NATIONAL BANK OF KAZAKHSTAN

Inflation Report

The Second Quarter of 2017

Almaty, Kazakhstan

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

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as at 03.08.2017.

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SUMMARY

The annual inflation slowed down from 7.7% at the end of the first quarter to 7.5% and remained unchanged throughout the second quarter of 2017. The deceleration of inflation was constrained by a still high contribution of the food component. At the same time, core inflation indicators (excluding its volatile compionents) demonstrated the decline; thus, there was a downward trend in the most stable part of the consumer price index.

In general, inflationary processes were evolving in the environment of a persistently stable level of inflationary expectations, further recovery of economic activity and consumer and investment demand, gradual revival of lending as well as in the environment of increasing uncertainty in foreign markets.

The situation in the global commodity markets was characterized by the decline in oil quotations by the end of the second quarter against the growing output, with the oil price remaining at about USD 50 per barrel on average during the quarter. Apart from that, the global food price index was accelerating faster than it was expected as a consequence of the increased cost of dairy products and cereals. By the end of the quarter, pre-requisites for tightening external monetary conditions had been realized. The external demand was supported by positive trends of the economic growth in trading partner countries; this, in its turn, caused the increase in the growth rates of the domestic export volumes. Deceleration of inflation in the Russian Federation from the beginning of the year resulted in the decreasing external inflationary background.

The business activity in the country continued recovering, and the real GDP growth accelerated. The growth in production was recorded in key sectors of the industry due to the increased extraction of raw materials, in agriculture, and in the service sector. The investment activity keeps growing with a view to modernize the production. In the second quarter, the rates of retail sales kept growing. In this environment, a negative output gap was gradually shrinking thus reflecting the decreasing deflationary pressure of the real sector. However, a negative pattern of real cash income of the population against the growing labor productivity limits inflationary risks associated with the consumer demand.

A gradual recovery of lending activity, specifically the reviving consumer lending, supports the consumer demand. In general, monetary conditions remain neutral. In the second quarter, there was still a structural liquidity surplus in the money market. As a consequence, the TONIA index was at a lower boundary of the interest rate band. The National Bank continues to withdraw excess liquidity mainly via its short-term notes. In June 2017, the National Bank made a decision to lower its base rate to 10.5%. In August, the base rate was lowered by 0.25 pp and made up 10.25%.

The baseline scenario parameters are still maintained at USD 50 per barrel, given stable expectations regarding the commodity market. The external demand is expected to recover further due to positive growth rates in trading partner countries. However, assumptions regarding the external inflationary background deteriorated in connection with anticipated acceleration of inflation in the Russian Federation as well as with the increased world food prices.

Under the baseline scenario, the economy's real growth rates for 2017-2018 were revised. Estimates regarding the economic growth in 2017 became more positive – at 3.1%. Given a higher base in 2018, the economy's growth rates are expected to be at 3%. During the second half of 2017, the annual inflation will be closer to the upper boundary of the target band being driven by the effect of shocks of supply in the food markets. In the medium term, inflation will be within its target band owing to a stable situation in the commodity markets, given that the real effective exchange rate is close to its equilibrium, a weakly positive output gap against the decreased income of the population as well as the decreasing inflationary expectations. Declining oil prices, depreciation of the tenge and growing inflationary expectations still represent key risks for the inflation forecast.

The scenario with the oil price at USD 40 per barrel, which was considered together with the baseline scenario, assumes the possibility of inflation going beyond the target band in 2017 and being at the upper boundary of the target band in 2018. The forecast for the economic growth rates in 2017 is more moderate. Under this scenario, a more constraining monetary policy may be implemented.

I. MACROECONOMIC ENVIRONMENT AND THE FINANCIAL SECTOR DEVELOPMENT

1. EXTERNAL MACROECONOMIC ENVIRONMENT

1.1 Situation in the Global Commodity Markets

1.1.1 Oil Market

In the second quarter of 2017, the average price of oil (Brent) had been at USD 49.7 per barrel (Figure 1). As compared to the previous quarter, the price declined by 7.5% and grew by 9.1% as compared to the corresponding quarter of 2016.

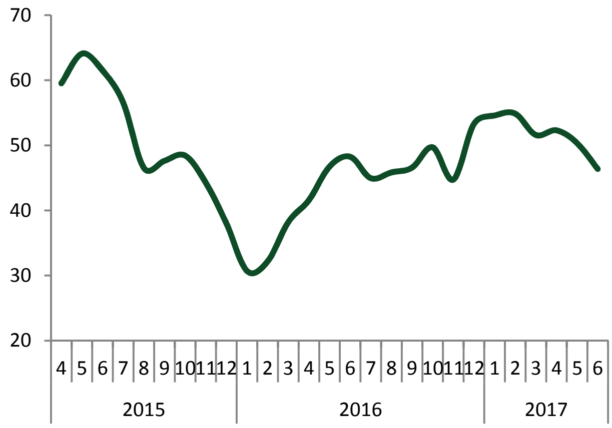
The decline in price was caused by the surplus in the oil market due to outstripping rates of its supply, thus resulting in dislocation of the market balance that was observed a quarter before (Figure 2).

Annual rates of growth in volumes of oil consumption in the world accelerated as compared to the previous quarter (1.4% versus 1.0%). The main contribution to acceleration of rates of oil consumption in the world was made by the USA where the demand for energy resources was increasing given the increased business activity. However, a positive growth in the demand for crude hydrocarbons on the part of India which cut its oil consumption significantly in the previous quarter served as a positive factor that encouraged growth in oil consumption volumes globally. Japan continues to make a negative contribution to the global demand in the oil market. China's positive contribution had been the smallest over the recent years (Figure 3).

The growth in the global oil production stemmed from a dramatic and strong acceleration of annual rates of growth in the supply of crude materials on the part of countries outside of OPEC. However, a negative contribution on the part of OPEC member countries increased as compared to the previous quarter (Figure 4).

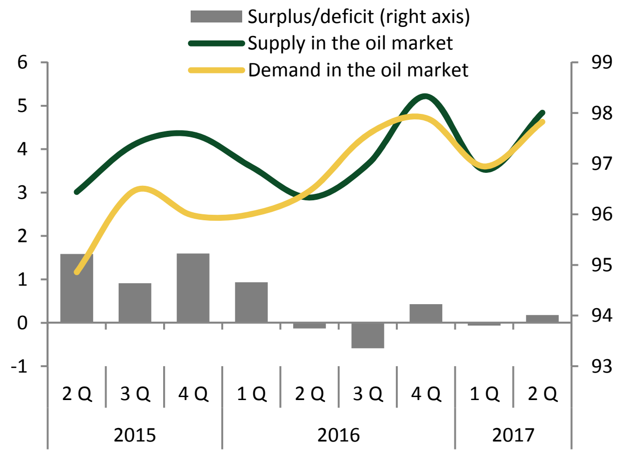
The main source for the increased growth rates of oil production in countries outside of OPEC was the acceleration of annual growth rates of extraction in Canada, USA, Europe and Latin America. The increased growth rates of oil supply in Canada are explained by a low base of the previous year when Canadian oil companies

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



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

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



Source: U.S. Energy Information Administration (EIA) were forced to cut their production volumes because of heavy woods fires. Starting from the third quarter of 2016, oil extraction volumes were restored in Canada. The growth of oil extraction in the USA was the result of the increased world prices of oil in the first quarter of 2017, which allowed the US oil companies resuming production of crude materials in the shale oil fields. Russia and other countries outside of OPEC that had signed the agreement on reduction of oil production with OPEC member countries had not made any significant positive influence on the growth rates of oil production in the world while strictly adhering to the terms of the Agreement.

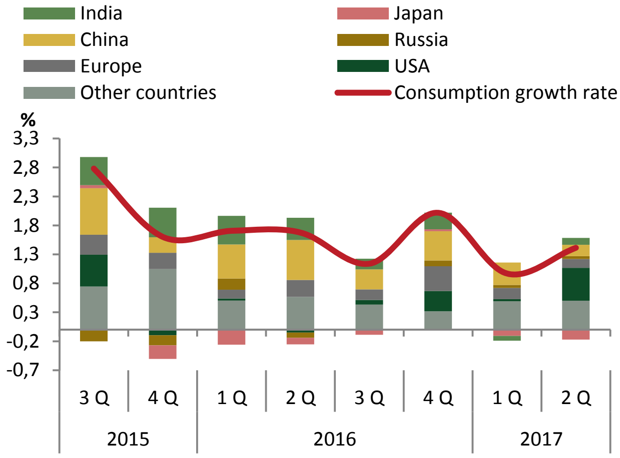
Oil extraction in OPEC member countries decreased in terms of volume versus the corresponding quarter of the last year. Production output of energy resources in such OPEC member countries as Saudi Arabia, UAE, Kuwait, Qatar and others continued to decline within the scope of the Algerian Agreement which was extended till April 1, 2018. Venezuela, where volumes of oil extraction have been declining six quarters in a row amidst the political and socio-economic crisis, has a constraining effect on the growth of oil production in OPEC member countries. Nonetheless, Libya and Nigeria which were excluded from the Algerian Agreement continued to make a positive contribution to oil production in OPEC member countries in the second quarter of 2017.

A further demand and supply pattern in the global oil market will be related to actions taken by countries within the framework of the Algerian Agreement as well as to the situation in the US shale oil market where the production output continued to recover against the growth in world oil prices.

1.1.2 Non-Ferrous Metals Market

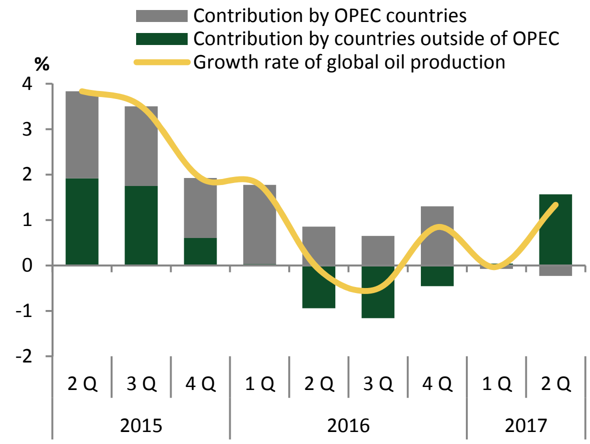
In April-June 2017, the metals market was demonstrating a divergent quarterly pattern. At the beginning of the second quarter, prices of copper, lead and zinc showed a decline but recovered to the levels of the end of the first

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



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

Figure 4. Global Oil Production, YoY



Source: U.S. Energy Information Administration (EIA) quarter of 2017 by the end of the period (Figure 5).

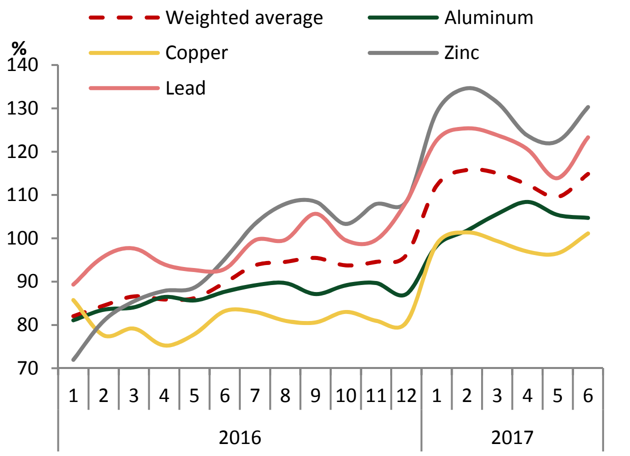
Recovery of copper prices is associated with more significant macroeconomic indicators in China as opposed to the market expectations, GDP in particular. At the same time, the growth in copper quotations in the second quarter was supported by a reduction in export supplies from Chile and Peru as well as by depreciation of the US Dollar against currencies of developing countries.

Prices of lead are growing in connection with a positive outlook regarding the industrial production in China as well as due to reduction of world reserves of raw commodities in warehouses.

Prices of zinc, after their minor decline, continue to grow because of reduction in reserves given the declining global production caused by the shutdown of a major portion of mines.

In the reviewed period, the price of aluminum was declining since the Chinese authorities tightened their requirements to producers as well as in connection with a further implementation of the government pollution mitigation program in the country.

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



Source: NBRK's calculations based on data from Bloomberg

1.1.3 Food Market

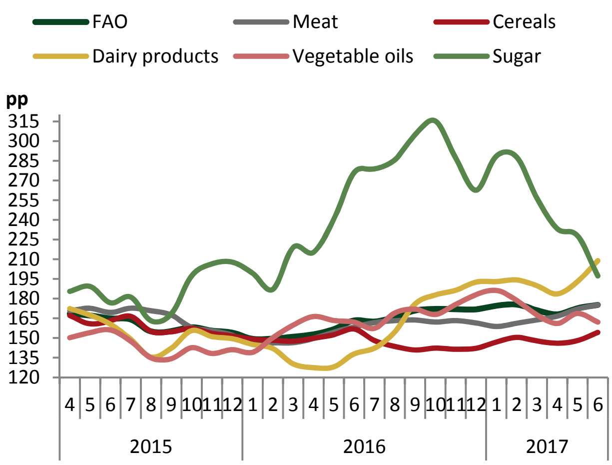
In June 2017 as compared to March, the FAO Index increased by 2.4%. Prices of sugar and vegetable oils are declining. In the reviewed period, prices of meat, dairy products and cereals demonstrated growth (Figure 6).

Prices of sugar are declining under the influence of positive view of the market regarding the sugar crops in connection with favorable weather conditions in Brazil, Thailand and India.

Prices of vegetable oils are going down given the declining price of palm oil. The reason for a low price of palm oil stems from reduction in the import demand coupled with anticipated seasonal growth in supply from the South-East Asia in light of heavy crops.

Reduction in international stocks as well as an existing export supply against a dramatic

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



Source: UN FAO

increase in foreign purchases on the part of Asian countries caused a continuing growth in prices of dairy products.

Prices of meat products are increasing under the impact of the growing prices of lamb in connection with the reduced export supplies in the Oceania. A significant growth in the import demand puts an additional pressure on the growth in prices of meat products, lamb in particular.

The cereal price index demonstrated growth which is associated with the shocks of weather conditions in the USA where harvest prospects for high-protein wheat have deteriorated because of the draught. At the same time, the growth in prices of cereals is supported by the increased demand for rice in the Middle East.

