to deceleration of price growth rates of the fruit and vegetable production (Figure 33).

At the same time, as a result of the decreased supply in the energy market (gasoline, diesel fuel, hard coal) as well as the persisting trend of the increasing price of durable goods, the contribution by the non-food component increased. The increase in price was caused by depreciation of the exchange rate of

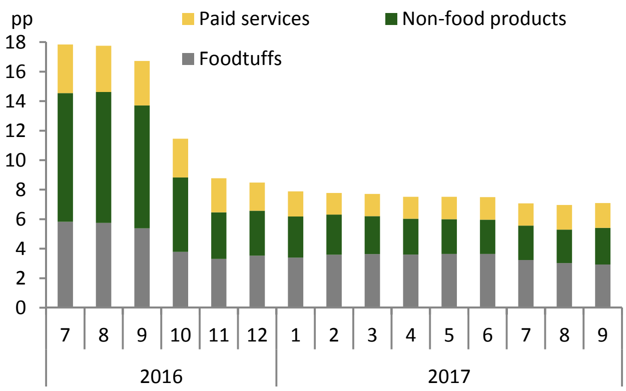
Figure 32. Annual and Core Inflation, YoY



Source: CS MNE RK

** excluding prices of fruits and vegetables, utilities, railway transport, communication, gasoline, diesel fuel and coal*

Figure 33. Contribution of its Components to Inflation, YoY



Source: CS MNE RK, NBRK's calculations

the tenge and the increased devaluation expectations as well as by the persisting growth trend of the cost of imported non-food consumer products from the neighboring countries (EAEU). In general, the growth rates of prices of non-food products accelerated from 7.7% to 8.2%.

The contribution to the annual inflation by paid services slightly increased as a result of the increased cost of unregulated services. In whole, the contribution by services to inflation remains minimal, and annual price growth rates increased from 4.8% to 5.2%.

2.2. Prices in the Real and External Sectors

In the real sector, annual growth rates of producer prices increased by the end of the quarter as a result of the increase in price of interim products. The growth in prices was caused by the increasing prices of mineral resources as well as of industrial services (Figure 34).

In the industry-based breakdown, the growth rates in the manufacturing industry continued to slow, and the price growth rates in the mining industry were recovering (Figure 35).

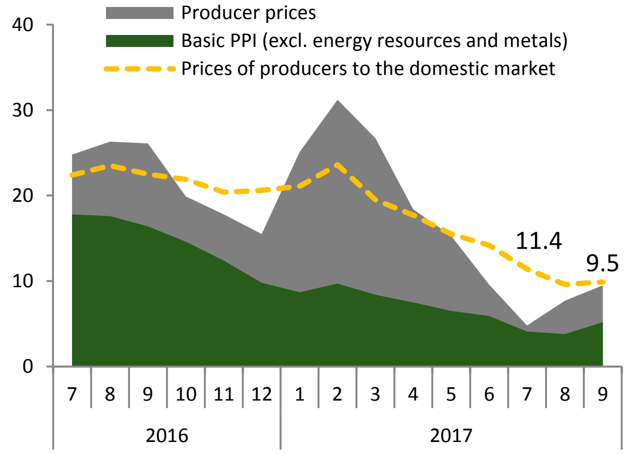
The growth rates of prices of products supplied to the Kazakh market decreased from 14.2% in June to 9.9% in September.

The growth rates of prices of products sold in the domestic market were slowing in the mining industry, namely in the crude oil production and in metal ore extraction. The price growth rates of production in the manufacturing industry in the domestic market declined from 11.5% in June to 7.7% in September 2017 as a result of cheapening of petroleum products, foodstuffs, chemical products and pharmaceuticals.

The annual growth in prices of industrial services continued, with prices growing from 7.2% in June to 7.6% in September 2017.

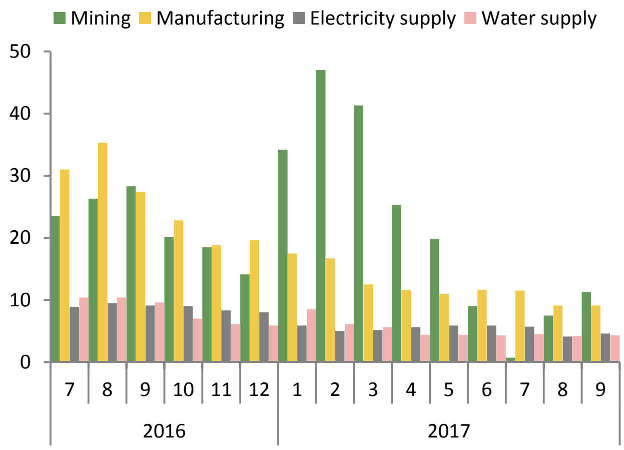
In agriculture, the price growth rates slowed from 5.1% to 4.4% because of the animal production (Figure 36), where the price growth rates decreased from 8.1% to 4.3%. The plant production increased from 2.7% to 3.9% in

Figure 34. Price Changes in the Industry, YoY



Source: CS MNE RK

Figure 35. Price Changes in the Industry by Types of Economic Activities



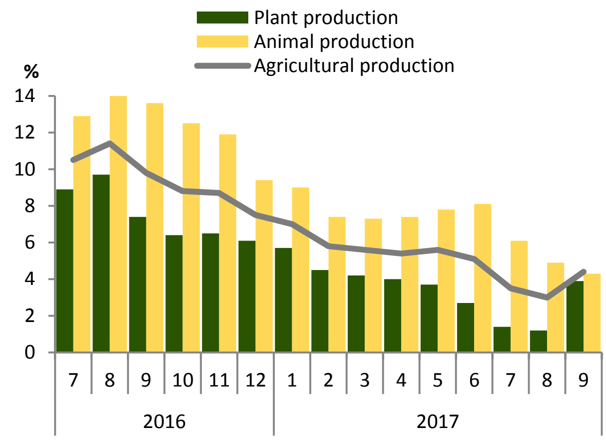
Source: CS MNE RK

terms of price due to the increased cost of certain types of fresh vegetables as well as certain types of cereals (corn, rice, barley) along with the declined cost of oil crops.

In the wholesale sector, the annual price growth in September 2017 slowed (to 5% from 5.7% in June).

As for the cost of imported goods, annual growth rates of prices of products delivered from the far abroad countries are slowing (in the tenge equivalent), while the growth rates of prices of goods imported from the CIS countries are accelerating. The annual growth rates of the cost of imported products are decreasing (both in the US Dollar equivalent and in the tenge equivalent) in the sector of investment goods, semi-finished products, transport vehicles, and agricultural production. At the same time, the price growth rates of imported crude minerals that were observed in the past quarter continued to increase, both in the US Dollar equivalent and in the tenge equivalent. In addition, prices of imported consumer food and non-food products were increasing.

Figure 36. Price Changes in Agriculture, YoY



Source: CS MNE RK

2.2.3 Inflation Expectations

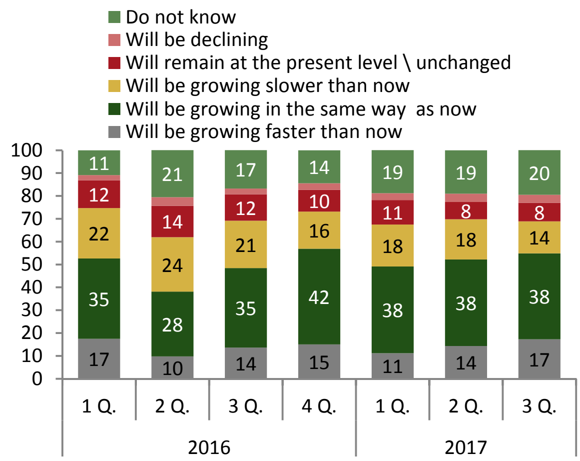
The households' survey outcomes show that the level of perceived inflation has not changed. The percentage of respondents who assess the price growth over the last 12 months to be within 10% has increased over the period due to a decrease in both those who estimate the price increase in the range of 10-20%, and those who expressed the opinion of more than 20% increase in prices over the past year.

Expectations of the households regarding the prospects of price changes in the next 12 months have not undergone significant changes. A large percentage of respondents continue to anticipate that the price growth rates will remain the same in the next 12 months (Figure 37). The ratio of the interviewed regarding the inflation pattern slightly changed towards acceleration of inflation.

