



National Bank of the Republic of Kazakhstan

INFLATION REPORT

September 2019

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 **15.08.2019**.

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SUMMARY

Since the publication of the previous Inflation Report released in June 2019, the National Bank has made two decisions regarding the base rate. On 16 July, the base rate was retained at 9.0% and on 9 September of this year the decision to increase the base rate by 25 basis points to 9.25% per annum was made.

The dynamics of actual inflation during recent months has been slightly higher than our forecast. In August of this year the annual inflation accelerated to 5.5% compared to our previous estimates of 5.1-5.2%.

According to the results of the forecast round, we expect an acceleration of inflation on the horizon of the next six months. By the end of 2019, inflation is assessed to be at 5.7%-5.8% as compared to the previous forecast of 5.5%. A number of existing pro-inflation factors create risks that inflation may go beyond the upper boundary of the target band in the first quarter of 2020; however, by the end of 2020 inflationary processes will decelerate and the inflation rate will be within the target band of 4-6%.

In the decision-making about increasing the base rate, the following crucial internal and external factors were taken into account.

First, it is a significant fiscal impulse as a result of the rise in the budget spending. The overall effect from the fiscal stimulus in 2019 is assessed by the National Bank to be 0.5 p.p. of an additional contribution to inflation as compared to the previous assessment of 0.3 p.p. This is related to a more significant, as compared to expectations, multiplicative effect from new social expenditures on the income of the population and the demand in the economy.

Given that in 2019 the budget expenditures for social support increased, minimum wages and salaries to civil employees and budget employees were raised, real wages in the economy as a whole increased by 8.9% during January-June, and real income of the population went up by 24.1% on a year-to-year basis.

The domestic consumer demand is expanding. During January-July, retail sales grew up by 5.4%. The consumer imports are expanding: in the first half of the year their growth accounted for 4.8%, especially as regards non-food products – for 7.3%. Along with that, the value of imports of consumer goods is growing faster than the domestic prices.

Second, it is the increase in world food prices. The FAO Food Price Index went up by 5.1% on a year-to-date basis as a result of the growing global consumption and the decreasing food reserves. First of all, it affected the prices of meat and cereals. The export price index of Kazakhstani meat producers has gone up by 36% since the beginning of the year and the export volume – by 2.8 times. The cereal exports appreciated nearly by 12% in terms of cost. According to the National Bank's assessments, because of the rise in prices in the global market the growth in domestic prices of meat products and bread products led to the 1% increase of inflation in annual terms. A further growth in world food prices will continue to influence the domestic food inflation in 2020.

Third, there is a pro-inflation pressure on the part of the business activity. The growth of economic activity is keeping above the National Bank's expectations. Over the first 7 months of this year, the short-term economic indicator has risen by 4.4%. The height is observed in all key sectors.

The real GDP growth is building above the National Bank's previous forecast in connection with the expanding domestic demand and higher actual prices of oil as compared to the baseline price forecast of USD 60 per barrel. A revised National Bank's forecast concerning the GDP growth is 3.8% at end-2019 and 3.5% in 2020. The difference between the actual and potential GDP volume is assessed to be positive up to the end of the forecast period thus serving as an indicator of persisting pro-inflation pressure in the economy.

Fourth, it is the deterioration in the country's current account of the balance of payments that affects the exchange rate dynamics with a pass-through onto prices. If the baseline scenario is realized, the current account deficit is anticipated to be 1.8-2.2% of GDP in 2019 and 3.4-3.8% of GDP in 2020. Exports of goods are expected to go down because of the increasing volatility of oil prices, planned overhaul in major oil and gas fields as well as due to a slowing external demand on the part of China and the EU.

During January-August of this year, the average price of oil (BRENT) was USD 65 per barrel versus USD 72 in 2018. Consensus forecasts about the oil price for 2019-2020 are building at USD 64-67 per barrel. Accordingly, the recovery of world oil quotations to the levels of prior years is not expected.

A high growth in imports of goods is forecasted in connection with the implementation of large infrastructure and investment projects such as the TCO expansion, construction of the "Saryarka" pipeline and others which will be supporting the demand for imported investment goods. The increasing demand for consumer imports is anticipated because of the growing real income of the population.

The following factors were having a positive impact on the inflation dynamics.

First, it is a reduction in the cost of gasoline within the structure of non-food inflation as well as of tariffs for regulated services within the structure of paid services.

Second, the stabilization of inflation expectations during the recent months. According to the public poll conducted in August, 60% of respondents anticipate that the existing inflation rate will remain the same or will decelerate in the next 12 months. The inflation rate as perceived by the population one-year ahead is assessed at 5.3% as compared to 5.4% in June and in July 2019.

Third, external monetary conditions are easing thus reducing the risks of capital outflow from developing countries. The US Fed, for the first time over 10 years, has reduced its interest rate. The Central Bank of Russia, in view of decelerating inflationary processes and a transition to a neutral monetary policy, is easing monetary conditions.

However, a constraining effect of positive external factors does not offset the impact of internal pro-inflation factors to the full extent.

Taking into consideration the balance of internal and external conditions, the National Bank is taking proactive measures in order to prevent inflation risks.

The base rate in real terms taking account of inflation expectations is assessed to be 3.3-3.5 in 12 months. This level is in line with the upper boundary of the National Bank's assessments about its neutral rate of 3-3.5%.

From June of this year, interest rates on operations conducted by the National Bank in the money market are building closer to the upper boundary of the interest rate band. The maturities of issued short-term notes have been extended; as a result, the percentage of notes with maturities of 6-12 months increased from May to August from 43% to 73%. This limits the potential of a fast overflow of the tenge liquidity to the foreign exchange market.

In August of this year, the situation in the foreign exchange market had stabilized: the demand and supply are in balance. Nonetheless, the foreign exchange channel remains one of the key risks for the growth of inflation. The rise of the base rate will enable to limit the pass-through effect onto inflation and will be helping to increase attractiveness of the tenge assets.

With a view to attain the declared inflation targets, further decisions regarding the base rate will be taken based on the current and forecasted dynamics of inflation relative to its target band, realization of risks on the part of domestic demand, the growth of imports and the situation in the global economy.

I. PROSPECTS OF THE DEVELOPMENT OF THE ECONOMIC SITUATION IN THE MEDIUM TERM AND RISKS OF THE FORECAST

Based on the unfolding situation in the global economy, in the global oil market, given forecasts of international organizations, future assumptions, in the context of the “August-сентябрь 2019”, the NBRK considered the scenario with the price of oil being at USD 60 per barrel as the baseline scenario for the forecast period from the third quarter of 2019 through the first quarter of 2021.

1.1 Dynamics of the Economic Development under the Baseline Scenario

As compared to the previous forecast round, short-term forecasts for non-food and service components of inflation have not undergone major changes. Expectations regarding the food price dynamics have been adjusted upwards.

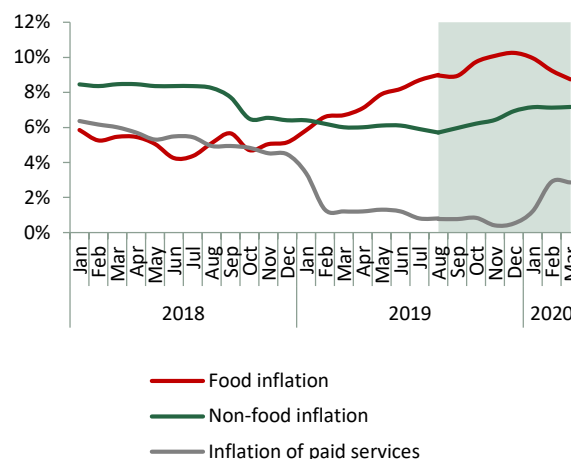
An anticipated growth of world food prices, specifically of cereals, will be putting a pro-inflation pressure on the food component of inflation. Along with that, the pressure on inflation on the part of trading partner countries is expected to decline which is associated with deceleration of inflationary processes in Russia. Already by the beginning of 2020, inflation in Russia is thought to go down to its targets.

The growth in prices of certain foodstuffs that has been observed since the beginning of 2019 will continue to put pressure on prices up to the end of this year.

The downward pattern in the cost of fuel and lubricants amidst a high supply in the domestic market of energy resources, coupled with the declining prices of regulated services, will be having a constraining effect on the growth of non-food and service components in the CPI in 2019.

However, already at the beginning of 2020 this effect will start to gradually damp out causing acceleration of the annual price growth among non-food products and paid services (Figure 1).

Figure 1. Forecast of Inflation Components for 2019-2020, YoY



Source: NBRK's forecasts

In the medium term, inflation will be gradually decelerating as a result of a more significant impact of disinflation factors.

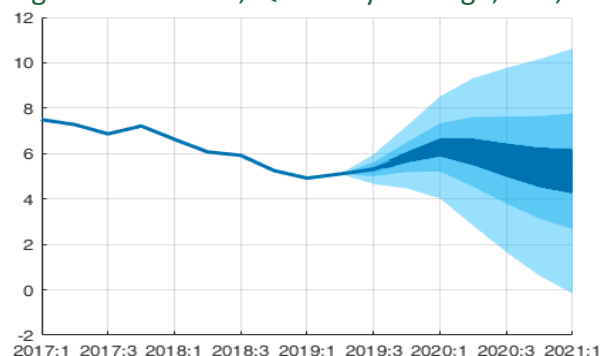
An external inflation background will be favorable given that the actual inflation is in line with its targets in the main trading partner countries.

The external background will be overarching the upward impact by the growth in world cereal prices on the dynamics of food inflation.

As for internal factors, the upward impact on the inflation dynamics that is affected by expansion in the domestic demand in a short term will be gradually slowing down by the end of the forecast period.

According to the National Bank's assessments, inflation will be staying within the target band of 4-6% in the mid-term perspective (Figure 2).

Figure 2. Inflation, Quarterly Average, YoY, %



Source: NBRK's forecast

In 2019, the economic growth in Kazakhstan will account for 3.8%. The key growth driver over a short-term horizon will still be the consumer demand amidst the increasing real cash income of the population as a result of the implementation of social support projects as well as due to the persistently high dynamics in the consumer lending.

The general government consumption, after a significant cut during 2018 (the 14% reduction in 2018), will be recovering over the forecast horizon. The general government consumption is expected to go up as a result of the increased costs related to labor remuneration and recovery of expenditures associated with the purchase of goods and services.

Given the implementation of large infrastructure projects in the economy, gross formation will be making a positive contribution to the GDP growth.

The dynamics of net exports will be serving as a constraining factor for the economic activity. The real exports will be demonstrating feebler dynamics. This will be occurring as a result of reduced production of oil and gas condensate in 2019. In 2020, the output of oil and gas condensate will reach the level of 2018.

The real imports, judging from a high consumer and investment activity in the economy, will restrain the dynamics of economic activity.

Over a short-term horizon, the GDP growth by the production method will be demonstrating positive dynamics amidst a positive economic activity in all key sectors of the economy.

In 2020, the GDP growth will slow down to 3.5%. Reduction in the growth rate of consumer demand will be associated with diminution of a positive fiscal impulse and a more modest uprise in real wages and social benefits.

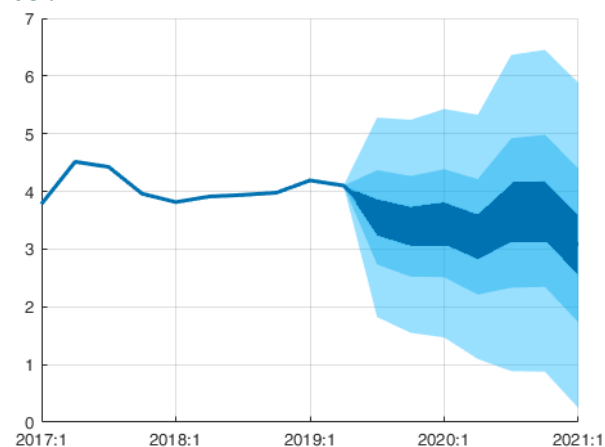
With this in mind, the effect from implementation of large-scale infrastructure projects and projects in the industry on the

investment activity will be slightly lower than in 2019.

Apart from that, a positive contribution of net exports will also slightly decrease as a result of the slowing economic activity in the countries-Kazakhstan's main trading partners (Figure 3).

Along with that, the output gap will remain positive throughout the forecast horizon putting a pro-inflation pressure on the pricing processes in the economy.

Figure 3. Dynamics of the GDP growth, YoY, as %



Source: NBRK's forecast

In the short-term perspective, the national budget deficit will be expanding as a consequence of higher growth rates of the expenditure side of the budget as compared to revenues.

In 2019, the growth in the revenue side of the budget will be secured by the rise in tax revenues and transfers.

In 2019, the increased revenues from the value-added tax driven by the growth in production volumes of goods and services as well as in revenues from the personal income tax which will be secured by the rise of the payroll fund will serve as a positive growth factor for tax revenues.

A constraining impact on the growth in tax revenues will be made by the dynamics of proceeds from export customs duties for crude oil which have a limited growth potential in 2019. This will be caused by reduction in overall oil production volumes

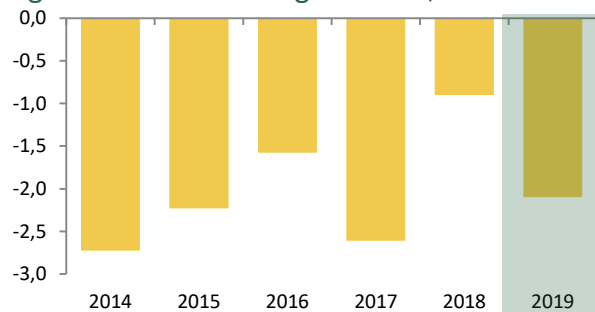
amidst scheduled repair works at the country's large oil fields during 2019.