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

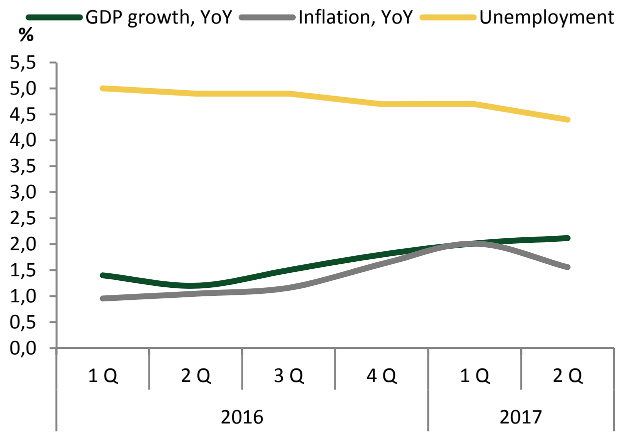
According to the data of initial assessment by the US Bureau of Economic Analysis, the GDP growth in the USA based on performance in the second quarter of 2017 slightly accelerated to 2.1% (Figure 7), being in line with the market expectations.

The increase in the real GDP growth rates occurred owing to the accelerated growth in personal spending on final consumption (in connection with a steadily decreasing unemployment rate and deferred tax refunds to the population) as well as the growing investments in the equipment and the government spending. The decreasing private investments in residential construction and a slowdown in exports appeared to be the constraining factors for the growth.

The annual inflation diverged from the target of 2% and in June slowed down to 1.4% (Figure 7). The decline in prices of gasoline, transport vehicles and communication services were conductive to such deceleration. The factors which supported inflation included the increased cost of rental housing, transport services, education and medical services.

The US economy continues to function in the environment close to the full employment.

Figure 7. US Economic Performance

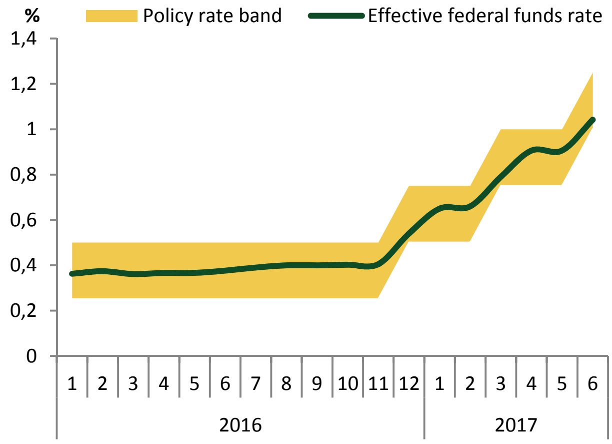


Sources: U.S. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics (BLS)

According to the data from the U.S. Bureau of Labor Statistics, in June 2017 the unemployment rate in the USA decreased to 4.4% as compared to 4.5% in March 2017. The highest employment growth was noted in such sectors as healthcare, social care, financial activities and in the mining industry. The growth in hourly salaries and wages has steadily been above the inflation rate and in June 2017 it accounted for 2.5%, which is reflective of competition for the qualified working force among employers.

As a result, a steady economic growth and positive trends in the labor market were the reason for increasing the US Fed's policy rate band by 25 basis points in June 2017 to 1%-1.25% (Figure 8). Moreover, the Federal Open Market Committee announced about its plans to gradually reduce the portfolio of government and mortgage bonds on its balance sheet[1] in the nearest future. However, the discernible deceleration of inflation may serve as an obstacle for a further tightening of the monetary policy.

Figure 8. US Rates



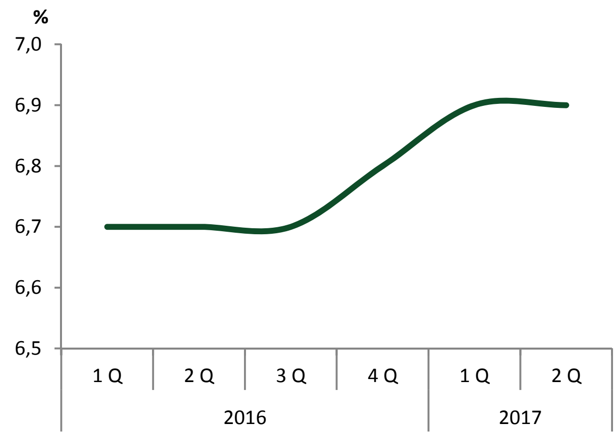
Source: Reuters

1.3 Economic Situation in Countries – Kazakhstan's Trading Partners

1.3.1 China

In the second quarter of 2017, the China's annual GDP growth as compared to the previous quarter had not changed and accounted for 6.9% (Figure 9). In the reviewed period, the economic growth in China was positively influenced by acceleration of the global trade, the continued implementation of the government stimulus measures (investments into the infrastructure and a further slashing of business rates) as well as active lending to residential construction. Meantime, given the Government's goal to ensure the GDP growth of 6.5% in 2017 and a solid growth of the economy in the first half of the year, some slacking of the growth with a view to decrease arrears of state-owned companies, curb the growth of mortgage lending and reduce systemic risks in the

Figure 9. China's Real GDP Growth, YoY



Source: Bloomberg

[1] Initially, the balance sheet is expected to be cut by USD 10 bln. and every quarter the curtailment will be increasing by the same amount until it reaches USD 50 bln.

financial sphere should be anticipated. A possible deterioration of trade relations with the USA in the environment of President Trump's protectionist policy as well as deceleration of the EU's economy in connection with Brexit still represent external risk factors.

The annual inflation, after its deceleration in March 2017 to 0.9%, accelerated to 1.5% in June (Figure 10). There is a steady growth in prices of a wide range of services and household items, thus reflecting the growth in the domestic consumption. However, prices of food, first of all, of vegetables and pork meat, are declining.

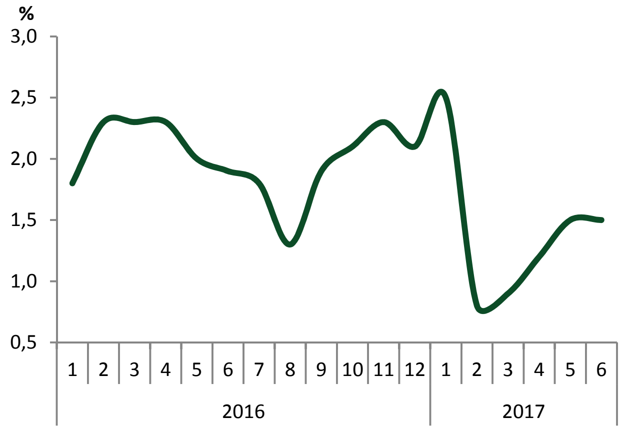
In general, consumer prices will be further demonstrating a moderate growth being impacted by a gradual exhaustion of the effect of declining food prices and the continuing increase in prices of services.

However, the neutral monetary policy as well as the slowing price growth in the industry (from 7.6% in March 2017 to 5.5% in June 2017) may act as constraining factors for the inflation growth.

In the second quarter of 2017, the People's Bank of China was pursuing a generally neutral monetary policy, while retaining its policy rate at the existing level (Figure 11). However, given that short-term and medium-term borrowing rates increased in the previous quarter as well as due to the tightened regulation of interbank operations, interbank borrowing rates increased. So, the average monthly value of the SHIBOR daily rate increased from 2.49% in March 2017 to 2.78% in June.

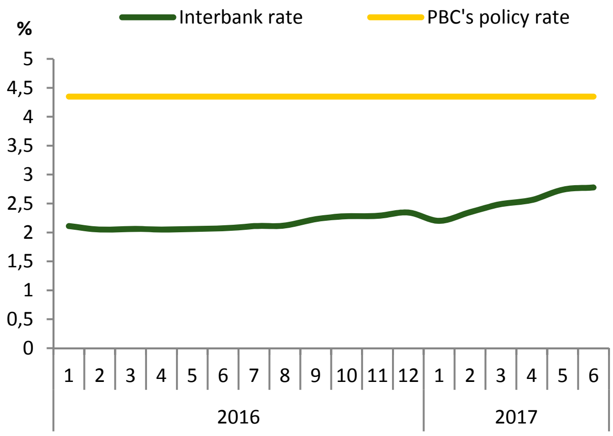
The average monthly exchange rate of the Yuan against the US Dollar had gradually appreciated from CNY 6.8935 in March to CNY 6.8068 per USD in June (Figure 12). The main reasons for appreciation were the increased money market rates, an overall depreciation of the US Dollar as well as the countercyclical adjustment ratio which was included in the pricing formula in May and which enables the People's Bank of China to curb a speculative pressure on the exchange rate and to better reflect the behavior of fundamental factors.

Figure 10. Inflation in China, YoY



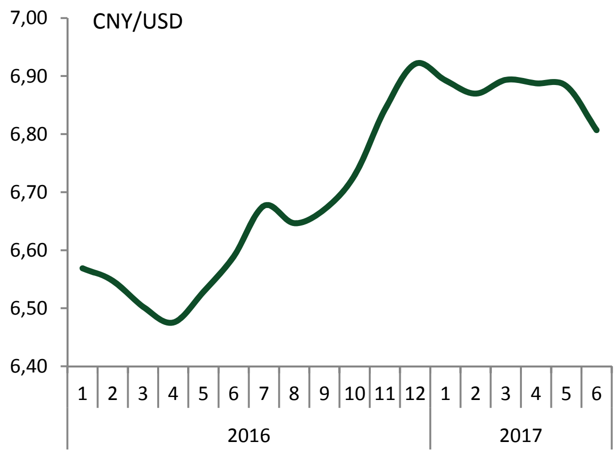
Source: National Bureau of Statistics of China

Figure 11. Interest Rates in China



Source: Reuters

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



Source: Reuters

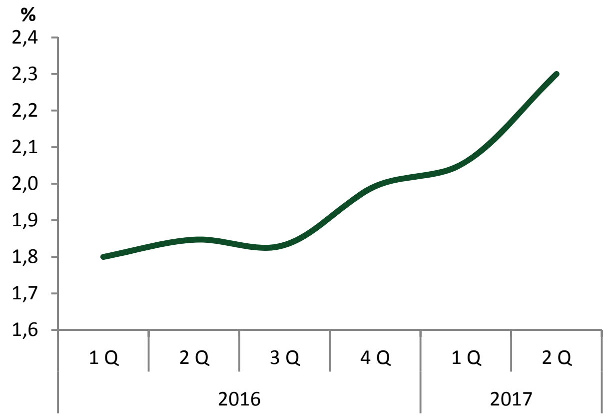
1.3.2 European Union

According to an initial assessment of the Eurostat, the annual growth in the European Union's GDP in the second quarter of 2017 accelerated by 0.2 pp versus the previous quarter and accounted for 2.3% (Figure 13). The accelerated growth was noted in all key EU countries except the UK. The main growth sources still include the consumer and investment demand supported by favorable lending terms and the decreasing unemployment. Risk factors of the economic slowdown in the EU shall include a possible acceleration of the growth in imports against the appreciated Euro as well as a high government debt and the percentage of non-performing loans in assets of the banking sector in some countries (Greece, Italy, Spain, and Ireland).

The inflation pattern in the EU is still determined by the behavior of energy prices. So, the annual rate of inflation in April as compared to March 2017 increased from 1.6% to 2.0% under the impact of a temporary surge in prices of services, and it fell to 1.4% by June due to the slowing rate of growth in prices of gasoline (Figure 14). The rate of headline inflation which excludes the energy component was slightly above 1% and was determined by a low growth rate of real disposable income per capita because of a high rate of unemployment. Since inflation was quite below the target of 2%, the ECB left key money market rates unchanged (Figure 15). Also, the regulator confirmed that it is going to implement the asset purchase program (EUR 60 bln. every month) further till the end of 2017, with the possibility of its extension, if a steady inflation trend will not be in line with the goals.

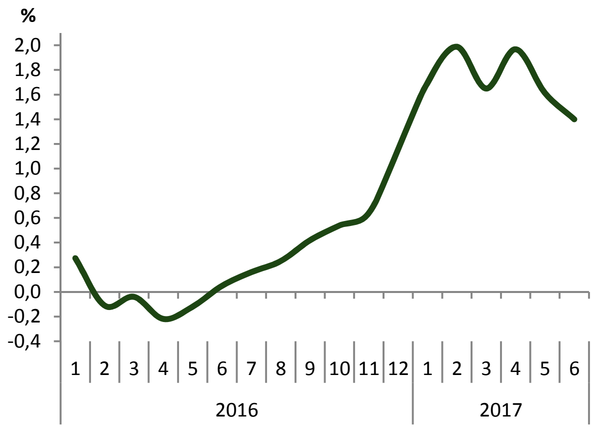
Over the reviewed period, the Euro has appreciated from USD 1.0686 per EUR on average in March 2017 to USD 1.1236 США per EUR on average in June 2017 (Figure 16). The main reasons for such appreciation were the overall depreciation of the US Dollar due to a possibility that the US Fed's policy rate will be increasing at a slower pace given the

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



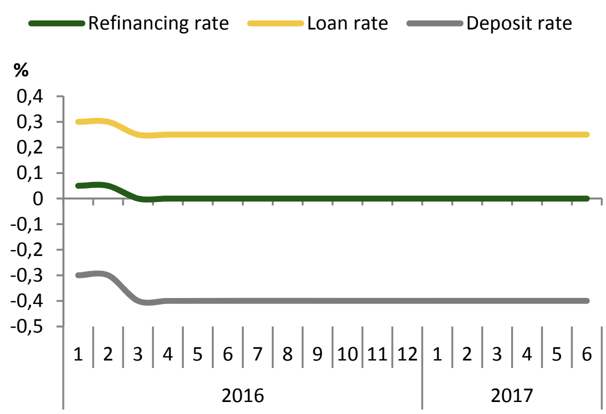
Source: Eurostat

Figure 14. Inflation in the EU, YoY



Source: Eurostat

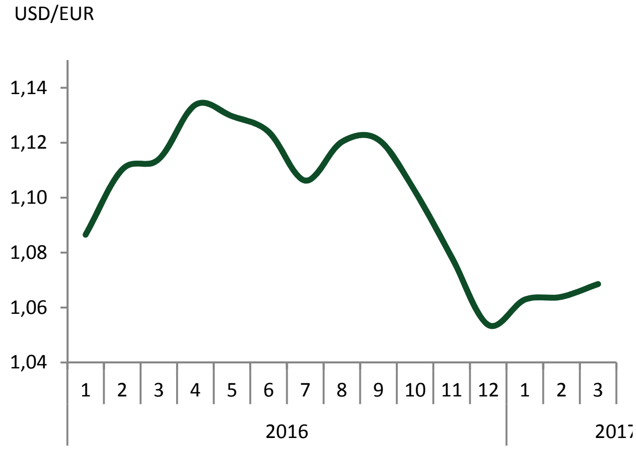
Figure 15. ECB's Rates



Source: Reuters

decelerating inflation and a sluggish implementation of Trump's reforms as well as the statement by the ECB's Governor regarding a notable mitigation of the deflation risk in the Euro zone that signaled the market about a possible reduction in the ECB's monetary stimuli already next year. Nonetheless, the uncertainty associated with actual implementation of Brexit as well as US sanctions against Russia that may bear upon the energy safety of Europe represent the risks for a possible depreciation of the Euro.

