NATIONAL BANK OF KAZAKHSTAN

Inflation Report

The Second Quarter of 2016

Almaty, Kazakhstan

The Inflation Repiort was compiled based on the statistical data as of 01.07.2016.

The forecast of macroeconomic indicators was prepared on the basis of statistical information as of 28.07.2016.

CONTENTS

SUMMARY

In the second quarter of 2016, oil prices in the global markets continued recovering and prices of some foodstuffs were growing. Economies in the countries–main trading partners demonstrated a feeble revival of macroeconomic indicators including the anticipation that the economic downturn in Russia will slow down. At the same time, the aggregated external GDP and inflation indicators had not undergone significant changes as compared to the first quarter of 2016.

As the external economic environment improved in the second quarter of 2016, the growth rate of Kazakhstan's GDP became positive; nonetheless the growth in sectors of the economy remains uneven. A feeble recovery in the business activity resulted from the growth in retail sales and consumer demand against the growth in nominal income and a gradual deceleration in monthly inflation rates. Implementation of infrastructure projects as part of governmental programs is conductive to the growth of production in certain sectors of the economy. At the same time, a stimulative fiscal policy is constrained by a slow utilization of public resources.

The National Bank's monetary policy in the second quarter was implemented in the environment of the structural surplus of the Tenge liquidity. To that end, the National Bank was withdrawing excess liquidity, mainly via its short-term notes.

As a result of dedollarization, the decreasing inflationary expectations, stabilization of the situation in the foreign exchange market as well as with a view to encourage the overflow of resources into assets denominated in the Tenge, the National Bank lowered its base rate to 15% while narrowing the interest rate band to 1 pp.

The annual inflation remains high and it accounted for 17.3% at the end of June 2016, of which 10.6% falls on the price growth in the fourth quarter of the last year as a result of a dramatic depreciation of the exchange rate of the Tenge against the US Dollar. The inflation rate in the second quarter of 2016 is in line with the rates of price growth in the past years. While the inflation rate as perceived by the general public remains high, inflationary expectations in the second quarter gradually decreased.

When designing the forecasts, the oil price in the baseline scenario was left at USD 40 per barrel. According to the National Bank's forecast, the peak of inflation under the baseline scenario is anticipated in the third quarter of 2016. The main inflation risks are the price volatility in the oil market and acceleration of devaluation and inflationary expectations associated with such volatility. A negative output gap would be serving as a constraining factor for food inflation and non-food inflation in 2016-2017.

Additionally, a scenario where the price of oil (Brent) would increase to USD 50 per barrel was considered. In the medium term, this would lead to the improved external demand and would also have a positive impact on the external inflationary background. This, in its turn, would result in a potential appreciation of the Tenge and, therefore, in a lower inflation, rapid recovery of the Kazakh economy against the decreasing dollarization and the growing economic activity as compared to the baseline scenario.

I. MACROECONOMIC ENVIRONMENT AND THE FINANCIAL SECTOR DEVELOPMENT

1. EXTERNAL MACROECONOMIC ENVIRONMENT

In the second quarter of 2016, the situation in the global commodity market was characterized by the growth in prices for key commodities and foodstuffs. Given the decreasing surplus of oil in the world associated with the disruption of supplies of raw materials from some regions of the world, stock exchange quotations for energy resources had demonstrated their recovery. Prices of non-ferrous metals were supported by the government stimulus packages for the real sector in China as well as by the reduced world supply caused by the decreased profitability of production because of the fall in prices of metals in 2015. In their turn, shocks of weather and climatic conditions and various industry-specific factors led to the growth in prices of foodstuffs.

In the reviewed period, the US economy continued demonstrating poor performance in the economic growth, employment and inflation; therefore, monetary conditions of the Fed remained unchanged.

In the economies of Kazakhstan's main trading partners, including Russia, China and the EU, in April-June 2016 key macro indicators were demonstrating a slightly positive behavior. GDP's annual rates in the EU and China had not changed versus the previous quarter and the economic downturn in Russia was slowing down, being in line with the market's expectations.

Given a stable path of the economic growth indicators and the price levels in the countries of main trading partners, aggregated external GDP and inflation indicators did not undergo significant changes in the reviewed quarter as compared to the previous quarter.

1.1 Situation in the Global Commodity Markets

1.1.1 Oil Market

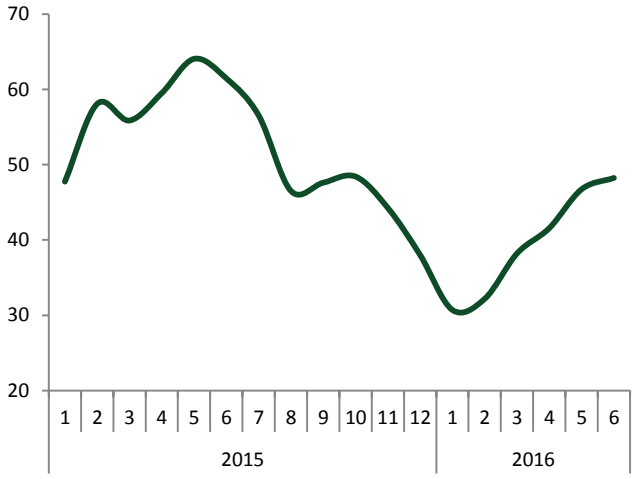
In April-June 2016, the price of oil (Brent) increased from USD 34.6 to USD 46.7 on average during the quarter or by 35%, being the most significant quarterly indicator of growth in percentage terms since 2009 (Figure 1). Oil prices were recovering against the decreasing surplus of oil from 1.28 million to 0.94 million barrels a day (Figure 2); this was both related to the increasing annual growth rates of the demand and to a significant slowdown in annual growth rates of oil supply.

The increased demand in the oil market in the reviewed period was expressed in accelerated rates of annual growth in oil consumption from 1.51% in the first quarter to 1.64% in the second quarter of 2016 (Figure 3). A positive contribution to the growth in oil consumption is still made by China, India and countries of the South-East Asia which, while being net exporters of energy resources, increase the consumption given their low prices. At the same time, because of deceleration in economic growth in Japan and European countries as well as recession in Russia, oil consumption in these countries notably decreased.

Another factor that contributed to the decrease in surplus in the oil market to a larger extent – a slowdown in the annual growth rates – was expressed by the slowdown in the volumes of oil production. So, if in the first quarter of 2016 the global oil production increased by 0.93% as compared to the corresponding quarter of the last year, in the second quarter the growth accounted for 0.46%, which appeared to be the consequence both of the decline in oil production in the countries outside of the OPEC and of a slowdown in the oil extraction in the OPEC member countries (Figure 4).

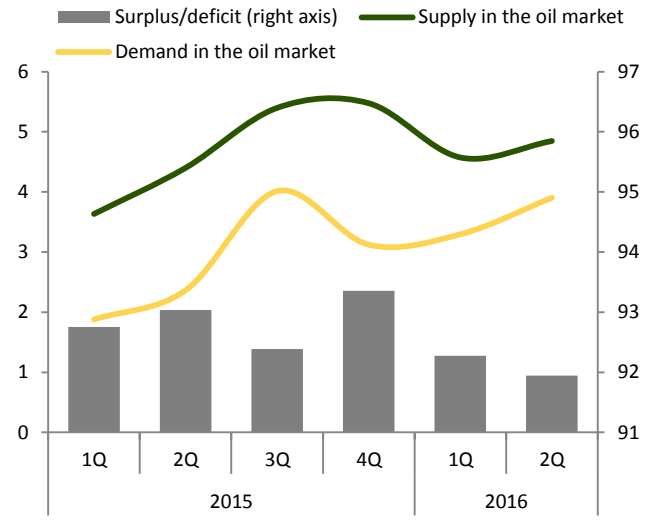
The decreasing profitability of the oil sector because of low energy prices resulted in the reduced volumes of crude oil extraction and production in the US, China, Mexico, Equatorial Guinea, Australia, Egypt, Columbia, and Yemen.

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



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

Figure 2. Demand and Supply in the World Oil Market, million barrels a day



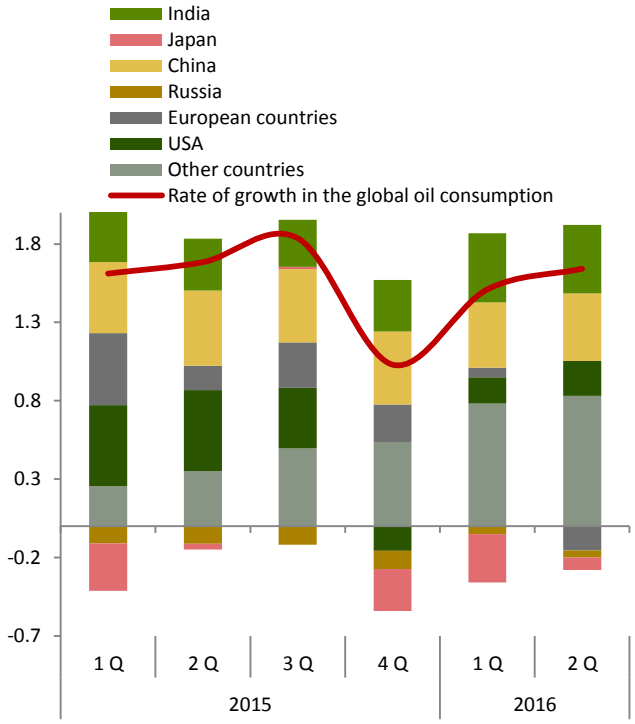
Source: U.S. Energy Information Administration (EIA)

At present, Russia is the only country which is not a member of the OPEC, where the oil extraction is growing with a view to increase exports. However, such growth does not allow offsetting the decline in oil extraction in other countries outside of the OPEC.

The slowing annual growth of oil extraction in the OPEC countries in the second quarter of 2016 to 1.99% (versus 2.38% in the first quarter of 2016) was observed against the decline in oil supplies because of military and political commotions in Nigeria, Libya, Venezuela, the decreasing profitability of production in Algeria, Angola and Ecuador as well as strikes of workers in the oil industry in Kuwait. An additional reason for a slowdown in oil extraction in the OPEC countries was the decrease in oil production in Iraq and Saudi Arabia. The decreased production of oil was compensated by a significant and continuing increase in the oil extraction in Iran which was resumed after the lapse of international sanctions. So, during April-June 2016, the oil extraction in Iran increased to 3.58 million barrels a day, which means a 27% increase as compared to the corresponding period of 2015 (in the first quarter of 2016 the same indicator accounted for 8% only).

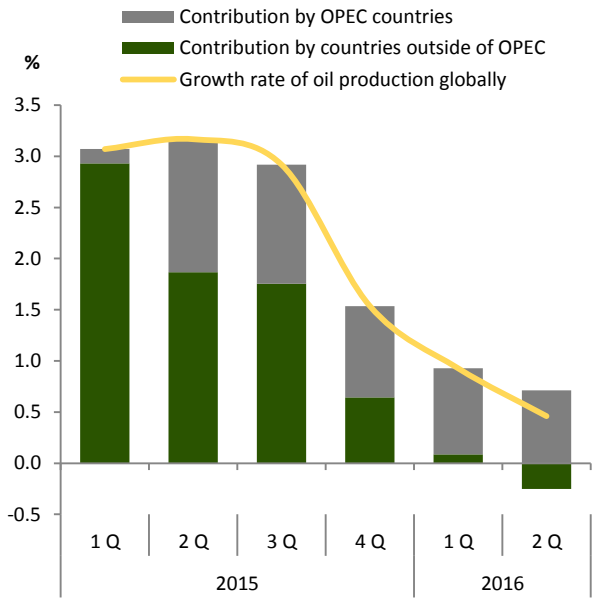
Thus, despite the decreased surplus in the oil market, its absolute values remain high and may have a downward pressure on the stock exchange quotations of energy resources in future.

Figure 3. Global Oil Consumption and Contribution by Countries



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

Figure 4. Global Oil Production, YoY



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

1.1.2 Non-Ferrous Metals Market

In the second quarter of 2016, there was a small growth of market quotations on average in the non-ferrous metals market. The arithmetical mean index of prices for copper, aluminum, zinc and lead increased by 3.6% in June versus March (Figure 5). Such growth was secured by the increase in prices for copper, aluminum, zinc and lead. The behavior of lead prices, in its turn, had a downward pressure on average prices of non-ferrous metals.

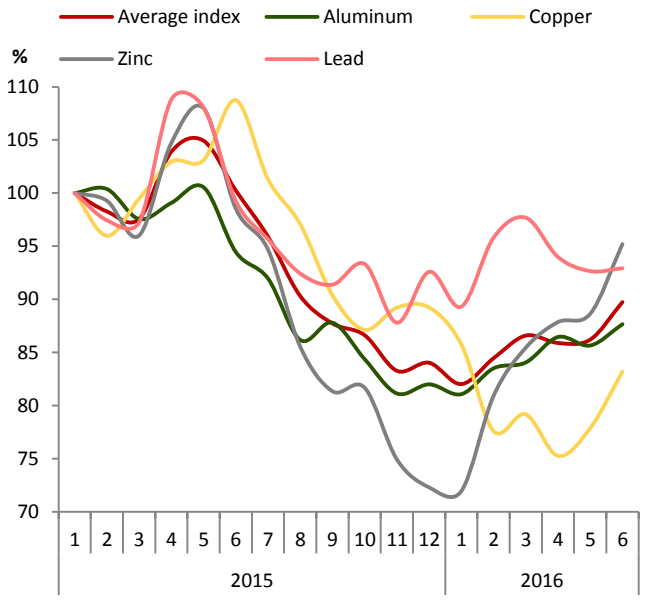
The growth in copper prices was conduced by the decreased extraction of copper ore in the ore deposits in Chile developed by the largest copper producer in the world – national Chilean company Codelco. The reasons for the decreased extraction were weather and climatic conditions. Alongside with that, a recovering demand on the part of China based on active government support for the sector also favored the growth of stock exchange quotations for copper.

In China, the government support of unprofitable enterprises in the sector of aluminum production propped up the growth of world prices for this metal. Also, one of the factors for the increase in prices for aluminum was an extensive use of cheap and low-waste melting furnaces in the Chinese aluminum industry.

The closure of a number of large mines because of their decreased profitability in Australia – one of the largest zinc producers in the world – as well as the recovery of demand on the part of China amidst the decreasing quality of zinc ores extracted in the country became the main factors for the growth in zinc prices which continued in the second quarter of 2016.

The reasons for the downward pattern in lead prices to a larger extent were associated with the Chinese market. At present, the consumption of lead is slowing down given the decreased manufacturing of electric bicycles and cars.

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



Source: NBRK's calculations based on data from Bloomberg

1.1.3 Food Market

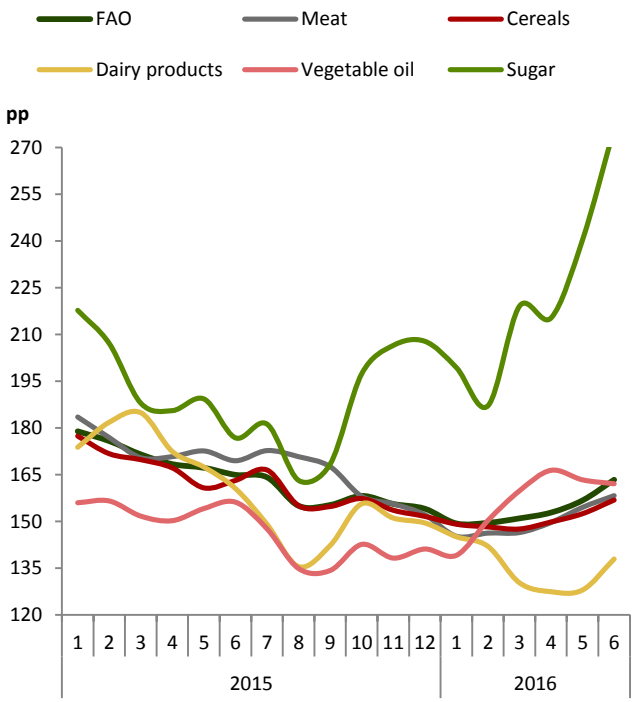
FAO Food Price Index (FPI) in the second quarter of 2016 continued its growth which began in the first quarter of 2016 (Figure 6). Moreover, the observed quarterly growth (by 8.4%) was the largest over the last four years.

The largest contribution to the FPI growth was made by the increase in prices of sugar which had increased by 26% from May to June. Such growth in prices of sugar was caused by the deterioration in forecasts regarding the largest sugar producer and exporter – Brazil – as a result of heavy rains which led to the decreased volumes of sugar cane harvest. An additional pressure on prices in this segment of the food market was made by the fact that large volumes of sugar cane were redirected to the production of ethanol.

The increase in the FAO Index in the second quarter of 2016 was also caused by the increase in prices of cereals, dairy products, meat and vegetable oils, apart from the growth in sugar prices. So, the growth in prices of cereals which accounted for 6.3% was associated with the growth in prices of corn caused by the reduced supplies from Brazil because of unfavorable weather and climatic conditions. In turn, the 8.5% increase in prices of meat occurred as a result of the livestock reduction (cattle and small ruminants) in the countries of the Pacific Region and the shortage of slaughter pigs in the EU. The price growth of dairy products which accounted for 5.9% stemmed from the increasing uncertainties about prospects of production in the countries of the Pacific Region in the 2016-2017 agricultural year.

Stock exchange quotations for vegetable oils in the reviewed period showed the smallest growth among all reviewed foodstuffs. So, the FAO Vegetable Oil Price Index had increased by 1.4% from May to June. Such slowdown in the growth of vegetable oil quotations occurred as a result of a weakened demand in the global market as well as of a seasonal increase in production in Malaysia and Indonesia.

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



Source: UN FAO

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

According to the data of initial assessment by the US Bureau of Economic Analysis, the economic growth in the US based on performance in the second quarter of 2016 accounted for 1.2% (Figure 7), which appeared to be half as high versus the market's expectations. So, according to the poll conducted by Bloomberg, experts anticipated the 2.5% growth of the US economy on average. Along with that, the Bureau of Economic Analysis revised its assessment of the US economy growth for the first quarter of 2016 downwards from 1.1% to 0.8%.

