



NATIONAL BANK OF KAZAKHSTAN

# Inflation Report

The Fourth Quarter of 2016

Almaty, Kazakhstan

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

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as of 02.02.2017.

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## SUMMARY

In the fourth quarter of 2016, the pattern of oil prices was recovering its path being supported by the agreement among OPEC member countries and largest exporters regarding reduction of production volumes. As a result, despite the surplus of oil production, during the quarter the average price of oil increased by 7.5% as compared to the previous quarter. The 25 pp. increase of its key rate by the US Fed had been an important development amidst the accelerating inflation and employment which, in its turn, affected depreciation of the Euro and Yuan. A minor increase in GDP and inflation was observed in China, as well as acceleration of inflation in the European Union. In general, aggregated external indicators improved due to deceleration of inflation and of the rates of economic downturn in Russia.

GDP growth rates in Kazakhstan by the end-use method increased to 0.3% during nine months of 2016, being driven by the decreasing rates of slowdown in exports, growing consumer spending as well as the increased investment volume. GDP growth rates by the production method continued to recover and accounted for 0.4%; the growth was observed in all key sectors of the economy. The rates at which real cash income of the population was decreasing slowed down and the growth in retail sales was noted.

The growth of government spending for social security, healthcare and education as well as for the anti-crisis support of the economy in the environment of the reduced tax revenues resulted in the increase in the budget deficit to 2.7%. Thus, inflationary effect of the stimulative fiscal policy is persisting.

At end-2016, inflation accounted for 8.5%, having decreased from 11.5% at the end of the third quarter. An insignificant overshooting the National Bank's target was related to the increase in prices of certain goods, mainly foodstuffs, influenced by the decreased supply in the market. A constraining impact was made by moderate rates of growth in tariffs for paid services as well as by the decreasing rates of growth in prices of non-food products as a result of neutralizing the effect of the exchange rate pass-through.

In the fourth quarter, there was still a structural liquidity surplus in the money market. Excess liquidity was withdrawn by the National Bank mainly via short-term notes. The National Bank continues to build an yield curve and conducted auctions to sell government securities.

During the quarter, the base rate was lowered from 13% to 12%, and in February 2017 – to 11%, while preserving the band width of +/-1%. The TONIA rate had been around the lower boundary of the interest rate band. The situation in the foreign exchange market remained stable, and the exchange rate appreciated during the quarter under the impact of external macroeconomic factors.

The lending market continued its recovery due to issuing the loans to corporate entities. Weighted average interest rates on loans were decreasing and loans in the domestic currency were growing. The dedollarization process in the deposit market continued due to the growth in the domestic currency deposits, with minor reduction of interest rates.

Due to the fact that the average price of oil increased and its stable level over USD 50 per barrel was reached, the baseline scenario for the economy's development was revised. Under the baseline scenario of USD 50 per barrel, in 2017 the inflation is expected to be steady within its target band of 6-8% and to decrease further in the medium term. Along with that, the inflation may fall below the target band's boundary in the third quarter of 2018.

The real GDP forecast in 2017 is over 2%. According to the National Bank's estimates, the output will be higher than its potential level already in the fourth quarter 2017.

The main assumptions in the forecast have not changed significantly relatively to the third quarter. The external demand is expected gradually to recover, and a moderate inflationary background in the countries - trading partners and moderate rates of household consumption are anticipated. Low and volatile oil prices and the growing state budget deficit still represent risks for improper forecasting and not achieving the inflation target.

## I. MACROECONOMIC ENVIRONMENT AND THE FINANCIAL SECTOR DEVELOPMENT

### 1. EXTERNAL MACROECONOMIC ENVIRONMENT

In the fourth quarter of 2016, the situation in the global commodity markets was characterized by the increased oil surplus. Alongside with that, as a result of the agreement among OPEC member countries and largest exporters regarding reduction of production volumes, prices of energy resources were growing. Apart from that, a minor growth in prices of metals was observed as a reflection of a feeble demand on the part of China. Food prices showed a steady pattern, which is explained by the divergent movement of prices for certain foodstuffs.

Given the increasing employment and acceleration of inflation, in December 2016 the US Fed made the decision to raise the target band of its policy rate by 25 basis points.

In the fourth quarter of 2016, economies of Kazakhstan's major trading partners including Russia, China and the EU, showed moderate improvement of key macro indicators. In the EU, the inflation was increasing, in China – GDP and inflation was slightly accelerating and in Russia the recession was slowing and the inflation reached its historical minimum.