In general, inflation expectations of the households regarding the growth in prices of foodstuffs, non-food products and paid services

Figure 37. Assessment of the Price Growth in a Year

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

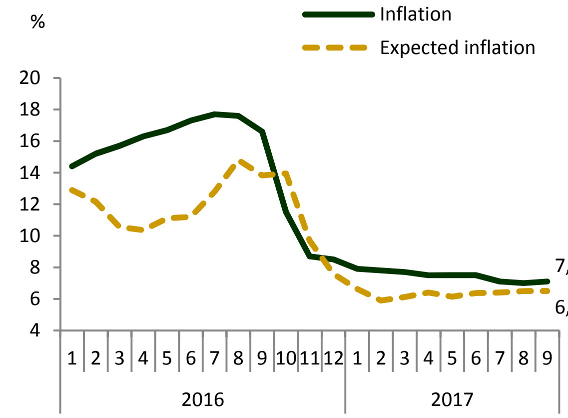


Source: GfK Kazakhstan

remain at a relatively constant level.

A quantitative inflation assessment[3] for the next twelve months shows stability of the expected inflation rate. Along with that, the gap between actual and expected inflation has been narrowing over the recent months; this is also indicative of some stabilization of inflation expectations of the households. At the quarter-end, a quantitative assessment of inflation expectations accounted for 6.5% (Figure 38) and is within the target band for 2018.

Figure 38. Expected Inflation, YoY



Source: Committee on Statistics of the MNE RK, GfK Kazakhstan

2.3 Real Sector Development

In the second quarter of 2017, the GDP growth rates were accelerating against the growth in the oil extraction volumes and realization of the deferred consumer demand. A continued implementation of the government economic stimulus programs was conductive to the growth in investment activity.

2.3.1 Domestic Demand

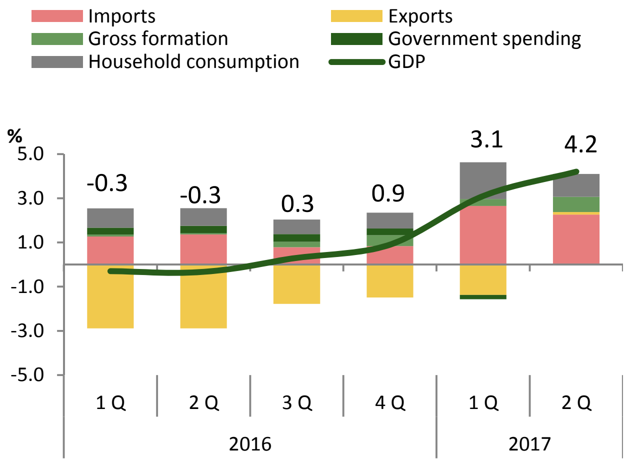
In the first half of 2017, the GDP by the final consumption method accelerated to 4.2%, primarily due to a significant contribution of net exports (Figure 39). The consumer and investment demand, as before, make a positive influence on the GDP growth.

A positive contribution of net exports was observed against the decreased real imports of goods and services. However, the rates of reduction in imports slightly slowed down given the growth of value of non-food products and investment imports.

In addition, the increase in contribution of net exports was accompanied by the recovering exports of goods and services.

Within the structure of exports of goods and services, crude oil exports increased in real terms. Such increase was occurring both against the improving pricing environment in the global

Figure 39. Decomposition of the GDP Components by the Final Consumption Method, YoY year-to-date total



Source: CS MNE RK, NBRK's calculations

[3] The Methodology for calculating the quantification of inflation expectations is posted on the official Internet resource of the National Bank in the "Monetary Policy"- "Inflation and Inflation Expectations" Section

crude commodity markets and as a result of the increase in volumes of crude oil and gas condensate production, first of all, in the Kashagan oil field. The growth in gross fixed capital formation slightly increased accounting for 3.5%. Acceleration of the growth was accompanied by the increased fixed capital investments in education – by 31.4%, agriculture – by 10.8%, in the manufacturing industry – by 2.7% and in the transport sector – by 1.9%. However, the growth of investments in the residential construction slowed down to 2.0%.

In the first half of 2017, the growth of household spending on final consumption slightly slowed (to 1.9%) (Figure 40). The slowdown in the growth of household consumer spending was accompanied by reduction in real cash income of the population. At the same time, the increased consumer lending as well as realization of deferred demand maintain real household spending at a positive level.

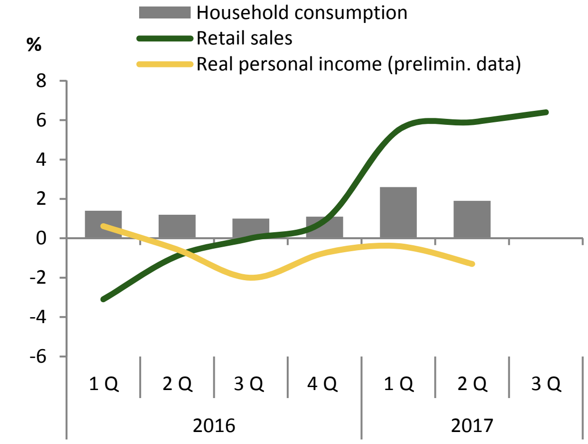
In the second quarter of 2017, expenditures for foodstuffs still were making the largest contribution to the growth in nominal consumer spending, with their growth accounting for 14.9%. Along with that, the growth in spending on paid services accelerated notably to 12.7%. Therefore, their contribution to the growth in nominal consumer spending increased significantly. Spending on non-food products has also demonstrated acceleration of growth to 9.5% (Figure 41).

Income of the Population

In August 2017, the growth in nominal cash income accounted for 4.3%. In 2017, the growth rates of nominal cash income have been gradually slowing and remain limited (Figure 42).

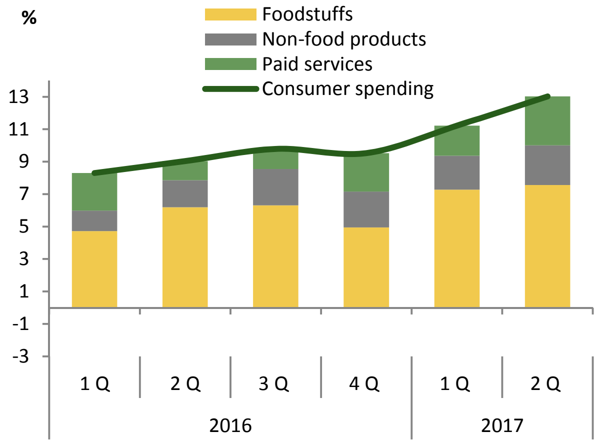
At the same time, real cash income has been decreasing since the beginning of 2017, despite the decelerating inflation. A negative impact on the behavior of real cash income of the population is made by a low growth of real wages in many sectors of the economy. So, real cash income of the population decreased by 2.5% in August 2017.

Figure 40. Household Consumption, Household Real Cash Income and Retail Sales, YoY, year-to-date total