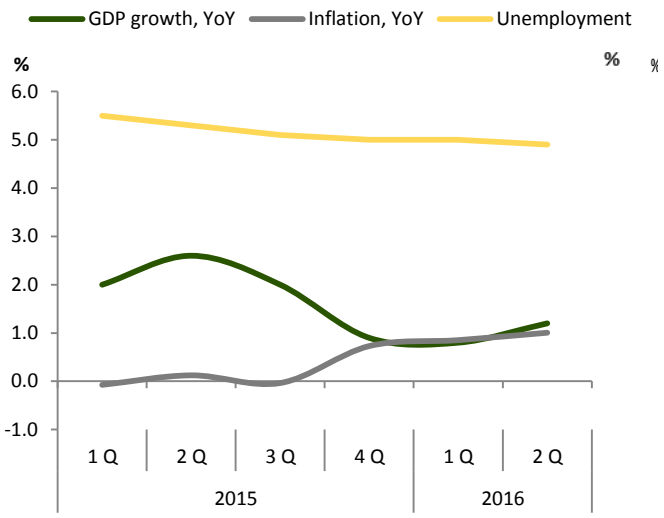
The increase in personal spending on final consumption and exports of goods were highlighted as positive factors which contributed to the US economy growth in the second quarter of 2016. In turn, the decreased private investments in inventories, fixed capital investments as well as the local and general government spending made a negative contribution to the economic growth in the country.

The annual inflation rate in the US is still below the target of 2%. So, based on performance in the second quarter of 2016, the annual growth in consumer prices in the country accelerated to 1% only (Figure 7). The growth in prices of gasoline and other energy carriers as well as the increased personal spending on final consumption were conductive to the inflation growth.

According to the Bureau of Labor Statistics, in the second quarter of 2016 the unemployment in the US decreased to 4.9% (5% in the first quarter of 2016). A maximum growth in jobs over the recent two quarters has been observed, along with the increased wages. A major constraining factor for a more rapid reduction in the unemployment rate in the US is a feeble growth in the number of the employed in non-agricultural sectors.

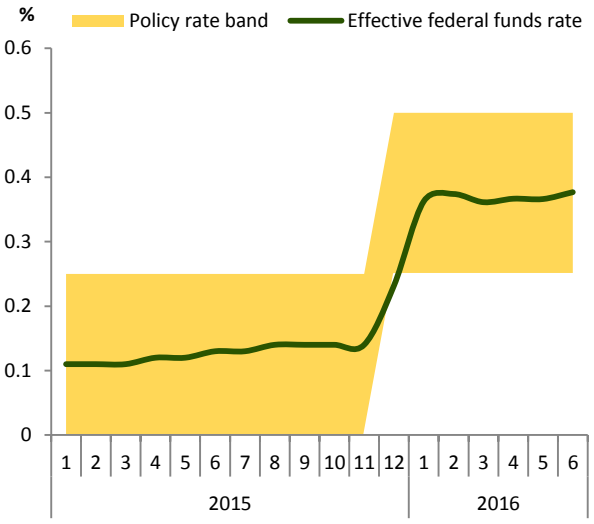
Thus, given unsatisfactory indicators of the economic growth, employment and inflation in the US, the Fed's rate in the second quarter of 2016 remained unchanged (Figure 8).

Figure 7. US Economic Performance



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

Figure 8. US Interest Rates



Sources: Reuters

1.3 Economic Situation in Countries – Kazakhstan's Trading Partners

1.3.1 China

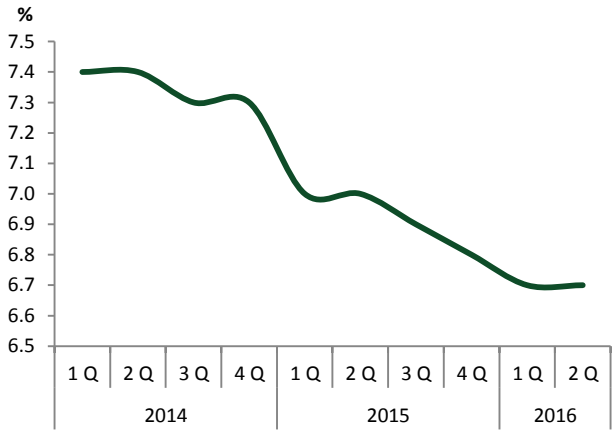
In the second quarter of 2016, the GDP growth in China accounted for 6.7% as compared to the previous year (Figure 9). The Yuan devaluation, accelerated growth in the services sector and government stimulus packages including reduction of taxes and bureaucratic barriers in doing business, the growth in government spending for infrastructure and injections in the financial system, had a positive effect on China's economic growth in the reviewed period. Redundant production capacities in many branches of the economy, the growing debt of state-owned companies in the real sector as well as slowing growth in the mining and manufacturing industries served as negative factors curbing the acceleration of economic growth in the country. The risks of a further cooling of the Chinese economy are related to the deteriorating quality of bank assets in the country as well as with uncertainty in the global economy, in the EU's economy in particular in connection with the Brexit.

The annual inflation in China, after its dramatic growth in January-March 2016 to 2.7% amidst the price surge in the domestic market of foodstuffs, tobacco and alcohol products, in the second quarter of 2016 went down to 2.2% (Figure 10). Such slowdown in the annual price growth in China was conduced by a low level of prices in the industry, declining prices of foodstuffs as well as the cooling of the economy.

Based on the decelerating annual inflation and the cooling economic growth, in the second quarter of 2016 the People's Bank of China retained its stimulative monetary policy. So, the regulator left its policy interest rate unchanged, thus the interbank rate remained at a stable level (Figure 11). Alongside with that, the People's Bank of China continued to actively inject resources in the financial system with a view to provide support to the real sector of the economy.

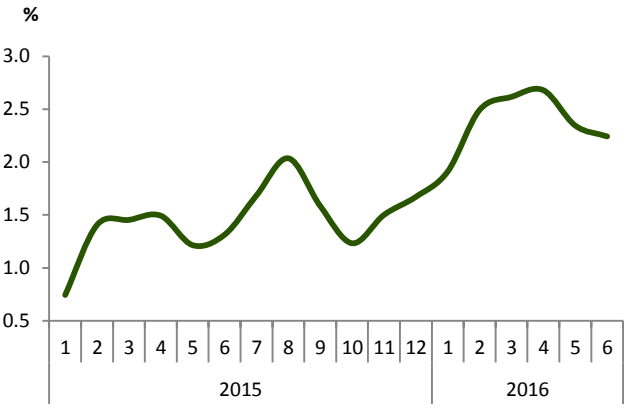
In April-June 2016, given the increased

Figure 9. China's Real GDP Growth, YoY



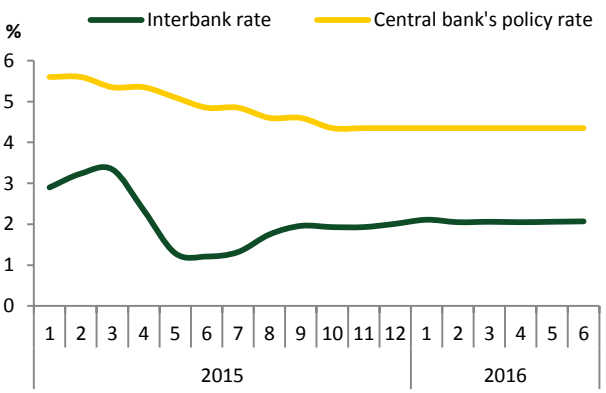
Source: Bloomberg

Figure 10. Inflation in China, YoY



Source: National Bureau of Statistics of China

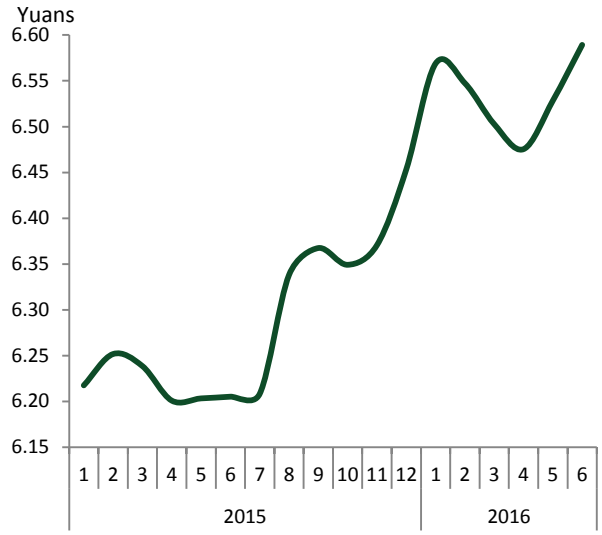
Figure 11. Interest rates in China



Source: Reuters

devaluation expectations and a significant capital outflow, the People's Bank of China conducted devaluation of the Yuan nominal exchange rate to the 5-year minimums (Figure 12). This decision was also made in order to support domestic exporters. A further behavior of the Yuan, apart from the internal factors, will be also dependent on developments around the Brexit. So, in case of a factual exit of Britain from the European Union, the US Dollar would appreciate against major world currencies thus having an impact on devaluation of the Yuan.

Figure 12. USD/CNY Exchange Rate, a monthly average

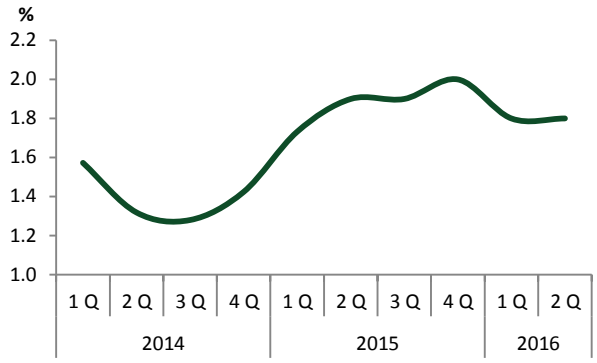


Source: Reuters

1.3.2 European Union

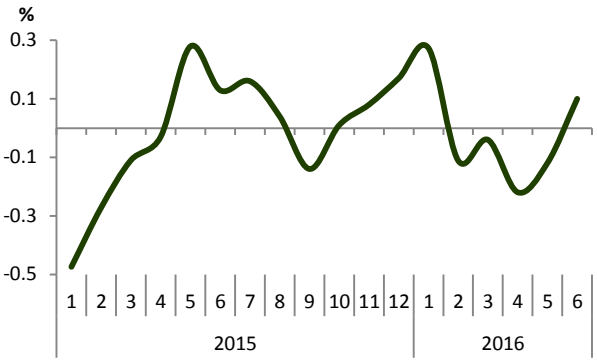
According to a preliminary estimate of the Eurostat, in the second quarter of 2016 the European Union's real GDP continued to demonstrate a low growth rate (Figure 13), which was caused by a feeble consumer and investment demand as well as well as a reduced contribution by exports. Retention of bilateral political and economic sanctions with Russia and the cooling of the Chinese economy also had a negative impact on the economic growth in the region. The decreased rates of growth in imports had served as a positive factor. The increasing economic and political uncertainties associated with the Brexit as well as the increasing liquidity problems in regional banks create risks for potential acceleration of the EU economy.

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



Source: Eurostat

Figure 14. Inflation in the EU, YoY

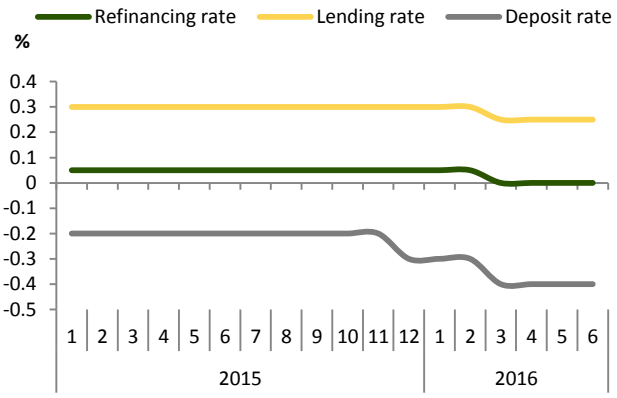


Source: Eurostat

Based on the outcomes of the reviewed period, the annual inflation rate was 0.1%, which is well below the target level of 2% as set by the ECB. Deflationary price pressure in the industry amidst low energy prices as well as a feeble consumer demand served as the factors for a low inflation rate. A feeble price growth in the economy motivated the ECB to continue implementing its stimulative monetary policy. So, a zero refinancing rate (Figure 15) as well as the volumes of monthly targeted long-term

refinancing operations and quantitative mitigation measures which include Assets purchase programs and which were expanded at the end of the last quarter remained unchanged.

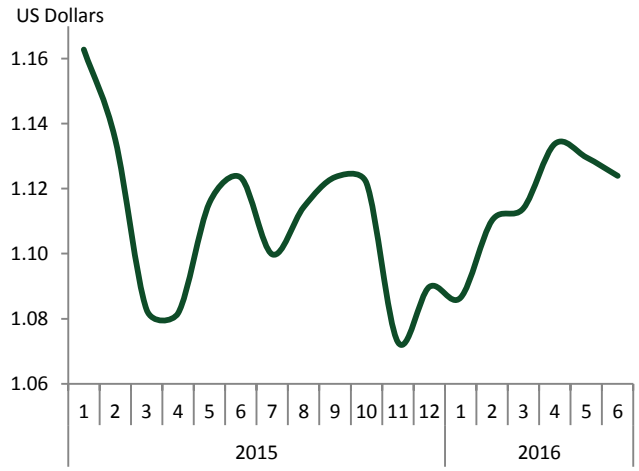
Figure 15. Rates in the ECB



Source: Reuters

In April-June 2016, the nominal exchange rate of the Euro against the US Dollar had increased from USD 1.1036 to USD 1.1291 per 1 Euro or by 2.3% on average over the quarter (Figure 16). However, within the quarter the behavior of the exchange rate of the Euro against the USD Dollar was downward. So, in June versus April the Euro exchange rate was depreciating from USD 1.1338 to USD 1.1239 per 1 Euro, or by 0.89%. Such shift in the behavior of the Euro from the appreciation path to the depreciation was mainly caused by the growing political and economic uncertainties in connection with the Brexit. Also, quantitative mitigation measures acted as an additional factor for depreciation of the Euro. As part of such non-traditional monetary policy, at the end of the first quarter of 2016 the ECB made the decision to increase a monthly volume of asset purchases from Euro 60 bln. to Euro 80 bln.

Figure 16. EUR/USD Rate, a monthly average



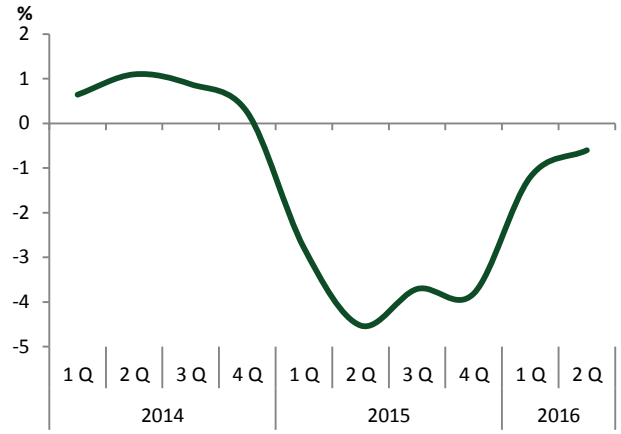
Source Reuters

1.3.3 Russia

According to the data of the Ministry of Economic Development of the Russian Federation published in the Monitoring Study entitled “Current Situation in the Economy of the Russian Federation Based on the First Half of 2016”, in April-June 2016 recession processes in the Russian economy continued to slow down. So, Russia’s GDP in the second quarter of

2016 reduced by 0.6% versus the corresponding quarter of 2015 (Figure 17). The slowdown in the economic downturn was impacted by the sectors of transport, industrial production and agriculture. In turn, the recession in the construction and trade sectors continued having a negative effect on the economic growth in the country. Still, the main external sources of negative GDP growth rates in Russia are low prices in the energy markets as well as political and economic sanctions imposed by the EU.

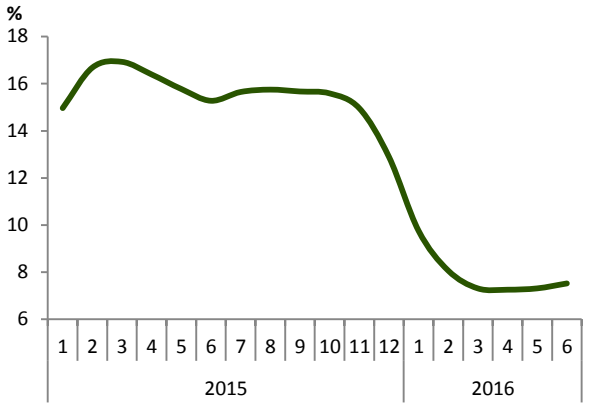
Figure 17. Russia's Real GDP Growth, YoY



Source: Rosstat, RF's Ministry of Economic Development

At the end of the second quarter of 2016, the annual inflation in Russia accounted for 7.5%, which exceeds that of the previous quarter by 0.2 pp. (Figure 18). The growth in the annual inflation is explained by the "low base effect" of the year 2015; though, the monthly inflation was demonstrating a steadily low pattern and was at 0.4% on average throughout the second quarter of 2016, while in the first quarter of 2016 it accounted for 0.68%. A low consumer demand, stabilization of the Ruble exchange rate as well as a moderately tight monetary policy of the Bank of Russia are conductive to deceleration of inflationary processes in Russia.

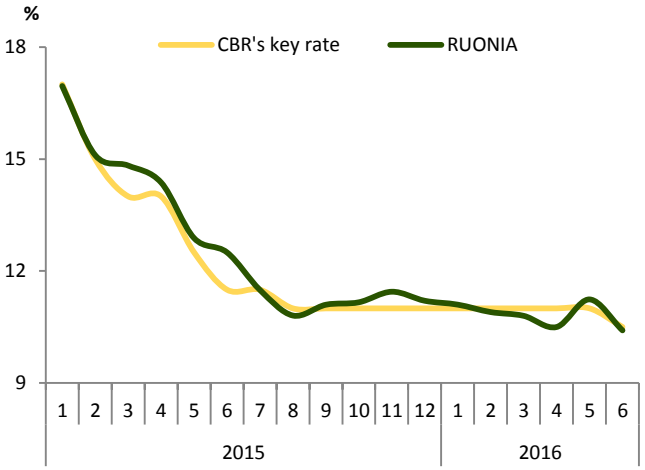
Figure 18. Inflation in Russia, YoY



Source: Reuters

In June 2016, the Bank of Russia made the decision to lower its key rate to 10.5% (Figure 19). Steady positive trends in the inflation pattern and the decreasing inflationary expectations among the population and the business community acted as positive factors which helped make this decision. Despite the fact that the key rate has been lowered, monetary conditions in Russia remain as moderately tight amidst inertia of inflationary expectations, the absence of a medium-term strategy of the fiscal consolidation and uncertainty about parameters for future indexation of wages and retirement benefits in the country.

