



NATIONAL BANK OF KAZAKHSTAN

# Inflation Report

The First Quarter of 2017

Almaty, Kazakhstan

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

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as at 18.05.2017.

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## SUMMARY

During the first quarter of 2017, the annual inflation was maintained within the National Bank's target band of 6-8%, having decelerated to 7.7% in March. Within the structure of inflation, the contribution of non-food inflation and the paid services inflation decreased while the contribution of food inflation remained at the level of the previous quarter.

A further recovery of oil prices supported by the meeting of commitments to limit the oil production taken by exporting countries as well as the increased metal quotations assured appreciation of the tenge. This contributed to the behavior of prices favoring their deceleration, despite some increase in prices of imported products. Prices in foreign food market demonstrated a feeble decline in the first quarter of 2017. However, the decline in wheat prices amidst high competition in the global markets as well as sufficient reserves in the domestic market had a downward pressure on processed grain products in terms of their price growth within the structure of the food component of inflation.

The situation in countries – main trading partners demonstrates a weak recovery of the external demand, and the inflationary background remains neutral because of a dramatic deceleration of inflation in Russia as well as its acceleration in the EU countries.

The behavior of macroeconomic parameters indicates the outlining signs of the economy's revival. The GDP growth in 2016 accounted for 1%, being promoted by a favorable external environment, gradual recovery of the business activity and improved performance in the consumer demand.

In the first quarter of 2017, the recovery trend continued. So, the growth rates of the short-term economic indicator were increasing. The industry as well as construction, agriculture, trade, and transport sectors became the main drivers for the growth.

The household consumer spending was supported by recovering positive rates of growth in the real income of the population because of decelerating inflation rates and increasing rates of growth in the social benefit payments. So, the share of non-food products in the structure of retail sales increased; this is an evidence of a gradual recovery of the consumer demand and realization of the effect of deferred demand. Preparation for the EXPO-2017 international exhibition has a positive effect on the employment and consumer demand while representing a short-term effect. In general, due to the absence of positive pattern in the production sector, a negative output gap is gradually decreasing, thus decreasing deflationary impact of the real sector of the economy.

At the same time, prices in the real sector of the economy are influenced by the increased cost of interim goods and industrial services constraining the price growth rates for certain categories of consumer goods.

In the first quarter of 2017, the money market was still characterized by the structural liquidity surplus. As a consequence, the TONIA rate had been between the base rate and the lower boundary of the interest rate band. Excess liquidity was withdrawn by the National Bank primarily via its short-term notes. The deposit market still shows the trend of the shift in foreign currency preferences of the population towards the domestic currency. In the environment of persisting excess liquidity, interest rates were decreasing. The credit market showed a minor growth rate of lending in the domestic currency and the decreasing interest rates. In February 2017, the National Bank made the decision to lower the base rate from 12% to 11% while preserving the interest rate band width of +/-1%, and in April 2017 the base rate was maintained at that level. On June 5, 2017 the National Bank lowered the base rate to 10.5%.

Due to consolidation of stable oil prices in global markets, parameters in the baseline scenario were maintained at USD 50 per barrel.

The real GDP forecast in 2017 is expected to be at 2.8%, and in 2018 – 3.6%. The reason for the increase in forecasts for the economic growth was a more rapid recovery of the economic activity than it was expected. A further recovery of the domestic consumption, growth in fixed capital investments, and increased volumes of extraction of mineral resources will become the main drivers for the economic growth. In the long term, the potential GDP is still anticipated to be at 3-4%. According to the National Bank's estimates, migration of the GDP gap to a weakly positive zone is expected in the first quarter of 2018.

Under the baseline scenario, in 2017 the inflation will be within its target band of 6-8% followed by its deceleration in the medium-term. However, in the short-term, the inflation may increase slightly because of the low base of the second half of 2016. A favorable external inflationary background, recovery of the real effective exchange rate to its equilibrium, and stable situation in the global food markets will be conducive to deceleration of inflation.

## 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 first quarter of 2017, the average price of oil (Brent) had been at USD 53.7 per barrel, thus demonstrating the growth of 9.1% as compared to the previous quarter and of 59.3% as compared to the corresponding quarter of 2016 (Figure 1).

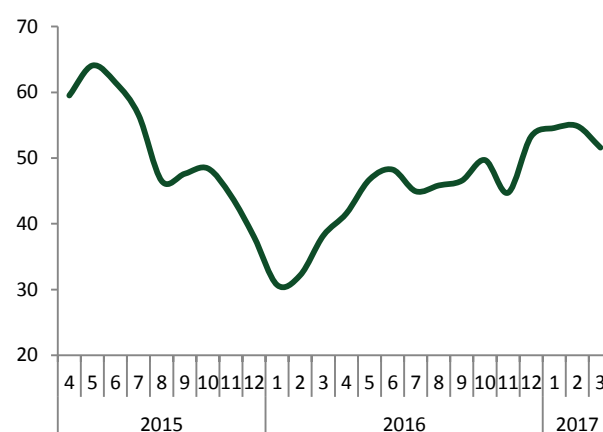
Intra-quarterly fluctuations of market quotations of oil were in line with the price level which outlined in December 2016. A continuing significant growth in prices of energy resources was secured by a sizable reduction of surplus in the global oil market. According to the U.S. Energy Information Administration<sup>1</sup>, a surplus between the oil production and consumption in the world amounted to 0.32 million barrels a day, which is by 58% less than in the previous quarter and by 87% less than the surplus in the first quarter of 2016. Thus, in the first quarter of 2017 the global oil market approached a balance between the demand and supply (Figure 2). Both the global production and consumption of energy resources decreased.

Annual rates of growth in oil consumption globally showed the weakest numbers since the end of 2015, being the consequence of the reduced oil consumption in Japan and in the US as well as of the reduction in demand in annual terms in the European countries. At the same time, the reduction in oil consumption volumes in annual terms in India as the largest world net importer of energy resources had the strongest impact on the slowdown in the growth rates of the demand for oil (Figure 3).

Reduction in the oil production globally resulted both from the continuing drop in the supply on the part of countries outside of OPEC and a significant decline in the extraction volumes in OPEC countries (Figure 4).

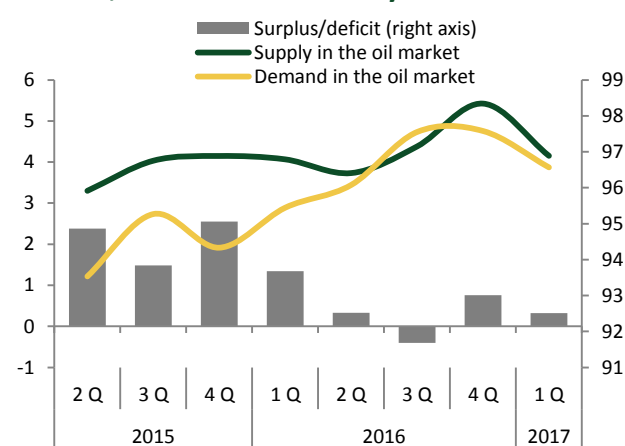
The main factor for reduction in the oil production in the countries outside of OPEC in

**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)

<sup>1</sup>Published on April 11, 2017 in the monthly "Short-Term Energy Outlook"

the first quarter of 2017 had been a considerable slowdown in the annual extraction volume in Russia in line with commitments made in November as part of the Algerian Agreement on Reduction of Total Oil Production from January 1, 2017. A continuing drop of oil production in China in annual terms served as an additional factor.

In the first quarter of 2017, the growth rates of oil production volumes in OPEC countries slowed to 0.7% as compared to the corresponding quarter of the previous year (in the fourth quarter of 2016 – 3.7%). Reduction in the volumes of energy production in OPEC countries also occurred due to the Algerian Agreement. Alongside with that, a positive contribution to the oil production was still being made by Libya which was excluded from the Agreement together with Iraq due to a difficult military and political situation.

A future demand and supply pattern in the global oil market that determines market quotations of energy resources will be connected with actions taken by countries within the framework of the Algerian Agreement as well as with the situation in the US shale oil market where the production volumes are recovering amidst the growth in the world oil prices.

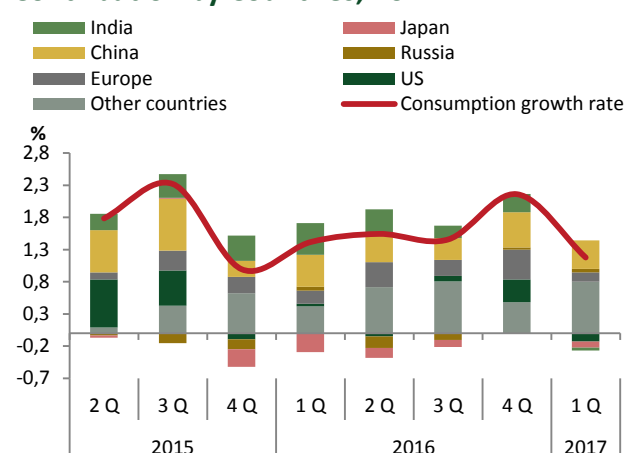
### 1.1.2 Non-Ferrous Metals Market

In the first quarter of 2017, the metals market demonstrated the growth in market quotations which was outpacing the expectations of market participants. The mean arithmetic index of prices of copper, aluminum, zinc and lead in March 2017 versus December 2016 increased by 19% (Figure 5), which was caused by the increase in prices of all metals under review.

The growth in prices of copper was associated with the decreased supply on the part of Chile and was also supported by signs of stability in the Chinese economy.

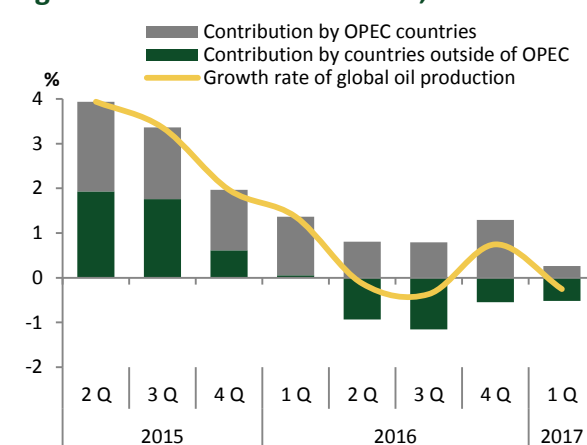
Lead prices increased given the growth in raw material imports on the part of China as well as reduction in the stock reserves of this

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



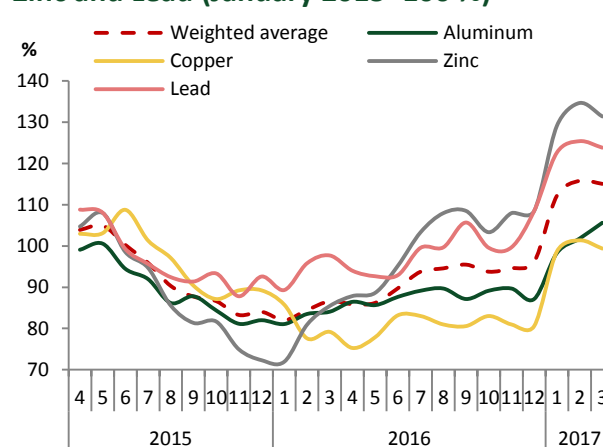
Source: U.S. Energy Information Administration (EIA)

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



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

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



Source: NBRK's calculations based on data from Bloomberg

metal.

Zinc quotations demonstrated growth given the reduced production in the South Africa and reduced capacities in Peru. Alongside with that, the growth in zinc prices was associated with the increased investments and increased profitability in the sector.

From December 2016 to March 2017, the price of aluminum increased because of the reduced production of this metal in China.

### 1.1.3 Food Market

In March 2017 as compared to December 2016, the FAO Index decreased insignificantly by 0.4%. Prices of sugar, dairy products, and vegetable oils were declining. Prices of meat and cereals demonstrated a feeble growth (Figure 6).

Sugar prices are declining under the impact of a persistently low import demand as well as of the market expectations about a future increase in supplies from Brazil.

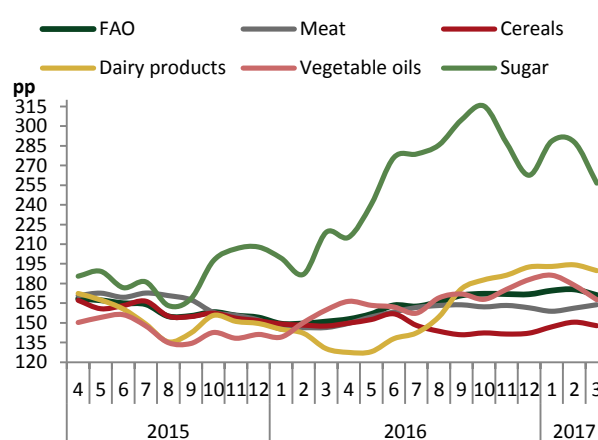
Prices of vegetable oils were declining throughout the first quarter of 2017 because of the declining prices of palm oil and soya oil. The reason for declining vegetable oil prices is mainly the reduced import demand, the increased acreage and a record-high crop of oilseeds as well as an anticipated seasonal growth in supply.

Given an anticipated peak seasonal growth in the production volume of dairy products in the North America and Europe, prices of these foodstuffs show a slight decline. Along with that, due to the excessive demand over supply among dairy products, prices of butter are growing.

Prices of meat products are increasing being influenced by the growth in prices of lamb and pork. If lamb increased in terms of price because of the seasonal demand, the price of pork increased because of the growth in the domestic demand in European countries and the increase in supplies to the Republic of Korea and China.