Figure 16. USD/Euro Rate, a Monthly Average



Source Reuters

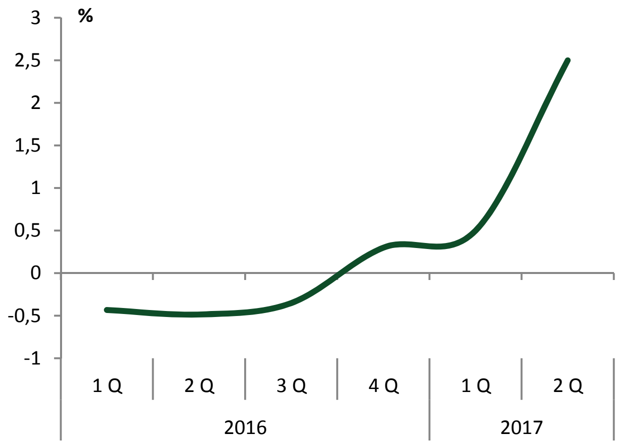
1.3.3 Russia

According to the initial assessment by the Rosstat, in the second quarter of 2017 the growth of the Russian economy accelerated significantly and accounted for 2.5% in annual terms as compared to 0.5% in the previous quarter (Figure 17). Along with that, the growth in extraction of mineral resources, in the manufacturing industry and transport as well as the slowing drop off in retail sales acted as positive factors. Also, a gradual recovery of the consumer and investment demand serves as the source for GDP. A possible unfavorable behavior of oil prices as well as the US tightened sanctions in the energy sphere should be referred to the risk factors that slacken the economic growth further.

In April-May 2017, the annual inflation in Russia reached 4.1%; however, it increased dramatically to 4.4% in June (Figure 18). Such change in the annual inflation pattern was caused by a surge in prices of fruit and vegetable production because of a cold spring in Russia that led to a late planting of vegetables, as well as by depreciation of the ruble.

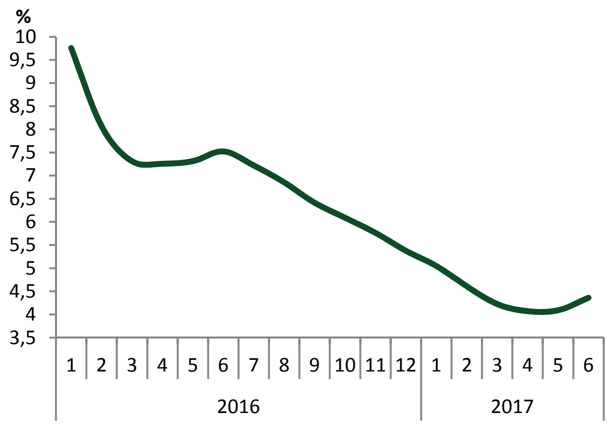
In the environment of decelerating inflation and inflationary expectations which were observed from the beginning of the year, during the quarter the Bank of Russia lowered its key rate from 9.75% to 9% (Figure 19). Nonetheless, the possibility that the ruble would keep depreciating, a further negative impact of the

Figure 17. Russia's Real GDP Growth, YoY



Source: Rosstat

Figure 18. Inflation in Russia, YoY

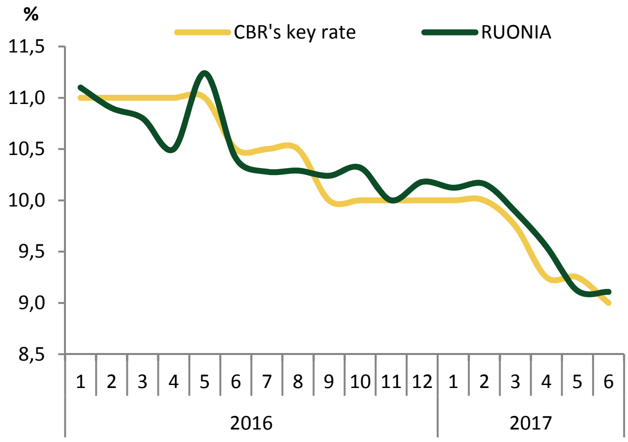


Source: Reuters

shock of vegetables supply, both on the inflation and inflationary expectations, as well as recovery of the consumer demand work as risk factors for escalation of inflation.

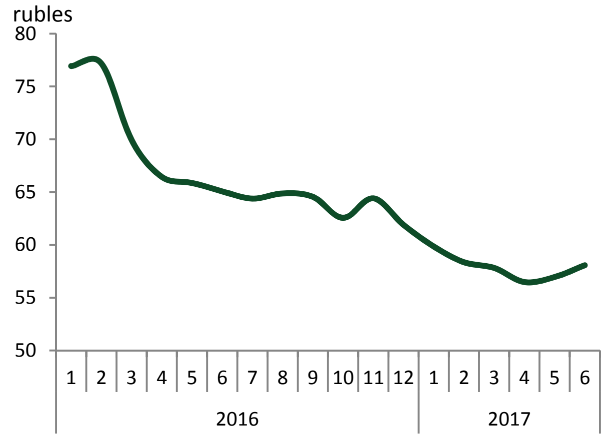
The exchange rate of the Russian ruble against the US Dollar showed a divergent behavior (Figure 20). So, in April the average monthly exchange rate of the ruble appreciated versus March 2017 by 2.4%, and depreciated by 2.8% during the quarter as a whole, with the exchange rate being at g RUB 58.07 per US Dollar. Such turnaround in the exchange rate behavior was furthered by a high volatility of world oil prices, reduction of interest rate differentials between Russia and USA, a possibility that the USA will tighten its sanctions against the Russian energy sector, as well as by the internal factor of growth in imports given the recovering demand of the business and the population. In future, these factors will be having a significant impact on pricing of the Russian currency.

Figure 19. Rates in Russia



Source: Reuters

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



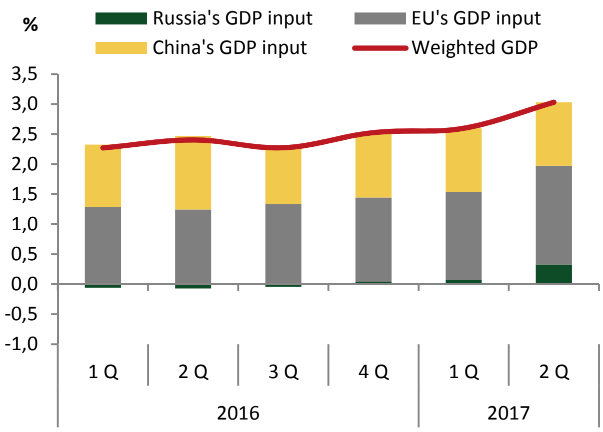
Source: Reuters

1.3.4 Aggregate External GDP and Inflation

Aggregate external GDP which is calculated on the basis of the data about Kazakhstan's international trading structure and is characterizing the demand for Kazakhstani exports had increased by 43 basis points in the reviewed period (Figure 21). This was driven by a significant growth of the Russian economy and sustainable rates of GDP growth in the EU and China.

Aggregate external consumer price index which is calculated based on the share of main trading partners in Kazakhstan's imports demonstrated a decline of 31 basis points (Figure 22). Such decline is caused by the fact that the annual inflation in Russia was close to

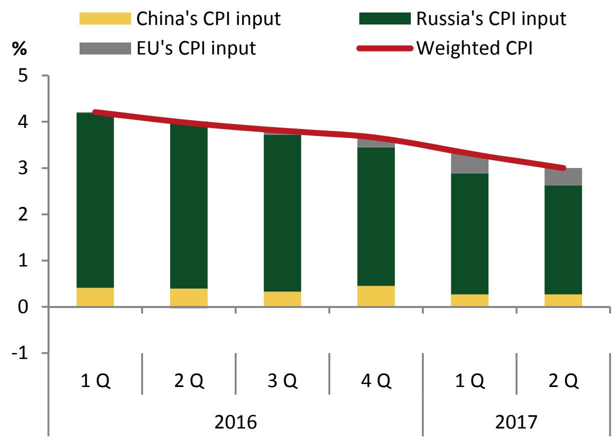
Figure 21. External Weighted GDP , YoY



Source: NBRK's calculations

its target level throughout the second quarter of 2017, as well as by moderate inflation in China and in the EU. Thus, the decline in the indicator speaks for a persisting trend of the weakening of external inflationary pressure on consumer prices in Kazakhstan.

Figure 22. External Weighted CPI, YoY



Source: NBRK's calculations

2. DOMESTIC ECONOMY

2.1 Monetary Policy and the Financial Sector Development

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

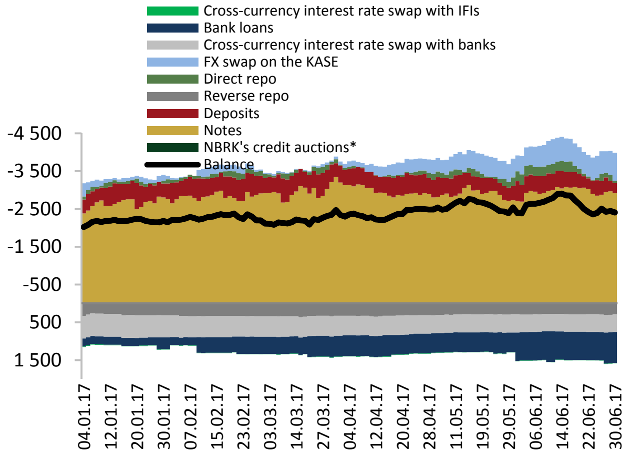
In the second quarter of 2017, the money market continued to function in the environment of structural liquidity surplus of the tenge. Hence, the volumes of the National Bank's operations made to withdraw excess liquidity preserved their growing trend. As before, the bulk of liquidity was withdrawn via the National Bank's short-term notes with maturities of 7, 28, 91, 182 and 364 days. In doing so, a minor growth in a negative balance on the National Bank's operations is primarily related to the growth in FX swaps made on the stock exchange that were conducted to prevent arbitrage between the swap and repo markets. In addition, as part of its bank support measures, the National Bank increased the volume of short-term loans provided to banks (Figure 23).

Given that the inflation rate has been stabilizing within its target band as well as given the decreasing inflationary expectations, the National Bank continued to ease its monetary terms by lowering the base rate level. So, on June 5, 2017 the base rate was lowered from 11% to 10.5% while preserving the band of +/- 1%.

Throughout the quarter, the TONIA rate was mainly at about the lower boundary of the interest rate band (Figure 24).

The Money Market Index was fluctuating within 9.16-11.60%. The weighted average MMI was 9.95% (in the first quarter of 2017 – 10.30%). The major share of transactions in the market fell on repos (Figure 25).

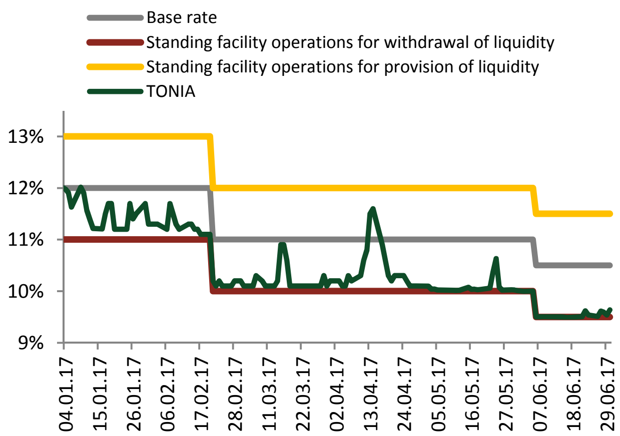
Figure 23. NBRK's Operations in the Domestic Market (exposure, KZT bln.)



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

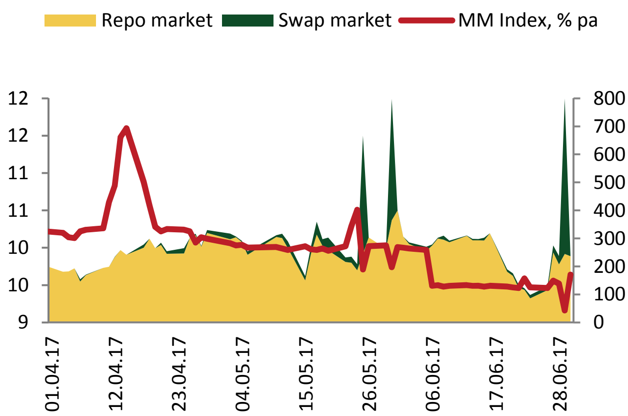
Source: NBRK

Figure 24. Base Rate and TONIA Rate



Source: NBRK, KASE

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



Source: KASE

2.1.2 FX Market and FX Operations of the National Bank

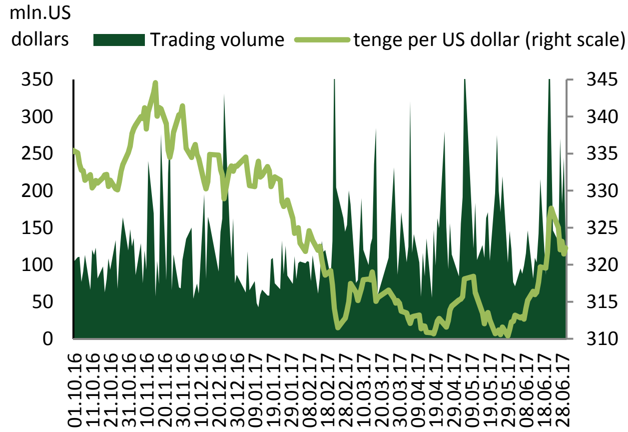
The situation in the FX market was characterized by divergent fluctuations of the tenge exchange rate. World oil prices and changes in the exchange rate of the ruble affected behavior of the tenge.

The tenge was fluctuating against the US Dollar within the range of 310.40-327.63. at the end of the quarter, and the official exchange rate of the tenge against the US Dollar depreciated from 313.73 to 322.27 or by 2.7% (Figure 26).

In the reviewed period, volumes of on-exchange and over-the-counter trades in the USD/KZT/ currency pair increased by +34.3% and 10.7%, respectively.

During April, May and the most of June, the National Bank's participation in the domestic FX market was equal to zero. However, in June, in order to limit the increasing volatility of the tenge in the domestic FX market that was not driven by fundamental factors but was induced solely by the mood of panic among the market participants, on June 21 and 22 the National Bank made interventions by selling foreign currency worth USD 101 mln. FX interventions were made in the periods of peak demand for foreign currency.