Figure 19. Rates in Russia

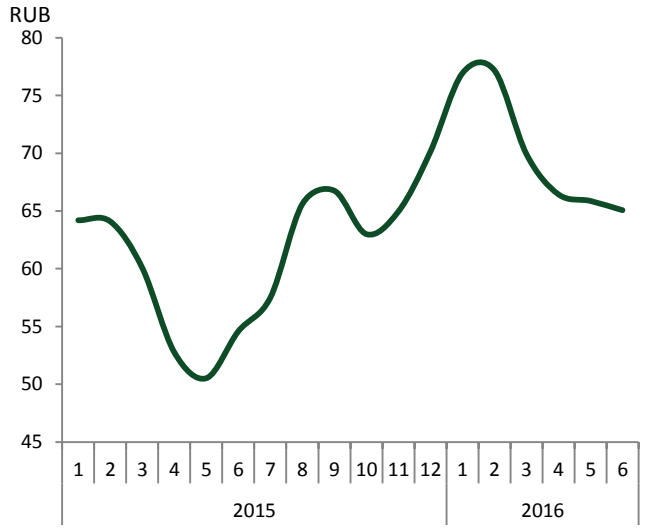


Source: Reuters

In the reviewed period, the nominal exchange rate of the Ruble had demonstrated appreciation given the recovery of prices of

energy resources. So, in April-June 2016 the Russian ruble had appreciated against the US Dollar by more than 11% over the quarter on average (Figure 20). Apart from the factor of growing oil prices, a positive impact on the Ruble exchange rate was made by tax and dividend payments of companies that started in the second half of June 2016. However, the increased deficit of the country's budget serves as a factor that conduced depreciation of the Ruble.

Figure 20. USD/RUB Exchange Rate, a monthly average



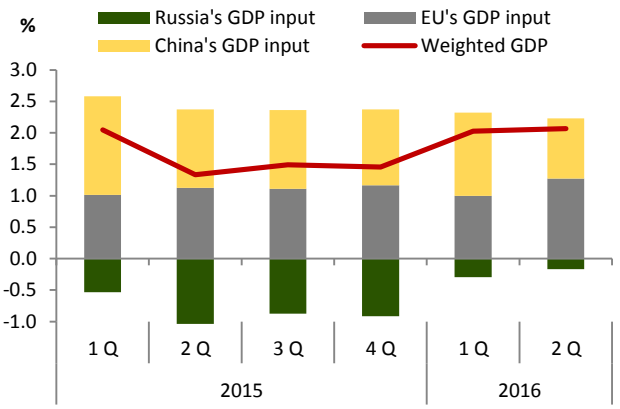
Source: Reuters

1.3.4 Aggregated 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, had increased by 0.04 pp over the reviewed period. (Figure 21). Such minor growth was observed as a result of a slowing downturn in Russia's GDP. A minor growth of external aggregated GDP of countries-main trading partners shows a feeble improvement in the external demand factor in the second quarter of 2016.

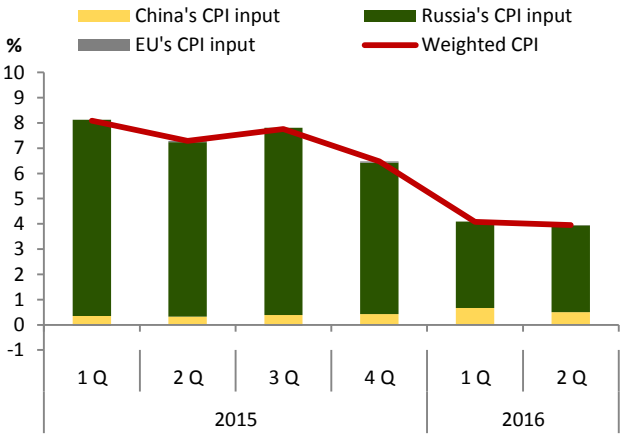
In the second quarter of 2016, the aggregate external food price index which is calculated based on the share of main trading partners in Kazakhstan's imports had demonstrated a weak decline of 0.12 pp. (Figure 22). A minor decline in this indicator is associated with deceleration of annual inflation in China offset by the growth in annual inflation in Russia. However, the input by inflation in the EU remained unchanged. Generally, deceleration in this indicator shows that the pressure put by the external inflation on the Kazakh consumer market continues to decrease.

Figure 21. Weighted External GDP, YoY



Source: NBRK's calculations

Figure 22. External Weighted CPI, YoY



Source: NBRK's calculations

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

In the second quarter of 2016, the money market was functioning in the environment of structural surplus of the Tenge liquidity.

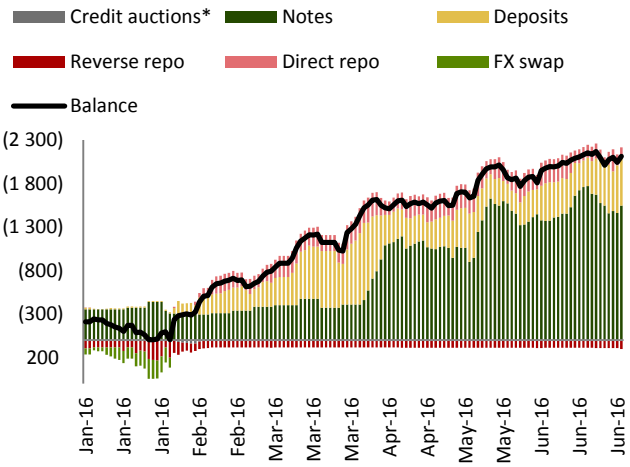
As a result of the National Bank's dedollarization measures in the economy as well as appreciation of the Tenge exchange rate along with the improved situation in the global raw commodities market, currency preferences of the population and of market participants were changing towards the domestic currency. As a consequence of conversion of deposits from foreign currency into the Tenge as well as large expenditures of the government and quasi-government sectors, banks happened to accumulate an excess Tenge liquidity; this, given a low demand for credit resources, resulted in the need to withdraw such excess liquidity. With a view to curb inflationary processes, the National Bank conducted operations to withdraw liquidity.

Short-term notes of the National Bank, direct repos and bank deposits with the National Bank served as key instruments of the excess liquidity absorption (Figure 23).

As part of measures aimed to create conditions for building up a risk-free yield curve, from April 2016 the National Bank started to gradually issue notes with maturities of 7, 28, 91 and 182 days and with an option of partial redemption. As a result, demand of banks shifted from 1-day operations, deposits in particular, to longer short-term notes of the National Bank with maturities of 7, 28 and 91 days.

As the situation in the financial market was improving, the National Bank was gradually mitigating its monetary policy. On May 5, 2016, given the improved balance of risks between ensuring the price stability and ensuring financial stability, the National Bank made the decision to lower its base rate to 15% while narrowing the interest rate band to 1 pp (Figure 24). The decision to lower the base rate was made due to the improved situation in the

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



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

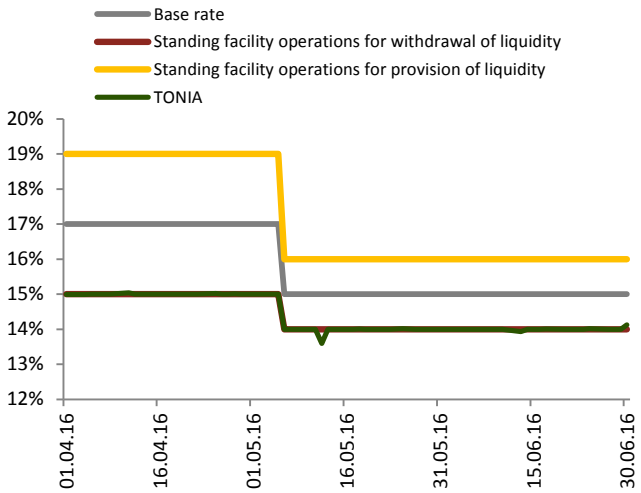
Source: NBRK

financial market, the decreased inflationary expectations as well as the increasing trend of recovery of confidence in assets denominated in the Tenge.

On June 6, 2016, while adhering to the prudent interest rate policy, the National Bank retained the base rate at the existing level. The decision to retain the base rate level was made with a view to support the demand for assets denominated in the Tenge in order to prevent inflationary expectations.

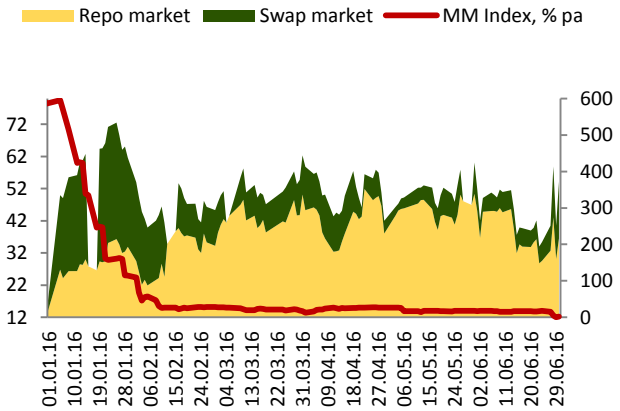
In the second quarter of 2016, interest rates in the money market were building around a lower boundary of the base interest rate band. During the second quarter of 2016, MMI was fluctuating within 11.96 – 15.05%. The weighted average MMI in the second quarter of 2016 accounted for 14.14%. The major portion of operations was in the repo market (Figure 25).

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

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

In the second quarter of 2016, the situation in the foreign exchange market was stable. Daily fluctuations of the Tenge exchange rate were occurring in both directions, depending on fundamental factors, primarily on the price of oil and the exchange rate of the Russian ruble.

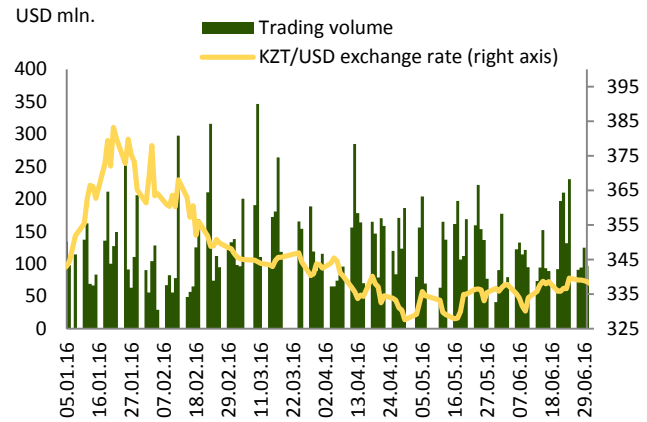
Given a favorable influence of external factors and excessive supply of foreign exchange in the foreign exchange market, the exchange rate of the Tenge was appreciating. So, in the second quarter of 2016, the official exchange rate of the Tenge against the US Dollar appreciated by 1.2%. Fluctuations of the exchange rate of the Tenge in the reviewed period occurred within the range of KZT 327.66-

345.52 per 1 US Dollar (Figure 26).

The National Bank's participation in the foreign exchange market was aimed to smooth destabilizing fluctuations of the exchange rate that do not reflect the correlation between demand and supply and the impact of fundamental factors, while not affecting the general trend.

In April and May 2016, in connection with the deposit dedollarization trend, the National Bank made a foreign exchange purchase in the domestic market of USD 830.9 million and USD 728.3 million, respectively. In June 2016, in the environment of balanced demand and supply in the foreign exchange market, the National Bank's participation share was minimal and accounted for 0.1%.

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



Source: KASE

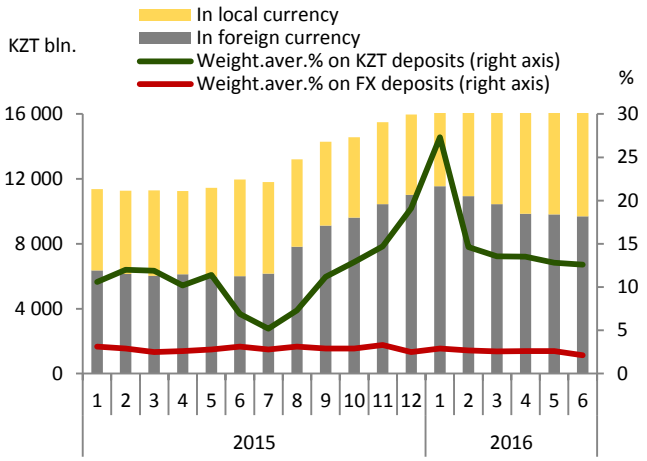
2.1.3 Deposit Market

In the second quarter of 2016, deposits in the banking system kept growing further, being associated with the increased positive expectations regarding inflation as well as with stabilization of the exchange rate.

Measures taken in February 2016 in order to dedollarize the economy as regard to raising a recommended interest rate on deposits in the domestic currency and lowering the rate on deposits in foreign currency continue to have a positive effect on the change in the FX structure of deposits in the second quarter of 2016.

So, in June 2016 as compared to March 2016, deposits in the domestic currency increased by 18%, and deposits in foreign currency decreased by 7.2% (Figure 27). The share of deposits in foreign currency decreased from 63.4% in March 2016 to 57.6% in June 2016.

Figure 27. Volumes and Interest Rates on Deposits in the Tenge and in Foreign Currency



Source: NBRK

2.1.4 Credit Market

Despite the increase in lending volumes in May and June 2016 as compared to prior months, in the second quarter of 2016 the volume of bank credits to the economy decreased by 0.2% as compared to the previous

quarter (Figure 28).

The main reason for the decreased lending is the reduced demand for credit resources on the part of consumers.

The improving situation with liquidity in the banking sector helped stabilize interest rates as compared to the beginning of the first quarter of 2016. The weighted average interest rate on loans in June 2016 accounted for 15.1% (in March 2016 – 14.3%).

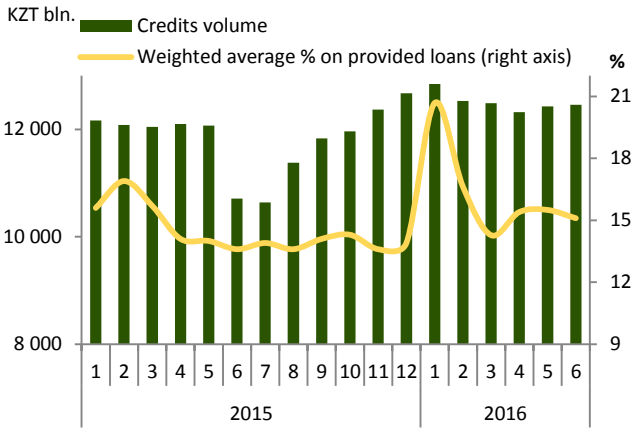
2.1.5 Monetary Aggregates

In the second quarter of 2016, the growth rates of monetary aggregates M3 (money supply) and M0 (cash in circulation) remained as in the first quarter and accounted for 40.6% and 38.4%, respectively. However, the rate of expansion in the reserve money decreased from 51.9% at end-March to 16.8% in June 2016 (Figure 29).

The main factor for the growth in money supply was revaluation of foreign currency components of the money supply, namely, foreign assets and due to the banking system from non-bank financial organizations and non-government non-financial organizations. A constraining factor for the growth in money supply was the growth in capital accounts associated with revaluation of foreign currency and gold (Figure 30).

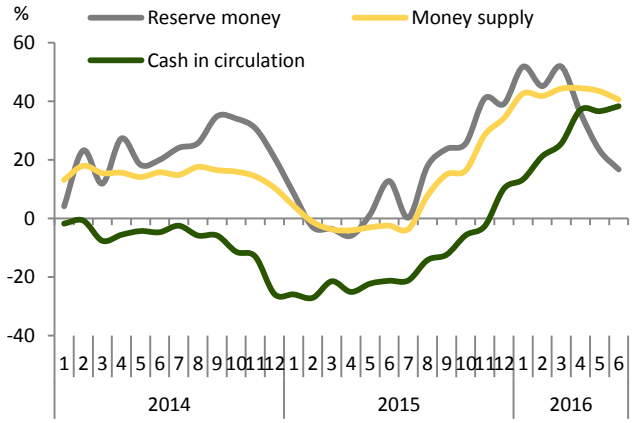
The rates of expansion in the reserve money reduced in the second quarter of 2016 primarily because of placement of short-term notes by the National Bank with a view to withdraw excess liquidity in the money market; therefore, claims of the National Bank to banks decreased significantly. So, from March to June 2016, the volume of short-term notes in circulation increased from KZT 408.7 bln. to KZT 1.5 trln.

Figure 28. Volumes and Interest Rates on Loans



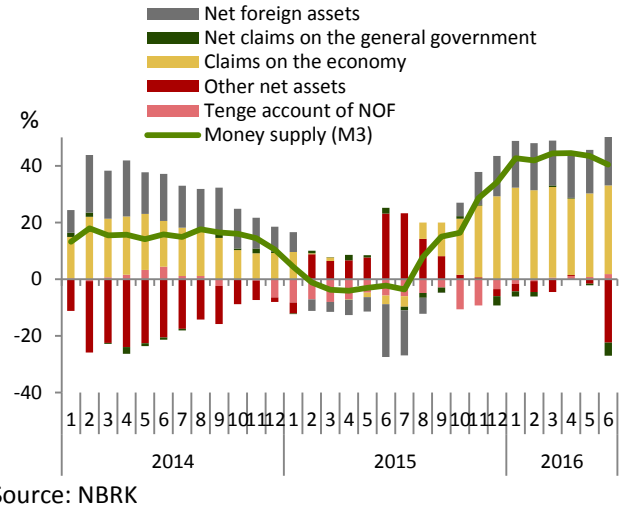
Source: NBRK

Figure 29. Growth in Monetary Aggregates, YoY



Source: NBRK

Figure 30. Dynamics of Contributions to the Formation of Money Supply, YoY



Source: NBRK

2.2 Prices and Inflationary Processes

In the second quarter of 2016, inflationary processes slowed down as compared to the previous quarter based on stabilization and appreciation of the exchange rate of the Tenge against the US Dollar as well as due to the decreased inflationary expectations of the population. However, inflation risks associated with the increased costs incurred by producers and with the reduced supply in the consumer goods market are persisting.

2.2.1 Consumer Price Index

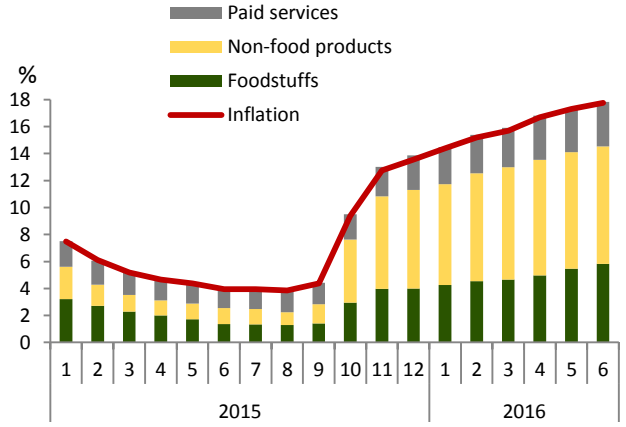
The annual inflation increased from 15.7% in March to 17.3% in June 2016 (Figure 31). Still, the main factor for a high annual inflation is a significant price growth in the fourth quarter of the previous year as a result of a sharp depreciation of the Tenge against the US Dollar. In the second quarter, the inflation accounted for 1.6%, being in line with the normal quarterly inflation trends of the prior years (except for the year 2015 when the prices were going down). If in the first quarter of 2016 a dramatic rise in prices was observed as a result of the increase in tariffs for regulated services, in the second quarter of 2016 the contribution to the annual inflation was made by the food and non-food inflation to a larger extent (Figure 32).