In the first quarter of 2017 as compared to the previous quarter, prices of cereals slightly

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



Source: UN FAO

increased. Among prices of cereals, the major price growth occurred in the price of rice the demand for which increased in the Middle Eastern countries. At the same time, wheat prices showed a minor decline under the pressure of sharpened competition among exporters and because of supply which is maintained at a sufficient level.

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

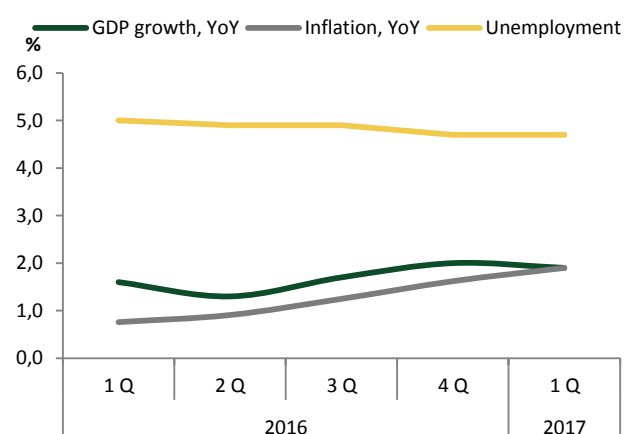
According to the data of initial assessment by the US Bureau of Economic Analysis, the GDP growth in the US based on performance in the first quarter of 2017 slowed to 1.9% (Figure 7), thus appearing to be below the market expectations. So, experts interviewed by the Bloomberg anticipated the growth of 2.1% (the growth of 1.2% versus the previous quarter in annual terms). Earlier, the Bureau of Economic Analysis revised the US economy's growth in the fourth quarter of 2016 from 1.9% to 2%.

The decreasing rates of real GDP growth in the first quarter of 2017 caused the slowdown in the growth of personal spending on final consumption (the energy consumption decreased due to the warm weather) as well as the decrease in the government spending on defense. The growth in private investments into residential construction and extraction of mineral resources had a positive impact on the economic growth.

In the first quarter of 2017, the annual inflation was generally around the 2% target and was determined by the behavior of energy prices (Figure 7). So, in February 2017 the annual inflation accelerated to 2.1% as compared to 1.6% in December 2016 given the increased prices of energy commodities and slowed to 1.8% in March 2017 as their prices were going down. The increase in prices of rental housing and transportation services served as additional factors for acceleration of inflation.

According to the data from the U.S. Bureau of Labor Statistics, in March 2017 the unemployment rate in the US decreased to 4.5% as compared to 4.7% in December 2016;

**Figure 7. US Economic Performance**

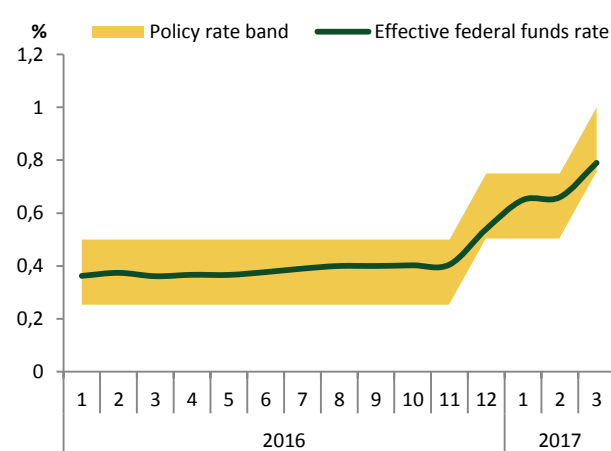


Sources: U.S. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics (BLS)

this fact confirms that the US economy is approaching its full employment. The drop in the employment in the retail trade amidst slowing consumption can be referred to negative factors and a steady growth of employment in the sector which supports extraction of mineral resources (oil, in the first instance) can be referred to positive factors. The growth in hourly salaries and wages in March 2017 accounted for 2.7% as compared to March 2016, which is way above the inflation rate and reflects the shortage of labor force in the labor market.

Therefore, such factors as inflation being at the levels close to its targets, steady deceleration of unemployment, and moderate economic growth were the reasons to increase the US Fed's policy rate band by 25 basis points in March 2017 to 0.75%-1% (Figure 8). According to forecasts made by members of the Federal Open Market Committee, the median of the policy rate made up 1.4% by the end of 2017 remaining unchanged as compared to forecasts made in December 2016; this came as a surprise to market participants who expected more rapid rates of normalization of the monetary policy.

**Figure 8. US Rates**



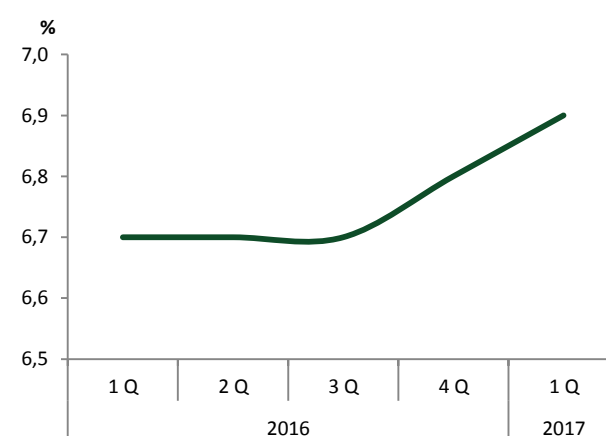
Sources: Reuters

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

#### 1.3.1 China

In the first quarter of 2017, the Chinese economy accelerated by 0.1 pp as compared to the previous quarter, with its growth accounting for 6.9% in annual terms (Figure 9). Government investments into the infrastructure and active lending for residential construction as well as an outlining growth in private investments amidst an overall recovery of the economic growth still represent the main sources of the GDP growth. Negative factors constraining acceleration of the economic growth in the country include redundant capacities in many sectors of the economy, and high degree of debt of the Chinese enterprises. Given the Government's declaration to decrease the target of GDP growth to 6.5% in 2017 as well as some tightening of the

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



Source: Bloomberg

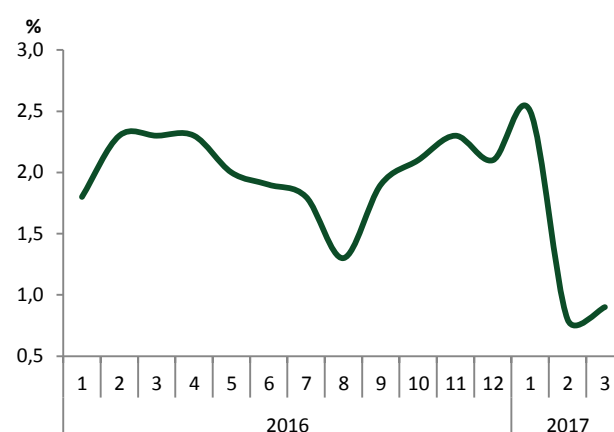
monetary policy at the beginning of the year, the Chinese economy may slow down because of cooled mortgage lending and the government stimulus package. A potential protectionist policy in the US as well as deceleration of the EU's economy in connection with Brexit still represent external risk factors.

The annual inflation, after its acceleration to 2.5% in January 2017, decreased to 0.9% in March (Figure 10). This fact is explained by a high base of the previous year when prices of vegetables and meat increased dramatically because of unfavorable weather conditions. At the same time, seven months in a row prices in the industry show a steady growth in annual terms (in March – 7.6%) reflecting expansion in the domestic demand for raw materials. This fact, alongside with a steady increase in prices of services speaks for a temporary nature of decelerating inflation and its future comeback to the rates of the previous year.

In the first quarter of 2017, the People's Bank of China pursued a generally neutral monetary policy while retaining its policy rate at the existing level (Figure 11). Nonetheless, with a view to curb the growth of arrears of the Chinese enterprises, to restrict an excessive growth in housing prices, mitigate systemic risks in the banking system and to ensure sustainability of the Yuan exchange rate against world major currencies, the People's Bank of China twice raised short-term and medium-term money market interest rates by 0.1 pp.

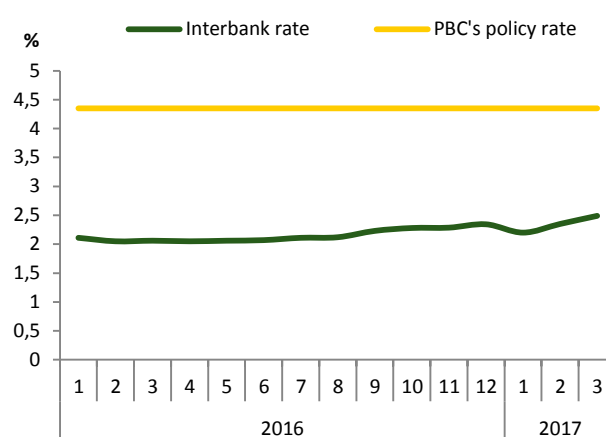
During the first quarter of 2017, the exchange rate of the Yuan against the US Dollar was demonstrating a divergent pattern. So, in January-February, in the environment of tightened measures of control over the capital outflow as well as the increased borrowing rates in the money market, the Yuan was appreciating and in February it made up CNY 6.8698/1USD on average. However, given that the Fed's policy rate was raised in March, the Yuan depreciated to CNY 6.8935/1USD (Figure 12).

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



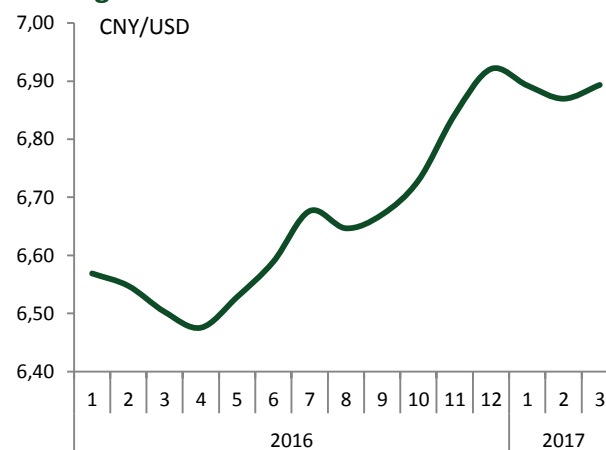
Source: National Bureau of Statistics of China

**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 estimate of the Eurostat, the annual growth in the European Union's GDP in the first quarter of 2017 accounted for 2.0% (Figure 13). Such insignificant growth was related to a moderate consumption and fixed capital investments supported by ECB's stimulative measures and a steadily decreasing unemployment as well as by recovery of global trade and a relatively weak Euro. Negative factors may include a potential decrease in consumption against a dramatic boost of inflation as well as remaining risks in the banking sector because of a significant percentage of NPLs within bank assets in some countries (Cyprus, Greece, Italy, and Ireland).

Dynamics of inflation in the EU in the first quarter of 2017 was mainly determined by the behavior of prices of energy commodities. So, in February as compared to December 2016, the annual inflation rate increased to 2.0%, and in March it dropped to 1.5% because of the slowing growth in prices of gasoline and recreation services (Figure 14). Nonetheless, in future the pressure on the cost-push inflation will be made by the recovery of prices of raw commodities in 2016, and the pressure on the demand-pull inflation will be made by stimulative measures of the ECB's monetary policy and the drop in unemployment. Given that the inflation boost was mainly associated with a volatile energy component, the ECB left the key monetary policy parameters unchanged (Figure 15). The regulator confirmed that the asset purchase program will be extended (EUR 60 bln. every month) till the end of 2017, with a possibility of its prolongation in case if a sustainable inflation trend is not in line with the inflation goals.

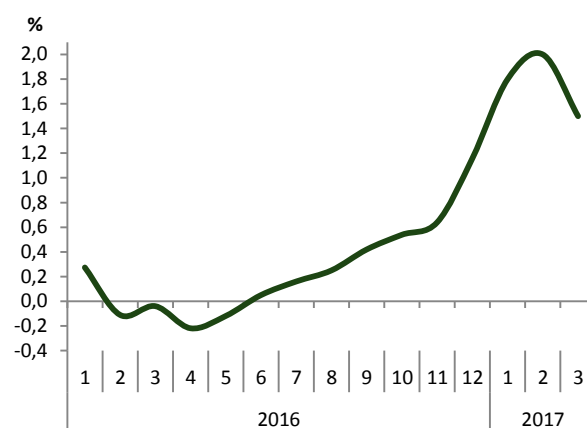
During the reviewed period, the Euro appreciated from USD 1.0537/1EUR on average in December 2016 to USD 1.0686/1EUR on

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



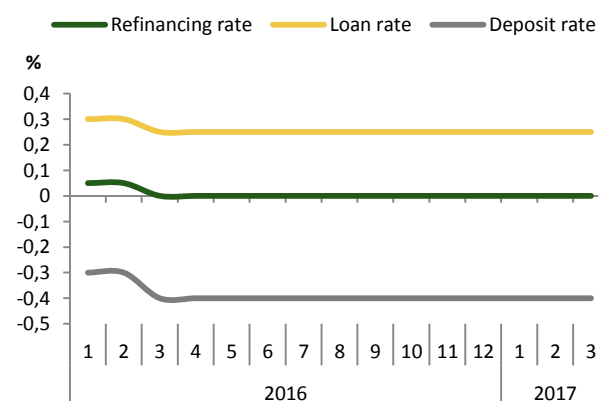
Source: Eurostat

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



Source: Eurostat

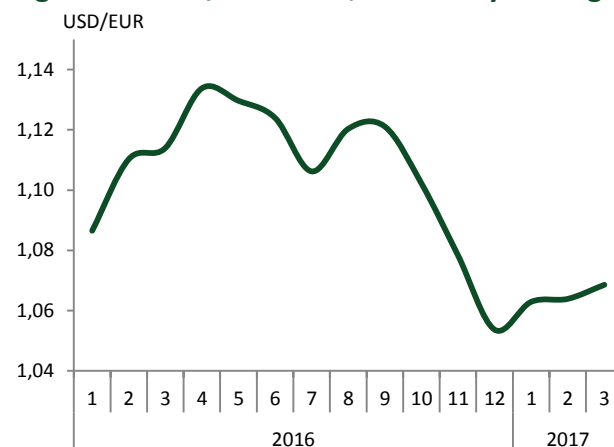
**Figure 15. ECB's Rates**



Source: Reuters

average in March 2017 (Figure 16). Such appreciation is associated with depreciation of the US Dollar given the US Fed's posturing about retention of the pace of its policy rate increase till the end of 2017 and the appearing uncertainty of the market regarding the support of the intended US President's policy by the US Congress. Nonetheless, the risks for a possible depreciation of the Euro are the political uncertainty related to implementation of Britain's exit from the EU, outcomes of elections in Germany in September 2017 as well as the US policy in the area of trade.