Given the stable pattern of the economic growth indicators and the price level in the countries of trading partners, external indicators of GDP and inflation also slightly improved in the fourth quarter of 2016 as compared to the previous quarter.

#### 1.1 Situation in the Global Commodity Markets

##### 1.1.1 Oil Market

In the fourth quarter of 2016, the average price of oil (Brent) had been at USD 49.2 per barrel, thus demonstrating the growth of 7.5% as compared to the previous quarter and of 13.1% as compared to the corresponding quarter of 2015 (Figure 1).

Despite a significant growth, a quarterly pattern of market quotations of oil was divergent. So, in November the growth in oil prices gave way to a steep drop from USD 49.7 to USD 44.7 per barrel. Such price behavior was associated with a significant growth of surplus

in the oil market. According to the updated information from the U.S. Energy Information Administration<sup>1</sup>, overabundance of oil in the world in October-December 2016 was 2.04 million barrels a day, which is a maximum for the entire 2016. A significant surplus of oil was caused both by the growth in production and the decreased demand for energy carriers (Figure 2).

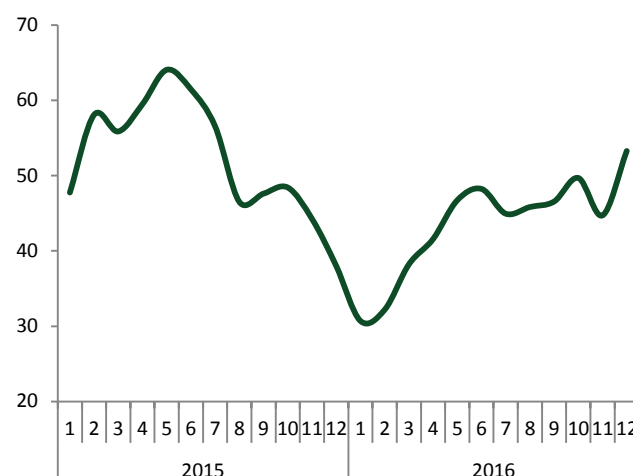
In the fourth quarter of 2016 as compared to the previous quarter, the growth rates of oil consumption volumes have slowed down globally amidst a continuing decline in the demand on the part of the US, Russia, Japan, European and South American countries. At the same time, in the reviewed period there was still a positive contribution to consumption on the part of countries in Africa and South-East Asia, India and China (Figure 3).

In the fourth quarter of 2016, the growth in the global oil production occurred as a result of a slow-response buildup in the oil production in OPEC countries. So, the growth in oil production was observed in Iran, Saudi Arabia and Iraq; also, production volumes were recovered in Libya and Kuwait. Alongside with that, among OPEC countries there was still a significant negative contribution on the part of Venezuela and Nigeria where the volume of oil extraction continues to fall as a result of domestic commotions.

In the fourth quarter of 2016, the increase in the global oil production was also caused by the growth in oil extraction in Russia and Canada as well as by the reducing rates of decline in the oil extraction in the US. Despite this fact, given the decreased profitability of the oil sector, negative contribution to the global growth in oil extraction by countries outside of OPEC persisted in the reviewed period as a result of reduction in the volume of extracted crude hydrocarbons in Australia, China, Mexico, Egypt, Columbia and other countries outside of OPEC members (Figure 4).

