



NATIONAL BANK OF KAZAKHSTAN

# Inflation Report

The Third Quarter of 2016

Almaty, Kazakhstan

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

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as of 27.10.2016.

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## SUMMARY

In the third quarter of 2016, the situation in the global oil market was in line with the baseline scenario of the National Bank – the price of oil remained relatively stable except for a short-time decline at the beginning of the quarter. During the period, the price environment in the global food markets and metal markets was characterized by an upward trend to a larger extent.

The economic situation in countries-trading partners in the third quarter of 2016 had not undergone significant changes against the previous quarter; the external demand was slightly improving and the external inflationary pressure eased, which was generally in line with the National Bank's expectations.

The domestic economic situation demonstrated a gradual recovery of positive growth rates owing to implementation of government stimulus packages. In the third quarter of 2016, the short-term economic indicator demonstrated growth rates, after the period of continuing downturn. The GDP by the production method demonstrated positive growth rates in the second quarter of 2016 because of growing volumes in agriculture, transport sector and in the manufacturing industry.

The monetary policy of the National Bank in the third quarter of 2016 was implemented in the environment of a persisting structural liquidity surplus. As a result, the National Bank was conducting operations to absorb liquidity mainly in the form of short-term notes, and interest rates in the money market were near the lower boundary of the interest rate band. In the third quarter of 2016, the credit market was characterized by the positive rate of growth in lending volumes and by the slackening of weighted average interest rates. However, trends in the deposit market changed insignificantly and were driven by the situation in the foreign exchange market.

Decelerating inflationary expectations and a gradual recovery of the macroeconomic situation resulted in the reduction of the base

rate in the second quarter of 2016 to 13% with the band of +/-1%.

In the environment of persisting behavior of macroeconomic parameters and dedollarization of the financial sector as well as moderate inflationary expectations of the population, the National Bank's base rate was lowered to 12.5% in October and to 12% in November 2016, with the width of the interest rate band being unchanged.

The path of the annual inflation was in line with the National Bank's expectations and was of a downward nature. According to estimates, the annual inflation will keep going down till the end of 2016, gradually offsetting the statistical effect of inflation surge at the end of 2015. Under the baseline scenario of USD 40 per barrel, the annual inflation will reach the upper boundary of the set target band of 6-8% at the end of 2016.

In the medium-term, according to the National Bank's forecasts under the baseline scenario, the annual inflation will be within the target band throughout 2017. This will be secured by a persisting negative output gap, neutral fiscal policy, and moderate inflationary pressure on the part of the external sector. Increased inflationary expectations, a possibility of non-oil deficit to remain at the existing level represent the risks of a failure to meet the forecast, apart from the decline in oil prices and their increased volatility.

## **I. MACROECONOMIC ENVIRONMENT AND THE FINANCIAL SECTOR DEVELOPMENT**

### **1. EXTERNAL MACROECONOMIC ENVIRONMENT**

In the third quarter of 2016, the situation in the global commodity markets was characterized by a low volatility of energy prices as well as by the growth in prices of metals and food. Given the growth in the world oil surplus associated with the reduced consumption of raw hydrocarbons in developed and developing countries, an average quarterly price of oil slightly declined. Average prices of non-ferrous metals demonstrated growth against the decreasing world supply and the increased demand on the part of the EU. In turn, because of the reduced stocks and the growing demand for food globally, prices of main foodstuffs also increased in the reviewed period.

The US economy in the third quarter of 2016 demonstrated high growth, however, its employment and inflation rates were not quite reasonable. Hence, monetary conditions of the US Fed remained unchanged; however, they may change by the end of 2016.

In July-September 2016, economies of Kazakhstan's main trading partners, including Russia, China and the EU, demonstrated a minor improvement of key macro indicators. Annual GDP growth rates in the EU and in China had not changed as compared to the previous quarter, and Russia demonstrated a slowing recession which was in line with the market expectations.

In the environment of a stable behavior of the economic growth indicators and the price level in countries of trading partners, aggregated external indicators of GDP and inflation in the third quarter of 2016 also changed insignificantly versus the previous quarter.

## 1.1 Situation in the Global Commodity Markets

### 1.1.1 Oil Market

During the third quarter of 2016, the price of oil (Brent) was demonstrating a stable behavior being at USD 45.6 per barrel on average during the quarter, which is by 2.5% less than in the previous quarter (Figure 1).

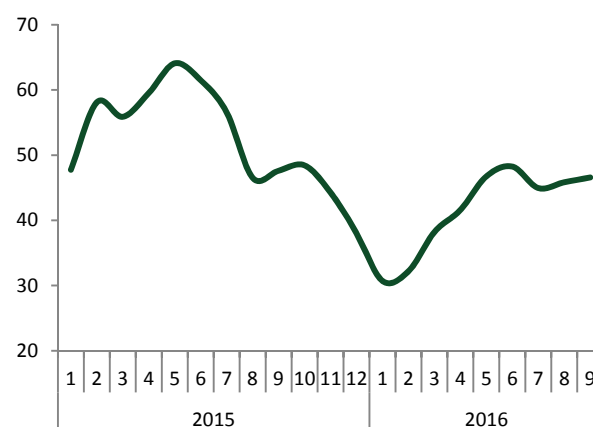
A minor decline in the average quarterly price of oil resulted from the increased oil surplus in the global market. So, according to the revised data from the U.S. Energy Information Administration<sup>1</sup>, a surplus of oil in the world in July-August 2016 as compared to the previous period increased from 0.25 to 0.45 mln. barrels a day, or by 79% (Figure 2).

In the third quarter of 2016, volumes of oil consumption were decreasing against a low level of business activity in Canada, USA, Mexico, Brazil, the EU countries, Russia and Japan. In turn, in African and Southeast Asian countries, China and India retain their high annual rates of oil consumption (Figure 3).

According to reconfirmed data from the U.S. Energy Information Administration, in the third quarter of 2016 the annual rate of decline in the global oil extraction accounted for 1.1%, which is a record-high reduction in production of oil since 2009. A key factor for the fall in oil extraction was a persistently low profitability of the oil sector that for the second consecutive quarter was causing the decline in production of oil in the countries outside of OPEC: USA, Australia, China, Mexico, Egypt, Columbia, Vietnam, Equatorial Guinea, and Yemen (Figure 4). Along with that, in a number of other countries outside of OPEC production of oil was growing during the reviewed period. So, after localization of woods fires in Canada and as a result of an ambition on the part of Russia to increase its market share, the volume of oil extraction in these countries increased significantly in July-September of this year.

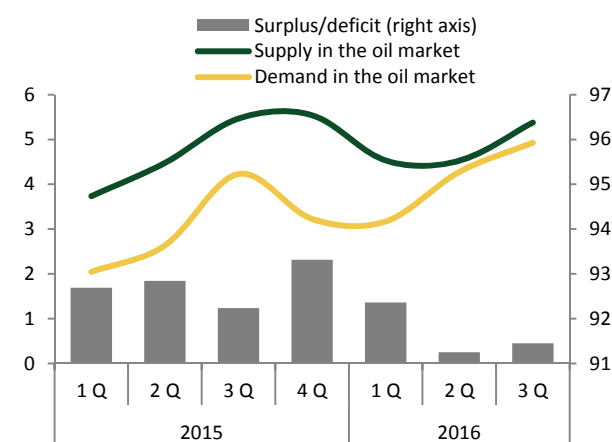
In OPEC member countries, the annual growth in oil extraction continued to slow down (Figure 4). At the same time, the list of factors

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



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

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



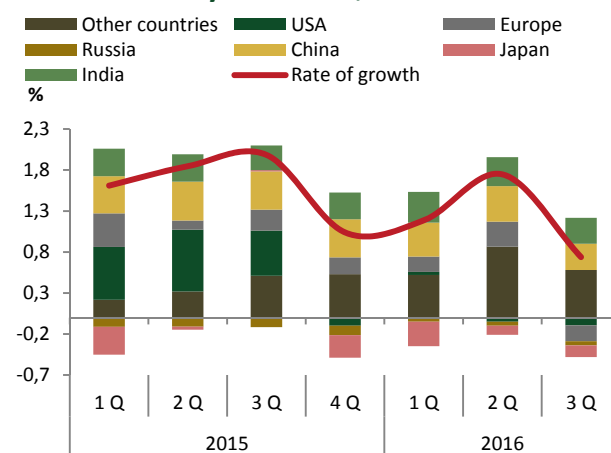
Source: U.S. Energy Information Administration (EIA)

<sup>1</sup> Published on October 13, 2016 in the monthly Short-Term Energy Outlook

causing the slowdown in oil extraction had not changed as compared to the previous quarter. Unstable economic situation in Libya, Nigeria and Venezuela against military and political crises as well as a loss-making oil sector in Algeria, Angola, Ecuador and Gabon once again were the factors which caused the fall in the level of oil extraction in these countries. Apart from that, production of oil in Iraq decreased against the backdrop of hostilities. In the reviewed period, the growth in oil extraction within OPEC was observed in Saudi Arabia, Iran and Kuwait. So, despite the beginning of negotiations regarding reduction of volumes of produced oil in OPEC countries, Saudi Arabia continues to increase production of oil in the Shaybah oil field, the largest one in the world. Iran, in its turn, keeps adhering to the previously announced plan of increasing the oil extraction to “pre-sanction” levels.

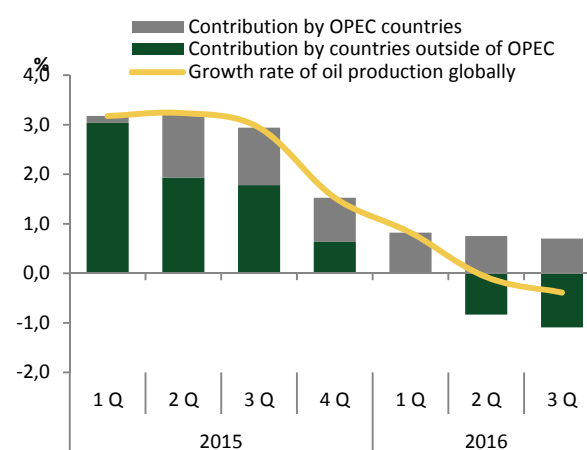
Thus, in July-September of 2016, despite the reduced consumption of raw hydrocarbons, the oil market began to demonstrate more signs of a near recovery of the balance between the demand and supply as a result of a further decline in the production volumes that would decrease volatility of oil prices.

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



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

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



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

### 1.1.2 Non-Ferrous Metals Market

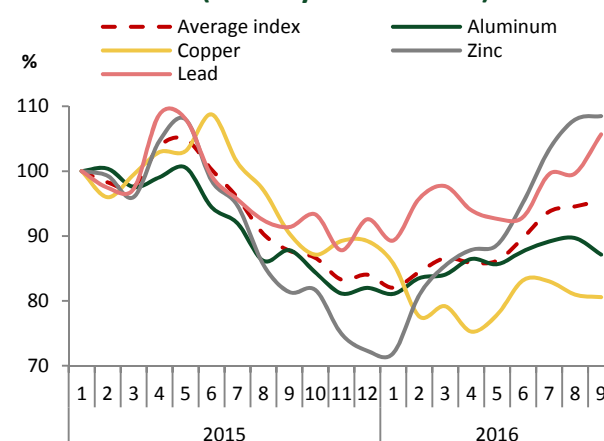
In the third quarter of 2016, a significant growth in market quotations was observed in the metals market on average. The arithmetical mean of prices of copper, aluminum, zinc and lead increased by 6.3% in September versus June (Figure 5).

The growth in prices of lead was caused by the curtailed production of the metal in Australia, USA and India as well as by the increased demand in the EU countries given the car industry's recovery.

The reduced supplies by international companies Glencore and Nyrstar, the largest companies in the sector of lead production, promoted the growth in world prices of this metal. There are constraints for a further price growth, which are associated with a possible slump in the “overblown” steel market of China where a significant portion of lead produced globally is consumed.

A fundamental factor that caused the decline in prices of aluminum and copper in the reviewed period was the decreased demand on the part of China. In future, there is an expectation that aluminum consumption in Europe will increase given the car industry’s recovery as well as the revival of copper production in Zambia and Peru, which may result in the growth of stock exchange quotations for these metals.

**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

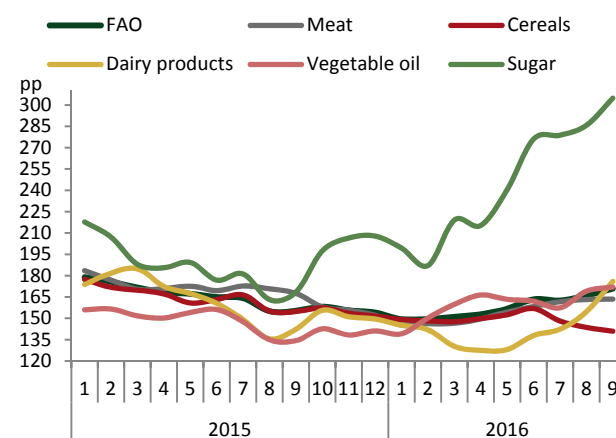
In the third quarter of 2016, the growth in the FAO Price Index which began in the first quarter of 2016 continued (Figure 6). However, the observed quarterly growth was lower than in the previous quarter (4.5% versus 8.4%).

As before, the largest contribution to the FAO growth was made by the increase in prices of sugar which had increased by 10% from June to September. Such growth in prices was caused by unfavorable weather conditions in southern regions of Brazil where the majority of sugar producers are based. In addition, the growth in prices of sugar is related to the decreased volumes of production in India, China and Thailand.