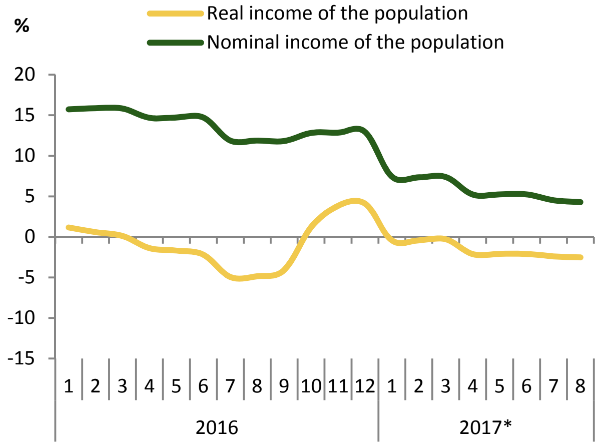
Source: CS MNE RK

Figure 41. Structure of Growth in Household Nominal Consumer Spending, YoY



Source: CS MNE RK, NBRK's calculations

Figure 42. Indices of Nominal and Real Cash Income of the Population, YoY



*-preliminary data

Source: CS MNE RK

Investment Activity

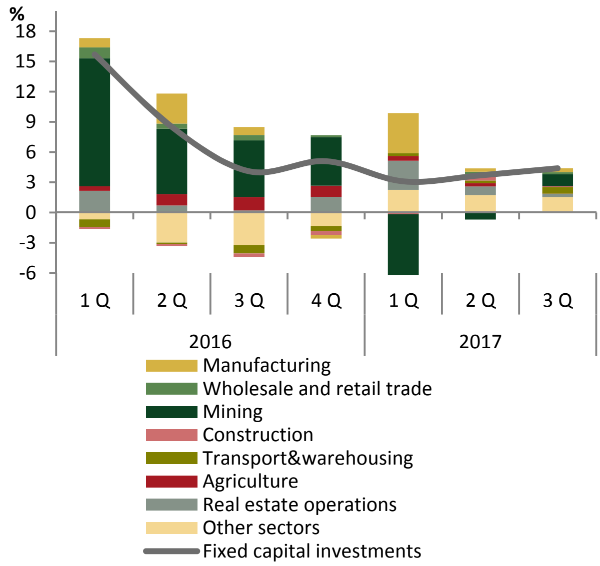
In the third quarter of 2017, the investment activity in the real sector kept growing. During 8 months of 2017, the growth in fixed capital investments accounted for 4.4% as compared to the corresponding period of the previous year (Figure 43).

In the industry-based breakdown, the largest contribution to the investment growth was made by the mining industry due to works performed to increase the oil production in the Kashagan and Tengiz oil fields. Along with that, the extension of a pipeline system for oil transportation helped accelerate the investment growth in the transport sector. Also, given the economic recovery and implementation of government support programs, investments in the manufacturing industry, in the water supply and electricity supply sectors, in the construction sector, trade, and communication were growing. Meantime, the growth in agriculture is slowing being caused by the decreased investments in the cultivation of seasonal and perennial crops against the decreased flow of borrowed funds.

A large portion of investments was channeled for modernization of production. However, the growth in costs related to purchases of equipment, transport vehicles and tools slowed down during January-September 2017 as compared to the first half of the year and accounted for 13.1%, being associated with the gradual run-off of the low base effect of 2016 before the launching of production in the Kashagan oil field.

During January-September 2017, the share of domestic investments in the total investment volume accounted for 74.3%, and the share of foreign investments – 25.7%. During the first half of 2017, a gross inflow of foreign direct investments amounted to USD 10.5 bln. and increased by 41.4% as compared to the corresponding period of the previous year. Non-residents were mostly active in investing into oil extraction, metallurgy and trade.

Figure 43. Fixed Capital Investments, by Types of Economic Activity, Contribution, YoY, year-to-date total



Source: CS MNE RK, NBRK's calculations

2.3.2 Domestic Production

In the first half of 2017, the real GDP growth by the production method accounted for 4.3% versus the corresponding period of the previous year (Figure 44).

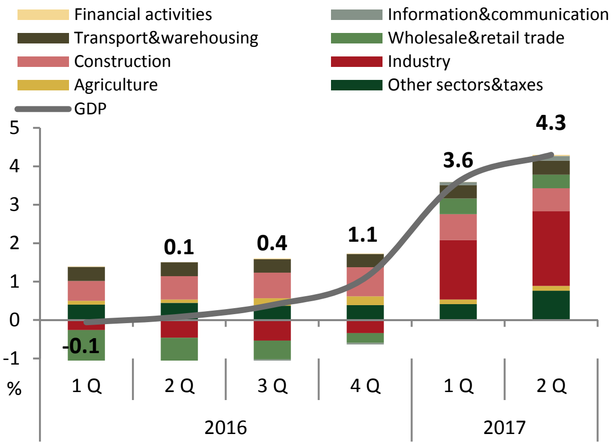
The 7.4% increase in the overall production of goods became the main source of the economic growth, first of all due to extraction of mineral resources and industrial production. The service sector also keeps recovering; its growth in the first half of 2017 accounted for 2.4% as compared to the corresponding period of the previous year.

The data from the CS MNE RK on key economic sectors for the first 9 months of 2017 indicate that recovery processes are continuing, however, at a slowed pace. The short-term economic indicator increased by 6.0% as compared to the third quarter of the previous year (Figure 45).

Actual overfulfillment of plan for crude oil extraction in the country's large oilfields (Tengis and Kashagan) as well as steady rates of growth in volumes of extracted natural gas, iron ores and ores of non-ferrous metals were the cause for acceleration of annual growth rates in the mining industry to 11.3% as at the end of the first 9 months of 2017 (Figure 46).

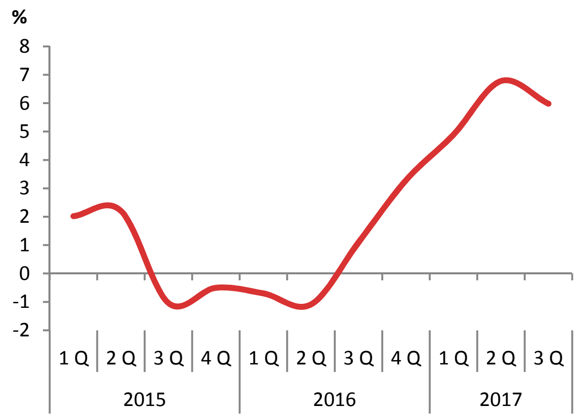
In January-September 2017, the growth in the manufacturing industry continued to be high and accounted for 5.7% as compared to the corresponding period of the previous year (Figure 47). The metallurgical industry served as the main source for the growth. So, the growth rates of production in the non-ferrous metallurgy as at the end of the first 9 months of 2017 accounted for 6.6% and 7.8%, respectively. During January-September 2017, the growth in production of refinery products against the increase in oil extraction accounted for 5.8% but it slowed down slightly because of major overhaul at the end of the third quarter at the Atyrau and Pavlodar Petrochemical Plants. The processes of imports substitution and development of non-primary sectors are going on. Thus, the output in the light industry increased by 9.6%, in the food production – by

Figure 44. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY, *(the period versus the corresponding period of the previous year)*



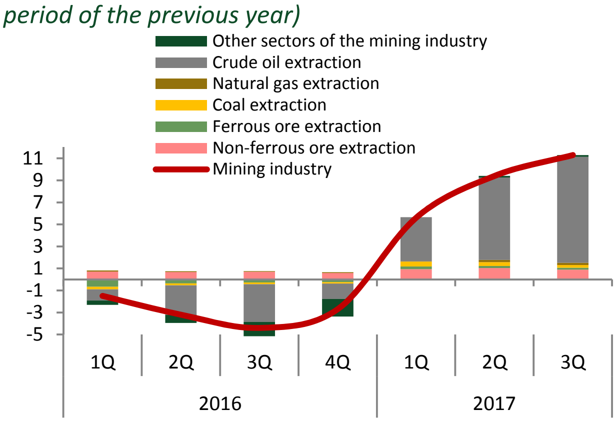
Source: CS MNE RK, NBRK's calculations

Figure 45. Short-Term Economic Indicator *(the quarter versus the corresponding quarter of the previous year)*



Source:: CS MNE RK, NBRK's calculations

Figure 46. Decomposition of the Mining Industry. Contribution by Sectors to the Growth, YoY *(the period versus the corresponding period of the previous year)*



Source: CS MNE RK, NBRK's calculations

5.3%, in the production of major pharmaceutical products – by 36.1%, and the growth in the mechanical engineering industry was secured by the increased manufacturing of motor vehicles (by 39.2%) and electrical equipment (by 32.1%).

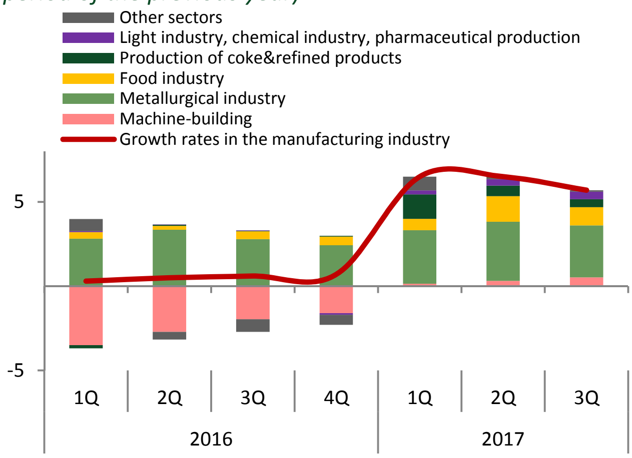
During the first 9 months of 2017, agricultural output increased by 1.9% due to the increase in the output of animal products (by 3.3%) and a weakly positive growth in the plant production (by 0.8%) given the reduction in the yield of cereals in 2017[4].