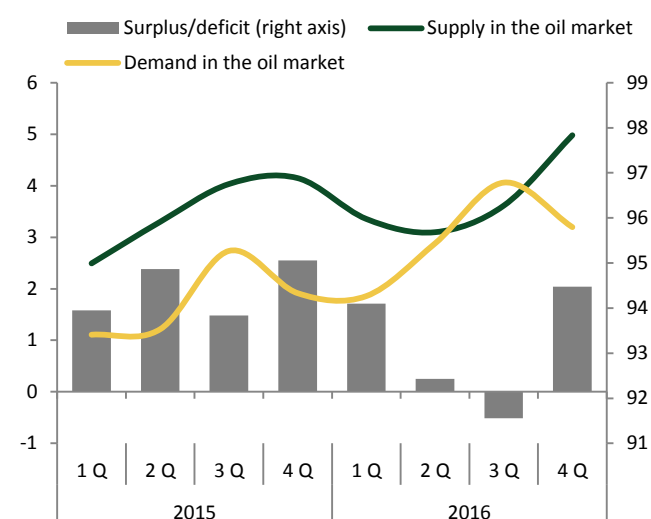
Despite the increasing overabundance in

**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, Mln. Barrels a Day**



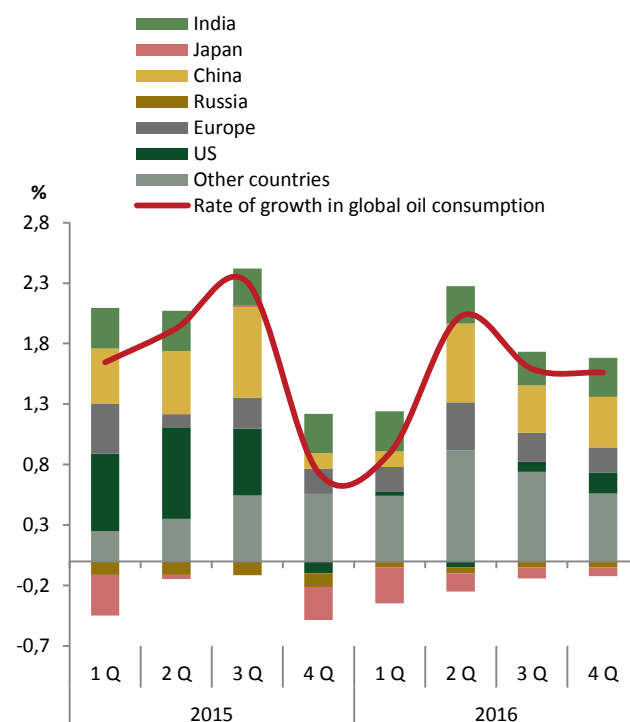
Source: U.S. Energy Information Administration (EIA)

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

the oil production that was observed in the reviewed period, market quotations for energy resources at the end of December 2016 had demonstrated a significant growth, thus contributing to the increase in the average quarterly price of oil above its prior values. A key factor for the growth in oil prices at the end of the fourth quarter of 2016 were the outcomes of the 171<sup>st</sup> OPEC Conference which took place on November 30 in Vienna (Austria). Based on the Conference, member countries of the international cartel as well as other oil exporting countries outside of OPEC reached an agreement regarding the reduction of oil production volumes from January 1, 2017 in accordance with the Algerian Treaty. In doing so, OPEC members committed themselves to reduce the volume of oil production by 1.2 million barrels a day to 32.5 million barrels a day. Russia – one of the largest oil exporters among the countries outside of OPEC – agreed to reduce the volumes of hydrocarbon production by 600 thousand barrels a day. On December 10, such countries as Mexico, Azerbaijan, Oman, Kazakhstan, Malaysia, Bahrain, Sudan and others joined the Agreement. It should be mentioned that the term of the Agreement is six months with a possibility of extending it for additional six months based on the prevailing market conditions and prospects.

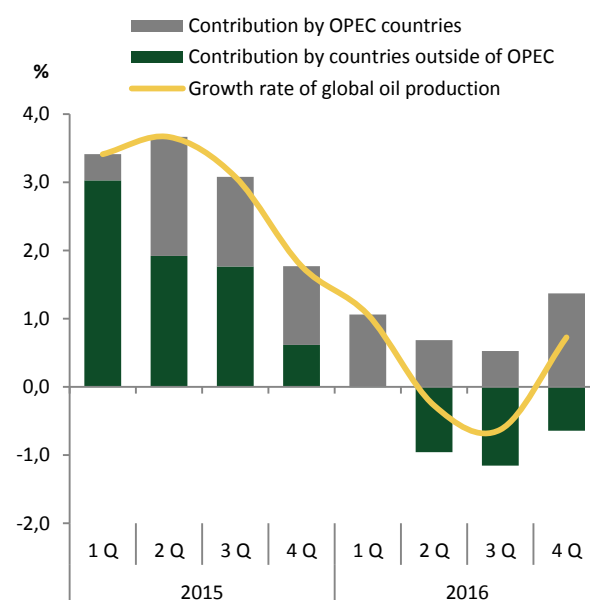
Implementation of measures specified in the Agreement would accelerate the restoration of balance between the demand and supply in the oil market.