The increase in transfers from the National Fund in 2019 to KZT 3.07 trln. will also have a positive influence on the revenue side of the budget.

The expansion in the expenditure side of the budget in 2019 will be associated with the increased expenditures for social support and social security given the rise in benefits for the low-income families and large family allowances, subsistence allowances, reduction in the debt burden of the population on consumer loans as well as the raise of salaries and wages to employees of state-owned organizations. An additional contribution to the growth will be made by expenditures for healthcare, education and debt service.

The outstripping growth of the expenditure side of the budget over the revenue side will entail the expansion of budget deficit to 2.1% in 2019 (Figure 4).

Figure 4. National Budget Deficit, as % of GDP



Source: Kazakhstan's Ministry of Finance, NBRK's forecast

If the baseline scenario is realized, the deficit on the balance of payments current account of 1.8-2.2% of GDP in 2019 and 3.4-3.8% of GDP in 2020 is expected.

The reduction in exports of goods is projected. This will be furthered by a scenario-based decline in oil prices, a scheduled repair at three large oil and gas fields, retirement of old oil and gas fields as well as by the slowing external demand on the part of China and the EU.

The growth in imports of goods will be secured by the purchase of equipment and spare parts for large investment projects and

government programs, by the uprise in disposable income of the population and high volumes of consumer loan disbursements.

Over the forecast horizon, the current account improvement is constrained by high payouts of returns to foreign direct investors under joint investment projects. The key risks to the balance of payments forecast include: deviation of oil prices and its production volumes from the scenario-based assumptions; acceleration of development rates of investment projects; a dividend policy of large enterprises as regards the accrual of returns to foreign direct investors.

1.2 Alternative Forecast Scenarios

Given a high degree of uncertainty about the path of oil prices, the National Bank, alongside with the baseline scenario, considered alternative scenarios of the oil price dynamics.

Under the pessimistic scenario, the price of oil is assumed to decline to USD 40 per barrel. The scenario envisages a higher inflation and more modest GDP growth rates. Deterioration in the external conditions will have a negative effect on the current account that would tell on depreciation of the tenge and the growth of inflation expectations. In this environment, inflation is expected to accelerate as compared to the baseline scenario; over the mid-term horizon the annual inflation will be above the target band of 4-6%. The deterioration of external conditions will cause contraction in the external demand for Kazakhstani exports; the growing inflation expectations will be limiting the expansion of consumer demand. Against this backdrop, the economic growth rates are expected to slow down to 3.5% in 2019 and to 2.9% in 2020.

The optimistic scenario suggests that oil prices will rise to USD 70 per barrel. Realization of this scenario assumes that the domestic demand will be growing at higher rates as compared to the baseline scenario, thus putting inflation pressure. Meantime, a stronger exchange rate will be offsetting the effect of this factor. Over the forecast

horizon, inflation will be building within the target band of 4-6% in 2019-2020. As compared to the baseline scenario, in the mid-term perspective the economic growth will be by 0.2 pp higher given a stronger upturn of the domestic consumption and exports.

1.3 Risks in the Medium Term

As compared to the previous forecast round, the balance of risks has changed. The dynamics of external risks are divergent and internal risks of inflation are persistently high.

The risk profile in relation to external factors has subsided as a result of the improved external monetary conditions and the slowing external inflation. A milder rhetoric of the US Fed and other central banks lowers the risks of the global capital redistribution in favor of developed countries and reduces the pressure on currencies of developing economies including Kazakhstan. Risks of importing a high external inflation slightly decreased as a result of an expected faster comeback to the inflation goal in Russia and persistently moderate growth rates of consumer prices in China and the EU countries.

As compared to the previous forecast round, the assessment of risks of the growing world food prices has not changed; however, it remains high due to the outstripping growth of global consumption over production and reduction in reserves.

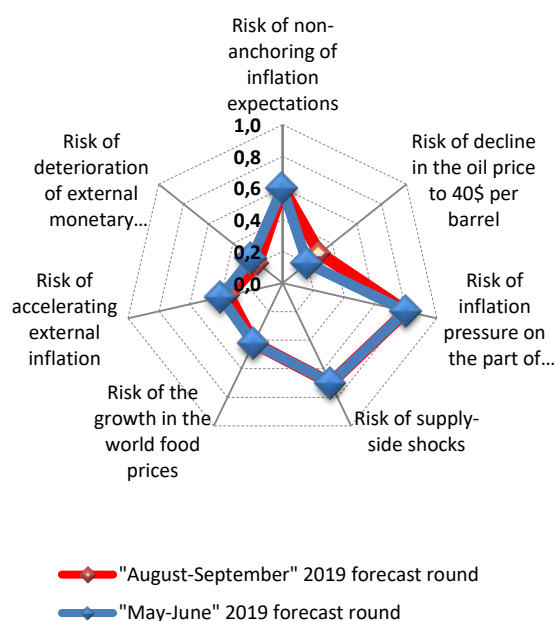
At the same time, risks regarding uncertainty about the further dynamics of oil price and its possible decline to USD 40 per barrel increased. Realization of this scenario is possible in case of a still greater escalation of trade disputes between the USA and China, a further slowdown in the global trade and global economy and a weakening demand for oil as well as the increase in oil production in the USA and unwillingness of OPEC+ countries to adhere to the agreement on cutting oil production as a consequence of losing shares in the global oil market.

Among internal factors, risks of a stronger influence of the consumer and investment demand on the price growth in the economy are still high. These risks are stemming from a steady increase in real cash income of the population and expansion of the social support measures on the part of the government.

Risks of the supply-side shocks in certain commodity markets also remain high. Moreover, due to an anticipated growth in world cereal prices as well as taking into account the dependence of food pricing on the weather conditions, acceleration of the price growth of certain groups of foodstuffs as observed in the first half of 2019 cannot be excluded.

The assessment of the risk of non-anchoring of inflation expectations has not changed. Nonetheless, the inertia of inflation expectations and their sensitivity to the rise in prices of certain goods and services and to the dynamics of the exchange rate of the tenge still represent the risk factors for achieving a low and steady inflation (Figure 5).

Figure 5. Risk Map Based on the Expert Judgment



Source: NBRK's calculations

II. EXTERNAL ASSUMPTIONS OF THE FORECAST

2.1 External Assumptions of the Forecast

During the first half of the year, international trade, investment activity and the overall global demand were characterized by feebleness dynamics than it was expected before. It was caused by aggravation of tension in trade relations between the USA and China, uncertainty about the Brexit and by geopolitical risks in the Gulf.

The IMF, for the third time this year, lowered the global economic growth for 2019 from 3.3% to 3.2%, and for 2020 – from 3.6% to 3.5%. According to the IMF's expectations, the economic downturn observed nowadays can have a negative impact on other developing markets, apart from China.

Future development of the global economy will be closely connected with the prospects of dispute resolutions in the global trade, with issues regarding the Brexit, the growing government debt and political uncertainty in some countries as well as the escalating protectionist policy on the part of the USA.

The economy in the EU countries will be developing at a slower pace than forecasted. The main reason is related to aggravation of the trade conflict between the USA and China that is negatively reflecting on the growth of the industrial sector and the investment activity. Uncertainty regarding a decision about the Brexit continues to have an additional constraining effect.

In 2019, a negative impact of the above factors is expected to persist. The economic and political situation, a high level of sovereign debt in some countries as well as an anticipated slowdown in the growth of employment amidst the increasing shortage of labor force will be making an additional contribution to the economic slowdown.

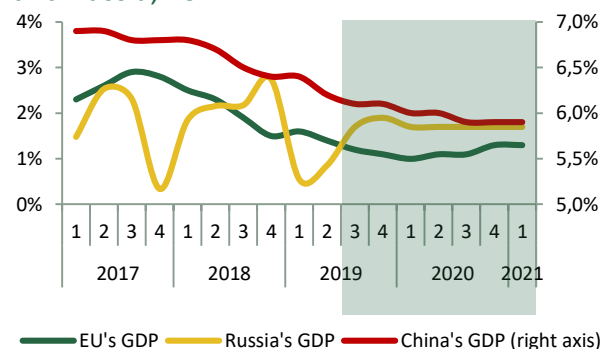
By 2020, a negative effect of the above factors will be exhausted or will be brought down to a minimum. The external demand will gradually recover. The economic growth

will be supported by the increasing disposable income of the population as well as by the stimulative measures of the European Central Bank within the frames of a more adaptive monetary policy.

The Chinese economy will continue to slow down till the end of the forecast period, despite some improvement at the end of the second quarter of 2019 in the industrial sector, investment and retail sales. In the opinion of some analysts, the Chinese economy will be slowing down not only because of the trade war but also by virtue of existing internal structural problems associated with the growing shadow economy and problems in the debt market. Besides, the effect from stimulative measures taken by the People's Bank of China is anticipated to be minimal.

Russian economy. According to forecasts made by the Russian Ministry of Economic Development (MED), at the end of 2019 the economic growth rates will accelerate and will account for 1.3%. The increased federal budget spending and the effect from the monetary policy easing will be supporting the GDP growth. In 2020, the GDP growth will accelerate to 1.7%, which is associated with the anticipated growth of fixed capital investments (Figure 6).

Figure 6. Real GDP Growth in China, the EU and Russia, YoY



Source: Eurostat, National Bureau of Statistics of China, Rosstat, Russia's MED, Consensus Ecs., European Commission

2.2 External Inflation Dynamics

Over the forecast horizon, the external inflation background is expected to improve. Inflation figures in the main

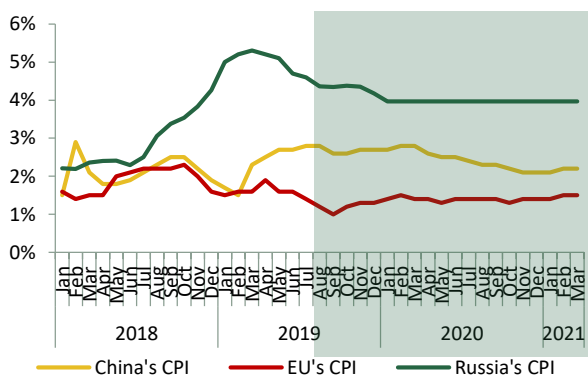
trading partner countries will be close to their targets.

Inflation in the EU will remain close to its existing rates up to the end of the forecast period. The constraining effect is expected to be made by moderate growth rates of the economy, a stronger exchange rate of the domestic currency as well as the feebler projected dynamics of energy prices.

Inflation in China, given the anticipated depreciation of the Yuan against the US Dollar, will be building up at a higher than expected rate almost up to the middle of 2020. At the end of the forecast horizon, inflation will stabilize at 2.2%.

Inflation in Russia, according to forecasts made by the Central Bank of Russia, will account for 4.0-4.5% at the end of 2019. Deceleration in the price growth will be associated with the sluggish dynamics of the domestic and external demand. The inflation is assumed to come back to its targeted level already at the beginning of 2020 (Figure 7).

Figure 7. Inflation in China, the EU, Russia, YoY



Source: Eurostat, National Bureau of Statistics of China, Rosstat, Central Bank of Russia, Consensus Ecs., European Commission

2.3 Monetary Conditions in the External Sector

As a result of a milder rhetoric of large central banks, external monetary conditions eased significantly.

On 31 July 2019, the US Fed for the first time since 2008 reduced its policy rate by 25 basis points to 2.0%-2.25% and also announced about the ahead-of-schedule lapse in the cut-down of the balance from 1

August 2019. The reduction in interest rate was influenced by the escalation of trade war which had a negative impact on the growth of global economy and trade as well as by a low inflation in the USA. The future dynamics of the US Fed's rate will be determined depending on the existing situation and will be going down only in case if such necessity arises.

In order to support the economic growth and to bring inflation more in line with its target, the ECB left its interest rates unchanged until the first half of 2020; it also announced that the quantitative easing program will be resumed from 1 November 2019.

In the environment of slow economic growth rates, the Central Bank of China put in place the interest rate reform. Bank interest rates will be tied not to the policy rate but to the LRP (loan interest rate for prime borrowers), which is regarded as the rate which is more close to the market interest rates. Such arrangements are expected to reduce the cost of loans for enterprises and households.

Given that in 2019 the dynamics of inflationary processes in Russia had been building below expectations of the Central Bank of Russia and at the beginning of 2020 it is anticipated to decelerate to the targets, on 6 September 2019 the Central Bank of Russia reduced the key rate from 7.25% to 7.00%.

2.4 Commodity Markets

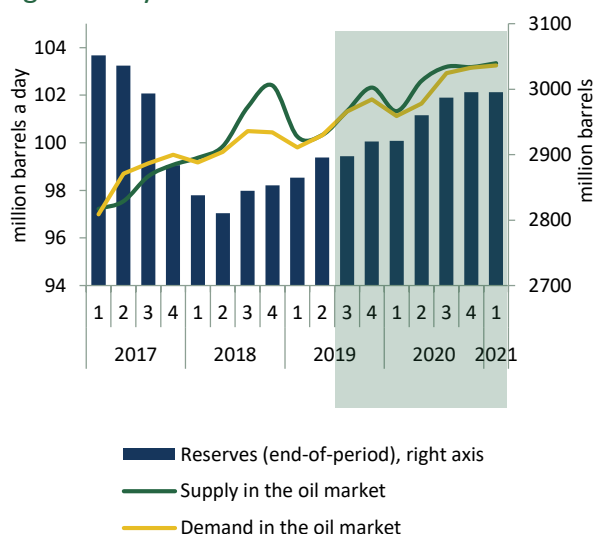
According to assessments made by the U.S. Energy Information Administration, over the forecast horizon the growth rates of world oil reserves will be gradually declining. However, no essential reduction is anticipated due to a high oil output and a slower growth in its global consumption. According to estimates, the oil market will approximate the balance by the end of the forecast period.

