



NATIONAL BANK OF KAZAKHSTAN

Inflation Report

The First Quarter of 2018

Almaty, Kazakhstan

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

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as at 15.05.2018.

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SUMMARY

On June 4, 2018, the National Bank made the decision to reduce the base rate further. This is the fourth cut of the base rate for the year-to-date – from 10.25% to 9.00%, while retaining the band of +/- 100 basis points.

The inflation rate continues to stay within the target band of 5-7% set for 2018. In May, the annual inflation decreased to 6.2% as compared to 7.1% in December 2017. The factors which caused deceleration of inflation included the declining producer prices in the food industry, the decreasing external inflation background along with a relatively stable exchange rate of the tenge, and neutral impact of the fiscal policy.

Despite a downward trend, households' inflation expectations remain unstable. Negative impact of the external background in April which caused nominal depreciation of the tenge against the US Dollar resulted in a short-term surge of inflation expectations which had considerably decreased in May. The quantitative assessment of inflation as expected by households a year ahead accounted for 6.0% in May (7.1% in December 2017) and is at the upper boundary of the inflation band of 4-6% for 2019.

The National Bank, as part of the "May-June 2018" forecast round adjusted its inflation forecast for this year and the year to come. According to updated forecasts, in 2018 the annual inflation will be within the target band of 5-7%, and in 2019 it will start to smoothly enter into a new target band of 4-6%, while remaining at the upper half of the band. As compared to the previous forecast round – "February-March 2018" – the inflation path was revised upwards.

The National Bank continues to assess monetary conditions as neutral. A new level of the base rate in real terms is in line with long-term potential rates of the economic growth, the exchange rate of the tenge in real terms is tending to its equilibrium, and the situation in the money market is still characterized by a structural liquidity surplus. However, in the attempt to manage inflation expectations and to reduce them further, it is possible that monetary conditions will be of a tighter nature in the coming years.

At the end of the first quarter of 2018, the real GDP growth was estimated at 4.1%. According to updated forecasts of the National Bank, under the baseline scenario which assumes the price of oil (Brent) to be at USD 60 per barrel, the real GDP growth in Kazakhstan will account for 3.5% at end-2018. The economic activity dynamics in 2018 is assessed in a more positive manner as compared to previous assessments; this is related to the fact that the domestic consumer and investment demand became more active. In the medium term, the economy will be growing at a more moderate pace due to expected deceleration processes in the pattern of consumer demand and exports. Under the baseline scenario, at end-2019 the economic growth in Kazakhstan will account for 2.7%.

According to the National Bank's updated estimates, the output gap will be positive for the first time since 2014; however, a positive gap will be observed in the near term whereas in the medium term the output will reach its potential levels. Therefore, a pro-inflation feature of the output gap will be limited.

The National Bank revised the risk map of mid-term forecast that will be limiting the pace of further disinflation processes. The growth of domestic consumer demand against the growing cash income of the population supported by the positive pattern of consumer lending represents a key risk. There is still a probability of supply shocks which are mainly associated both with the market of fuel and lubricants and with a high index of producer prices.

Pro-inflation risks associated with the tightening of external monetary conditions as well as with expected acceleration of imported inflation associated with the growth in world energy prices and food prices and possible acceleration of inflationary processes in trading partner countries, have been revised upwards.

However, the risk of the oil price drop to USD 40 per barrel given higher current prices of energy resources decreased. An upward trend in the energy market was accompanied by the growth in demand on the part of India and China as well as by a possible reduction in the supply of oil on the part of Iran. Mitigation of this risk decreases uncertainty about the exchange rate dynamics and the import of inflation. The probability of realization of risks of fiscal impulse and volatility of oil prices remained unchanged.

Meantime, a riskier scenario which assumes that oil price would fall to USD 40 per barrel was considered by the National Bank along with the baseline scenario. If this scenario is realized, inflation may go beyond the upper boundary of the target band in 2018-2019, and the GDP growth rates will slow down to 1.2% in 2019. A possible reaction of the National Bank would be to tighten its monetary policy, and the monetary policy conditions would change from neutral to constraining ones. In future, in its assessment of the balance of risks, the National Bank will take into account not only the external and internal factors described above but also decisions regarding the government's fiscal and pricing policy since such decisions may significantly affect the inflation and GDP.

I. MACROECONOMIC ENVIRONMENT AND THE FINANCIAL SECTOR DEVELOPMENT

1. EXTERNAL MACROECONOMIC ENVIRONMENT

1.1 Situation in the Global Commodity Markets

1.1.1 Oil Market

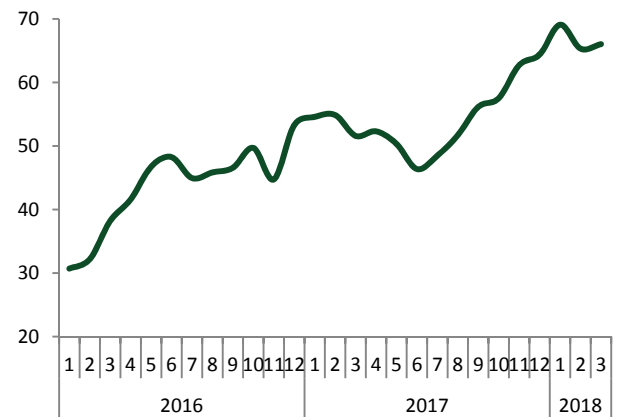
At the end of the first quarter of 2018, the average price of oil (Brent) was USD 66.8 per barrel (Figure 1). The price grew by 8.6% as compared to the previous quarter and by 24.5% as compared to the corresponding quarter of 2017.

The oil price was significantly affected by the deepening shortage of oil that was driven by an increasing global demand and the decelerating growth rates of supply on the part of some oil producers (Figure 2). As a result of the situation which developed in the first quarter of 2018, the oil consumption exceeded the volumes of its production.

The growth rates of global oil consumption slightly accelerated due to the following factors. First, imports to the USA increased significantly given a positive trend in the country’s industry and transport sectors. Second, in India the demand has been growing for four quarters in a row given the improved situation with truck freights after the reform of the national taxation system as well as the growing popularity of cars and scooters in the country. Large imports of oil in China as consequence of the increase in oil refining capacities and the buildup of strategic fuel reserves had a positive impact on the growth of final oil consumption in the world. The reduced demand for oil on the part of Latin American countries and the EU member countries served as a constraining factor (Figure 3).

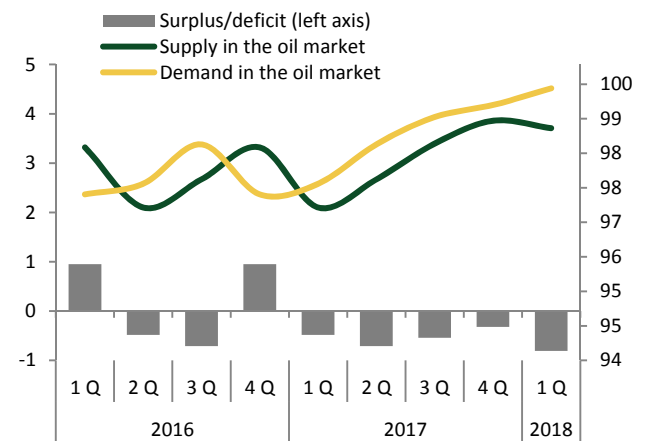
Growth rates of the global oil production streamed up after their significant drop at the end of 2017 (Figure 4). A considerable input in the growth of the global oil production is still made by countries outside of OPEC where the oil extraction increased by 1.3% in the first quarter of 2018 (in the fourth quarter of 2017 – 1.1%). The USA once again acted as the leader in the oil production among countries outside of OPEC; volumes of oil production in the USA increased by 11.3% versus the corresponding quarter of 2017. A dramatic reduction in oil extraction in countries outside of OPEC was

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



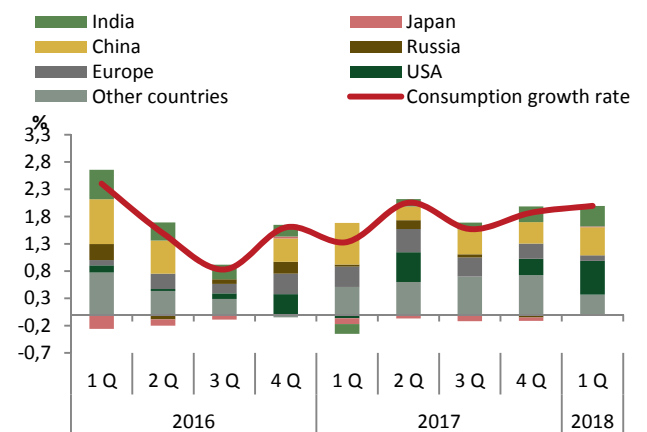
Source: U.S. Energy Information Administration (EIA)

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



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

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



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

noted in Canada and the EU due to the fact that many oil refineries were closed for a regular overhaul and also because of yet another shutdown of the Forties pipeline in the North Sea.

In general, at end-March 2018 OPEC countries made good on the agreement on reduction of oil production. Angola, Kuwait, the UAE and Venezuela reduced oil production. Reduction in the oil production by OPEC countries was slightly offset by the increased production volumes in Iraq and Equatorial Guinea.

1.1.2 Non-Ferrous Metals Market

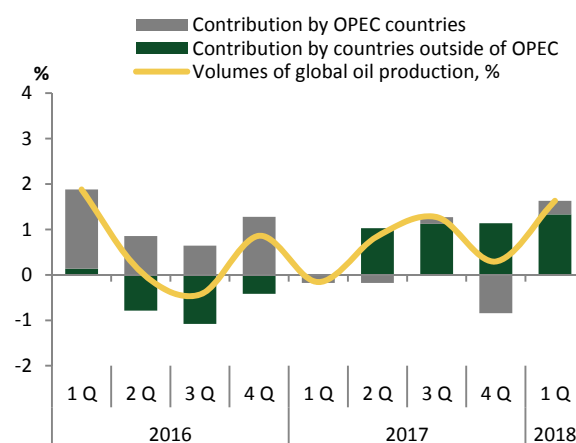
In the first quarter of 2018, non-ferrous metals markets showed a divergent trend: the price of aluminum, copper and lead declined and the price of zinc slightly increased. As a result, the weighted average price index of these metals decreased after a solid growth in the previous quarter (Figure 5).

In the past period, a considerable negative impact on the price behavior in the non-ferrous metals markets was made by a slowing trading activity in China given celebration of the Chinese New Year as well as by the introduction of customs duties for imports of steel and aluminum by the USA. A positive effect on the base metals market was made by some depreciation of the US Dollar, despite a continuing cycle of interest rate increase.

According to Thomson Reuters, the price of aluminum declined by 1.2% in March 2018 versus December 2017. Apart from the abovementioned negative factors, the price of aluminum was also influenced by the anti-dumping duties for imports of aluminum foil from China introduced by the USA. Along with that, the price of the metal remained high because of the reduced production in China as well as due to a stable demand on the part of Japan and the North America.

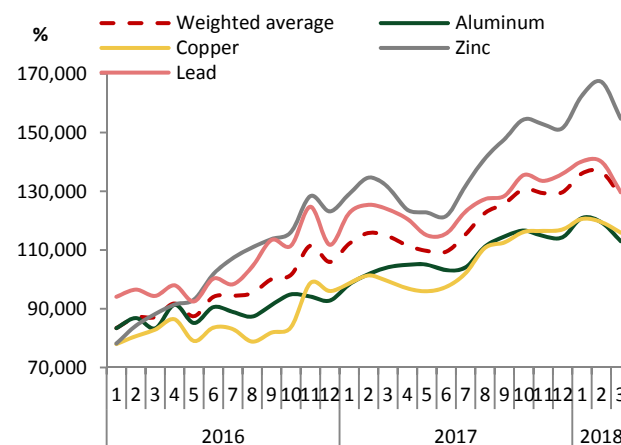
Over the quarter, the price of copper had declined by 0.9%. Such decline was to a large extent driven by the growth in world reserves. The price behavior in the copper market was also supported by the growing concerns regarding reduction in supply from the world's

Figure 4. Global Oil Production, YoY



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

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



Source: NBRK's calculations based on data from Bloomberg

leading producer of copper – Codelco – where risks of unsettled employment disputes increased.

Over the quarter, the price of zinc had increased by 2.1% given the decreasing world reserves as well as due to difficulties in the transportation of the metal because of unfavorable weather conditions in the North-Western China where zinc is produced.

The price of lead had declined by 4.6% over the quarter. The price of lead is maintained at the existing levels given a possible reduction in supply by the Chinese lead producing factories because of the increased air pollution.

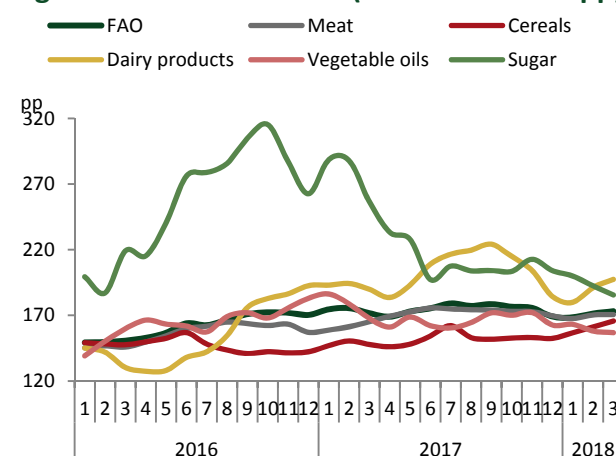
1.1.3 Food Market

According to the Food and Agriculture Organization of the United Nations, in March 2018 the FAO Food Price Index made up 173.1%; as compared to December 2017, prices increased by 2.4% (Figure 6). The index increased under the impact of the growth in prices of dairy products, cereals and meat. The constraining factors for the growth had been the prices of vegetable oil which were declining in February and in March 2018 as well as low-key performance in the sugar market.

Over the quarter, prices of cereals have increased by 8.7%, reflecting the growth in prices of wheat, corn and rice. Wheat price quotations increased due to the expected reduction in supply on the part of the USA against the backdrop of rainless weather and reduction in wheat acreage in 2018, and also on the part of Europe because of cool and damp weather in some countries of the region. Prices of cereals were also significantly supported by a high global demand for corn and rice, deteriorated prospects for the harvest of corn in Argentina as well as the grown world oil prices.