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



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

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



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

### 1.1.2 Non-Ferrous Metals Market

In the fourth quarter of 2016, the metals market was generally demonstrating a minor growth of market quotations. The mean arithmetic index of prices of copper, aluminum, zinc and lead in December increased by 0.8%



versus September (Figure 5). Such growth, just like in the previous quarter, was caused by the increase in prices of zinc and lead. In turn, the change in prices of copper and aluminum had a downward pressure on average prices of non-ferrous metals.

Prices of lead in October and November declined significantly amidst speculative and investment demand due to the shrinkage of the global market of electric batteries production. However, in December market quotations recovered and demonstrated growth above the September values given the increased demand on the part of China.

Glencore, which is the largest company in the sector of zinc production, continued to curtail its supplies of zinc. This factor once again supported the growth in world prices of this metal in the fourth quarter of 2016.

A sluggish demand in China appeared to be the fundamental factor which caused the decline in prices of aluminum in the reviewed period. The consumption of crude aluminum by smelters in China continues to decrease as a result of measure of the Chinese Government aimed to reduce hazardous emissions released to the atmosphere. So, the existence of redundant industrial capacities in China is a key factor for the decline in aluminum prices.

Just as in the case of aluminum, the reduced demand in China became a reason for feeble dynamics of copper prices.

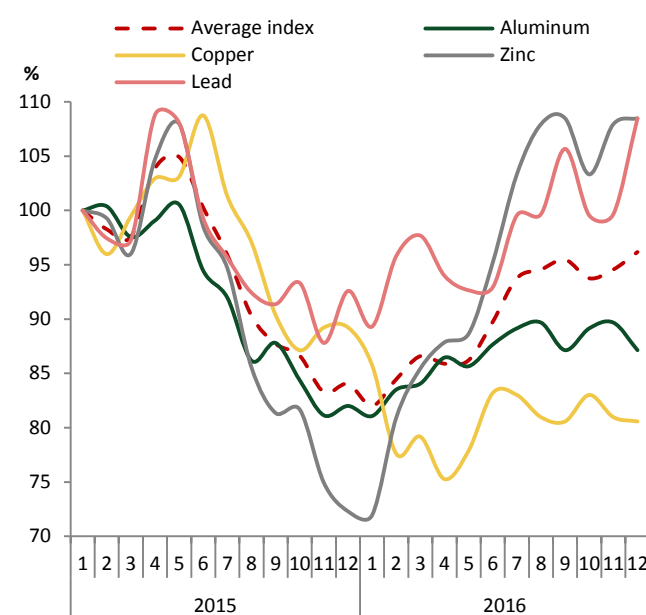
### 1.1.3 Food Market

In the fourth quarter of 2016, the behavior of the FAO Index had stabilized (Figure 6). A steady behavior of this indicator is associated with the flattening of growth in prices of vegetable oils and dairy products by a dramatic decline in prices of sugar as well as by the slowing growth in prices of cereals and meat.

There was a significant decline in prices of sugar which were growing from February 2016, such decline being caused by the increased sugar exports in Brazil.

The growth in prices of vegetable oils occurred as a result of the continuing

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



Source: NBRK's calculations based on data from Bloomberg

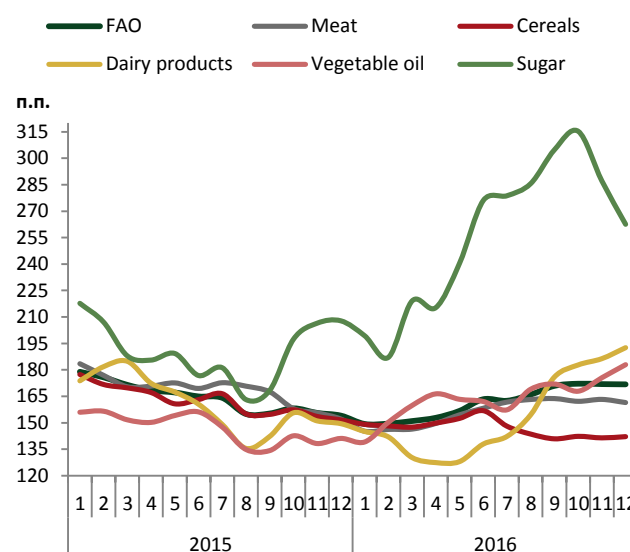
curtailment of their stocks in importing countries. Apart from that, concerns about curtailment of production in 2017 are persisting.

Sluggish dynamics of meat prices resulted from the decreased demand in Asian and African countries because of the market flooding with pork and lamb as well as with the poultry meat.