Beginning from mid-July 2019, world oil prices started to fall because of a sluggish demand and a high oil output in the USA which, in summation, led to the growth in

world oil reserves (Figure 8). An additional pressure was put by escalation of the trade conflict between the USA and China as well as by the growing concerns about a further reduction in oil consumption.

During eight months of 2019, the average price of oil (Brent) was USD 64.91 per barrel, whereas in the corresponding period of the previous year the price of oil was recorded at USD 71.4 per barrel.

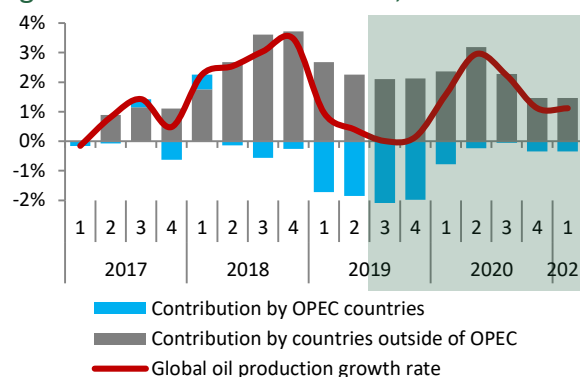
Figure 8. Dynamics of the Global Oil Market



Source: EIA

According to the EIA assessments, the global oil production will continue to increase. Countries outside of OPEC, especially the USA, Brazil, Canada and Norway, will remain to be the main oil suppliers (Figure 9). The production growth in these countries will be supported by the launch of new pipelines. OPEC+ countries will keep cutting oil production in line with the concluded agreement. Unscheduled shut-downs, the geopolitical uncertainty, lengthy maintenance at the oil fields, dynamics of investments into exploration and production of mineral resources represent the key factors of uncertainty for the further growth in oil supplies.

Figure 9. Global Oil Production, YoY

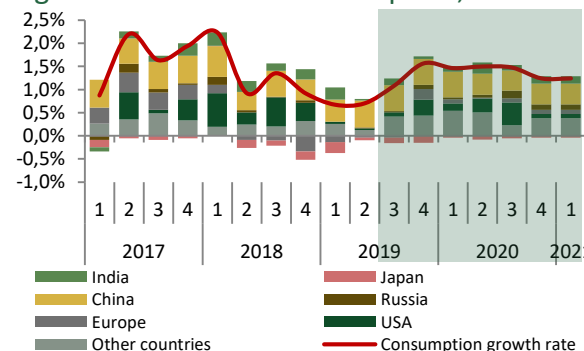


Source: EIA

Given the coming small signals related to the economic activity in oil importing countries, the demand for oil is expected to grow, however, at a slower pace than was earlier forecasted (Figure 10). The key growth sources will include India, China, the USA and Russia. Acceleration of the demand for oil will be compensated by the reduced consumption in Japan, Europe and Canada.

The movement pattern of oil prices in the nearest term will be at large depending on the outcomes of trade negotiations between the USA and China as well as on the future rhetoric of the US Fed.

Figure 10. Global Oil Consumption, YoY



Source: EIA

The volatility of oil prices may intensify because of disruption of supplies from the Middle Eastern countries, the tightening of sanctions against Iran and Venezuela, introduction of new IMO 2020 marine claims as well as due to the expansion of the protectionist policy in the world.

According to forecasts of international organizations, the consensus forecast for the price of oil (Brent) in 2019 will be on average USD 66.5 per barrel, in 2020 – USD 65.2 per

barrel, and at the beginning of 2021 – USD 65.9 per barrel (Table 1).

Table 1. Forecast of the Oil Price (Brent), USD per barrel

	2019	2020	Q1 2021
Thomson Reuters*	65.0	64.5	66.0
IMF**	68.4	66.7	-
World Bank**	68.7	67.6	68.1
Bloomberg***	65.0	63.5	64.0
Consensus forecast****	65.5	63.9	65.4
On average	66.5	65.2	65.9

* The forecast median based on data at 30.08.2019

** The IMF's (July 2019) and the World Bank's (June 2019) forecast is based on the averaging of oil price of such oil brands as U.K.Brent, Dubai Fateh, and West Texas Intermediate crude oil

*** The forecast median based on data at 13.09.2019

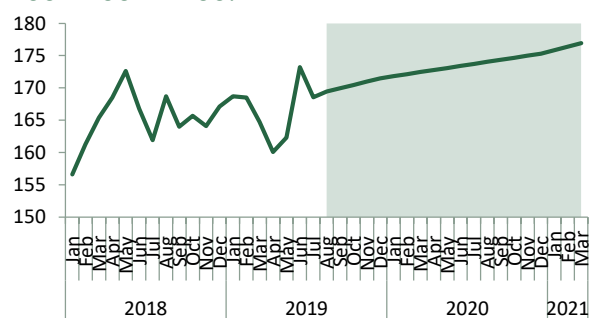
**** Survey of 19 August 2019

In the mid-term perspective, given a decline in the cereal stock, the FAO Cereal Price Index which is a proxy of the food component of inflation is going to go up.

In the 2019-2020 season, the UN Food and Agriculture Organization forecasts the 1.2% growth in production of cereals and 1.0% increase in their consumption. In this context, the cereal stocks will decline by 3.2% as compared to the past season. The ratio between cereal stocks and their consumption will shrink to 29.6, which will be the minimum for the last six years.

The food consumption of wheat will be in line with the population growth rates; consequently, limitations for the crop acreage will serve as the factors of a further reduction in cereal stocks (Figure 11).

Figure 11. FAO Cereal Price Index, 2002-2004 = 100%

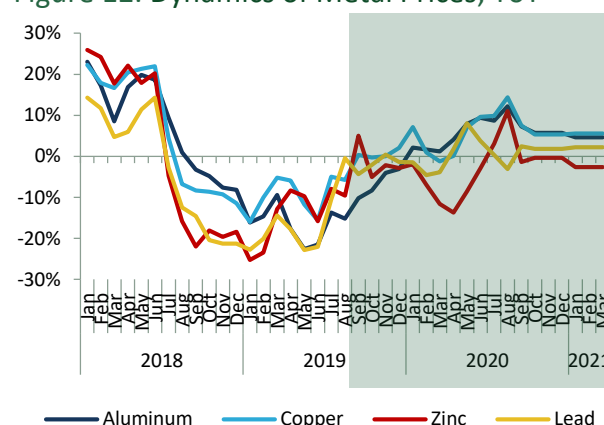


Source: the UN Food and Agriculture Organization (FAO)

The forecast regarding the metal prices for the second half of 2019 and for 2020 is generally positive.

In the reporting period, the non-ferrous metals market was characterized by strong price volatility. Over the forecast horizon, the growth in prices of metals will be curbed by a slowdown in the Chinese economy including due to the persisting uncertainty in trade relations with the USA as well as a sluggish investment activity. An upward pressure on prices is expected on the part of a weaker exchange rate of the US Dollar and the Chinese Yuan as well as a result of possible disruptions in supplies of metals and reduction in their reserves (Figure 12).

Figure 12. Dynamics of Metal Prices, YoY



Source: Reuters, Consensus Ecs.

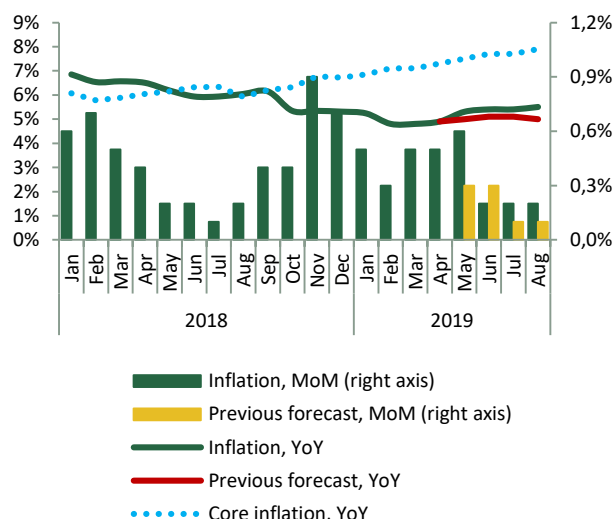
III. PRICES AND INFLATION EXPECTATIONS

3.1. Inflation

Based on performance in May-August 2019, the inflation dynamics was building above the forecasted numbers (Figure 13). This fact is related to acceleration of the food component given a stronger than expected growth in prices of meat and bread and bakery.

A major underestimation of inflation occurred in May when the monthly inflation had been at 0.6% with the forecast of 0.3%.

Figure 13. Dynamics of Actual and Forecasted Inflation

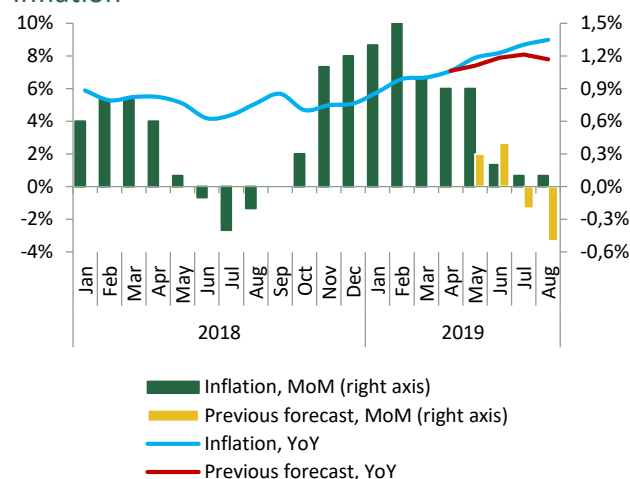


Core inflation excl. the growth in prices of vegetables and fruits, regulated services and energy resources.

Source: CS MNE, NBRK's forecasts

Acceleration of inflation in May-August 2019 is explained by the dynamics of food prices (Figure 14). In their structure, the increase in prices of meat by 8.9% (January-August 2018 – by 3.8%), bread and bakery – by 9.9% (1.4%), and fish and seafood – by 7.0% (3.1%) is worth noting.

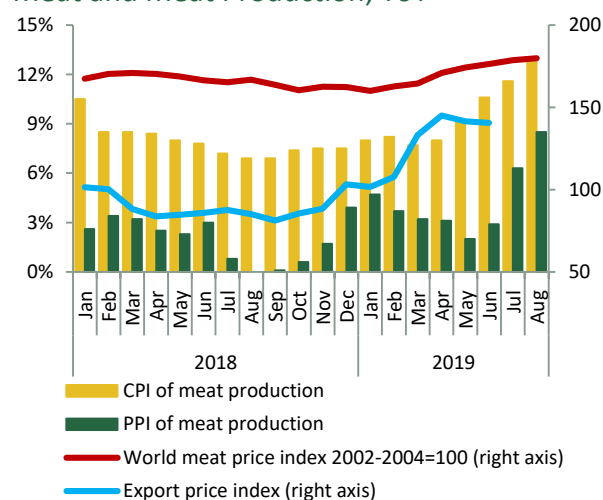
Figure 14. Actual and Forecasted Food Inflation



Source: CS MNE, NBRK's forecasts

Prices of meat products were rising against the growth in world prices which led to the corresponding increase in prices of export and import supplies as well as prices of Kazakhstani producers (Figure 15).

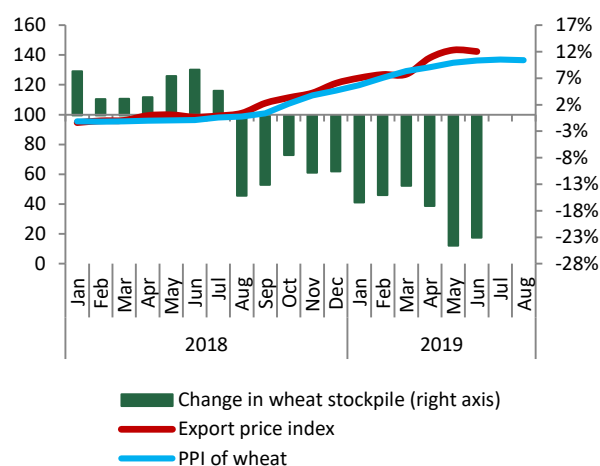
Figure 15. World and Domestic Prices of Meat and Meat Production, YoY



Source: CS MNE, FAO

At the end of 2018, the increased external demand for wheat was observed which was furthering the growth in exports and decline in reserves of Kazakhstani grain. This reflected on the rise in the domestic producer prices and prices of wheat export supplies (Figure 16), whereby the increase in consumer prices of bread and bakery was observed.

Figure 16. Producer Prices, Export Prices and Wheat Stockpile, YoY



Source: CS MNE

In August 2019, a dramatic upswing in prices of eggs was observed after a seasonal price decline which has been evidenced since February 2019. So, in August 2019 as compared to the previous month, prices of eggs increased by 6.3% on the back of growing producer prices (by 12%).

In January-August 2019, the fruit and vegetable production appreciated in terms of price by 4.1% (in January-August 2018 – the 4.4% decline).

Despite the fact that deflationary processes in the monthly dynamics of vegetable prices typical for the summer period have been observed since June 2019, in general the price of vegetables increased by 3.6%. To a large extent, this was related to a significant rise in prices which occurred in the first quarter of 2019 (the growth of 25.1%).