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

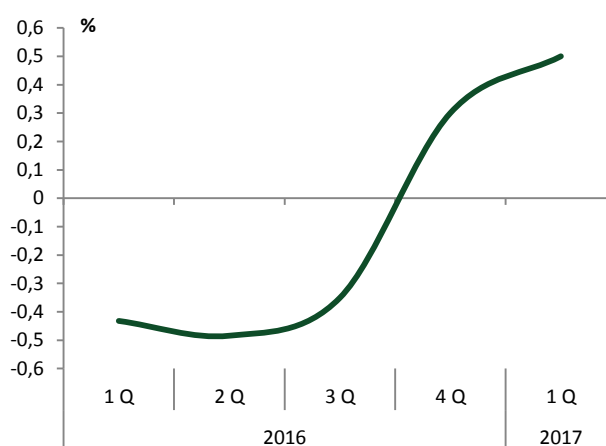


Source: Reuters

### 1.3.3 Russia

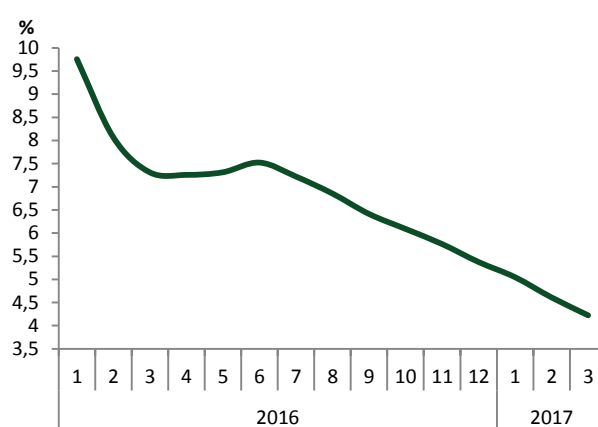
According to the initial assessment by Rosstat, in the first quarter of 2017 the growth of the Russian economy continued a second quarter in a row and accounted for 0.5% versus 0.3% in the fourth quarter of 2016 in annual terms (Figure 17). The growing extraction of mineral resources; production and distribution of electricity, gas and water; agriculture; transport as well as a slowing decline in retail sales turnover served as positive factors. Negative factors include the increasing downturn in the construction sector and a temporary drop in the manufacturing industry. A gradual recovery in the consumer and investment demand serve as sources for the GDP growth whereas an unfavorable situation in the commodity markets may curb such growth in future.

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



Source: Rosstat

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



Source: Reuters

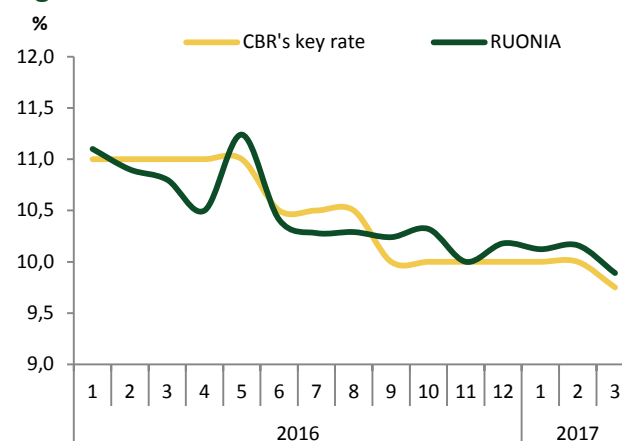
During the first quarter of 2017, the annual inflation in Russia decreased from 5.4% in December 2016 to 4.3% in March 2017 (Figure 18). Such dramatic deceleration of annual inflation was driven by appreciation of the ruble, moderate consumer demand as well as significant mitigation of inflationary expectations.

In order to support the propensity to save as well as to entrench inflation at the target level of 4% in the short and medium term, the Bank of Russia continued to pursue a moderately tight monetary policy but due to a more rapid than expected deceleration of

inflation it lowered its key rate from 10% to 9.75% in March (Figure 19). Nonetheless, expiration of the pass-through effect of the ruble appreciation, a gradual recovery of real wages and exposure to external shocks represent the risk factors for the growth of inflation in future.

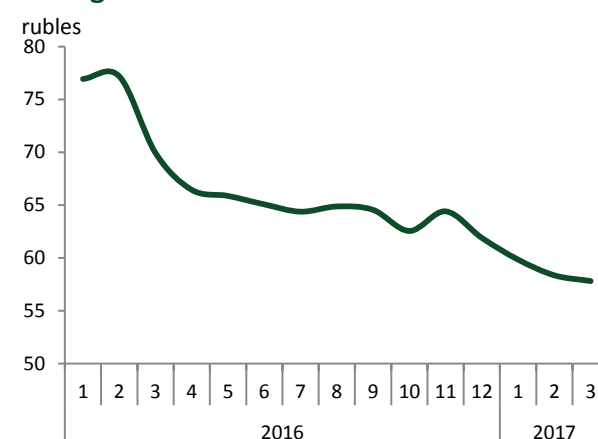
The exchange rate of the Russian ruble to the US Dollar in March 2017 appreciated versus December 2016 by 6.6% (Figure 20); this was promoted by the growing supply of foreign exchange in connection with the recovery of oil prices, continuing attractiveness of Russian assets against high interest rates and by the reduced country risk premium. Purchase of foreign exchange by the Russian Ministry of Finance that was made as part of the transitional budget rule as well as actual external debt payments (according to the Bank of Russia's estimates, up to USD 15.8 bln. in the first quarter of 2017) had not made a significant impact on the exchange rate behavior. The decline in oil price and a corresponding capital outflow represent key risks for depreciation of the ruble.

**Figure 19. Rates in Russia**



Source: Reuters

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



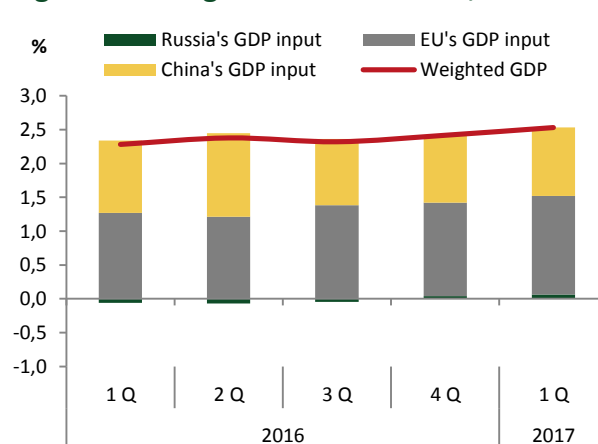
Source: Reuters

### 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 11 basis points in the reviewed period (Figure 21). Such improvement was caused by recovery of Russia's economic growth and an insignificant acceleration of the EU's and China's GDPs. A sluggish growth of aggregate external GDP of main trading partner countries reflects a moderate improvement in the external demand in the first quarter of 2017.

Aggregate external consumer price index which is calculated based on the share of main

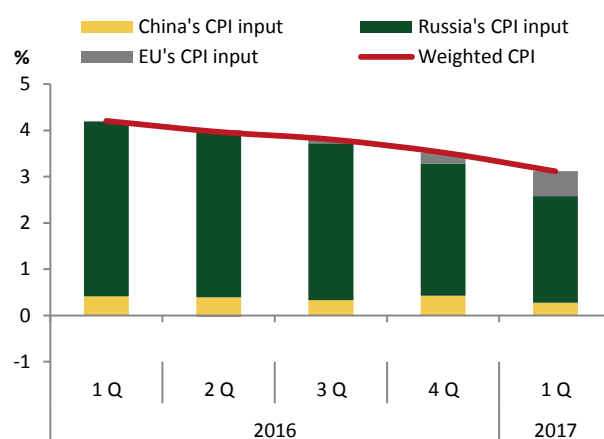
**Figure 21. Weighted External GDP , YoY**



Source: NBRK's calculations

trading partners in Kazakhstan's imports demonstrated a decline of 40 basis points (Figure 22). Such decline is caused by deceleration of annual inflation in Russia and a temporary deceleration in China. In general, the decline in the indicator reflects a continuing weakening impact of the external inflation on the Kazakh consumer market.

**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 first quarter of 2017, there was still a structural surplus of the tenge liquidity in the money market. In this environment, volumes of operations for withdrawal of excess liquidity conducted by the National Bank were growing. The bulk of liquidity in the money market was withdrawn via the National Bank's short-term notes with maturities of 7, 28, 91, 182 and 364 days. As compared to December 2016, the volume of outstanding notes at end-March 2017 increased by 27%. The demand for overnight deposits of the National Bank was also growing. As part of the measures to support the second-tier banks, in the first quarter of 2017 the National Bank provided short-term loans to banks, including as part of support for the announced bank consolidation processes (Figure 23).

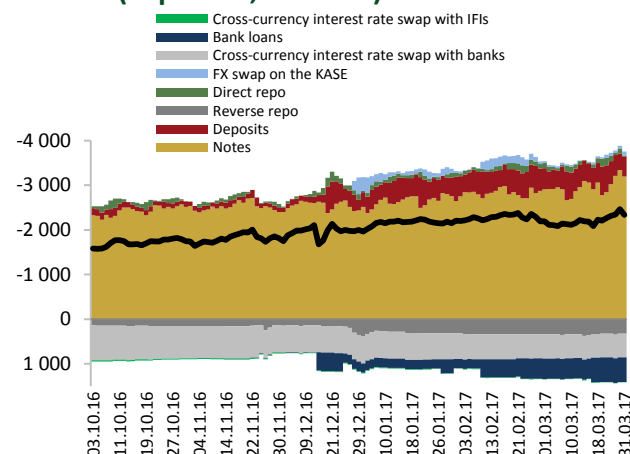
Given favorable internal and external environment in the economy, during the first quarter of 2017 the National Bank continued to ease monetary terms and conditions by lowering its base rate. So on February 20, 2017 the base rate was lowered from 12% to 11% while retaining the band of +/-1%.

In January-February as well as in mid-March 2017, there was a minor volatility of money market rates due to a high demand for the tenge liquidity in certain banks. As a result, the TONIA rate had been primarily above the lower boundary of the interest rate band. Along with that, the National Bank's participation in the overnight repo market in the first quarter of 2017 decreased as compared to the previous quarter.

From end-February, after the base rate was lowered, the TONIA rate had been closer to the lower boundary of the interest rate band (Figure 24).

During the first quarter of 2017, the Money Market Index was fluctuating with the band of 7.65-11.96%. The weighted average MMI for the first quarter of 2017 made up 10.30% (in the fourth quarter of 2016 – 11.11%). The major

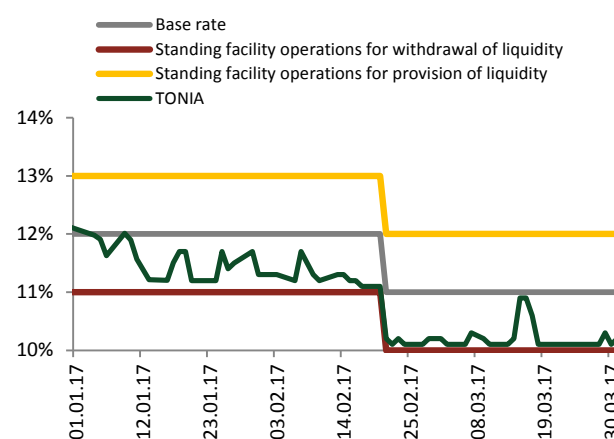
**Figure 23. NBRK's Operations in the Domestic Market (exposure, KZT bln.)**



\* NBRK's securities buy/sell back auction

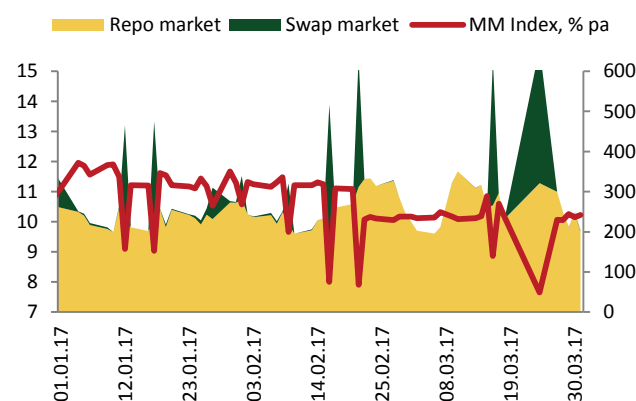
Source: NBRK

**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

share fell on the repo market (Figure 25).