A continuing growth in the demand and the reduced stocks in the EU had been the factors that caused acceleration of the growth in prices of dairy products in the fourth quarter of 2016.

At the same time, prices of cereals had not demonstrated a significant change. The growth in prices of corn that was caused by unfavorable weather conditions in the US was offset by the decline in prices of wheat owing to rich harvest in Russia, Canada and Australia.

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



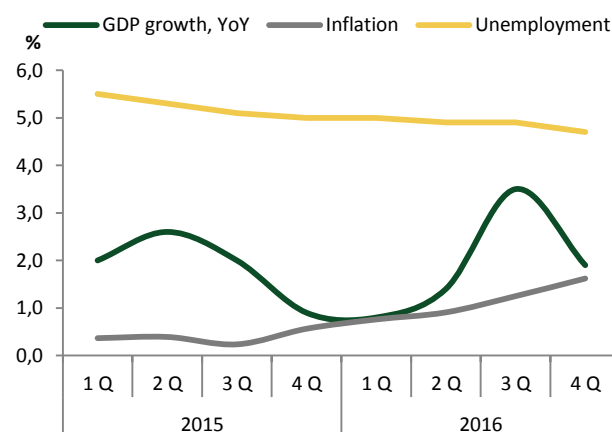
Source: UN FAO

## 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 fourth quarter of 2016 slowed to 1.9% (Figure 7), which turned to be below the market expectations. So, experts interviewed by the Bloomberg anticipated the growth of 2.2%. Such drop in the rates of GDP growth was associated with the decline in exports. The real GDP increase in the fourth quarter was secured by the increased personal spending on final consumption, by the growth in private investments into inventory and fixed capital as well as by the growth in expenditures of local and general government. In turn, the reduced exports and expenditures of federal government as well as the increased imports had a constraining effect on the economic growth in the US.

In December 2016, the annual inflation accelerated to 1.6% as compared to 1.2% in September 2016, which is still lower than the 2% target (Figure 7). Such acceleration was driven by the increase in prices of gasoline and other energy carriers as well as in the cost of rental housing.

**Figure 7. US Economic Performance**

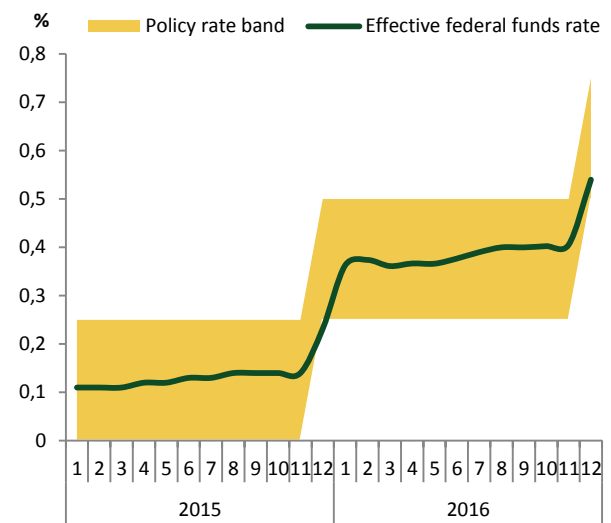


Sources: U.S. Bureau of Economic Analysis (BEA), U.S. Bureau of Labor Statistics (BLS)

According to the data from the U.S. Bureau of Labor Statistics, in December 2016 the unemployment rate in the US decreased to 4.7% as compared to 4.9% in September; this fact confirms that the US economy is approaching its full employment. The growth in hourly wages accounted for 2.9% as compared to December 2015, since due to a low unemployment level, companies had to offer higher labor compensation with a view to attract and retain the staff.

Thus, acceleration of inflation, favorable situation in the labor market, moderate economic growth prompted the increase in the US Fed's policy rate by 25 basis points in December 2016 (Figure 8).