At the same time, in January-August 2019 the 4.9% decline in prices of sugar was recorded (in January-August 2018 – the growth of 10.9%).

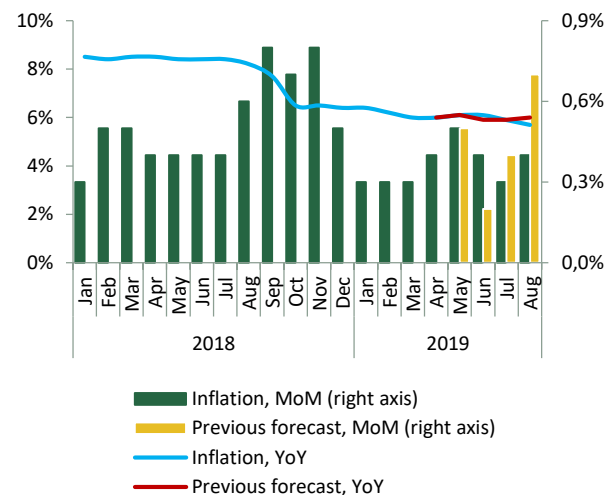
The reduction in price of sugar occurred against the declining prices of import from Russia, curtailment of exports and favorable terms for imports of unrefined sugar from outside the EAEU that will be in effect till the end of this year.

Since meat products, bread and bakery, fruit and vegetable production and eggs appreciated in terms of price despite the

monthly decline in prices of vegetables and sugar, deflationary processes on the food component which are typical for the summer period have not been observed.

The growth in prices of non-food products in May-August 2019 was modest and was generally in line with the forecast dynamics (Figure 17).

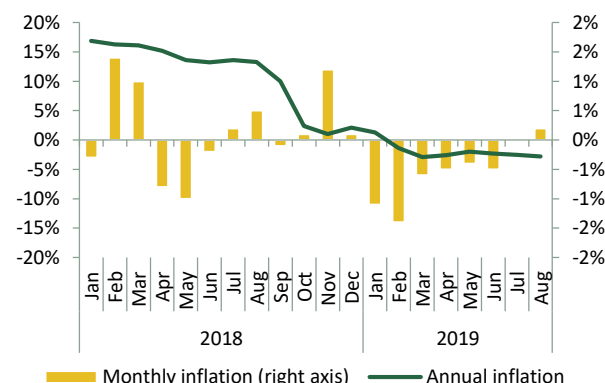
Figure 17. Actual and Forecasted Non-Food Inflation



Source: CS MNE, NBRK's forecasts

This year, the annual non-food inflation was decelerating and accounting for 5.7% in August 2019. The dynamics of prices of fuel and lubricants limits the growth in prices of non-food products (Figure 18). So, over 8 months of 2019, gasoline has cheapened by 4.5%, and diesel fuel – by 0.9%.

Figure 18. Price Dynamics of Fuel and Lubricants



Source: CS MNE

The decline in prices of gasoline and diesel fuel was occurring against the growing

production volumes as a result of modernization of oil refineries at the end of 2018 as well as due to the increase in excise rates of gasoline imports, introduction of a ban for gasoline import by railways and a ban for shipment of diesel fuel by road.

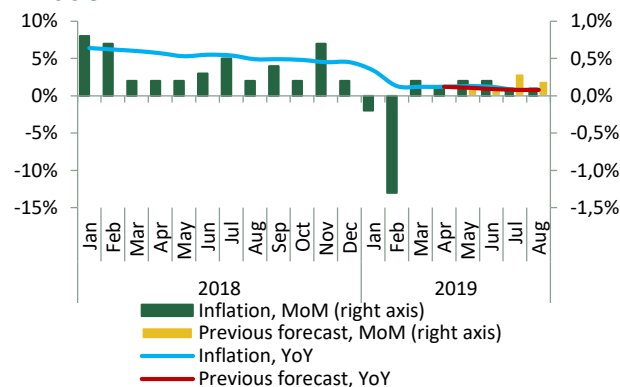
In the structure of non-food products, the price growth has been observed on other items. So, over 8 months of 2019, footwear and clothes appreciated by 4.1% in terms of price, household utensils and household appliances – by 4.0%, medications – by 5.0%, and purchase of vehicles – by 5.6%.

The upward impact on prices of goods in this category was made by expansion in the consumer demand that was accompanied by the growing retail sales of non-food products and by the increased volumes of consumer lending. Besides, given that a major portion of non-food products in the consumer basket is imported, a gradual depreciation of the nominal exchange rate of the tenge against the US Dollar and the Russian ruble during this year also put an upward pressure on the pricing processes of goods in this category.

The actual growth in prices of paid services in May-August 2019 was in line with the forecast dynamics (Figure 19).

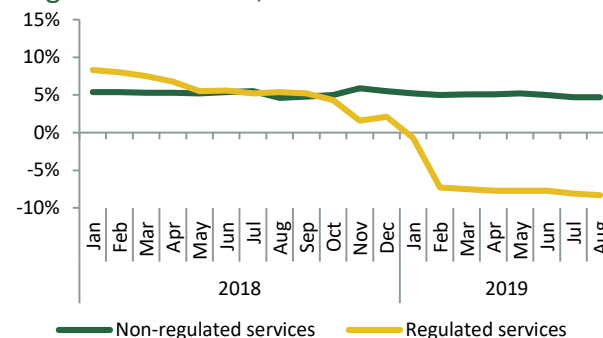
In August 2019, the annual growth in prices and tariffs for paid services has been at its historical minimum (0.8%). The annual inflation of non-regulated services slowed down to 4.7% from 5.2% in May, and regulated services became cheaper by 8.3% (Figure 20).

Figure 19. Actual and Forecasted Service Inflation



Source: CS MNE, NBRK's forecasts

Figure 20. Dynamics of Regulated and Non-Regulated Services, YoY



Source: CS MNE

The 2.3% reduction in the cost of airline services in August 2019 as compared to the corresponding period of the last year was conducive to the disinflation of non-regulated services. The dynamics of other non-regulated services remain weakly positive.

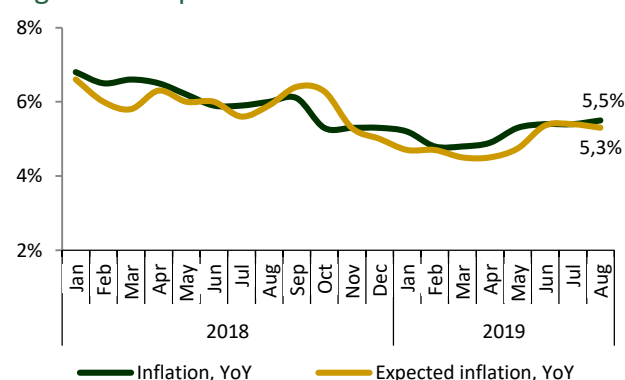
The monthly dynamics of prices and tariffs for regulated services are staying at zero and weakly negative values. Generally, over 8 months of 2019 utilities have cheapened by 4.3%, including cold water – by 7.8%, hot water – by 10.1%, waste water disposal – by 7.2%, and electric energy – by 5.6%.

3.2. Inflation Expectations

In August 2019 as compared to June-July 2019, inflation expectations were subsiding.

In August 2019, the quantitative assessment of inflation in one year ahead made up 5.3% as compared to 5.4% in the previous two months (Figure 21).

Figure 21. Expected and Perceived Inflation

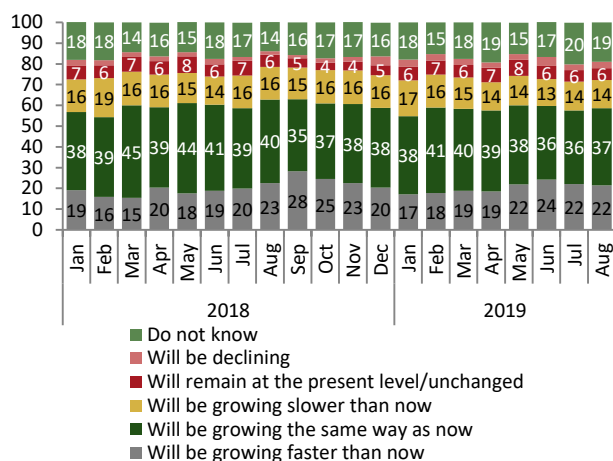


Source: CS MNE, Lab Fusion

According to the public opinion poll, 60% of respondents anticipate that the existing inflation rate will remain or will decelerate within the next 12 months (Figure 22).

Figure 22. 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: FusionLab

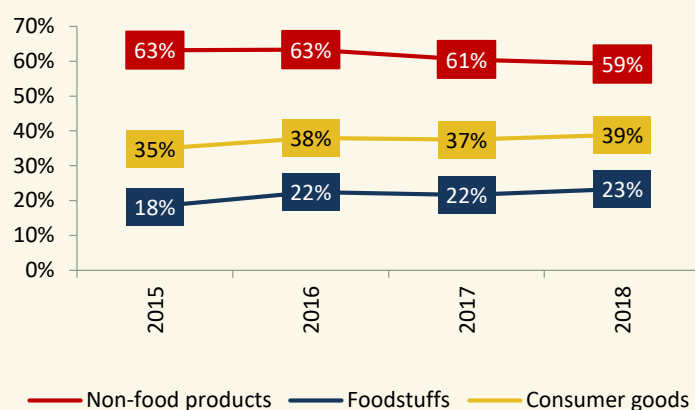
Respondents note the growth in prices of foodstuffs which reflects the sensitivity of population to the rise in prices of day-to-day items that account for a large share in the household spending. Based on the outcomes of poll conducted in August 2019, 32.2% of respondents mentioned the growth in prices of meat and poultry as compared to 24.9% in July, bread and bakery and cereals – 16.6% versus 15.9%. There was an increased percentage of respondents who noted the rise in prices of cereals and macaroni products – from 10.1% in July to 14.2% in August, dairy products – from 14.4% to 15.9%, eggs – from 2.6% to 4.1% [Supplement 3].

Answers of respondents are generally corresponding to the official inflation statistics. According to the CS MNE RK, in July and August prices of meat and meat products, bread products and cereals were growing at the largest pace.

Box 1. About the Share of Imports in the Consumption

Inflationary processes in Kazakhstan are developing under the impact of various factors among which external factors play an important role. In order to assess the importance of such impact, one should take into account the share of imports in the consumption of goods. In Kazakhstan, the import component has not changed significantly in the recent years. So, over the last four years, the share of imports in the consumption of goods has been fluctuating within 35-39% (Diagram 1).

Diagram 1. Share of Imports in the Consumption of Goods



Source: CS MNE

The largest share of imports is seen in the consumption of non-food products; it accounted for 59% in 2018. At the same time, the share of imports in the consumption of foodstuffs is much smaller: in 2018 it was 23%.

The Russian Federation is Kazakhstan's main trading partner and it provides the largest portion of both food and non-food imports.

Domestically produced goods account for a significant portion in the consumption of the majority of **foodstuffs**. At the same time, a high share of imports in January-June 2019 was

observed in the consumption of fish and seafood (95%), tea and coffee (78%), sugar (54%), cheese and cottage cheese (46%), vegetable oils (40%)¹. A significant portion of Russian goods is presented in the consumption of sugar, vegetable oil, confectionery, fish and seafood, poultry, and dairy products.

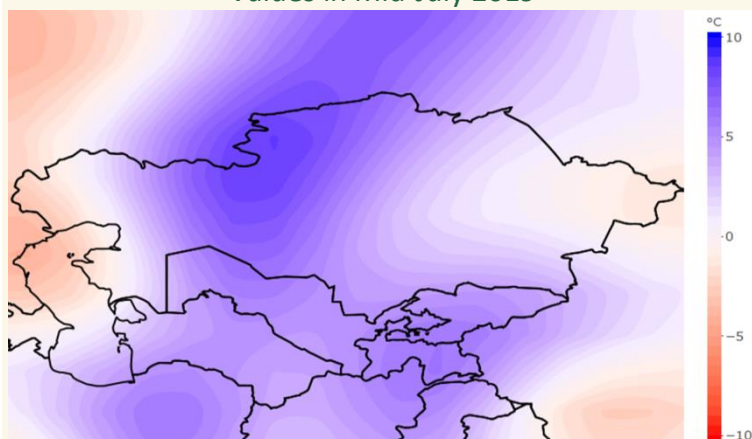
The imports of **non-food products** are considerably exceeding the imports of foodstuffs due to insufficient development of the domestic production. The consumption of footwear, clothes, household appliances, perfumery products and beauty products is almost fully backed by imports. A sizable portion of Russian products is presented in the consumption of cars, home furniture, detergents, household appliances, linoleum, and vitamins.

A large share of imports in the consumption of non-food products given the absence or insufficient domestic production creates high risks of the price upswing in case of depreciation of the tenge as well as in case of the growth in prices of such goods in the trading partner countries.

¹ Calculated based on the data from the Bulletin of CS MNE RK on the balance of resources and the use of some types of products (goods) and raw materials in the Republic of Kazakhstan, share of imports = imports/realization in the domestic market

Box 2. Risks of Fight Crop of Cereals in 2019

Diagram 1. Temperature Deviation from its Average Values in Mid-July 2019



Source: NBRK, based on the data from Earth System Research Laboratory

In July 2019, an abnormal temperature rise above the average temperature was observed across much of Kazakhstan. So, in Kostanay oblast and in the adjacent oblasts the instances of 40 degree (Centigrade) heat were recorded (Diagram 1). This fact caused the draught in the region and led to a depression of yield of cereals and pulse crops; this compelled to start the harvesting in the season ahead of a normal schedule.