The price of dairy products increased by 4.0% as compared to March 2017, and by 7.0% - as compared to December 2017. The intensified price growth was caused by a significant growth in demand, especially on the part of China, the USA and Europe. The situation with the growth in prices of dairy products was heated up by lower than expected volumes of milk

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



Source: UN FAO

production in New Zealand.

The 0.5% increase in prices of meat in March as compared to December 2017 occurred because of an active demand for lamb meat in China as well as due to the reduced supplies of pork from Europe. The demand for beef was sluggish as a result of growing expectations about the increased supplies from New Zealand.

During first three months of the year sugar prices declined by 9.1%, having reached the three-year minimum due to the expansion in production in Thailand, India and Europe which are the largest sugar producers in the world.

Prices of vegetable oil declined in connection with the fall in prices of soybean oil, rapeseed oil and sunflower oil. The growth in prices of palm oil served as a constraining factor against the expanded global demand and the EU's intentions to resume imports of biodiesel.

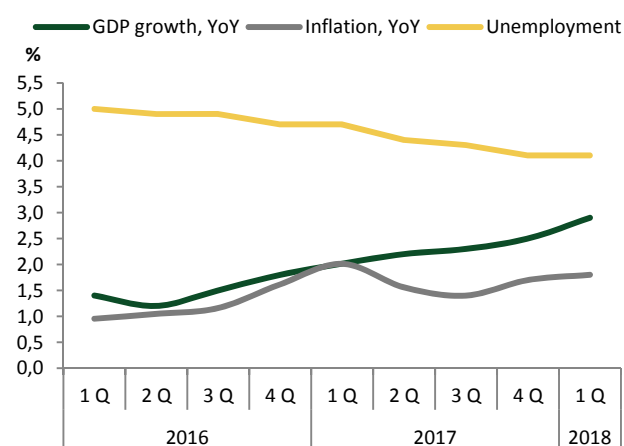
1.2 Economic Situation in the USA and the Fed's Rate

In the first quarter of 2018, the US economy had demonstrated a positive growth trend in the environment of growing world oil prices as well as the increased activity of economic entities as a result of tax abatements that were introduced earlier and the continuing protectionist policy. According to the data from the US Bureau of Economic Analysis with the US Ministry of Trade, the growth of the US economy in the first quarter of 2018 accounted for 2.9% versus the corresponding quarter of 2017 (Figure 7). A significant increase in gross domestic investments, especially for the purchase of equipment and non-residential premises, as well as a significant growth in government spending and exports served as key growth drivers. A slowdown in consumer spending in connection with a high base of the previous year had a constraining effect on the US economy's growth.

The annual inflation slightly accelerated, which is explained by the growth in purchases of motor vehicles and leisure goods; besides, the price of utilities was growing, particularly the price of electricity and gas.

The labor market continued to demonstrate a positive trend. The number of

Figure 7. US Economic Performance

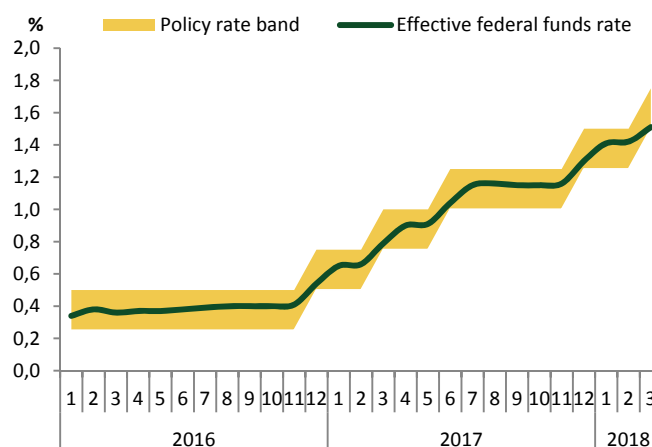


Sources: U.S. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics (BLS)

workers who applied for unemployment benefits fell to the lowest level over the last 50 years. Also, wages and benefits to employers demonstrated growth. Unemployment rate has not changed as compared to the fourth quarter of 2017 and accounted for 4.1%.

Based on its session in March 2018, the US Fed's Federal Open Market Committee raised its policy rate from 1.00-1.50% to 1.25-1.75% per annum (Figure 8). This was the fourth time when the Fed was raising its policy rate since March 2017 when the interest rate was at 0.75-1.00%. The decision to raise the rate was motivated by a steady development of the labor market as well as by moderate growth rates of the US economy. According to Fed's forecasts, in 2018 the policy rate will be 2.1%, and in the long run – 2.9%.

Figure 8. US Rates



Source: Reuters

1.3 Economic Situation in Countries – Kazakhstan’s Trading Partners

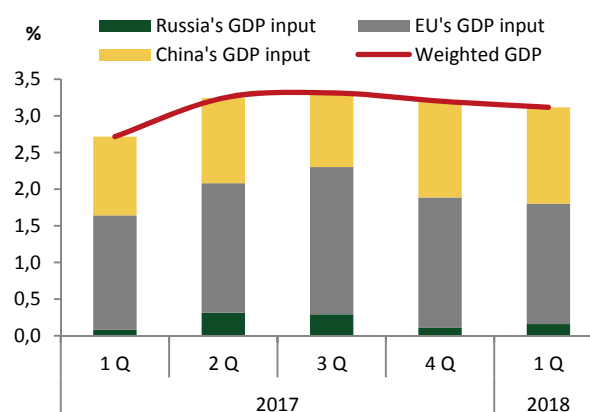
1.3.1 Aggregate External GDP

Aggregate external GDP which is calculated on the basis of the data about Kazakhstan’s international trading structure and is characterizing the demand for Kazakhstani exports, in the reviewed period had slightly decreased as compared to the fourth quarter of 2017 (Figure 9). The main reason for such decrease had been the slowdown of the EU’s economy whereas the growth of the Russian economy made a positive contribution. The input by the Chinese economy remained unchanged (Figure 10).

The annual GDP growth rates in China remained unchanged throughout three quarters accounting for 6.8% in the first quarter of 2018.

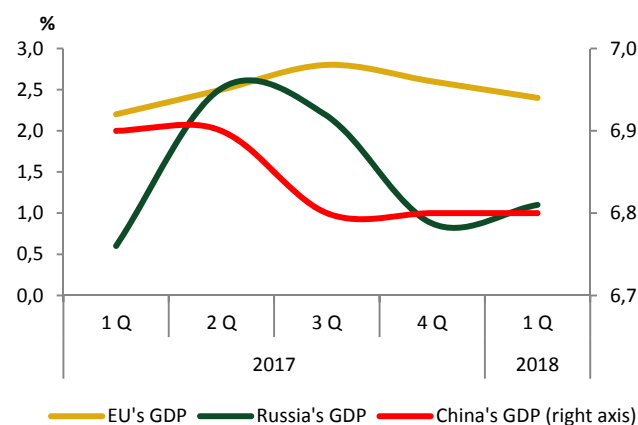
A positive effect on the economic growth in China in the reviewed period was made by the increased industrial production, despite measures taken to limit the environmental pollution. The growth in retail sales was driven by the increased domestic consumption as well as by the global economic growth which secured a high demand for export goods. Also, the real estate market is growing and volumes of fixed capital investments are increasing; the fixed capital is still financed mainly with public funds. A possible deterioration of trade relations with the USA still represents an

Figure 9. Weighted External GDP , YoY



Source: NBRK’s calculations

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



Source: Bloomberg, Eurostat, Rosstat

external risk factor. Internal risk factors include more decisive measures of the Chinese authorities in struggling with financial risks, particularly, curtailing large infrastructure projects in regions in order to reduce the volumes of debt as well as closing up a number of ineffective industrial enterprises which pollute the environment.

According to preliminary data of the Eurostat, the economic growth in the EU in the first quarter of 2018 accounted for 2.4%. Some slowdown in the European economy was to a large extent related to the slowing rates of growth in the industrial production in Germany and France.

The growing cost of export goods as a result of appreciation of the European currency as well as a possible tightening of financing terms in the global markets may serve as constraining factors for a further growth in the EU's GDP.

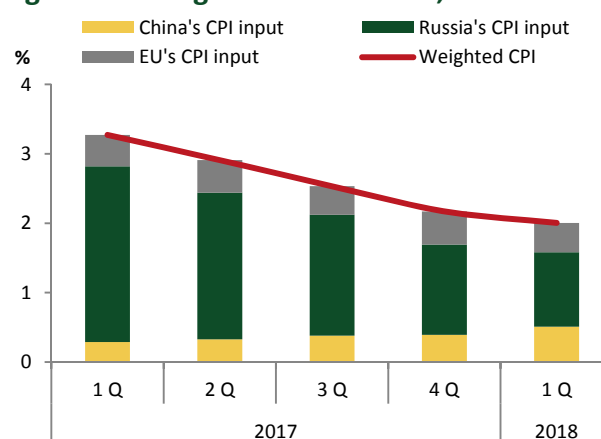
According to the initial assessment made by the Ministry of Economic Development of Russia, in the first quarter of 2018 the growth rate of the Russian economy accounted for 1.1%. The GDP growth was driven by the increased industrial production and the freight turnover. In the environment of high demand for energy resources on the part of Europe, the increased industrial production is associated with the growing extraction of coal and gas. Expansion in extraction of mineral resources resulted in the growth of the freight turnover, including the pipeline freight.

A negative impact on the economic growth was made by reduction in volumes of construction works, which, in turn, resulted in a slowdown of fixed capital investments.

1.3.2 Aggregate External Inflation

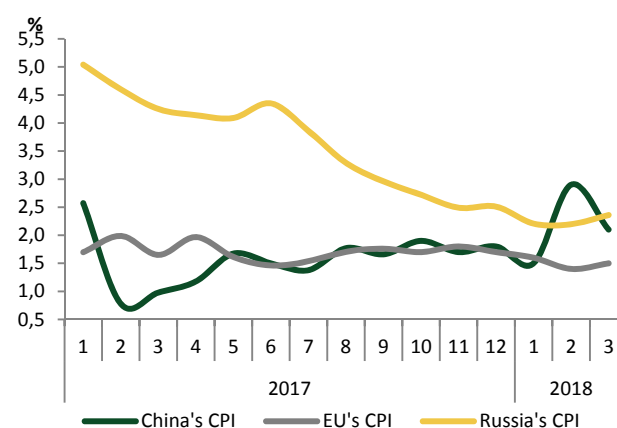
Aggregate external consumer price index which is calculated based on the share of main trading partners in Kazakhstan's imports continues to demonstrate a decline (Figure 11). Such decline is caused by low inflation in Russia and in the EU. At the same time, inflation in China is growing thus resulting in the increased input in the index by this country (Figure 12). The decreased weighted external index speaks

Figure 11. Weighted External CPI, YoY



Source: NBRK's calculations

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



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

for the weakening of external inflationary pressure on consumer prices in Kazakhstan.

The intra-quarter inflation pattern in China was divergent; after its acceleration to 2.9% in February, in March inflation slowed to 2.1%. A dramatic growth of inflation in February was caused by expansion of consumer demand in connection with celebration of the Chinese New Year; this entailed the growth in consumer prices and transport services (the growth in the passenger turnover).

The largest role in deceleration of inflation in March was played by the decline in the price of foodstuffs, particularly, because of the fall in prices of pork meat and vegetables which are the key elements of the consumer basket in China.

Despite a growing business activity in the EU, inflation remains moderate accounting for 1.5% in March. Low inflation was caused by feeble growth rates of real disposable income per capita. Low inflation was observed in Italy, Greece and Cyprus.

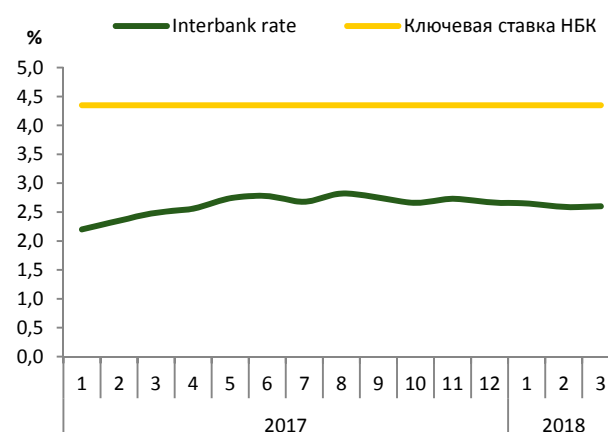
After deceleration of inflation in Russia in January-February to 2.2%, in March this indicator had grown accounting for 2.4%. Such acceleration of inflation was caused by the increase in prices of fruit and vegetable production given an earlier depletion of stocks as compared to 2017 as well as the adjustment of tariffs for passenger traffic by railway. Risk of a certain growth of inflation in the near term include the growth in consumer demand in view of the increase in wages in the budget-funded sector, depreciation of the ruble as a result of new sanctions on the part of the USA, the increased demand for some services due to the World Football Championship.

1.3.3 Money Market Rates

In the first quarter of 2018, the People's Bank of China retained its policy rate at the existing level (Figure 13). However, the average monthly over-night SHIBOR slightly increased from 2.59% in February to 2.60% in March 2018.

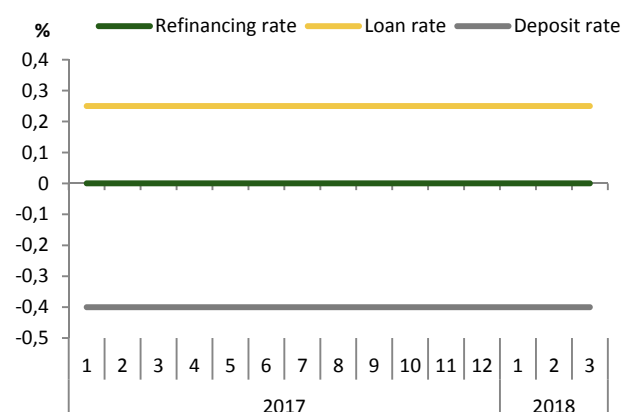
A sluggish growth of real wages in the EU serves as a constraining factor for anchoring inflation about its target of 2%. Since inflation

Figure 13. Rates in China



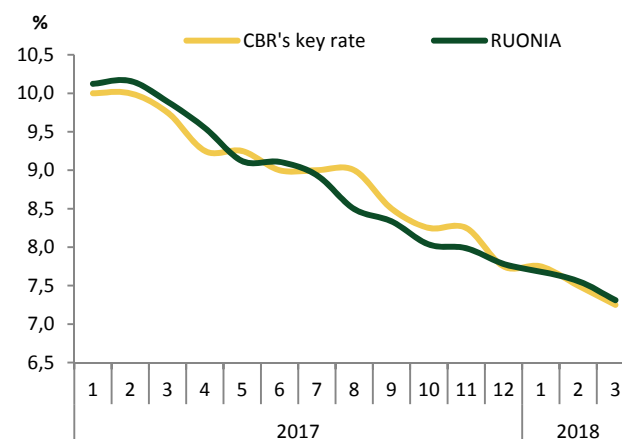
Source: Reuters

Figure 14. ECB's Rates



Source: Reuters

Figure 15. Rates in Russia



Source: Reuters

stays below the 2% target, the ECB left the key money market rates unchanged (Figure 14). Also, the regulator will continue with its program of asset purchases in the monthly amount of EUR 30 bln. till September 2018 with a possibility of its extension in case if a steady inflation trend will not be in line with inflation goals.