**Figure 8. US Interest Rates**



Sources: Reuters

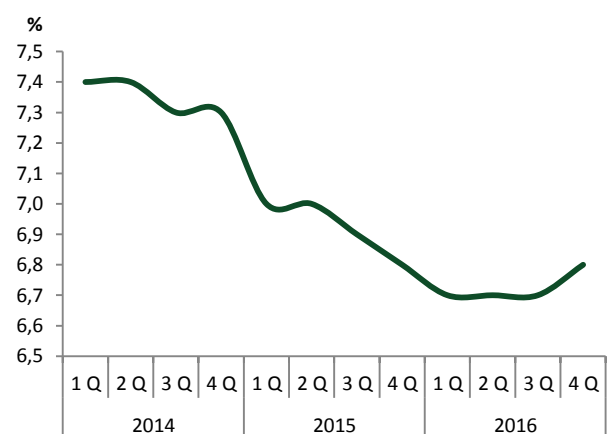
### 1.3 Economic Situation in Countries – Kazakhstan's Trading Partners

#### 1.3.1 China

In the fourth quarter of 2016, the GDP growth in China accelerated by 0.1% as compared to the previous quarter and accounted for 6.8% in annual terms (Figure 9). Government investments into infrastructure and active housing construction continue to make a positive impact on the economic growth. Constraining factors for the economic growth were shrinkage of exports, slowdown in the growth of private investments, retention of redundant capacities in a number of industries, and high degree of debt of the Chinese enterprises. The key risks for the Chinese economy should include the cooling of mortgage lending, a weakened effect from the government stimulus measures, and a further decline in exports in the face of the US protectionist policy as well as the economic slowdown in the EU in connection with Brexit.

In December as compared to September 2016, the annual inflation accelerated by 0.2 percentage points to 2.1% (Figure 10). A seasonal growth in prices of vegetables and fruits as well as a steady growth in prices in the area of services contributed to such increase. At the same time, a fourth month in a row prices in the industry have been showing an accelerated growth in annual terms (in

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



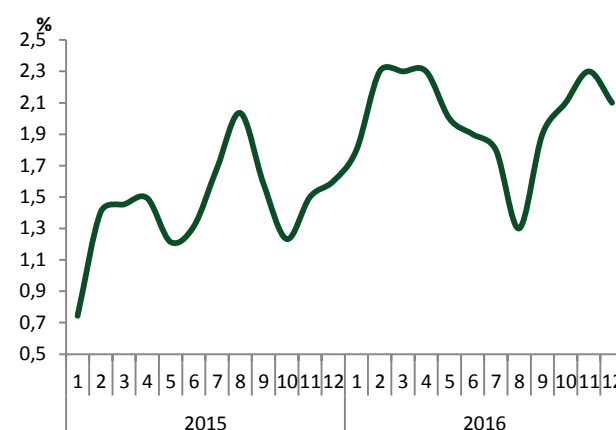
Source: Bloomberg

December – 5.3%), reflecting the increased domestic demand for raw materials and the reduced supply in the steel and coal industries as a result of curtailment of redundant capacities.

In the fourth quarter of 2016, the People's Bank of China continued to pursue stimulative monetary policy while retaining its policy rate at the existing level (Figure 11). However, it should be mentioned that in 2017, according to a December message of the Xinhua news agency, China will be adhering to the neutral monetary policy. Effectively, a possible increase in borrowing rates in 2017 will be aimed to curb the growth in debt of the Chinese enterprises, to mitigate the risks of excessive increase in prices of housing, and to maintain financial stability and sustainability of the Yuan exchange rate against major world currencies.

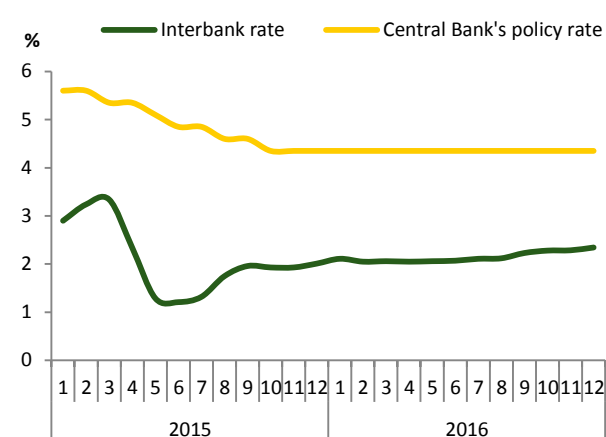
During the fourth quarter of 2016, following the capital outflow and the increase in the US Fed's rate, the exchange rate of the Yuan against the US Dollar was depreciating and reached its eight-year minimum at the end of December (Figure 12). However, the tightening of measures to control the capital outflow and a neutral monetary policy may have a positive effect on the Yuan exchange rate in future. Negative factors may include a slowdown of the global economy in the environment of a potential protectionist policy in the US and consequences of Brexit.