Figure 26. Exchange Rate dynamics and the Trading Volume in the FX Market



Source: KASE

2.1.3 Deposit Market

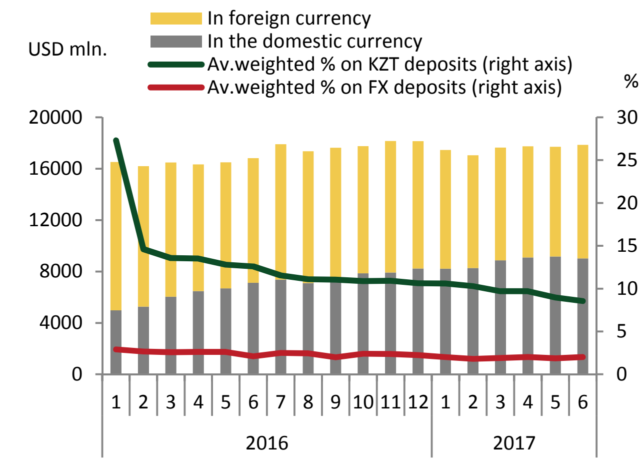
A stable situation in the domestic foreign exchange market and remaining attractiveness of the domestic currency deposits continued having a positive influence on the growth in the volume of the tenge deposits. During the second quarter of 2017, deposits in the domestic currency increased by 1.8%, and deposits in foreign currency increased by 0.7%. As a result, the volume of the tenge deposits exceeded that of foreign currency deposits and at the end of June the dollarization of deposits accounted for 49.5% (49.8% in the first quarter of 2017).

During the second quarter, foreign currency deposits of corporate entities increased by 3.3%, against the 4.0% reduction in the tenge deposits; this resulted in the growth of the

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

percentage of foreign currency deposits of corporate entities from 43.6% in March 2017 to 45.5% in June 2017. The foreign currency structure of retail deposits shows the decreased dollarization of deposits – from 58.0% to 54.7% during the same period as a result of the 2.0% reduction in foreign currency deposits and the 12.3% increase in the tenge deposits.

The weighted average interest rate on deposits attracted in the domestic currency decreased from 9.7% in March 2017 to 8.5% at end-June, and the weighted average interest rate on foreign currency deposits increased from 1.9% to 2.0% (Figure 27).



Source: NBRK

2.1.4 Credit Market

In the second quarter of 2017, the credit market showed the increase in lending volumes. Over the quarter, the lending volume had increased by 1.6% (Figure 28).

The increase in medium- and long-term loans in the domestic currency (by 4.3%) was conductive to the increase in lending volumes.

New loans increased by 20.4% as compared to the previous quarter.

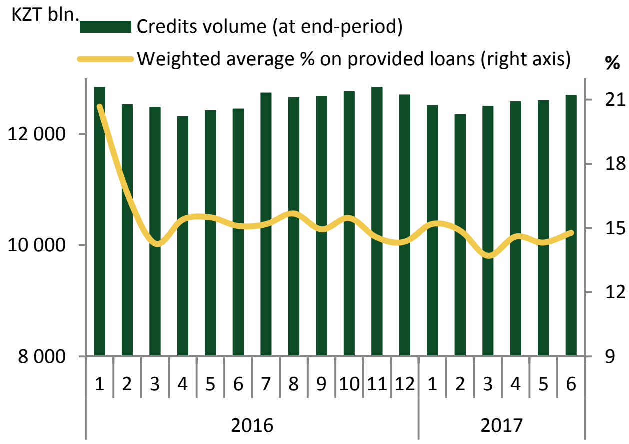
As per the currency structure, credits in the domestic currency continue to grow (by 3.4%) and rates of lending in foreign currency are decreasing (by 2.7%).

Credits to the population served as a driver for the growth of the bank loan portfolios in the second quarter (the growth of 4.3% as compared to the previous quarter), especially consumer loans (the 5.3% growth). Growth in credits to corporate entities turned positive (by 0.3% from -2.3% in the previous quarter).

As per the industry-based breakdown, the "Others" sector which includes a non-production sphere and individual entrepreneurship made a significant contribution to the growth of the lending portfolio. This sector is followed by the agricultural sector, transport, and construction. A negative contribution was made by credits to the trade sector and the industry (Figure 29).

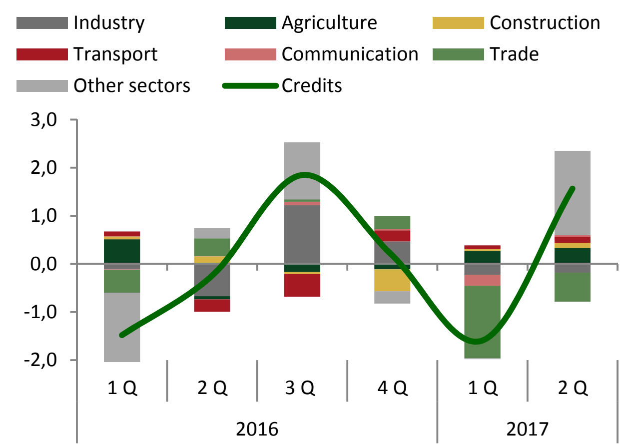
In the second quarter of 2017, the weighted average interest rate on loans in the

Figure 28. Volumes and Rates on Loans



Source: NBRK

Figure 29. Contribution to Growth Rates of Lending by Sectors, quarter versus the previous quarter, %



Source: NBRK

domestic currency remained virtually unchanged – at 14.6% (in the first quarter – 14.5%). At the same time, interest rates on credits in the domestic currency provided to corporate entities slightly decreased to 13.8% from 14.0% in the first quarter of 2017.

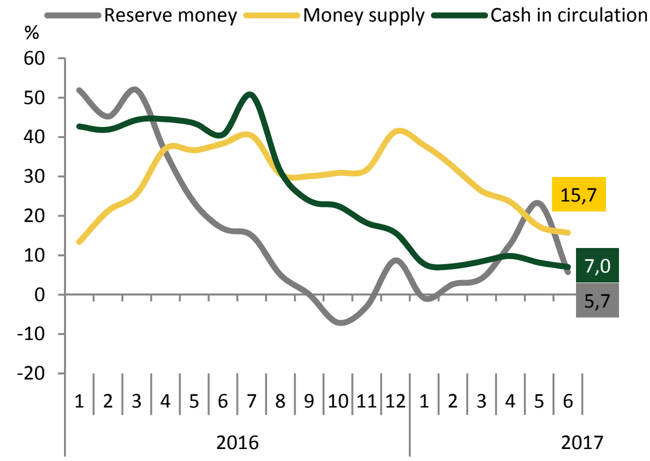
2.1.5 Monetary Aggregates

In the second quarter, the annual growth rate in the money supply remained at the level of the first quarter and accounted for 7.0% (Figure 30). During April-June, the money supply increased by 2.1%, the reserve money slightly contracted by 0.5%, and cash in circulation increased by 11.3%.

The main positive contribution to the formation of money supply in annual terms was made by the growth in other net domestic assets that was associated with the foreign currency revaluation. A negative contribution to the formation of money supply was made by the decreased claims on the general government as a result of transfer of the "Problem Loan Fund" JSC from the National Bank to the Government (Figure 31).

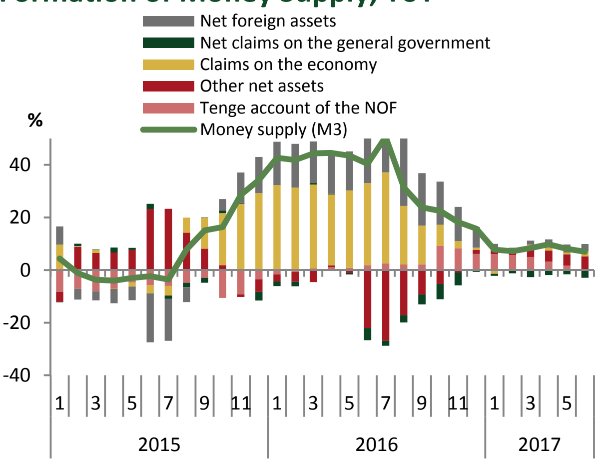
A positive contribution to the behavior of the reserve money was made by other net domestic assets and due from banks. Despite the annual growth of 41.8% in short-term notes from banks, due from banks increased by 27.0% as a result of increase in loans to banks. A constraining impact on the behavior of the reserve money was made by net international reserves and net claims on the Central Government.

Figure 30. Growth in Monetary Aggregates, YoY



Source: NBRK

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



Source: NBRK

2.2 Prices and Inflationary Processes

2.2.1 Prices in the Consumer Sector

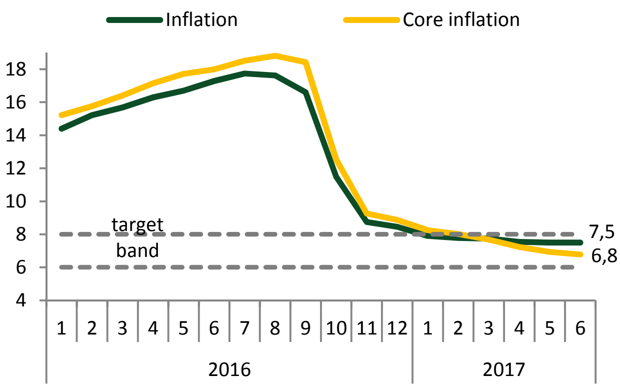
In April, the annual inflation accounted for 7.5%, having decelerated from 7.7% over the month, being driven by a downward trend in the non-food inflation rates. At the same time, depreciation of the tenge, revival of the domestic demand as well as negative impact of supply factors in the market of certain foodstuffs constrained a further deceleration of inflation rates during the second quarter. In

May-June, the annual inflation remained unchanged (Figure 32).

Core inflation indicators cleaned of the impact of volatile components demonstrated a decline from 7.7% to 6.8% and fell below the headline inflation rate. The contribution of food inflation excluding fruit and vegetable production decreased and there were unusually high seasonal price fluctuations in the fruit and vegetable market (Figure 33). The contribution to inflation by such categories as bread and bakery and cereals, vegetable oils and fats decreased considerably. Prices of these commodities were declining throughout the quarter being influenced by the growth of production and larger stocks of grain and oil seeds. As a result, growth rates of the food inflation in annual terms excluding fruits and vegetables decreased from 9.7% to 8.4%. The contribution made by the fruit and vegetable production to the food inflation had increased from 0.6 to 1 pp over the quarter.

Non-food inflation slowed down from 8.5% to 7.7%, and the cost of paid services in June 2017 increased by 4.8% (March – 4.7%) in annual terms. Contribution made by paid services to the annual inflation slightly increased due to the increased contribution to inflation by regulated services. Price growth rates of non-regulated services decreased given the slowing rates of growth in prices of transport services and out-patient services.

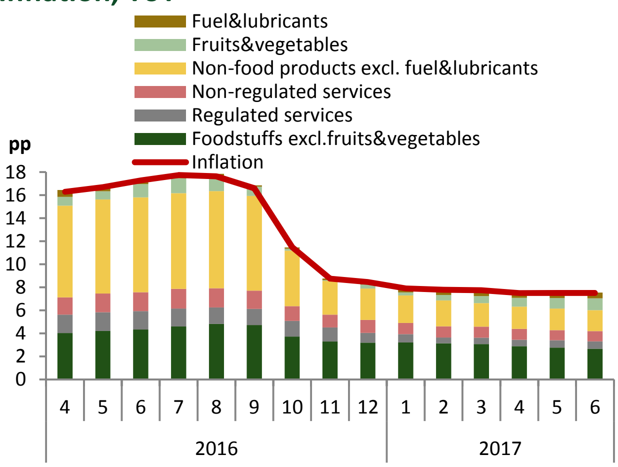
Figure 32. Annual and Core Inflation Dynamics, YoY



Source: CS MNE RK

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

Figure 33. Contribution of its Components to Inflation, YoY



Source: CS MNE RK, NBRK's calculations

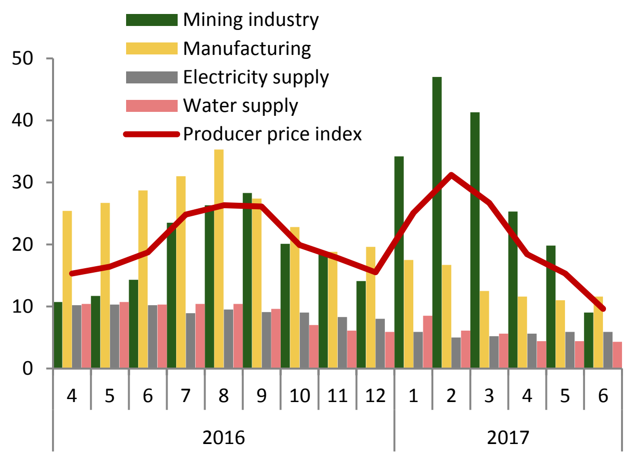
2.2.2 Prices in the Real and External Sector

Producer prices decreased in annual terms from 26.7% in March to 9.6% in June 2017, mainly due to the decelerating price growth rates of production in the mining industry (Figure 34).

The price growth rates of products supplied to the Kazakh market decreased from 19.5% in March to 14.2% in June 2017.

The price growth rates of products realized in the domestic market were observed in the mining industry, namely in the production of crude oil and extraction of metal ores. The price growth rates of products in the manufacturing

Figure 34. Price Changes in the Industry by Types of Economic Activities, YoY



Source: CS MNE RK

industry in the domestic market slightly increased from 11.3% in March to 11.5% in June 2017 resulting from the increase in prices of the metallurgical products, oil refinery products and in the production of beverages.

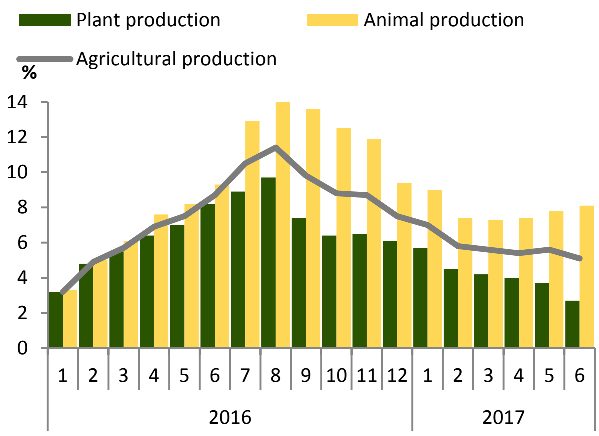
The annual prices of industrial services continued to grow from 5.7% in March to 7.2% in June 2017.

In agriculture, the price growth rates slowed down from 5.6% to 5.1% owing to the plant production (Figure 35), where price growth rates decreased from 4.2% to 2.7% as a result of a continuing decline in the price growth rates of grain and oil seeds against the increase in prices of field vegetables. The animal production increased from 7.3% to 8.1% in terms of price against the increased price of meat and dairy products and eggs.