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

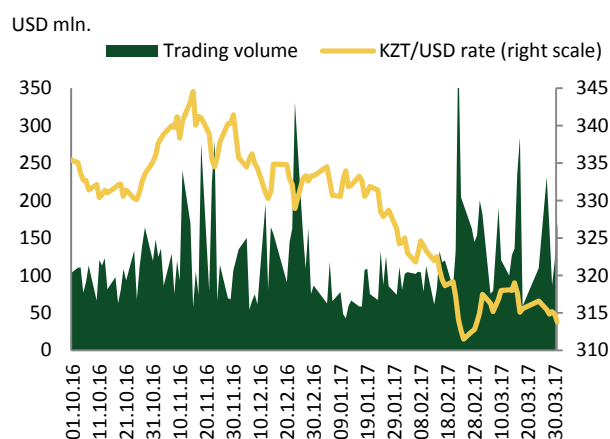
In the first quarter of 2017, the situation in the foreign exchange market remained stable. Fluctuations of the exchange rate of the tenge against the US Dollar were driven not only by world oil prices and the behavior of the Russian ruble but also by internal factors, for instance, the so-called “tax week” which takes place every second month of a quarter and promotes appreciation of the tenge.

During the quarter, the exchange rate of the tenge was fluctuating within the range of KZT 311.49-334.51 per US Dollar (Figure 26), mainly demonstrating the appreciation trend. At the end of the quarter, the stock exchange (market) rate of the tenge against the US Dollar appreciated by 5.9%.

Throughout the first quarter of 2017, the share of the National Bank’s participation in the domestic foreign exchange market was equal to zero (Figure 27). The exchange rate of the tenge was put into equilibrium impacted by external and internal factors.

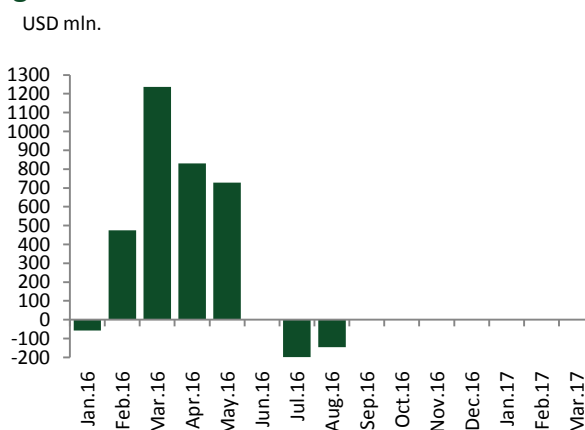
In the reviewed period, volumes of on-exchange and off-exchange trades in the KZT/USD currency pair decreased slightly by 5.2% and by 4.6%, respectively.

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



Source: KASE

**Figure 27. NBRK’s Interventions**



Source: NBRK

### 2.1.3 Deposit Market

A stable situation in the domestic foreign exchange market and persisting attractiveness of deposits in the domestic currency kept having a positive impact on the growth in the volume of the tenge deposits. During the first quarter of 2017, deposits in the domestic currency increased by 7.6% against the 11.3% decrease in foreign currency deposits. As a result, the volume of the tenge deposits exceeded that of foreign currency deposits for the first time after October 2014 and as at end-March dollarization of deposits accounted for

49.8%, having decreased from 54.6% in the fourth quarter of 2016 (Figure 28).

Reduction in foreign currency deposits was caused both by revaluation as a result of appreciation of the tenge (by 5.9% on the year-to-date basis) and by a physical outflow (6.1%).

During the first quarter, foreign currency deposits of corporate entities decreased by 12.2% against the 8.7% increase in the tenge deposits, thus resulting in the decreased share of foreign currency deposits of corporate entities from 49% in December 2016 to 43.6% in March 2017. The foreign currency structure of retail deposits also showed the decreased dollarization of deposits – from 62% in December 2016 to 58% in March of this year as a result of the 10.3% drop in foreign currency deposits and the 5.6% increase in the tenge deposits.

The weighted average interest rate on deposits attracted in the domestic currency decreased from 10.6% in December 2016 to 9.7%, and on foreign currency deposits – from 2.2% to 1.9%.

#### 2.1.4 Credit Market

In the first quarter of 2017, the credit market showed the decrease in lending volumes associated with seasonal factors at the beginning of the year.

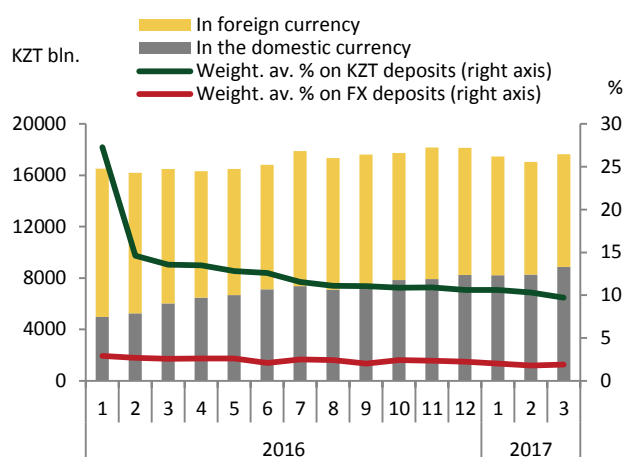
Over the quarter, the lending volume had decreased by 1.6% (Figure 29). The decrease in lending volumes was caused by the decrease in credits to corporate entities (by 2.3%), while retail lending remained unchanged.

However, in the first quarter of 2017, new loans exceeded those provided in the corresponding period of 2016 by 3.6%.

As per the currency structure, credits in the domestic currency continue to grow (by 1.9%) and rates of lending in foreign currency are decreasing (by 8.8%).

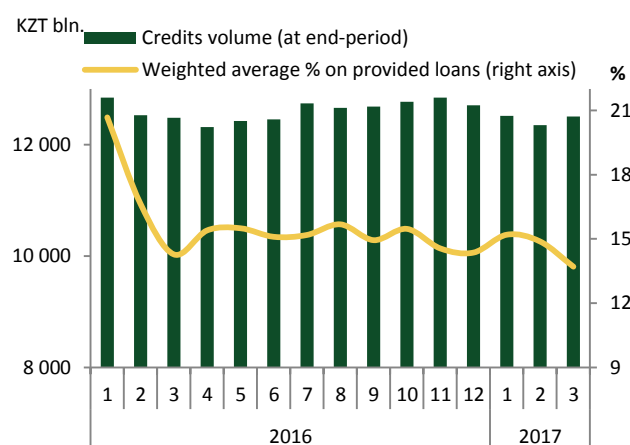
A positive contribution to the growth of lending that in the first quarter was made by such sectors as agriculture, transport and construction was offset by the reduced lending to the sector of trade which accounts for one

**Figure 28. Volumes and Interest Rates on Deposits in the Tenge and in Foreign Currency**



Source: NBRK

**Figure 29. Volumes and Rates on Loans**



Source: NBRK

fifth of the total lending volume. Credits to sales outlets decreased by 7.2% (in the fourth quarter of 2016 – the growth of 1.3%). The largest reduction in lending volumes occurred in the sector of communication (by 19.5%) (Figure 30).

During the first quarter of 2017, lending to small enterprises increased by 1.5% and amounted to KZT 3 trln., accounting for nearly one fourth of total credits to the economy (24.4%).

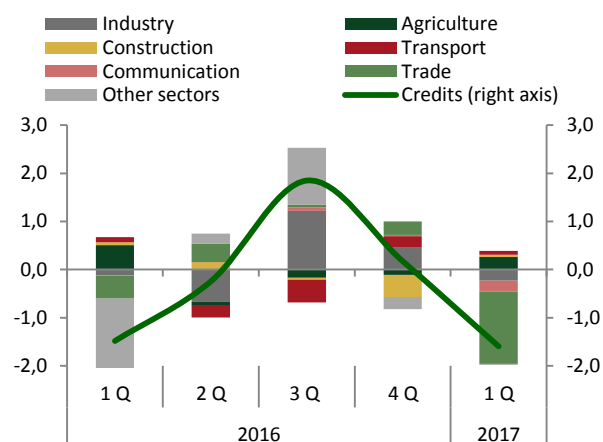
In March 2017, the weighted average interest rate on loans in the domestic currency decreased from 15.6% in December 2016 to 14.8% in March 2017.

### 2.1.5 Monetary Aggregates

In the first quarter of 2017, the money supply was stabilizing in annual terms (Figure 31). During January-March 2017, the reserve money expanded by 0.7%, the money supply contracted by 3.1%, and cash in circulation decreased by 5.9%.

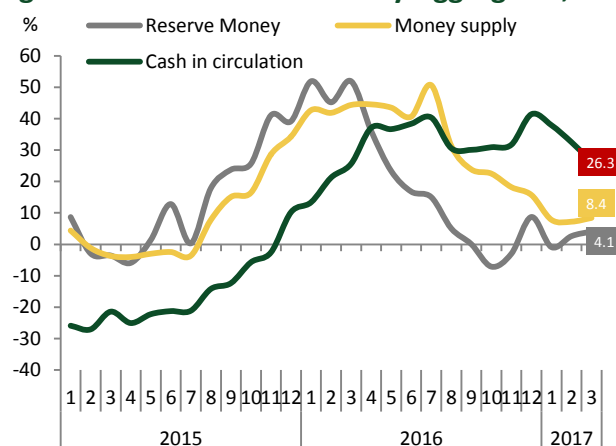
The main positive contribution to the formation of money supply in annual terms was made by the National Fund's account in the tenge and other net domestic assets. A negative contribution to the formation of money supply was made by claims on the Government as the National Bank's liabilities exceeded claims on the Government (Figure 32). The main constraining factor for the growth in the reserve money is the reduction in net international reserves. Along with that, in the structure of domestic claims on the economy positive contributions from the reduction of the National Fund's account in the tenge and capitalization of the Problem Loan Fund were fully offset by a negative growth in dues from banks as a result of short-term note placements with a view to withdraw excess liquidity. So, at end-March 2017, the volume of outstanding notes exceeds that as at end-March 2016 by about 8 times.

**Figure 30. Contribution to Growth Rates of Lending by Sectors, quarter versus the previous quarter, %**



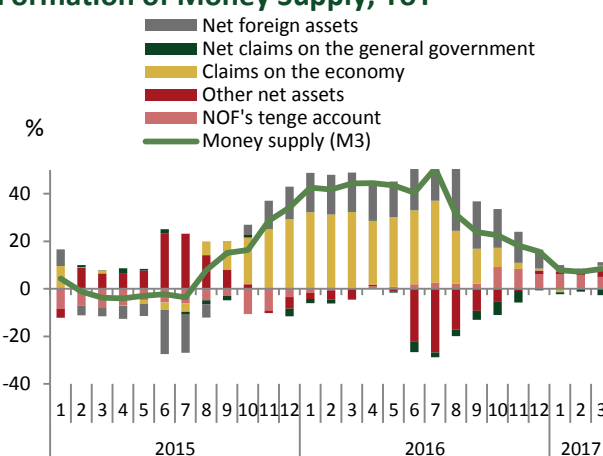
Source: NBRK

**Figure 31. Growth in Monetary Aggregates, YoY**



Source: NBRK

**Figure 32. Dynamics of Contributions to the Formation of Money Supply, YoY**



Source: NBRK

## 2.2 Prices and Inflationary Processes

### 2.2.1 Consumer Price Index

Inflation has been decelerating and since the beginning of 2017 it has been within the National Bank's target band.

Appreciation of the domestic currency, a stable price behavior in the global food markets as well as moderate inflationary expectations served as factors for deceleration of annual inflation.

### 2.2.2 Prices in the Consumer Sector

The annual inflation decreased from 8.5% in December 2016 to 7.7% in March 2017 (Figure 33).

Core inflation excluding prices of fruit and vegetable production, regulated services, and energy resources decreased from 8.9% to 7.7%; this indicates that the most stable part of the consumer price index (without the effect of volatile and seasonal components) continues its downward trend. However, coincidence of its value with that of the headline inflation shows that there are still risks in the structure of core inflation.

The annual inflation structure showed the decreased contribution of non-food products (excluding fuel and lubricants), regulated services as well as a minor decrease in the contribution by non-regulated services and the food inflation (excluding fruits and vegetables) (Figure 34).

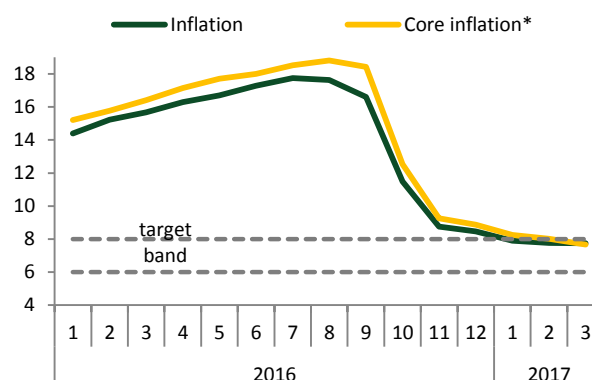
In general, in March 2017 the food inflation remained at the same rate as in December 2016 (9.7%). The increased growth rates of prices of vegetables and meat were slightly offset by slowing growth rates of prices of other foodstuffs categories (bread and bakery, sugar, soft beverages, etc.).

The non-food inflation decelerated from 9.5% to 8.5%, and the growth in tariffs for paid services – from 6.1% to 4.7%.