The increase in the FAO Index in the third quarter was also caused by the increase in prices of dairy products, meat and vegetable oils. So, the growth in prices of vegetable oils was caused by a low production volume in exporting countries, by the reduced stocks in importing countries as well as by the increasing concerns about a further contraction of production the next year.

In turn, a slight increase in prices of meat occurred because of an active demand for pork

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



Source: UN FAO



meat and poultry on the part of Asia and the reduced supply of lamb meat. However, due to recovering volumes of beef production in the USA its imports reduced, therefore world prices of meat had a limited growth.

The growth in prices of dairy products in the reviewed period resulted from an active demand against the reduced stocks in the EU as well as a poor performance in the Pacific countries.

A notable decline in prices of cereals stemmed from a sufficient global supply as a result of a record-high harvest of wheat and corn. Volumes of rice production are also expected to recover.

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

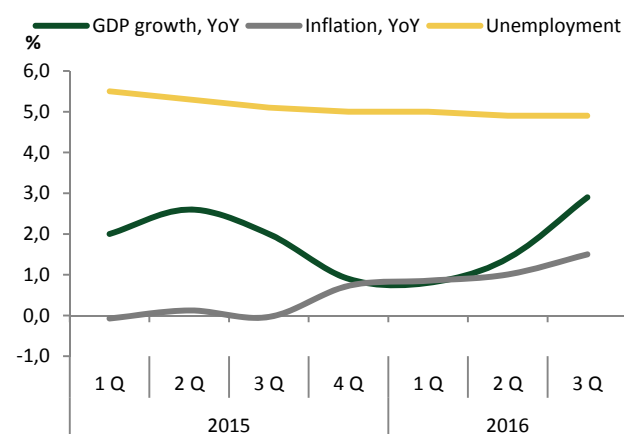
According to the data of initial assessment by the US Bureau of Economic Analysis, the GDP growth in the US based on performance in the third quarter of 2016 accounted for 2.9% (Figure 7). This number appeared to be the highest over the last two and a half years and exceeded expectations of experts interviewed by the Bloomberg by 0.3%. Earlier, the US Bureau of Economic Analysis revised its assessment of the US economy growth in the second quarter of 2016 upwards from 1.1% to 1.4%.

The GDP growth was promoted by the accelerated exports, the increased personal spending on final consumption and growth in private investments into inventories. At the same time, the reduced non-residential fixed capital investments and local and general government spending as well as the increased imports had a constraining effect on the US economic growth.

Based on performance in the third quarter of 2016, the annual inflation rate in the US was 1.5%, which is still below the target of 2% (Figure 7). The growth in inflation was caused by the increase in prices of gasoline and other energy carriers as well as the price of rental housing.

According to the Bureau of Labor Statistics, the unemployment rate in the US has been

**Figure 7. US Economic Performance**

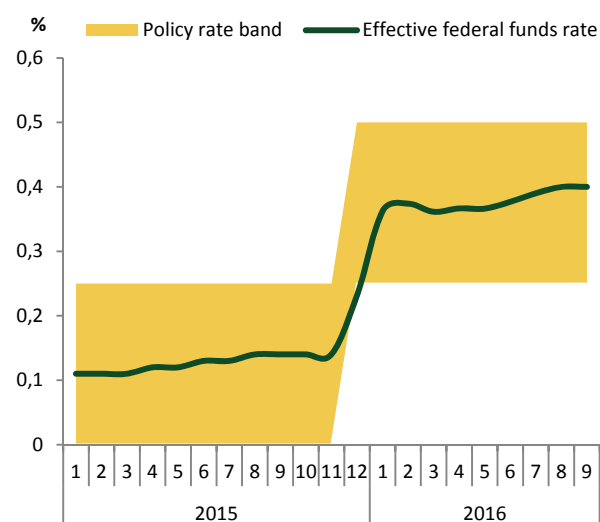


Sources: U.S. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics (BLS)

stable throughout the year and it accounted for 5% at the end of the third quarter of 2016 (it is a 0.1 pp increase against the previous quarter which is driven by the fact that the economy is approaching the full employment). Along with that, since the beginning of the year there has been a monthly growth in the number of employed people by 182 000 individuals on average, whereas in 2015 it accounted for 229 000 individuals and the unemployment rate decreased from 5.7% to 5%.

Therefore, the increased inflation rates, along with accelerated economic growth and stable rates of employment count in favor of a possible increase in the policy interest rate of the US Federal Reserve before the end of 2016 (Figure 8).

**Figure 8. US Interest Rates**



Sources: Reuters

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

#### 1.3.1 China

In the third quarter of 2016, the GDP growth in China remained unchanged and accounted for 6.7% in annual terms (Figure 9). The government stimulus packages and the real estate boom had a positive effect on China’s economic growth resulting in the increased fixed capital investments, growth in the industrial production and retail sales. Constraining factors for the economic growth include the declining exports, yet a high percentage of inefficient enterprises in the steel and coal industry, and the growing arrears in the corporate sector. Adverse effects for the Chinese economy may stem from deceleration of mortgage lending, the increasing systemic risks in the banking sector as well as the slacking economy in the EU in connection with the Brexit.

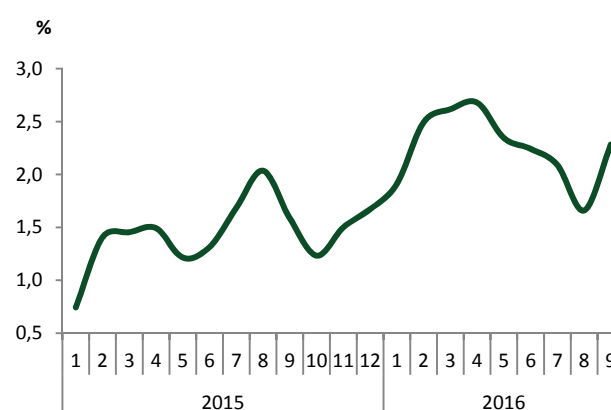
In September, the annual inflation accounted for 2.3% after its decrease in July and August (Figure 10). Such increase was driven by the growth in prices of foodstuffs, tobacco and alcohol beverages as well as education services, culture and leisure. At the same time, for the first time over the recent four and a half years, prices in the industry demonstrated growth in annual terms (0.1%), reflecting the increased

**Figure 9. China’s Real GDP Growth, YoY**



Source: Bloomberg

**Figure 10. Inflation in China, YoY**



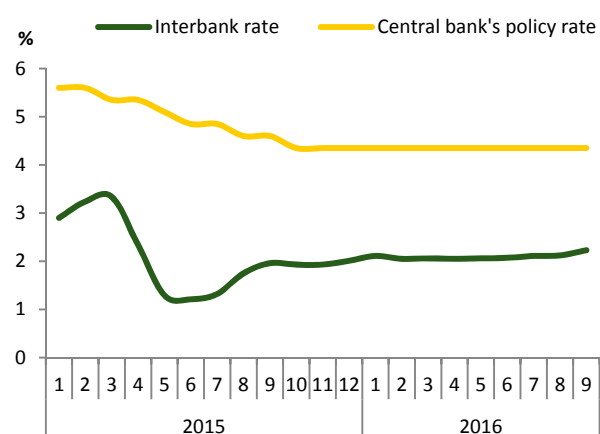
Source: National Bureau of Statistics of China

domestic prices of coal and steel as a result of curtailment of redundant production capacities.

In the third quarter of 2016, the People's Bank of China continued to pursue stimulative monetary policy while retaining its policy rate at the existing level (Figure 11). Meantime, with a view to diversify durations of provided liquidity, the regulator, for the first time since February 2016, resumed its 14-day and 28-day reverse repos. By doing so, the People's Bank of China was using the instrument of a 7-day repo to a lesser extent, therefore the interbank overnight rate slightly increased by the end of the third quarter of 2016.

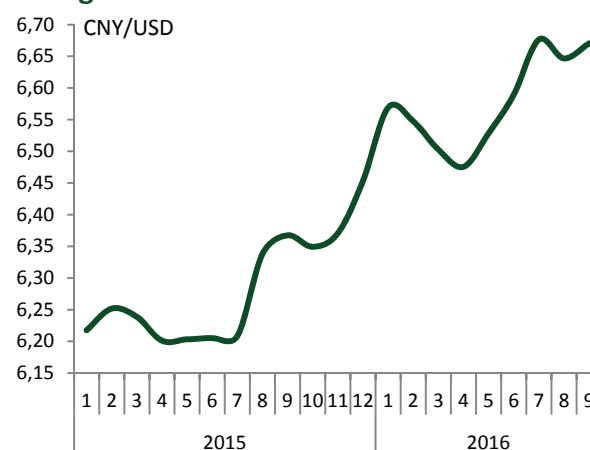
During the reviewed period, the exchange rate of the Yuan against the US Dollar showed divergent movement and was fluctuating between CNY 6.62 and CNY 6.70 against the US Dollar (Figure 12). By the end of the third quarter of 2016, the Yuan started to depreciate amidst the increased expectations that the US Fed's policy interest rate would be raised.

**Figure 11. Interest Rates in China**



Source: Reuters

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



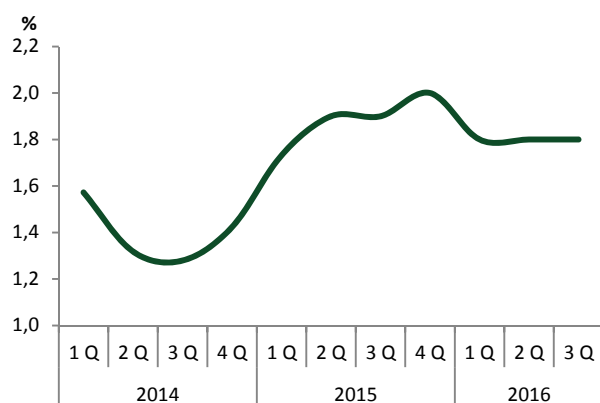
Source: Reuters

### 1.3.2 European Union

According to an initial estimate of the Eurostat, the growth in the European Union's GDP in the third quarter of 2016 in annual terms remained unchanged versus the second quarter and accounted for 1.8% (Figure 13). This was determined by moderate consumption and fixed capital investments. The existing bilateral sanctions between Russia and the EU affect the external demand in a negative way. Also, the economic growth may be negatively affected by the increasing risks in the banking sector because of poor asset quality in some banks of the South European countries as well as because of a lengthy period of low interest rates.

Throughout the third quarter, the annual

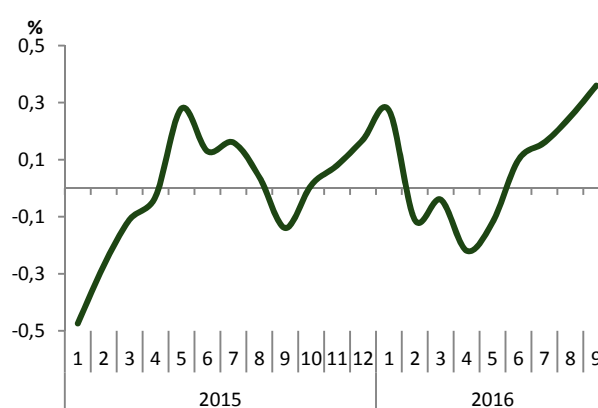
**Figure 13. EU's Real GDP Growth Rate, YoY**



Source: Eurostat

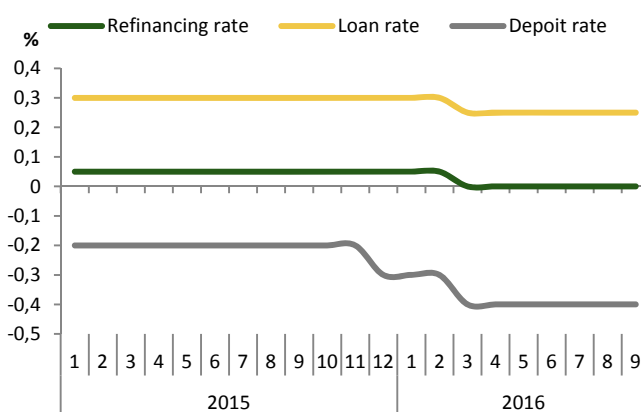
inflation rate increased from 0.2% to 0.4% (Figure 14). A positive contribution to the price growth was made by the increase in prices of services, foodstuffs, tobacco and alcohol beverages; and low prices in the industry still have a negative effect. A failure to achieve the target inflation rate (2%) prompted the ECB to leave the key monetary policy parameters unchanged (Figure 15). In December 2016, the ECB will be considering a further implementation of the quantitative easing program after March 2017.

**Figure 14. Inflation in the EU, YoY**



Source: Eurostat

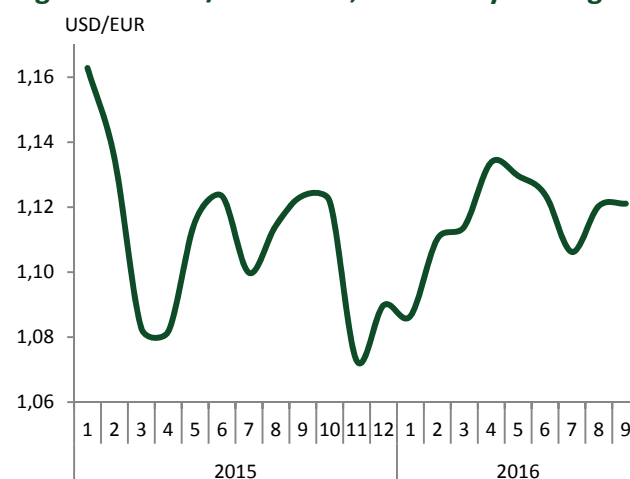
**Figure 15. ECB's Rates**



Source: Reuters

During the reviewed period, the nominal exchange rate of the Euro slightly appreciated from 1.1104 to 1.1238 US Dollars per Euro (Figure 16); this is related to a positive revaluation of consequences of the Brexit by the market. Meantime, a probable increase in the US policy interest rate and uncertainty associated with Britain's exit from the EU will be having a negative effect on the Euro exchange rate.