The food price index in the second quarter of 2016 was 1.8%. The pricing of foodstuffs was impacted by such factors as the increased price of some foodstuffs in the global markets, imposition of a temporary restriction for supplies of vegetable production from importing countries as well as the increased cost of cereals as a result of reduced supply in the domestic market.

In the second quarter, the non-food price index made up 2.1%, with the main impact on prices made by the increase in price of imported goods.

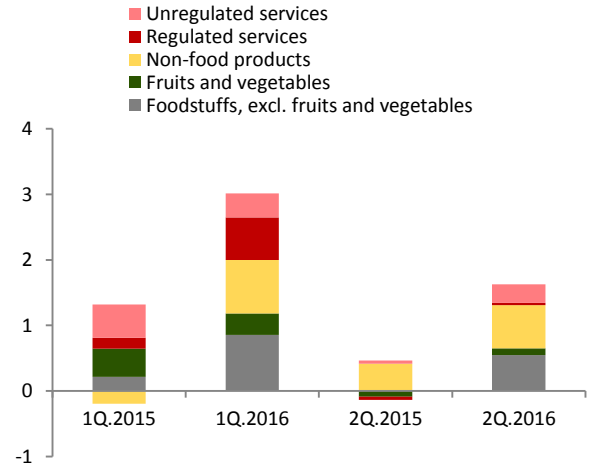
The inflation excluding the seasonality factor (see Box 1 on page 22) in the second quarter increased from 2.2% to 2.6% (Figure 33). As per the structural breakdown, the seasonally-adjusted quarterly indices increased

Figure 31. Annual Inflation and the Contribution of its Components, YoY



Source: CS MNE RK

Figure 32. Contribution of Components to Inflation, Quarterly



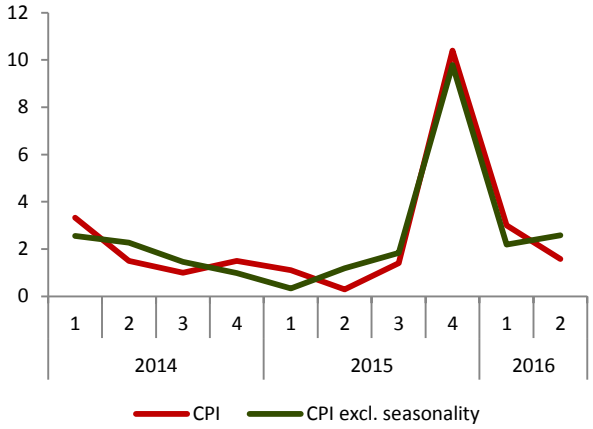
Source: CS MNE RK, NBRK's calculations

in all components, to a larger extent in non-food products (by 3.1%).

2.2.1 Core Consumer Price Index

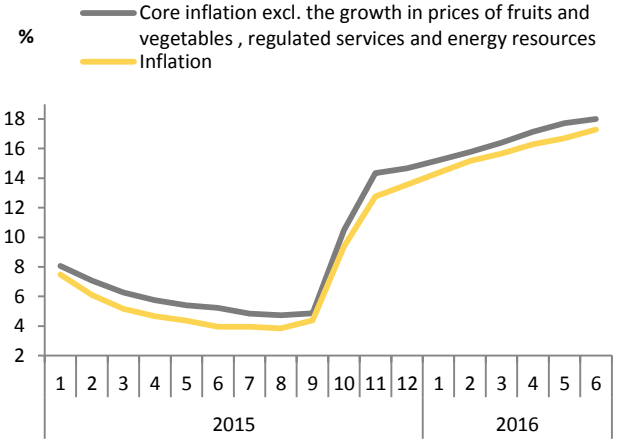
At the quarter-end, the core inflation excluding the growth in prices of fruits and vegetables, regulated services and energy resources accounted for 18%, which is above the headline inflation by 0.7 pp. (Figure 34). Such trend was determined by the increased cost of production in the domestic markets as well as by the growth in prices of imported products. On the one hand, the impact of the exchange rate of the Tenge against the US Dollar on the imported consumer goods was not significant (given appreciation of the Tenge against the US Dollar in the second quarter of 2016). On the other hand, increased expenditures of enterprises in the prior periods still affect the pricing in the current period.

Figure 33. Inflation and Seasonally-Adjusted Inflation, quarterly



Source: CS MNE RK, NBRK's calculations

Figure 34. Inflation and Core Inflation, YoY



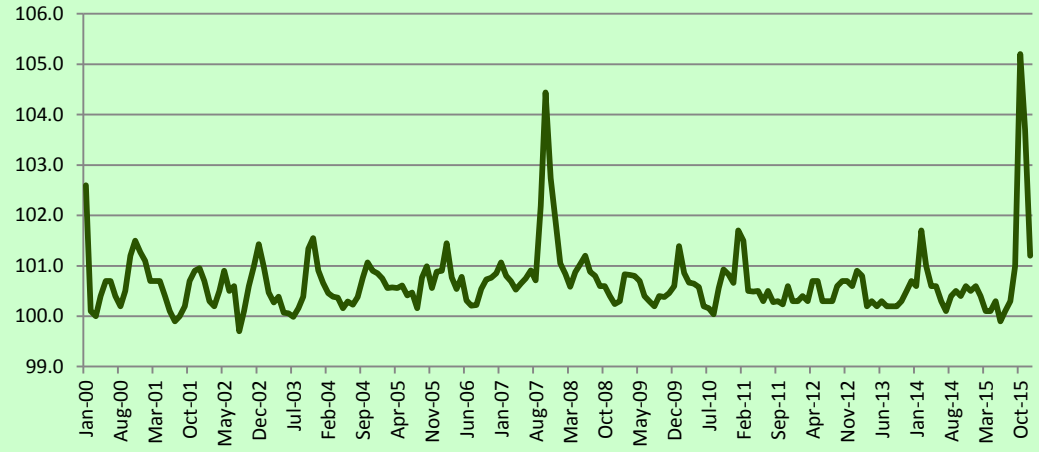
Source: CS MNE RK

Box 1

Seasonality of Inflation

As a rule, the first (January-February) and the last (October-December) months of a year are characterized by high rates of the price growth. This is associated with the fact that, being influenced by the seasonality factors, the growth in prices for certain foodstuffs (fruit and vegetable production, cereals) and tariffs for paid services accelerates in the winter period. Apart from that, the growing consumer activity and demand in the winter period have a certain impact on a seasonal increase in the overall price levels. Over the period from 2000 to 2015 on average (arithmetic mean), a monthly inflation in October and November accounted for 1.1-1.2%, December – 0.9%, January – 1.0%, and February – 0.8%. In the summertime of a year, low monthly rates of the price growth are observed; as a rule, this helps decelerate the annual inflation. Over the same period, the average monthly inflation in June (0.4%) and July-August (0.3%) was half as high as in the winter period. Thus, inflation has a strongly pronounced seasonality.

Figure 1. Inflation, MoM



Source: CS MNE RK

The seasonality is driven by the presence of goods in the CPI that would be unavailable in certain periods of a year or whose prices are subject to frequent fluctuations depending on the season.

Seasonal fluctuations of inflation make it more difficult to indentify basic price trends. In this connection, there are a number of tools to adjust the indicator and exclude the seasonality. The most common method to identify the seasonality in the time series is decomposition of the series (Cencus X-12, Cencus X-13, TRAMO-SEATS, STL).

Many countries use annual price changes when analyzing inflationary processes. This parameter is much easier to interpret than monthly changes which might be somewhat unstable, even in the absence of seasonal fluctuations.

Rectified indices are not intended to substitute quarterly or monthly CPIs; however, they could be useful as additional information.

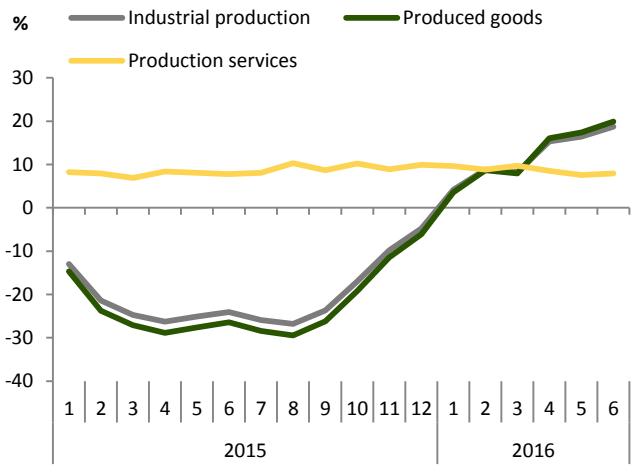
2.2.2 Producer Price Index

At the end of the second quarter of 2016, the producer price index increased to 18.7% in annual terms (Figure 35). The major growth in prices occurred in the mining industry, accounting for 13% in the reviewed quarter only. Prices in the manufacturing industry and water supply increased to a smaller extent whereas in the electricity supply sector prices did not change (Figure 36).

A dramatic growth in prices of crude oil and natural gas producers occurred in the mining industry (28% over the quarter). Such trend was driven by the increase in the world prices of oil. The increase in producer prices in this group of commodities occurred both in terms of exported products and also in terms of products supplied to the domestic market.

In the second quarter of 2016, the rates of price growth in the manufacturing industry were lower than in the mining industry (2.6%); the increase in prices for products was

Figure 35. Price Changes in the Industry, YoY

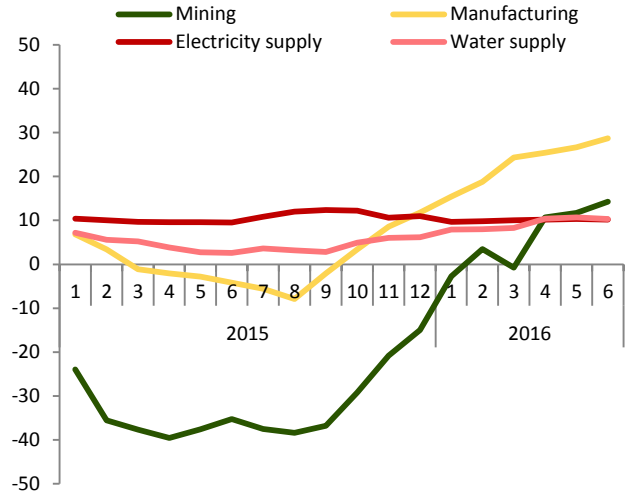


Source: CS MNE RK

observed in the metallurgical, chemical industry, in the manufacturing of clothes and cars.

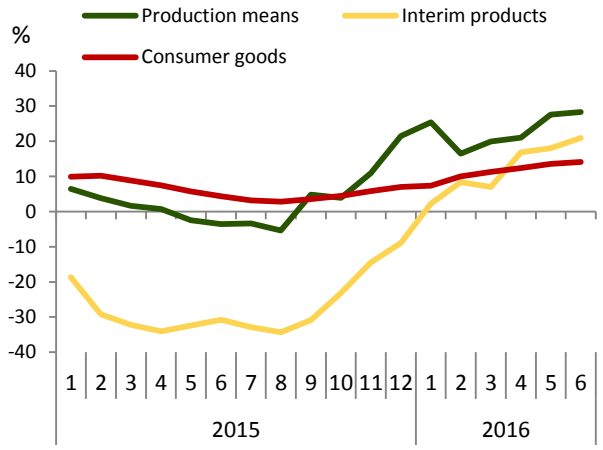
Based on the end use principle, in the second quarter of 2016 the largest increase in prices occurred in prices of interim products (Figure 37). This is explained by the increased price of capital goods including those which are to a larger extent produced in Kazakhstan as well as in the CIS countries.

Figure 36 . Price Changes in the Industry by Types of Economic Activity, YoY



Source: CS MNE RK

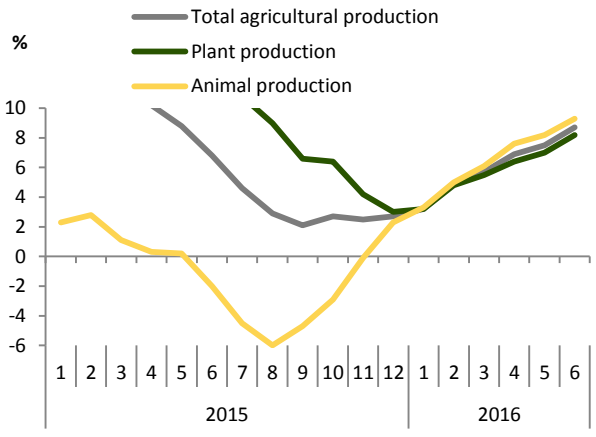
Figure 37. Producer Price Index (classified based on the end use principle)



2.2.3 Agricultural Producer Price Index

Prices for agricultural production continued their growth in annual terms in the second quarter of 2016 by 8.7%, because of the animal production to a larger extent (Figure 38). The upward trend in the behavior of prices of animal production was driven by the increase in prices in the second half of 2015 (in the second quarter of 2016 there was a 1.9% decline in prices). The growing price trend in the plant production was mainly caused by the increase in prices of cereals (in the second quarter of 2016 prices increased by 3.2%). Alongside with the seasonal reduction in the stocks of cereals, a part of the stocks was used for the export of wheat, whose price increased given the price

Figure 38. Price Changes in Agriculture, YoY



Source: CS MNE RK

growth in the global markets as well as given the increase in prices by competitor wheat exporters.

In the second quarter of 2016, prices of agricultural production increased by 0.6%, where prices of plant production increased by 2.3%, and prices of animal production declined by 1.9%. Excluding the seasonality, prices of agricultural production in the second quarter of 2016 increased by 2.4%.

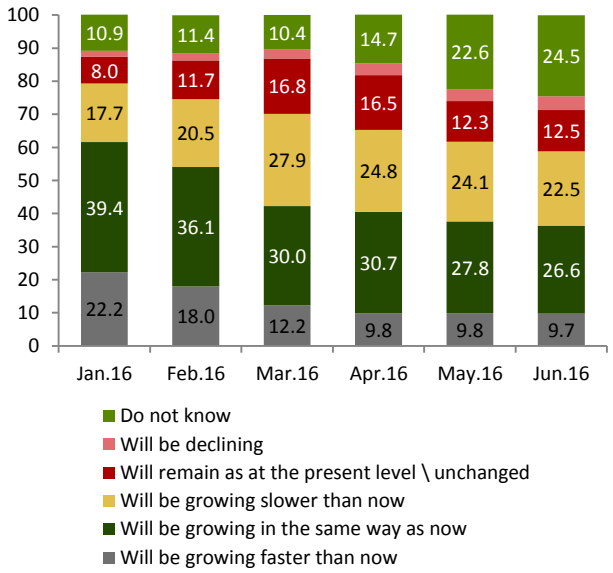
2.2.4 Inflationary Expectations

The poll outcomes for the second quarter of 2016 demonstrate that the level of inflation as perceived by the population remains high. From May 2016, the uncertainty about future inflation among the general public is growing (Figure 39). However, expectations of the general public regarding inflation in the next 12 months are of a more positive nature. A smaller number of respondents anticipate a significant price growth during the year, and about one quarter of the interviewed anticipate that the inflation rates will decelerate.

Devaluation expectations among the general public in the second quarter of 2016 decreased (Figure 40). The trend of an increasing percentage of those who anticipate that the Tenge would depreciate against the US Dollar persisted, and the share of those who believe that the Tenge would be stable increased to 20%. Along with that, given negative developments the percentage of respondents who were undecided about their expectations regarding the Tenge exchange rate increased (in May – 27%, in June – 27.9%).

Figure 39. Assessment of the Price Growth in a Year

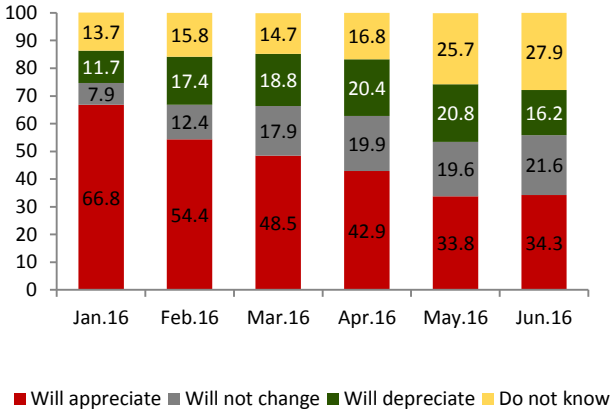
In your opinion, how much will prices of foodstuffs, non-food products and services grow in the next 12 months?



Source: GFK Kazakhstan

Figure 40. Expectations Regarding the Exchange Rate

Please tell what are your expectations about the exchange rate of the Tenge against the US Dollar?



Source: GFK Kazakhstan

2.3 Real Sector Development

In the first quarter of 2016, the real GDP decreased, to a larger extent due to the decreased exports. In the second quarter of 2016, a minor revival of the business activity outlined. Alleviation of negative influence of the external and internal environment became the main impetus for a positive shift in the economic development as compared to the first quarter of 2016.

2.3.1 Domestic Demand

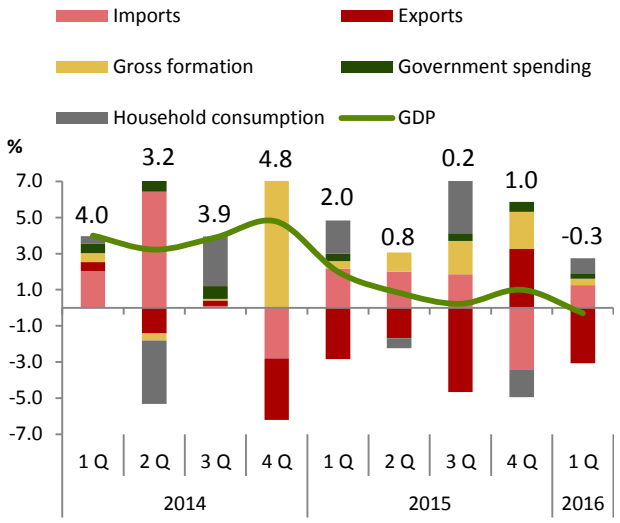
The decrease in GDP in the first quarter of 2016 to a larger extent was caused by the decreased exports of mineral products given the weakening of external demand and declining volumes of the domestic production. Nonetheless, a negative impact on the part of export dynamics was partially offset by the decreased imports caused by the decreased imports of machinery, equipment and chemical production in value terms, given a feeble growth in the consumer and investment demand.

As a result, the real GDP growth rates at the end of the first quarter of 2016 decreased by 0.3% (Figure 41).