### 2.2.3 Prices in Real and External Sectors

Producer prices increased in annual terms from 15.5% in December 2016 to 26.7% in March 2017 due to accelerated growth of prices

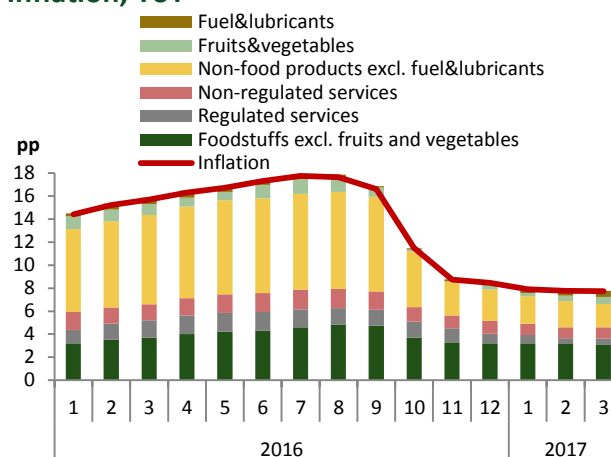
**Figure 33. Annual and Core Inflation Pattern, YoY**



Source: CS MNE RK

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

**Figure 34. Contribution of its Components to Inflation, YoY**



Source: CS MNE RK, NBRK's calculations

for products of the mining industry (Figure 35). At the same time, growth rates of prices for products supplied to Kazakhstan's market slowed insignificantly from 20.6% to 19.5%. In particular, in the first quarter of 2017 as compared to the same period of the previous year, the price growth rates decreased virtually across all sectors of the economy except production of crude oil, natural gas as well as motor vehicles.

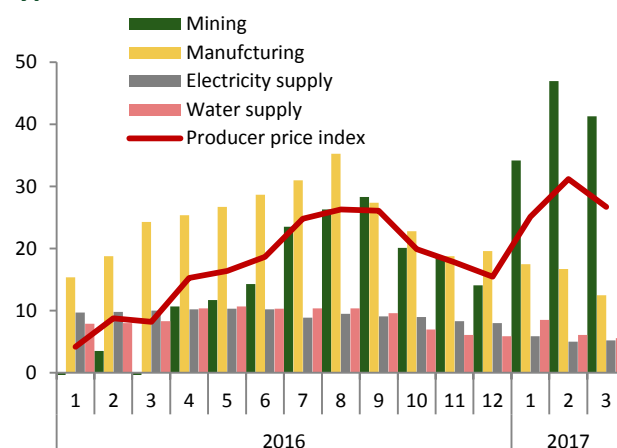
The growth in prices of industrial services accelerated from 3.6% to 5.7%.

In agriculture, the price growth rates decreased from 8.7% to 5.6% (Figure 36). The decrease was driven by decelerating growth rates of prices of cereals while growth rates of prices of vegetable production and meat and dairy products accelerated. The downward trend in the behavior of prices of cereals was associated with the existence of sufficient stocks and the decreased wheat exports because of high competition in the global markets. Accelerated growth rates of prices of vegetable and meat production could be caused by the increased price of purchased resources, fixed and working capital as well as by the impact of anticipated and actual changes in the sphere of subsidies and taxation in the agricultural sector.

In the wholesale sector, the annual price growth in March 2017 slowed down (from 11.8% to 7.2%). The slowing price growth was observed among consumer non-food products and production means. During the first quarter prices of interim products (fuel, metals, and chemical products) accelerated their growth rates.

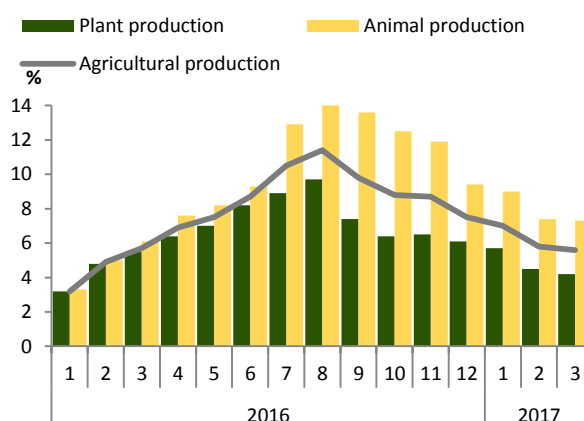
In the first quarter of 2017, annual growth rates of prices of imported goods (in US Dollars) were accelerating but were offset by appreciation of the domestic currency. The increased cost of imported goods was noted among consumer and investment goods in the US Dollar equivalent while the growth rates in the tenge equivalent decreased (Figure 37).

**Figure 35. Price Changes in the Industry by Types of Economic Activities, YoY**



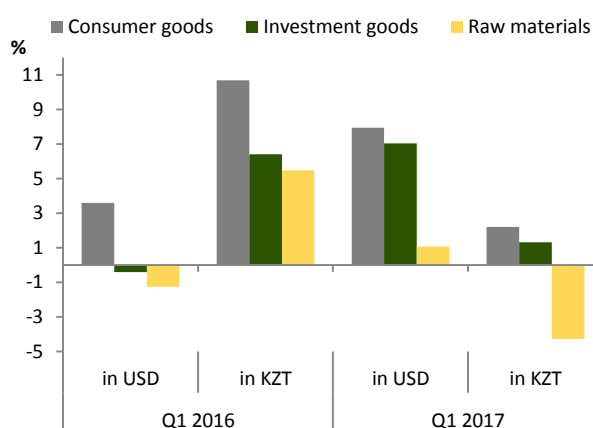
Source: CS MNE RK

**Figure 36. Price Changes in Agriculture, YoY**



Source: CS MNE RK

**Figure 37. Change in Prices of Imported Goods, for the Quarter**



Source: CS MNE RK, NBRK's calculations

### 2.2.4 Inflationary Expectations

The households' survey outcomes in the first 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. The percentage of respondents who note high rates of growth among prices of consumer goods and services over the recent 12 months decreased as compared to the previous periods. The percentage of respondents who noted the slowdown in the price growth rates increased.

In the first quarter, expectations of the households regarding the prospects of price changes in the next 12 months improved. The percentage of respondents who anticipate the price growth in the next 12 months decreased from 73% to 67% (Figure 38). The majority of respondents anticipate the growth to be at the existing level with some decrease in the percentage of those who predict acceleration of inflation and a minor increase in the number of respondents who anticipate that prices will be growing at a slower pace than now.

Therefore, inflationary expectations of the households regarding long-term prospects of the growth rates of prices of foodstuffs, non-food products and paid services in the first quarter of 2017 had stabilized.

## 2.3 Real Sector Development

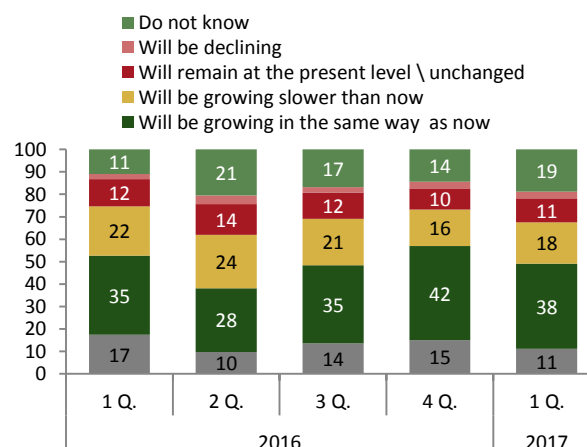
Given that external economic environment improved and the situation in the domestic market stabilized, the economic activity continued its recovery.

### 2.3.1 Domestic Demand

In 2016, the GDP by the final consumption method increased by 0.9%, mainly due to the growth in gross formation and household consumer spending. A trend of negative contribution by exports continued its downward path (Figure 39), being associated with the improved pricing environment in the global commodity markets. The growth in exports of mineral products and ferrous metals promoted the restoration of overall export volumes. Gross

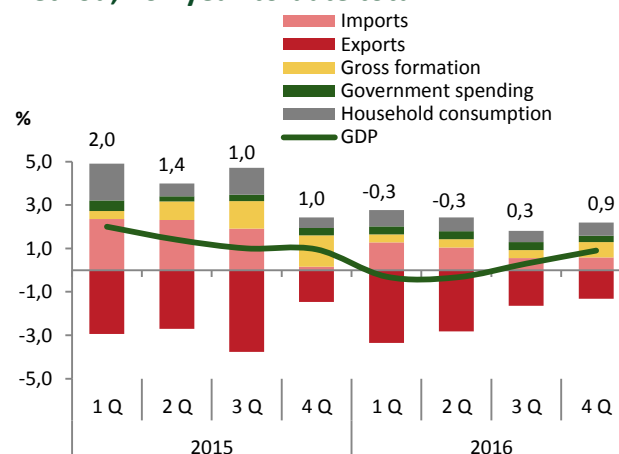
**Figure 38. Assessment of the Price Growth in a Year**

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



Source: GfK Kazakhstan

**Figure 39. Decomposition of the GDP Components by the Final Consumption Method, YoY year-to-date total**



Source: CS MNE RK, NBRK's calculations

fixed capital formation increased by 3.0%. Such increase was determined by the growth in fixed capital investments in the mining industry by 14.8%, in agriculture – by 46.7% and in real estate operations – by 13.7%. Also, a trend of recovery is observed among tangible working assets where a negative contribution to GDP decreased significantly.

Imports continue to recover as a result of revival in the investment and consumer demand. In the fourth quarter of 2016, all components of imports of goods (consumer, investment and interim imports) showed a moderate growth in nominal terms.

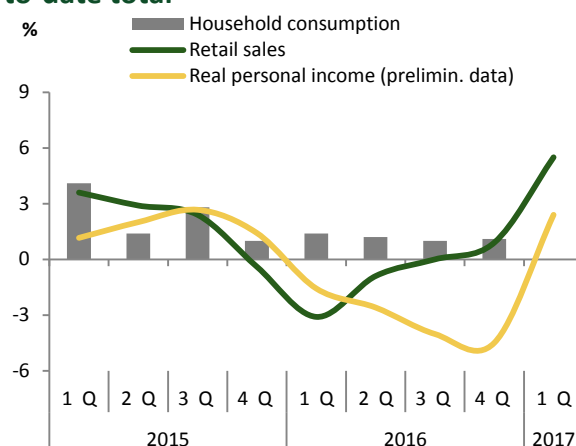
Based on performance in 2016, household spending on final consumption increased by 1.1% (Figure 40). A positive pattern in the consumer demand is related to the increased real wages, deceleration of inflation as well as a stable situation in the foreign exchange market. In the fourth quarter of 2016, the highest contribution to the growth in consumer spending was made by the increased spending on foodstuffs. Apart from that, a positive contribution on the part of paid services is increasing (Figure 41).

### Income of the Population

In the first quarter of 2017, the growth in nominal cash income accelerated (to 10.4%) since pension benefits and social benefits were increased at the beginning of 2017 (Figure 42).

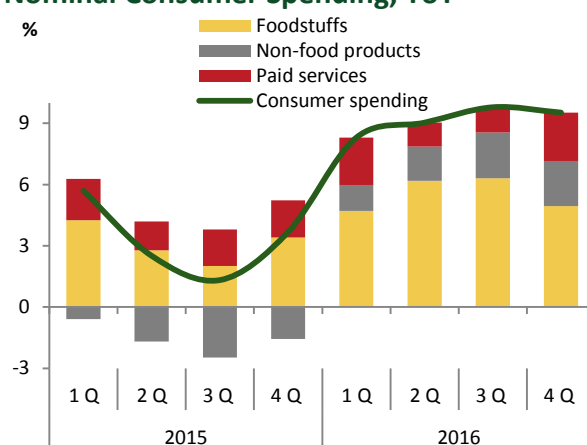
Real cash income was turning positive (the growth of 2.4%), which was related both to deceleration of annual inflation and a significant growth in nominal income in March 2017.

**Figure 40. Household Consumption, Household Real Cash Income and Retail Sales, YoY, year-to-date total**



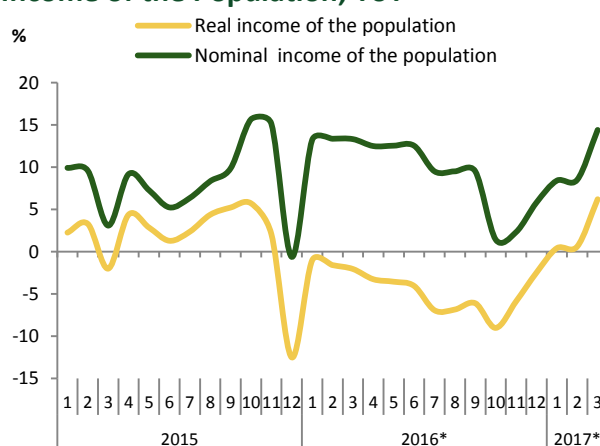
Source: CS MNE RK

**Figure 41. Structure of Growth in Household Nominal Consumer Spending, YoY**



Source: CS MNE RK, NBRK's calculations

**Figure 42. Indices of Nominal and Real Cash Income of the Population, YoY**



\*-preliminary data, Source: CS MNE RK

### Investment Activity

In the first quarter of 2017, investment activity held up, the growth in fixed capital investments accounted for 3.1% as compared to the corresponding quarter of the previous year (Figure 43).

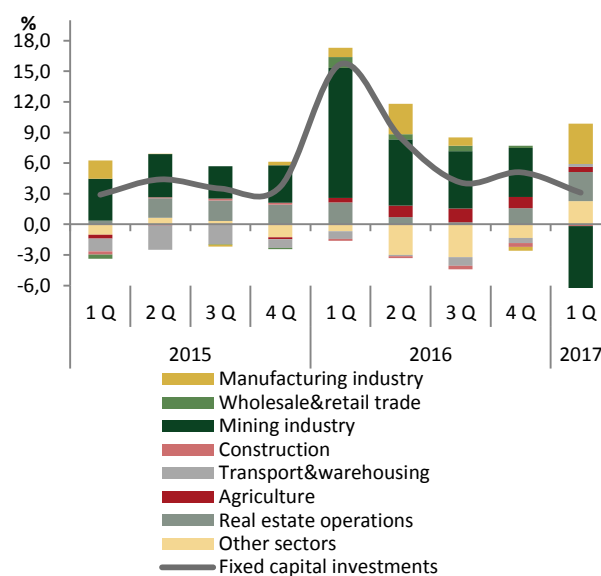
Some slowdown in the growth rates of investments was caused by the 14.1% decrease in fixed capital investments in the mining industry as compared to the first quarter of the previous year that accounts for the largest share in the investment structure being associated with the completion of construction works in the Kashagan oil field.