In the environment of a steadily low inflation rate as well as the downward pattern of inflation expectations, the Bank of Russia in March 2018 made the decision to lower its key rate from 7.50% to 7.25% (Figure 15).

Nonetheless, volatility of the ruble, the growth in real wages at pace which outstrip the growth rates of labor productivity as well as the change in the household behavior pattern towards consumption still represent the risk factors for increase in inflation.

1.3.4 Foreign Exchange Rates

The average monthly exchange rate of the Yuan against the US Dollar appreciated from CNY 6.4274 in January 2018 to CNY 6.3185 in March 2018 (Figure 16).

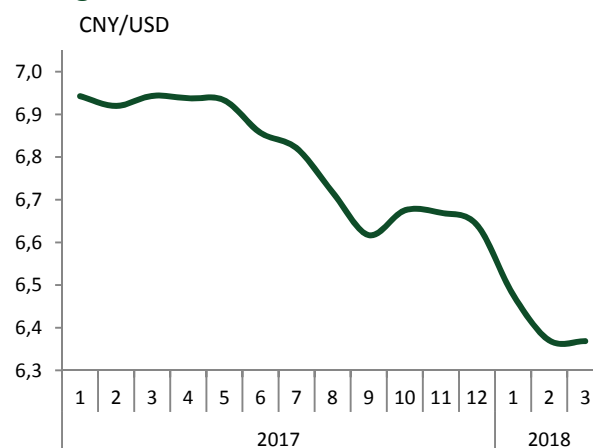
The main reasons were depreciation of the US Dollar in the global market as well as concurrent inclusion of the Yuan into international reserves of several central banks in the European Union. The expectation about the start of oil futures trades in the Yuan was also conducive to appreciation of the Chinese currency.

During the reviewed period, the Euro appreciated from USD 1.2190 on average in January 2018 to USD 1.2334 per EUR on average in March 2018 (Figure 17). One of important reasons for appreciation of the Euro was political stabilization of the situation in the region given the agreement reached regarding creation of the coalition government in Germany.

The Russian ruble had been demonstrating a depreciation trend against the US Dollar throughout the first quarter of 2018. Such behavior was to a larger extent determined by volatility of world oil prices (Figure 18).

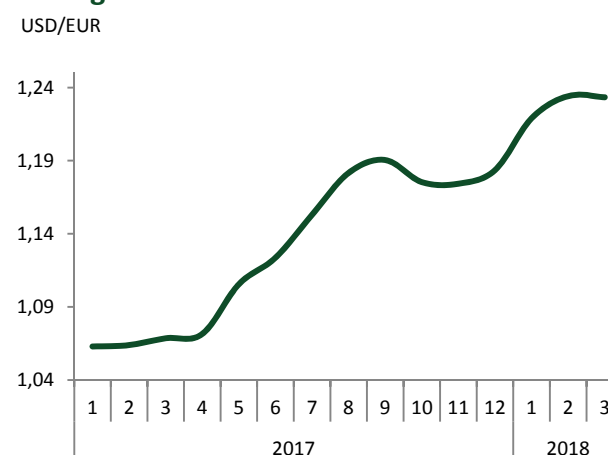
In March, the average monthly exchange

Figure 16. CNY/USD Exchange Rate, Monthly Average



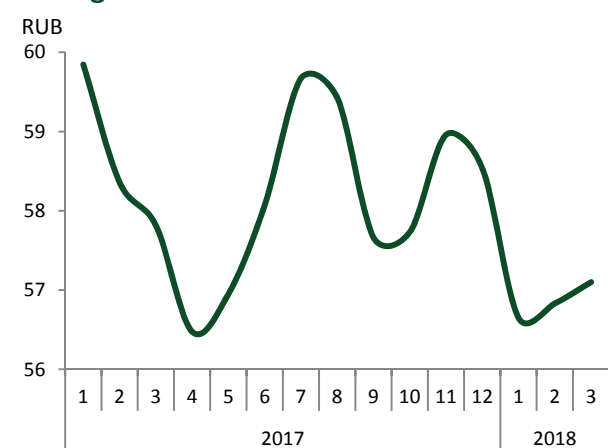
Source: Reuters

Figure 17. USD/EUR Exchange Rate, Monthly Average



Source: Reuters

Figure 18. RUB/USD Exchange Rate, Monthly Average



Source: Reuters

rate of the ruble depreciated by 2.5% versus December 2017, amounting to RUB 57.10 per 1 USD in March.

1.4 Kazakhstan's Balance of Payments

In the fourth quarter of 2017, a favorable external environment had a positive effect on the balance of payments indicators (Figure 19). An increase in the balance of trade surplus under the impact of recovering energy prices had been the key factor for reduction in the current account deficit to USD 745.1 mln. or 1.5% of GDP as compared to USD 2879.3 mln. in the fourth quarter of 2016 (Figure 20).

The increase in prices of key export goods was accompanied by the increased payouts of dividends to foreign investors thus curbing reduction of the current account deficit.

The financial account (excluding reserve assets) records a net capital outflow.

The overall net balance of payments was in surplus and amounted to USD 2.0 bln.

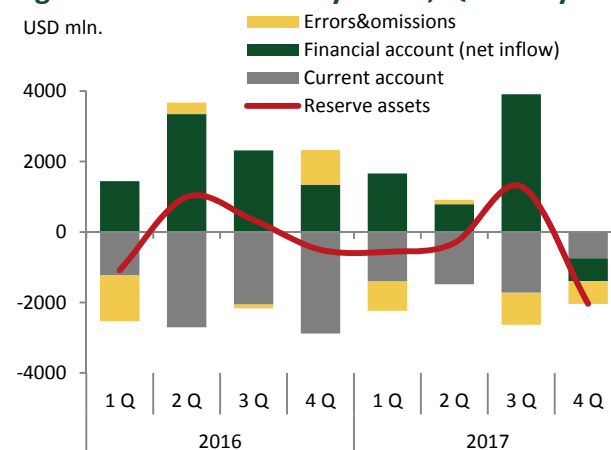
Exports of goods amounted to USD 14.1 bln. increasing by 34.5% as compared to the fourth quarter of 2016. The growth was observed among all major commodity groups (mineral products – by 39.0%, including oil and gas condensate (53.8% of total exports) – by 40.9% (Figure 21).

The growth rates of imports were slowing down (the growth of 9.3%). Among consumer goods, the increase in imports accounted for 12.6%, being primarily driven by the growth in imports of non-food consumer products – 17.3% (the rise in imports of foodstuffs accounted for 6.2%). The import of investment goods (36.3% of total imports) increased by 7.8%, and of interim industrial goods – by 10.1%.

As a result, in the fourth quarter of 2017 a trade surplus amounted to USD 5.3 bln. increasing by 2.2 times as compared to the fourth quarter of 2016.

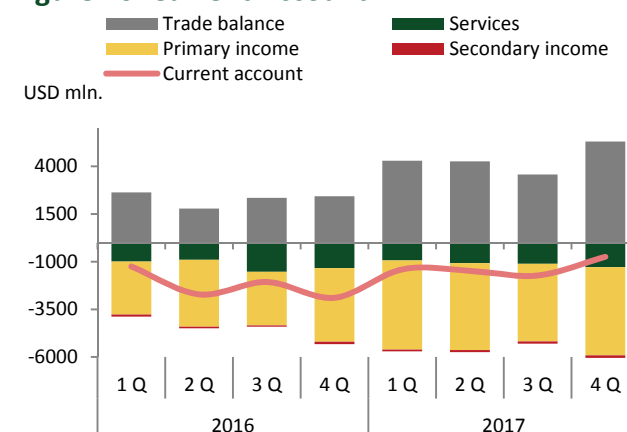
The deficit of the balance of international services amounted to USD 1.3 bln. decreasing by 3.6% compared to the fourth quarter of 2016 to due to the 3.7% growth in exports (mainly, growth in non-residential expenditures due to trips to Kazakhstan). There was a slight increase

Figure 19. Balance of Payments, Quarterly



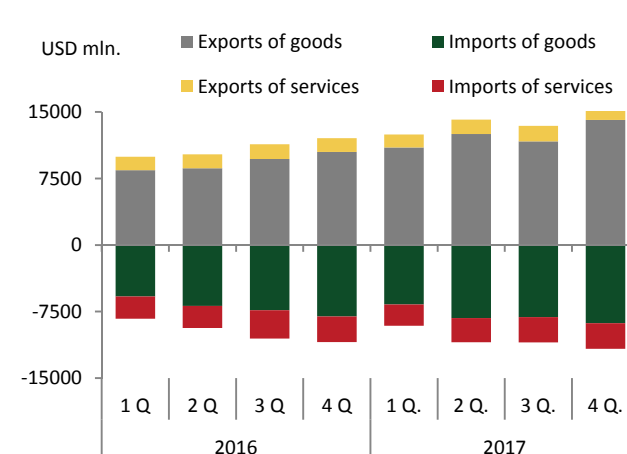
Source: NBRK

Figure 20. Current Account



Source: NBRK

Figure 21. Exports and Imports of Goods and Services



Source: NBRK

in imports of services (by 0.3%). Reduction in imports of construction services provided by non-residents (by 40.6%) as a result of completion of construction of large infrastructure facilities was compensated by the growing volumes of business services associated with their involvement in implementation of large infrastructure projects within the territory of Kazakhstan (by 15.2%), and transport services of non-residents related to freights by railway and motor transport (by 11.3%).

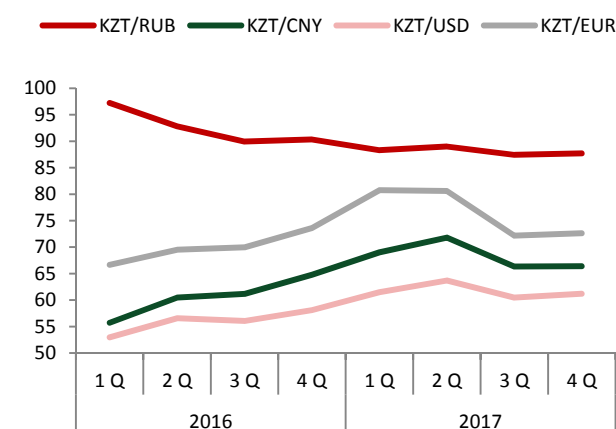
The growth in export revenues helped to increase returns of non-residents on direct investments by 21.2%. A part of returns was transferred to finance Kazakhstani subsidiaries, mainly in the oil and gas sector and in the metallurgical industry. Payments of interest to creditors that are not in direct investment relationship rose by 9.4%. As a result, a negative balance on the investment return increased by 21.1% to USD 4.3 bln., which partially offset the improvement in the trade balance thus holding the reduction in the current account deficit.

The financial account (excluding reserve assets) showed up a net capital outflow of USD 0.7 bln. due to reduction in residents' liabilities against a minor growth in their assets. The capital inflow of direct and short-term investments was offset by an outflow on portfolio investments (Figure 22).

Foreign direct investments showed up a net inflow of USD 1.0 bln. which was caused by repayment of liabilities to Kazakhstani enterprises by foreign companies, by the sale of a participating interest in a foreign company by a resident, by equity investments made by foreign investors into Kazakhstani enterprises including reinvestment of returns. An inflow was partially offset by repayment of the inter-company debt to non-residents by Kazakhstani enterprises.

The 2.3 bln. growth in foreign assets of residents including assets of the National Fund and JSC "UAPF" invested in foreign securities, repayment of the earlier issued securities by non-bank organizations as well as the sale of Kazakhstan's Ministry of Finance Eurobonds by non-residents in the secondary market

Figure 22. Real Effective Exchange Rate Index (December 2013 = 100%)



Source: NBRK

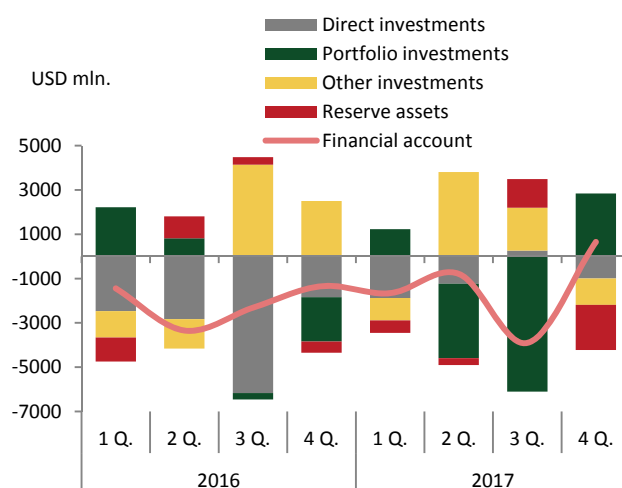
contributed to the net outflow of USD 2.8 bln. portfolio investments.

Other investments showed a net inflow of USD 1.2 bln. which was mainly associated with reduction of residents' assets in foreign accounts as well as the increase in accounts payable by non-bank organizations and their liabilities on credits and loans.

The real effective exchange rate of the tenge depreciated by 2.4% on the year-on-year basis and made up 77.0% of the benchmark competitiveness index of December 2013.

Indices of bilateral real exchange rates of the tenge against currencies of countries – main trading partners were mainly demonstrating an upward trend. Thus, at end-2017 the tenge appreciated in real terms against the US Dollar by 5.0%, against the Yuan – by 0.4% and depreciated against the Euro and the ruble by 5.8% and 1.5%, respectively (Figure 23).