**Figure 16. USD/Euro Rate, a Monthly Average**



Source Reuters

### 1.3.3 Russia

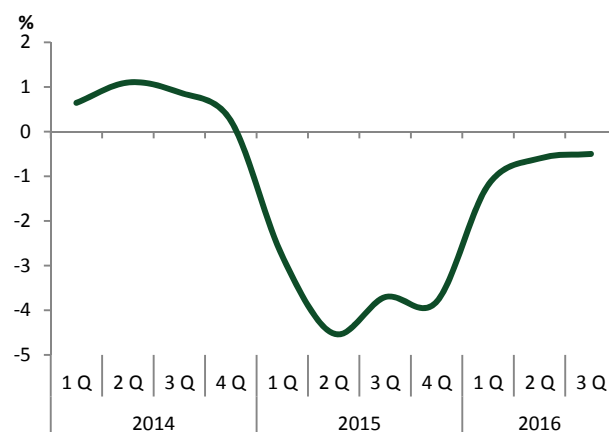
According to the data of the Ministry of Economic Development of the Russian Federation published in the Monitoring Study entitled “Current Situation in the Economy of the Russian Federation in January-September 2016”, in the third quarter of 2016, recession processes in the Russian economy continued to slow down. So, Russia’s GDP in the third quarter of 2016 decreased by 0.5% versus the corresponding quarter of 2015 (Figure 17). The growing volumes of minerals extraction, of production and distribution of electricity, gas and water, and in the agricultural sector fostered a slowdown in the economic downturn. However, a downturn in the manufacturing industry, construction and trade continued to have a negative impact on the economic growth. Low prices of raw commodities as well as mutual economic sanctions with the EU are the reasons for negative rates of the GDP growth in Russia.

At the end of the third quarter of 2016, the annual inflation in Russia accounted for 6.4%, which is by 1.1 pp less than at the end of the previous quarter (Figure 18). Stabilization of the ruble exchange rate as well as moderately tight monetary policy of the Bank of Russia help reduce the annual inflation rate.

Given the decelerating inflation and the decreasing inflationary expectations, in September 2016 the Bank of Russia made the decision to lower its key rate to 10% (Figure 19). Despite the lowering of the key rate, monetary conditions in Russia remain moderately tight against the inertia of inflationary expectations, uncertainty about the amount of indexation of wages and social benefits, and a possible slacking of incentives for households to save.

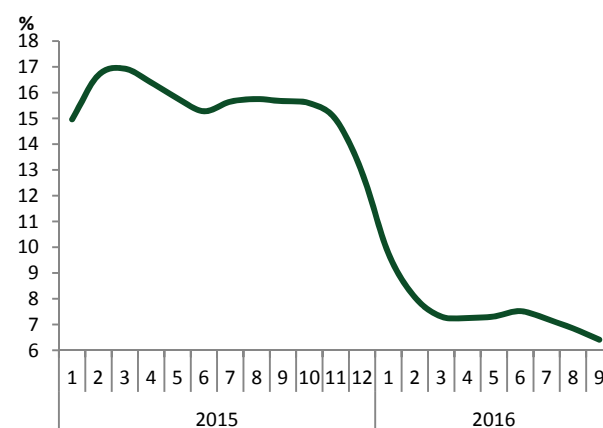
During the third quarter, the Russian ruble was demonstrating a divergent behavior against the US Dollar (Figure 20). So, in July the Russian ruble depreciated by 4.5%, and in August and September it mounted a comeback. This was associated with a corresponding oil price behavior. A further movement of the ruble exchange rate is expected to be determined

**Figure 17. Russia’s Real GDP Growth, YoY**



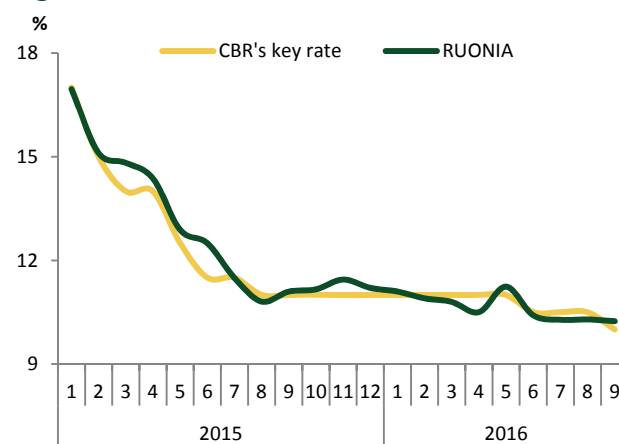
Source: Rosstat, RF’s Ministry of Economic Development

**Figure 18. Inflation in Russia, YoY**



Source: Reuters

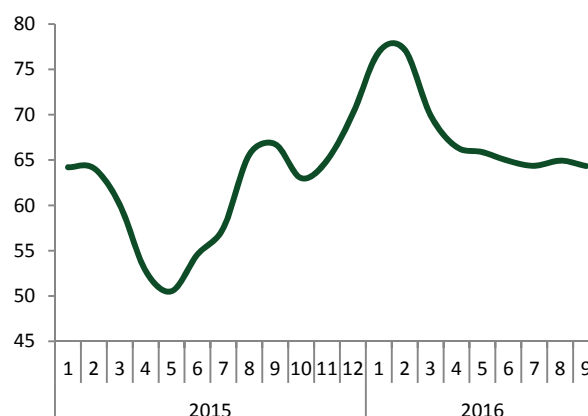
**Figure 19. Rates in Russia**



Source: Reuters

largely by the situation in the hydrocarbons market.

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



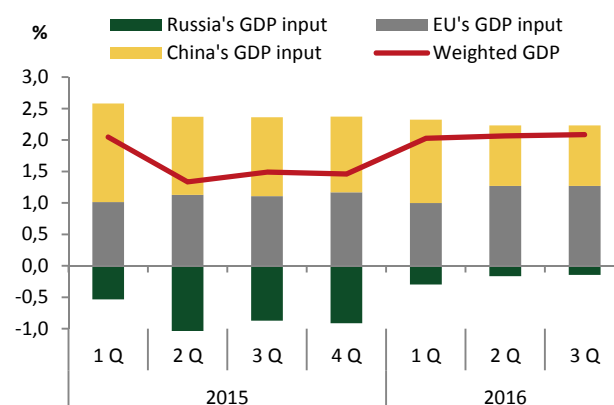
Source: Reuters

### 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 0.02 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 the external aggregated GDP of countries-main trading partners reflects a feeble improvement in the external demand indicator in the third quarter of 2016.

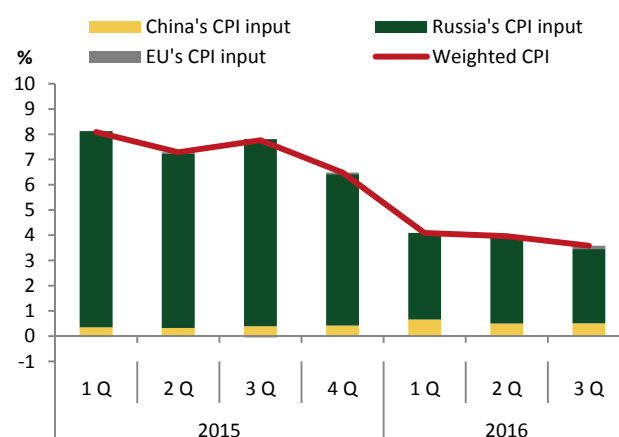
In the third quarter of 2016, the aggregate external food price index which is calculated based on the share of main trading partners in Kazakhstan's imports demonstrated a minor decline of 0.37 pp (Figure 22). Such decline is caused by deceleration of annual inflation in Russia. At the same time, the input of inflation in China remained unchanged and the input by the EU was not so considerable. 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 third quarter of 2016, the money market was still characterized by a structural surplus of the tenge liquidity. Under these circumstances, the volumes of excess liquidity withdrawals by the National Bank were growing. The demand for standing facilities of the National Bank (deposits and direct repo) by banks continued to decrease (Figure 23). Also, the upward trend in the issuance of short-term notes persisted against extension of their maturities. So, in September 2016, for the first time since 2008, notes with maturity of one year had been issued. As a result, the percentage of short-term notes of the National Bank in the total volume of absorbed liquidity reached 83.7% on average during the third quarter (61.5% and 66.8% – in the first and in the second quarter, respectively).

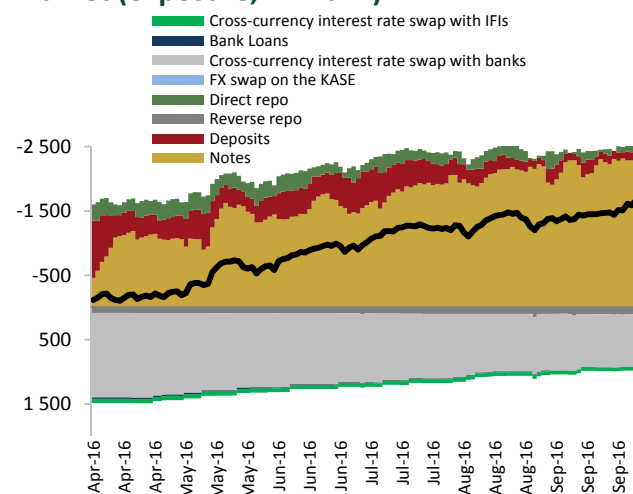
Throughout the reviewed period, weighted average interest rates on placed notes with the maturity of 7 days were also decreasing and were approximating with the level of base rate (from 14.6% in June to 13.0% in September 2016).

Given that the situation in the external and the domestic sector of the economy was improving, in the third quarter the National Bank continued to ease monetary conditions.

In July 2016, the National Bank made the decision to lower the base rate to 13% with the band of  $\pm 1\%$  in connection with the decreasing inflationary expectations, the persisting positive trends in the behavior of external macroeconomic indicators as well as with a stable situation in the domestic foreign exchange market.

In August 2016, the base rate was retained at 13% with the band of  $\pm 1\%$ . The decision about retention of the base rate at the same level was dictated by the need to achieve the target band for inflation of 6-8% and to keep it within the band during the 12-month horizon and up to the end of 2017. The main reason for keeping the base rate at the existing level was

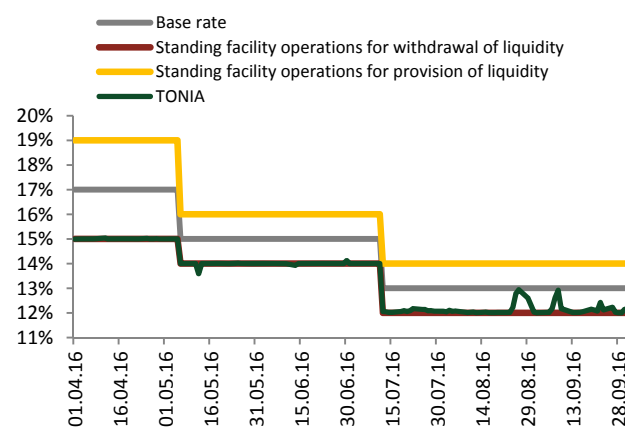
**Figure 23. NBRK's Operations in the Domestic Market (exposure, KZT bln.)**



\* NBRK's securities buy/sell back auction

Source: NBRK

**Figure 24. Base Rate and TONIA Rate**



Source: NBRK, KASE

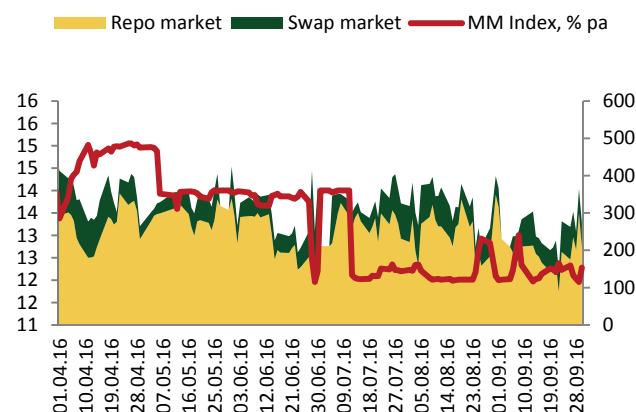


the increased inflationary pressure as a result of decline in oil prices in July 2016 (Figure 24).

The operational system of monetary policy instruments allowed the National Bank to keep the targeted rate within the interest rate band of the base rate. In the environment of a structural surplus of the tenge liquidity and regular operations for liquidity absorption conducted by the National Bank, interest rates in the money market were building around the lower boundary of the interest rate band.

During the third quarter of 2016, the MMI was fluctuating within the range of 11.96-14.0%. The weighted average of MMI in the third quarter of 2016 was 12.34% (in the second quarter – 14.14%). The major portion of operations was conducted in the repo market (Figure 25).