During January-September 2017, production growth rates in the construction sector slowed to 3.5% in annual terms, which is explained by the effect of completed construction works performed as part of preparation for EXPO-2017 in Astana (Figure 48). Meantime, implementation of government housing programs and infrastructure projects, major overhauls at petrochemical plants, construction of industrial facilities, transport and warehousing facilities are conductive to positive growth rates; this is expressed in the structure of commissioned facilities.

In the third quarter of 2017, a steady growth is demonstrated by the service sphere. As at the end of the first 9 months of 2017, the annual growth rate of retail sales accelerated to 6.4% given the increased sales both of food and non-food products (Figure 50). Such trend was significantly supported by the international exhibition EXPO-2017 held in Astana city[5]. However, a slower growth in the wholesale turnover (1.5%) was caused by the decreased wholesales of foodstuffs as a result of slackening of the growth rate in agriculture.

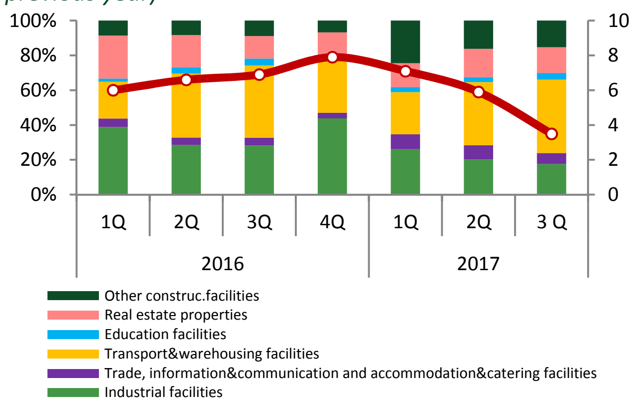
Owing to positive trends in the trade sector and a stable external demand, the demand for transport services has been increasing. As at the end of January-September 2017, the annual growth in the sector accounted for 4.7%, with a significant contribution being made by railway cargo transportations (11.6%), pipeline

Figure 47. Decomposition of the Manufacturing Industry. Contribution by Sectors to the Growth, YoY *(the period versus the corresponding period of the previous year)*



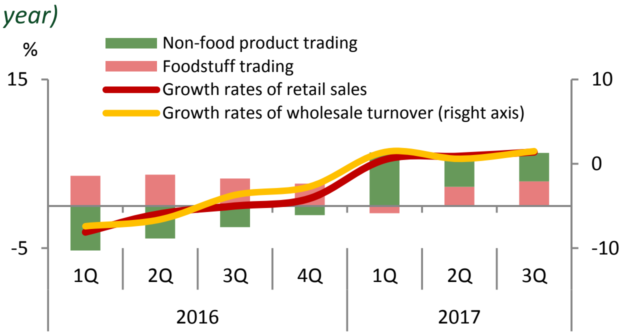
Source: CS MNE RK, NBRK's calculations

Figure 48. Growth Rates of Construction and a Relative Share of Commissioned Facilities, YoY *(the period versus the corresponding period of the previous year)*



Source: CS MNE RK, NBRK's calculations

Figure 49. Growth Structure of Retail Sales and Growth Rates of Wholesale Turnover, YoY *(the period versus the corresponding period of the previous year)*



Source: CS MNE RK, NBRK's calculations

[4] According to the Ministry of Agriculture of the RK, yield of cereals in 2016 was 15.2 dt/ha, and in 2017 - 14.4 dt/ha

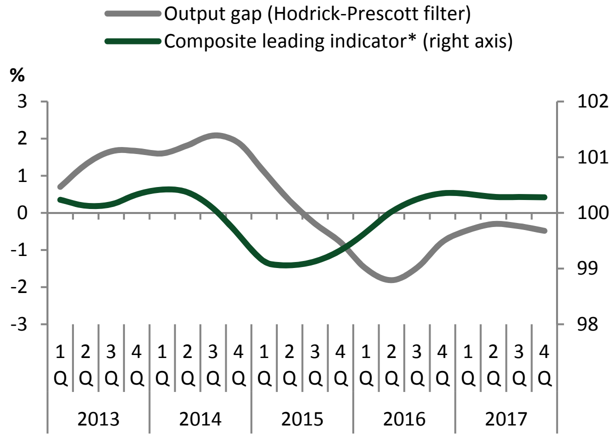
[5] According to the CS MNE RK, during January-September 2017 the growth in retail sales in Astana city accounted for 12% versus the same period of the last year

transport (1.2%) and motor transport (0.1%).

The information and communication sector increased by 3% in the reviewed period mainly due to the increase in the volume of services provided via the Internet (12.9%). In addition, there was an increase in the volume of mobile telephone services (0.8%) and regular and express mail services (11.4%).

The composite leading indicator, which summarizes the assessment of the existing situation and expectations of CEOs of companies in the real sector of the economy in the third quarter of 2017, remained positive, thus indicating that recovery processes in the economy are on-going. Respondents note the improvement of demand indicators in all key sectors of the economy as well as a slowdown in the price growth rates of final products and raw materials and supplies. Assessment methods based on filtration principles showed the persistence of negative values of the output gap. However, gap parameters are close to zero indicating that deflationary pressure in the economy is gradually decreasing (Figure 50).

Figure 50. Behavior of the Composite Indicator, Cyclical Component of GDP and Output Gap



Source: NBRK

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

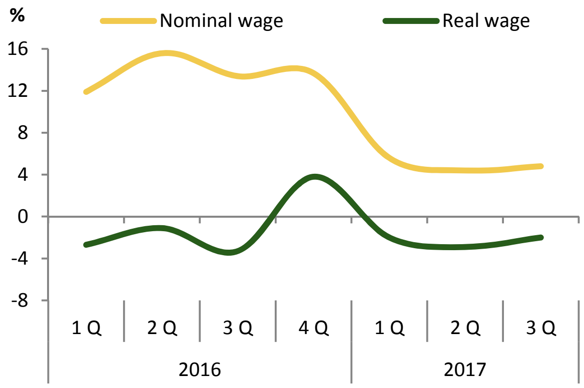
2.3.3 Labor Market and Unemployment

In the third quarter of 2017, nominal wages accelerated their growth to 4.8% after the 4.4% growth in the second quarter of 2017 (Figure 51).

At the same time, real wages are decreasing despite a decline in the overall price level. Real wages have been decreasing in the professional, scientific and technical activities (by 22.4%), public administration and defense (by 5.1%), education (by 3.5%), healthcare (by 2.7%), electricity and gas supply (by 1.7%) and in the mining industry (by 1.4%). In the meantime, there was a growth in real wages in activities in the area of administrative and ancillary service (by 24.7%), real estate operations (by 16.1%), agriculture (by 9.1%), information and communication (by 2.7%) and in the transport sector (by 1.7%).

In the first half of 2017, labor productivity in the economy accelerated to 3.6%. The increase in labor productivity in the economy as

Figure 51. Nominal and Real Wage Indices, YoY



Source: CS MNE RK

a whole was driven by a significant growth in productivity in the sectors where goods are manufactured (by 11.9%). So, in the industry labor productivity increased by 12.3% given the increased productivity in the mining and the manufacturing industry (by 8.8% and 13.3%, respectively). In construction and agriculture, the growth in labor productivity accounted for 9.7% and 7.8%, respectively.

At the same time, a negative pattern of labor productivity in the services sector has been persisting since the first quarter of 2015. So, in the first half of 2017, labor productivity in the services production decreased by 1.2%. The drop in labor productivity in the services sector was caused by the decreased productivity in such sectors as real estate operations (by 13.4%), accommodation and catering services (by 7.9%), activities in the area of administrative and ancillary service (by 4.3%), professional, scientific and technical activities (by 2.8%) as well as financial and insurance activities (by 1.1%).