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



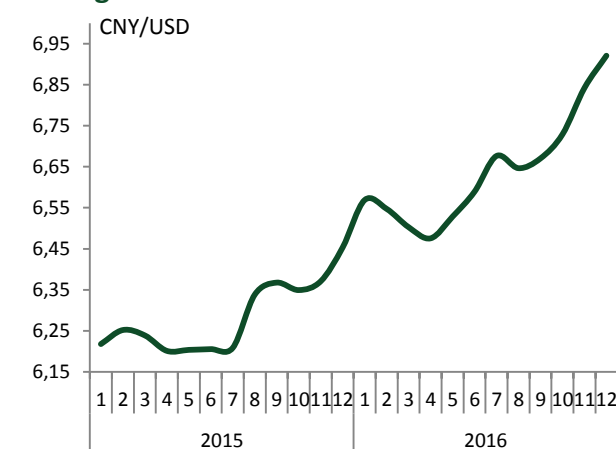
Source: National Bureau of Statistics of China

**Figure 11. Interest Rates in China**



Source: Reuters

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



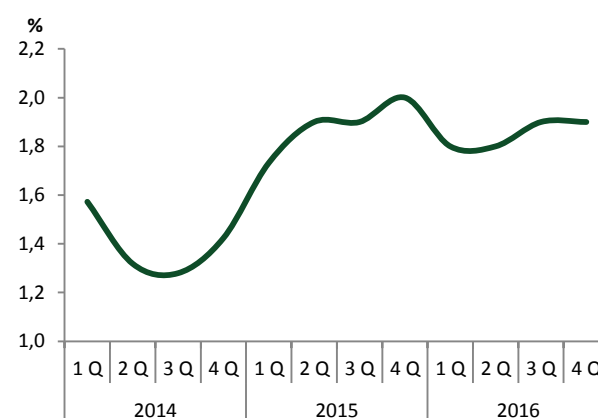
Source: Reuters

### 1.3.2 European Union

According to an initial estimate of the Eurostat, the growth in the European Union's GDP in the fourth quarter of 2016 in annual terms remained unchanged versus the third quarter and accounted for 1.9% (Figure 13). As before, this is related to a moderate consumption and fixed capital investments. The GDP growth may be positively influenced by a steady decline in unemployment and the ECB's stimulative measures and depreciation of the Euro may encourage the growth in exports. However, the existing bilateral sanctions between Russia and the EU still constrain the external demand. Also, there are still risks in the banking sector caused by the asset quality and low profitability in the environment of low interest rates.

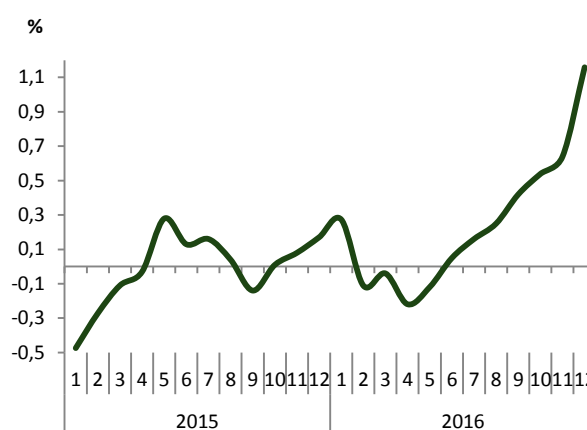
During October-December 2016, the annual inflation rate increased from 0.4% to 1.2% (Figure 14). A significant positive effect on the inflation was made by the growth in prices of gasoline, vegetables and fruits and a negative contribution was made by prices of gas, telecom services and personal care products. Acceleration of inflation would be furthered by a positive price growth in the industry (in December 2016 the annual growth accounted for 2.4%), the increase in oil prices as well as by stimulative measures of the monetary policy implemented by the ECB. Since the inflation has not reached its target (2%), the regulator left the key parameters of its monetary policy unchanged (Figure 15). Meantime, in December 2016 the ECB made the decision to extend the asset purchase program from April 2017 to the end of the year, while reducing the annual volume from EUR 80 bln. to EUR 60 bln.