**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

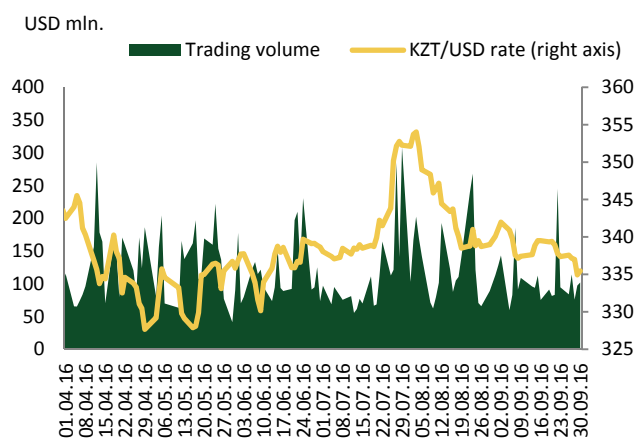
In general, in the third quarter of 2016 the situation in the foreign exchange market remained stable. Behavior of the tenge exchange rate was divergent and was determined primarily by movements in oil and the exchange rate of the Russian ruble.

The decline in the price of oil at the end of July 2016 and depreciation of the Russian ruble caused depreciation of the tenge exchange rate. The oil price at USD 45-50 per barrel from the second half of August 2016 resulted in appreciation of the tenge by the end of the third quarter of 2016.

In the third quarter of 2016, the exchange rate of the tenge was fluctuating within the range of KZT 334.93-354.01 per US Dollar. At the end of the third quarter of 2016, the tenge exchange rate having appreciated versus the second quarter of 2016 by 0.9% amounted to KZT 335.46 per US Dollar (Figure 26). On the whole, the tenge exchange rate still remains balanced due to impact of fundamental external and internal factors.

In July and August 2016, the share of the National Bank's participation in the foreign exchange market decreased significantly and

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



Source: KASE



was only aimed at limiting dramatic and destabilizing fluctuations of the tenge exchange rate. In September, due to stabilization of the foreign exchange market, the National Bank did not participate in foreign exchange trades.

### 2.1.3 Deposit Market

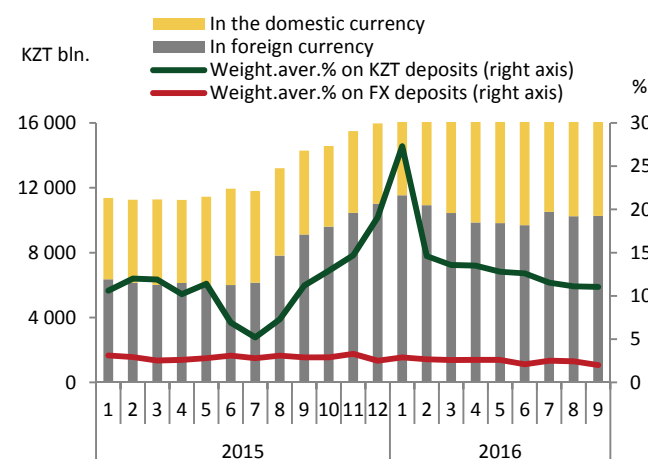
The volume of bank deposits in the third quarter of 2016 as compared to the second quarter increased by 4.8% and amounted to KZT 17.6 trln. (Figure 27).

In the structure of deposits of individuals, there was still a high inflow of deposits in the domestic currency (5.3%) as compared to foreign currency deposits (1.0%), although their rates have slowed down significantly as compared to the second quarter (32.6% and 7.6%, respectively). A significant gap in maximum recommended interest rates on new deposits of individuals attracted by banks (14% on the tenge deposits versus 2% on foreign currency deposits) contributes to dedollarization of deposits of individuals. Corporate deposits that are not secured by the government guarantee are more sensitive to changes in the exchange rate. The 10.7% growth in corporate deposits denominated in foreign currency versus the 2.4% growth in the tenge deposits in the third quarter of 2016 was fully secured in July.

At the end of the third quarter, the share of all foreign currency deposits remained virtually the same as in the second quarter of 2016 and accounted for 58.3% (in June 2016 – 57.6%).

In the third quarter of 2016, interest rates on deposits in the domestic currency decreased further (from 12.6% to 11.0%) while interest rates on foreign currency deposits remained virtually unchanged (changed from 2.1% to 2.0%). Along with that, the pressure on banks on the part of corporate entities decreased significantly. If during the first and the second quarter interest rates on corporate deposits in the tenge exceeded corresponding interest rates on retail deposits, in the third quarter the situation changed. Banks were not badly in

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



Source: NBRK

need of the tenge liquidity; so this resulted in the overall lowering of deposit rates.

#### 2.1.4 Credit Market

In the third quarter of 2016, there was some revival in the credit market associated with stabilization of market interest rates. The lending volume in September 2016 as compared to June 2016 increased by 1.8% (Figure 28).

The growth in credits was also supported by the increased volumes of SME lending (a quarterly growth of 2.9%), which was related to participation of banks in various governmental SME support programs.

As a result of stabilization of situation in the money market and the change in foreign currency preferences of depositors, interest rates on loans continued to decrease. In September 2016, the weighted average interest rate on loans in the domestic currency was 16.3% (in June 2016 – 17.1%).

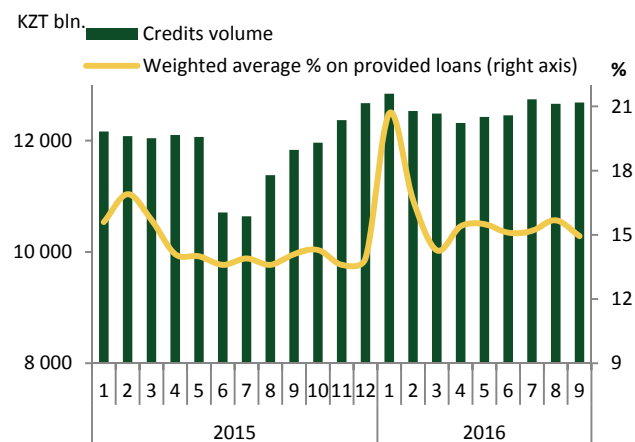
#### 2.1.5 Monetary Aggregates

In the third quarter of 2016, the annual growth rates of monetary aggregates M3 (money supply) and M0 (cash in circulation) decreased and accounted for 23.8% and 30.1%, respectively at the end of September. The rate of growth in the reserve money continued to decrease in the third quarter and equaled 0.1% at the end of September (Figure 29).

The main factor for the slowdown in the growth of money supply was the decrease in the rates of growth of foreign currency components, namely, foreign assets and claims of the banking system on non-bank financial organizations, as a result of a weakening effect of revaluation because of the change in the tenge exchange rate (Figure 30).

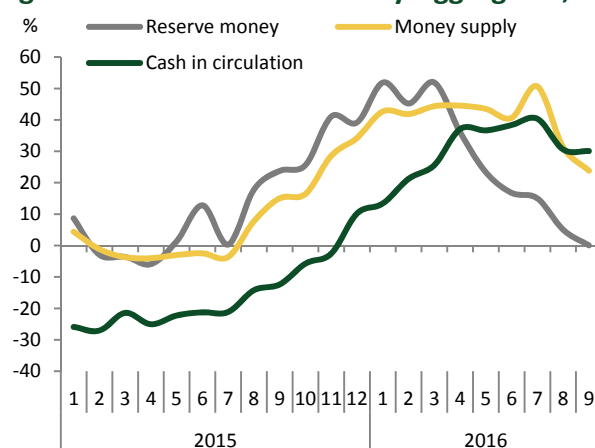
The growth in placed short-term notes of the National Bank in the third quarter of 2016 appeared to be the main reason for a further reduction in the growth rates of the reserve money.

Figure 28. Volumes and Interest Rates on Loans



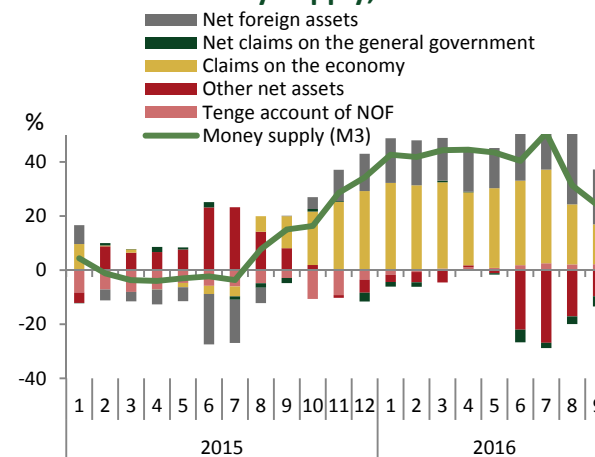
Source: NBRK

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

### 2.2.1 Consumer Price Index

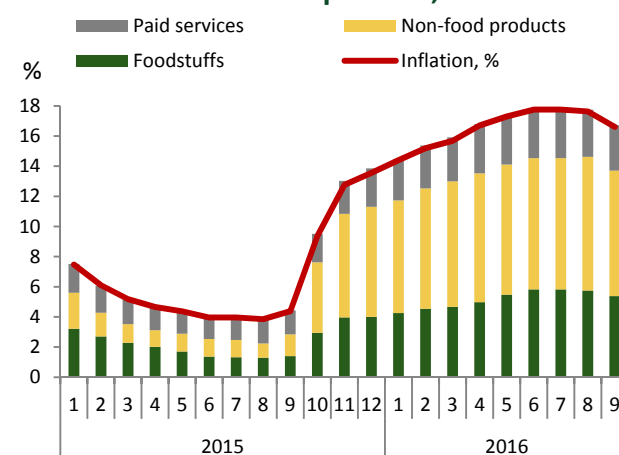
The annual inflation started to slow down from 17.3% in June to 16.6% in September 2016 (Figure 31). In the CPI structure, non-food products still tend to increase in terms of price to a larger extent than other components. Trends in the behavior of non-food inflation in the third quarter of 2016 were associated with the increased price of goods whose prices in the neighboring countries were at a higher level than in the domestic market. As consequence, producers of certain goods (diesel fuel, liquefied gas) exported their products to the countries bordering with Kazakhstan. Deregulation of prices for diesel fuel in August and the increase of the marginal price for the liquidized gas in July helped retain the supply of such goods in the domestic market. As a result, prices of such goods increased significantly affecting the overall price growth.

In the reviewed period, the contribution by food prices to the CPI was gradually decreasing due to the cheapening of agricultural products.

Behavior of prices for paid services in the third quarter of 2016 to a larger extent was determined by the increase in tariffs for regulated services in certain regions of Kazakhstan.

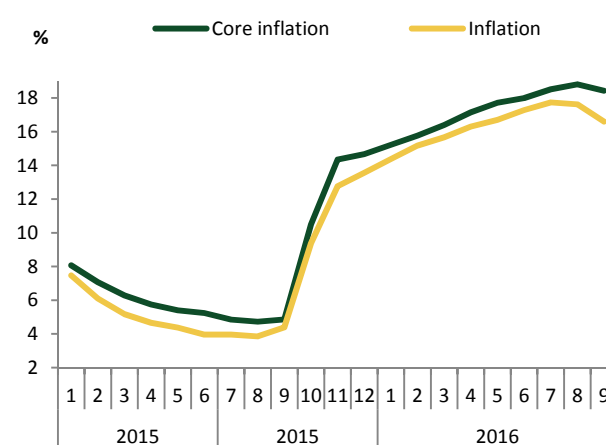
In September 2016, the core inflation excluding prices of fruit and vegetable production, regulated services and energy resources accounted for 18.4%, i.e. it was higher than the headline inflation by 1.8 pp; this was caused by a lower rate of growth in prices of fruit and vegetable production (Figure 32).

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



Source: CS MNE RK

**Figure 32. Core Inflation**



Source: CS MNE RK

### 2.2.2 Producer Price Index

In the third quarter of 2016, annual producer prices continued its upward trend which was observed in the previous quarter. In annual terms, prices of industrial production increased from 19.9% in June to 28.4% in September 2016 (Figure 33). The major price growth also occurred in the mining industry where prices increased in oil and natural gas production sector, as well as in the metallurgical industry. The price growth in the sector of metal ore extraction was observed in connection with the growth in world prices of noble metals and non-ferrous metals (lead and zinc).

Along with that, export prices for products of the oil and metallurgical industry as well as prices for products sold in the Kazakh market were growing. As a result, prices of products of the manufacturing industry such as petroleum products, metals sold in the domestic market increased in the third quarter of 2016 by 11.2% and 5.2%, respectively.

In addition, a minor growth occurred in the manufacturing industry in prices of foodstuffs realized in the Kazakh market, in particular, for products of dairy and meat industry.

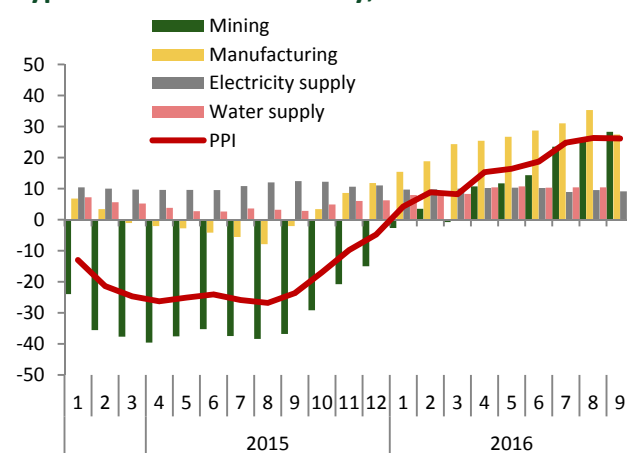
In the third quarter, prices of electricity production also increased by 3.8%.