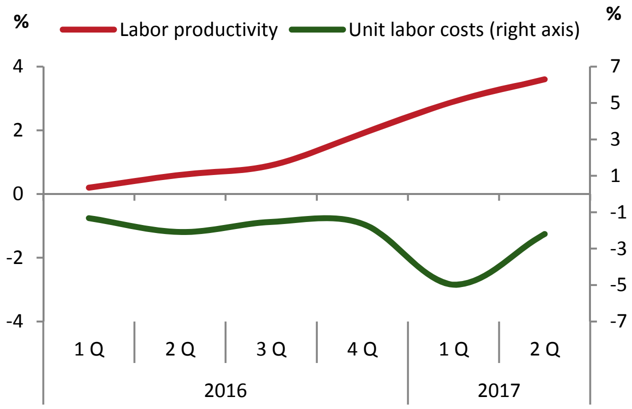
The trend of an outstripping GDP growth as compared to nominal wages continues to determine the downward pattern of unit labor costs (Figure 52). However, the decline rates slowed down. So, the decrease in unit labor costs in the first half of 2017 accounted for 2.2%.

In the third quarter of 2017, the unemployment rate had not changed. The persistently stable unemployment rate was followed both by the overall recovery of economic activity and by a continuing creation of new jobs as part of implementation of government employment programs and economic stimulus programs.

In the third quarter of 2017, the number of employed population decreased by 0.2% as a result of the decreased number of self-employed (by 2.2%). However, the number of employees increased. However, such growth has been slowing down since the first quarter of 2017 (Figure 53).

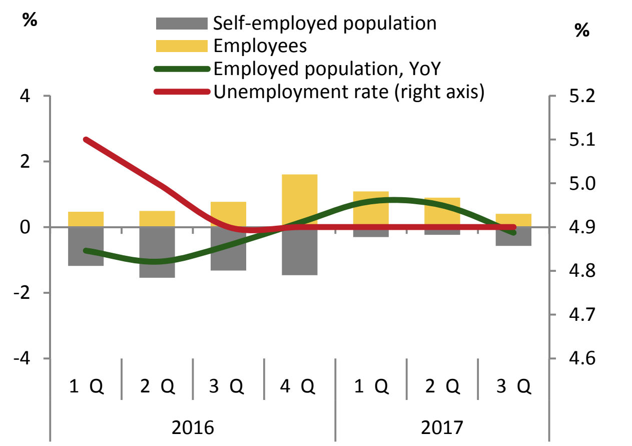
In the third quarter of 2017, the number of employees increased by 1.1%. The change in the

Figure 52. Labor Productivity and Unit Labor Costs, YoY, year-to-date total



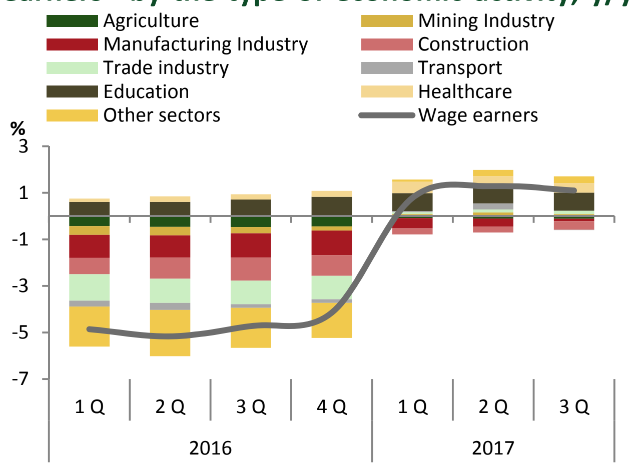
Source: CS MNE RK, NBRK's calculations

Figure 53. Unemployment Rate, Growth Structure of the Employed Population, YoY



Source: CS MNE RK

Figure 54. Structure of the growth of wage earners* by the type of economic activity, y/y



Source: CS MNE RK, NBRK calculations

**- without taking into account small enterprises engaged in entrepreneurial activities* number of employees in the industry-based breakdown of the economy was not homogenous. So, the increase was observed in activities in the area of administrative and ancillary service (by 9.7%), accommodation and catering services (by 5.1%), healthcare (by 3.5%), education (by 3.0%), trade (by 3.0%) and in the mining industry (by 1.5%). At the same time, the drop in the number of employees occurred in such sectors as communication (by 9.4%), real estate operations (by 7.7%), construction (by 6.8%), professional, scientific and technical activities (by 4.3%) and in the manufacturing industry (by 1.3%). In agriculture, the number of employees continues to decrease (by 5.0%) against the growth in labor productivity (Figure 54).

2.4 Fiscal Policy

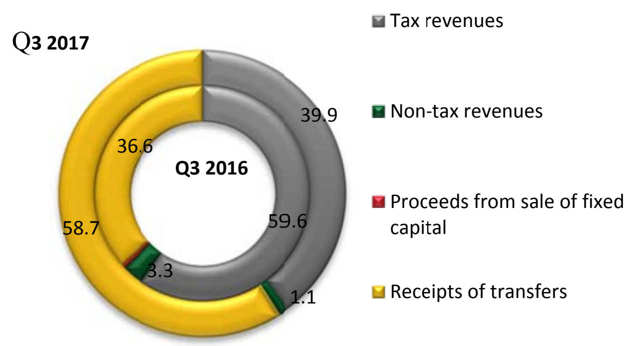
In the third quarter of 2017, the budget is characterized by a large structural change in revenues and expenditures.

The state budget revenues increased by 57.5% as compared to the same period of 2016 and amounted to KZT 3783.4 bln. or 36% of GDP (in the third quarter of 2016 – 20% of GDP). In revenues, a major change is observed in the receipt of transfers (Figure 55). Their volume increased to KZT 2219.9 bln. (in the third quarter of 2016 – KZT 879 bln.). First of all, this is related to allocation of resources from the National Fund for capitalization of the Problem Loan Fund. Accordingly, the structure of revenues changed significantly, where the relative share of transfers increased from 36.6% to 58.7% (Figure 56).

The cost profile also has undergone significant changes as a result of capitalization of the Problem Loan Fund. The state budget spending more than doubled as compared to the third quarter of 2016 and amounted to KZT 4704.2 bln.

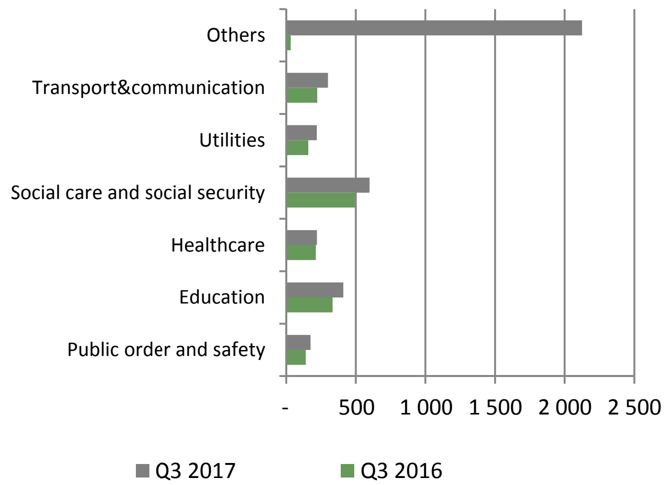
Resources allocated to support the banking sector were attributed to other costs (Figure 54). Among other items, the growth in the following expenditures should be mentioned: for education (23.2%), social care and social

Figure 55. Structure of State Budget Revenues



Source: Minfin RK

Figure 56. Change in the State Budget Spending



Source: Minfin RK

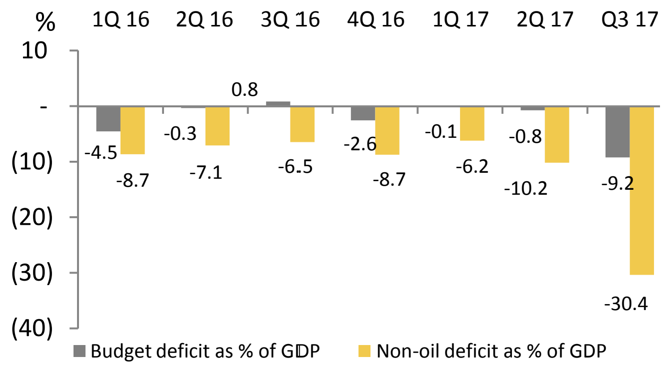
security (21.3%), utilities (38.8%), transport and tourism (34.6%). In terms of percentage, if other expenditures are not taken into account, social care and social security still account for the largest relative share in costs. The increased expenditures in this area are associated with the increased social benefit payments.