According to the updated information from the Ministry of Agriculture, by 28 August 2019 22.8% or 3.5 million hectares of crop acreage were harvested in Kazakhstan,

which shows a two-fold increase as compared to the corresponding period of 2018 (Table 1). Meantime, this year the average crop productivity decreased to 12 hundredweights on a hectare from 14.7 hundredweights on a hectare in 2018.

With this background, if one assumes that till the end of 2019 the crop productivity will remain at the existing levels, the gross crop of cereals may amount to 18.3 million tons, which is by 20% less than in 2018 (22.8 million tons).

In addition, it is worth mentioning that from August 2018 cereal stocks have been going down given the 50% growth in export volumes in 2018 and the rising domestic prices of wheat producers (Diagram 2). On the year-to-date basis, exports somewhat decreased (by 2.6% over six months of 2019), meanwhile the domestic stocks continue to go down.

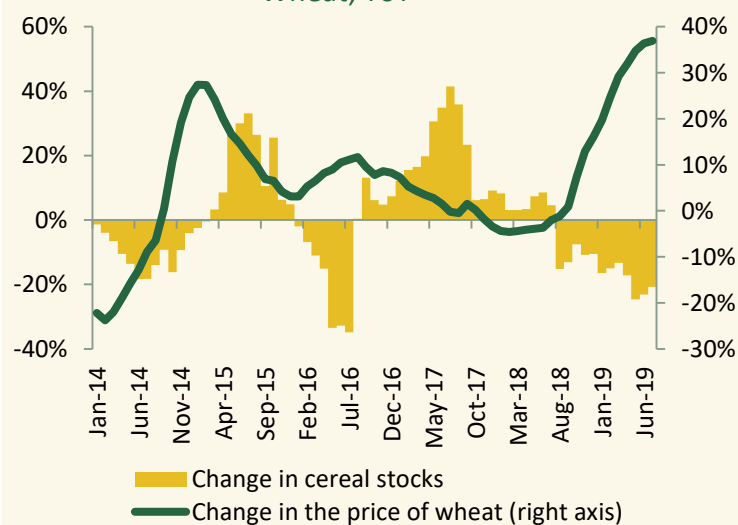
Reduction in the domestic stocks, coupled with the anticipated depression of cereal crops, poses the risks of a further price growth in the domestic market. The increasing cost of cereals may cause the rise in price of flour; this, in turn, will tell on the cost of all bread and bakery products.

Table 1. Updated Information about Harvesting of Cereal Crops in 2018-2019*

Region	Harvested, th. ha				Productivity, t / ha	
	2018		2019		2018	2019
	th. ha	%	th. ha	%		
Akmola	29.5	0.7	396.1	9.0	11.2	9.9
Kostanay	221.0	5.4	1034.5	26.1	8.0	4.6
North	32.6	1.2	500.0	17.5	13.2	14.3
Karaganda	5.6	0.7	94.6	11.2	9.8	9.3
Pavlodar	25.7	3.5	148.2	18.9	10.8	9.1
East Kazakhstan	152.6	28.3	159.7	29.0	15.0	18.1
Aktobe	128.2	29.1	114.0	24.9	6.1	4.9
Almaty	258.0	57.3	278.4	61.7	19.4	21.2
Zhambyl	280.4	99.6	332.3	99.6	22.9	23.0
West Kazakhstan	187.2	77.1	175.2	71.0	7.1	9.0
Turkestan	236.3	99.1	224.4	97.3	17.8	20.8
Kyzylorda	6.1	6.4	8.4	8.7	17.0	17.5
Total	1563.2	10.4	3465.8	22.8	14.7	12.0

Source: Kazakhstan's Ministry of Agriculture. * Data at 28 August

Diagram 2. Dynamics of Cereal Stocks and the Price of Wheat, YoY



Source: Kazakhstan's Ministry of Agriculture, CS MNE

IV. ECONOMIC DEVELOPMENT

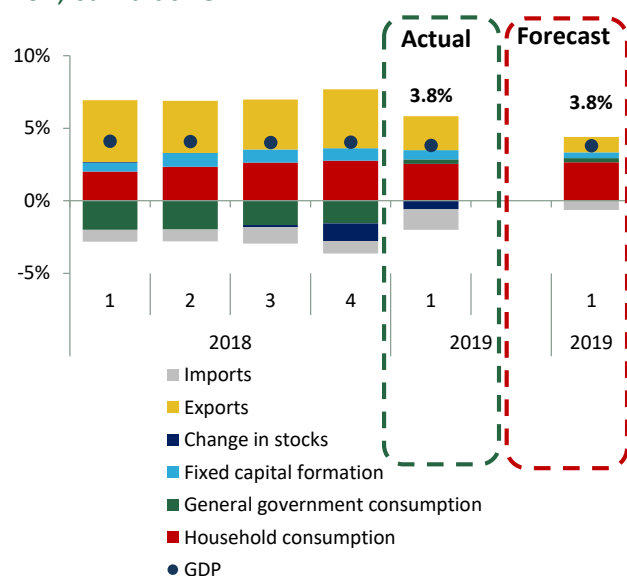
4.1. Domestic Demand

In 2019, the consumer and investment demand is expanding owing to a significant fiscal impulse and implementation of large infrastructure projects. As a result, real wages and cash income of the population are growing, thus intensifying inflation pressure in the economy.

The GDP growth by the final use method at the end of the first quarter of 2019 made up 3.8%, which is fully in line with the forecasts (Figure 23).

Forecasts of the consumer demand and of the general government consumption appeared to be the most precise. There were deviations in the forecast of exports and imports which were underestimated; the forecast of gross formation turned out to be more optimistic (overestimated) as compared to the actual number.

Figure 23. Actual and Forecasted GDP by the Final Use Method. GDP Decomposition Broken Down by Component Contributions, YoY, cumulative



Source: CS MNE, NBRK's calculations, NBRK's forecasts

In the first quarter of 2019, the real growth of exports accounted for 5.3%, with the forecast of 2.4%. A slowdown in real exports was expected in connection with more moderate assessments about

production of oil and gas condensate (22 million tons of oil and gas condensate).

The underlying assumptions for such assessments included the shut-down of a large field (Kashagan) for a major overhaul, a cut in the daily production of oil within the frames of the OPEC+ agreement, a natural slow-up of production at old fields given a high depreciation of property, plant and equipment, and reduction in external demand for Kazakhstani exports.

Meantime, due to a full load of all large fields in the country, the actual extraction of oil and gas condensate amounted to 23 million tons, which exceeds the extraction in the corresponding period of the last year by 2.7% in real terms.

Despite a feeble growth of oil production, its exports decreased by 3.1% in kind, and by 9.7% - in value terms. To a large extent, this was associated with the reduced demand for oil on the part of key consumers of Kazakhstani oil: Italy (reduction by 16.8%), the Netherlands (by 50.6%) and France (by 6.9%).

Total exports declined by 4.3% in value terms. In this context, the growth of real exports in the first quarter of 2019 was mainly driven by the weaker tenge as compared to the first quarter of 2018 (the 16.8% depreciation of the tenge).

Imports of goods and services in the first quarter of 2019 went up by 5.0%, with the forecast of 2.2%. Assumptions about a constraining effect of imports on the GDP growth given a high consumer demand have realized. So, in the structure of imports the growth was seen in consumer goods only (the 3.5% in kind), with their share in total imports accounting for 24%.

Imports of the remaining groups of goods decreased: imports of interim goods – by 4.5%, imports of investment goods – by 6.3% and imports of other goods – by 0.2%.

Therefore, the growth in real imports, same as with exports, was mainly determined by depreciation of the exchange rate of the tenge against the US Dollar in the first

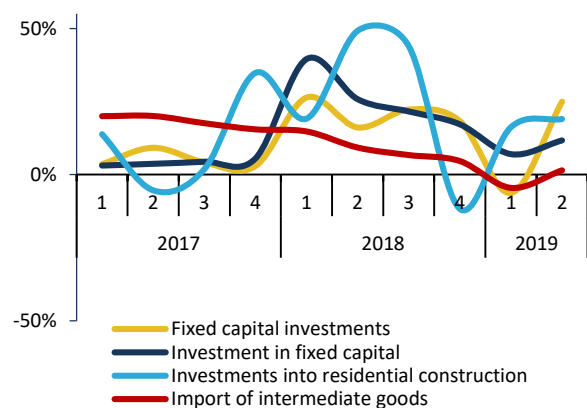
quarter of 2019 as compared to the corresponding period of 2018.

The dynamics of investment activity in the first quarter of 2019 was moderate. Fixed capital investments grew by 7.0%. This resulted in the 3.4% growth of fixed capital formation. Meanwhile, amidst the continuing reduction of reserves in the economy, the gross formation in the first quarter of 2019 increased by 0.2% only, which is well below the forecasts (the growth of 1.7%).

At present, fixed capital investments accelerated (the growth of 11.7% in the first half of 2019 as compared to the corresponding period of the last year) (Figure 24). Specifically, the amount of construction and major overhaul works increased given the implementation of large infrastructure projects in the economy. As a result, after its deceleration in the first quarter, the investment imports accelerated as at the end of the first half of 2019 (the growth of 25%) and imports of interim goods increased (by 1.5%).

Investments into residential construction based on performance in January-June 2019 showed a strong growth of 19%. The increase in investments was observed in all regions except such oblasts as Karaganda (the drop by 7.9%), Kostanay (by 17.4%) and Mangistau (by 17.5%). A significant growth is observed in the city of Shymkent (by two times), in Turkestan (by 45.3%) and the North Kazakhstan oblasts (by 42.7%).

Figure 24. Investment Activity Indicators, YoY cumulative

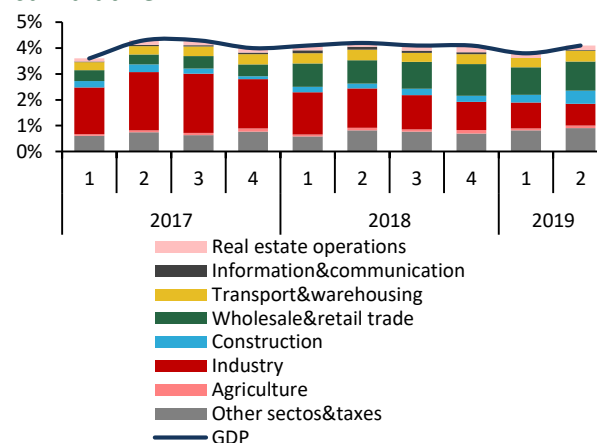


Source: CS MNE, NBRK

4.2. Domestic Supply

According to preliminary data from the Ministry of National Economy for January-August 2019, the real GDP growth by the production method accounted for 4.3% as compared to corresponding period of the previous year (Figure 25).

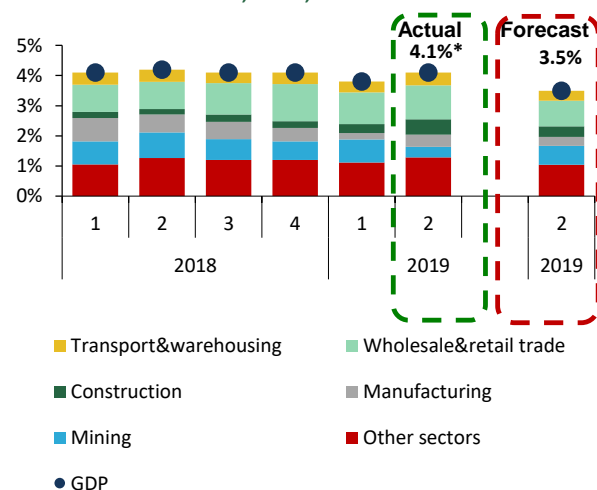
Figure 25. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY, cumulative



Source: CS MNE, NBRK's calculations

The growth accelerated in the manufacturing industry, in construction, trade and transport sector; its pace appeared to be more optimistic as compared to the National Bank's assessments. However, actual growth rates in the mining industry were feeble as compared to the forecast (Figure 26).

Figure 26. Actual and Forecasted GDP by the Production Method. GDP Decomposition by Economic Sectors, YoY, cumulative



Source: CS MNE, *Estimates

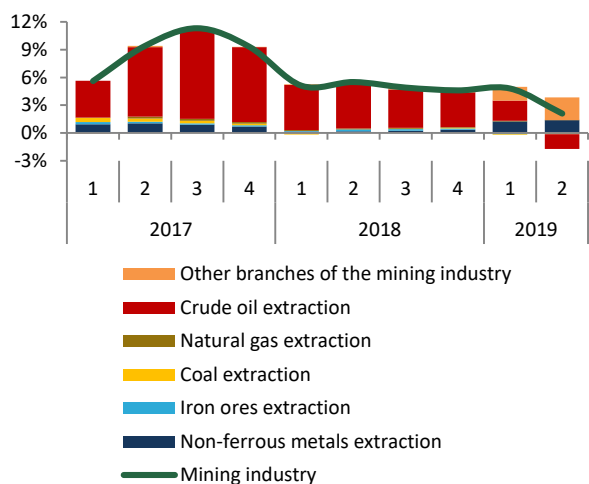
In January-August 2019, the growth in the mining industry accounted for 3.1%.

During the year, deceleration was associated with the decreased production of crude oil and gas condensate, coal and lignite, and iron ore. The reduction in production of crude oil and gas condensate stemmed from the drop in the oil extraction at the Karachaganak oil field (shutting-in of wells because of the boosted content of stratal water) and Kashagan (scheduled repair works for 35 days with a total shutdown of production).

A positive contribution to the growth in the sector was made by the increased volumes of metal ores production, namely ores of non-ferrous metals (Figure 27).