A positive trend is observed in the majority of economic sectors. So, in the first quarter of 2017, a significant growth in fixed capital investments was recorded in the manufacturing industry (32%), which was secured by activities undertaken to modernize oil refineries in Atyrau and South Kazakhstan regions as well as by the growth of fixed capital investments in the production of foodstuffs (19.9%).

High rates of growth of fixed capital investments are maintained in agriculture (22%), in the sector of real estate operations (12.8%), transport (2.9%) and accommodation and catering services (121.7%) associated with preparations for EXPO-2017. High rates of growth are demonstrated by investments in residential construction (13.8%), whose relative share in the total volume of fixed capital investments accounted for 14%.

In the first quarter of 2017, the share of domestic investments in the total investment volume accounted for 71.8%, and the share of foreign investments – for 28.2%. Based on performance in 2016, gross inflow of foreign direct investments amounted to USD 20.1 bln. and increased by 40% as compared to 2015. Such sectors as extraction and processing of mineral resources, geological survey and trade are still attractive for foreign investors.

**Figure 43. Fixed Capital Investments, by Types of Economic Activity, Contribution, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

### 2.3.2 Domestic Production

Based on performance in 2016, the real GDP growth by the production method accounted for 1.0% versus the corresponding period of the previous year (Figure 44).

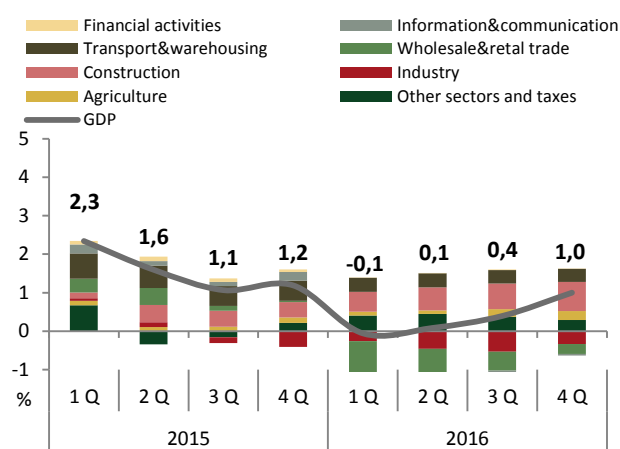
Statistical data on key sectors for the first quarter of 2017 indicate that the economy is recovering more rapidly; this, on the one hand, is determined by the low base effect and, on the other hand, by the improving situation in foreign and domestic markets. A short-term economic indicator in the first quarter of 2017 increased by 4.9% as compared to the first quarter of the previous year (Figure 45).

The rates of growth in the industrial production were recovering due to the increased production of crude oil including that in the Kashagan oil field, and of metal ores given a gradually recovering demand on the part of Russia and China, production of oil refinery products and the metallurgical industry.

In the structure of the manufacturing industry whose growth accounted for 6.5% in the first quarter of 2017 as compared to the first quarter of the previous year, all sub-industries show a better performance (Figure 46). So, the metallurgical industry accounts for a major share in the structure and makes a positive contribution. At the end of the first quarter of 2017, the growth rates of production in the non-ferrous and ferrous metallurgy accounted for 7.0% and 7.3%, respectively. The processes of import substitution and development of non-primary sectors continue. The output of oil refinery products increased by 17.8%, volumes of production of key pharmaceuticals increased by 25.1%, in the light industry the increase accounted for 17.0%, in furniture manufacturing – for 5.8% and in food industry – for 3.4%. In the machine-building industry, after a long-run decline, the output has grown by 1.8%.

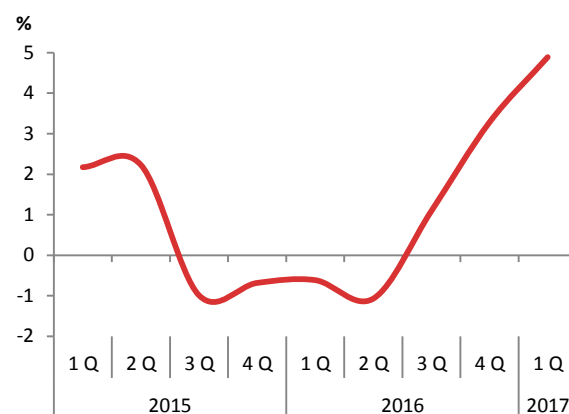
Volumes of construction works increased by 7.1% in the first quarter of 2017 in annual terms (Figure 47). High growth rates are determined by the continued implementation of governmental housing programs and

**Figure 44. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY, (the period versus the corresponding one of the previous year)**



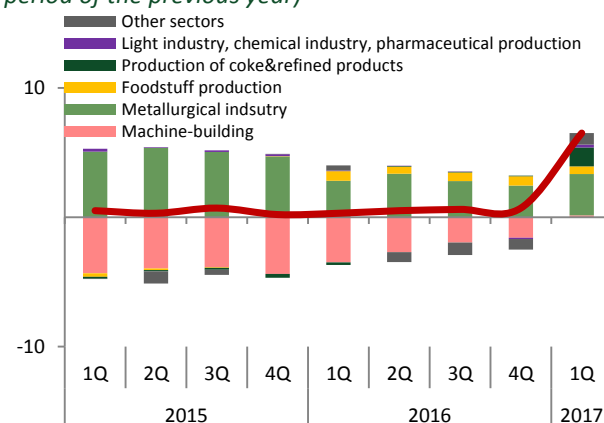
Source: CS MNE RK, NBRK's calculations

**Figure 45. Short-Term Economic Indicator (the quarter versus the corresponding quarter 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

infrastructure projects, activities for modernization of oil refineries, and construction of industrial facilities; these are reflected in the structure of facilities put into operation.

The recovering real cash income of the population secured the 5.5% growth in volumes of retail sales (Figure 48). A share of non-food products in the structure of retail sales increased significantly, indicating a gradual recovery of the consumer demand and realization of the deferred demand effect. However, sales of foodstuffs decreased by 2.2% given high levels of the food inflation.

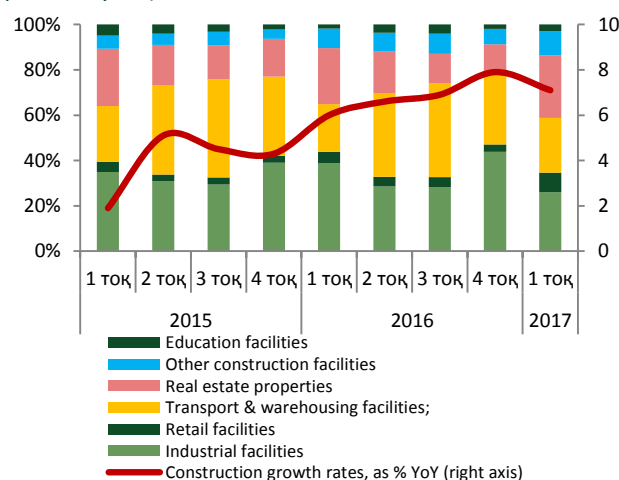
The increased import and export supplies in the first quarter of 2017 helped recover the wholesale turnover whose annual growth accounted for 1.4%.

Alongside with the increasing recovery trends in the first quarter of 2017, the volume of communication services increased by 1.3% as compared to corresponding quarter of the previous year, largely due to the increased volumes of Internet services (11.6%) and mobile communication services (3.6%). The growth in the volumes of transport services remains stable and at the end of the first quarter of 2017 it accounted for 3.4%.

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, remains positive in the first quarter of 2017; this indicates that the economic activity continues to recover due a gradual adaptation to new environment. Outcomes of the poll reflect the signs of a further increasing demand for final products in all key sectors of the economy.

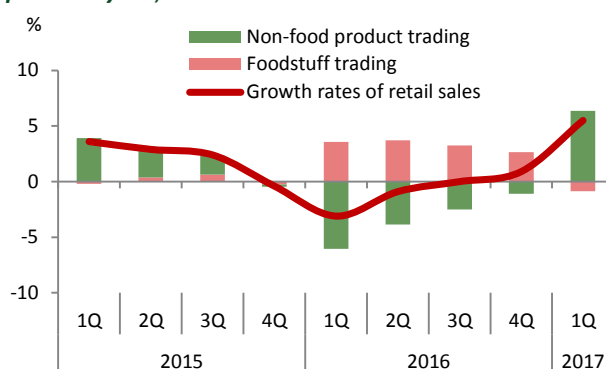
Respondents positively assess stabilization of the exchange rate of the tenge against currencies of main trading partners, and some improvement in the lending terms. Assessment methods based on filtration principles showed the existence of negative values of the output gap at the end of the first quarter of 2017. However, the gap begins to shrink indicating that deflationary pressure in the economy is gradually decreasing (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)



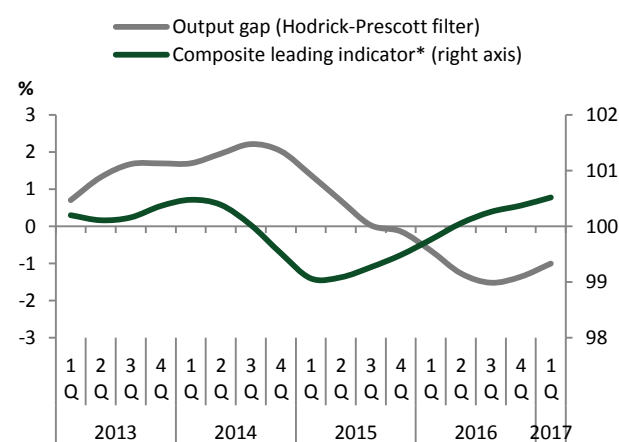
Source: CS MNE RK, NBRK's calculations

**Figure 48. Growth Structure of Retail Sales, 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 revised based on the OECD methodology

### 2.3.3 Labor Market and Unemployment

In the first quarter of 2017, nominal wages increased by 5.6%, after their growth of 13.7% in the fourth quarter of 2016 (Figure 50).

After their migration to the positive zone in the fourth quarter of 2016, real wages showed the decline again. A significant negative contribution to the real wages behavior was made by the professional, scientific and technical activities where the decline accounted for 26.0%.

At the same time, the growth in real wages was noted in the area of administrative and ancillary service (by 15.8%), financial and insurance activities (by 8.1%) and in agriculture (by 7.9%).

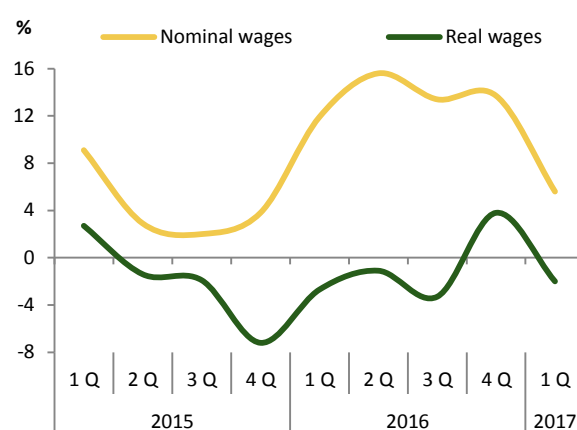
In 2016, the growth in labor productivity in the economy accounted for 1.8% and somewhat accelerated after its 1.1% increase at the end of nine months of 2016. The labor productivity in the production of goods is growing (by 6.9%) and it is decreasing in the services production (by 1.1%). In the industry-based break-down, a significant growth in labor productivity was observed in agriculture (by 17.9%), construction (by 9.5%) and financial and insurance activities (by 9%). The growth in labor productivity in these sectors outpaces the growth in real wages, which generally does not create any prerequisites for boosting inflation risks.

The trend of an outstripping GDP growth as compared to nominal wages continues to determine the behavior of unit labor costs (Figure 51). So, in 2016 unit labor costs decreased by 4.7%.

In the first quarter of 2017, the growth in the number of employed population accounted for 0.8%. The growth trend in the number of employees (the growth of 1.5%) and reduction in the number of self-employed (by 1.2%) persists (Figure 52).