Since the state budget spending significantly exceeded revenues, the state budget showed up a deficit of KZT 970 bln. or 9.2% of GDP (Figure 57).

Non-oil deficit increased nearly three-fold as compared to the second quarter of 2017 and accounted for 30.4% of GDP. Such growth is explained by the fact that a significant portion of the budget revenues in the form of transfers from the National Fund is not included in calculation of non-oil deficit.

Based on performance in the quarter, the fiscal policy was primarily focused on maintaining the banking sector's sustainability. Also, measures have been taken to improve the housing conditions and utilities for the population, and key social and education programs were implemented.

Figure 57. Change in Deficit and Non-Oil Deficit



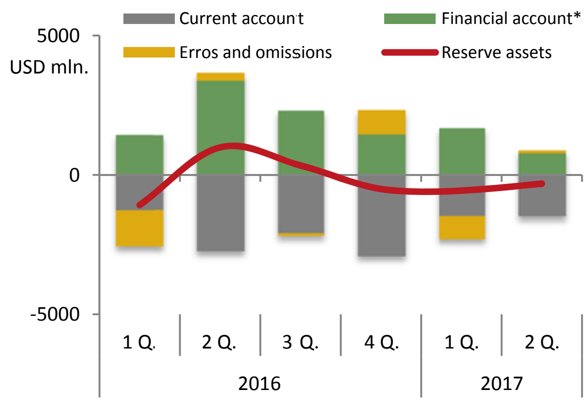
Source: Minfin RK, NBRK's calculations

2.5 Balance of Payments

In the second quarter as compared to the same period of the previous year, the current account of the balance of payments was characterized by a significant growth of the trade balance and the increased payouts of their returns to foreign direct investors. The current account deficit which was partially financed with financial account operations on direct and portfolio investments secured an overall external surplus of USD 0.3 bln. (Figure 58).

The growth in export revenues given a relatively favorable market environment of world oil prices and the commissioning of commercial production in the Kashagan oil field resulted in the 45.7% decrease in the current account deficit to USD 1.5 bln. (or 4,. % of GDP) as compared to USD 2.7 bln. in the same period

Figure 58. Balance of Payments, Quarterly



Source: NBRK

*excl. NBK's reserve assets (a net inflow) of the last year[6](Figure 59).

The behavior of world energy prices is still the main factor for the change in volumes of commodity exports (Figure 60). During the quarter, the price of oil (Brent) made up USD 50.2 per barrel on average, which exceeds the price in the same period of 2016 (USD 46.0). As a result, net exports of goods increased by 43.5% to USD 12.4 bln.

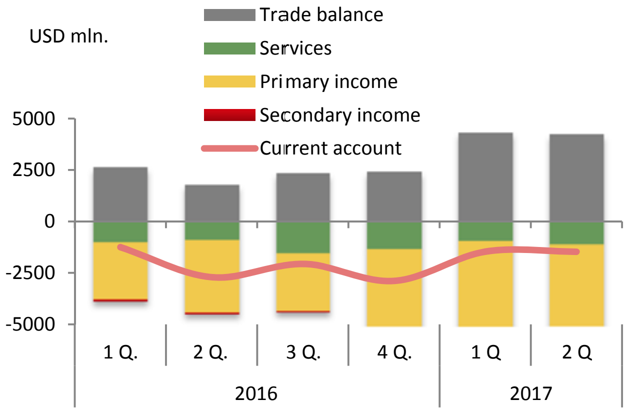
The growth in the value of exports occurred among all key groups of commodities. Exports of mineral resources increased by 58.5%, including the 58.1% growth of exports of oil and gas condensate (55.1% of official exports). Exports of ferrous metals increased by 66.5%, exports of non-ferrous metals – by 27.4%, and grain exports increased insignificantly – by 1.0%.

The trend of outstripping growth rates of exports is persisting. In the reviewed quarter, the growth rates of exports demonstrate more than a double increase versus the growth rates of imports (imports of goods increased by 19.1%). The largest increase in imports occurred among imports of consumer non-food products (by 31.2%). Imports of interim industrial consumption products increased by 19.0%, and imports of investment goods – by 26.4%. In respect of main trading partners – Russia and China – the increase in imports accounted for 26.1% and 43.0%, respectively.

As a result, a balance of trade surplus increased by 2.4 times in the second quarter.

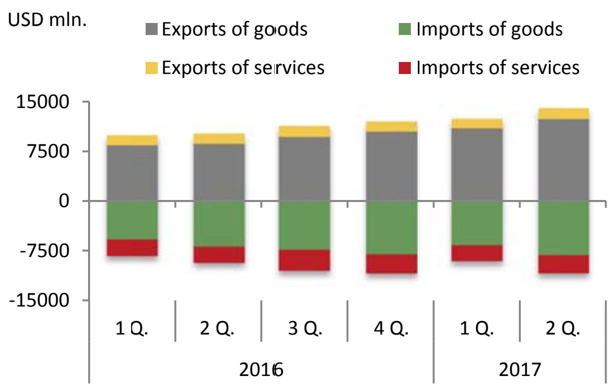
The deficit in international services increased by 24.2% because of outstripping growth rates of imports over growth rates of exports (exports of services increased by 3.1%, while imports grew by 10.8%). The growth in imports of services was mainly secured by the increase in imports of other business services which are related to engagement of non-residents in implementation of large infrastructure projects in the country. Also, there was an increase in expenditures of non-residents on such service components as payment for transport services of non-residents,

Figure 59. Current Account



Source: NBRK

Figure 60. Exports and Imports of Goods and Services



Source: NBRK

[6] Henceforth, the comparison is made with the second quarter of 2016

trips abroad and construction services related, inter alia, to preparation of facilities as part of EXPO-2017 international exhibition.

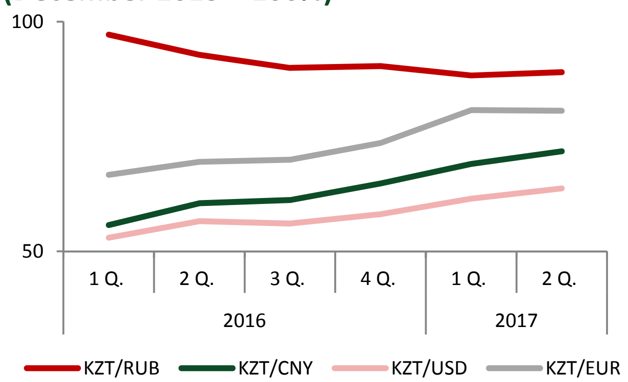
Despite a significant reduction in the current account deficit, pressure on the current account has been increasing because of the growth in investment returns of non-residents. The 26.0% growth in returns of non-residents on direct investments resulted from the growth in revenues from primary exports, with a significant portion of such returns being channeled to finance their Kazakhstani subsidiaries in the oil and gas sector. Payments of interest to creditors that are not in direct investment relationship increased by 9.9%.

A flexible exchange rate of the tenge is a filter from negative external shocks and it helps to maintain sustainability of the Kazakh economy. The real effective exchange rate index of the tenge increased by 12.7% (the tenge appreciated in real terms against the CIS-currency basket and other currencies). However, the tenge had depreciated by 7.1% against the CIS-currency basket, and appreciated by 16.7% against currency basket of other countries. Bilateral real exchange indices (RER) of the tenge against currencies of countries – main trading partners were mainly demonstrating an upward trend. So, at the quarter-end, in real terms the tenge appreciated against the US Dollar by 12.5%, against Euro – by 16.0%, against Yuan – by 18.8 and depreciated against ruble by 4.1%. The real effective exchange rate index decreased by 17.3% versus the benchmark competitiveness index of December 2013, thus indicating that the exchange rate competitiveness of Kazakhstani goods has been maintained (Figure 61).

The financial account (less reserve assets) showed up a negative balance (net capital inflow) of USD 0.8 bln. because of higher growth rates of residents' liabilities as compared to the growth rates of their assets.