During January-August 2019, the manufacturing industry grew by 3.3%.

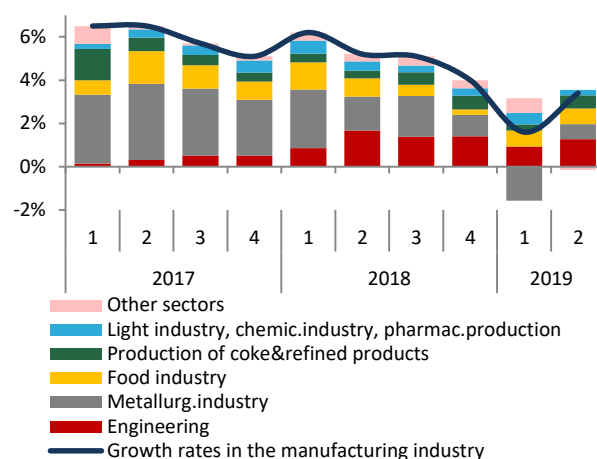
Figure 27. Decomposition of the Mining Industry. Contribution by Sectors to the Growth, YoY, cumulative



Source: CS MNE, NBRK's calculations

The key positive factor for the growth in the sector has been the increased output in the metallurgical industry, namely in the production of basic precious metals and non-ferrous metals. A positive contribution to the sector's growth was also made by expansion in production of foodstuffs, refinery products, engineering (Figure 28).

Figure 28. Decomposition of the Manufacturing Industry. Contribution to the Growth by Sectors, YoY, cumulative

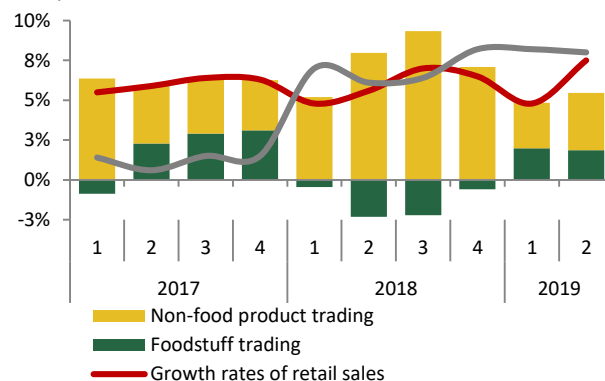


Source: CS MNE, NBRK's calculations

During January-August 2019, production in the construction sector increased by 11.8%. A strong growth is mainly related to the construction of industrial facilities, namely the precious metals production plant of the "Altynalmas" JSC, sulfide ore dressing plant, and construction and assembly works at the TCO plant. The growth was also impacted by the road construction works and trunk pipelines laying under the "Construction of the "Saryarka" trunk pipeline" project.

During 8 months of 2019, the volumes of trade grew by 7.6%, largely as a result of the growth in wholesale trade (Figure 29).

Figure 29. Growth Structure of Retail Sales and Growth Rates of Wholesale Turnover, YoY, cumulative



Source: CS MNE, NBRK's calculations

Given an upward trend in the dynamics of trade, the development of transport sector

had a positive nature. In general, during January-August 2019 the advancement in the sector accounted for 5.5%. A significant contribution to the sector's growth was made by road haulage.

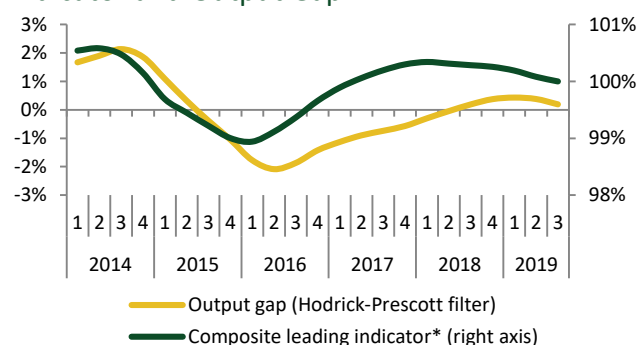
The dynamics of the composite leading indicator which represents an aggregated assessment based on the enterprise survey in the real sector is indicative of a steady development of the business activity in Kazakhstan.

A favorable environment in the global oil market as well as the recovering domestic consumption against the growing real cash income had a positive effect on final products of enterprises. The interviewed enterprises (the industry, agriculture, transport, trade, and construction sector) note the deceleration of price growth for raw materials and supplies, the increased capacity utilization rate and average return on sales. The number of enterprises which note deterioration in the lending terms and which have suffered from a negative impact on their business operations from the

movement of the exchange rate of the tenge against the US Dollar decreased.

In the first half of 2019, the composite leading indicator, just as the output gap, is in a weakly positive zone. This indicates a persisting growth of the business activity in the real sector and the existence of a minor pro-inflation pressure in the economy (Figure 30).

Figure 30. Behavior of the Composite Leading Indicator and Output Gap



Source: CS MNE, NBRK, NBRK's calculations

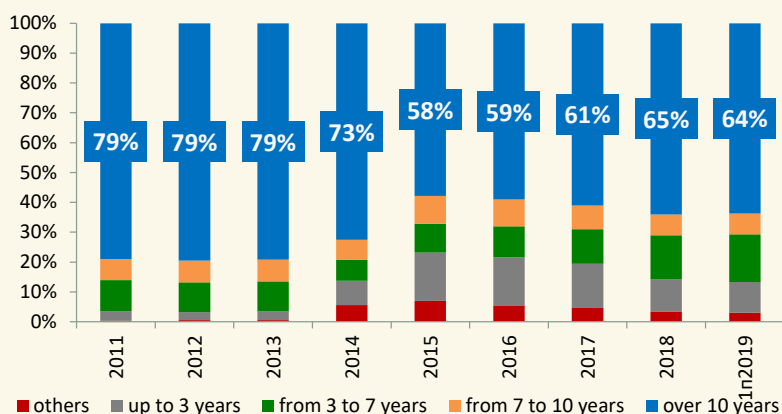
* the calculation of a composite leading indicator based on the OECD methodology

Box 3. Development of Car Manufacturing in Kazakhstan

In the Republic of Kazakhstan, at 1 July 2019 the number of registered cars was 3 687.6 thous. vehicles. Despite the fact that at the end of 2016 the government program for utilization of motor vehicles was launched, the country's car fleet continues to grow obsolete. A share of new (less than 3 years) cars is decreasing and the share of cars over 10 years old is increasing.

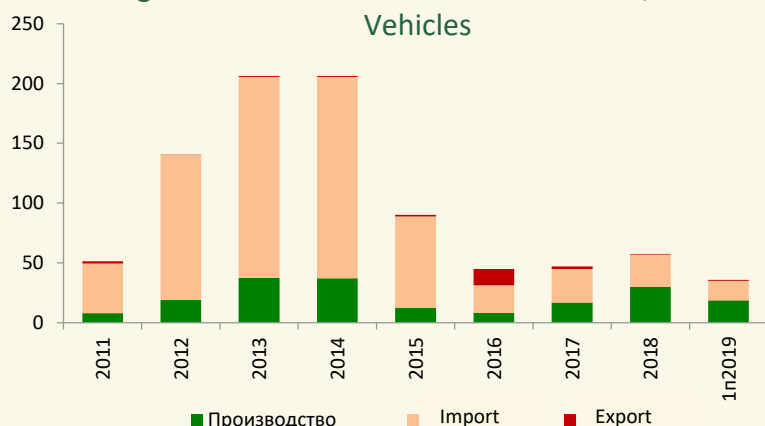
In 2019, this trend somewhat slowed down, being driven, among other factors, by the launch

Diagram 1. The Number of Registered Cars, by Year of Manufacturing



Source: CS MNE

Diagram 2. Resources and the Use of Cars, thous. Vehicles



Source: CS MNE. Production; Imports; Exports

of easy-term loans for purchasing the domestically manufactured cars (the program was designed and financed by the NBRK).

As at the end of the first half of 2019, within total registered cars, the percentage of cars which are over 10 years old was 64%, from 7 to 10 years – 7%, from 3 to 7 years – 16%, and up to 3 years – 10% only (Diagram 1).

The easy-term loan program, among other factors, helped to expand the demand for cars and had a positive effect on the development of domestic production. So, in the first half of 2019, 34.3 thous. cars were sold in the local market, of which 54.7% are the cars manufactured in Kazakhstan; this represents the maximum during the entire history of car manufacturing (Diagram 2). As at the end of the first half of 2019, the output in the manufacturing

sector was KZT 144.8 bln. (by 47.6%

more as compared to corresponding period of 2018) or 0.5% in the total volume of the produced GDP.

Thus, measures aimed to renew the car fleet in the country foster the development of the domestic car manufacturing including the growth of employment in the sector as well as the design and implementation of new technologies.

4.3. Labor Market

In the second quarter of 2019, a strong labor market was characterized by the growth of employment and real wages. The rise in wages has a pro-inflation nature due to its higher growth as compared to the labor productivity.

The labor force in the second quarter of 2019 increased by 1.4%, including the employed population – by 1.4%; and the number of the unemployed population remained unchanged (Figure 31).

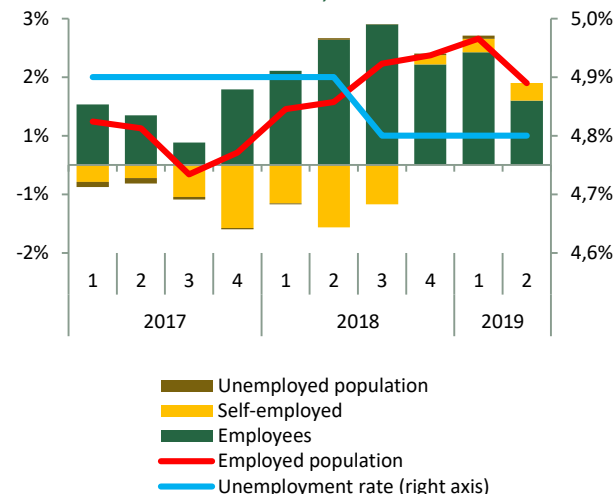
The employed population continued to grow, both in terms of employees and the self-employed. The growth in the employed population was observed in all sectors except information and communication and real estate operations.

Given a significant expansion in the construction sector, the number of employees in this branch was recovering. The number of employees in the education and healthcare sectors continues to increase.

The growth of the self-employed population that was observed in the recent quarters, in the second quarter of 2019 retained its pace. The self-employed population is concentrated in the agricultural sector (34.6%), trade (34.4%), transport (10.3%) and construction (6.7%). The growth of the self-employed is accompanied by the increase in the number of productively employed population whereas the number of non-productively employed population keeps going down.

The increase in minimum wages, raise in the labor remuneration of the public sector employees fostered the accelerated growth of real wages in the second quarter of 2019 to 8.9% (Figure 32). The positive dynamics of real wages were observed in all economic sectors except the sector of accommodation and catering services.

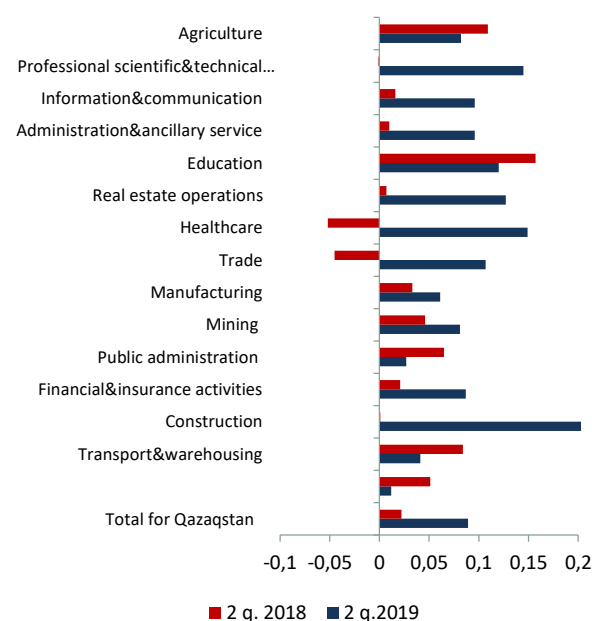
Figure 31. Unemployment Rate, Structure of the Labor Force Growth, YoY



Source: CS MNE

In this environment, expenses of large and medium-sized enterprises related to the payroll fund increased. The last time, such positive situation in the labor market was observed in 2014.

Figure 32. Real Wages Broken Down by Sectors, YoY



Source: CS MNE

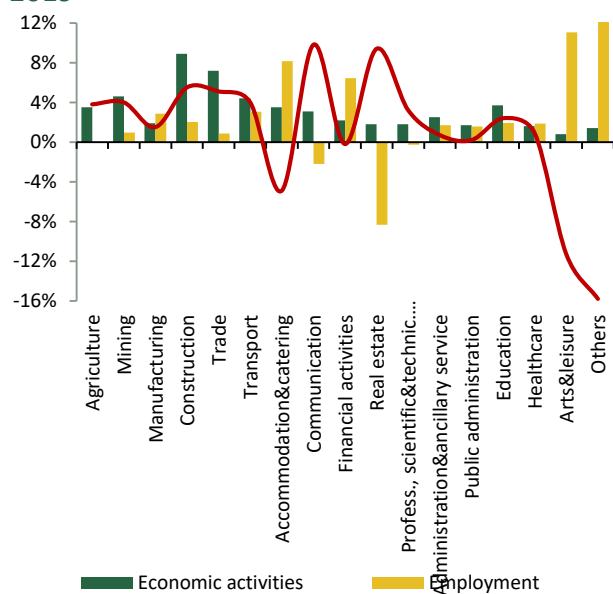
Given the accelerating growth of the labor remuneration, the real wage growth rates have been exceeding the labor productivity growth rates for the first time over the recent 4 years thus putting a pro-inflation pressure on producer prices. The outstripping growth rates of real wages as

compared to the labor productivity growth rates are typical for all key sectors of the economy, except transport and construction.