The reduced real cash income of the population, high interest rates in the consumer lending amidst a high inflation rate determined a poor level of the consumer demand. So, the growth in household consumption at the end of the first quarter of 2016 accounted for 1.4% (Figure 42). Given the slowing rates of reduction in real wages and new loans to individuals, retail sales in the second quarter of 2016 increased. However, given a significant reduction in its volumes in the first quarter of 2016, the volumes of retail sales decreased in the first half of 2016 as a whole.

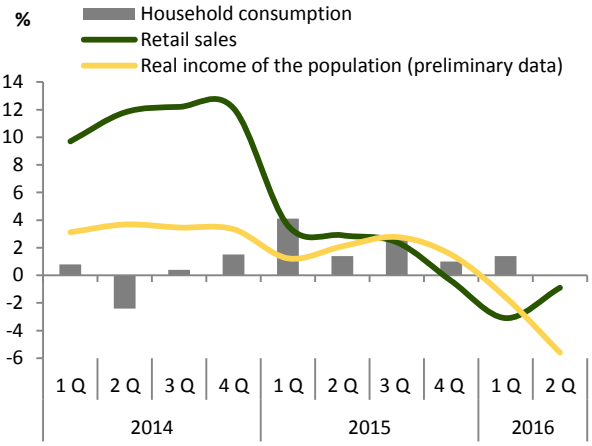
Also, stabilization of monthly inflation and some appreciation of the Tenge against the US Dollar that were observed in April-June 2016, supported retail sales. The reduction in retail sales in January-June 2016 versus the corresponding period of 2015 accounted for

Figure 41. Decomposition of the GDP Components by the Final Consumption Method, YoY



Source: CS MNE RK, NBRK's calculations

Figure 42. Household Consumption, Household Real Cash Income and Retail Sales, year-to-date total, YoY



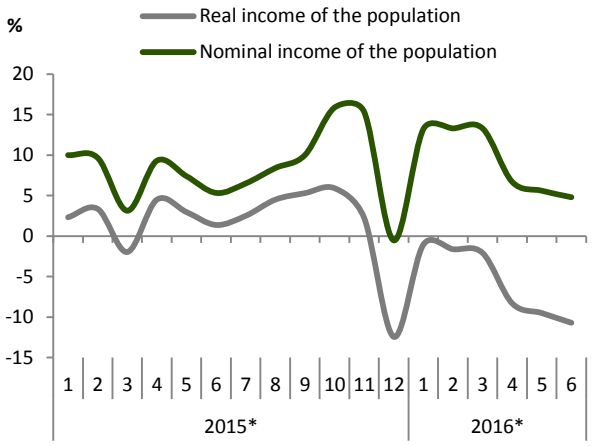
Source: CS MNE RK

0.9%.

Personal Income

A high level of the annual inflation continues to determine the downward trend of the real cash income. Real wages also continue to decline, despite some slowdown in the rates of such decline. The decline in real cash income in June 2016 accounted for 10.7% (Figure 43).

Figure 43. Indices of Nominal and Real Cash Income of the Population, YoY



*-preliminary data

Source: CS MNE RK

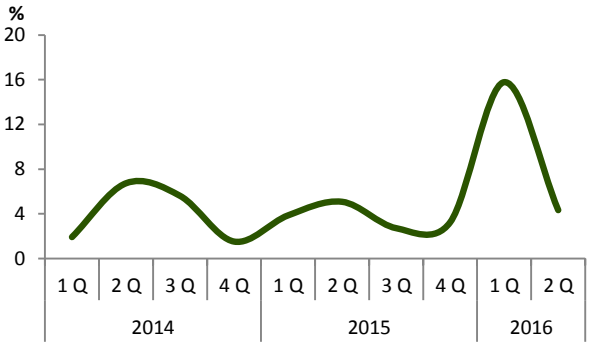
Investment Activity

In the second quarter of 2016, fixed capital investments whose growth accounted for 4.3% versus the same quarter of 2015 continued to having a positive effect on the economic development (Figure 44).

Enterprises continue to fund a large portion of fixed capital investments with their own funds (in the second quarter of 2016 such share accounted for 58.3%), which is furthered by financial and economic performance of enterprises. So, at the end of the first quarter of 2016 as compared to the first quarter of the previous year, profit before tax and product revenues in the corporate sector increased by 87.0% and 14.0%, respectively. At the same time, in the second quarter of 2016 funding of investments with funds from the budget increased (their share accounted for 15.2%), and the share of funds borrowed from non-residents, including foreign banks, within the funding decreased (15.9%). Implementation of the governmental economic support programs also helps improve the investment demand; however, the effect is reduced significantly as a result of a low rate of funds utilization.

As per the plant-equipment ratio, in the second quarter of 2016 the highest share in investments is still represented by investments into construction works and major overhaul of buildings and structures (57.9%).

Figure 44. Fixed Capital Investments, YoY ***(a quarter versus the corresponding quarter of the previous year)***

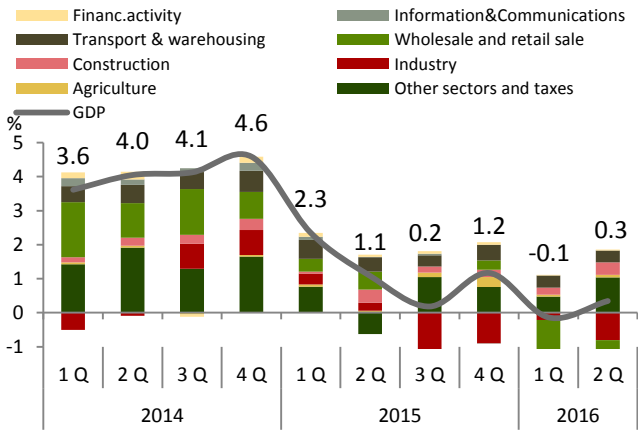


Source: CS MNE RK, NBRK's calculations

2.3.2 Domestic Production

Given that the foreign economic environment improved, in the second quarter of 2016 positive trends in the country's economy outlined. So, after the reduction in the real GDP in the first quarter of 2016, in the second quarter it increased by 0.3% as compared to the corresponding quarter of the previous year. The improved business activity in the construction sector (the 6.2% growth) and in agriculture (19.4%) and continuing stable pattern in the rates of growth in the transport services sector (4.4%) made a positive contribution to GDP. However, positive trends were partially offset by the reduced industrial production (by 2.8%) and wholesale turnover (by 6.4%) and telecom services (by 4.1%) (Figure 46) (See Box 2).

Figure 46. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY ***(a quarter versus the corresponding quarter of the previous year)***



Source: CS MNE RK, NBRK's calculations

Box 2

Trends in the Real Sector of the Economy Broken Down by Industries

Industries

Since the main products of the country's mining industry and metallurgical industry are exported, changes in such sectors of the economy are directly dependent on the demand on the part of countries – Kazakhstan's trading partners as well as on changes in the stock exchange quotations in the global commodity markets.

The improved pattern of the world oil prices in April-June 2016 did not affect extraction of crude oil including gas condensate, which reduced by 3.1% in the second quarter of 2016 in kind as compared to the corresponding quarter of the previous year. The main reasons for such reduction were the continuing depletion of reserves and the water cut of oil wells in Kyzylorda region and reduction in the reservoir pressure in oil fields of the Aktobe region. In addition to that, the weakening of external demand and the reduced profitability of a number of operating oil companies in the country had a negative impact on oil extraction towards its reduction.

A continuing decline in the iron ore extraction was caused by the fact that stock exchange quotations were still at a low level and by the reduced demand on the part of Russia because of its economic downturn and on the part of China due to the measures taken by its government to reduce reliance on the heavy industry, excessive production of steel and the cutting of production capacities in the steel industry. However, the growth in market prices of non-ferrous metals in the second quarter of 2016 and the start of copper ores extraction in new deposits of Bozshakol and Aktogai helped increase the volumes of extraction of non-ferrous metal ores by 9.1% at the end of the first half of 2016. This, in the first instance, had a positive impact on the metallurgical industry, specifically, on the growth in production of key noble metals and non-ferrous metals, which accounted for 13.6% at the end of 6 months of 2016.

The positive trend persists in the manufacturing industry whose growth in the second quarter of 2016 accounted for 0.6% as compared to the second quarter of 2015. Favorable trends, in addition to the metallurgical industry, were still demonstrated by the food industry, chemical industry, and production of textile articles and paper products. The domestic demand in the construction industry entailed the increase in production of construction materials, wooden ware and metal constructions. The growth in production of foodstuffs was secured by the 19.4% increase in the agricultural production in the second quarter of 2016 as compared to the second quarter of 2015. Such growth was driven by the increased crop acreage, by refurbishment of machinery and tractors, purchase of machinery for livestock raising, the increased crop

productivity and the quality of plant production as well as an active extension of the process of farm amalgamations into production cooperatives. Along with that, exports of agricultural production and foodstuffs to the CIS countries and to the far abroad countries including China are increasing, being explained by structural adjustments in the Chinese economy and the shift of priorities towards the domestic consumption and the services sector.

The production of oil refinery products increased, in particular, the production of gasoline, black strap and diesel fuel. Also, the production of liquefied petroleum gas increased in connection with the replacement of traditional buses with the environmentally friendly buses operated on a compressed natural gas in municipal bus depots of large cities in the country.

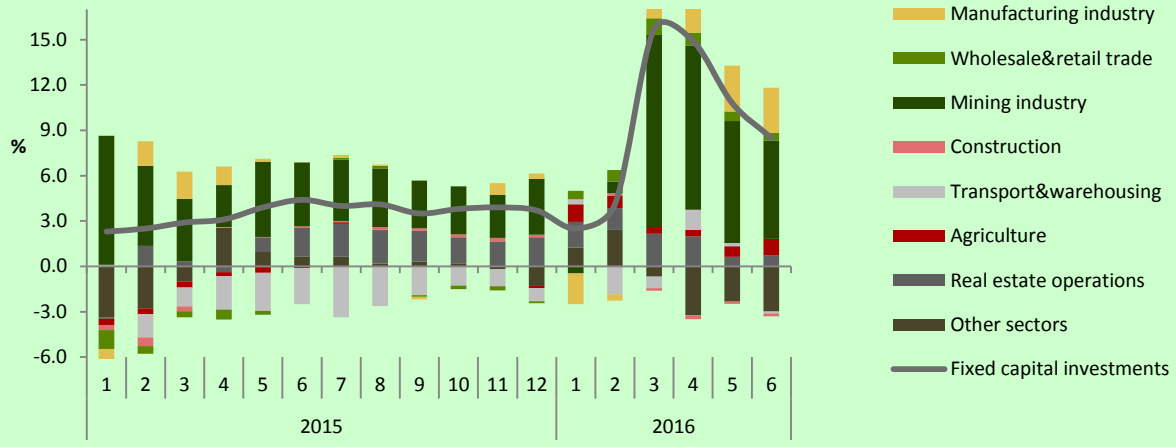
Implementation of infrastructure projects as part of preparation for EXPO-2017 and the Universiade, governmental programs for residential construction and reconstruction of motorways continues to contribute to the growth in construction services, which accounted for 6.2% in the second quarter of 2016 as compared to the corresponding quarter of the previous year. In the second quarter of 2016, the highest volume of construction works was completed in the facilities of transport and warehousing, industrial facilities and real estate facilities. A significant contribution to the growth in construction services is made by the construction of a new network for advanced petroleum refining in the Atyrau Oil Refinery; by overhaul of oil pipelines in the Kashagan oil field which is expected to be put into operation before the end of 2016.

Along with the outlining positive trends in the economic activity, in some sectors other than the mining industry negative trends persist. So, in the second quarter of 2016 as compared to the second quarter of 2015, the reduction in services provided by telecom companies accounted for 4.1% and reduction in the wholesale turnover – 6.4%. Among branches of the manufacturing industry, the machine building sector still demonstrates recession, in particular, in the production of vehicles which reduced by 58.8% based on performance for the first half of 2016.

Investments

Fixed capital investments continue to demonstrate positive trends. In the industry-based breakdown, the mining industry accounts for the largest share in the overall investment volume. This is determined by a high capital intensiveness of that industry as compared to other industries (Figure 1).

Figure 1. Fixed Capital Investments by Types of Economic Activity, Input, YoY year-to-date total



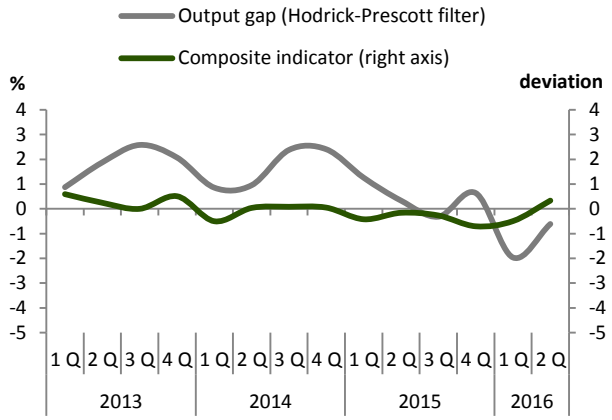
Source: CS MNE RK, NBRK's calculations

At the same time, a high growth was secured by implementation of large investment projects in the oil refining and energy industry, including by the extension of production capacities in the Tengiz field, by the increased extraction of liquid hydrocarbons in the Karachaganak field as well as preparation for commissioning of the Kashagan oil field. In addition to that, "KazMunaiGas NC" JSC is conducting a comprehensive inventory of the equipment installed in the facilities of the Kashagan oil field ("Bolashak" Complex and Island D). The growth in fixed capital investments at the end of the first half of 2016 was recorded in agriculture and in the manufacturing industry; this is explained by paramount importance of these

industries in the economic and investment policy of the country. According to the Ministry of Investments and Development of Kazakhstan, 30 projects totaling over KZT 175 bln. were launched in the first half of 2016 as part of industrialization.

The aggregate composite indicator, which summarizes the assessment of the existing situation and expectations of CEOs of companies in the real sector of the economy, in the second quarter of 2016 turned to the growth; this fact signalizes the emergence of signs of gradual recovery of the business activity. At the same time, assessment methods based on the filtration principles point to negative values of the output gap at the end of the second quarter of 2016, thus continuing to have a constraining effect on the price growth in the economy (Figure 47). In the third quarter of 2016 respondents anticipate that the economic situation will improve further due to adaptation to new conditions and expectation of the improved demand for final products (see Box 3).

Figure 47. Behavior of the Composite Indicator, Cyclical Component of GDP and Output Gap



Source: NBRK

Box 3

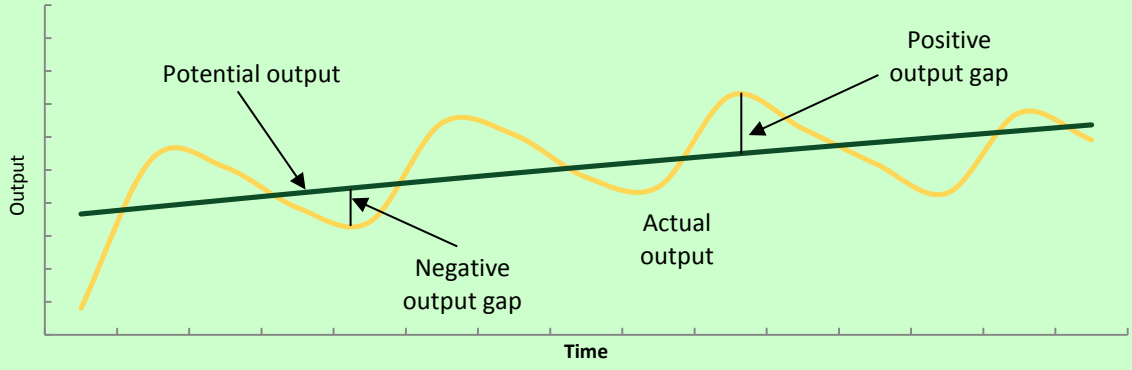
Output Gap as an Important Indicator for Monetary Authorities

Among many economic indicators, the indicators which represent the presence of inflationary pressure in the economy are of specific interest since the extent of pressure in the economy may give some indication of the future change in prices.

The output gap is one of such indicators and it represents the differential between the actual and potential output in the economy. As a composite indicator of components of relative demand and supply in the economy, the output gap is considered as a link between the real sector which produces goods and services and the inflation.

Positive output gap speaks for an increased demand which causes inflationary pressure in the economy. The situation where an actual output appears to be below a potential one indicates that there are unused production capacities and deflationary pressure in the economy (Figure 1).

Figure 1. Correlation Between Actual and Potential Output and Output Gap



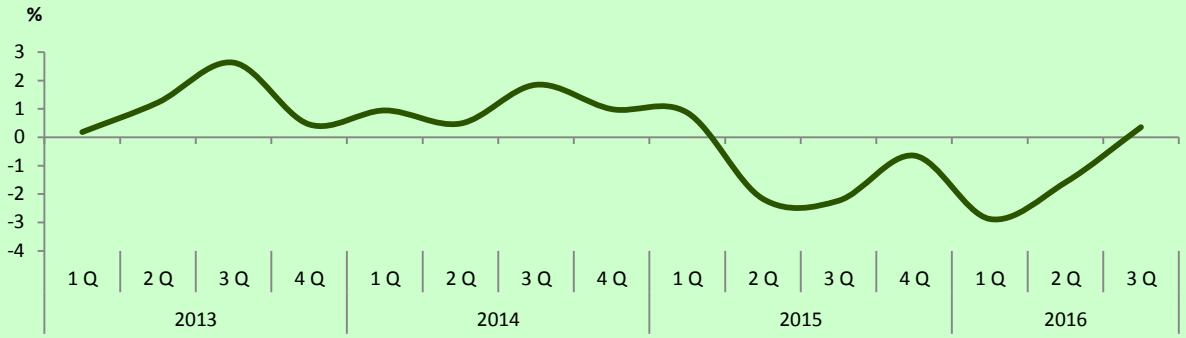
From a practical standpoint, the output gap is a measure which is not directly observable. It is

calculated on the basis of parameters of actual production output (real GDP) and estimates of potential output which is also an unobservable measure. To this end, the economic theory has various methods and approaches to the valuation of potential output and the output gap.

In addition to traditional statistical procedures, filtration methods and structural approaches to valuation of potential output and the output gap, the National Bank conducted an econometrical valuation of the output gap in the Kazakh economy, using the results of the quarterly enterprise monitoring. Advantage of this method is the promptness of data capture about the economic situation and expected trends in the real sector.

The valuation outcomes based on the interviews showed that there has been a negative output gap in the Kazakh economy since 2015, which indicates that the actual output went below the potential output (Figure 2).