### 2.2.3 Agricultural Producer Price Index

The trend of a growing agricultural producer price index that has been observed since the fourth quarter of 2015 changed in annual terms by the decreased growth rates at the end of the third quarter of 2016 (Figure 34). Such decline in the annual price level was caused by the decreased price index of plant production as compared to the same quarter of the previous year.

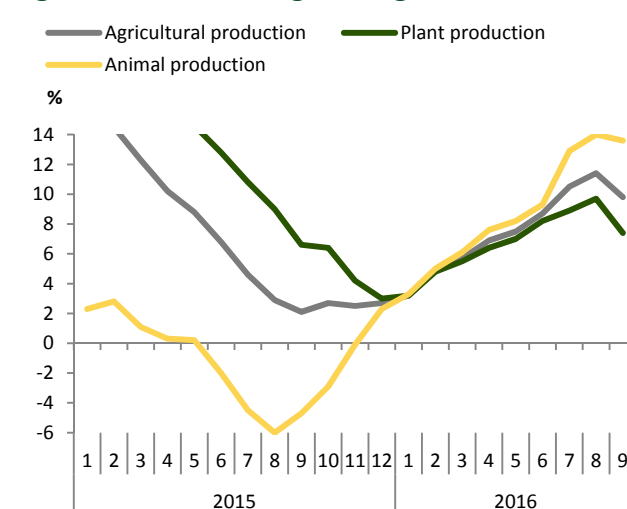
This was driven by the decline in prices of plant production in connection with a good crop owing to favorable weather conditions in 2016. Gross output of plant production in August and in September exceeded that of the same period of the previous year by 17.9% and 5%, respectively. During the quarter, the highest

**Figure 33. Price Changes in the Industry by Types of Economic Activity, YoY**



Source: CS MNE RK

**Figure 34. Price Changes in Agriculture, YoY**



Source: CS MNE RK

decline in prices was recorded in the price of rice, with a record-high harvest of rice in the Kyzylorda region.

### 2.2.4 Inflationary Expectations

The public poll outcomes for the third quarter of 2016 demonstrate that the majority of people still note a high price growth rate over the last year.

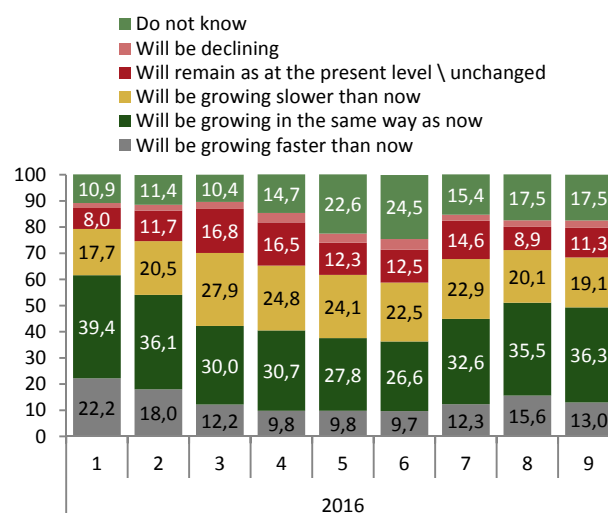
After the trend of decreasing inflationary expectations that outlined in the first half of the year, in the third quarter inflationary expectations demonstrated growth.

In July and August, negative expectations of the population regarding the price growth in the next 12 months increased. The percentage of respondents who anticipate a rapid and the same rate of price growth increased from 36.3% in June to 51.1% in August (Figure 35). In September, some positive trends in the distribution of responses had outlined.

Responses provided by respondents show that uncertainty about the future which was expressed in May and June had decreased. If in May-June about 25% of the interviewed population found it hard to make an assumption about the future inflation and the exchange rate behavior, in July-September the number of such respondents decreased.

**Figure 35. 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

## 2.3 Real Sector Development

In the second quarter of 2016, the real GDP calculated by using the final consumption method and the production method showed a divergent trend. So, net exports which remain negative appeared to be the decisive factor that caused the decrease in the GDP by the final consumption method. The GDP by the production method shifted to a positive sign showing that a negative impact by the external and domestic environment was weakening as compared to the first quarter of 2016.

### 2.3.1 Domestic Demand

In the second quarter of 2016, the GDP by the final consumption method decreased by 0.3% (Figure 36), such decrease being associated with the decreased exports of goods and services.

The volume of exports in the first half of 2016 decreased by 8.6% in real terms. The main factor for such reduction was the 42% decline in the value of exports of fuel and energy commodities (oil, gas, and coal), whose share in the total volume of exports accounted for 60.1%.

A negative impact on the part of exports was partially offset by the 4.0% reduction in imports. Reduction in imports was caused to a larger extent by the 35.0% decline in the value of imports of machinery and equipment (the share of 37.0%) and products of petrochemical industry – by 20.2% (the share of 16.8%).

Apart from that, a moderate growth of consumer demand and gross fixed capital formation in real terms was observed.

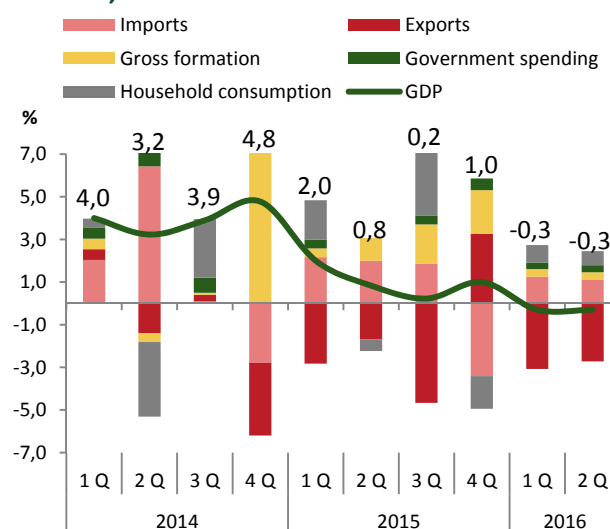
Gross fixed capital formation increased by 3.9%. The highest growth in fixed capital investments was observed in agriculture (by 48.6%), in the manufacturing industry (by 27.7%), trade (by 29.4%), and in the mining industry (by 18.6%).

Financing of fixed capital investments with bank loans increased significantly (by 62.5%), being secured by implementation of programs by the government aimed to support strategic sectors of the economy by subsidizing interest rates on loans.

A steadily low rate of unemployment secured by creation of jobs as part of governmental employment and economic stimulus programs continues to support the consumer demand. So, at the end of the first half of 2016 the growth in household consumption accounted for 1.2% (Figure 37).

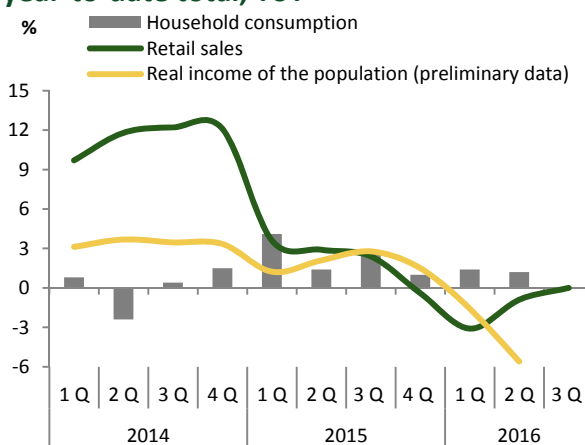
The growth in household spending on consumption in the second quarter of 2016 was mainly driven by the increased spending on foodstuffs (by 12.6% in nominal terms), whereas spending on non-food products and

**Figure 36. Decomposition of the GDP Components by the Final Consumption Method, YoY**



Source: CS MNE RK, NBRK's calculations

**Figure 37. Household Consumption, Household Real Cash Income and Retail Sales, year-to-date total, YoY**



Source: CS MNE RK

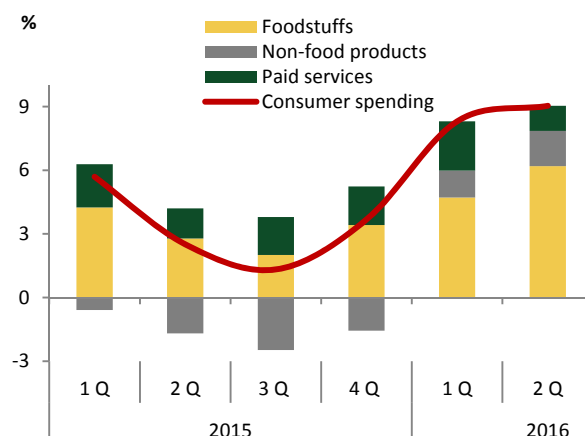
paid services increased by 6.3% and 4.8% only (Figure 38).

Thus, in the second quarter of 2016, the structure of household consumption changed, making a shift towards the increase in spending on foodstuffs.

A constraining effect on the consumer demand was made by the decreasing cash income of the population caused by a high annual inflation as well as high interest rates on loans to individuals (in the third quarter of 2016 – 19%). However, the retail trade had overcome the downturn which was observed from the beginning of the year and reached zero values already at the end of eight months of 2016 (Figure 39).

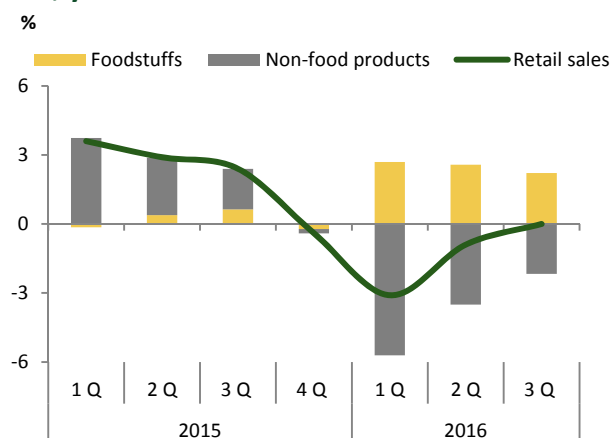
The retail trade was supported by the increase in the sale volumes of goods by retail businesses as well as by the growth in nominal cash income of the population.

**Figure 38. Structure of Growth in Household Nominal Consumer Spending, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

**Figure 39. Structure of Growth in Retail Sales, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

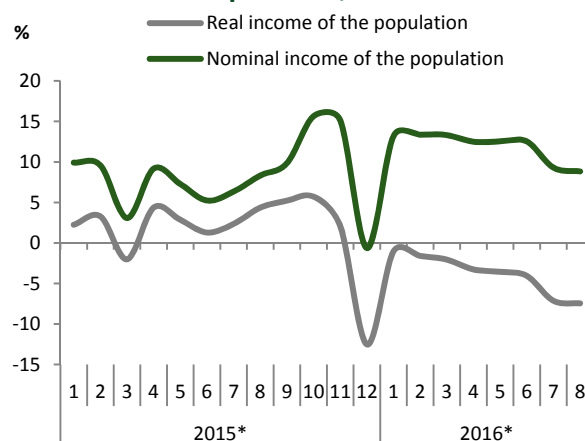
### Personal Income

In August of 2016 as compared to August 2015, nominal cash income increased by 8.8% as a result of growing income from employment and increased retirement benefits (Figure 40).

The largest growth in nominal cash income of the population was recorded in Atyrau, Mangistau and West-Kazakhstan regions.

Real cash income of the population continues to decrease at speedy rates. So, the decrease in real cash income in August of 2016 accounted for 7.5%. As per a regional breakdown, real cash income of the population decreased to the largest extent in Astana, and in Zhambyl and Almaty regions.

**Figure 40. Indices of Nominal and Real Cash Income of the Population, YoY**



\*-preliminary data

Source: CS MNE RK



### Investment Activity

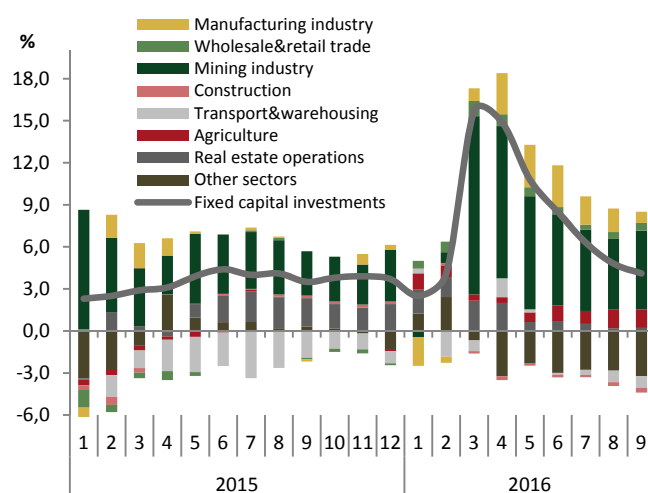
In the third quarter of 2016, the growth in fixed capital investments slowed down as compared to the previous quarter. During January-September 2016, the investment volume increased by 4.1% as compared to the same period of the previous year (Figure 41).

The growth was largely determined by implementation of industrial and innovation projects, infrastructure and housing projects as part of the governmental “Nurly Zhol” Program and the GPIID. At the same time, despite a high share of government investments, the main source of funding for investment is still represented by own funds of enterprises (their share in the structure is 60.7%).

The increased investments in the animal production and cultivation of seasonal crops, particularly owing to government support programs for agricultural producers, promoted the 50.9% growth of investments in agriculture based on performance for nine months of 2016.