Figure 23. Financial Account



Source: NBRK

2. DOMESTIC ECONOMY

2.1 Monetary Policy and the Financial Sector Development

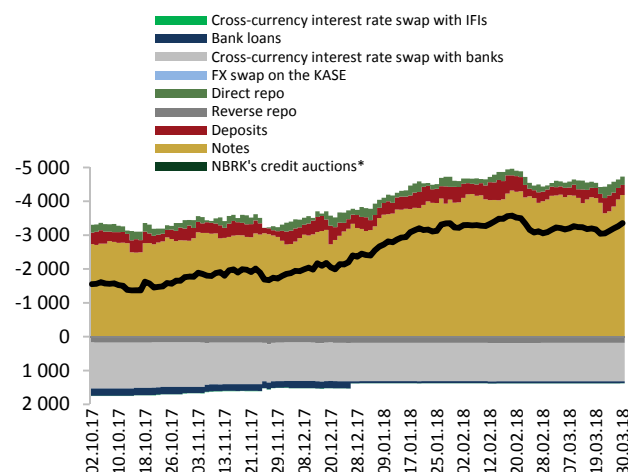
2.1.1 Money Market and Operations of the National Bank of the Republic of Kazakhstan

In the first quarter of 2018, there was a structural liquidity surplus in the tenge in the money market. In this context, the volumes of the National Bank’s operations on withdrawal of excess liquidity with a view to limit potential realization of inflation risks retained their upward trend. The bulk of excess liquidity was withdrawn via the National Bank’s short-term notes (Figure 24). In doing so, significant growth in the negative balance on the National Bank’s operations was primarily associated with the increased demand for the National Bank’s notes, including on the part of non-residents. The share of non-residents in the National Bank’s notes increased from 3.1% to 12.2% over the quarter. Additional auctions of the National Bank’s short-term notes with maturity of 364 days were conducted as part of the Program for Increasing Financial Soundness of the Banking Sector.

Given that inflation was decelerating more rapidly as compared to the forecasts and inflation expectations were subsiding, the monetary conditions were eased further. The base rate was reduced twice (on January 15 and March 5) by 75 basis points in toto. In general, monetary conditions remained neutral. The TONIA rate had been mainly staying at the lower boundary of the interest rate band and made up 8.51% at the end of the period (Figure 25).

The Money Market Index was ranging between 8.48-9.40%. At March 30, 2018 the index made up 8.51% (Figure 26).

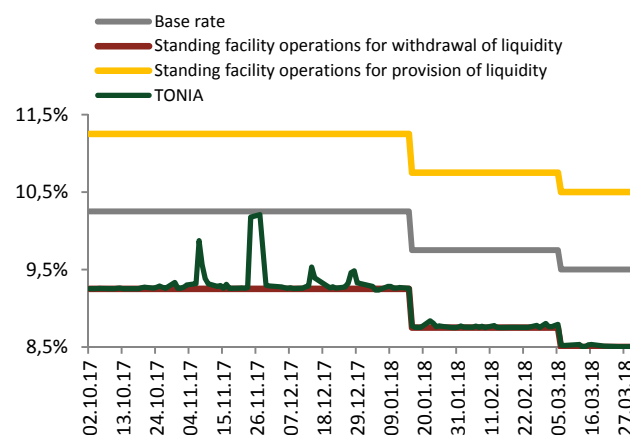
Figure 24. NBRK’s Operations in the Domestic Market (exposure, KZT bln.)



* NBRK’s securities buy/sell back auction

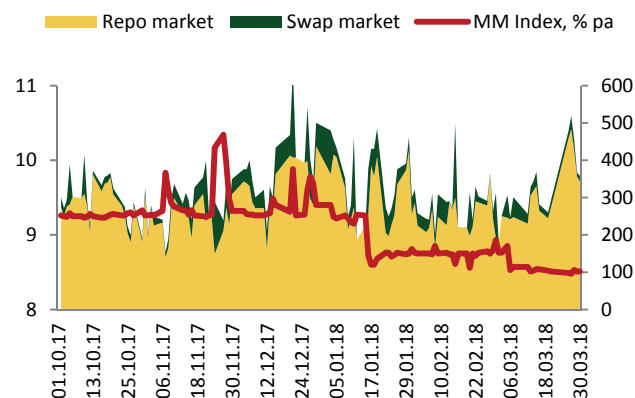
Source: NBRK

Figure 25. Base Rate and TONIA Rate



Source: NBRK, KASE

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



Source: KASE

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

The foreign exchange market was demonstrating stability. The dynamics of fundamental factors of the tenge exchange rate was favorable. The improving situation in the global commodity markets and gradual stabilization of devaluation expectations created prerequisites for decreasing the amplitude of exchange rate movements and appreciation of the tenge against foreign currencies.

The exchange rate of the tenge against the US Dollar was ranging between KZT 318.3-333.3 per 1 USD. At the end of the quarter, the KZT/USD rate on the stock exchange appreciated by 4.2% to KZT 318.3 (Figure 27).

The exchange rate was formed by demand and supply of foreign currency in the foreign exchange market. A net participation of the National Bank in the foreign exchange market was equal to zero.

The demand for foreign exchange was contracting due to decreased devaluation expectations. Reduction in volumes of trading in the USD/KZT currency pair accounted for 5.7% as compared to the fourth quarter of 2017 – from USD 10.1 bln. to USD 9.5 bln.

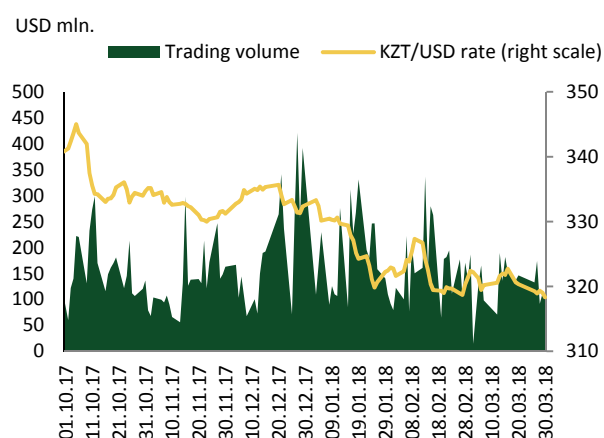
2.1.3 Deposit Market

At the end of the first quarter of 2018, the deposit volume amounted to KZT 16.8 trln., having decreased by 3.9% since the beginning of the year. Excluding the impact of the exchange rate, deposits decreased by 2.1%.

Deposits in the domestic currency increased by 2.9%, and foreign currency deposits decreased by 11.4% (7.5% excluding revaluation). Overall dollarization level showed a minimum over the last four years – 44% (Figure 28).

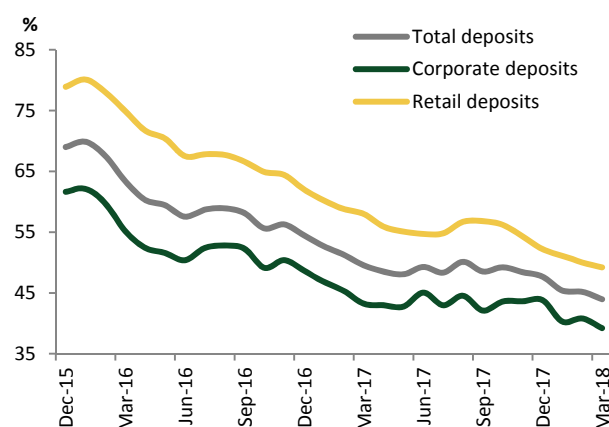
The largest contribution to reduction in deposits was made by reduction of corporate foreign currency deposits (Figure 29). Meantime, the tenge deposits of the corporate sector started to grow for the first time over the recent four quarters. A significant outflow of foreign currency deposits against the inflow of the tenge deposits in the corporate sector

Figure 27. Exchange Rate Behavior and the Trading Volume in the Foreign Exchange Market



Source: KASE

Figure 28. Dollarization of Deposits



Source: NBRK

ensured dedollarization of corporate deposits to 39.2% from 43.8% in the fourth quarter of 2017. In general, deposits of the corporate sector decreased by 6% (4.4% excluding revaluation).

In the retail segment, an inflow of the tenge deposits of KZT 180 bln. over the first quarter against a physical outflow of foreign currency deposits in the volume equivalent to KZT 125 bln. is indicative of a continuing conversion of foreign currency deposits into deposits in the tenge. In general, the tenge deposits of the population made the largest positive contribution to the growth of total deposits. In the first quarter of 2018, retail deposits in the tenge started to prevail over foreign currency deposits for the first time since the beginning of 2014. The share of foreign currency deposits decreased to 49.2% (in the fourth quarter of 2017 – 52.2%). The overall volume of retail deposits decreased by 1.5%; however, retail deposits excluding revaluation demonstrated a minor growth equal to 0.6%. The weighted average interest rate on deposits attracted in the domestic currency decreased from 8.2% in December 2017 to 7.6% as at the end of March, and on foreign currency deposits – from 1.5% to 1.4% (Figure 30).

2.1.4 Credit Market

At the end of the first quarter of 2018, the volume of bank loans amounted to KZT 12.6 trln., having decreased by 1.1% over the quarter because of seasonal factors (excluding revaluation, the loan portfolio had not changed).

In the corporate segment, the loan portfolio decreased by 2.1% or by KZT 173 bln. to KZT 8 trln. primarily because of its foreign currency portion (reduction of 4.5% or KZT 137 bln.). The 4.2% appreciation of the domestic currency in the first quarter resulted in reduction in foreign currency loans as translated into the tenge whereas a physical volume of foreign currency loans remained virtually unchanged – reduction in the equivalent made up KZT 8.2 bln. only. Revaluation of corporate foreign currency loans made the largest negative contribution to the behavior of the total loan portfolio of banks (Figure 31).

Figure 29. Composition of Components to the Growth in Deposit Volumes

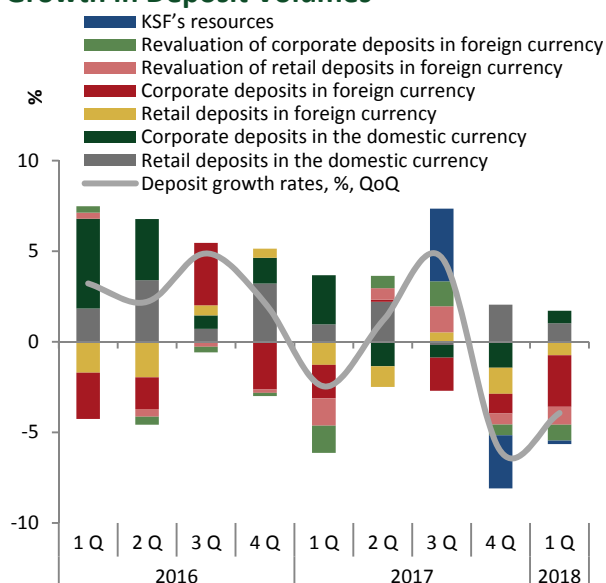
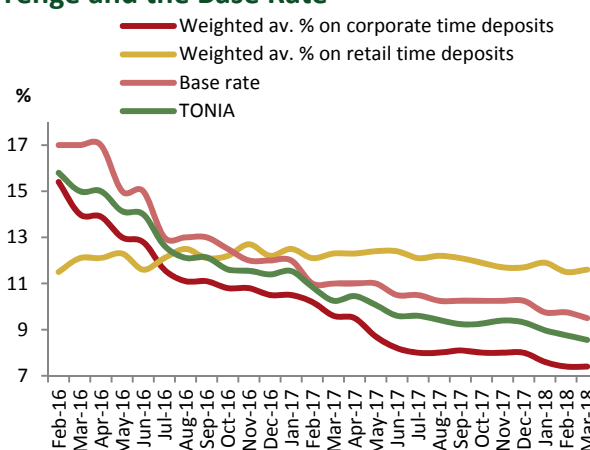


Figure 30. Interest Rates on Deposits in the Tenge and the Base Rate



Source: NBRK

According to the poll conducted by the National Bank among enterprises in the real sector, the demand of enterprises for bank loans somewhat decreased amidst a slowing business activity typical of the beginning of a financial year. 21.1% enterprises participating in the National Bank’s monitoring survey applied to banks for a loan; 84.8% enterprises (17.9% of the total number of the interviewed) obtained the loan.

The loan portfolio in the retail sector showed the growth of 0.7% or KZT 33.5 bln. to KZT 4.7 trln. The growth in the tenge loans within their structure (by 1.8% or KZT 78 bln.) was partially offset by reduction in foreign currency loans (by 16% or KZT 45 bln., excluding revaluation – by 12% or KZT 33 bln.). Retail loans in the tenge appeared to be the only growth factor for the loan portfolio of banks thus making positive contribution. Consumer loans which represent the main driver for the growth, both in respect of retail loans and total loans, increased by 2% or KZT 55 bln. and amounted to KZT 3 trln.

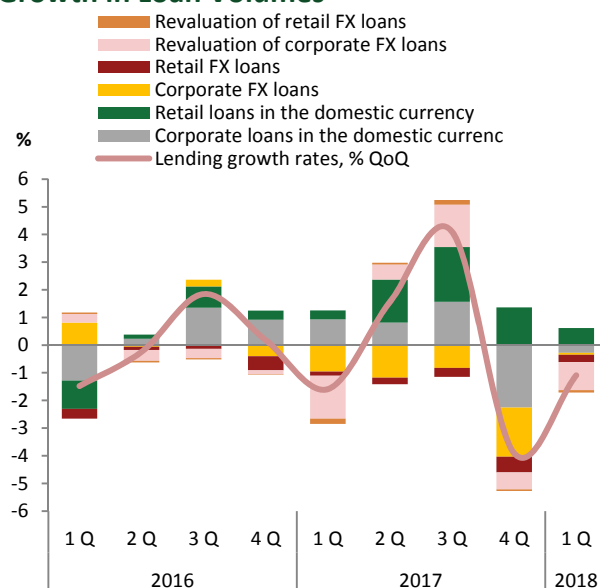
At the end of the first quarter, the weighted average interest rate on corporate loans in the domestic currency decreased to 12.8% from 13.2% in the fourth quarter of 2017 (Figure 32).

2.1.5 Monetary Aggregates

After an active policy pursued by the National Bank to rehabilitate the banking sector in 2017 that was manifested in the reserve money expansion (allocation of resources to support banks) with a concurrent reduction in the money supply (cleaning up bank balance sheets from non-performing assets), in this year the focus was shifted onto regulation of inflationary processes. As a result of increase in the volume of placed short-term notes, contraction in the reserve money in March accounted for 12.2% in annual terms (Figure 33) or for 17.6% on the year-to-date basis.