Figure 2. Output Gap, as % of Potential GDP



Source: NBRK's calculations

Such phenomenon is caused by realization of a negative shock on the part of the aggregate demand and points to the absence of inflationary pressure in the economy. The reduction in the demand was caused both by deterioration in the foreign economic environment followed by its persisting unfavorable trend at the beginning of 2016 and structural problems in the domestic economy. Respondents that participated in the monitoring process noted the reduced demand for final products, especially in the services sector.

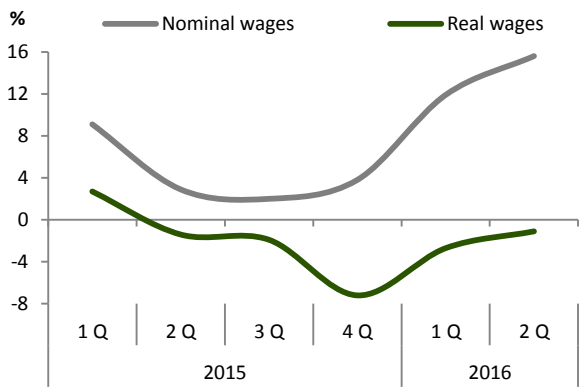
At the same time, outcomes of interviews conducted in the second quarter of 2016 indicate the appearance of positive trends in the economy. So, performance in the sectors improved, investment and credit activity of enterprises increased given the improved anticipations about the demand for final products in the next quarter, particularly, in the manufacturing industry. However, the outlining trends should not be regarded as a transition by the economy to a new phase of recovery growth since the improvements are occurring unevenly in different industries and are not accompanied by an actual growth in the consumer demand. Apart from those, the development of the country's economy is still very much exposed to shocks from external economic conditions.

2.3.3 Labor Market and Unemployment

A low level of economic activity continues to have a negative impact on the labor compensation. At the same time, some mitigation of uncertainty in the economy and stabilization of the exchange rate amidst moderate inflation in the second quarter of 2016 helped slow down the rates of reduction of real wages of the population to 1.1% as compared to the second quarter of 2015 (Figure 48).

The outstripping growth of nominal GDP as compared to nominal wages in the first quarter of 2016 helped reduce labor compensation unit costs

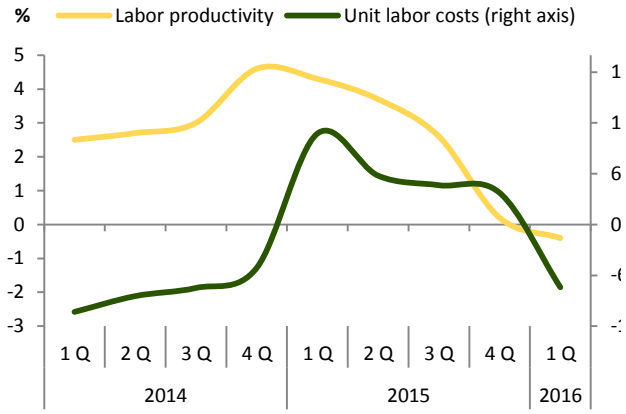
Figure 48. Nominal and Real Wage Indices, YoY



Source: CS MNE RK

by 7.4% (Figure 49). For the first time since 2009, the labor productivity index in the economy as a whole turned to negative and at the end of the first quarter of 2016 the decline in the index was 0.4%. In the production of goods, the labor productivity increased by 1.8% and in the production of services it decreased by 1.8%.

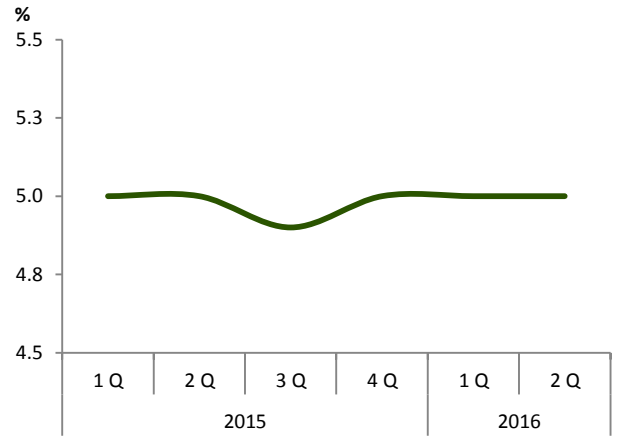
Figure 49. Labor Productivity and Unit Labor Costs, YoY



Source: CS MNE RK, NBRK's calculations

Memorandums that were made between Akimats, enterprises and trade unions some time ago helped retain the jobs in the periods of uncertainties about the economic environment. Moreover, governmental economic stimulus packages which imply additional jobs creation as well as positive financial performance of enterprises at the end of the first quarter of 2016 secured the growth in employment among the population. Given the reduced numbers of the unemployed population and the growth of the employed population, the unemployment rate in the second quarter of 2016 decreased to 4.9% (Figure 50).

Figure 50. Unemployment Rate



Source: CS MNE RK

2.4 Fiscal Policy

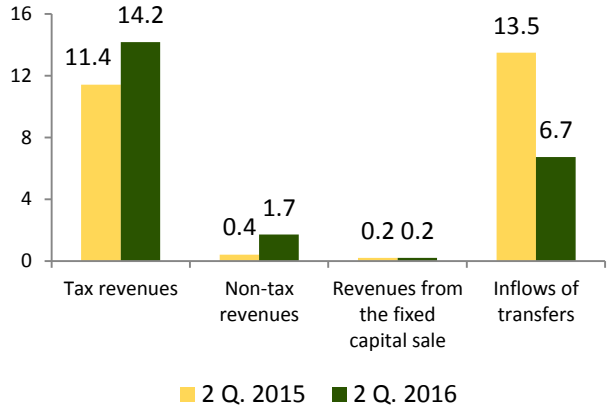
According to the National Bank's estimates, in the second quarter of 2016 the fiscal policy was of a stimulative nature. This is demonstrated by a nominal growth of the state budget spending and by the expanded deficit.

Budget revenues in the second quarter of 2016 as compared to the second quarter of 2015 increased in nominal terms by 1.5% to 22.8% of GDP (in the second quarter of 2016 – 25.5% of GDP).

In the second quarter of 2016, tax and non-tax revenues increased versus GDP whereas transfers decreased (Figure 51).

In the second quarter of 2016 as compared to the same quarter of 2015, tax revenues increased by 40.9%, mainly due to the increased revenues

Figure 51. State Budget Revenues, as % of GDP



Source: RK's Ministry of Finance, NBRK's calculations

from VAT, corporate income tax and taxes on international trade and foreign operations.

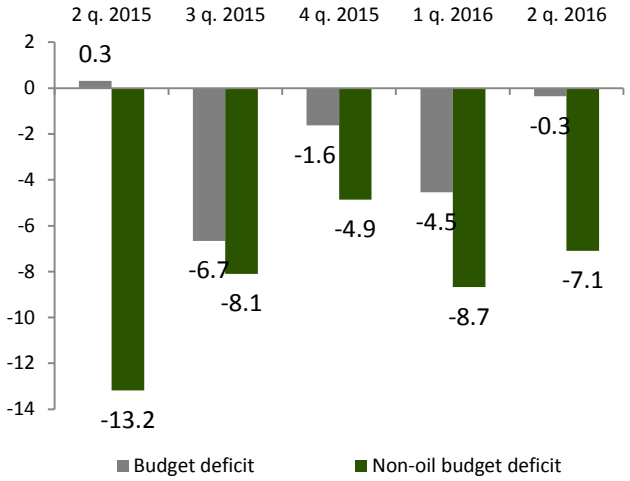
The 4.6 times increase in non-tax revenues over the same period was mainly related to the payback to the state budget of 50% of compulsory pension contributions transferred from the budget to the military staff.

The amount of a guaranteed transfer from the National Fund to the state budget accounted for 6.7% of GDP and decreased as compared to the second quarter of 2015 by 43.2%. The guaranteed transfer was allocated to a smaller extent in connection with sufficiency of tax revenues to the state budget as well as with the USD 1 bln. loan borrowed from the World Bank in June 2016.

The state budget spending in the second quarter of 2016 as compared to the second quarter of 2015 increased insignificantly in nominal terms – by 3.3% - and accounted for 21.7% of GDP (in the second quarter 2015 – 23.8%). The nominal growth in expenditures was secured due to the increased intensiveness in resource uses in the areas of "Social aid and social security", "Education" and "Public healthcare".

In the second quarter of 2016, the state budget deficit accounted for 0.3% of GDP (in the second quarter 2015 – the surplus of 0.3% of GDP). At the same time, in the second quarter of 2015, despite the budget surplus, the non-oil deficit was higher – 13.2% of GDP. Excluding the transfers to the state budget from the National Fund, the second quarter of 2016 would have ended with a non-oil deficit of 7.1% of GDP (Figure 52).

Figure 52. State Budget Deficit, as % of GDP



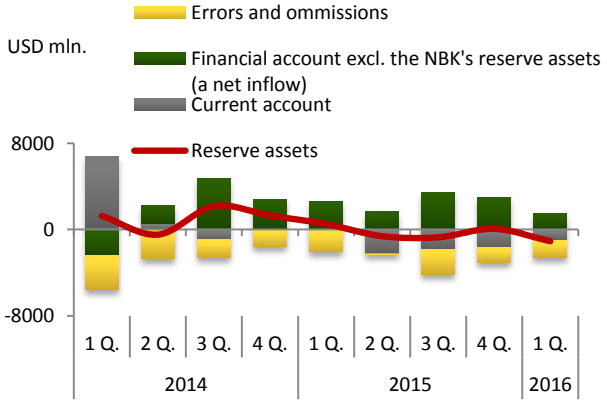
Source: RK's Ministry of Finance, NBRK's calculations

2.5 Balance of Payments

The balance of payments in the first quarter of 2016 was characterized by the continuing reduction in the balance of trade surplus and reduction in negative balances on other current account components (balances on international services and primary income). A net inflow of financial resources was secured by inflow from direct investments that was practically offset by the outflow on portfolio investments (Figure 53).

The current account balance in the first quarter of 2016 showed up a deficit (USD 1.0 bln.). The growth in the negative balance of the current

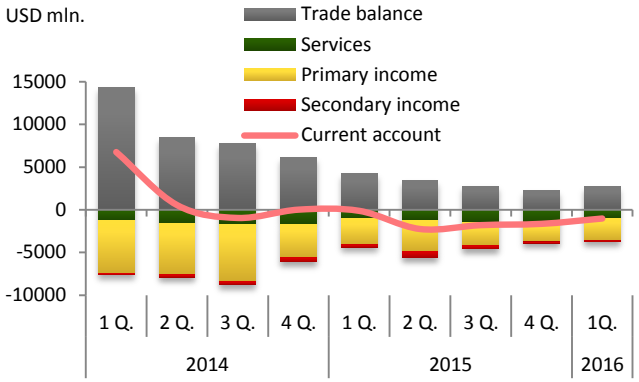
Figure 53. Balance of Payments, Quarterly



Source: NBRK

account versus the first quarter of 2015 is explained by a significant reduction in the balance of trade surplus (Figure 54), see Box 4 on page 34. In the reviewed period, the trend of excessive rates of reduction in the value of exports over the rates of reduction in import volumes is persisting. Along with that, the value of exports is affected by the low prices of Kazakhstan's export products while the volumes of physical supplies are growing. Whereas the reduction in the value of imports is secured both by the decline in contractual prices and by the volumes of physical supplies of certain commodity lines (Figure 55). The one-third reduction in export volumes of goods (-30.5%) is primarily related to the price factor. So, the decline in the price of oil as the main export item of Kazakhstan and the growth in the value of imports caused the deterioration in the aggregate terms of trade index (Table 1). The main effect here was on the part of the EU (-48%), being associated with the structure of imports from that region (a factor of the shift in the imports structure towards expensive investment goods, while the consumer imports were substituted by cheaper goods from other countries, including from Russia) in the environment of the decreased proceeds from exports of oil to Europe. The terms of trade with Russia had a neutral effect on the trade balance since the change in prices of exports goods corresponded to the change in prices for imports goods.

Figure 54. Current Account



Source: NBRK

Figure 55. Export and Import of Goods and Services

Source: NBRK

Table 1. Change in Price Indices and the Terms of Trade

(as % of the corresponding period of the previous year)

	4 Q 14	1 Q 15	2 Q 15	3 Q 15	4 Q 15	1 Q 16
Export prices	-12	-34	-41	-39	-42	-36
Import prices	-14	-19	-13	-10	0	9
Terms of trade	2	-19	-32	-32	-42	-42
including:						
Euro zone countries						
Export prices	-15	-41	-46	-46	-49	-41
Import prices	-14	-58	-10	-15	-43	14
Terms of trade	-1	40	-39	-36	-10	-48
Russia						
Export prices	-2	-22	-16	-30	-19	-12
Import prices	-13	-30	-22	-32	-23	-11
Terms of trade	13	10	7	3	6	0

Source: NBRK

Box 4

Factors of the Decreased Balance of Trade in the First Quarter of 2016

In the reviewed period of this year, there was a change in the exports structure of countries within the EU. If a year before a major portion of oil exports fell on the Netherlands, Italy and France, in the first quarter of 2016 there was a significant growth in oil exports to Switzerland (the growth in the construction sector and energy sector in this country) and Spain (the growth in the domestic consumption). In addition, Kazakhstan's positions in the CIS market, particularly in Ukraine, as well as in the Japanese market are reinforcing.

As for other exports goods, a significant growth in exports of ferroalloys, wheat and barley is worth mentioning. The increase in supplies of ferroalloys is secured by active construction of roads and industrial facilities in China. Whereas the growth in exports of wheat and barley is explained by low prices of cereals, supplies under the already concluded contracts in anticipation of the introduction of embargo for import of grain in Iran (Iran is the world's third largest importer of barley after Saudi Arabia and China) and the growth of processing of raw materials in the food sector of Uzbekistan.

A significant reduction in the imports of goods (-27.1%) was associated with the impact made by devaluation of the Tenge, with the declined contractual prices, shift to cheaper substitutes of goods as well as with the reduction in the volumes of physical supplies of certain commodity lines. The largest reduction in the imports volumes was among consumer non-food products (-36.5%), also because of a more than a three-fold reduction in imports of cars, and among investment goods (-34.3%) mainly because of the reduced imports of aviation machinery, mechanisms and other technological equipment.

Imports from Russia (by 30.8%) and China (by 43.9%) continue to decrease. Here, if a reduction in imports from Russia is mainly related to the declining contractual prices (a shift to cheaper substitutes of goods) with the growth in physical volumes of imports), the reduction in volumes of imports from China occurred as a result of the declining contractual prices and the decreasing physical volumes of imported goods.

As per the trade in services account, there is a growth in exports of transport services, specifically cargo transportations by a pipeline (by 2.3 times). Such growth is partially explained by the increase in revenues from transit duties associated with the growing volumes of exports of Russian oil to China and the EU (the growth in physical volumes of crude oil exports by Russia is associated with the lowered export duties and the maximum volume of oil extraction in Russia since the Soviet time).

There is a minor reduction in the imports of services caused by the decreased imports of transportation services of non-residents as well as trips of residents abroad. The growth in the imports of construction services is associated with the construction of facilities for Expo-2017, construction and modernization of motorways and railways of nation-wide importance, reconstruction of oil refineries. Other business services (48.5% of the overall volume of imports of services) prevailing in the imports volume that are mainly associated with participation of non-residents in implementation of large infrastructure projects within the territory of the country also increased insignificantly (by 7.8%). Within a broad range of other business services provided by non-residents, the largest expenses fall on architectural and engineering and technical services as well as services related to business consulting and management.

Despite a considerable reduction in the balance of trade surplus, the pressure on the current account is decreasing due to the reduction in negative balances on other components of the current account. The decreased volumes of foreign trade transactions and imports of consumer services had driven the reduction in the deficit of international services (-9.1%). As revenues of residents from primary exports decreased, payment of returns to foreign direct investors decreased by (-12.9%).

As for economic sectors, a positive balance on investment returns is only in the general government sector and the National Bank due to returns on resources of the National Fund invested in foreign assets and international reserves. In the banking sector and other sectors, the balance on investment returns is traditionally negative (the decrease of 10.6%).

The financial account less reserve assets has been negative because of the rates of growth in liabilities exceeded the rates of growth in assets. A net inflow of financial resources was secured by the inflow on direct investment operations that was partially offset by the outflow on portfolio investments (Figure 56).

As for foreign direct investments, a net capital inflow amounted to USD 2.6 bln. as compared to USD 1.4 bln. in the first quarter of 2015. A gross inflow of foreign direct investments (FDIs) amounted to USD 4.3 bln. (the reduction of 2.7%). Because of low prices, oil companies had less opportunities to extract oil as well as to invest resources in deep hole drilling machines; and this resulted in the decreased (by 26.9%) foreign direct investments into the oil and gas extraction. The growth in foreign direct investments was noted in the geoexploration and surveying (by 37.5%).

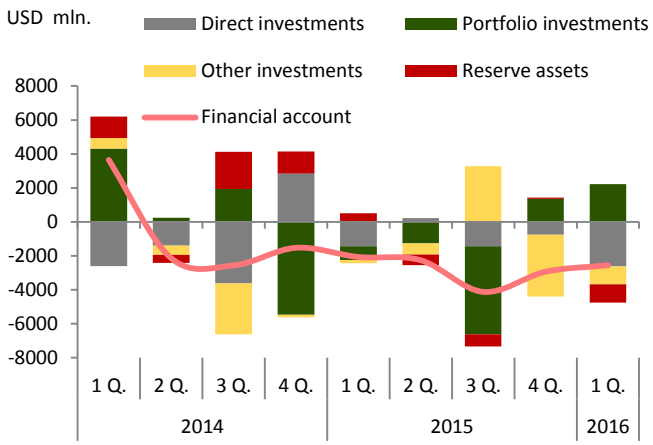
The growth in the National Fund's foreign assets, purchase of Eurobonds of the Kazakh Government and of Kazakh banks by residents in the secondary market, partial redemption of the earlier issued Eurobonds by non-bank organizations furthered a net outflow on portfolio investments (-USD 2.2 bln.).

Real Effective Exchange Rate

The depreciation pattern of the real exchange rate of the Tenge (2.8%) in the first quarter of 2016 was closely related to deterioration in the terms of trade. The real exchange rate of the Tenge depreciated to the largest extent in January 2016 when the price of oil dropped to minimal levels.