In the wholesale sector, in June 2017 the annual price growth slowed down (from 7.2% to 5.7%). The slowing rates of the price growth were observed among consumer non-food products and interim products. The price growth rates of production means (trucks, tires and buses) increased.

The annual growth rates of the cost of imported products (both in the US Dollar and in the tenge equivalent) are decreasing in the sector of consumer and investment goods, and semi-finished products. At the same time, the price growth rates of imported mineral commodities were increasing, both in the US Dollar and in the tenge equivalent.

Figure 35. Price Changes in Agriculture, YoY



Source: CS MNE RK

2.2.3 Inflationary Expectations

The public poll outcomes in the second quarter of 2017 demonstrate the deceleration of perceived inflation despite the fact that the majority of respondents still note the price growth over the year. During the second quarter, the percentage of respondents who believe that over the recent 12 months prices have been growing faster than before is decreasing.

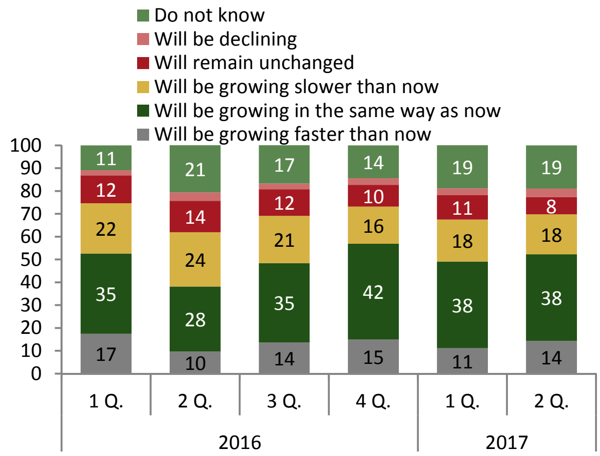
Expectations of the population regarding the prospects of price changes in the next 12 months virtually have not changed. The majority of respondents anticipate that the price growth rates would retain their pace in the nearest year (Figure 36). A slightly larger number of the interviewed anticipate acceleration of inflation. Along with that, the percentage of respondents who estimate the future inflation to be in the range of up to 10% (c 33% to 39%) increased.

Therefore, inflationary expectations of the population regarding prospects of the price growth rates of foodstuffs, non-food products and paid services in the second quarter demonstrated a relative stability.

This fact is supported by the quantitative assessment of inflation[2] for the year ahead, which is calculated based on the data from responses to the question "In your opinion, how much will overall prices change in the next 12 months?". Based on the second quarter, the quantitative assessment of inflationary expectations accounted for 6.4% (Figure 37) and is within the target band for 2018.

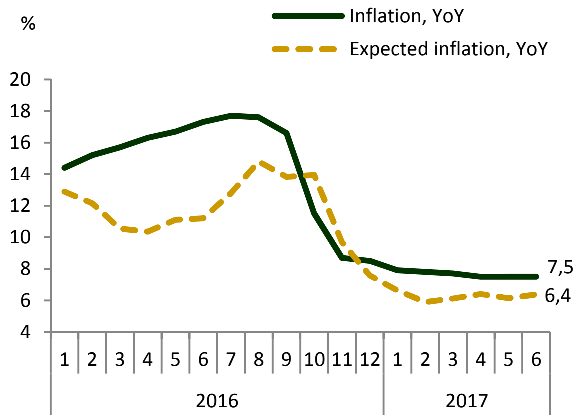
Figure 36. Assessment of the Price Growth in a Year

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



Source: GfK Kazakhstan

Figure 37. Expected Inflation



Source: Committee on Statistics of MNE RK, GfK Kazakhstan

2.3 Real Sector Development

Given a positive behavior of energy prices and the recovering domestic demand, the GDP growth accelerated. Implementation of the infrastructure and residential construction programs supported the positive trends in the investment activity.

2.3.1 Domestic Demand

In the first quarter of 2017, the GDP by the final consumption method accelerated its growth to 3.1%, mainly due to the recovering

[2] The methodology for calculating the quantification of inflationary expectations is published on the National Bank's official Internet-resource in the "Monetary Policy"- "Inflation and Inflationary Expectations" Section

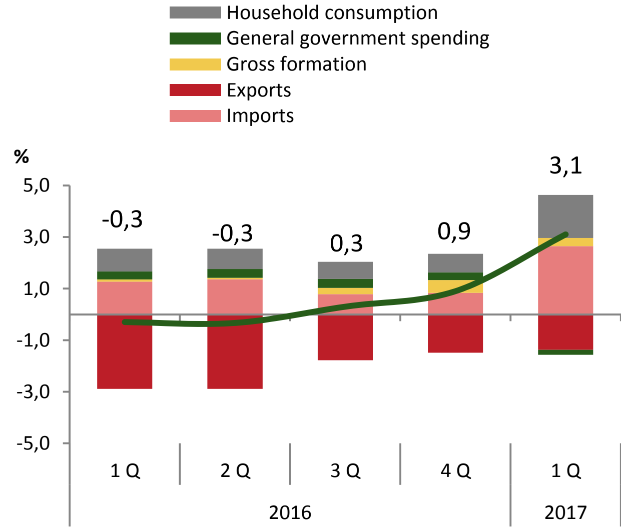
consumer demand, and the growth in gross formation. Moreover, for the first time since the second quarter of 2015 there was a positive contribution by net exports.

A positive contribution of net exports was accompanied by the decline in imports of goods and services. Along with that, a moderate recovery of exports was occurring against the increased value of exports of mineral products and metals; this was connected with the improved pricing environment in the global commodity markets (Figure 38). The growth in gross fixed capital formation accounted for 3.0% and was secured by the increased fixed capital investments in the manufacturing industry – by 32.0%, agriculture – by 22.0%, real estate operations – by 21.8%, transport – by 2.9% as well as activities in the area of administrative and ancillary service – by 90.2%. In addition, investments in residential construction demonstrated the 13.8% growth.

Household spending on final consumption accelerated its growth to 2.6% (Figure 39). Household spending increased against the decreased consumer price index, the decreasing volatility of the exchange rate as well as realization of the deferred consumer demand as a result of the growth in wages in the fourth quarter of 2016.

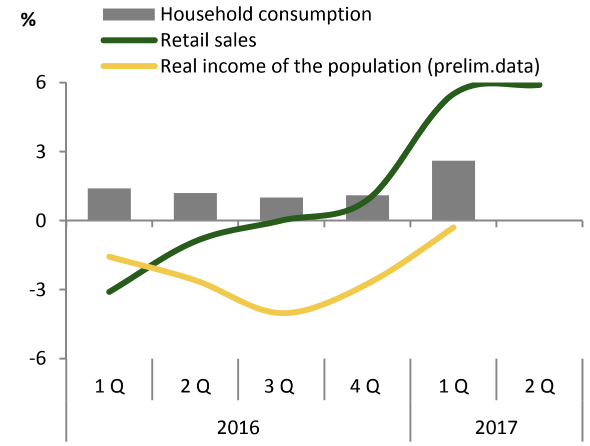
The largest contribution to the growth in nominal consumer spending was made by spending on foodstuffs where the growth accounted for 14.9%. The growth in spending on non-food products and paid services had not undergone any significant changes (accounting for 7.9% and 7.4%, respectively) (Figure 40).

Figure 38. Decomposition of the GDP Components by the Final Consumption Method, YoY year-to-date total



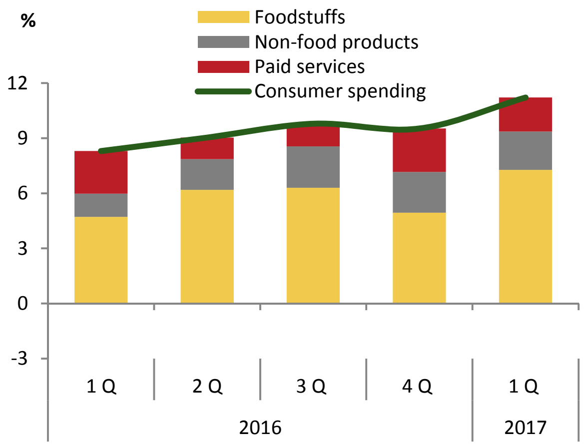
Source: CS MNE RK, NBRK's calculations

Figure 39. Household Consumption, Household Real Cash Income and Retail Sales, YoY, year-to-date total



Source: CS MNE RK

Figure 40. Structure of Growth in Household Nominal Consumer Spending, YoY



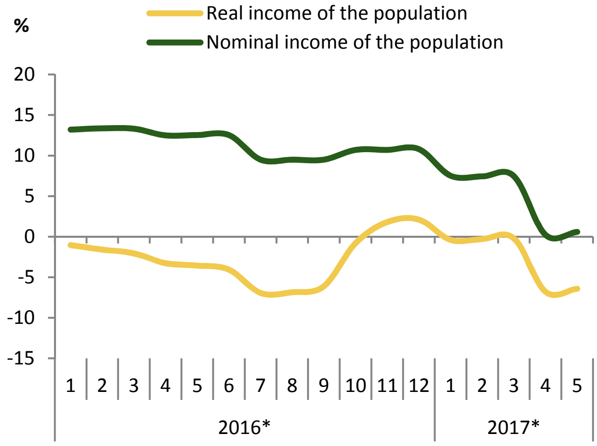
Source: CS MNE RK, NBRK's calculations

Income of the Population

In May 2017, the growth in nominal cash income slowed down significantly (to 0.6%) due to the decreasing rates of growth in wages (Figure 41).

Real cash income was decreasing more significantly being associated both with the decreasing real wages and a slow deceleration of inflation in the same period.

Figure 41. Indices of Nominal and Real Cash Income of the Population, YoY



Source: CS MNE RK, *-preliminary data,

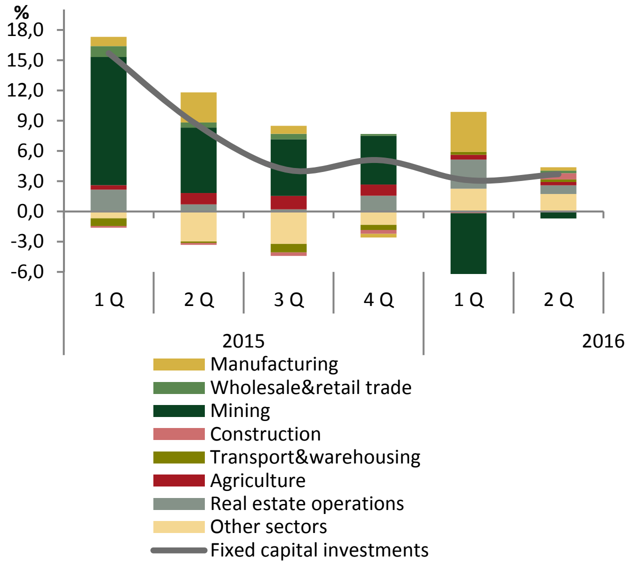
Investment Activity

In the second quarter of 2017, the investment activity in the real sector demonstrated growth. Based on performance in January-June 2017, the growth in fixed capital investments accounted for 3.7% as compared to the corresponding period of the previous year (Figure 42).

In the industry-based breakdown, a positive contribution to the investment pattern was made by the industrial sector given the increased investments into the manufacturing industry, water supply and electricity supply as well as due to the fact that investments into the mining industry slowed their decline. A high growth of fixed capital investments is retained in agriculture given implementation of programs aimed to automate the sector and to renew its fixed assets. Investments into education also demonstrated growth, being associated with the commissioning of educational institutions in regions of Kazakhstan, and into accommodation and catering services as part of the EXPO-2017 in Astana. Investments in residential construction slowed to 2% as a result of considerable curtailment of residential investments in Almaty Region. Apart from that, fixed capital investments in the construction sector, information and communication continued to decrease.

A major portion of investments was channeled to modernization of the production

Figure 42. Fixed Capital Investments, by Types of Economic Activity, Contribution, YoY, year-to-date total



Source: CS MNE RK, NBRK's calculations

process. The growth in expenditures for purchases of machinery, equipment, transportation vehicles and tools accounted for 38%, being caused by the increased output volumes in the economic sectors. In the second quarter of 2017, the percentage of domestic investments within total investments accounted for 75.2%, and foreign investments accounted for 24.8%. Own funds of enterprises still represent the main source of funding for fixed capital investments.

2.3.2 Domestic Production

In the first quarter of 2017, the GDP growth by the production method accounted for 3.6% in real terms versus the corresponding period of the previous year (Figure 43).

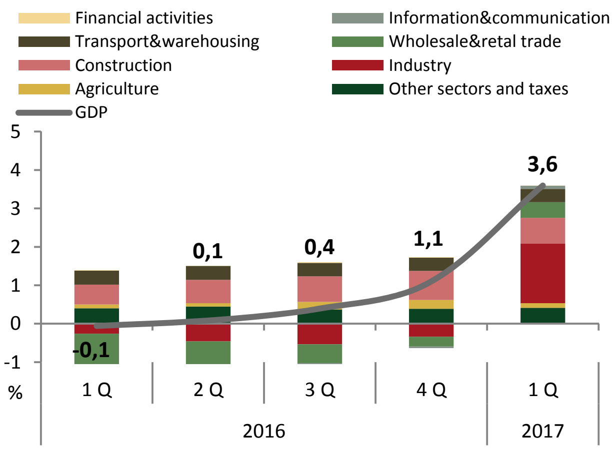
The key driver for the economic growth was the 6.2% increase in the annual volumes of production of goods, extraction of mineral resources and manufacturing of industrial products in particular. A positive contribution was also made by recovery in the services sector where the growth in the first quarter of 2017 accounted for 2.1% as compared to the corresponding quarter of the previous year.

The production trend in the key sectors of the economy in the second quarter of 2017 indicates that the processes of recovery determined by the improved foreign economic environment and the domestic demand are progressing. A short-term economic indicator increased by 6.8% as compared to the second quarter of the previous year (Figure 44).

A significant increase in volumes of crude oil extraction in the country's large oil fields including the Kashagan oil field as well as the recovering volumes of iron ore extraction and the increasing extraction volumes of non-ferrous metal ores helped accelerating the growth rates in the mining industry to 9.4% in annual terms at the end of the first half of 2017 (Figure 45).