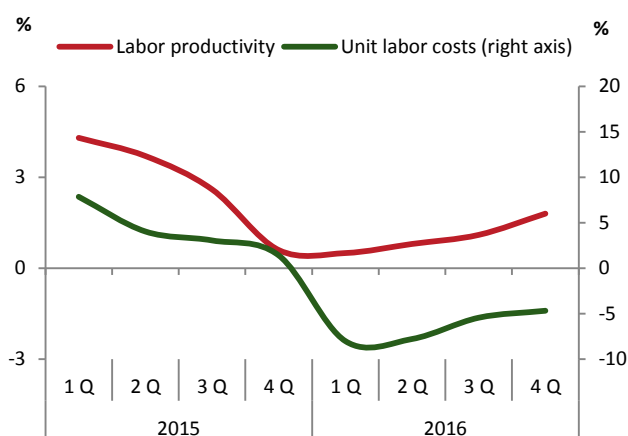
A stable unemployment rate is explained by an overall recovery of the economic activity, a continuing creation of new jobs as part of the government employment and economic stimulus programs, EXPO-2017 as well as by the growth in output in most sectors of the

Figure 50. Nominal and Real Wage Indices, YoY



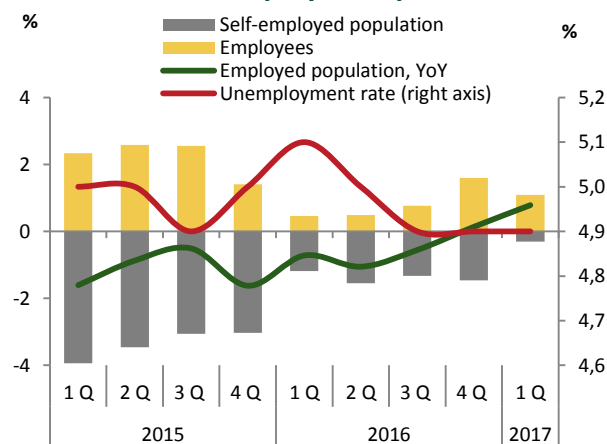
Source: CS MNE RK

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



Source: CS MNE RK, NBRK's calculations

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

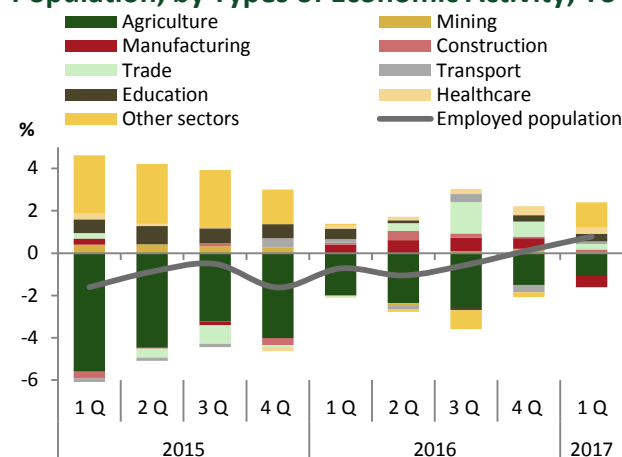


Source: CS MNE RK, NBRK's calculations

economy.

A significant growth in employment was observed in the sector of real estate operations (by 25.2%). As part of preparation for EXPO-2017, there was an increase in employment in the sector of catering and accommodation services (by 19.2%), in other services (by 11.8%) as well as in activities in the area of administrative and ancillary service (by 7.2%). The growth in the employed population in the construction (by 1.7%) and in the transport sector (by 1.6%) occurred in the environment of positive growth rates in those sectors as well as due to the measures to ensure development of the economy and support the employment as part of the governmental programs implementation. In the mining industry, the increase in the employed population (by 1.2%) was occurring against the growth in oil prices and the increased production in the Kashagan oil field. A positive trend in real cash income as well as the growth in wholesale and retail turnover furthered the increase of employment in the sector of trade (by 1.7%) (Figure 53).

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



Source: CS MNE RK, NBRK's calculations

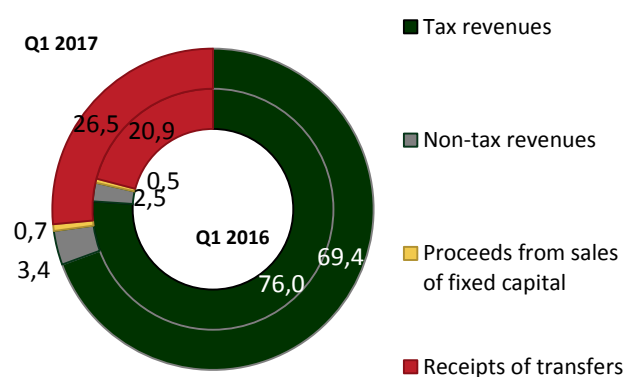
## 2.4 Fiscal Policy

In the first quarter of 2017, revenues to the state budget slightly increased as compared to the first quarter of 2016 – by 2.9%, and the revenue plan was implemented for 104.7%.

State budget revenues increased by 25.3% as compared to the same period of the previous year; this was mainly secured by the increased tax revenues and transfers. In the structure of revenues, the share of tax revenues decreased from 76% to 69.4% as a result of increase in the share of transfers from 20.9% to 26.5%. (Figure 54).

The state budget spending decreased by 0.7% as compared to the first quarter of 2016. The decrease in spending is observed in such areas as defense, public services of a general nature, healthcare, transport and communications (Figure 55). In general a relative share of such expenditures in total expenditures accounts for 27.9%. The largest increase in absolute terms was demonstrated

**Figure 54. Structure of State Budget Revenues, %**



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

by expenditures related to the social care and social security (by 11.5%) and education (by 5.5%). The spending structure has not undergone any changes, however, the share of expenditures related to the social care and social security as well as to education slightly increased. The growth in social benefit payments was determined by the planned increase of retirement benefits by 9% and social benefits by 7% in January 2017 as part of the first stage, and the second stage is scheduled for July of this year.

Despite the excess of revenues over expenditures, at the end of the first quarter of 2017 the state budget showed up a deficit caused by operations on budget credits and financial assets. The amount of provided budget credits increased by 1.5 times and the amount of acquired financial assets – by 1.8 times as compared to corresponding indicators in the same quarter of 2016.

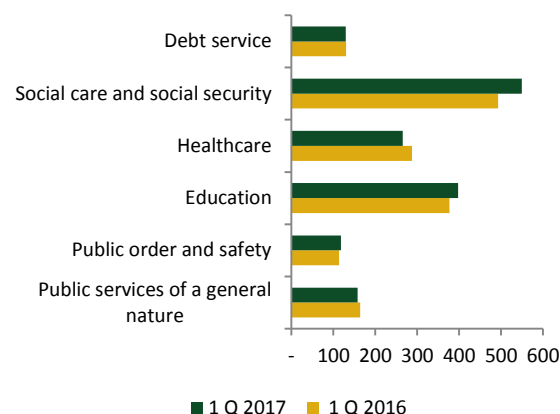
In the first quarter of 2017, the state budget deficit had been at 0.1% of GDP (Figure 56). The non-oil deficit accounted for 6.1% of GDP. The decrease in the deficit was due to the 1.6 time increase in the amount of transfers from the National Fund because of the growth in the guaranteed transfer. In general, the guaranteed transfer for 2017 was approved in the amount of KZT 2.88 trln., and the amounts of earmarked transfer were increased from KZT 441.6 bln. to KZT 1 534.6 bln. in February 2017; therefore, the total amount of transfers from the National Fund will make up KZT 4.4 trln.

In the reviewed period, the fiscal policy had a stimulative nature. At the same time, budget spending increased significantly only in terms of social expenditures. Along with that, budget deficit, including non-oil deficit, decreased. In general, the impact made by the fiscal policy on inflationary processes is considered to be neutral.

## 2.5 Balance of Payments

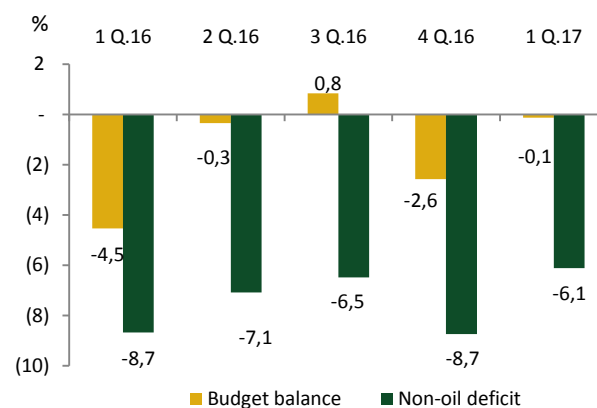
In the fourth quarter of 2016, the current account of the balance of payments was characterized by the growth in export revenues

**Figure 55. Change in the State Budget Spending, KZT bln.**



Source: Ministry of Finance of Kazakhstan

**Figure 56. State Budget Balance, as % of GDP**



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

that ensured the increase in payouts of returns to foreign direct investors as compared to the fourth quarter of 2015. Operations across the financial account, while they have partly financed the current account deficit, secured an overall positive balance of payments of USD 0.5 bln. (Figure 57).

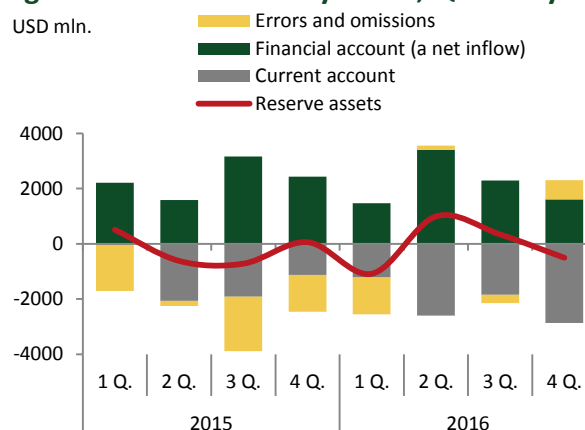
A more rapid growth in expenditures of residents as compared to their revenues in virtually all current account components resulted in a 2.5-fold increase in the current account deficit up to USD 2.9 bln. (or 6.7% of GDP) (Figure 58).

In the reviewed period, both the value of exports and the value of imports increased. The behavior of world energy prices continued to remain the main factor for the change in the volumes of commodity exports (Figure 59). The growth of world oil prices supported the 2.6% increase in exports of goods.

The value of exports increased virtually among all major groups of goods except exports of grain. Exports of mineral products increased by 4.5% (including the 7.0% increase in the value of exports of oil and gas condensate). Exports of ferrous metals also demonstrated the increase, mainly due to the increase in volumes of physical supplies that accounted for 26.8%. The increase in physical supplies against the declined contractual prices caused the 2.5% increase in exports of non-ferrous metals. The declining contractual prices of cereals were the reason for the 12.2% decrease in exports of grain.

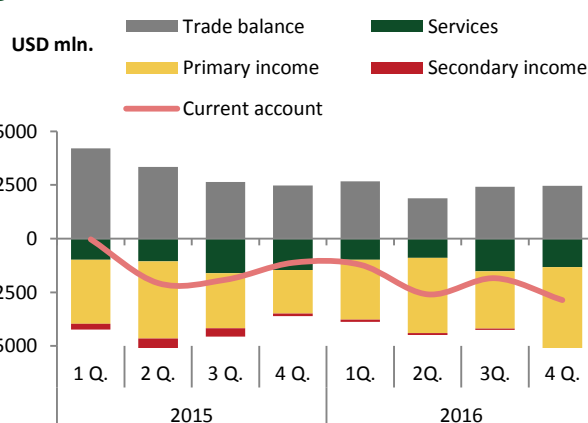
The increase in imports of goods accounted for 3.5% and was related to the growth in the nominal exchange rate of the tenge and a positive pattern in the consumer demand. The growth in imports occurred due to the increased volumes of physical supplies against the declined contractual prices on import of industrial goods and investment goods – by 9.1% and 2.9%, respectively. There was a minor increase among consumer goods (by 0.9%). Along with that, import of foodstuffs increased by 3.4% and import of non-food products decreased by 0.8 %.

**Figure 57. Balance of Payments, Quarterly**



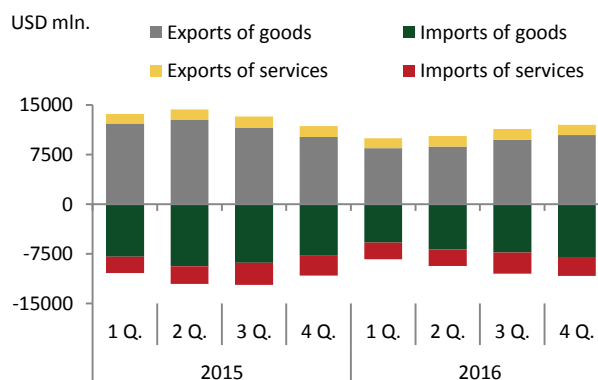
Source: NBRK

**Figure 58. Current Account**



Source: NBRK

**Figure 59. Exports and Imports of Goods and Services**



Source: NBRK

The real effective exchange rate index of the tenge had depreciated by 0.5% (the tenge depreciated in real terms against the CIS currencies basket and against currencies of other countries). Depreciation against the CIS currencies basket accounted for 7.3% and against the currency basket of other countries the tenge appreciated by 2.8%.

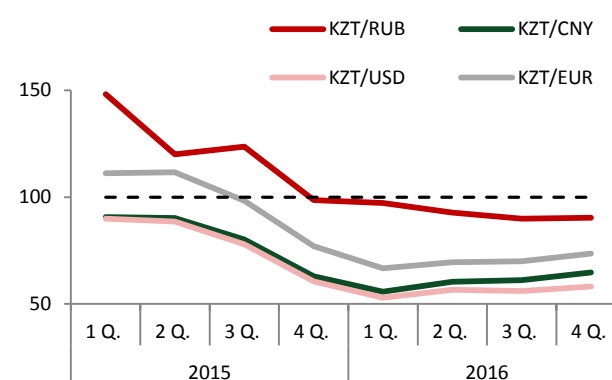
Versus the previous quarter, the tenge depreciated in real terms against the US Dollar by 4.0%, against Euro – by 4.4%, against ruble – by 8.4%, and appreciated by 3.0% against the Yuan. The real effective exchange rate index decreased by 23% versus the benchmark competitiveness index of December 2013, thus indicating that the exchange rate competitiveness of Kazakhstani goods has been maintained (Figure 60).

It is notable that the real depreciation of the tenge against the Russian ruble, although leading to the cheapening of Kazakhstani goods as compared to similar Russian goods, at the same time does not restrict the growth in imports of goods from Russia (by 14.0%). Given appreciation of the exchange rate of the tenge against the Yuan, the growth in the volume of goods imported from China (by 9.2%) was observed.

Depreciation of the real exchange rate of the tenge against currencies of main trading partners caused some deterioration in the terms of trade index (by 10%). The terms of trade index with the Euro zone countries decreased by 13%, and with Russia – by 27% (Table 1).