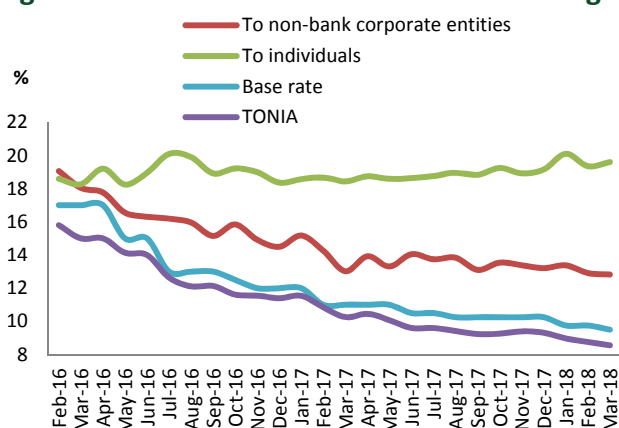
The 3.2% reduction in the money supply as compared to March of the previous year, or the 4.2% reduction as compared to the beginning of the year keep reflecting systemic changes in the

Figure 31. Composition of Components to the Growth in Loan Volumes



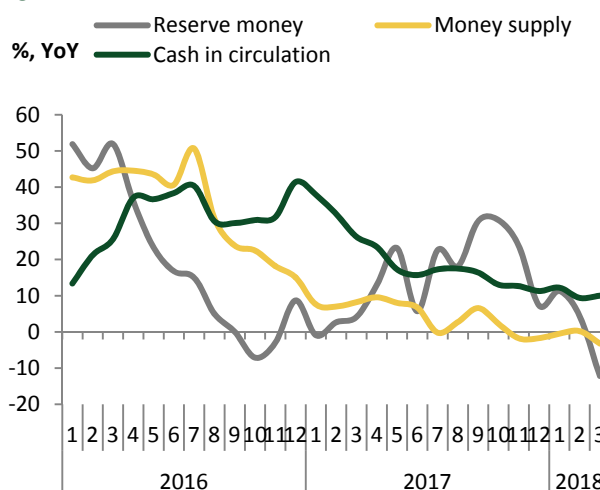
Source: NBRK

Figure 32. Interest Rates on Loans in the Tenge



Source: NBRK

Figure 33. Growth in Monetary Aggregates, YoY



Source: NBRK

banking sector’s loan portfolio.

During the first quarter, the main negative contribution to the money supply was made by reduction in net foreign assets (largely because of revaluation as a result of appreciation of the tenge), and claims of the National Bank on the Government and the economy. Reduction in the money supply was partially offset by the increase in the National Fund’s account in the tenge (Figure 34).

2.2 Prices and Inflationary Processes

2.2.1 Prices in the Consumer Sector

The annual inflation slowed down from 7.1% at end-2017 to 6.6% in March 2018 and throughout the first quarter it had been within the target band of 5-7% set for the end of the year (Figure 35). The persistent downward trend in the food market was to a larger extent conducive to deceleration of inflation (Figure 36).

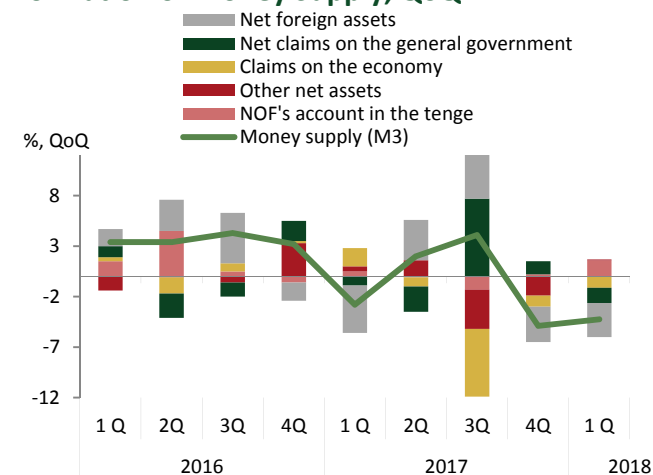
The annual growth in prices of foodstuffs slowed 6.5% to 5.5% over the quarter. The structure of the food inflation showed the slowdown in the price growth on such main groups as meat and meat products, bread and bakery products and cereals. Prices of food and vegetable production demonstrated a moderate growth. In certain food markets (eggs, sugar, vegetable oils) the rates of price decline decelerated. Prices of alcohol beverages and tobacco products retained their high growth rate as a result of the increase in excises and minimum prices as well as because of a significant increase in price of the imported tobacco at the beginning of the year.

The non-food inflation decelerated from 8.9% to 8.5%. Prices of domestic goods, motor vehicles and gasoline slowed their growth.

The contribution to the annual inflation by paid services remained virtually unchanged as a result of deceleration in the growth rates of utility fees and the increase in price of transport services. In March, prices of paid services increased by 6% in annual terms.

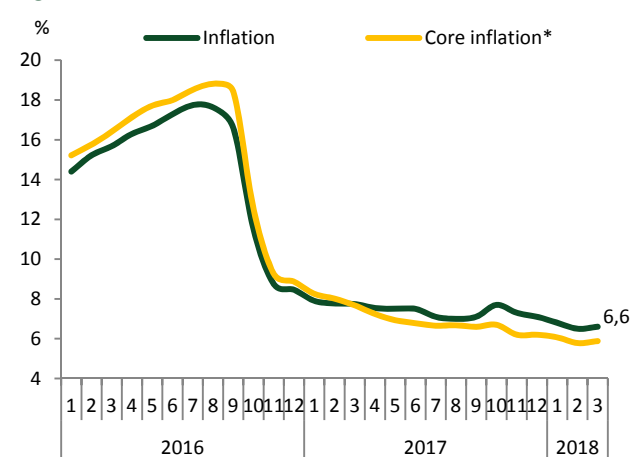
Over the quarter, the core inflation, excluding fruit and vegetables, energy carriers and regulated services, had decreased from

Figure 34. Dynamics of Sources to the Formation of Money Supply, QoQ



Source: NBRK

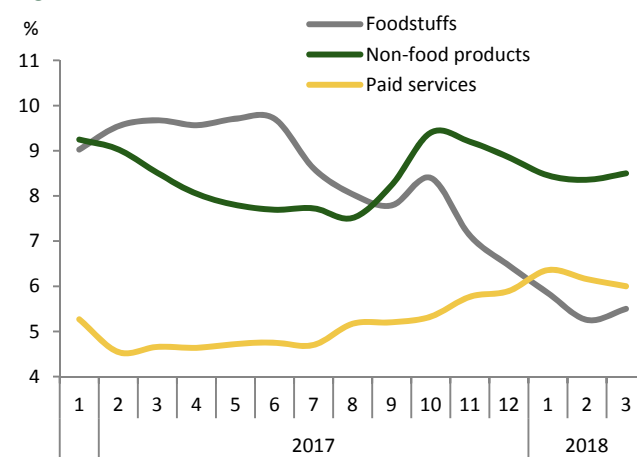
Figure 35. Annual and Core Inflation Dynamics, YoY



Source: CS MNE RK

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

Figure 36. Dynamics of Inflation Components, YoY



Source: CS MNE RK

6.2% to 5.9% in annual terms, being driven by the decline in price of food producers and by deceleration in the growth rates of prices of beverage producers as well as the cheapening of imported foodstuffs including due to appreciation of the tenge.

2.2.2 Prices in the Real and External Sectors

The growth of prices in the industry slowed from 17.6% in December of the previous year to 13.5% in March 2018 (Figure 37). The growth rate of prices in the mining industry (crude oil, metals) decreased significantly given a high base of the previous year. Producer prices of goods sold in the domestic market also demonstrated a decline in the growth rates – from 9.5% to 7.3%.

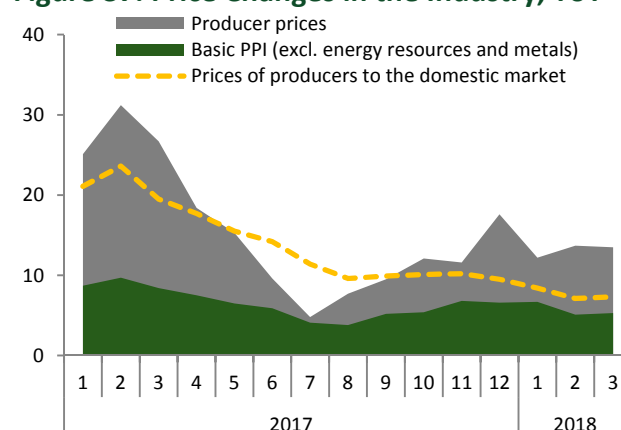
In the manufacturing industry, price growth rates were accelerating from 8.3% to 9.4% (Figure 38). The increasing cost of products is noted in the production of petroleum products and in the chemical industry.

However, a decline in prices was recorded in the food production; it was associated with the cheapening of products in the flour-milling industry. The decline in prices which was observed during previous quarters in the production of oils and fats and sugar slowed down.

The annual growth in prices of industrial services accelerated from 6.9% in December 2017 to 8.4% in March 2018, to a larger extent due to the increase in prices of services related to metal casting. The cost of water supply services remained virtually unchanged, and the annual growth in fees for electricity supply to enterprises slowed down.

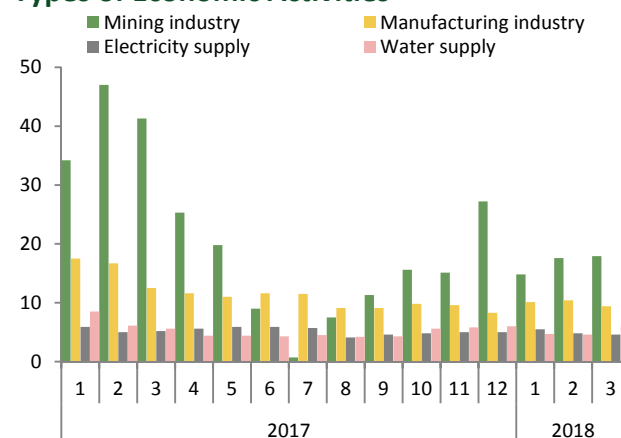
In agriculture, growth rates of producer prices continued to slow down – from 2.6% to 1.6% in annual terms due to the cheapening of the plant production in the first quarter (Figure 39). Just as in the previous quarter, prices of cereals (wheat) and oil-bearing crops continued to decline; the growth in prices of fresh vegetables also slowed down. One of the factors of the decline in prices was the outstripping level of stocks; however, this effect was gradually diminishing by the end of the quarter because of the increased export

Figure 37. Price Changes in the Industry, YoY



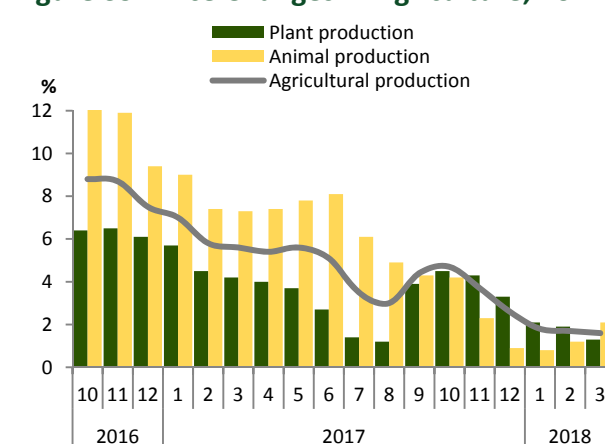
Source: CS MNE RK

Figure 38. Price Changes in the Industry by Types of Economic Activities



Source: CS MNE RK

Figure 39. Price Changes in Agriculture, YoY



Source: CS MNE RK

volumes.

The price index of imported goods increased from 6.8% in December 2017 to 7.0% in March 2018 as a result of a minor increase in prices of goods from the far abroad countries. In particular, fish products, tobacco products as well as textile increased in terms of price.

2.2.3 Inflation Expectations

The public poll outcomes show that in the first quarter of 2018 the level of perceived inflation and expected inflation had slightly decreased.

The percentage of respondents who anticipate that inflation rates will remain unchanged within next 12 months increased because of reduction in the percentage of those who anticipate acceleration of inflation. Accordingly, the largest portion of respondents keeps anticipating that price growth rates will remain unchanged in the next 12 months (Figure 40).

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

A quantitative assessment of expected inflation¹ for the coming year notably decreased at the end of the first quarter of 2018 and in March accounted for 5.8% (Figure 41), being below the actual inflation.

Perceived inflation² which is generated based on the subjective basket of goods of an individual has been gradually decreasing following the actual inflation and it continues to update the minimum for the entire history of observations – 17.5% in March of this year (Figure 41).

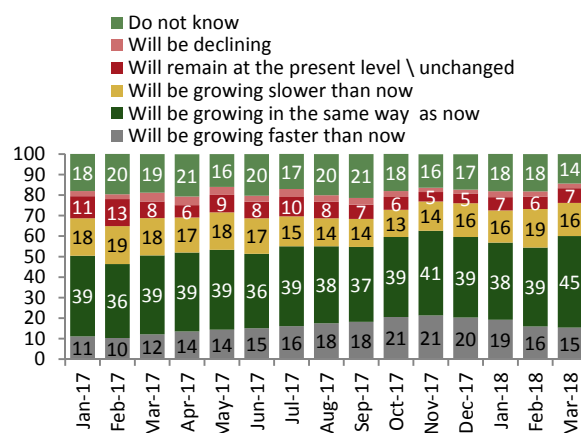
2.3 Real Sector Development

2.3.1 Domestic Demand

Throughout 2017, the economic activity was demonstrating a positive pattern amidst a favorable external pricing environment in the global energy and metals markets. The annual

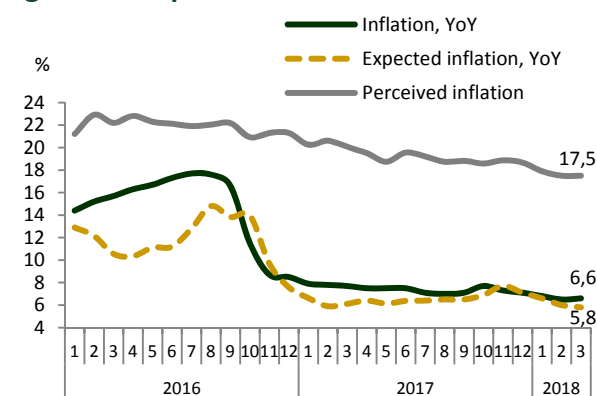
Figure 40. Assessment of the Price Growth in a Year

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



Source: GfK Kazakhstan

Figure 41. Expected Inflation



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

¹ The Methodology for calculating the quantification of inflation expectations is posted on the official Internet resource of the National Bank in the “Monetary Policy”- “Inflation and Inflation Expectations” Section

² The median of the results of answers to the question “In your opinion, how much have prices of foodstuffs, non-food products and services grown over the past 12 months?” is used as perceived inflation.