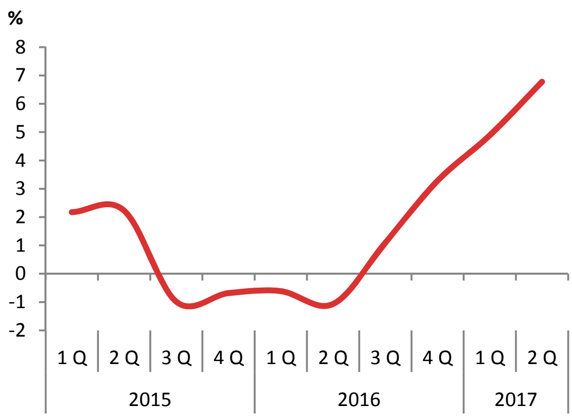
The persistence of production activity in the manufacturing industry was secured both by the increased production of interim goods (metallurgical industry and oil refinery) and of

Figure 43. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY, ***(the period versus the corresponding period of the previous year)***



Source: CS MNE RK, NBRK's calculations

Figure 44. Short-Term Economic Indicator ***(the quarter versus the corresponding quarter of the previous year)***



Source: CS MNE RK, NBRK's calculations

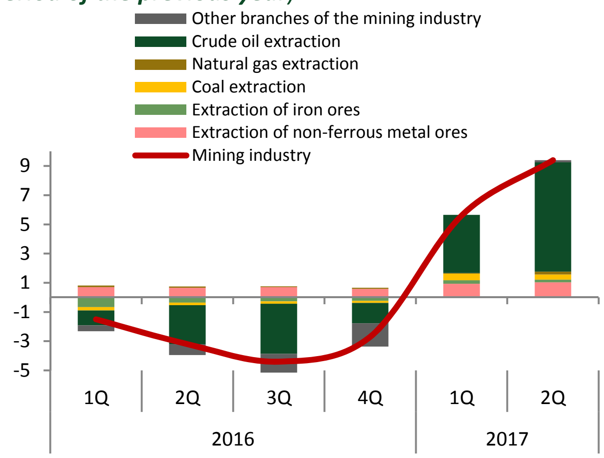
consumer goods. In January-June 2017, the growth in the sector accounted for 6.5% as compared to the corresponding period of the previous year (Figure 46). The growth in production of oil refinery products (7.3%) was ensured by the increased production of raw materials and the percentage of its realization in the domestic market[3]. The production structure of consumer goods shows the growth in the food industry (7.5%), light industry (15.4%), production of major pharmaceuticals (34.6%) and in furniture manufacturing (8.3%). The recovering economic activity was also conductive to the acceleration in production of investment goods. So, the manufacturing of electrical equipment increased by 28.9%, manufacturing of motor vehicles, truck trailers and other transport vehicles increased by 20.1% and of machinery and equipment – by 1.7%. At the same time, the limited line of investment goods and limited volumes of their production in the country along with the growing demand triggered the expansion of investment imports.

The growth in production of gross agricultural output accounted for 3.1% based on performance in January-June 2017 and was secured by the increased production of livestock products.

Volumes of construction works in the second quarter of 2017 slightly slowed down; at the end of the first half of the year the growth accounted for 5.9% in annual terms (Figure 47). Such pattern is determined by completion of construction works performed during preparation for EXPO-2017 exhibition in Astana. However, positive rates persist owing to the continuing implementation of government housing programs and infrastructure projects, works performed to modernize oil refineries, construction of industrial facilities, transport and warehousing facilities that are reflected in the structure of commissioned facilities.

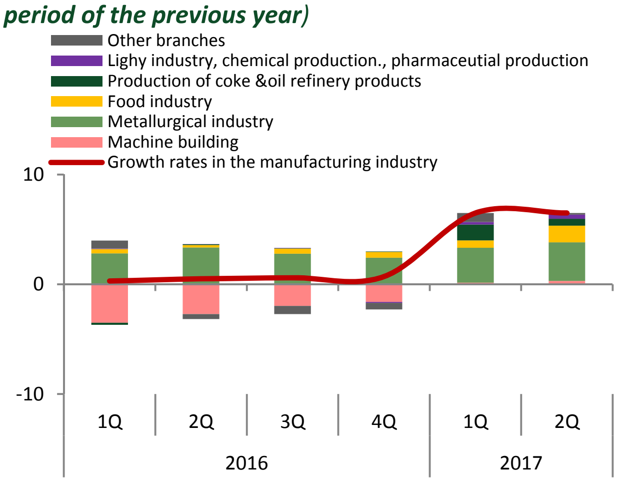
In addition to the production sector, in the second quarter of 2017 recovery processes

Figure 45. Decomposition of the Mining Industry. Contribution by Sectors to the Growth, YoY ***(the period versus the corresponding period of the previous year)***



Source: CS MNE RK, NBRK's calculations

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



Source: CS MNE RK, NBRK's calculations

[3] According to the CS MNE RK, given the increase in production of crude oil and natural gas in January-May 2017 of 9.5% as compared to January-May 2016 and the retention of the same export volumes, realization of raw materials in the domestic market increased by 60% in annual terms.

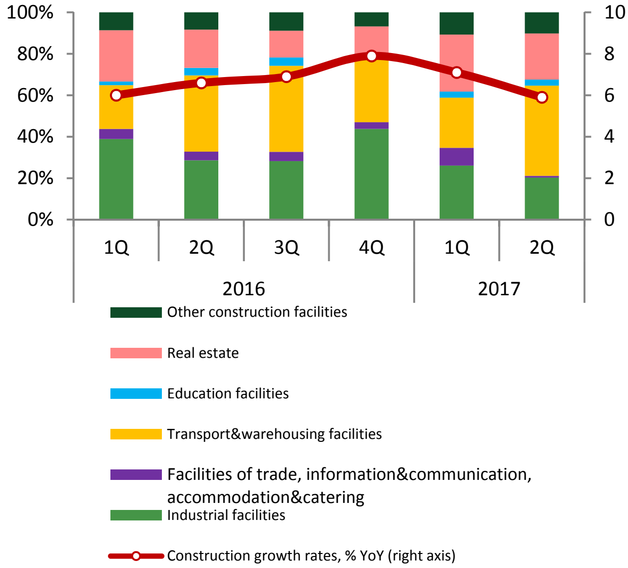
were also observed in the services sphere. Annual growth rates in retail sales accelerated to 5.9% at the end of the first half of 2017 given the improved pattern in the consumer demand and the growth in employment (Figure 48). In the retail sales structure, a positive contribution was made by both the sales of foodstuffs and of non-food products. The growth in wholesale turnover slowed to 0.6% in January-June 2017 as compared to the corresponding period of the previous year as a result of the decreased wholesale selling of foodstuffs.

Recovery of trade and the growth of external demand entailed the increase in transportation services. The growth in revenues from transportation services accounted for 3.9%; a sizeable contribution to its dynamics was made by cargo transportations by the railway (14.4%), pipeline (4.3%) and road transport (1.9%).

The expansion of the Internet served as a main driver for the growth in communication services that accounted for 2.5%. In addition, provision of mobile services and postal and messenger services increased (the growth of 0.8% and 11.7%).

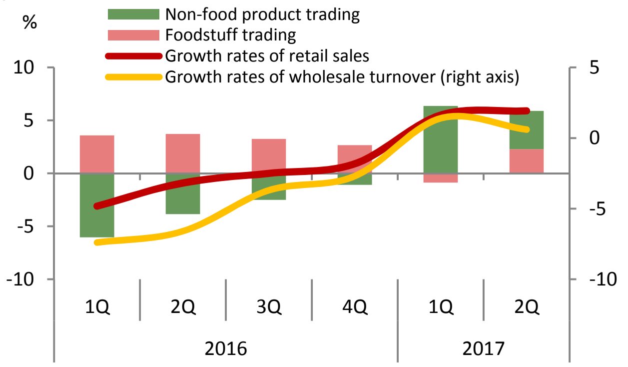
The behavior of the composite leading indicator, which summarizes the assessment of the existing situation and expectations of CEOs of companies in the real sector of the economy, continued to grow in the second quarter of 2017; this is an indication of the continuing recovery processes in the economy. According to respondents, this is promoted by the improved demand parameters, particularly in export-oriented sectors and in sectors which produce consumer goods. Also, financial and economic performance of enterprises and the growing volumes of output and investment activity are noted. Assessment methods which are based on filtration principles showed the persistence of negative values of the output gap. At the same time, gap indicators are approaching to zero which indicates a gradual release in deflationary pressure in the economy (Figure 49).

Figure 47. Growth Rates of Construction and a Relative Share of Commissioned Facilities, YoY *(the period versus the corresponding period of the previous year)*



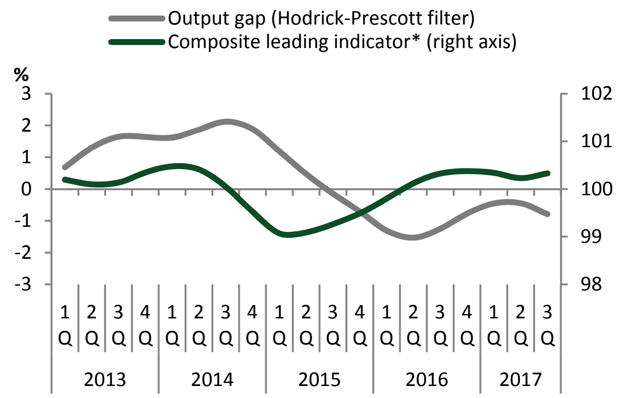
Source: CS MNE RK, NBRK's calculations

Figure 48. Growth Structure of Retail Sales and Growth Rates of Wholesale Turnover, YoY *(the period versus the corresponding period of the previous year)*



Source: CS MNE RK, NBRK's calculations

Figure 49. Behavior of the Composite Indicator, Cyclical Component of GDP and Output Gap



Source: NBRK

* *the calculation of a composite leading indicator was*

2.3.3 Labor Market and Unemployment

In the second quarter of 2017, nominal wages slowed their growth to 4.4% after the 5.6% growth in the first quarter of 2017 (Figure 50).

Real wages continued to decrease (by 2.9%). The decrease in real wages is noted in professional, scientific and technical activities (by 23.6%), education (by 4.0%), financial and insurance activities (by 2.3%), healthcare (by 1.3%), in the construction sector (by 1.2%) and trade (by 0.5%). At the same time, the growth in real wages was observed in the activities in the area of administrative and ancillary services (by 14.9%), real estate operations (by 7.4%), agriculture (by 4.8%), information and communication (by 3.3%) and in the industry (by 1.1%).

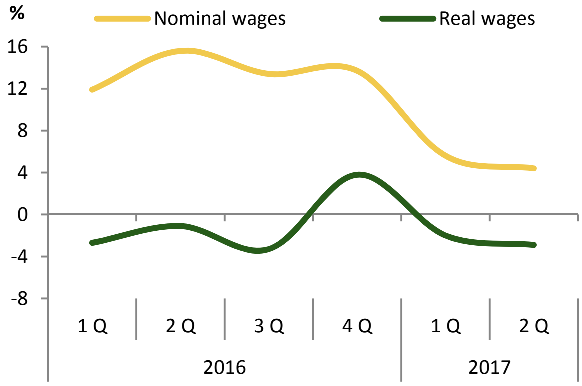
In the first quarter of 2017, the labor productivity in the economy accelerated to 2.8%. The labor productivity in the production of goods increased (by 10.9%) and it decreased in the services production (by 1.4%). The increased labor productivity in the production of goods was secured by the growth in productivity in the industry (by 11.0%), agriculture (by 10.4%) and in construction (by 5.3%). The increase in labor productivity in these sectors is outpacing the real wage growth in these sectors, which in general does not create any pre-requisites for boosting inflation risks.

The drop in labor productivity in the services sector is determined by the decrease in productivity in the real estate operations (by 19.0%), in accommodation and catering services (by 15.2%), in professional, scientific and technical activities (by 7.6%), in the activities in the area of administrative and ancillary services (by 6.2%) and in financial and insurance activities (by 4.5%).

The outstripping GDP growth as compared to nominal wages strengthened the downward trend in the unit labor costs (Figure 51). So, in the first quarter of 2017, unit labor costs decreased by 5.0% (at the end of 2016 – the

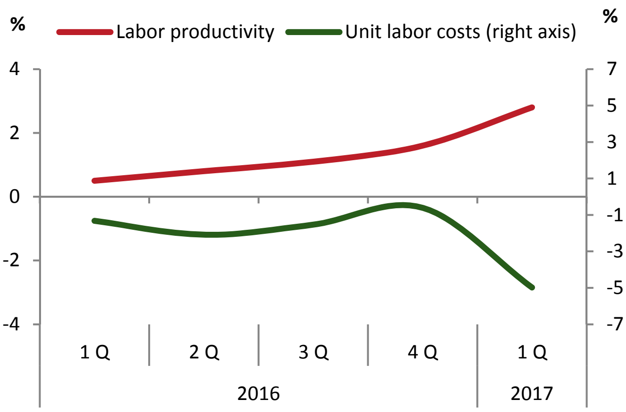
revised based on the OECD methodology

Figure 50. Nominal and Real Wage Indices, YoY



Source: CS MNE RK

Figure 51. Labor Productivity and Unit Labor Costs, YoY, year-to-date total



Source: CS MNE RK, NBRK's calculations

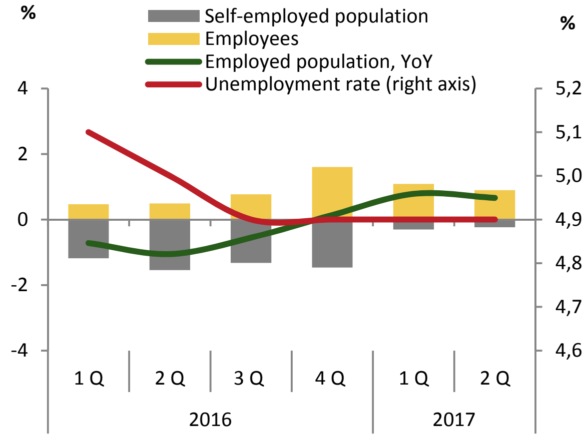
decrease made 0.6%).

Starting from the third quarter of 2016, the unemployment rate remains unchanged. An overall recovery of the economic activity, a continuing creation of new jobs as part of the government employment and economic stimulus programs, as well as the growth in output in most sectors of the economy promotes the establishment of additional jobs and helps keeping the unemployment at a stable rate.

In the second quarter of 2017, the number of the employed population increased by 0.7%. The growth trend in the number of employees (the growth of 1.3%) and reduction in the number of self-employed (by 0.9%) persists (Figure 52).