Direct and portfolio investments whose inflow was partly offset by an outflow associated with the growth in short-term assets

Figure 61. Real Effective Exchange Rate Index (December 2013 = 100%)



Source: NBRK

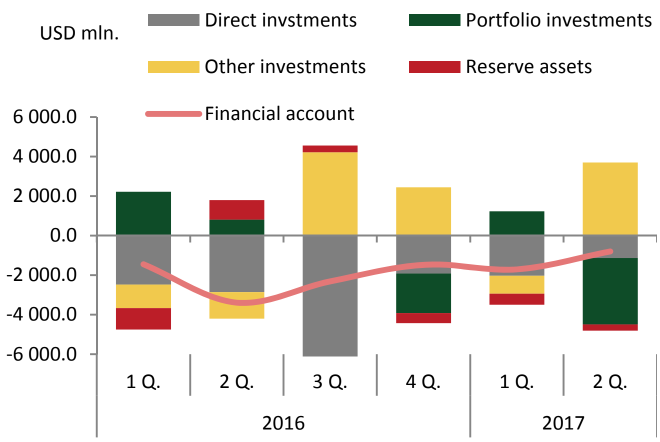
of residents on foreign accounts and repayment of liabilities of residents on long-term loans served as the main funding source for the balance of payments in the reporting quarter (Figure 62).

As for foreign direct investments, their net inflow amounted to USD 1.1 bln. as compared to USD 2.9 bln. in the second quarter 2016 and was secured mainly by reinvestment of their returns by foreign direct investors as well as by the intercompany borrowing from foreign parent companies. The bulk of FDIs was channeled to finance the oil and gas sector, metallurgical industry and wholesale and retail sale outlets.

Issue of Eurobonds by non-banking organizations in international capital markets as well as reduction in assets of residents invested in foreign securities contributed to a net inflow on portfolio investments of USD 3.4 bln.

There was a net outflow of USD 3.6 bln. on other investments, which was mainly secured by the increased assets of non-banking institutions maintained on accounts with foreign banks. In addition, a net outflow was also related to repayment by banks and entities from the non-banking sector of their liabilities on long-term loans.

Figure 62. Financial Account



Source: NBRK

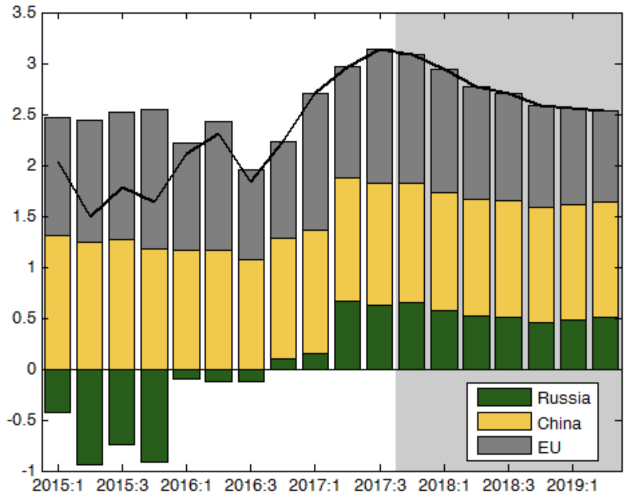
II. FORECAST OF KEY MACROECONOMIC INDICATORS AND FURTHER MONETARY POLICY GUIDELINES

The forecast of macroeconomic indicators was prepared on the basis of statistical information as at November 9, 2017

1. KEY ASSUMPTION FOR EXTERNAL FORECAST PARAMETERS

The price of oil (Brent) for 10 months of this year made up USD 52 per barrel on average. By end-October 2017, daily oil quotations (Brent) surpassed a psychological mark of USD 60 per barrel, thus indicating the existence of positive expectations among the market participants. At the same time, the National Bank adheres to a conservative approach when designing forecasts of macroeconomic variables, both for a short-term (to the end of the second quarter of 2018) and the medium-term (to the end of the second quarter of 2019) periods. As a result, a scenario which assumes the price of oil to be at USD 50 per barrel was considered as the baseline scenario; this is generally in line with assumptions of international institutions and also corresponds to settings in the baseline scenario of the previous forecast round (see the Inflation Report for the second quarter of 2017).

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



Source: NBRK's calculations

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 584.9% of the total foreign trade turnover of Kazakhstan in the third quarter of 2017, had not undergone dramatic changes as compared to previous forecasts presented in the Inflation Report for the second quarter of 2017.

According to assertions which take into account estimates of international organizations, recovery of the external demand in the medium term will serve as a factor promoting the economic growth in Kazakhstan. To a larger extent, the external demand will be improving owing to recovery of positive growth rates of the Russian economy as well as due to a moderate growth of the Chinese economy around its potential and persistently stable rates of economic growth in the EU (Figure 63).

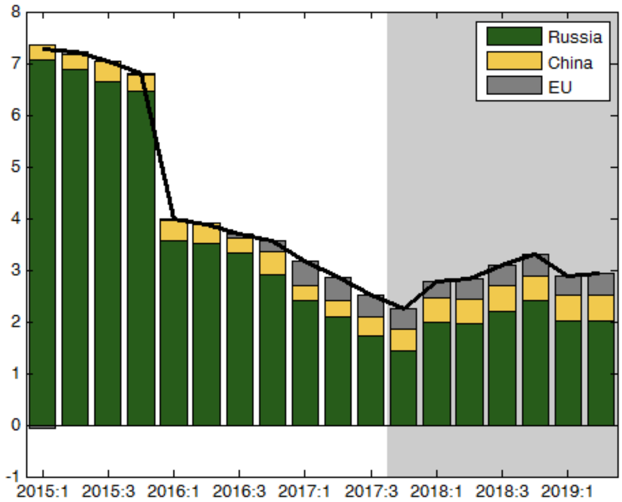
Assessment of a future pattern of external inflation characterized as consumer inflation in main trading partners weighted based on their shares in Kazakhstan's imports (Figure 64) also had not demonstrated significant changes as compared to the previous forecast round (see the Inflation Report for the second quarter of 2017).

The baseline scenario assumes that in the medium-term the analyzed indicator will show a feeble growth against a minor acceleration of inflation in the Russian Federation to the target of 4% set by the Bank of Russia. At the same time, in the analyzed period inflation in the EU and China will not show a significant difference from the existing levels. Therefore, by the end of the first half of 2019, a negative impact of aggregate external inflation on the consumer price behavior in Kazakhstan will be quite small.

In the short term, according to projections made by the Food and Agriculture Organization of the United Nations (FAO), the supply in the food market, cereals in particular, will prevail over demand. So, according to the FAO, one may expect that by the end of the season of 2018 cereal stocks will reach a new record-high level. This will result in a further stabilization of the ratio between stocks and utilization of cereals at a maximum possible level for the last 15 years[7]. According to the National Bank's expectations, under the baseline scenario the situation in the world food market in the absence of weather and climate shocks will remain unchanged in the medium term, too. Thus, at present there are good reasons to assume that world cereal prices will be having a neutral impact on the behavior of food prices in Kazakhstan till the end of the first half of 2019.

Expectations regarding external monetary environment in the medium term have not changed. As before, monetary conditions are expected to be tightened against a further increase in the US Fed's federal funds rate.

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



Source: NBRK's calculations

[7] http://www.fao.org/worldfoodsituation/csdb/en/

2. FORECAST UNDER THE BASELINE SCENARIO

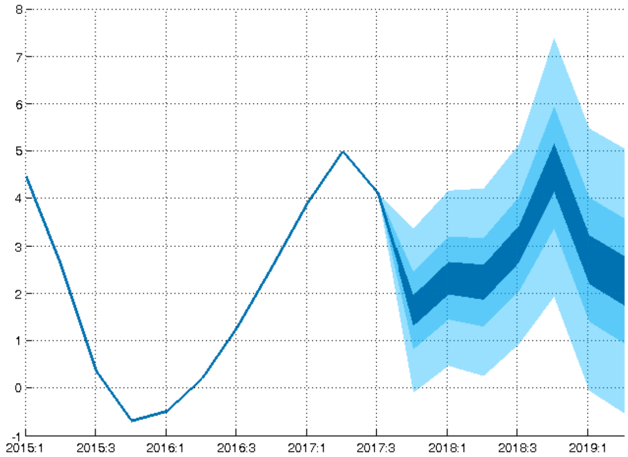
In July-September 2017, the economic growth in Kazakhstan has been recovering at a higher pace than it was expected before (see the Inflation Report for the second quarter of 2017). This was furthered by higher growth rates in the mining industry given the increased oil extraction in the Kashagan oil field as well as an on-going moderate recovery of trade due to realization of the effect of deferred demand on the part of the population and, as consequence, the growth in the physical volume of output index in the sector of transport and warehousing.