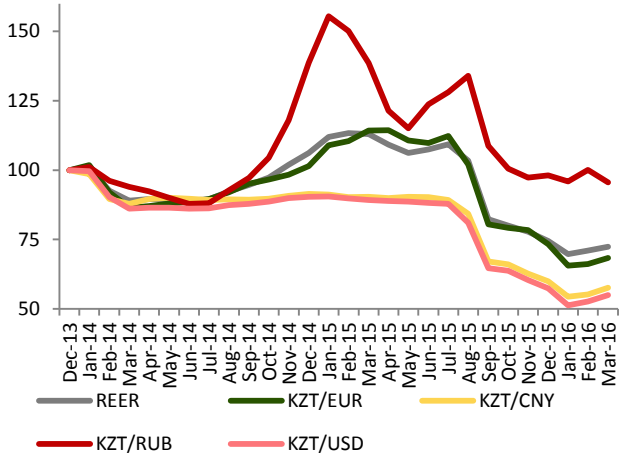
In March 2016 as compared to December 2015, the Tenge depreciated in real terms by 4.3% against the US Dollar, by 6.9% - against the Euro, and by 2.5% against the Russian ruble (Figure 57).

Figure 56. Financial Account



Source: NBRK

Figure 57. Real Effective Exchange Rate Index (December 2013 = 100%)



Source: NBRK

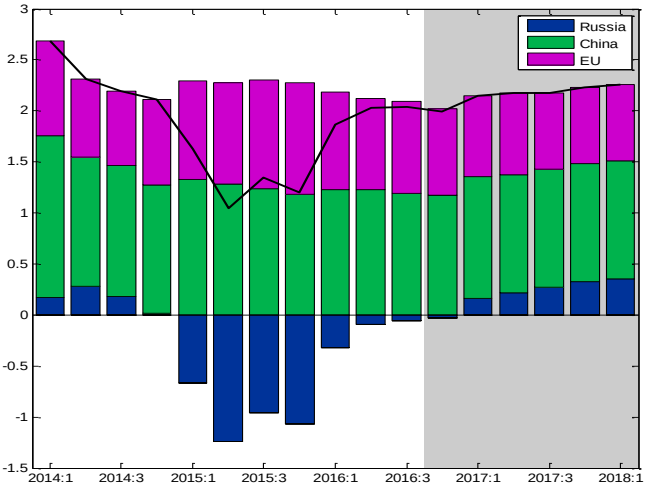
II. FORECAST OF KEY MACROECONOMIC INDICATORS AND FURTHER MONETARY POLICY GUIDELINES

The forecast of macroeconomic indicators was prepared on the basis of statistical information as of July 28, 2016.

1. Key Assumptions for External Forecast Parameters

Pre-requisites regarding the terms of trade related to the demand for Kazakhstan's export commodities on the part of Russia, EU and China, which accounted for 51.2% of the total foreign trade turnover of Kazakhstan in the first quarter of 2016, had undergone changes as compared to previous forecasts presented in the Inflation Report for the first quarter of 2016. According to the National Bank's expectations, which take into account estimates of international organizations, in the medium term the economic growth in China will retain its slowing trend, and the economic growth in the EU will be slowly recovering (Figure 58). Meantime, the economic activity in Russia is expected to recover. Thus, a moderate recovery of the external demand will continue; in doing so, the economic growth rates in Russia will start making their positive contribution to recovery of the external demand starting from the first quarter of 2017.

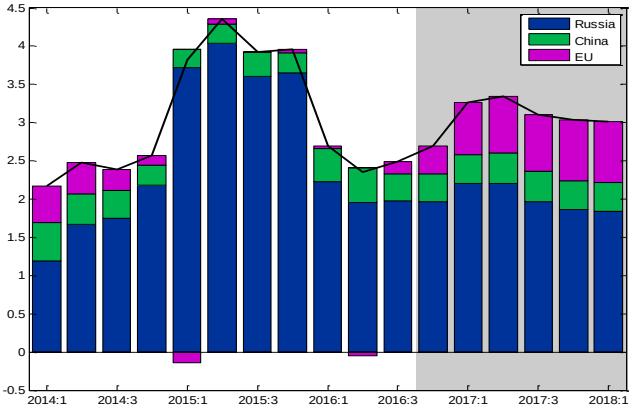
Figure 58. External GDP Decomposition Broken Down by Kazakhstan's Main Trading Partners, %, YoY



Source: NBRK's calculations

The inflationary background in countries-main trading partners remains erratic (Figure 59). So, according to estimates of international organizations, the consumer inflation in the EU will accelerate to 1.5% before the first quarter of 2018. The main reasons are a soft monetary policy, extended volumes of the asset purchase program and targeted long-term refinancing operations. Because of the growing budget deficit of the Russian Federation and the absence of a medium-term strategy for the budget consolidation, the inflation will slightly accelerate. But because of a low domestic consumption, the rates of inflation growth in Russia will be having a downward path from the third quarter of 2017.

Figure 59. Average-Weighted Inflation Broken Down by Kazakhstan's Main Trading Partners, %, YoY



Source: NBRK's calculations

World food prices will be demonstrating growth. Risks that the crops will decrease because of potential shocks of weather and

climatic conditions may be referred to the main factors. Thus, acceleration of the growth in prices of cereals is anticipated in the medium term. As a result, the expected acceleration of external consumer inflation will be putting pressure on inflationary processes in Kazakhstan.

In January-July 2016, an average price of oil (Brent) was USD 40.9 per barrel. Thus, the baseline scenario remained unchanged.

Expectations regarding external monetary conditions in the medium term have not changed. As a result of the tightening of monetary conditions given that the US Fed raised its federal funds rate, a number of significant risks for Kazakhstan arise; they are associated with a possible capital outflow, depreciation of currencies in the countries with developing markets as well as with the increased cost of funding in foreign markets, which are not reflected in the forecast outcomes to the full extent.

2. Forecast under the Baseline Scenario

With the oil price at USD 40 per barrel, the forecast of Kazakhstan's real GDP growth was changed from 0.5% in 2016 to 0.3%; this was related to the fact that statistical data on the GDP growth rates by the final use method were refined by the CS MNE RK from 1% to 1.1% in 2015 (the base effect). Also, the rate of growth of fixed capital investments at the end of the first quarter of 2016 happened to be at a much lower level – 1.7% (the previous forecast was 7.1%) because of a slower utilization of resources in the course of implementation of the economic activity stimulation programs. Weak positive growth rates, to a greater extent, are associated with large-scale economic support measures in 2016-2017. These measures translate into a more moderate reduction in import volumes, thus negatively affecting net exports and inflationary processes at the expense of supporting the domestic demand and also lead to a weaker influence on the inflation by the monetary policy.

Forecasts regarding the economy's growth

in в 2017 have not changed, the economy's growth will account for about 2%. Adaptation rates will be depending on effectiveness of the governmental economic support programs, institutional reforms and dedollarization.

According to the National Bank's estimates, in 2016-2017 the output will be below its potential level. Reduction in imports as a result of the slowing domestic consumption will be making a positive contribution to the dynamics of net exports; however, it will be weaker as compared to the previous forecast. A weak reduction in imports is associated with implementation of long-term investment projects which imply the use of imported services and equipment (Expo-2017, Kashagan, TCO expansion project), alongside with weak positive rates of growth in the household consumption. A floating exchange rate will be having a positive influence on profitability and competitiveness of domestic producers of goods in the oil and non-oil sectors, which may have a favorable impact on the exports dynamics and the growth in fixed capital investments.

Exports dynamics will be making a negative contribution to the output gap until the first quarter of 2018. The growth rates of real exports will turn positive from the second quarter of 2017. The growth in the primary portion of exports is related to the monetary policy regime, stabilization of the oil price at USD 40 per barrel, recovery of the external demand and the growth in extraction volumes. The growth of a non-oil portion of exports is related to undervaluation of the real effective exchange rate that will be in effect up to the third quarter of 2017. Actions taken to increase non-primary exports (petroleum products, uranium compounds, grain meal and products of primary metal processing) may have a positive effect on diversification of the economy and the growth in export volumes.

Household consumption growth rates are expected to be sluggish. As the degree of dollarization goes down and confidence about economic prospects is gained, the consumption

will be increasing.

Forecasts regarding the Government consumption have not undergone any changes. A stimulative fiscal policy is anticipated in the medium term.

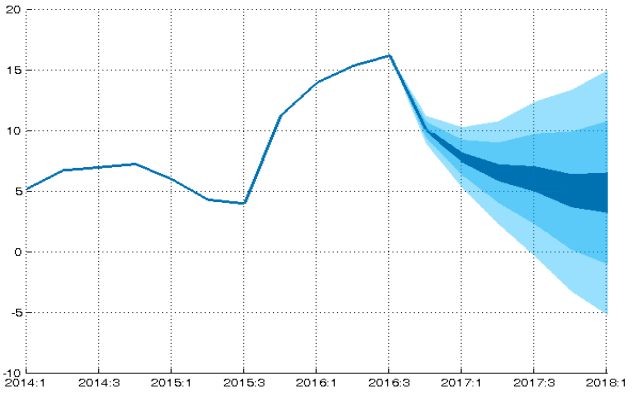
Under the baseline scenario of USD 40 per barrel, the peak of inflation will fall on the third quarter of 2016 (Figure 60). Volatility in the oil market has a negative impact on devaluation expectations. A significant contribution to the inflation growth in the forecast period is still made by the non-food component as well as by the behavior of the exchange rate of the Tenge and the inflationary background in Russia in the short term.

An external inflationary background for the food component of the inflation increased in the medium term because of assumptions related to the growth in prices of cereals.

A negative output gap will be serving as a constraining factor for the food inflation and non-food inflation in 2016-2017.

Despite the fact that the base rate was lowered, the nature of implemented monetary policy is assessed as moderately constraining; this is related to the absorption of the Tenge liquidity by the National Bank. Implementation of the anti-crisis and other economic stimulus measures as well as stabilization of the exchange rate of the Tenge makes a positive contribution to the medium-term dynamics of the economic activity. Interest rates will be going down as a result of deceleration in the inflation rate to 6-8% in the medium term.

Figure 60. Inflation, Average for the Quarter, YOY, % (confidence intervals of 75%, 50% and 10%)



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.

Risks of the forecast under the scenario of oil price being at USD 30 per barrel have not undergone any changes as compared to the conclusions made in the Inflation Report for the first quarter of 2016.

Additionally, the following scenarios were considered:

– recovery of oil price (Brent) to USD 50

per barrel in the medium term would result in the improved external demand in connection with higher rates of recovery of the Russian economy and would also positively influence the external inflationary background as there would be a higher probability of reaching the inflation goal in Russia. In turn, such developments would lead to a probable appreciation of the Tenge, lower inflation and rapid recovery of the Kazakh economy against the background of decreased dollarization and the growth in economic activity as opposed to the baseline scenario;

– a low rate of utilization of resources allocated from the Unified Accumulation Pension Fund and the National Fund with a view to stimulate the economy in the medium term would lead to higher rates of GDP growth in connection with the more decreasing imports and, as a consequence, to more positive net exports;

– a slower growth in prices of cereals in the medium term could result in lower food prices and, accordingly, in a lower inflation in 2017 as compared to the baseline scenario;

– the risk of forecast also includes a higher volatility of oil prices which is not taken into consideration when projecting the paths of key variables. In case of higher volatility of oil prices, devaluation and inflationary expectations would increase; the rates of dedollarization may stop down thus affecting the forecasted parameters in a negative way.

BASIC TERMS AND DEFINITIONS

Core Inflation – means the inflation which excludes transitory 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; 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. The National Bank's FX swaps represent the instrument of provision of the Tenge liquidity on the overnight basis at a fixed interest rate against collateral in foreign exchange.

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.

GPIID – government program for industrial and innovation development of the Republic of Kazakhstan for 2015 – 2019. Was approved by the Presidential Decree of the Republic of Kazakhstan as dated August 1, 2014 No.874. The program is a part of Kazakhstan's industrial policy and is focused on developing the manufacturing industry with the concentration of efforts and resources on a limited number of sectors, regional specialization with the use of a cluster approach and effective industry-based regulation.

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, 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.

Other Inflation Measures. According to the international practice, mainly two indicators are used as a measure of inflation: consumer price index and core inflation. Theoretically, the GDP deflator may be used. However, since the GDP deflator does not take into account the change in prices for imported goods, it is hardly used by any country as a measure of inflation. The most commonly used indicator of inflation

in the international practice is the consumer price index.

Central banks of the Euro zone countries as well as central banks of Canada, UK, Poland, Czech Republic, Thailand, and Indonesia use the consumer price index or its modifications (for example, the harmonized index of consumer prices in the Euro zone).

Inflation Measurement in Kazakhstan. In Kazakhstan, inflation is measured with the use of consumer price index. The Committee on Statistics of the Ministry of National Economy is monitoring and fixing prices in all regional centers and, on a selective basis, in regions of Kazakhstan.

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 contains 510 goods and services which represent the largest portion 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 – is an increase in the general price level of goods and services.

A stable and predictable inflation rate is required for a sustainable economic development. A high inflation rate has a negative impact on the investment activity, palling process at enterprises, production of goods and on the economy as a whole. In developed countries, the inflation rate does not exceed 3%; in developing countries (corresponding to the level of their economic development) the inflation rate exceeds 6%.

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

The advantage of this regime is a clear identification of monetary policy goals as decreasing and stabilizing inflation at a low level. A precise orientation of the central bank at one target potentially increases confidence in the central bank on the part of markets. In addition, disinflation and effective maintenance of its rates at a low level eventually supports a stable economic growth.

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.

Credit Auctions mean the National Bank's auctions for 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.

With a view to regulate inflation, central banks influence those indicators which they can directly manage or the so-called nominal anchors. For example, the money supply in the monetary targeting regime or exchange rate in

the exchange rate targeting regime or short-term money market rates in the inflation targeting may serve as a nominal anchor. The choice of this or that "anchor" by a central bank depends on the specifics of the country's economy and the existing system of the money market and financial market as well as a monetary policy regime.

Reverse Repo is the purchase of securities with the agreement to sell them at a specific price and at a specific future date. 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.

"Affordable Housing-2020" Program is the government housing program approved by the Governmental Decree of the Republic of Kazakhstan as dated June 21, 2012 No. 821 on approval of the "Affordable Housing-2020" Program. The Program is intended to solve the problems of developing the housing construction in a comprehensive way that will help further increase affordability of housing for the population.

"Roadmap of Business-2020" Program is the unified program for the support and development of business "Roadmap of Business-2020". Was approved by the Governmental Decree of the Republic of Kazakhstan as dated March 31, 2015 No.168. The "Roadmap of Business-2020" Program was designed to implement the Message of the President of the Republic of Kazakhstan to the people of Kazakhstan "New Decade-New Economic Upturn-New Opportunities for Kazakhstan" and the Strategic Development

Plan of Kazakhstan till 2020. The Program's goal is the post-crisis development, retention of existing jobs and creation of new jobs, ensuring a sustainable and balanced growth of regional entrepreneurship in non-energy sectors of the economy.

"Nurly Zhol" Program – the government infrastructure development program "Nurly Zhol" for 2015-2019, designed with a view to implement the Message of the President of the Republic of Kazakhstan to the people of Kazakhstan as dated November 11, 2014 "Nurly Zhol – a road to the future". The Program is focused on building a common economic market via integration of the country's macro-regions by building an efficient infrastructure on the hub basis to ensure a long-term economic growth of Kazakhstan; it is also focused on implementation of anti-crisis measures for support of certain sectors of the economy in the environment of deteriorating conditions in foreign markets.

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 securities with the agreement to repurchase them at a specific price and at a specific future date. 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 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.

In the inflation targeting regimen, a central bank, as a rule, uses the inflation forecast as an operating target for the decision-making about the interest rate level. In general, the central bank, with a view to control inflation, influences short-term rates which, in their turn,

influence the cost of credit resources, investments, business activity and inflation. Assessment of inflationary expectations of the general public is an important element in achieving inflation goals.

If an expected inflation rate exceeds the inflation target in the medium term, the central bank makes the decision to increase the existing base rate.

As a rule, a short-term (in most cases, one-day) interest rate serves as the main operating monetary policy target. The National Bank regards an interest rate on one-day operations as its targeted rate.

At present, the National Bank, as part of its effort to implement the inflation targeting, is in the process of designing the system for modeling and forecasting of macroeconomic indicators, developing and improving monetary policy tools.

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

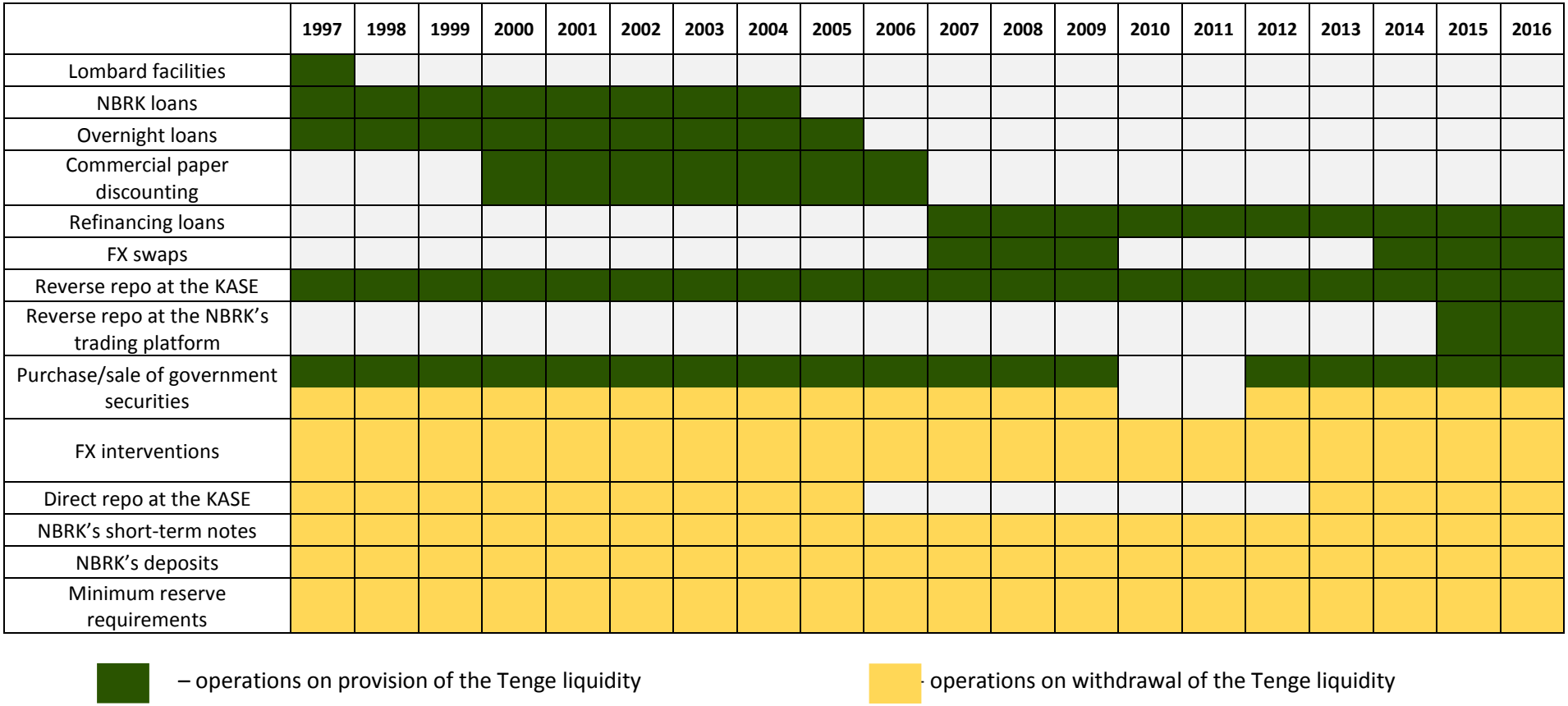
Factors Affecting Inflation. Inflation is a complex social and economic phenomenon which is influenced by multiple internal and external factors, including business activity level, output gap (the gap between actual GDP and its potential level), labor productivity, household cash income, employment rate, the degree of competition in the markets, adequate supply of goods and services, prices in the global commodity markets and other factors.