GDP growth was accompanied by a positive contribution of all key components: net exports, consumer and investment demand.

Based on performance in 2017, the real GDP by the final consumption method increased by 3.9% given a significant positive contribution by net exports (Figure 42). The consumer and investment demand were also demonstrating a positive pattern.

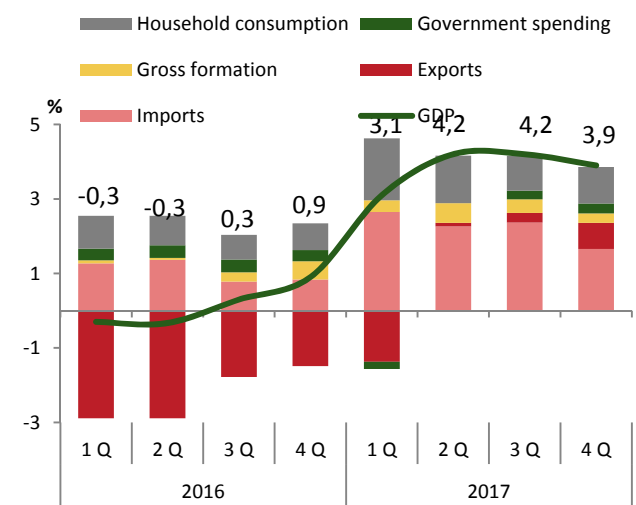
A positive contribution of net exports was to a larger extent secured by reduction in real imports of goods and services. Reduction in real import volumes was observed against reduction in real cash income of the population in the fourth quarter of 2017. At the same time, the growth in real exports slightly accelerated as a result of increase in exports of crude oil and gas condensate. In the fourth quarter of 2017, the average price of oil exceeded USD 60 per barrel, which has also had a favorable effect on the growth in volumes of extraction and export of energy resources.

The 2.4% increase in gross formation was accompanied both by implementation of government economic stimulus programs and by acceleration in growth rates of fixed capital investments, including in accommodation and catering services, healthcare, education, real estate operations, trade as well as in construction and in the industry. Growth rates of investments into residential construction accelerated to 11.6%.

Growth rates of consumer demand virtually remained unchanged and accounted for 1.5% at end-2017 (Figure 43). Reduction in real cash income of the population served as a constraining factor for expansion in the consumer demand. Meantime, real household spending demonstrated growth which was mainly caused by expansion in the consumer lending given deceleration of inflationary processes.

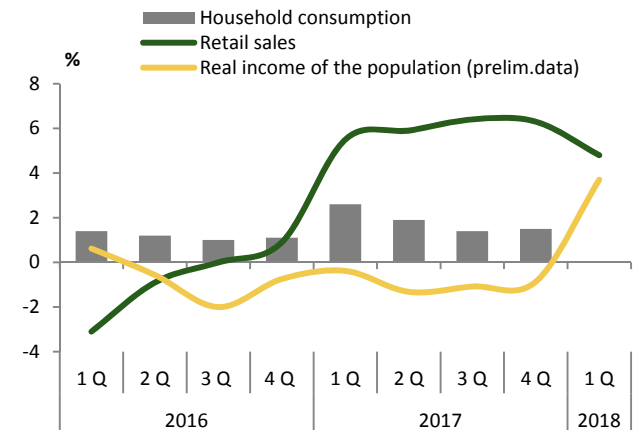
In the fourth quarter of 2017, nominal consumer spending by households increased by 10.8% and slightly decelerated as compared to previous quarter. Reduction in a positive contribution of non-food products and paid services was noted in their structure. The contribution by foodstuffs increased

Figure 42. Decomposition of the GDP Components by the Final Consumption Method, YoY, year-to-date total



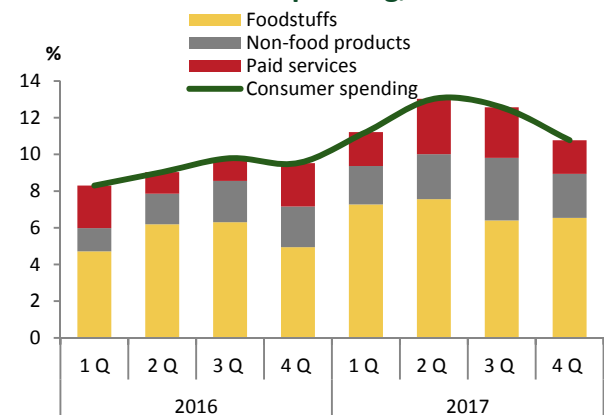
Source: CS MNE RK, NBRK's calculations

Figure 43. Household Consumption, Household Real Cash Income and Retail Sales, YoY, year-to-date total



Source: CS MNE RK

Figure 44. Structure of Growth in Household Nominal Consumer Spending, YoY



Source: CS MNE RK, NBRK's calculations

insignificantly (Figure 44).

Income of the Population

In the first quarter of 2018, real cash income turned positive for the first time since its continuous decline throughout 2017 (Figure 45). The main reason for the increase in real cash income of the population was acceleration of growth in their nominal values. In turn, nominal cash income accelerated as a result of higher growth rates of real wages. Besides, a moderate deceleration of inflationary processes at the beginning of the year was also conducive to the growth of income in real terms. Thus, as a result of increased nominal cash income and a moderate deceleration in the growth of consumer prices, in March 2018 real income of the population increased by 5.1%.

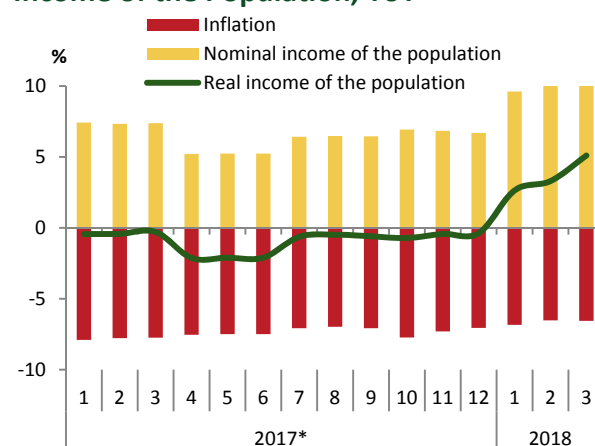
Investments

In the first quarter of 2018, investment activity of enterprises in the real sector stirred up significantly and the growth in fixed capital investments accounted for 39.5% based on performance in the first three months of 2018 (Figure 46).

Such pattern was mainly secured by a significant inflow of investments into the mining industry (the annual growth of 70.6%) owing to the continued implementation of projects on increasing oil extraction in the Atyrau Region, particularly, at the Kashagan and Tengiz oil fields. Investments into oil extraction were accompanied by their growth in the transport and warehousing sector in order to support and develop the pipeline network. A significant growth of investments in the manufacturing industry (by 24.5%) is explained by preparation for repair works as part of modernization and reconstruction of Shymkent Oil Refinery Plant. There was an ongoing positive trend of the growing investments in real estate operations due to the increased residential construction in the city of Astana. Other sectors made a moderate contribution to the investment growth in the first quarter of 2018 in the environment of a favorable macroeconomic situation and implementation of government development programs.

As before, own funds of enterprises still

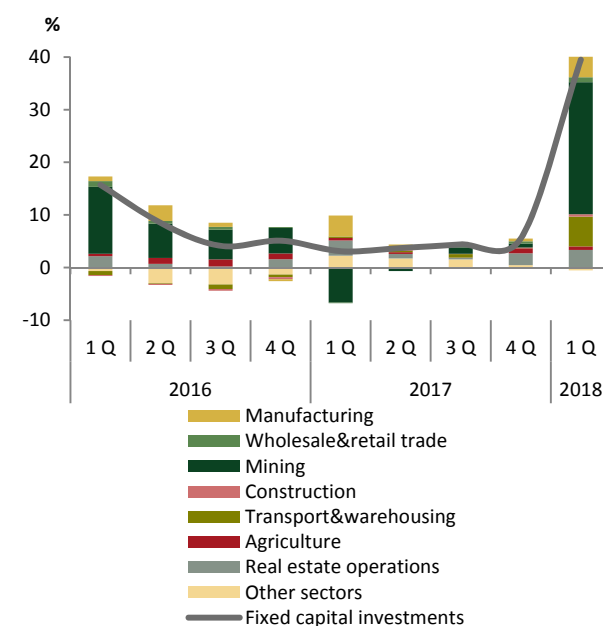
Figure 45. Growth Structure of Real Cash Income of the Population, YoY



*-preliminary data

Source: CS MNE RK

Figure 46. Fixed Capital Investments, by Types of Economic Activity, Contribution, YoY, year-to-date total



Source: CS MNE RK, NBRK's calculations

represent the main source of investment financing (about 75%). In the first quarter of 2018, the share of domestic investments in total investments accounted for 71.8%, and the share of foreign investments – for 28.2%.

2.3.2 Domestic Production

In 2017, the development of the Kazakh economy was characterized by a positive trend and the real GDP growth by the production method accounted for 4.0% versus the previous year (Figure 47).

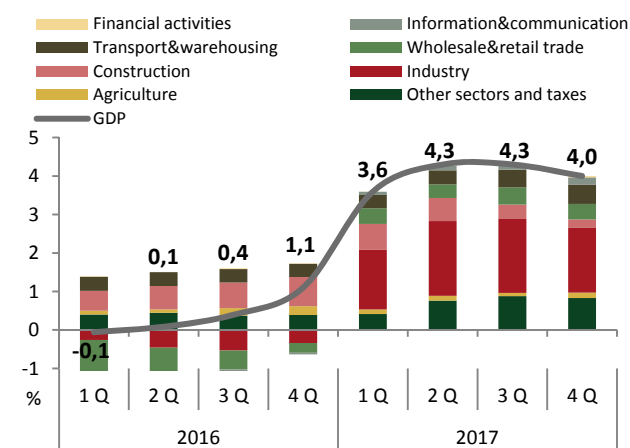
Production of goods in annual terms increased by 5.9%, and provision of services – by 2.7%. The main contribution to the growth was made by industrial sectors owing to extraction and processing of mineral resources as well as the sectors of transport and warehousing, and wholesale and retail trade.

Positive development trends also persisted at the beginning of 2018. So, the short-term economic indicator in the first quarter increased by 5.3% as compared to the same period of the previous year (Figure 48).

The high base effect of 2017 was the cause for deceleration of growth (to 5.1%) in the first quarter of 2018 in the mining industry (Figure 49). As before, the main contribution to the growth in the sector is being made by oil extraction at the Kashagan and Tengiz oil fields. Meantime, a slowdown in extraction of metal ores is associated with the high base effect of 2017 as well as with the increased content of the metal in the extracted raw materials.

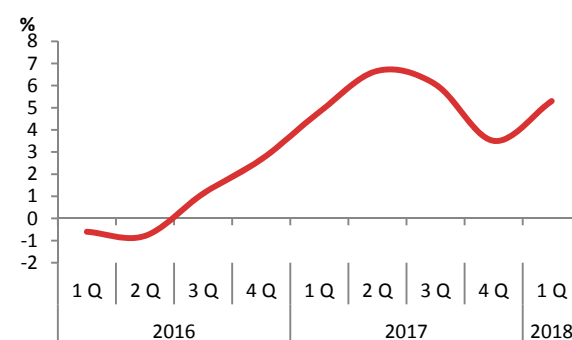
In the manufacturing industry, the growth accelerated to 6.2% as compared to the corresponding period of the previous year (Figure 50). Given the existing favorable external market environment, the metallurgical industry remains as the main growth driver. Output in ferrous metallurgy had grown as a consequence of the increased production of ferroalloys, and in the non-ferrous metallurgy – owing to the growth in production of lead and gold. The production growth in the food industry notably accelerated being associated with the growth in production of canned vegetables, fruit juices, vegetable oil, and flour. A positive growth trend is also observed in

Figure 47. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY, year-to-date total



Source: CS MNE RK, NBRK's calculations

Figure 48. Short-Term Economic Indicator, YoY



Source: CS MNE RK, NBRK's calculations

other sectors, particularly, in oil refinery, in the light industry and in the pharmaceutical industry. The growth in engineering industry was secured by the increased production of motor vehicles and electrical equipment.

Gross output in agriculture in the first quarter of 2018 increased by 3.6% due to the increased production of animal products.

However, the growth in volume of construction works during the first three months of 2018 accelerated to 5.9% (Figure 51); this was driven by the increase in major overhauls and current repair works against a minor reduction in construction and assembly works. As before, reduction in volumes of construction and assembly works is related to the high base of the first half of 2017 because of sizeable volumes of construction EXPO-2017 facilities, and the increase in repair works – with reconstruction of industrial facilities and highways that is reflected on the structure of commissioned facilities.

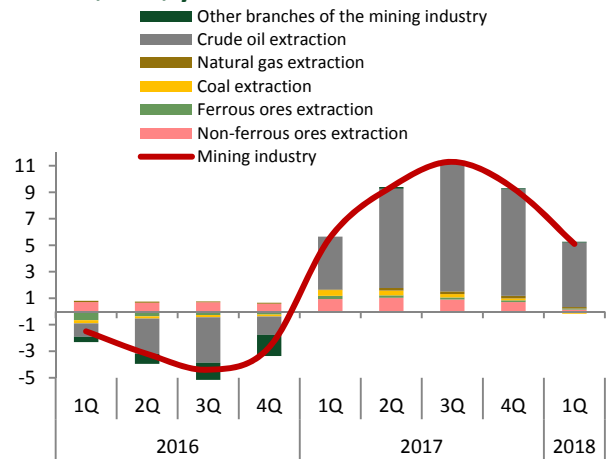
In addition to production of goods, the service sector also demonstrates a positive growth trend. In the first quarter of 2018, the growth in retail sales slightly slowed down to 4.8% (Figure 52). Meantime, the main contribution to its growth was made by sales of non-food products. This fact may be explained by the growth in real cash income of the population which started in 2018. The growth of wholesale turnover accelerated to 7% as a result of significant increase in the wholesale of foodstuffs.