With that in mind, a forecast regarding the real GDP growth in the medium term became more positive (Figure 65). So, with the oil price of USD 50 per barrel, the forecast about the growth of Kazakhstan's real GDP in 2017 is expected to be at 3.5% (a previous forecast published in the Inflation Report for the second quarter of 2017 was 3.1%). Expectations regarding the economic growth rates for 2018 under the baseline scenario decreased to 2.8% because of a higher base of 2017 (a previous forecast published in the Inflation Report for the second quarter of 2017 was 3%).

In a short-term horizon, the growth rates of domestic consumption are expected to be more moderate as compared to the first half of 2017 because of a continuing reduction in household real cash income, a limited potential for a further growth of consumer lending as well as the completion of a larger portion of government support programs for the real sector. However, in the medium-term horizon, as long as the economic entities adapt to a new environment and the positive growth in real wages recovers given the improving financial environment of enterprises, the growth rates of domestic consumption are expected to slightly increase.

In turn, as the domestic consumption slows down followed by its feeble growth, real import indicators will be slowly going over the recovery growth phase, thus producing a general positive effect on the overall GDP trend.

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



Source: NBRK's calculations

As at the end of the first half of 2017, real exports are still demonstrating weakly positive values. Under the baseline scenario, their pattern will be moving along the path of active recovery followed by changing over to the moderate growth phase in the forecast horizon of up to the second quarter of 2019. This pattern is determined both by persistently high volumes of crude hydrocarbon extraction in Kazakhstan and a further improvement of external terms of trade (Figure 63). Thus, net exports will serve as the main driver for Kazakhstan's real GDP growth in the medium term; the increase in net exports will be related to the outstripping growth rates of real exports over the trends in the growth of real imports.

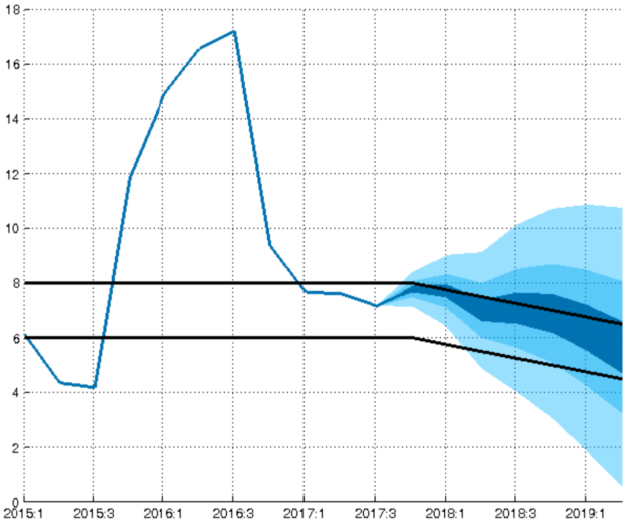
Assumptions regarding the influence of government consumption on the GDP growth rates in the medium-term forecasts as compared to previous forecast round have been revised downwards. So, in connection with plans of the Kazakh Government regarding a significant reduction of the budget deficit in 2018 that implies curtailment of expenditures, the government consumption is expected to provide a constraining fiscal impetus on the economic growth rates.

In general, according to the National Bank's updated estimates, in the medium term the output gap in Kazakhstan will be weakly negative. At the same time, it is expected to be closed in the second quarter of 2019; this, in turn, will be having a neutral impact on inflationary processes in the country.

According to the baseline scenario, some depreciation of the real exchange rate of the tenge is expected in the medium term followed by its stabilization at a new level. This will be providing a positive impetus on the GDP growth rates in terms of encouraging net exports. However, such behavior of the tenge exchange rate will be pronounced in a limited pressure on inflationary processes thus requiring a more restraint monetary policy.

Under the baseline scenario, in the fourth quarter of 2017 the annual inflation will be closer to the upper boundary of the target band of 6-8%. In 2018, inflation will start to smoothly move to the target band of 5-7%, which is driven by the effect of the tenge exchange rate, in the first instance. So, under the baseline scenario which implies that world oil prices (Brent) would decline from their existing level of over USD 60 per barrel to USD 50 per barrel, the tenge exchange rate behavior, other things being equal, might follow the depreciation path; this, in turn, would help curbing disinflation in the country because of the intensified pass-through effect. At the same time, under the baseline scenario, a positive disinflationary and neutral impact on Kazakhstan's consumer price index would be made by the external inflationary background in the form of a feeble growth of aggregate external inflation (Figure 64) and steadily neutral behavior of world food prices, an output gap which is weakly negative in the short-term and neutral in the medium-term as well as "anchoring" of inflation expectations at steadily low levels. The increasing impact of these factors would help bringing the inflation down to the lower boundary of the target band of 4-6% in 2019.

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



Source: NBRK's calculations

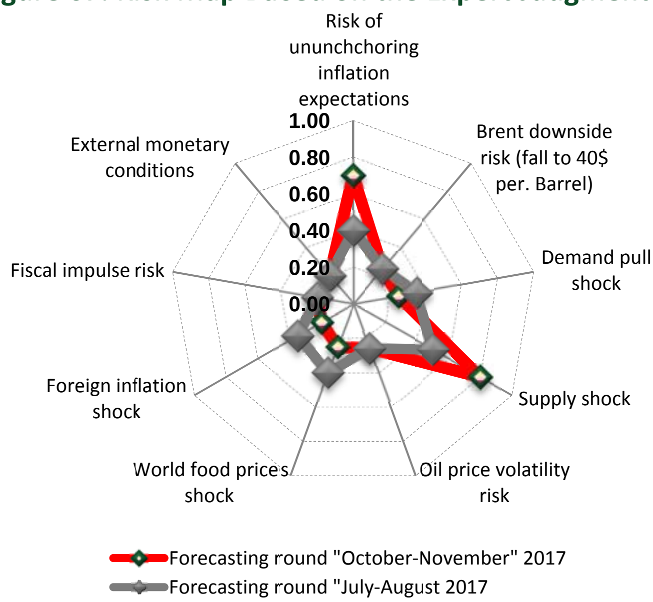
3. RISKS IN THE MEDIUM TERM

The key risk of the forecast is still the decline in oil price (Brent) throughout the entire forecast period.

So, alongside with the baseline scenario the scenario of USD 40 per barrel was considered, where a higher inflation and more modest GDP growth rates are anticipated. According to such scenario, there is a probability that inflation would go beyond its target band in 2017-2018. The economic growth rates are expected to slow and such slowdown would occur mainly in 2017 because of an immediate reaction to deterioration in the external environment. Under this scenario, 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.

Risks which, if realized, may have a

Figure 67. Risk Map Based on the Expert Judgment



Source: NBRK's estimate

significant effect on the inflation forecast are (Figure 67):

– the non-anchoring of inflation expectations caused both by supply shocks and devaluation expectations of a non-fundamental nature may significantly change the forecast path of the baseline scenario;

– unforeseen supply shocks that were observed during this year and their recurrence serve as a serious factor of uncertainty for implementation of the baseline scenario;

– a dramatic and a more significant tightening of the US Fed's policy without preliminary preparatory discussions that would affect redistribution of global assets and potentially increase inflationary expectations;

– an oil price volatility which is not taken into account in forecasting key variables would conduce higher devaluation and inflation expectations;

– the risk of acceleration of external inflation approximated through inflation in countries-trading partners;

– due to stabilization of world cereal prices, the risk of growth in the world food prices is lower as compared to the previous forecast round;

– the fiscal consolidation is anticipated in the forecast period. Any unscheduled fiscal impetus will be affecting the inflation and GDP path.

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 the target interest rate on the National Bank's one-day operations in the money market.

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
ФРС – Federal Reserve System
MMI – Money Market Index
bln. - billion
mln. - million
thous. – thousand
USD – dollars