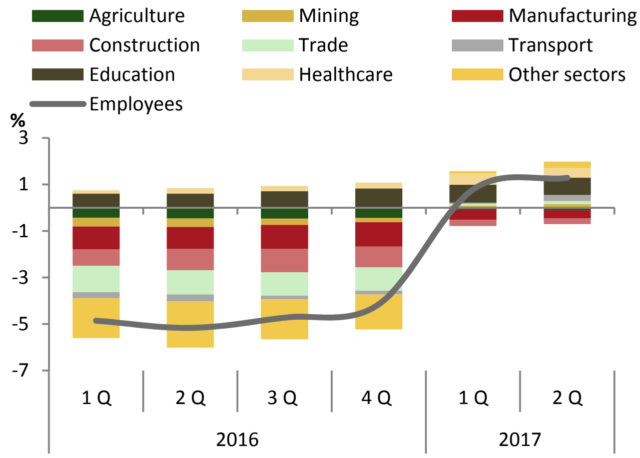
In the industry-based break-down (Figure 53), the number of employees increased in the activities in the area of administrative and ancillary services (by 10.9%), in accommodation and catering services (by 5.4%), in the transport sector (by 4.2%), healthcare (by 3.6%), in the mining industry (by 2.9%), education (by 2.9%) and in trade (by 2.7%). At the same time, the number of employees was decreasing in the following sectors: in communication sector (by 16.2%), in professional, scientific and technical activities (by 6.0%), agriculture (by 4.6%), and construction (by 4.5%) and in the manufacturing industry (by 4.2%).

Figure 52. Unemployment Rate, Growth Structure of the Employed Population, YoY



Source: CS MNE RK, NBRK's calculations

Figure 53. Structure of Growth in the Employed Population*, by Types of Economic Activity, YoY



Source: CS MNE RK, NBRK's calculations

**-Excluding small businesses engaged in entrepreneur activities*

2.4 Fiscal Policy

The fiscal policy was aimed to stimulate the economy, give an additional impetus to development of key socially-oriented sectors, improve housing and living conditions of the population, and to solve problems in the financial sector.

In the second quarter, receipts of the state budget increased by 18.6% as compared to the corresponding quarter of 2016.

In comparative terms, revenues to the state budget increased by 18.0% or 25.7% of GDP (in the second quarter of 2016 – 22.8% of GDP). In the revenue structure, the growth occurred in tax revenues (13.8%) and transfers (by 1.5 times). The relative share of transfers in the revenue structure increased from 29.5% to 36.7%, and the shares of tax and non-tax revenues decreased (by 2.2% and 4.5%, respectively) (Figure 54).

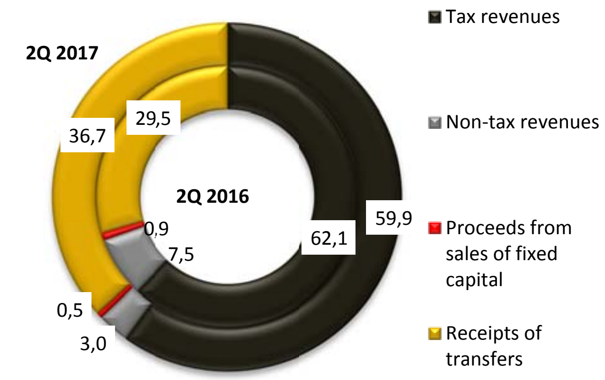
The guaranteed transfer from the National Fund of Kazakhstan to the state budget for the year 2017 was approved in the amount of KZT 2.88 trln.; based on performance in the first half of the year, the plan was fulfilled by 50.7%. As compared to the second quarter of 2016, the amount of the guaranteed transfer received to the budget increased two-fold and accounted for 8.3% of GDP. The earmarked transfer from the National Fund amounted to KZT 122 bln., which is twice less than the corresponding amount in the second quarter of 2016.

The state budget spending increased by 16.6% as compared to the second quarter of 2016, and the amount of expenditures increased from 21.7% to 24.2% of GDP.

Expenditures for the following sectors increased significantly: public utilities sector (by 1.8 times); agriculture; water management, forestry and fishery; protected areas; environmental and wildlife protection; land matters (by 1.6 times); defense (41%), public order and safety (30.4%); industry, architectural and construction activities (by 45%)(Figure 55). Nonetheless, education, healthcare and social expenditures continue to account for the largest relative share in expenditures; in toto, they started to account for 55.2% of government spending (in the second quarter of 2016 – 53.8%). Expenditures for these items also increased: social care and social security – by 11.5%, healthcare – by 1.5 times, and education – by 13.3%. The increased expenditures for these areas are associated with the increase in social benefits, and implementation of reforms in the healthcare and education system.

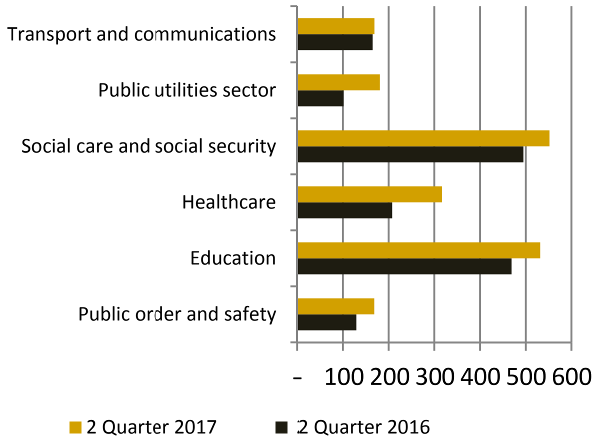
Despite the fact that the state budget revenues in the second quarter of 2017 exceeded expenditures by KZT 165.6 bln., the state budget showed up a deficit of KZT 78.9 bln. or 0.8% of GDP. Thus, a positive balance

Figure 54. Structure of State Budget Revenues



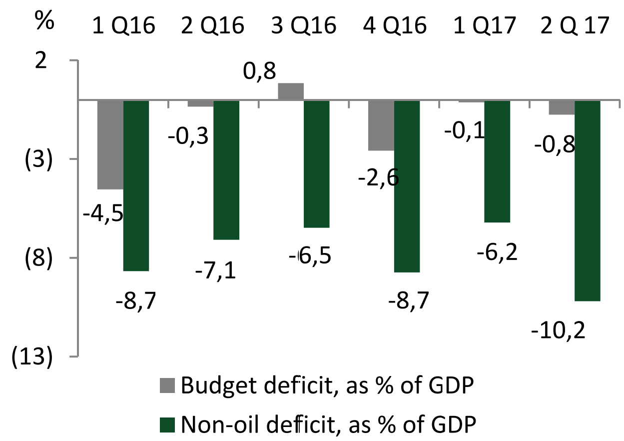
Source: Ministry of Finance of Kazakhstan

Figure 55. Change in the State Budget Spending



Source: Ministry of Finance of Kazakhstan

Figure 56. Change in the Overall and Non-Oil State Budget Balance



Source: Ministry of Finance of Kazakhstan was offset due to operations on credits from the budget (the balance made up KZT 150.8 bln.) and financial assets (KZT 93.7 bln.). Provision of credits from the budget just as financial asset purchases increased by 1.7 times as compared to corresponding period of 2016. Credits from the budget were channeled for reconstruction and construction of heating, water supply and water discharge systems, and also for development of the agro-industrial complex. Financial asset operations, in their turn, are intended to promote the country's financial system soundness.

The non-oil deficit increased by 1.5 times as compared to the second quarter of 2016 and accounted for 10.2% of GDP (Figure 56).

2.5 Balance of Payments

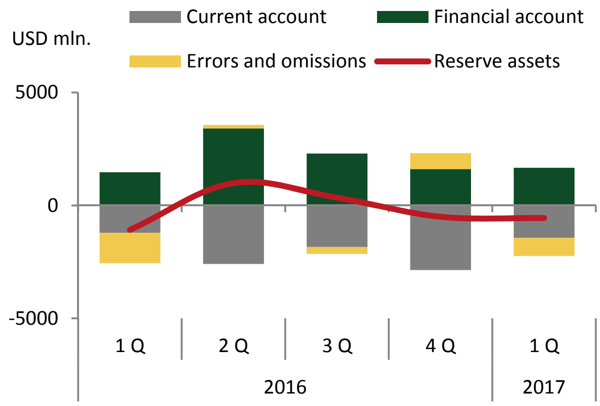
In the first quarter of 2017, given the recovering world oil prices and the start of commercial production in the Kashagan oil field, volumes of commodity exports were growing, which resulted in the increased payouts of returns to foreign direct investors. The current account deficit which was partially financed by the financial account operations secured an overall positive net balance of payments of USD 0.6 bln. (Figure 57).

The increased export revenues and expenditures of residents on direct investments led to a minor expansion in the current account deficit to USD 1.4 bln. (or 4.5% of GDP) as compared to USD 1.2 bln. in the first quarter of 2016 (Figure 58).

The dynamics of world energy prices continues to remain the key factor for the change in the commodity export volumes (Figure 59). As a result of significant growth in oil prices as compared to the same quarter of 2016, exports of goods increased by 29.5% to USD 11.0 bln.

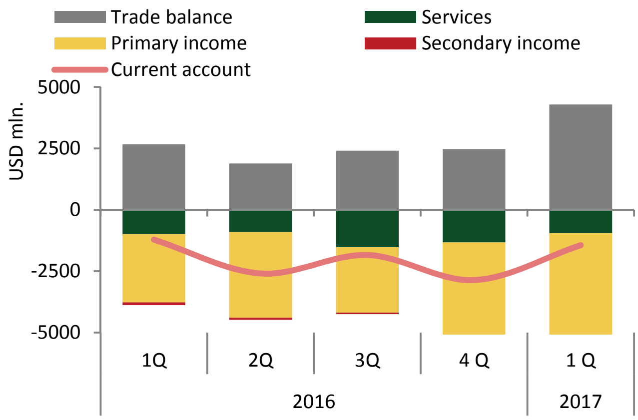
The growth in the value of exports occurred virtually in all key commodity groups except grain exports. Exports of mineral products increased by 36.9%, where the value of exports of oil and gas condensate increased by 33.5%, of ferrous metals – by 73.8% and of non-ferrous metals – by 24.2%. Exports of grain decreased

Figure 57. Balance of Payments, Quarterly



Source: NBRK

Figure 58. Current Account



Source: NBRK

by 26.6%.

Imports of goods increased by 15.1%. The growth was related to the 21.2% increase in imports of consumer non-food products, and interim industrial products and investment goods - by 19.8% and 8.2%, respectively. As per main trading partners – Russia and China – the increase in imports of goods accounted for 41.5% and 23.7%, respectively.

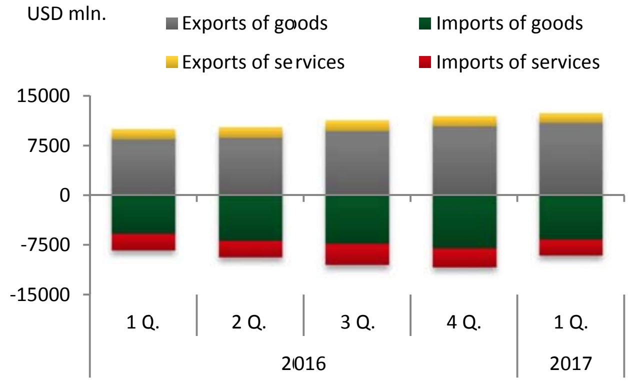
More rapid rates of growth in exports of goods versus the growth rates of imports (by 1.6 times) promoted the increase in the balance of trade surplus.

The deficit in the balance of international services shrunk by 4.2%. Exports of services decreased by 3.6% because of the decreased exports of construction and transport services (services related to the oil and gas transit by pipeline through the country's territory).

Imports of international services decreased by 3.8%, being secured by the decreased imports of construction and other business services which are mainly related to the engagement of non-residents in implementation of large infrastructure projects within the country's territory. At the same time, expenditures of residents associated with the payment for transport services of non-residents increased by 6.7% and trips abroad increased by 6.5%.

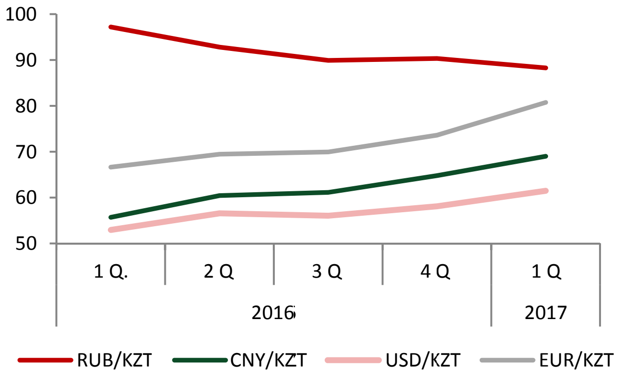
The real effective exchange rate index of the tenge had increased by 14.9% (the tenge appreciated in real terms against the CIS currencies basket and against currencies of other countries). Depreciation against the CIS currencies basket accounted for 7.7% and against the currency basket of other countries the tenge appreciated by 21.6%. Versus the corresponding quarter of the previous period, the tenge appreciated in real terms against the US Dollar by 16.1%, against the Euro – by 21.1%, against the Yuan – by 23.9%, and it depreciated by 9.2% against the ruble. The real effective exchange rate index decreased by 18.3% versus the benchmark competitiveness index of December 2013, thus indicating that the exchange rate competitiveness of Kazakhstani

Figure 59. Exports and Imports of Goods and Services



Source: NBRK

Figure 60. Real Effective Exchange Rate Index (December 2013 = 100%)



Source: NBRK

goods has been maintained (Figure 60).

A negative balance on primary income increased by 1.7 times. Such increase was driven by a nearly two-fold growth in returns of foreign direct investors where over a half of them was used to finance their Kazakhstan-based subsidiaries in the oil and gas sphere.

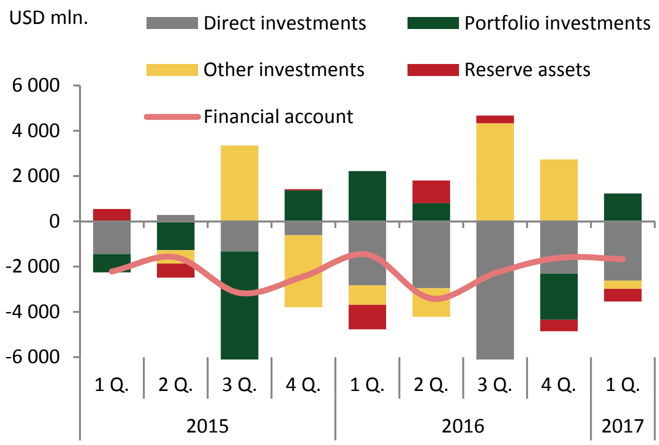
The financial account (less reserve assets) showed up a net capital inflow of USD 1.7 bln. due to the growth in liabilities of residents against reduction in their assets.