In the first quarter of 2019, the labor productivity increased by 2.1%, including in the sectors engaged in goods production by 2.5% and in production of services – by 1.8%. The largest growth was recorded in the sector of information and communication and in real estate operations against the decreased employment in these sectors.

The decreased labor productivity was recorded in the sector of accommodation and catering services, arts, entertainment and leisure and other sectors alongside with the outstripping growth rates of employment over the growth rates of the added value in these sectors (Figure 33).

Figure 33. Labor Productivity and Real Wages by Types of Economic Activities, YoY in Q1 2019



Source: CS MNE

Box 4. Labor Productivity and Factors Affecting Labor Productivity

In the first quarter of 2019, for the first time since 2013, the real wage growth started to outrun the labor productivity growth. The increase in labor remuneration which is not accompanied by a concurrent growth of productivity puts an upward pressure on the cost of producer production and, respectively, on final prices in the economy. In general, the labor productivity is characterized by strong variability and buoyancy as a consequence of effect produced by a large number of factors which may be conveniently classified into 3 main groups: material and technical, organizational and socio-economic ones.

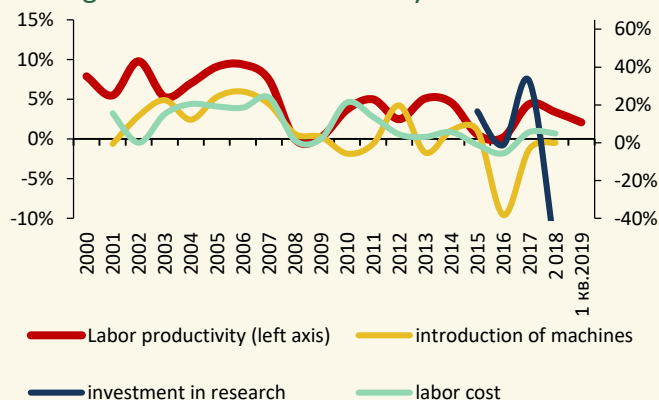
Diagram 1. Decomposition of Labor Productivity (by Types of Economic Activities for Q1 2019)



*Positive contribution of employment means its reduction

Agriculture; Industry; Construction; Trade; Transport; Communication; Financial activities; Real estate; Scientific & technical activities; Administrative service; Public administration; Education; Healthcare; Others. Employment Types of economic activities; Labor productivity

Diagram 2. Labor Productivity and Factors



Socio-economic factors are related to the level of staff qualification, to effectiveness of motivation on the part of employers, labor conditions at an enterprise, etc. One may assume that the employer motivation channel expressed by labor inputs (the data from the System of National Accounts) is an effective channel of influence on the labor productivity since these indicators have unidirectional dynamics over lengthy historical series (Diagram 2). However, in 2019 given the government policy measures aimed to increase salaries and wages, the real wages are growing and the rates of their growth significantly exceed the labor productivity growth. A similar gap was typical for Kazakhstan's economy before 2013 when the average growth of employment was 2.6% (in 2013-2018 the average growth of employment accounted for 1%).

Basing on the contribution of employment to the labor productivity (Diagram 1), one may say that in Kazakhstan the development of some sectors remains extensive. Internationally, the effectiveness of labor productivity is attained with a help of intensive production factors, namely expenditures related to the scientific development and implementation of its achievements in the production (material and technical factors).

In analyzing the dynamics of other material and technical factors, namely the automation of production and new technology implementations,

one may note that they are influencing the labor productivity in a positive way. However, the influence remains limited given an uneven distribution of investments across economic sectors, insignificant depth of technology implementations, and low costs for research and development. So, the coefficient of renewal of machinery and equipment is only equal to 9.2% (total PPE – 9.3%), whereas the depreciation reserve ratio accounts for 43% (total PPE – 38.3%). At the same time, there are also positive changes in the maintenance base. For instance, the capital-employment ratio (the cost of physical capital per one worker) in Kazakhstan in 2018 as compared to 2010 showed a two-fold increase in real terms (in 2010, the cost of capital per one worker was KZT 1185 thous., and in 2018 – KZT 2499 thous. in the prices of 2010).

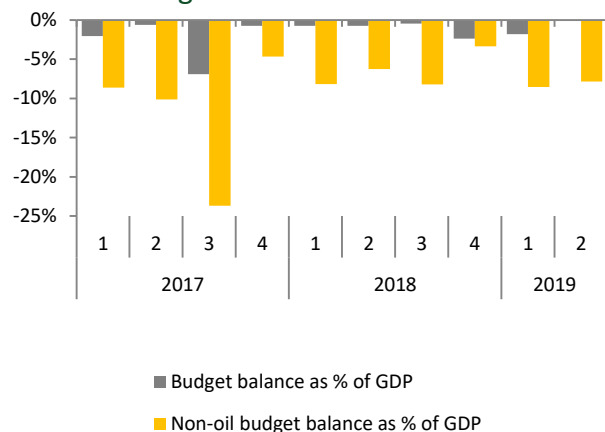
Therefore, it can be said that the labor productivity in Kazakhstan is growing primarily due to the improved labor conditions whereas the technical and technological capability of labor require further development and investment.

4.4. Fiscal Policy

This year, the fiscal stimulus of the domestic demand that is expressed in a considerable increase in the budget spending, especially for social support and wages as well as in the larger transfers from the National Fund, still represents the main factor responsible for a persisting inflation pressure.

During January-August 2019, the budget deficit increased by 1.7 times as compared to the corresponding period of 2018 and amounted to KZT 722.6 bln. (Figure 34).

Figure 34. Overall and Non-Oil Balance of the National Budget



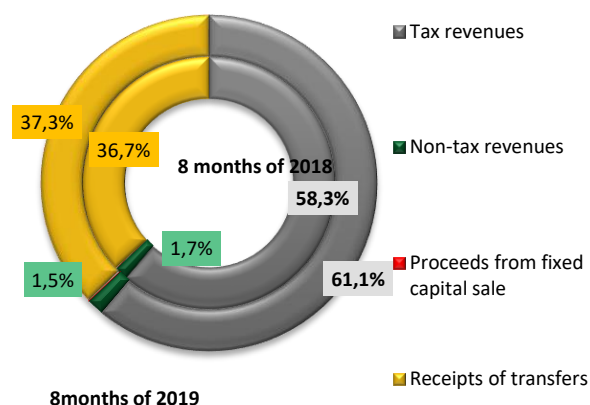
Source: Kazakhstan's Ministry of Finance

The non-oil budget deficit in January-August 2019 amounted to KZT 3.1 trln.

During January-August 2019, the national budget revenues increased by 19.2% as compared to the same period of the previous year and amounted to KZT 7.0 trln. (Figure 35). The main reason for the growth in revenues was the ramp-up in receipts of official transfers by 21.1% and of tax revenues by 18.3%.

The receipts of larger tax revenues to the budget were accompanied by the growing production of goods and services in the key sectors of the economy and by the rise in prices of major export items.

Figure 35. Structure of the National Budget Revenues



Source: Kazakhstan's Ministry of Finance

During January-August 2019, the national budget spending increased by 20.5% as compared to the corresponding period of the last year and amounted to KZT 7.3 trln. The main contribution to the growth in spending was made by expenditures for social welfare and social security (the growth by 28.3%), education (by 26.5%), healthcare (by 8.2%), and other expenditures (by 5.0 times).

V. FINANCIAL MARKET DEVELOPMENT

5.1. Money Market

Liquidity surplus in the money market continued to have a downward impact on the cost of borrowing in the tenge up to the level of the lower boundary of the interest rate band. The National Bank's operations ensured that the operating target is kept within the base rate band, excluding the risk of distortion of the monetary policy impulse. The spread between interest rates in different segments of the money market was persisting, however, in August it started to shrink.

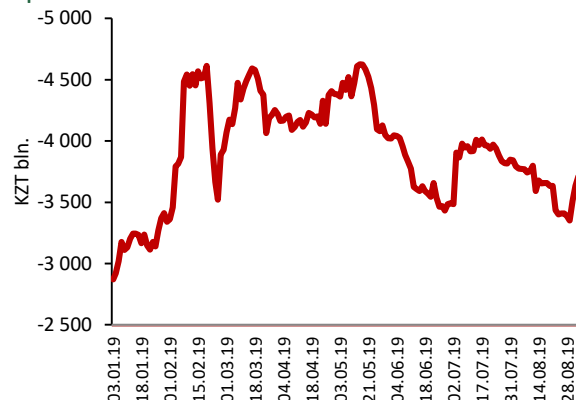
In June-September 2019, three decisions regarding the National Bank's base rate were made. On 3 June and 15 July, the base rate was retained at 9.00%, and on 9 September it was raised by 25 basis points to 9.25%.

Monetary conditions remained neutral.

At the end of the second quarter, the National Bank took actions to raise the money market rates. Interest rates on the open market instruments in June were increased to the level above the base rate. Measures have been taken to make short-term notes longer-term. Such measures adjusted the majority of interest rates in the money market to the level of the base rate. As a result of overflow of withdrawn volumes to longer-term notes, the share in the exposure of notes with 6- and 12-month maturities increased from 42% in May to 73% at end-August 2019.

The situation in the money market has been progressing under the impact of the structural liquidity surplus which continues to be withdrawn by the NBRK's operations. The bulk of liquidity is withdrawn via short-term notes with 28-days maturity, direct repo as well as deposit operations including deposit auctions (Figure 36).

Figure 36. Exposure on the NBRK's Operations in the Domestic Market

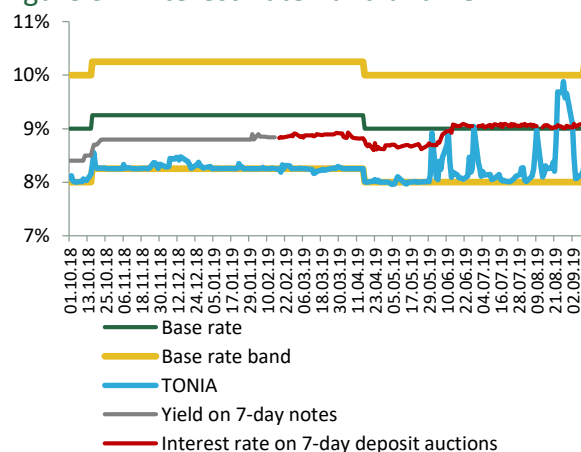


Source: NBRK

Yields of short-term notes in July-September 2019 were building up between the base rate level and the upper boundary of the interest rate band within the range of 8.56-10.00%, which helped to mop up liquidity with a view to limit inflation pressure on the economy on the part of the financial market.

The TONIA rate was setting mainly closer to the lower boundary of the interest rate band. Short-term increases of the rate were associated with a higher demand for borrowings in the tenge amidst the exchange rate volatility as well as with the demand for liquidity in the context of tax payments period (Figure 37).

Figure 37. Interest Rate Band and TONIA

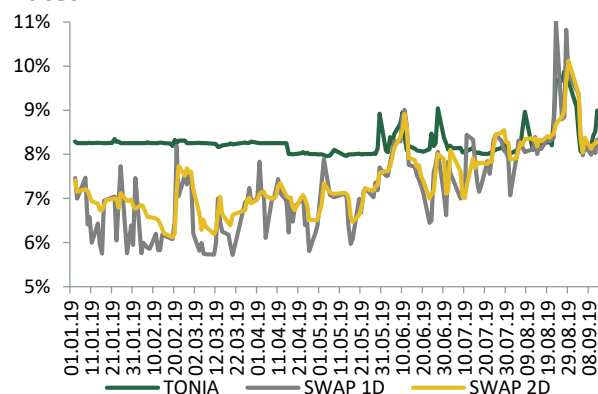


Source: NBRK, KASE

In the swap market, interest rates were setting under the impact of demand for foreign currency liquidity on the part of certain market participants (Figure 38).

Interest rates were staying closer to the lower, “targeted”, boundary, however, in July-August the spread between TONIA and SWAP 1D was narrowing based on the decreased supply of the tenge liquidity.

Figure 38. Dynamics of the Money Market Rates



Source: KASE

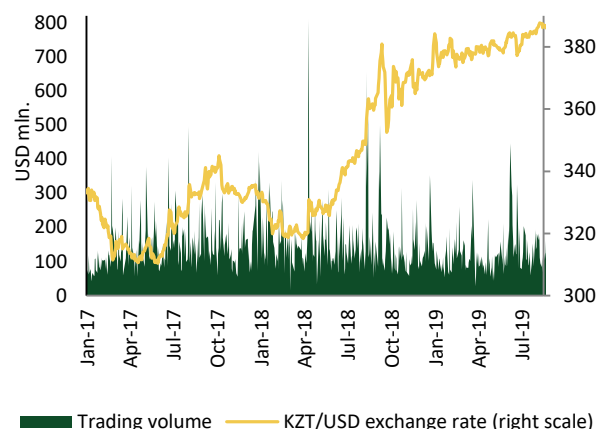
The base rate impulse in all segments of the money market is transmitted at comparable levels (close to the lower boundary of the interest rate band). The demand for the tenge liquidity in the money market remains relatively low, which represents one of the factors that constrain effectiveness of the interest rate channel at the present moment.

5.2. Foreign Exchange Market

The situation in the foreign exchange market, despite certain periods of volatility, in general had been relatively stable. To a larger extent, the exchange rate of the tenge is influenced by external factors. The trend of a gradual depreciation against the US Dollar still exists.