Fixed capital investments in the trade sector increased by 32.1% during January-September 2016; this is explained by construction of shopping malls in cities of Astana and Almaty. The growth of investments into the manufacturing industry accounted for 7.7% and was largely driven by investments in the metallurgical industry in Pavlodar region. Despite a positive pattern of fixed capital investments into the sectors which are strategic in terms of the economic and investment policy of the government (agriculture, manufacturing industry, agro-industrial complex, etc.), the mining industry still accounts for the largest share in the structure (36.8%). During nine months of 2016, investments into the sector increased by 17.3% due to investments in extraction of crude oil and natural gas as well as into the geological surveying and exploration. Based on performance in the first half of 2016, over 55% of gross foreign direct investments were channeled to these sectors. Investments attracted for opening of new fields will help replenish the country’s mineral and resource base, increase public revenues and employment

**Figure 41. Fixed Capital Investments, by Types of Economic Activity, Contribution, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations



of the population; however, in the long run this points to a high risk of retention of the raw-material orientation of the domestic economy.

### 2.3.2 Domestic Production

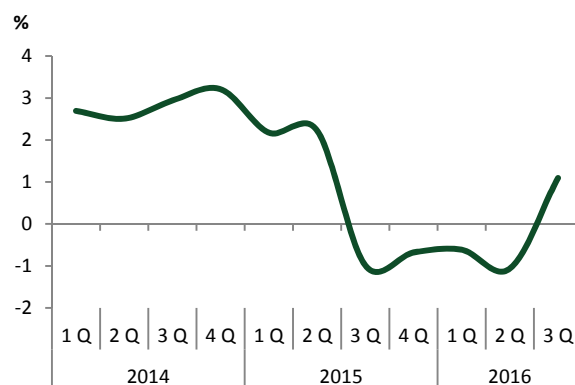
Positive trends in the development of the country's economy which had outlined in the second quarter of 2016, continued in the third quarter of 2016. So, after their reduction during the last four quarters, the rates of growth of a short-term economic indicator increased in the third quarter of 2016 as compared to the corresponding quarter of the previous year and accounted for 1.1% (Figure 42).

As per the industry-based breakdown, a positive trend was retained in the construction sector, agriculture, transport and the manufacturing industry. So, in the third quarter of 2016 versus the third quarter of the previous year, the volume of construction works and services increased by 6.9% as a result of increased residential construction and implementation of infrastructure projects under the "Nurly Zhol" Program (Figure 43). Positive trends in the sector, in their turn, increase investment demand and the demand for construction materials, both domestically produced and imported.

Modernization of a physical infrastructure as part of the government policy aimed to create favorable conditions for agro-business, coupled with the expanded acreage and favorable weather conditions fostered the 6.3% growth in the production of agricultural gross output in the third quarter of 2016 as compared to the corresponding quarter of the previous year.

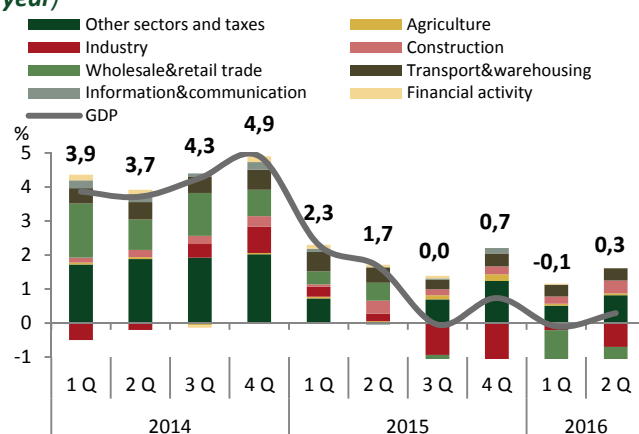
In the third quarter of 2016, the growth in transport services accounted for 3.8% versus the third quarter of 2015 (Figure 44). A positive contribution was made by the increased cargo turnover by automobile and pipeline transport as well as by the increased volumes of transit container transportations along the line of China – Europe – China and by the growth in volumes of transshipped dry cargoes in the port of Aktau.

**Figure 42. Short-Term Economic Indicator (a quarter versus the corresponding quarter of the previous year)**



Source: CS MNE RK, NBRK's calculations

**Figure 43. 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

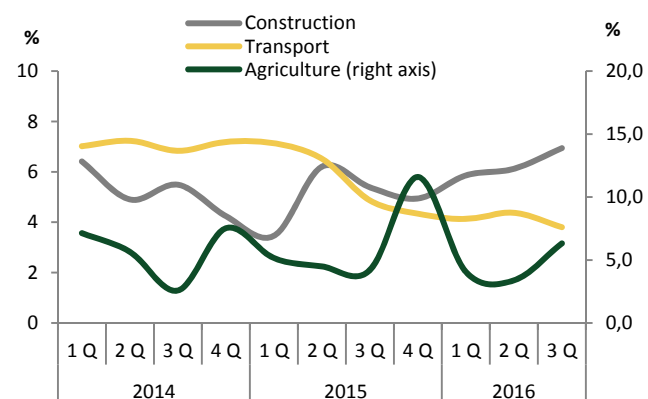
The situation in the manufacturing industry, whose growth in the third quarter of 2016 accounted for 1.0% as compared to the corresponding quarter of 2015, is characterized by instability and non-uniformity of trends depending on a sector. So, together with the increased production from the beginning of the year in the metallurgical (by 7.8%), textile (4.6%), and food industry (3.5%) and in the production of pharmaceutical products (2.1%), production continues to decline in the machine-building industry (-18.6%). Recession in this industry is related to the reduced consumer demand due to the growth in prices of local cars because of the increased cost of imported accessories and spare parts.

Despite positive trends in many sectors, negative dynamics still exists in the mining industry which showed contraction of 6.4% in the third quarter of 2016 versus the corresponding quarter of the previous year. The retention of factors which were building such dynamics in the second quarter of 2016 caused the decrease in volumes of extracted crude oil and gas condensate in the third quarter of 2016. At the same time, recession in the oil industry was partially offset by the increased extraction of natural gas (during January-September 2016 its growth accounted for 4.0%) and extraction of non-ferrous metal ores (9.4%).

Given a relative stability of the external market environment and domestic conditions in the third quarter of 2016 volumes of wholesale and retail turnover increased in annual terms by 1.0% and 1.2%, respectively (Figure 45).

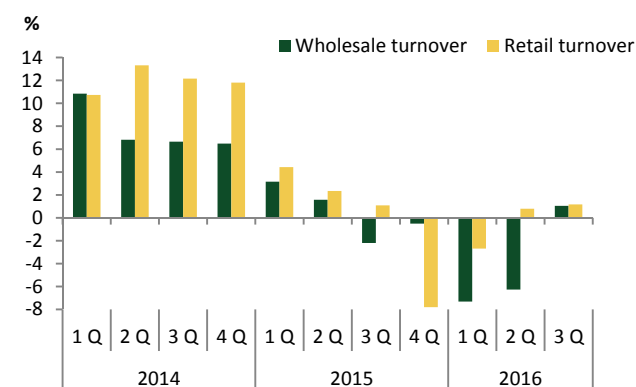
In the third quarter of 2016, the aggregate composite indicator, which summarizes the assessment of the existing situation and expectations of CEOs of companies in the real sector of the economy, grew as compared to the previous quarter, thus indicating a gradual recovery of the business activity. According to the opinion poll, the demand for final products improved in the industry, specifically, in the manufacturing industry, agriculture and construction. In addition, the lending activity improved, including a minor improvement in

**Figure 44. Growth Rates in the Construction Sector, Agriculture and Transport, YoY (a quarter versus the corresponding quarter of the previous year)**



Source: CS MNE RK, NBRK's calculations

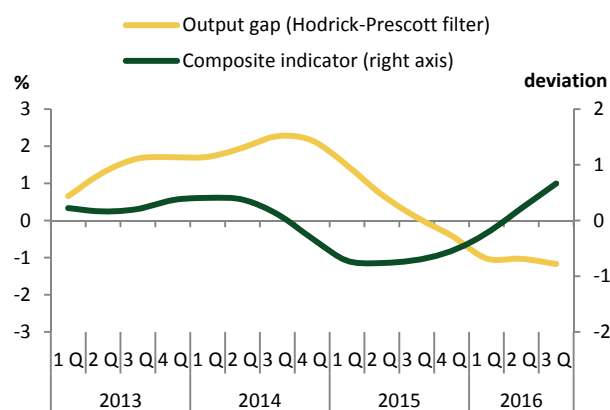
**Figure 45. Growth Rates of Wholesale and Retail Turnover, YoY (a quarter versus the corresponding quarter of the previous year)**



Source: CS MNE RK, NBRK's calculations

the terms and conditions of loans provided for working capital replenishment (interest rates, fees). However, it may take a while to develop and reinforce positive trends in the economic activity in the absence of unforeseen shocks. At the same time, estimation methods which are based on the principles of filtration point to negative values of the output gap at the end of the third quarter of 2016, thus continuing to make a constraining effect on the price growth in the economy (Figure 46).

**Figure 46. Behavior of the Composite Indicator, Cyclical Component of GDP and Output Gap**



Source: NBRK

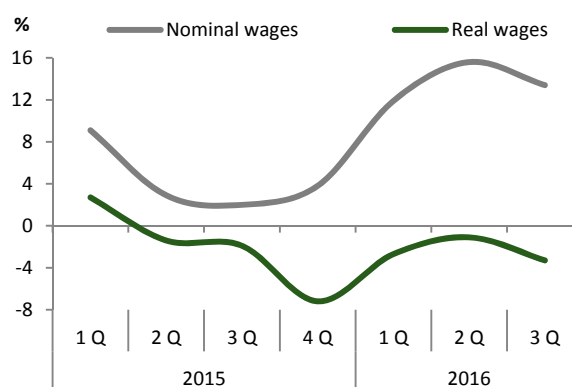
### 2.3.3 Labor Market and Unemployment

A low level of economic activity continues to have a negative impact on the labor compensation.

In the third quarter of 2016, the rates of decline in real wages increased because of a significant curtailment of real wages in the transport sector, in the manufacturing industry, trade and real estate operations (Figure 47).

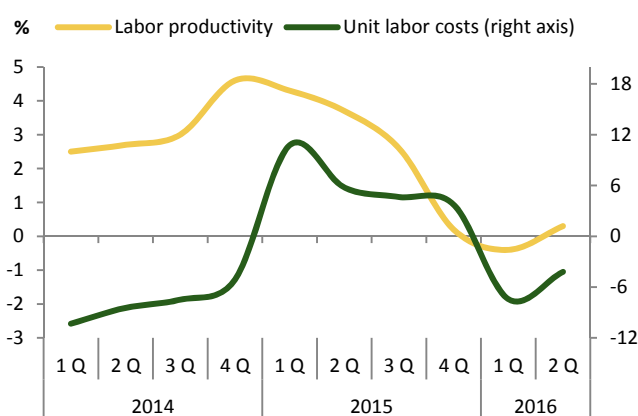
In the second quarter of 2016, labor compensation unit costs continued to go down because of the decreasing number of the employed population and the outstripping nominal GDP growth as compared to the nominal wages (Figure 48). After its decline in the first quarter of 2016, the labor productivity index turned positive in the economy as a whole and based on performance in the first half of 2016 the growth accounted for 0.3%. In the production of goods, labor productivity increased by 2.9% and in the production of services it decreased by 1.0%.

**Figure 47. Nominal and Real Wage Indices, YoY**



Source: CS MNE RK

**Figure 48. Labor Productivity and Unit Labor Costs, YoY**



Source: CS MNE RK, NBRK's calculations

Creation of additional jobs as part of implementation of governmental employment and economic stimulus programs as well as the improved financial performance of enterprises at the end of the second quarter of 2016 helped

keep the unemployment rate stable.

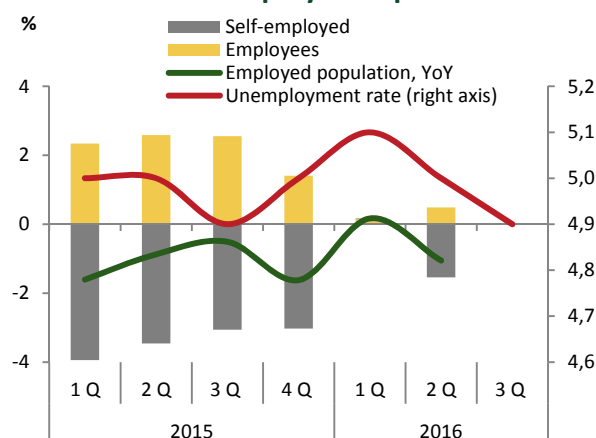
Given the growth in the unemployed population, the decreasing number of the economically active and employed population, in the third quarter of 2016 the unemployment increased by 0.1 pp as compared to the third quarter of 2015, accounting for 5.0%.

In the second quarter of 2016, the employed population decreased by 1.0%. The 5.7% decrease in the number of self-employed people was partially compensated by the growth in the number of employees (Figure 49).

A continuing decline in the employment in the agricultural sector (by 12.8%) is explained by the growth in labor productivity as well as by a low rate of profitability in the sector.