Foreign direct investments (FDIs) whose inflow was partially compensated by outflow associated with the growth in assets of residents in the form of securities, served as a main source of funding for the balance of payments (Figure 61). As for foreign direct investments, their net inflow of USD 2.6 bln. (USD 2.8 bln. in the first quarter of 2016) was secured mainly by reinvestment of their returns by foreign direct investors as well as by the intercompany borrowing from foreign parent companies. The bulk of foreign direct investments was channeled to finance the oil and gas sector, metallurgical industry and wholesale and retail sale outlets.

As for foreign direct investments, there was a net outflow of USD 1.2 bln., primarily due to the growth in foreign assets of residents of USD 1.4 bln. (investment of assets of the National Fund of Kazakhstan and pension assets into foreign securities). The growth of USD 149 mln. in liabilities on portfolio investments was secured by purchases of the National Bank's short-term notes by non-residents that were partially offset by redemption of debt securities issued by the Kazakh banks in foreign markets.

Other investments showed up a net inflow of USD 361 mln., which was mainly secured by the decrease in assets of banks and the National Fund of Kazakhstan with foreign accounts totaling USD 1.8 bln. At the same time, there was a net outflow on medium- and long-term debt instruments which is related to the reduction in bank liabilities and liabilities of non-bank organizations on long-term loans of USD 0.7 bln.

Figure 61. Financial Account



Source: NBRK

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as at August 3, 2017

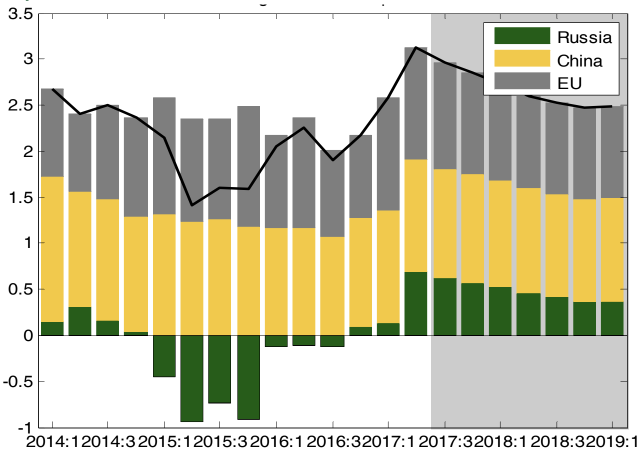
1. KEY ASSUMPTIOS FOR EXTERNAL FORECAST PARAMETERS

Assumptions regarding the terms of trade related to the demand for Kazakhstan's export commodities on the part of Russia, EU and China, which accounted for 58.0% of the total foreign trade turnover of Kazakhstan in the first quarter of 2017, had not undergone dramatic changes as compared to previous forecasts presented in the Inflation Report for the first quarter of 2017.

According to the National Bank's expectations which take into account estimates of international organizations, recovery of the external demand in the medium term will promote the economic growth in Kazakhstan. To a larger extent, the external demand will be expanding owing to recovery of positive growth rates of the Russian economy as well as due to a moderate growth of the Chinese economy around its potential and a feeble economic growth in the EU (Figure 62).

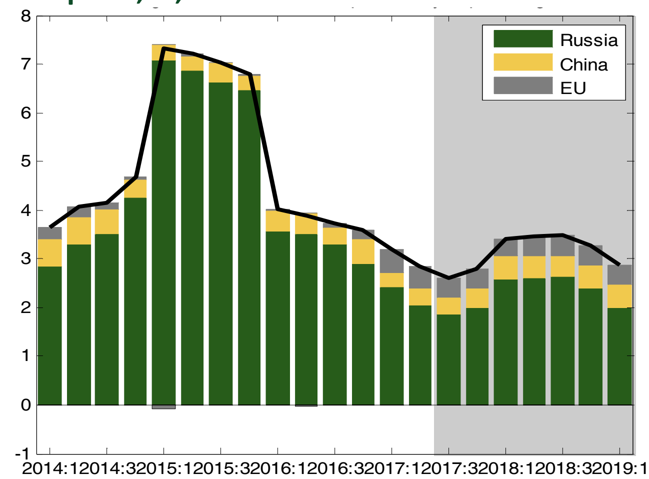
The inflationary background in countries-main trading partners had deteriorated as compared to the previous forecast round (Figure 63). Reassessment occurred mainly because of anticipation of a higher inflation in the Russian Federation given that the process of decreasing inflationary expectations held up. Nonetheless, in the medium term inflation is expected to be around the announced target. A minor inflationary pressure on the part of imported goods may take place given that the EU and China reached their inflation targets.

Figure 62. External GDP Decomposition Broken Down by Kazakhstan's Main Trading Partners, %, YoY



Source: NBRK's calculations

Figure 63. Weighted Inflation Broken Down by Kazakhstan's Main Trading Partners by Shares in Imports, %, YoY



Source: NBRK's calculations

In the short term, world food prices are expected to increase slightly given the deteriorated weather conditions. World food prices are expected to stabilize in the medium term. As a result, this factor will be putting pro-inflation pressure in the short term and neutral pressure in the medium term.

The price of oil (Brent) from December 2016 through May 2017 had been above USD 50 per barrel. In June the price of oil somewhat declined and during the second quarter of 2017 it was USD 49.7 per barrel. Given relatively stable expectations about the commodity market, the scenario which assumes the oil price to be at USD 50 per barrel was considered as the baseline scenario.

Expectations regarding external monetary environment in the medium term have not changed. The tightening of monetary conditions is still assumed given expectations about a further increase in the US Fed's federal funds rate.

2. FORECAST UNDER THE BASELINE SCENARIO

With the oil price of USD 50 per barrel, Kazakhstan's real GDP growth in 2017 is expected to be at 3.1%. In the second quarter of 2017, the economic activity was recovering at higher rates than it was expected earlier. The output growth was recorded in all key sectors of the economy amidst the improving external economic environment, a gradual recovery of the domestic demand and the continued implementation of government economic stimulus programs. Fixed capital investments retained their moderate growth. As a result, estimates about the real GDP growth in the short term became more positive.

The main driver for the economic growth will be the recovering domestic consumption as a result of adaptation by households to new economic environment, fixed capital investments and a further growth in extraction and production volumes of mineral resources. A positive effect from the recovering domestic consumption will be partially offset by the increase in imports. It is also expected that the real interest rate will be having a neutral effect i.e. it will not be constraining the domestic consumption in the medium term.

As a result, high growth rates in the manufacturing and the mining industry contributed to acceleration of the growth rates in 2017, which lead to a higher base and, accordingly, growth rates in 2018 were revised downwards to 3.0% (Figure 64).

In the long term, the GDP growth will be striving for its potential. According to the National Bank's estimates, the output will be slightly higher than its potential level from the second quarter of 2018 and will be having a feeble pro-inflation pressure, which will not require a response on the part of the monetary policy. A long-term growth potential of the Kazakh economy, as before, is estimated at 3-4%.

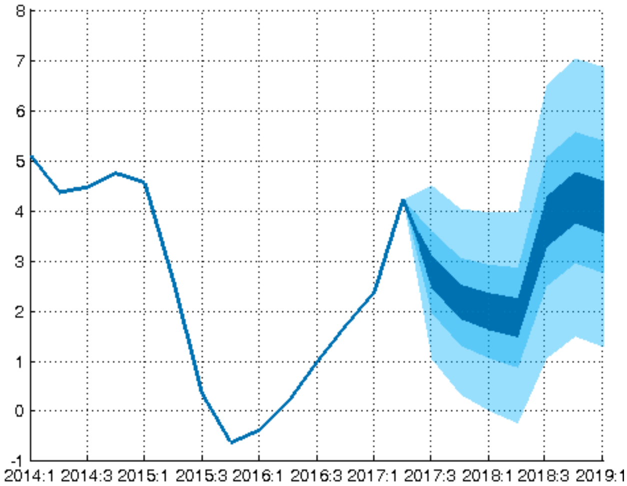
Forecasts for net exports had not undergone any significant changes as compared to the Inflation Report for the first quarter of 2017; accordingly, the assessment of contribution of net exports to the GDP growth has not changed.

As expected, rates of recovery in the domestic consumption continue to grow, which is confirmed by the data on retail sales; nonetheless, such growth has a limited nature because of the falling real wages and income against the growth in retail lending.

Expectations regarding the gross formation also haven't changed. During the forecast period, the gross formation will be growing due to fixed capital investments in the mining and manufacturing industries, in real estate operations, agriculture and transport. Terms and conditions for investment financing are further improving given the improving pricing terms in fund raising, namely the reduced cost of funding and a smooth attainment of its equilibrium by the real exchange rate, thus increasing affordability of imported investment goods.

Under the baseline scenario, the real effective exchange rate is expected to slightly appreciate in the medium term. However, such appreciation, given the asymmetry in the effect produced by the real effective exchange rate, will be putting a limited pressure on inflationary processes thus requiring a more constrained monetary policy.

Figure 64. GDP, Quarter to the Corresponding Quarter of the Previous Year, %



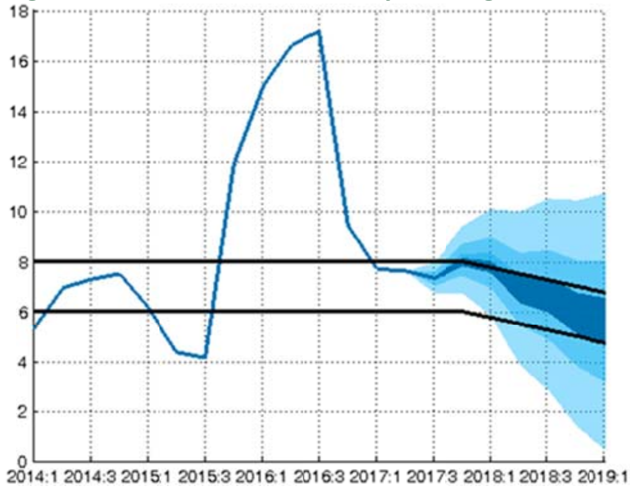
Source: NBRK's calculations

Assumptions regarding the government consumption in medium-term forecasts have not changed as compared to the previous quarter – the stance of fiscal policy will have a stimulative nature.

Under the baseline scenario, during the second half of 2017 the annual inflation will be closer to the upper boundary of the target band of 6-8% in connection with supply shocks in the food market (Figure 65). As shocks exhaust, in the medium horizon the inflation will be gradually going into a lower target band as compared to 2017. This will be promoted by stable oil prices, by the real effective exchange rate being close to its equilibrium, by a weakly positive output gap against the decreasing real wages and income of the population as well as by the decreasing and “anchoring” inflationary expectations.

Given the inflation forecasts and taking into account the estimate of potential growth of the Kazakh economy, the base rate behavior reflects a neutral monetary policy.

Figure 65. Inflation, Quarterly Average, YoY, %



Source: NBRK’s calculations

3. RISKS IN THE MEDIUM TERM

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

So, together with the baseline scenario, the scenario which assumes the oil price at USD 40 per barrel was considered; under such scenario, a higher inflation rate and more moderate GDP growth rates are anticipated. Under this scenario, there is a probability of inflation going beyond its target band in 2017 and be building at the upper boundary of the target band in 2018. Rates of the economic growth are expected to slow and such slowdown will be mainly observed in 2017, resulting from the instant response to deterioration in external environment. In case of this scenario, a possible reaction of the National Bank would be to tighten its monetary policy and the terms of the monetary policy implementation would change from neutral to constraining ones.

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

– the increasing pressure on the Russian Federation by the US sanctions in the short term is neutral in terms of the external demand and inflation and will not lead to deviation of inflation in Kazakhstan from its targets. Nonetheless, in the medium term, if the REER of the Russian ruble is weak, risks associated with depreciation of the tenge may translate into revision of the inflation path in the forecast period;

– unforeseen supply shocks in the food market that were observed this year and their repetition serve as a serious factor of uncertainty for realization of the baseline scenario of the forecast;

– if the scenario which implies the price of oil (Brent) to be at USD 30 per barrel in the medium term is realized, the risk of inflation going beyond upper boundaries of the target band for 2017 and 2018 would increase. The National Bank may use all available instruments to bring the inflation within the target band;

– the outpacing rates of growth in real wages over the growth in labor productivity, both economy-wide and in certain sectors of the economy, may lead to intensification of pro-inflation factors. The probability of such risk is insignificant due to negative rates of growth in real income and real wages;

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

– volatility of oil prices which is not taken into account in forecasting key variables would conduce higher devaluation and inflationary expectations; pace of dedollarization may stop, thus affecting the forecast parameters in a negative way;

– the forecast takes into account diminishment of inflationary expectations and their anchoring at the targeted levels. Should inflationary expectations increase, the actual inflation path will be building above the forecast.

BASIC TERMS AND DEFINITIONS

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

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

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

FX Swap – means a foreign exchange transaction which involves the concurrent purchase and sale of a certain amount of one currency in exchange of another currency with two different value dates. The National Bank's FX swaps represent the instrument of provision of the Tenge liquidity on the overnight basis at a fixed interest rate against collateral in foreign exchange.

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

Money Base (Reserve Money) includes cash issued in circulation by the National Bank, other than cash at the cash departments of the National Bank (cash outside the National Bank), transferable and other deposits of banks, transferable deposits of non-bank financial organizations and current accounts of government and non-government non-financial organizations in the Tenge at the National Bank.

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

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

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

Consumer Price Index (CPI) – the change in the overall level of prices for goods and services purchased by the population for consumption. The consumer basket of Kazakhstan for calculation of inflation reflects the structure of household expenditures and contains 510 goods and services which represent the largest portion in the consumption of population. The CPI is calculated as the ratio of the cost of a fixed set of goods and services in current prices and its cost in the prices of the previous (base) period. The index is calculated by the Committee on Statistics of the Ministry of National Economy of the Republic of Kazakhstan.

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

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

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

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

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

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

Reverse Repo is the purchase of securities with the agreement to sell them at a specific price and at a specific future date. The National Bank conducts reverse repos with a view to provide the Tenge liquidity to banks against the pledge of securities in line with the National Bank's list of collateral.

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

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

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

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

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

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

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

Direct Repo is the sale of securities with the agreement to repurchase them at a specific price and at a specific future date. The National Bank conducts direct repos with a view to withdraw excess liquidity in the Tenge.

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

Output Gap (GDP Gap). Deviation in GDP expressed as a percentage of a potential output. Expresses the difference between an actual GDP and potential GDP for a certain time frame. Serves as an indicator which reflects the effectiveness of resources utilized in the country. If an actual output exceeds the potential one (a positive output gap), other things remaining equal, the trend of acceleration in the price growth rates would be anticipated because of the overheating of the economy. The presence of a negative output gap indicates an expected slowdown in the price growth rates due to low economic activity. Output fluctuations around its potential level reflect business cycles in the economy.

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

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

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

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

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

LIST OF KEY ABBREVIATIONS

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