In May-August, the exchange rate was moving within KZT 377.18 and KZT 387.73 per US Dollar, having depreciated by 1.7% against the US Dollar. The difference between the minimum and the maximum values was 2.7% (Figure 39).

Figure 39. Exchange Rate Movements and Trading Volume in the Foreign Exchange Market



Source: KASE

Given minor volatility of the exchange rate, activity of the foreign exchange market participants somewhat decreased. The overall volume of trading in the USD/KZT currency pair went down by 12.5% and amounted to USD 11.3 bln. (in May-August 2018 – USD 12.9 bln.).

In May-August 2019, there was a period of volatility in the external sector.

The price of oil in the global market fell by 17.0% from USD 72.8 to USD 60.4 per barrel. Domestic currencies of countries – Kazakhstan’s trading partners also demonstrated depreciation. The Russian ruble has depreciated against the US Dollar by 2.8%, and the Yuan – by 6.2%.

The pressure on the tenge was also put by the dynamics of internal factors – high devaluation expectations and the heightened demand for foreign exchange versus its supply.

In June, against the backdrop of domestic political developments associated with the Presidential elections in Kazakhstan, devaluation expectations intensified and, as consequence, the demand for foreign exchange exceeded its supply. However, after the Election Day the situation in the foreign exchange market had normalized, devaluation expectations subsided, and the volume of trades plummeted and was maintained at a moderate level.

However, in August 2019 an unfavorable situation in the external markets was offset by beneficial effect of internal factors. In the third decade of August, based on the sales of foreign exchange proceeds by exporters, the balance between demand and supply of foreign exchange was recovering and volatility of the tenge was decreasing.

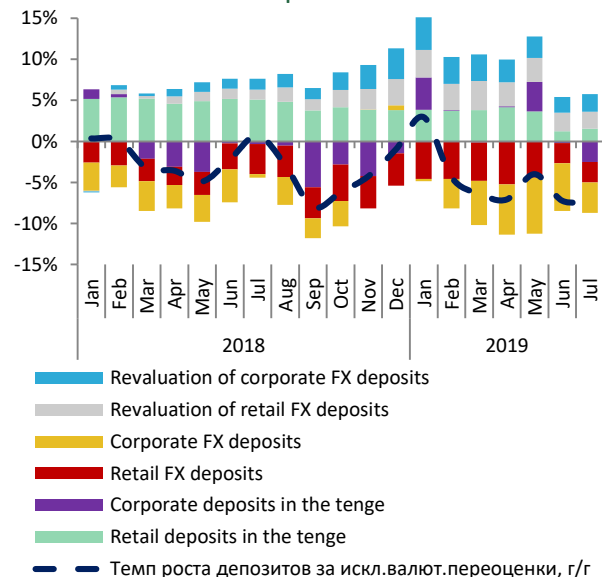
5.3. Deposit Market

Because of the increasing devaluation expectations in June-July 2019, the growth of foreign currency deposits was observed.

In July 2019, deposits with depository institutions decreased by 3.0% or by KZT 536 bln. in annual terms amounting to KZT 17.6 trln.

The main factor that caused reduction in the deposits base is still represented by foreign currency deposits (Figure 40), which have decreased by 4.4% or by KZT 358.7 bln. over the year.

Figure 40. Contribution by Components to the Growth in the Deposit Volume



Source: NBRK

Deposit growth rates excl. FX revaluation, YoY

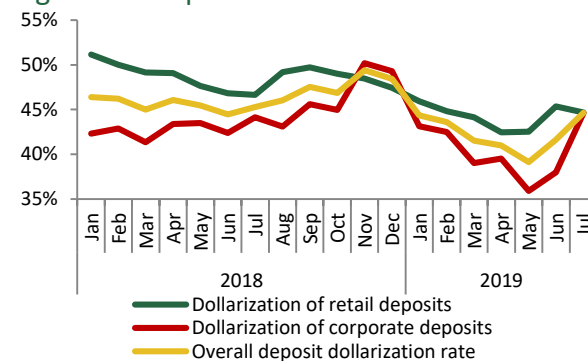
Outflows of large foreign currency depositors from the banking system since the beginning of 2019 were conducive to such dramatic drop in the FX deposit base. Over 7 months of 2019, foreign currency deposits of the corporate sector decreased by KZT 864.7 bln., which exceeds the reduction in retail

foreign currency deposits by more than three times (by KZT 257.3 bln.).

The most significant drop in the foreign currency deposits was observed in February (by KZT 867.5 bln.) and in March (by KZT 520.9 bln.). In June and in July, foreign currency deposits demonstrated growth (by KZT 1 017.3 bln. in two months) given the reduction of deposits in the tenge (by KZT 897.1 bln.) related to the devaluation expectations in June as well as to the increase in the cap rate on some categories of retail foreign currency deposits from 1% to 2% since 1 June 2019.

The total volume of foreign currency deposits at the end of July was KZT 7.9 trln., and of deposits in the tenge – KZT 9.7 trln. After achieving its five-year minimum of 39.1%, in May the deposit dollarization accounted for 44.6% at the end of July (Figure 41).

Figure 41. Deposit Dollarization

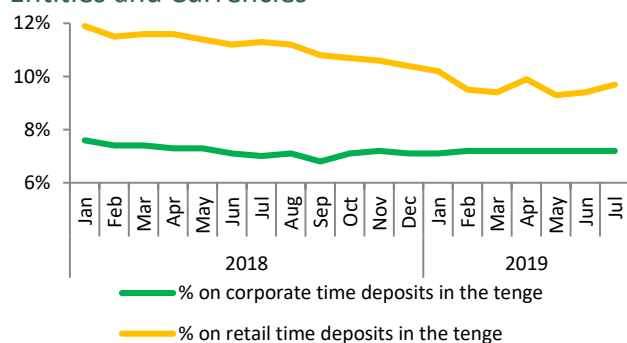


Source: NBRK's calculations

The growth of foreign currency deposits and reduction in the volume of deposits in the tenge in June-July was accompanied by the increase of interest rates on retail deposits in the tenge during the period. In July, the average rate on time deposits increased by 0.4 pp as compared to May and accounted for 9.7%.

Interest rates on corporate time deposits in the tenge did not change and were staying at 7.2% (Figure 42).

Figure 42. Interest Rates on Time Deposits by Entities and Currencies



Source: NBRK

5.4. Credit Market

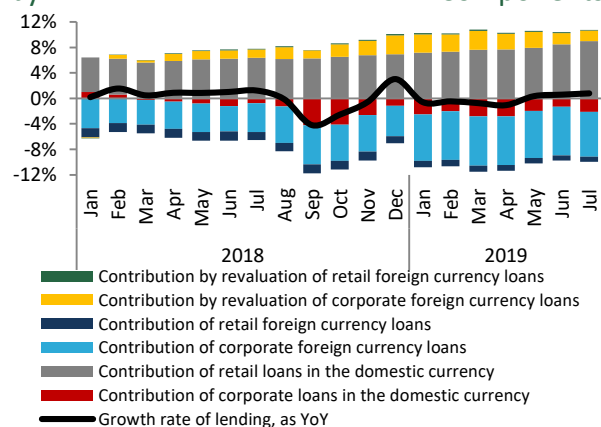
Despite reduction in the deposit base, lending demonstrated a minor growth owing to the retail sector and revaluation of foreign currency loans of businesses.

In April-July 2019, the credit market performance slightly improved owing to the retail sector and revaluation of foreign currency loans of businesses.

In July 2019, the bank loans portfolio increased insignificantly in annual terms – by 0.8% (Figure 43) and amounted to KZT 13.1 trln. Excluding revaluation, the loan portfolio decreased by 1.0%.

The retail segment (mainly, consumer loans) remained as a growth factor in credits to the economy. In July 2019, loans of the retail sector increased in annual terms by 21.7% or by KZT 1,1 trln., having reached KZT 5;5 trln.; their share in total loans amounted to a historical maximum – 46.1% in the structure of total credits to the economy.

Figure 43. Contribution to the Loan Growth by Components



Source: NBRK

An increasing contribution of consumer loans which accounts for 3/4 of the retail lending volumes is a key growth factor in the retail lending (the growth of 24.1% or KZT 738.8 bln.). Along with that, the mortgage lending came back to the positive zone after a lengthy stagnation period (the growth of 30.2% or KZT 356.2 bln.).

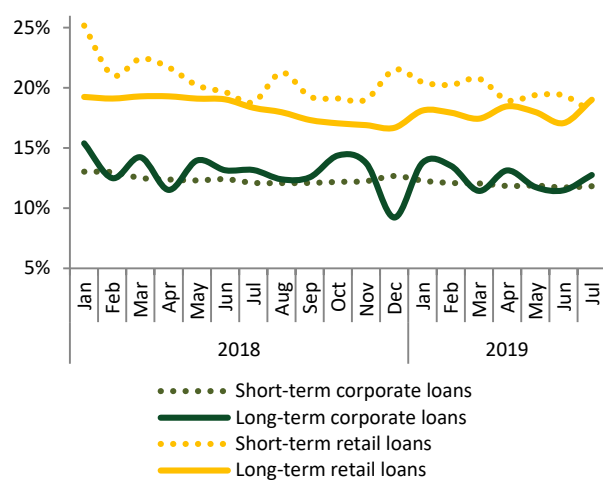
In the corporate segment, the loan portfolio decreased in annual terms by 12.1% or KZT 1 trln. to KZT 7.0 trln. Despite the fact that the physical volume of corporate loans in foreign currency is characterized by a persisting downward trend, their foreign currency revaluation makes a positive contribution to the loan growth amidst the exchange rate depreciation. This is related to the fact that foreign currency loans of enterprises account for about 1/5 of total bank credits.

According to the enterprise survey of the real sector conducted by the NBRK, in the second quarter of 2019 assessments of the lending terms (level of interest rates, maximum amount, and tenor) remained negative. Along with that, the number of enterprises which note deterioration in the lending terms is gradually decreasing. 19.9% of enterprises participating in the NBRK's survey applied to banks for loans, of which loans were obtained by 87.9% of enterprises (17.5% of the total number of enterprises participating in the survey).

A progressive easing of monetary conditions helps to make the loan resources in the tenge cheaper. The interest rate on loans to businesses in the domestic currency is smoothly declining. The spread between the actual interest rate and the rate acceptable for enterprises is shrinking as a consequence of reduction in the average loan interest rate.

The weighted average interest rate on corporate loans in the domestic currency went down to 12.0% at end-July 2019 (Figure 44).

Figure 44. Interest Rates on Loans in the Domestic Currency



Source: NBRK

BASIC TERM AND DEFINITIONS

Core Inflation – means the inflation which excludes transitory price changes subject to certain factors of administrative, event-related and seasonal nature. **Base Rate** – is the National Bank's key monetary policy instrument which enables to regulate nominal interbank interest rates in the money market. By setting the base rate level, the National Bank determines a target value of the targeted interbank short-term money market rate in order to achieve the goal of ensuring the 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; 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 (GDP) is an indicator that reflects the market value of all final goods and services 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.

Reserve Money includes cash issued into circulation by the National Bank, other than cash at the cash departments of the National Bank, transferrable and other deposits of banks, transferrable deposits of non-bank financial organizations and current accounts of government and non-government non-

financial organizations in the tenge at the National Bank.

Money Supply (M3) is determined on the basis of consolidation of balance sheet accounts of the National Bank and banks. It consists of cash in circulation and transferable and other deposits of non-bank corporate entities – residents and the population 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 overall price level of goods and services. In Kazakhstan, inflation is measured by the consumer price index.

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

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

Composite Indicator – is a generalizing indicator which is used to reflect short-term trends in the development of the real sector of the economy. Composite indicator as possessing the forward-looking feature is used to reflect a cyclical change and to identify turning points when recovery and

downturns in the economy occur and change. A composite indicator is built on the basis of the outcomes of survey 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 in 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.

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 repo operations 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 IMF's current classification, 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. 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 interval. Serves as an indicator which reflects the effectiveness of resources utilized in the country. If an actual output exceeds the potential one (a positive gap), other things remaining equal, the trend of acceleration in the price growth rates would be anticipated because of the overheating of 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, on relation between exchange rates of currencies, and prices for goods in the domestic currencies.

TONIA Rate – 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.

Fiscal Impulse means the difference of operating balances in periods t and $(t-1)$. If the operating balance at the time t is greater than the balance at the time $(t-1)$, the fiscal impulse in relation to the economic activity is negative (contractionary fiscal policy); if the operating balance at the time t is smaller than its previous value – the impulse is positive (stimulative fiscal policy). Where the

balances at periods t and $(t-1)$ are equal thus implying their zero difference, there is no fiscal impulse.

LIST OF KEY ABBREVIATIONS

bp – a basis point
GDP – the Gross Domestic Product
EU – the European Union
ECB – the European Central Bank
CPI – consumer price index
CS MNE – the Committee on Statistics of the Ministry of National Economy of the Republic of Kazakhstan
KASE – the Kazakhstan Stock Exchange
NBRK – the National Bank of the Republic of Kazakhstan
VAT - the value-added tax
OPEC – the Organization of Petroleum Exporting Countries
UN FAO – the Food and Agriculture Organization of the United Nations
Rosstat – the Russian Federal State Statistics Service
IMF – the International Monetary Fund
bln. – a billion
mln. – a million
MNE – the Ministry of National Economy
MED – the Ministry of Economic Development of the Russian Federation
thous. – a thousand
FAO – the UN Food and Agriculture Organization
FED – the Federal Reserve System