Given implementation of infrastructure projects as well as positive trends in the industry and trade, the growth in the transport and warehousing sector remains stable and it accounted for 4.6% in the first quarter of 2018. A significant contribution had been made by railway cargo transportations, pipeline transport and motor transport.

During 2017, the growth in the information and communication sector accounted for 6.3% mainly due to the increased volume of the Internet services, mobile communication, postal and express mail services.

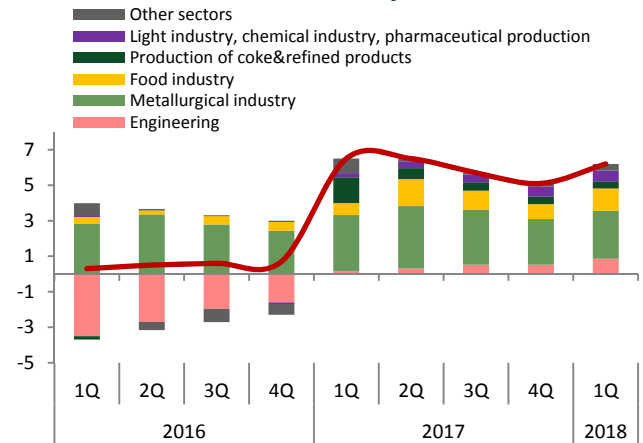
The composite leading indicator, which summarizes the assessment of the existing

Figure 49. Decomposition of the Mining Industry. Contribution by Sectors to the Growth, YoY, year-to-date total



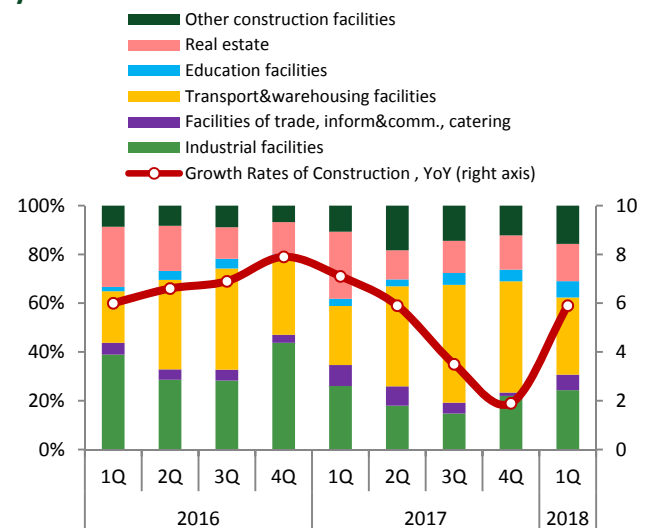
Source: CS MNE RK, NBRK's calculations

Figure 50. Decomposition of the Manufacturing Industry. Contribution by Sectors to the Growth, YoY, year-to-date total



Source: CS MNE RK, NBRK's calculations

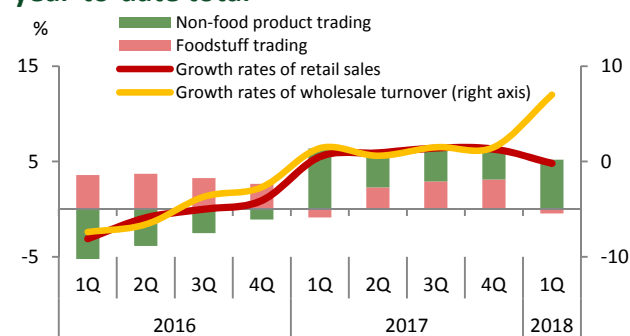
Figure 51. Growth Rates of Construction and a Relative Share of Commissioned Facilities, YoY, year-to-date total



Source: CS MNE RK, NBRK's calculations

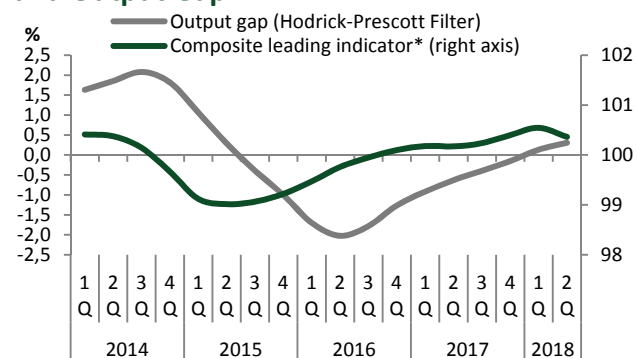
situation as well as expectations of CEOs of companies in the real sector of the economy, in the first quarter of 2018 remains in the positive zone which indicates that recovery processes in the economy are strengthening. The poll outcomes reflect the signs of a further strengthening of demand for final products in all key sectors of the economy, which, in turn, will be promoting the growth in prices of final products. Also, the percentage of enterprises which face negative impact of the exchange rate of the tenge is decreasing. Assessment methods based on filtration principles showed for the first time since 2014 positive values of the output gap. This indicates the beginning of pro-inflationary pressure in the economy (Figure 53).

Figure 52. Growth Structure of Retail Sales and Growth Rates of Wholesale Turnover, YoY year-to-date total



Source: CS MNE RK, NBRK's calculations

Figure 53. Behavior of the Composite Indicator and Output Gap



Source: NBRK

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

2.3.3 Labor Market and Unemployment

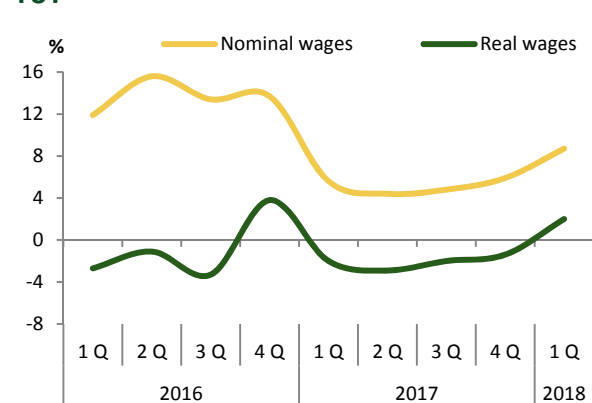
In the first quarter of 2018, real wages turned positive and grew by 2.0% for the first time since the fourth quarter of 2016. The growth in real wages was furthered both by acceleration of their nominal wages (to 8.7%) and deceleration of inflation (Figure 54).

In the industry-based breakdown, the growth in real wages was observed in the area of administrative and ancillary service, in the construction sector, in the mining and the manufacturing industry, agriculture, trade and real estate operations.

At the same time, real wages were decreasing in the healthcare sector, financial and insurance activities and education.

Based on performance in 2017, the growth in labor productivity slightly decelerated to 4.3% after a continuing acceleration of productivity beginning from the first quarter of 2016. A positive pattern in the labor productivity was accompanied by retention of a

Figure 54. Nominal and Real Wage Indices , YoY



Source: CS MNE RK

significant growth in productivity in the sectors which engage in goods production (by 10.3%). In the industry, labor productivity increased by 8.2% based on the increased productivity in the mining and the manufacturing industry, in agriculture and in construction – by 10.4% and 5.6%, respectively.

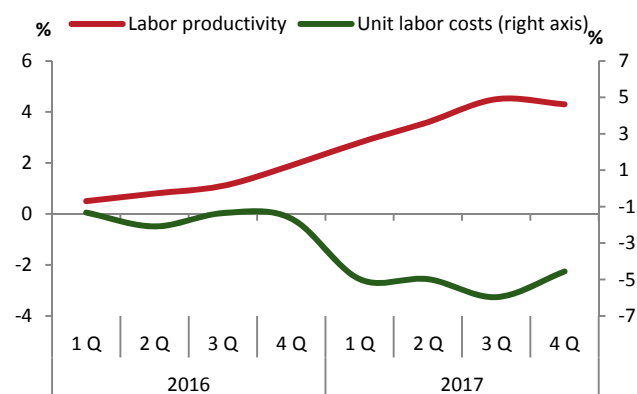
Based on performance in 2017, a negative pattern in the labor productivity in the service sector which had been persisting from the first quarter of 2016 through the third quarter of 2017 intermitted. The 0.6% growth in the productivity in the service sector was observed against its increase in the sectors of transport, communication, public administration and defense, trade and healthcare. At the same time, productivity was decreasing in real estate operations, professional, scientific and technical activities, financial and insurance activities and education.

At end-2017, reduction in unit labor costs accounted for 4.6%. Thus, a negative pattern of unit labor costs which started in the first quarter of 2016 is persisting. Reduction in unit labor costs was observed against the outstripping GDP growth rates as compared to nominal wages (Figure 55).

The situation in the labor market was generally favorable. The unemployment rate has not changed and accounted for 4.9%; a persisting positive pattern of the economic activity in many sectors of the economy is largely conducive to that fact. Besides, implementation of government programs of employment and infrastructure development coupled with the expansion project at the Tengiz oil field are also conducive to creation of new jobs.

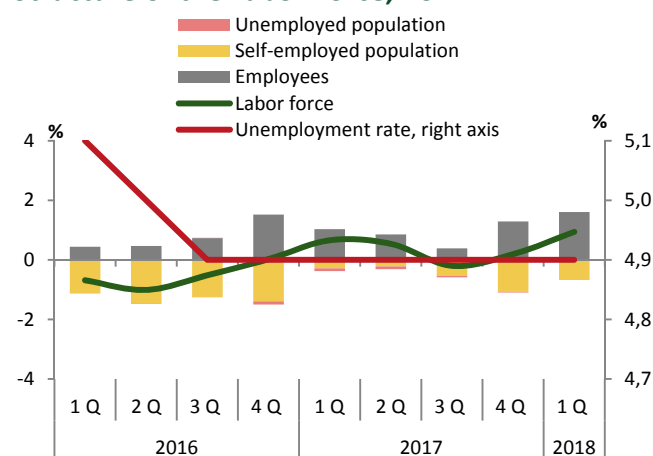
In the first quarter of 2018, the labor force increased by 0.9% given the growth in the numbers of the employed population. The growth in the employed population is caused by the increase in the numbers of employees whereas the self-employed population has been decreasing for four years in a row (the decline of 2.8%), mainly because of reduction in the number of the unproductively employed people. The number of the unemployed population decreased by 0.3% (Figure 56).

Figure 55. Labor Productivity and Unit Labor Costs, YoY, year-to-date total



Source: CS MNE RK, calculations

Figure 56. Unemployment Rate, Growth Structure of the Labor Force, YoY



Source: CS MNE RK, NBRK's calculations

The number of employees decreased by 1.4%. The number of employees increased in such sectors as trade, professional, scientific and technical activities, transport, the manufacturing industry, education, healthcare and activities in the area of administrative and ancillary service. However, the number of employees in the sectors of real estate operations, construction, the mining industry, electricity supply and communication was decreasing. The trend of reduction in the number of employees in agriculture (by 2.1%) persisted against the growth in labor productivity in the sector.

Growth rates of the number of employees had not changed and accounted for 1.1% (Figure 57). The number of employees was increasing in such sectors as activities in the area of administrative and ancillary service, trade, healthcare, transport and education. However, the number of employees was decreasing in the following sectors: communication, construction, water supply, real estate operations, electricity supply and professional, scientific and technical activities. The trend of reduction in the number of employees in agriculture was persisting against the growing labor productivity in the sector.

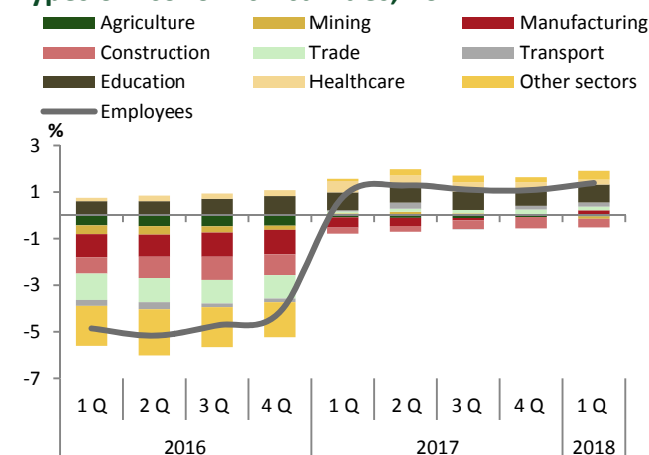
2.4 Fiscal Policy

In the first quarter of 2018 as compared to the same period of the previous year, budget revenues increased by 15% and amounted to KZT 2.7 trln. or 15.8% of GDP (Figure 58). Tax revenues increased by 11.6% and were secured by the increase in advance payments based on the growth in the production volume in the mining industry, manufacturing industry, trade, transport, communication and agriculture. Transfers to the state budget from the National Fund increased by 30% to KZT 0.8 trln.

The state budget spending increased by 13.5% and amounted to KZT 2.4 trln. (14.4% of GDP).

As a result, the state budget showed up a surplus of KZT 88.4 bln. or 0.5% of GDP (Figure 59). A part of the state budget deficit was channeled to repay debt obligations in the amount of KZT 31.6 bln.

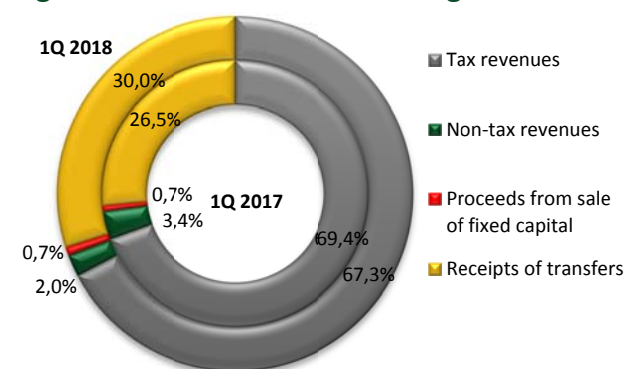
Figure 57. Employee Growth Structure*, by Types of Economic Activities, YoY



Source: CS MNE RK, NBRK's calculations

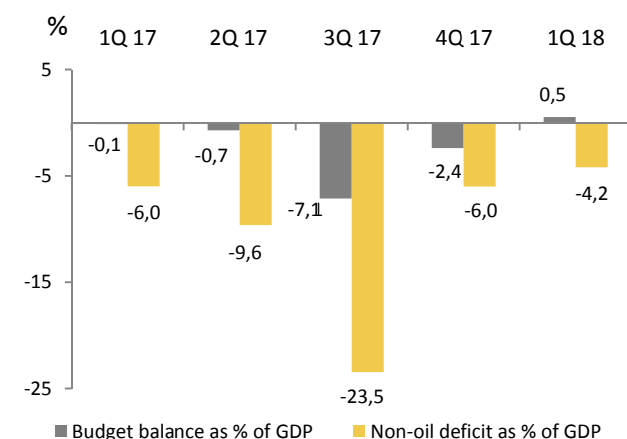
*- excl. small businesses engaged in entrepreneurship

Figure 58. Structure of State Budget Revenues



Source: Kazakhstan's Ministry of Finance

Figure 59. Change in the Overall Balance and Non-Oil Balance of the State Budget



Source: Kazakhstan's Ministry of Finance

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as at May 15, 2018

1. KEY ASSUMPTIONS FOR EXTERNAL FORECAST PARAMETERS

The average price of oil (Brent) in the first quarter of 2018 was USD 66.8 per barrel. The forecasts made by information agencies, international financial institutions and private companies regarding the oil price were revised upwards in the environment of the increased global consumption of oil as well as higher existing price levels. Imports from the USA increased significantly given a positive trend in the industrial and transport sectors of the country. In addition, the increased demand on the part of India and China also helped fix actual and forecasted value of oil prices at higher levels. The averaging of updated forecasts demonstrates that in 2018 the price of oil (Brent) will make up USD 66.2 per barrel (Table 1).