The pressure on the current account is decreasing owing to the decreasing deficit of trade in services (by 8.4% to USD 1.3 bln.). Such reduction was secured by outstripping rates of decline in imports of services over rates of decline in exports of services. The decline in exports of services occurred because of construction services and transport services where the major share falls on services of pipeline transit of oil and gas via the country's territory. There was a decline in imports of services among transport services of non-residents, trips abroad by

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



Source: NBRK

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

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

	Q3 15	Q4 15	Q1 16	Q2 16	Q3 16	Q4 16
Export prices	-39	-42	-36	-31	-21	-6
Import prices	-9	-2	9	-4	18	4
<b>Terms of trade</b>	<b>-33</b>	<b>-41</b>	<b>-42</b>	<b>-28</b>	<b>-33</b>	<b>-10</b>
including:						
<b>Euro zone countries</b>						
Export prices	-46	-49	-41	-34	-18	0
Import prices	-15	-43	15	-10	14	15
<b>Terms of trade</b>	<b>-36</b>	<b>-10</b>	<b>-48</b>	<b>-27</b>	<b>-28</b>	<b>-13</b>
<b>Russia</b>						
Export prices	-30	-20	-14	-23	-14	-16
Import prices	-31	-23	-10	-6	30	15
<b>Terms of trade</b>	<b>2</b>	<b>4</b>	<b>-4</b>	<b>-18</b>	<b>-33</b>	<b>-27</b>

Source: NBRK

residents and other business services which are mainly related to involvement of non-residents in implementation of large infrastructure projects within the country's territory. Such decline in imports of services was partially compensated by the growth in expenditures of residents on consumption of construction services associated with engagement of non-residents in construction of EXPO-2017 facilities and other facilities.

A negative balance on primary income more than doubled being caused by more than a two-fold growth in returns of foreign direct investors. Payments of interest to lenders not connected through the direct investment relationship increased insignificantly (by 2.1%) and amounted to USD 706.2 mln. At the same time, in the reviewed quarter there was a growth in revenues generated from financing of foreign affiliated non-residents by residents and from resources of Kazakhstan's National (Oil) Fund invested into foreign assets and international reserves.

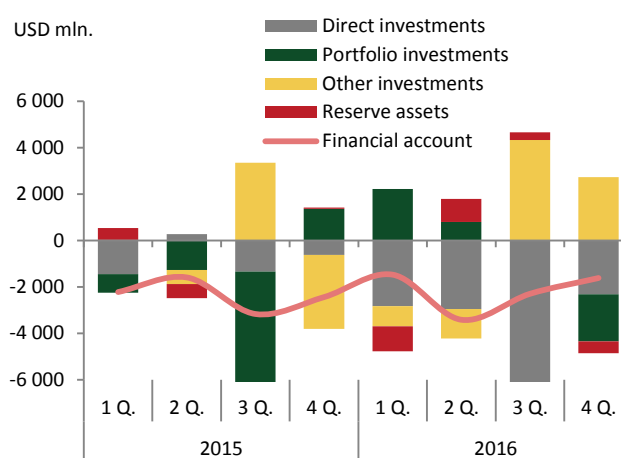
The financial account (less reserve assets) showed up a net capital inflow of USD 1.6 bln. because of the growth in liabilities of residents against reduction in their assets.

It was secured by the inflow on direct and portfolio investments that was partially offset by the outflow associated with the growth in assets of residents with foreign accounts (Figure 61).

As for foreign direct investments, their significant net inflow of USD 2.3 bln. was secured mainly by reinvestment of their returns by foreign direct investors as well as by the intercompany borrowing from foreign sister 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 portfolio investments, a net inflow resulted from reduction in the National Fund's foreign assets. At the same time, the reduction in liabilities on the Kazakh debt securities was partially offset by the inflow on the balance of portfolio investments which eventually

**Figure 61. Financial Account**



Source: NBRK

amounted to USD 2.0 bln.

As for medium- and long-term investments, a net outflow of USD 763.7 mln. was secured mainly by the decreased receivables of enterprises in the non-bank sector. A net outflow of USD 3.5 bln. on short-term investments was secured primarily by placements of assets of the National Fund and of non-bank organizations with foreign accounts.

## 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 if May 18, 2017*

### 1. KEY ASSUMPTIONS FOR EXTERNAL FORECAST PARAMETERS

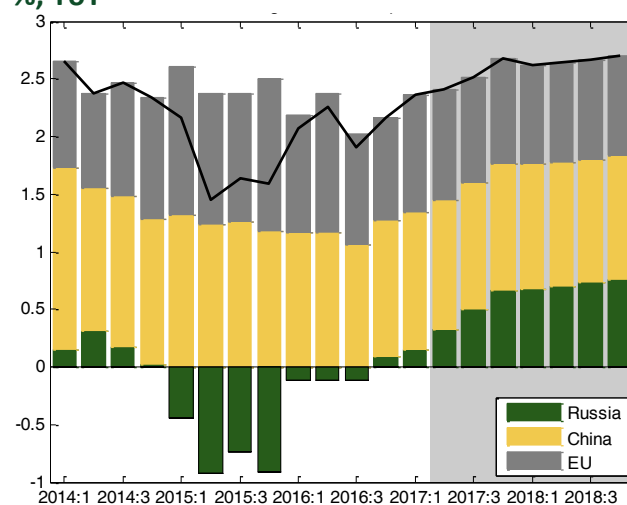
Assumptions regarding the terms of trade related to the demand for Kazakhstan's export commodities on the part of Russia, EU and China, which accounted for 55.5% of the total foreign trade turnover of Kazakhstan in the fourth quarter of 2016 had not undergone dramatic changes as compared to previous forecasts presented in the Inflation Report for the fourth quarter of 2016.

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 is generally favorable (Figure 63). Forecasts regarding inflation in the Russian Federation have not changed and the target of 4% is expected to be achieved; having said that, inflation will possibly reach the numbers below the designated target in 2017. There might be a minor inflationary pressure on the part of imported goods because of the anticipated growth of inflation in the EU that will reach 1.5% by the fourth quarter of 2018.

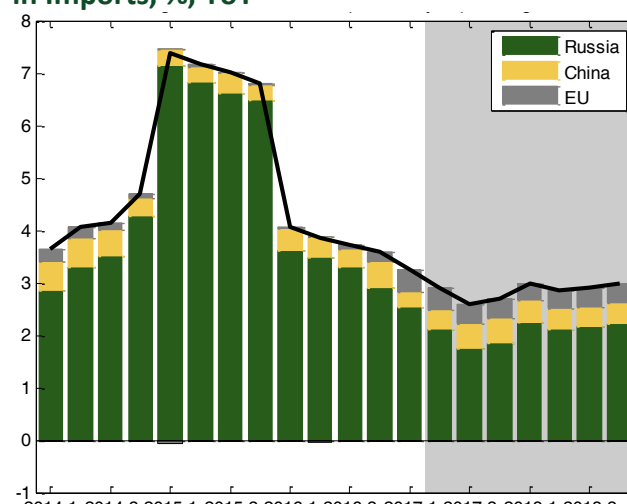
In the short term, world food prices are expected to be slightly lower in the environment of escalating competition among exporters, thus maintaining the volumes of supply in the world at a high level. World food prices are expected to stabilize in the medium term. As a result, the impact of this factor on inflationary processes in Kazakhstan is expected to be neutral.

**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 be slightly lower in the environment of escalating competition among exporters, thus maintaining the volumes of supply in the world at a high level. World food prices are expected to stabilize in the medium term. As a result, the impact of this factor on inflationary processes in Kazakhstan is expected to be neutral.

Price of oil (Brent) has been above USD 50 per barrel since December 2016 and during the first quarter of 2017 it was at USD 54.7 per barrel. Based on that as well as given positive 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 2.8%. In the first 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; fixed capital investments retained their growth; there are positive trends in the real income in the environment of decelerating annual inflation. As a result, estimates about the real GDP growth became more positive.

The recovering domestic consumption will serve as the main driver for the economic growth alongside with the growth in real wages, fixed capital investments and volumes of extraction and production of mineral resources. The long-term potential growth of the Kazakh economy had not changed and is still estimated at 3-4%.

A positive effect from the recovering domestic consumption will be partially offset by

the increasing imports. Also, the real interest rate is expected to have a neutral effect, i.e. it will not constrain the domestic consumption in the medium term.

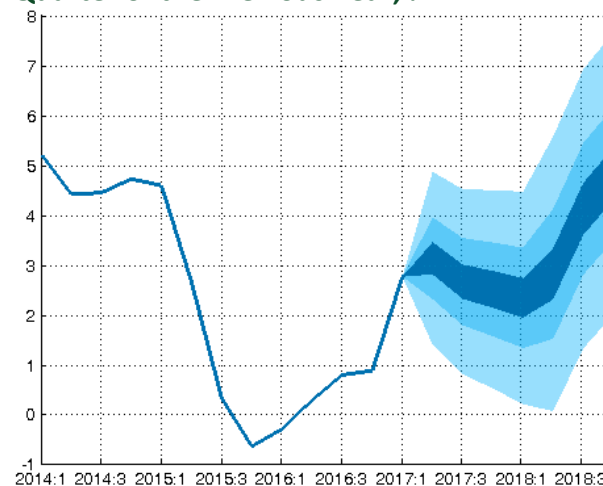
As a result, a higher base in 2017 as compared to previously made forecasts had an effect on the revision of the economic growth rates in 2018 and is estimated to be at about 3.6% (Figure 64).

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 first quarter of 2018 and will be having a feeble pro-inflationary pressure, i.e. the monetary policy will be implemented in a new environment – with a weakly positive output gap. Forecasts for real exports and imports indicators had not undergone any significant changes as compared to the Inflation Report for the fourth quarter of 2016. Accordingly, there was no significant change in net exports, and the assessment of contribution of net exports to the GDP growth has not changed.

Unexpectedly high rates of recovery in the domestic consumption since the beginning of 2017 appeared to be one of the factors for revision of GDP forecasts. The growth in household consumer spending was caused by the decreased volatility of the exchange rate and adaptation to a new economic environment, including deferred demand for non-food products, which is proved by the increased volume of retail sale of non-food products.

According to the National Bank's estimates, gross formation will be growing due to fixed capital investments in the manufacturing and mining industries, in real estate operations, agriculture and transport sectors. 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.

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



Source: NBRK's calculations

Under the baseline scenario, the real effective exchange rate will appreciate in the medium term. Such appreciation is driven by the decline in inflationary processes, appreciation of the nominal exchange rate as a result of stabilization of the oil price at 50\$ per barrel throughout the forecast period.

Assumptions regarding the government consumption in medium-term forecasts have changed as a result of the increased deficit and an earmarked transfer for 2017. In this connection, the stance of fiscal policy was revised and it will generally have a stimulative nature in the current year.

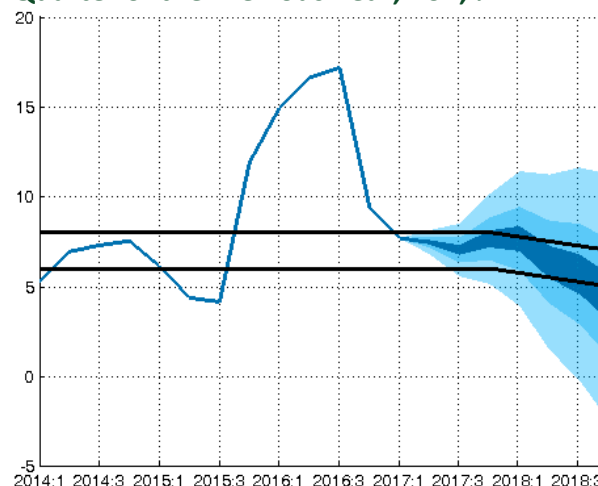
Under the baseline scenario, inflation is expected to stabilize within the target band in 2017 and to decline further in the medium term. However, in the short-term horizon, the inflation may slightly increase because of the low base of the second half of 2016. In the medium term, inflation may go down below the target band boundary from the second quarter of 2018 (Figure 65). The decline of inflation in the medium term will be furthered by a favorable external inflationary background, recovery of the real effective exchange rate to its equilibrium and an assumption about stability of prices of cereals which have a significant impact on the food inflation. As a result, it may become the reason for decreased inflationary expectations, firstly in the food component of the inflation. However, inflationary expectations regarding the non-food component of inflation are assumed to be diminishing slower given recovery of the consumer demand.

Based on the trend that the base rate will be lowering once inflation goals are achieved and the real effective exchange rate reaches its equilibrium, the monetary policy in the medium term should be regarded as neutral.

### 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. If the pessimistic scenario of USD 40 per barrel will be realized, there is a

**Figure 65. GDP, Quarter to the Corresponding Quarter of the Previous Year, YoY, %**



Source: NBRK's calculations

high degree of risk that the inflation would go beyond its target band in 2017. Under this scenario, the National Bank will be more conservative in its monetary policy implementation.

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

- If shocks on the part of supply in the food market persist, the risk of inflation going beyond its target band for 2017 will increase significantly; however, there will be no response in the form of a tightened monetary policy since the impact of this shock is of a limited nature and it will subside by the second quarter of 2018;

- If the scenario which implies the price of oil (Brent) to be at USD 60 per barrel in the medium term, the risk of inflation going beyond the lower boundary of the target band for 2018 will increase. The National Bank may use all available instruments to bring the inflation within the target band of 5-7% in 2018;

- the rates of growth in real wages exceed the growth in labor productivity, both economy-wide and in certain sectors of the economy; this may lead to a more accelerated growth of pro-inflation demand which may cause acceleration in the non-food component of inflation;

- 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;

- an oil price volatility 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