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

LIST OF KEY ABBREVIATIONS

GDP – Gross domestic product
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 the Petroleum Exporting Countries
UN FAO – UN Food and Agriculture Organization
RK – Republic of Kazakhstan
REER – real effective exchange rate
USA – United States of America
FAO – UN Food and Agriculture Organization
Fed – Federal Reserve System
MMI – Money Market Index
bln. - billion
mln. - million
thous. - thousand

EVOLUTION OF MONETARY POLICY INSTRUMENTS IN KAZAKHSTAN



ANNEX

Table 1

Interest Rates on the National Bank's Operations for Provision and Absorption of the Tenge Liquidity in 2016 (% pa)

Purpose	Instrument Type	Instrument	Collateral	Frequency	Timeframe for provision/ withdrawal	Rates (%)	
						from 02.02.16	from 05.05.2016
liquidity provision	standing facilities	FX swap at the KASE	US Dollars	at banks' request	1 day	-	-
		reverse repo at the KASE	government securities	at banks' request	1 day	19	16
	open market operations	NBRK's securities buy/sell back auction	Lombard list *	daily	7 days	auction yield	auction yield
liquidity withdrawal		NBRK's notes[1]	-	once a week	7, 28, 91, 182 days	auction yield	auction yield
	standing facilities	NBRK's deposits	-	at banks' request	1, 7 days	15	14
		direct repo at the KASE	government securities	at banks' request	1 day	15	14
Base rate						17	15
Refinancing rate						5,5	5,5

[1] bids are satisfied in full at a discounted price which corresponds to the level of yield around the existing rate

*Bonds of Kazakhstani and foreign issuers denominated in the Tenge with the issuing rating equal to or higher than the sovereign rating of Kazakhstan under the rating scale of one of the leading rating agencies (Standard&Poor's, Fitch or Moody's). Corporate bonds of Kazakhstani and foreign issuers denominated in the Tenge with the issuing rating not below BB- under the scale of Standard&Poor's and/or Fitch, and/or the Ba3 rating under the scale of Moody's or higher.

Table 2

Monetary Aggregates in Kazakhstan

	Reserve Money		Money Supply		Cash	
as of	*KZT mln.*	*%, YoY*	*KZT mln.*	*%, YoY*	*KZT mln.*	*%, YoY*
01.02.14	2 861 003	*4,2*	11 882 162	*13,2*	1 397 708	*-1.7*
01.03.14	3 240 023	*23,3*	12 432 486	*18,0*	1 399 675	*-0.7*
01.04.14	3 408 022	*11,9*	12 796 182	*15,5*	1 319 887	*-7.6*
01.05.14	3 633 316	*27,4*	12 782 103	*15,7*	1 359 033	*-5.6*
01.06.14	3 595 581	*18,3*	12 921 548	*14,2*	1 397 801	*-4.3*
01.07.14	3 715 258	*20,1*	13 411 461	*15,8*	1 452 216	*-4.7*
01.08.14	3 859 730	*24,1*	13 424 662	*14,9*	1 439 601	*-2.5*
01.09.14	3 654 727	*25,8*	13 352 628	*17,6*	1 382 569	*-5.8*
01.10.14	3 753 134	*34,9*	13 466 829	*16,5*	1 369 299	*-5.8*
01.11.14	3 723 626	*34,1*	13 550 620	*16,0*	1 274 397	*-11.4*
01.12.14	3 414 322	*30,8*	12 973 924	*14,4*	1 221 633	*-13.0*
01.01.15	3 413 841	*20,8*	12 816 554	*10,5*	1 122 319	*-25.8*
01.02.15	3 109 020	*8,7*	12 403 086	*4,4*	1 035 712	*-25.9*
01.03.15	3 144 815	*-2,9*	12 287 224	*-1,2*	1 020 848	*-27.1*
01.04.15	3 287 005	*-3,6*	12 322 119	*-3,7*	1 037 126	*-21.4*
01.05.15	3 418 576	*-5,9*	12 266 760	*-4,0*	1 018 439	*-25.1*
01.06.15	3 644 795	*1,4*	12 533 824	*-3,0*	1 086 948	*-22.2*
01.07.15	4 191 185	*12,8*	13 082 850	*-2,5*	1 143 598	*-21.3*
01.08.15	3 871 600	*0,3*	12 938 179	*-3,6*	1 135 293	*-21.1*
01.09.15	4 307 271	*17,9*	14 391 689	*7,8*	1 186 211	*-14.2*
01.10.15	4 644 278	*23,7*	15 494 985	*15,1*	1 199 959	*-12.4*
01.11.15	4 678 045	*25,6*	15 775 290	*16,4*	1 201 559	*-5.7*
01.12.15	4 816 225	*41,1*	16 684 442	*28,6*	1 190 243	*-2.6*
01.01.16	4 750 422	*39,2*	17 207 454	*34,3*	1 236 973	*10.2*
01.02.16	4 722 030	*51,9*	17 697 095	*42,7*	1 174 178	*13,4*
01.03.16	4 566 189	*45,2*	17 428 774	*41,8*	1 237 519	*21,2*
01.04.16	4 993 159	*51,9*	17 787 740	*44,4*	1 302 768	*25,6*
01.05.16	4 653 021	*36,1*	17 729 195	*44,5*	1 395 984	*37,1*
01.06.16	4 495 113	*23,3*	17 985 894	*43,5*	1 485 329	*36,7*
01.07.16	4 894 149	*16,8*	18 398 902	*40,6*	1 582 258	*38,4*

Source: NBRK

Table 3

Price Indices in the Kazakh Economy

Month	Consumer Pricer Index, %		Food Price Index, %		Non-food Price Index, %		Services Price Index, %		Producer Price Index, %		Agricultural Producer Price Index, %	
	MoM	YoY	MoM	YoY	MoM	YoY	MoM	YoY	MoM	YoY	MoM	YoY
Apr.14	100,6	106,6	101,0	106,4	100,6	106,4	100,2	106,9	100,3	112,0	101,2	92,7
May.14	100,6	107,0	100,8	107,0	100,6	106,9	100,3	106,9	100,7	117,9	100,5	94,3
Jun.14	100,3	107,0	100,4	107,3	100,3	107,0	100,2	106,6	101,4	120,3	101,4	97,0
Jul.14	100,1	107,0	99,8	107,0	100,3	107,2	100,3	106,6	101,4	119,8	101,4	99,5
Aug.14	100,4	107,2	99,9	106,9	101,1	108,1	100,4	106,5	99,2	115,3	101,2	101,1
Sep.14	100,5	107,5	100,3	107,4	100,5	108,4	100,7	106,6	97,3	109,6	101,0	104,1
Oct.14	100,4	107,6	100,5	107,7	100,5	108,5	100,2	106,6	96,8	107,2	101,4	107,9
Nov.14	100,6	107,7	100,7	107,7	100,5	108,6	100,5	106,7	95,9	103,3	101,6	110,8
Dec.14	100,5	107,4	101,1	108,1	100,0	107,9	100,3	106,5	95,0	98,4	101,9	113,4
Jan.15	100,6	107,5	101,2	108,8	99,9	107,4	100,7	106,2	89,7	87,0	100,7	114,5
Feb.15	100,4	106,1	100,2	107,4	99,5	104,9	101,3	105,7	91,7	78,6	99,8	114,6
Mar.15	100,1	105,2	100,2	106,3	100,0	103,9	100,1	105,3	103,6	75,3	99,7	112,4
Apr.15	100,1	104,7	100,3	105,5	100,2	103,4	99,9	105,0	98,2	73,8	99,2	110,2
May.15	100,3	104,4	100,0	104,7	100,8	103,6	100,0	104,7	102,2	74,9	99,2	108,8
Jun.15	99,9	104,0	99,5	103,7	100,3	103,6	100,1	104,6	102,8	75,9	99,6	106,9
Jul.15	100,1	104,0	99,7	103,6	100,2	103,5	100,5	104,8	99,0	74,1	99,2	104,5
Aug.15	100,3	103,9	99,8	103,5	100,5	102,9	100,7	105,1	98,0	73,2	99,5	102,8
Sep.15	101,0	104,4	100,6	103,9	102,0	104,5	100,7	105,1	101,3	76,2	100,2	102,0
Oct.15	105,2	109,4	104,6	108,0	110,2	114,5	101,1	106,0	105,4	83,0	102,0	102,7
Nov.15	103,7	112,8	103,3	110,8	106,5	121,3	101,4	106,9	104,3	90,2	101,4	102,5
Dec.15	101,2	113,6	101,2	110,9	101,1	122,6	101,4	108,1	100,2	95,2	102,2	102,7
Jan.16	101,3	114,4	101,8	111,6	100,9	101,2	101,2	108,6	98,1	104,2	101,2	103,2
Feb.16	101,1	115,2	100,9	112,4	100,8	101,6	101,6	108,9	95,8	108,8	101,4	104,9
Mar.16	100,5	115,7	100,5	112,7	100,9	100,3	100,3	109,1	103	108,2	100,5	105,7
Apr.16	100,6	116,3	100,7	113,1	100,8	127,3	100,4	109,7	104,7	115,3	100,3	106,9
May.16	100,5	116,7	100,4	113,5	100,7	127,3	100,5	110,3	103,2	116,4	99,8	107,5
Jun.16	100,4	117,3	100,7	114,9	100,5	127,5	100,1	110,3	104,9	118,7	100,5	108,7

Source: CS MNE RK

Table 4

Labor Market

Items	2015				2016	
	I	II	III	IV	I	II
Employment and unemployment						
Unemployment rate	5,0	5,0	4,9	5,0	5,0	4,9
The employed/unemployed ratio	18,9	19,1	19,5	18,9	19,1	19,5
Labor market index of the Real Sector Enterprise Monitoring (deseasonalized)*	55,6	65,9	64,2	59,8	57,5	65,4
Employed population (as % of the corresponding period of the previous year):						
Country total	-1,6	-0,9	-0,5	-1,6	0,2	-1,1
Agriculture, forestry and fishery	-25,1	-19,6	-14,4	-19,1	-4,3	-12,8
Industry	8,7	4,5	3,1	2,4	0,1	3,2
Mining industry and quarry operations	13.7	14.3	11.5	9.1	-3.8	-4.0
Manufacturing industry	4.6	-0.6	-3	-0.3	5.1	10.0
Construction	-4,2	-0,2	1,6	-3,8	1,0	5,7
Wholesale and retail trade; repair of bicycles and motorcycles	1,8	-2,9	-6,1	-0,6	0,1	2,5
Transport and warehousing	-4,3	-2,2	-2,1	6,2	1,7	-2,0
Information and communication	13,3	9,6	28,3	13,1	5,2	16,9
Real estate operations	-19,3	-4,1	-20,5	-14,9	3,2	2,1
Public administration and defense; compulsory social security	17,6	15,2	9,6	12,7	1,4	-5,1
Education	5,9	7,9	6,5	6,1	4,0	1,2
Public healthcare and social services	5,5	2,3	0,2	-3,7	2,1	3,1
Salaries and wages (as % of the corresponding period of the previous year)						
Nominal wages	9,1	2,9	2	3,8	11,9	15,6
Real wages:						
Country total	2,7	-1,4	-1,9	-7,2	-2,7	-1,1
Agriculture, forestry and fishery	3,2	1,3	4,4	-7	-8,9	-4,7
Industry	9,6	-2,1	-0,7	-6	-5,6	-3,3
Mining industry and quarry operations	15,8	-3,6	0,3	-4,4	-3,9	0,5
Manufacturing industry	3,8	-2	0	-6,2	-4	-2,9
Construction	1,8	-2	3	-1,9	2	2,0
Wholesale and retail trade; repair of bicycles and motorcycles	2,5	2,6	0	-4,7	-7,6	-5,9
Transport and warehousing	2,8	-2,2	-4,5	-11,9	-9,5	-6,8
Information and communication	6,1	0,8	-1	-7,8	-3,2	-11,5
Real estate operations	3,3	-0,8	-1,5	-3,1	1,1	1,2
Public administration and defense; compulsory social security	-6,1	-3,3	-3,2	-8,1	-4,9	-5,4
Education	1,9	3,3	-4,2	-7,3	4,1	5,9
Public healthcare and social services	4	-0,3	-0,9	-8,4	-1,3	-3,0

** - The indicator is calculated on the basis of a survey among the CEOs of the real sector enterprises. The value of the indicator shows the share of enterprises in the sampling frame where the number of the employed had not decreased*

Table 5

Deposits and Credits to the Economy

as of	01.07.2015	01.10.2015	01.01.2016	01.04.2016	01.07.2016
Deposit Volumes	11 939,3	14 295,0	15 970,5	16485,0	16816,7
Out of the total deposits amount:					
relative share in the domestic currency, в %	0,50	0,36	0,31	0,37	0,42
relative share in foreign currency, в %	0,50	0,64	0,69	0,63	0,58
Out of the total deposits amount:					
relative share of non-bank legal entities, %	0,64	0,60	0,57	0,58	0,58
relative share of individuals, %	0,36	0,40	0,43	0,42	0,42
Weighted average interest rates of banks on attracted deposits, %, for month					
in the domestic currency	6,92	11,17	19,13	13,57	12,55
in foreign currency	3,07	2,85	2,44	2,58	2,11
Volume of bank lending	10 711,5	11 834,1	12 674,2	12486,5	12456,9
Weighted average interest rates of banks on provided loans, %					
total	13,6	14,1	13,9	14,3	15,1
in the domestic currency	14,9	15,0	16,3	18,1	17,1
in foreign currency	8,1	7,5	7,7	7,7	7,9

Table 6

Balance of Payments of the Republic of Kazakhstan
(USD mln.)

	2015				2016
	1 Q	2 Q	3 Q	4 Q	1 Q
Current Account	-125,3	-2251,71	-1799,0	-1647,2	1020,9
Trade balance	4247,9	3369,5	2778,7	2252,9	2689,7
Exports	12144,3	12637,0	11372,8	10140,2	8445,3
Imports	7896,4	9267,4	8594,1	7887,3	5755,6
Balance of services	-1080,5	-1199,2	-1518,1	-1573,0	-982,4
Exports	1476,0	1551,4	1730,9	1722,1	1527,4
Imports	2556,5	2750,6	3248,9	3295,1	2509,8
Balance on primary income	-3005,6	-3664,74	-2663,9	-2181,0	-2611,5
Payroll (net)	-423,2	-416,3	-433,6	-393,5	-285,6
Investment returns	-2617,4	-3283,3	-2265,2	-1822,5	-2360,8
Income payable	509,5	465,04	432,7	436,1	435,6
Returns on direct investments	57,9	82,6	85,5	89,8	75,9
Returns on portfolio investments	296,4	271,2	236,7	231,1	260,9
Returns on other investments	155,2	111,2	110,5	115,1	98,9
incl. interest on the National Fund's reserves and assets	264,9	276,3	249,3	236,9	270,4
Income payable	3126,9	3748,38	2697,9	2258,6	2796,5
Returns on direct investments	2454,7	2943,3	1880,8	1564,2	2137,7
Returns on portfolio investments	341,6	465,6	485,6	348,6	315,9
Returns on other investments	330,7	339,4	331,5	345,8	342,8
Other primary income (net)	34,9	34,9	34,9	34,9	34,9
Balance on secondary income	-287,1	-757,3	-395,7	-146,0	-116,8
Capital account balance	-3,6	44,3	3,6	87,3	5,7

Source: NBRK

Table 6
(continued)

Balance of Payments of the Republic of Kazakhstan
(USD mln.)

	2015				2016
	1 Q	2 Q	3 Q	4 Q	1 Q
Financial Account (excl. the NBRK's reserve assets)	-2574,7	-1637,5	-3401,6	-2997,1	-1470,1
Direct investments	-1437,6	229,2	-1441,8	-754,6	-2615,8
Net acquisition of financial assets	1120,0	874,4	297,7	917,6	122,0
Net incurred liabilities	2557.7	645.3	1739.5	1672.3	2737.8
Portfolio investments	-797.6	-1270.4	-5173.8	1363.5	2212.9
Net acquisition of financial assets	-2115.6	-2667.3	-1581.2	-3148.8	1821.7
Government of Kazakhstan and the National Bank of Kazakhstan	-1529.5	-2531.8	-1619.1	-2678.0	1762.1
Banks	-632.2	-36.3	7.0	-158.3	50.9
Other sectors	46.1	-99.2	30.9	-312.6	8.7
Net incurred liabilities	-1318.0	-1396.9	3592.6	-4512.3	-391.3
Government of Kazakhstan and the National Bank of Kazakhstan	47,8	-122,5	3495,1	-63,3	-245,3
Banks	-51,7	-121,3	-55,7	-643,7	-80,2
Other sectors	-1314,1	-1153,2	153,1	-3805,3	-65,8
Derivatives (net)	-137,5	58,3	-62,0	25,8	-8,0
Other investments	-201,9	-654,6	3275,9	-3631,8	-1059,2
Equity participation instruments (net)	26,9	-0,5	0,6	59,5	37,1
Medium-and long-term instruments	-1427,9	-791,0	515,3	-2555,6	546,9
Net acquisition of financial assets	-1996,5	222,3	-425,4	-244,6	70,5
Net incurred liabilities	-568,6	1013,3	-940,7	2310,9	-476,4
Short-term debt instruments	1199,1	137,0	2760,0	-1135,7	-1643,1
Net acquisition of financial assets	-10,2	-81,0	2310,8	-1079,1	-1626,5
Net incurred liabilities	-1209,4	-218,0	-449,2	56,6	16,7
Errors and omissions	-1935,5	-49,0	-2325,1	-1373,2	-1538,1
Overall balance	-510,4	618,9	719,0	-64,1	1083,2
Financing	510,4	-618,9	-719,0	64,1	-1083,2
NBK's reserve assets	510,4	-618,9	-719,0	64,1	-1083,2
IMF credits	0,0	0,0	0,0	0,0	0,0
Exclusive financing	0,0	0,0	0,0	0,0	0,0

Source: NBRK