The National Bank in designing forecasts of macroeconomic variables, both for a short-term (to the end of 2018) and the medium-term (to the end of 2019) periods, set the price of oil (Brent) at USD 60 per barrel as its baseline scenario. As compared to the previous forecast round, the baseline scenario for the price of oil had not changed.

Expectations of the market participants speak for a possible moderate decline in the price of oil to USD 64.9 per barrel in 2019. In 2018-2019, the arising excess of world reserves of oil caused by the growth in supply and/or deceleration in growth of the global demand for energy carriers still represents a key risk for the oil market. Constraining factors for growth in oil prices include acceleration of extraction of shale oil in the USA given a favorable pricing environment and a new tax reform as well as the increased extraction of oil by other countries outside of OPEC. Lower growth rates of the global economy due to the slowdown in the economies of China and the EU may cause

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

Source	2018	2019	Date of the Forecast Release
International Monetary Fund	64.3	60.1	April 2018
World Bank	67.1	67.1	April 2018
Thomson Reuters	68.4	66.2	April 2018
Consensus Economics	66.2	64.9	April 2018
Bloomberg	65.0	66.3	May 2018
Average	66.2	64.9	-

Source: prepared by the NBRK

reduction in the demand. To that end, in its forecasts the National Bank additionally considers a risk scenario which assumes that the price of oil (Brent) will drop to USD 40 per barrel over the forecast horizon.

The National Bank’s assumptions regarding the terms of trade related to the demand for Kazakhstani export commodities on the part of Russia, EU and China, which accounted for 74% of the total foreign trade turnover of goods in the first quarter of 2018, had not undergone dramatic changes as compared to previous forecasts presented in the Inflation Report for the fourth quarter of 2017.

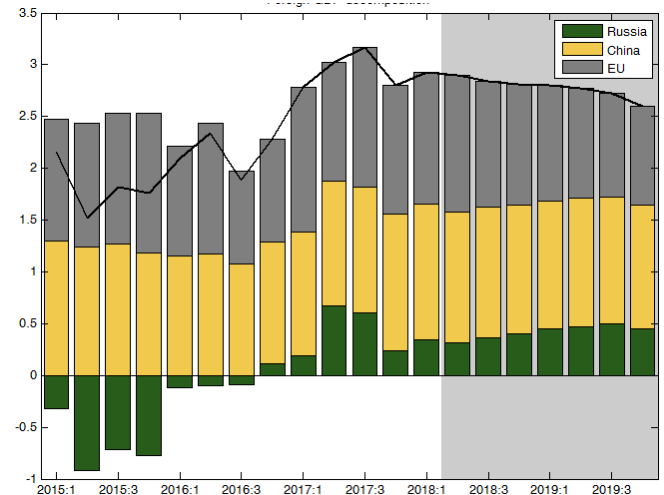
According to expectations which take into account estimates of international organizations, external demand will be demonstrating a positive pattern with a minor deceleration by the end of the medium-term horizon. To a larger extent, external demand will be slowing down against lower growth rates of the economic activity in China and the EU. However, this negative effect will be partially offset by recovery processes in the Russian economy (Figure 60).

Assessment of a future pattern of external inflation characterized as consumer inflation in main trading partners weighted based on their shares in Kazakhstan’s imports (Figure 61) was revised upwards due to higher inflation forecasts in Russia (see the Inflation Report for the fourth quarter of 2017). At the same time, inflation in China and the EU is not expected to demonstrate a significant diversion from the existing levels in the reviewed quarter.

In the short term, according to projections made by the Food and Agriculture Organization of the United Nations (FAO), the demand in the food market, cereals in particular, will prevail over supply. Therefore, world cereal stocks are expected to decrease in 2018-2019³.

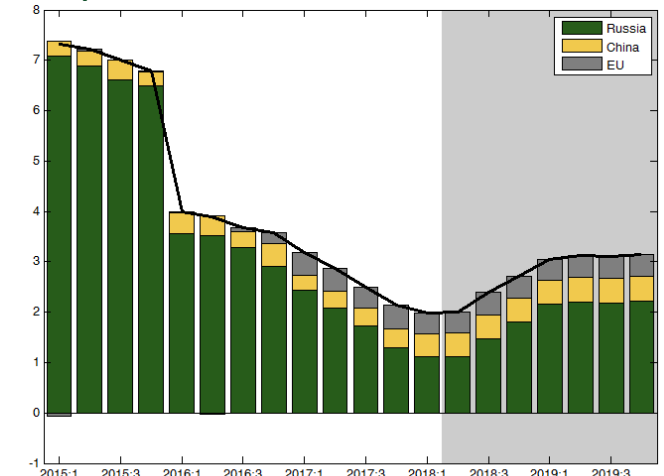
According to the National Bank’s expectations, under the baseline scenario, prices in the global food market will slightly increase in the medium term due to lower

Figure 60. External GDP Decomposition Broken Down by Kazakhstan’s Main Trading Partners, %, YoY



Source: NBRK’s calculations

Figure 61. Weighted Inflation Broken Down by Kazakhstan’s Main Trading Partners by Shares in Imports, %, YoY



Source: NBRK’s calculations

³ <http://www.fao.org/worldfoodsituation/csdb/en/>

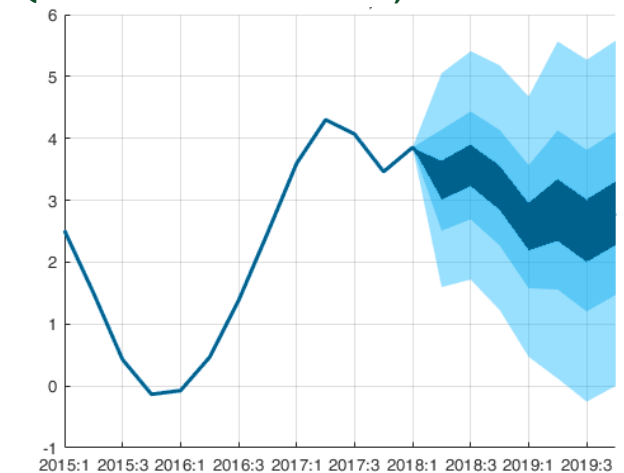
prospects for cereal crops as compared to 2017. Low prospects for cereal crops in the world are associated with risks of adverse weather conditions in the USA, the draught in Argentina as well as with the stirring up demand for rice on the part of countries in the South-Eastern Asia. Thus, at present there are good reasons to assume that world cereal prices will be having a moderately upward impact on the behavior of food prices in Kazakhstan till the end 2019.

Expectations regarding external monetary environment in the medium term have been slightly revised towards a stronger growth in the US Fed’s federal funds rate being fostered by a favorable situation in the US labor market.

2. FORECAST UNDER THE BASELINE SCENARIO

According to updated forecasts of the National Bank, under the baseline scenario Kazakhstan’s real GDP growth at the end of 2018 will account for 3.5% on a cumulative basis (Figure 62). The business activity in 2018 is expected to be of a more positive pattern as compared to prior estimates. In the short term, the consumer and investment demand will serve as key growth drivers. The growth in consumer demand will be promoted by recovery of real wages along with the increased pensions and a positive pattern in the consumer lending. A positive pattern of the investment demand will be accompanied both by the increase in fixed capital investments as a result of project implementations in the mining industry and by positive growth rates of investments into residential construction. Exports will be demonstrating a positive trend given the increased extraction of oil and gas condensate at major oilfields of the country. Based on the Government’s plans to gradually cut the budget deficit, there is an assumption that a positive contribution of the government spending on final consumption to the overall growth of the real GDP will be also limited. Imports of goods and services will be recovering following the growth in the consumer and investment activity making a constraining impact on the economic activity pattern.

Figure 62. GDP, Quarter to the Corresponding Quarter of the Previous Year, %



Source: NBRK’s calculations

In the medium term, the economy will be growing at a more moderate pace because of anticipated deceleration processes in the behavior of consumer demand and exports. Under the baseline scenario, at end-2019 the economic growth in Kazakhstan will account for 2.7%.

According to the National Bank’s updated estimates, in the short term the output gap will be positive for the first time since 2014 and will be putting a slight pro-inflationary pressure. In the medium term, the GDP gap will be at zero while it will shift to the negative value by the end of 2019.

Annual inflation forecasts were revised upwards for the short term, being caused by assumptions regarding acceleration of the domestic consumer demand given the growth in real cash income of the population along with a positive trend in the consumer lending, the growth in world prices of oil, cereals and dairy products, persisting high price growth rates in the manufacturing industry (in annual terms), deterioration of external inflationary background associated with a possible acceleration of inflationary processes in the Russian Federation as well as with the tightening of external monetary conditions.

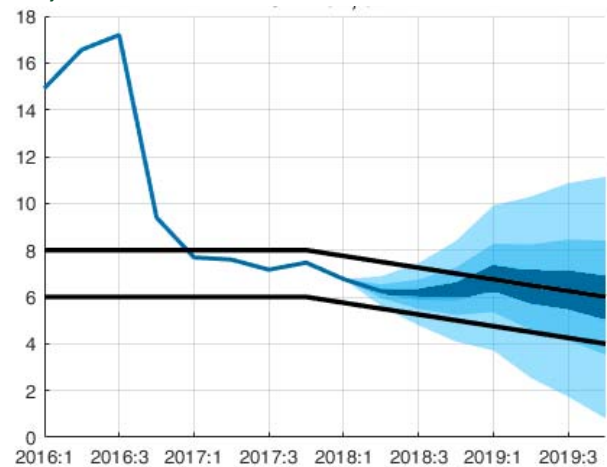
According to forecasts, under the baseline scenario, the annual inflation in Kazakhstan in 2018 will be within the target band of 5-7%, and in 2019 it will start to smoothly fit into a new target band of 4-6%, at the same time staying closer to its upper boundary (Figure 63).

3. RISKS IN THE MEDIUM TERM

Changes in the external market environment and in the domestic economic situation affected the National Bank’s decision to revise its assessment of risks in the medium term forecast (Figure 64).

The key risk of acceleration of inflationary processes in the medium term is a more positive pattern of the domestic consumer demand which is driven by the increase in wages and an anticipated significant growth in retirement benefit payments from July 2018. In

Figure 63. Inflation, Average for the Quarter, YoY, %



Source: NBRK’s calculations

addition to the above factors, a positive pattern of the consumer lending will be conducive to the growth in consumer activity.

Supply-pull shocks still represent a significant risk for the inflation forecast given high values of the producer price index.

A probability that the risks of growth in world food prices would realize was revised towards a minor increase. In the first quarter of 2018, the increase in world cereal prices amidst adverse weather conditions in the USA and the draught in Argentina served as an example of realization of such risk.

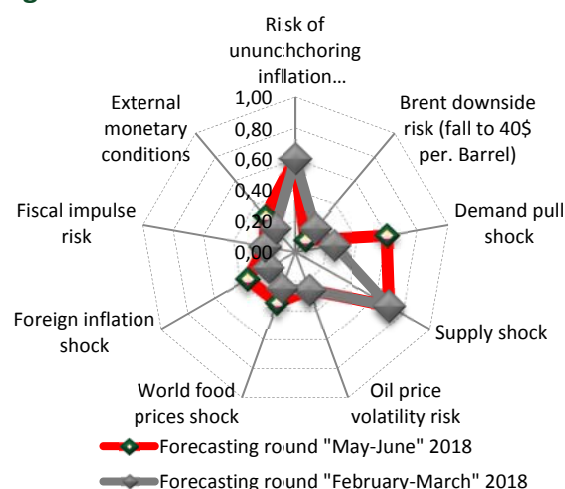
The non-anchoring of inflation expectations of the population is another risk for the price stability and it may significantly change the behavior of forecast estimates. Inflation expectations of the population remain adaptive and demonstrate a high degree of sensibility to the change in internal and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

Risks of deterioration in external monetary conditions slightly intensified as a result of anticipation of a higher US federal funds rate. In addition, risks of acceleration of external inflation were revised upwards. A higher probability of realization of such risks is related to the forecasted upward inflation pattern in Russia and achievement by inflation of its target rate in the medium term.

At the same time, the risk of the oil price drop to USD 40 per barrel has decreased given higher existing prices of energy resources. The upward trend in the oil market was accompanied by the growing demand on the part of India and China as well as a possible reduction in supply of oil on the part of Iran. Mitigation of this risk reduces uncertainty about the exchange rate behavior and the import of inflation. A probability of realization of risks of fiscal impetus and volatility of oil prices remained unchanged.

Meantime, alongside with the baseline scenario, a riskier scenario which assumes that the price of oil will fall below USD 40 per barrel was considered by the National Bank. If this scenario is realized, inflation would go beyond

Figure 64. Risk Map Based on the Expert Judgment



Source: NBRK estimates

the upper boundary of its target band in 2018-2019, and the GDP growth rates would slow down to 1.2% in 2019. A possible reaction of the National Bank would be the tightening of its monetary policy, and conditions in which the monetary policy is implemented would be changed from neutral to contracting ones. In future, in its assessment of the balance of risks, the National Bank will take into account not only external and internal factors described above but also the decisions regarding the government's fiscal and pricing policy since such decisions may significantly affect the inflation and GDP pattern.

BASIC TERM AND DEFINITIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LIST OF KEY ABBREVIATIONS

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