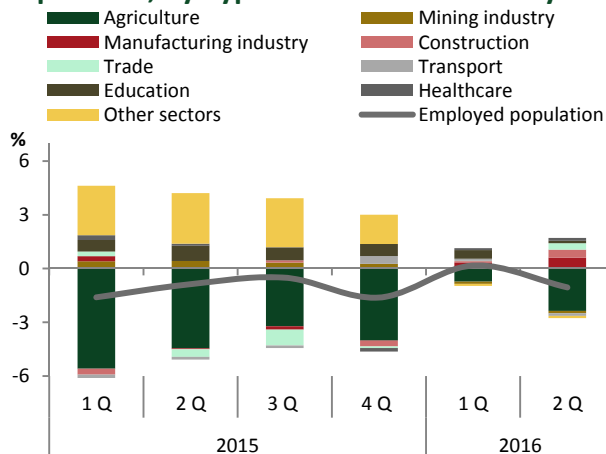
The growth in the employed population in the manufacturing industry (by 10%) and in the construction sector (by 5.7%) was secured by positive growth rates in those sectors. In addition, the increase of salaries to the teaching staff from the beginning of 2016 promoted growth of the employed population in the educational sphere (by 1.2%) (Figure 50).

**Figure 49. Unemployment Rate, Growth Structure of the Employed Population**



Source: CS MNE RK, NBRK's calculations

**Figure 50. Structure of Growth in the Employed Population, by Types of Economic Activity**



Source: CS MNE RK, NBRK's calculations

## 2.4 Fiscal Policy

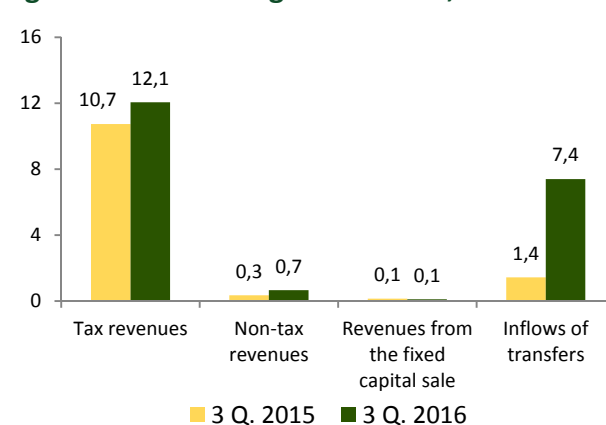
In the third quarter of 2016 as compared to the third quarter of 2015, the budget spending increased in nominal terms by 1.8 times to 20.2% of GDP (in the third quarter 2015 – 12.7% of GDP).

Tax revenues and transfers from the National Fund prevail in the structure of the state budget revenues (Figure 51).

In the third quarter of 2016 as compared to the same quarter of 2015, tax revenues increased by 24.3% mainly due to the increased revenues from the VAT and corporate income tax.

The amount of the guaranteed transfer to

**Figure 51. State Budget Revenues, as % of GDP**



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

the state budget from the National Fund accounted for 7.4% of GDP.

The 2.1 times increase in non-tax revenues during the same period was related to the fact that net revenue that was actually received by enterprises at the end of 2015 exceeded the plan and revenues from the lease of the Baikonur Cosmodrome increased because of a significant movement in the exchange rate of the domestic currency.

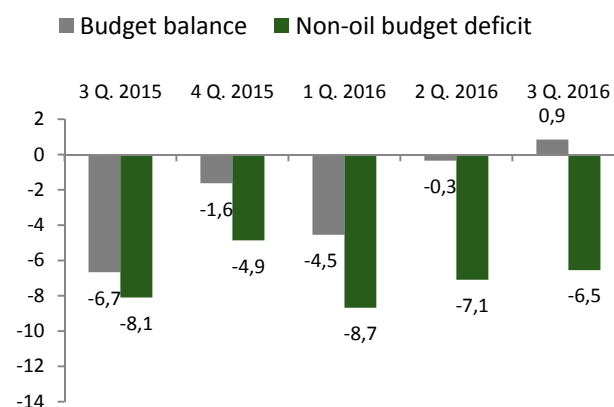
In the third quarter of 2016 as compared to the third quarter of 2015, the state budget spending increased by 10.1% in nominal terms and accounted for 18.7% of GDP (in the third quarter of 2015 – 18.8%). The growth in expenditures was mainly driven by the increased salaries and wages in such spheres as “Social Aid and Social Security”, “Education” and “Healthcare”.

In the third quarter of 2016, the state budget surplus amounted to KZT 101.5 bln. or 0.9% of GDP (in the third quarter of 2015 there was deficit of 6.7% of GDP). This was related to the excess of the budget revenues over the budget spending. The non-oil budget deficit in the third quarter of 2016 still remains high – 6.5% of GDP (Figure 52).

## 2.5 Balance of Payments

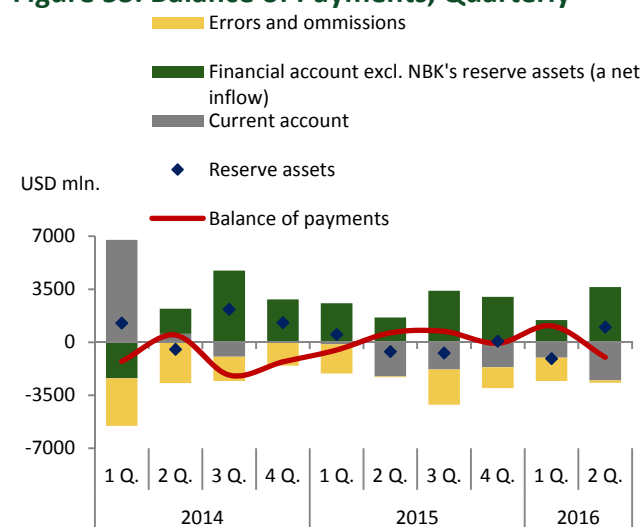
At the end of the second quarter of 2016 as compared to the second quarter of 2015, the current account of the balance of payments was characterized by higher rates of contraction in the balance of trade surplus. However, there was a pressure on the current account put by the decreased negative imbalances on other current account components. A significant inflow of financial resources was secured by proceeds from direct investments and borrowings of the government and corporate sector. An outflow of resources was associated with the growth in foreign assets of residents denominated in foreign securities and with redemption of their debt obligations by banks. Overall net balance of payments in the second quarter of 2016 had been negative and amounted to USD (-)1.0 bln. (Figure 53).

**Figure 52. State Budget Balance, as % of GDP**



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

**Figure 53. Balance of Payments, Quarterly**



Source: NBRK

As a result of the decrease in the balance of trade surplus in the second quarter of 2016 as compared to the same quarter of 2015 by more than 43.0% (to USD 1.9 bln.), the current account deficit increased by 14.7% and amounted to USD 2.5 bln.

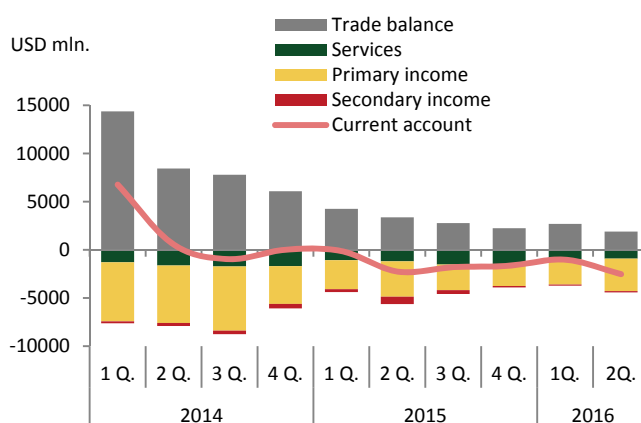
The trend persists where the value of exports is decreasing at higher rates than the value of imports. However, a positive sign is that in the second quarter of 2016 the spread between the rates of decline in exports and imports has been gradually narrowing to 5.2% (in the first quarter of 2016 – 6.4%) (Figure 54).

The value of imports is affected by still relatively low prices of energy carriers (an average quarterly price of oil in the second quarter of 2016 was by 26.0% lower than in the second quarter of 2015), with a less significant reduction in the volumes of physical supplies. The decline in the value of imports was driven by the reduced contractual prices. However, depreciation of the Tenge during the period limited the rates of decline in the value of imports (Figure 55).

The decline in the value of exports in the second quarter of 2016 as compared to the same period of 2015 occurred in all major groups of goods. Export of mineral products and non-ferrous metals decreased by 40.3% and 17.2%, respectively (including the 42.6% decline in the cost of export of oil and gas condensate to USD 4.3 bln). The increased demand for Kazakhstani grain and ferrous metals offset the decline in contractual prices, therefore the decline in the cost of export of these commodities was insignificant (by 8.3% and by 2.5%, respectively). Given a sluggish demand, volumes of imports of goods decreased nearly by one third (28.1%). The largest reduction in imports occurred among investment goods (31.9%) and consumer non-food products (30.8%).

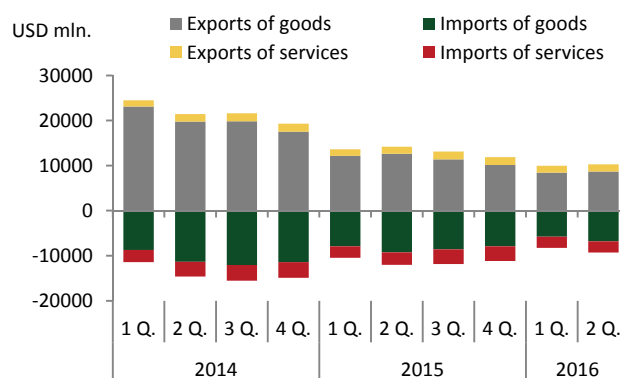
The decreasing volumes of foreign trade operations and import of consumer services resulted in reduction of the deficit of international services (-18.2%). Reduction in the balance of trade in services was secured by

**Figure 54. Current Account**



Source: NBRK

**Figure 55. Export and Import of Goods and Services**



Source: NBRK



reduction in imports of services (-6.1%) and the growth in exports of services (2.5%). So, services of cargo transportations demonstrate a concurrent significant reduction in imports on all types of cargo transportations (-27.1%) and the growth in exports of services by the pipeline (8.4%). As for other business services, the reduction in imports (-22.2%) and the growth in exports (18.1%) was also noted.

Persistently low oil prices and specifics of the Kazakh economy appeared to be the main reason for a negative aggregated indicator of the terms of trade (-25%) (Table 1). However, a significant improvement in the aggregated indicator of the terms of trade in the second quarter of 2016 due to the improvement in the terms of trade with the European Union is worth mentioning. A positive turn in the terms of trade with the European Union was secured by the decreasing volatility in the primary commodity markets and the corresponding growth in proceeds from oil exports to Europe. Due to a weaker tenge against the Russian ruble and inconsistency of the structure of the demand and supply of goods and services in Russia and in Kazakhstan, the terms of trade with Russia significantly deteriorated in the reviewed quarter. However, deterioration in the terms of trade with Russia did not have a significant negative impact on the aggregated indicator of the terms of trade.

The behavior of the real effective exchange rate was mainly determined by the change in the terms of trade for Kazakhstan. But depreciation of the tenge was insignificant and reflected positive expectations of the market participants in response to the growth in oil price and certain foodstuffs as well as a feeble recovery of macroeconomic indicators in the countries of main trading partners. So, during six months of 2016, the real effective exchange rate index of the tenge depreciated by 1.3%. The tenge had depreciated against the CIS-currencies basket by 4.8%, and appreciated by 0.8% against other currencies basket.

In June of 2016 as compared to December 2015, the tenge depreciated in real terms

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

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

	Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	Q2 16
Export prices	-35	-41	-39	-42	-36	-31
Import prices	-20	-7	-9	-2	7	-8
<b>Terms of trade</b>	<b>-18</b>	<b>-36</b>	<b>-33</b>	<b>-41</b>	<b>-41</b>	<b>-25</b>
including:						
<b>Euro zone countries</b>						
Export prices	-41	-46	-46	-49	-41	-34
Import prices	-58	17	-15	-43	15	-10
<b>Terms of trade</b>	<b>40</b>	<b>-53</b>	<b>-36</b>	<b>-10</b>	<b>-48</b>	<b>-26</b>
<b>Russia</b>						
Export prices	-22	-19	-30	-20	-14	-22
Import prices	-30	-22	-31	-23	-13	-1
<b>Terms of trade</b>	<b>11</b>	<b>3</b>	<b>2</b>	<b>4</b>	<b>-1</b>	<b>-12</b>

Source: NBRK

against the US Dollar by 1.6%, against the Euro – by 4.8%, and against the Russian ruble – by 6.0%; appreciation of the Tenge against the Yuan accounted for 2.1% (Figure 56).

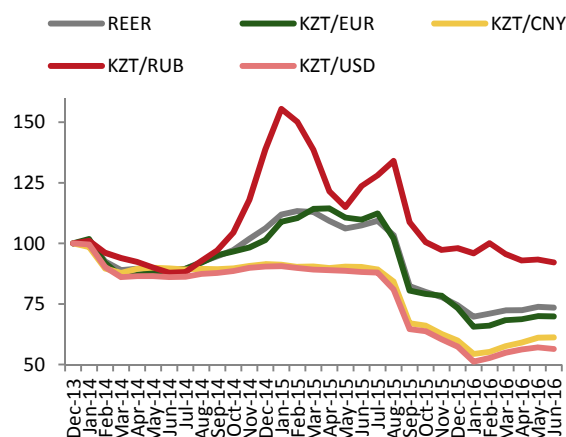
Despite a significant reduction in the balance of trade surplus, the pressure on the current account is decreasing owing to reduction in negative imbalances on other components of the current account. So, a negative balance on primary income decreased by 8.2% due to the growth in revenues generated from financing of foreign affiliated non-residents by residents and from resources of the National Fund invested in foreign assets and international reserves. In addition, payouts on portfolio investments decreased as a result of the decreased debt of residents on issued Eurobonds. At the same time, despite decreased revenues of residents from exports of raw commodities, payouts to foreign direct investors remained at the level of the second quarter of 2015 and amounted to USD 2.9 bln.

The financial account less reserve assets has been negative because 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 investments and medium- and long-term borrowing operations that was partially offset by the outflow on portfolio investments (Figure 57).

As for foreign direct investments, a net capital inflow amounted to USD 3.1 bln. as compared to a net outflow of USD 0.2 bln. in the second quarter of 2015. A gross inflow of foreign direct investments increased by 1.7 times and amounted to USD 5.0 bln. due to investments into the oil and gas extraction, into the metallurgical industry and geoexploration and surveying.

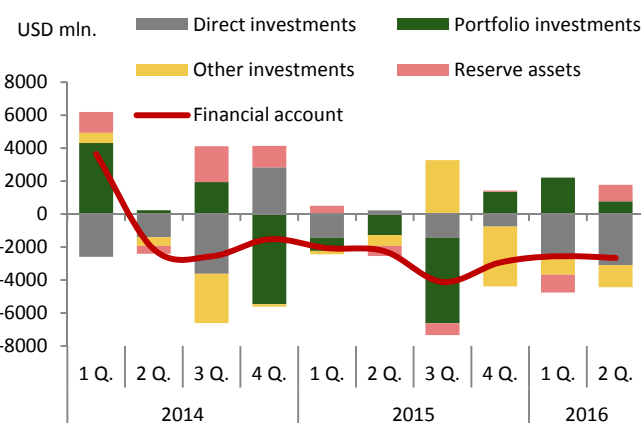
A growth in foreign assets of the non-bank sector and redemption of Eurobonds that were issued earlier contributed to a net outflow on portfolio investments which amounted to USD 0.8 bln.

**Figure 56. Real Effective Exchange Rate Index (December 2013 = 100%)**



Source: NBRK

**Figure 57. Financial Account**



Source NBRK



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

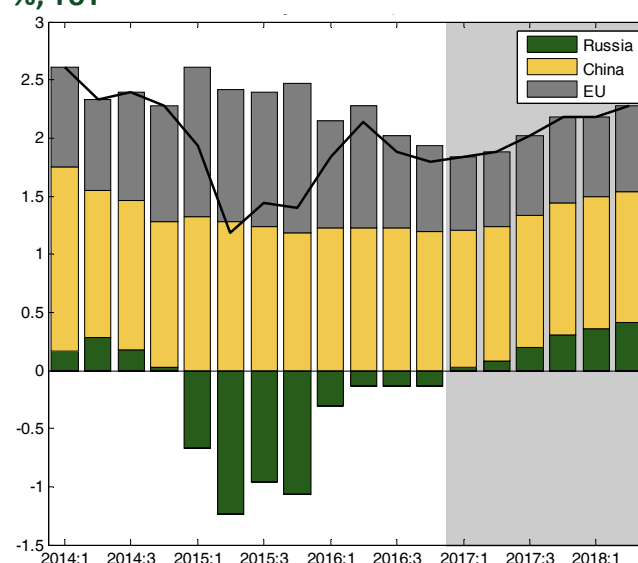
The forecast of macroeconomic indicators was prepared on the basis of statistical information as of October 27, 2016.

### 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 53.4% of the total foreign trade turnover of Kazakhstan in the second quarter of 2016, had not undergone dramatic changes as compared to previous forecasts presented in the Inflation Report for the second 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 feeble (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.

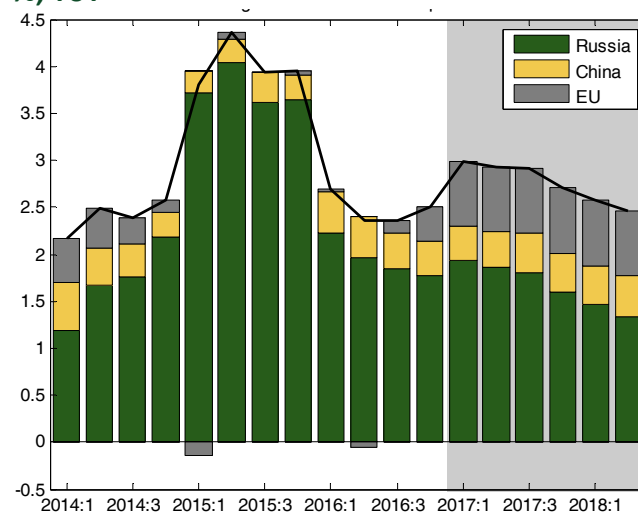
The inflationary background in countries-main trading partners remains erratic (Figure 59). So, according to estimates of international organizations, the consumer inflation in the EU will reach 1.3% by the second quarter of 2018. The main reasons are a soft monetary policy, extended volumes of the asset purchase program and targeted long-term refinancing operations. Forecasts regarding inflation in the Russian Federation became more positive and have a downward path from the first quarter of 2017 against a persisting low internal demand. First of all, a more positive inflation pattern was driven by appearance of some certainty regarding Russia's fiscal policy, which assumes a gradual reduction in the budget deficit of Russia from 3% in 2017 to 1.2% in 2019.

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



Source: NBRK's calculations

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



Source: NBRK's calculations

In the medium term, world food prices are expected to remain at their existing levels. The main factors may include the growth in export supply of cereals and a generally high level of stocks in the world that is related both to a record-high wheat crop and to the excess over average rates of corn crops in the North America. As a result, external food inflation which persists at a stable level will be putting a moderate pressure on inflationary processes in Kazakhstan.

In January-October 2016, an average price of oil (Brent) was USD 42.9 per barrel. Therefore, the baseline scenario remained unchanged.

Expectations regarding external monetary conditions in the medium term have eased to a certain extent. However, the tightening of monetary conditions is anticipated given that the US Fed may raise its federal funds rate, thus bringing a number of significant risks for Kazakhstan 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 in 2016 is expected to be at 0.2-0.5%. The largest contribution to the GDP growth will be made by gross capital formation due to the growth in fixed capital investments, mainly of a raw material orientation, which does not give grounds for the increase in a long-term growth potential of the Kazakh economy that is estimated to be at 3-4%.

Weak positive growth rates, to a larger extent, are associated with large-scale economic support measures in 2016-2017. However, these measures translate into a more moderate reduction in import volumes (because of the growth in investment imports), thus negatively affecting net exports and reducing their efficiency. In addition, these

measures support the domestic demand which results in a weaker influence on the inflation by the monetary policy.

Forecasts regarding the economy's growth in B 2017 have not changed; the economy's growth is estimated to be about 1.5-2%. (Figure 60). Further GDP growth rates will be determined by adaptation to the macroeconomic situation and will depend on effectiveness of the governmental economic support programs, institutional reforms and dedollarization.

According to the National Bank's estimates, the output will be below its potential level until the first quarter of 2018.

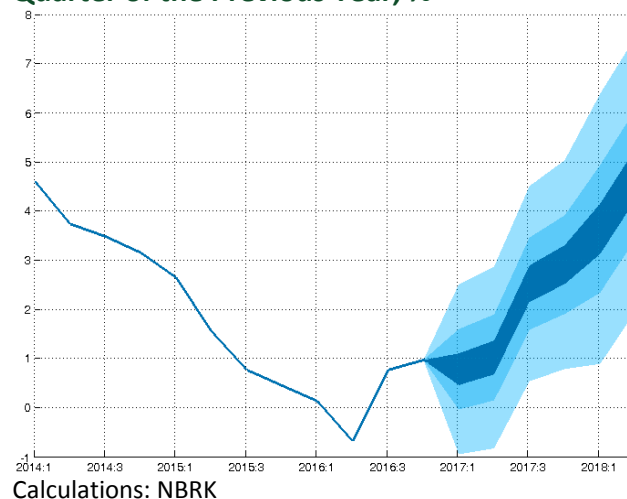
Forecast of real export and import indicators had not changed versus the Inflation Report for the second quarter of 2016. Thus, economic interpretation in the dynamics of exports and imports of goods and services remained unchanged.

Household consumption growth rates are expected to be sluggish as a result of a shift in the consumption pattern towards foodstuffs. This fact is confirmed by statistics on the retail sales; according to such statistics, the turnover of foodstuffs has been increasing since 2015 while the turnover of non-food products has been decreasing. Thus, if oil prices stabilize, consumption could be expected to increase in the medium term as the extent of dedollarization decreases and confidence in economic prospects is gained.

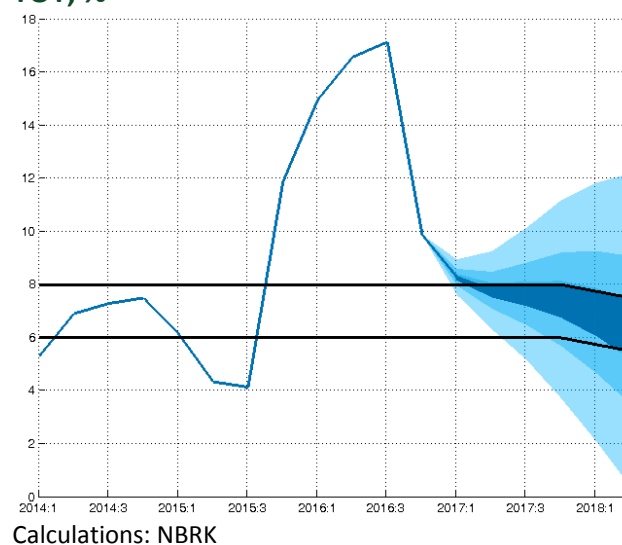
Forecasts regarding the government consumptions have undergone changes. In connection with the Government's plans to reduce the non-oil deficit, a neutral fiscal policy is anticipated in the medium-term.

Under the baseline scenario of USD 40 per barrel, further deceleration of inflation and its reversion to the target band is expected, as was previously forecasted, after the peak of inflation in the third quarter of 2016 (Figure 61). Volatility in the oil market has a negative impact on devaluation and inflationary expectations. A significant contribution to the inflation growth in the forecast period is still made by the non-

**Figure 60. GDP, Quarter to the Corresponding Quarter of the Previous Year, %**



**Figure 61. Inflation, Average for the Quarter, YOY, %**



food component due to a high share of imports.

An external inflationary background for the food component of the inflation in the medium term is expected to be moderate because of assumptions related to stable prices of cereals.

A negative output gap will be constraining factor for the food inflation and non-food inflation in 2016-2018.

Despite the fact that the base rate was lowered, the nature of implemented monetary policy in the medium-term horizon is assessed as moderately constraining; this is related to the absorption of the tenge liquidity by the National Bank that is of a structural nature. In the medium term, the economic activity will be supported by implementation of the anti-crisis and other economic stimulus measures as well as by a gradual recovery of the domestic demand.

### 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 are significant given the uncertainty in the oil market. Under this scenario, the National Bank will be tightening its monetary policy. Inflation will be going above the upper boundary of the target band in 2017 and in the first half of 2018 i.e. throughout the entire forecast period.

Additional scenarios which, if realized, may have a significant effect on the inflation forecast are:

- the scenario which assumes a recovery of oil price (Brent) to USD 50 per barrel in the medium term. In general, the results obtained do not significantly differ from the results of the previous forecasting round;

- in case of inconsistency of the path for reduction in the non-oil state budget deficit for 2017-2018 as published in the Projection of the Socio-Economic Development for 2017-2021, an additional pressure on the tenge exchange rate is possible which would ultimately have an impact on the growth of inflationary expectations;

- a more rapid growth in prices of cereals in the medium term may lead to higher food prices and, accordingly, to a higher inflation in 2017 as compared to the baseline scenario;

- a dramatic and a more significant tightening of the Fed's policy without preliminary preparatory discussions would affect redistribution of global assets, thus potentially increasing inflationary expectations;

- a low impact of the interest rate channel on the economic activity and the exchange rate of the tenge against the US Dollar is built in the forecast. In this regard, if the impact of monetary policy on the real economy is underestimated as compared to the fact, this may lead to a more significant pressure on the domestic demand and, consequentially, to a lower inflation;

- reduced confidence in the National Bank may tell on a longer process of anchoring the inflationary expectations. In turn, this may cause a slower reduction in expectations as assumed under the forecast;

- a change in the regulated prices may also serve as a trigger for the growth in inflationary expectations;

- an increased oil price volatility which is not taken into account in forecasting key variables would conduce higher devaluation and inflationary expectations; dedollarization may stop this, affecting the forecast 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.

**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.

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

**Consumer Price Index (CPI)** – the change in the overall level of prices for goods and services purchased by the population for consumption. The consumer basket of Kazakhstan for calculation of inflation reflects the structure of household expenditures and 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 Targeting** – is a monetary policy regime which is oriented at achieving a target inflation rate.

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

**Short-Term Macroeconomic Indicator** is calculated to ensure effectiveness and is based on the change in output indices on key sectors: agriculture, industry, construction, trade, transport and communication, which account for over 60% of GDP. The indicator is built without recalculations for the unobserved economy and without the use of other macroeconomic adjustments.

**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.

**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.

**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.

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

**NDF** – non-deliverable forwards used to hedge foreign exchange risks. **A Short-Term Macroeconomic Indicator** is calculated to ensure effectiveness and is based on the change in output indices on key sectors: agriculture, industry, construction, trade, transport and communication, which account for over 60% of GDP. The indicator is built without recalculations for the unobserved economy and without the use of other macroeconomic adjustments.



**LIST OF KEY ABBREVIATIONS****LIST OF KEY ABBREVIATIONS**

GDP – Gross domestic product  
EU – European Union  
ECB – European Central Bank  
CPI – consumer price index  
GPIID – Government Program for Industrial and Innovation Development  
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