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



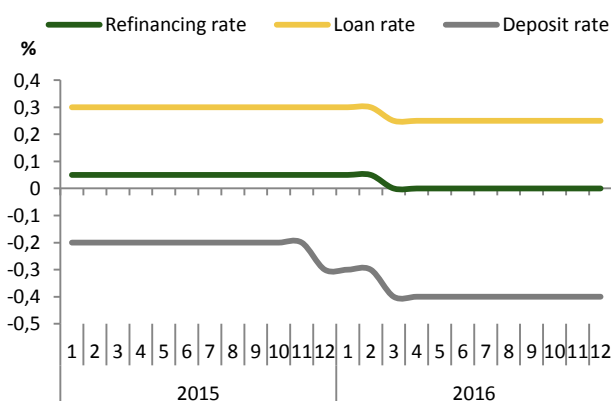
Source: Eurostat

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



Source: Eurostat

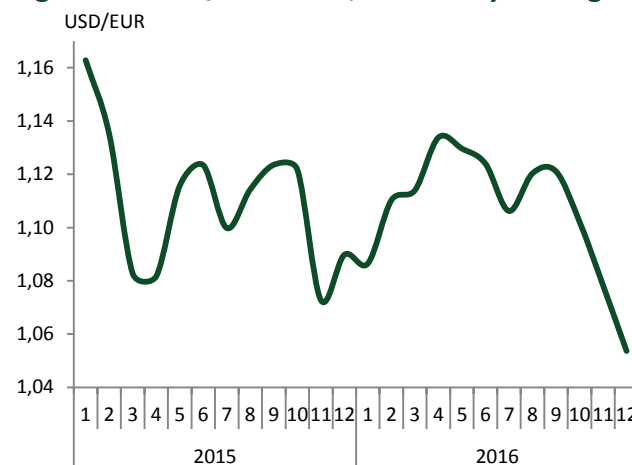
**Figure 15. ECB's Rates**



Source: Reuters

During the reviewed period, the nominal exchange rate of the Euro depreciated from USD 1.1238 to USD 1.0513 per 1 EUR (Figure 16); this was related to the growing attractiveness of the US assets given the increase in the US Fed's policy rate and D.Trump's victory in the presidential election. Also, uncertainty associated with Britain's exit from the EU and the results of elections in key countries of the Eurozone in 2017 will be having a negative effect on the Euro exchange rate.

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

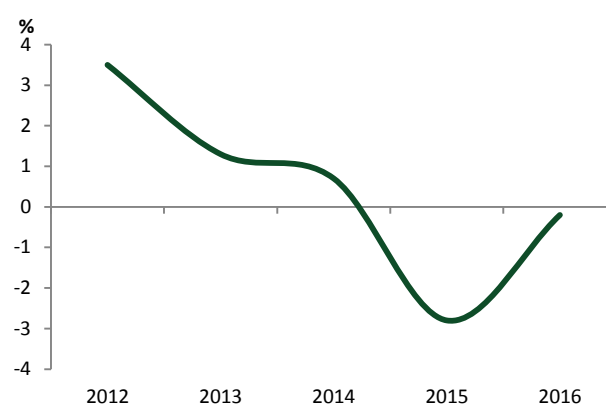


Source Reuters

### 1.3.3 Russia

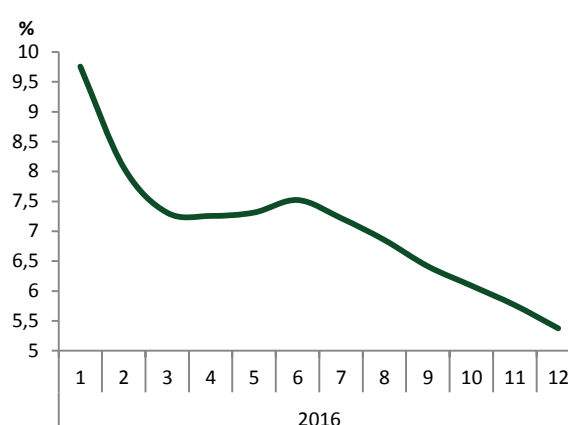
According to the initial assessment by Rosstat, in 2016 the Russian economy demonstrated a slowdown in the economic downturn. So, Russia's GDP in 2016 decreased by 0.2% in annual terms as compared to 2.8% in 2015 (Figure 17). The slowdown of recession was impacted by the growing volumes in agriculture, in mineral extraction, in the manufacturing industry and in the production and distribution of electricity, gas and water. Meantime, the downturn in the construction and trade sectors still makes negative contribution to the economic growth. The main reason for the economic recovery is a moderate increase in prices of raw commodities and a gradual adaptation of the economy to new conditions whereas reciprocal sanctions with the EU still constrain the growth.

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



Source: Rosstat

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



Source: Reuters

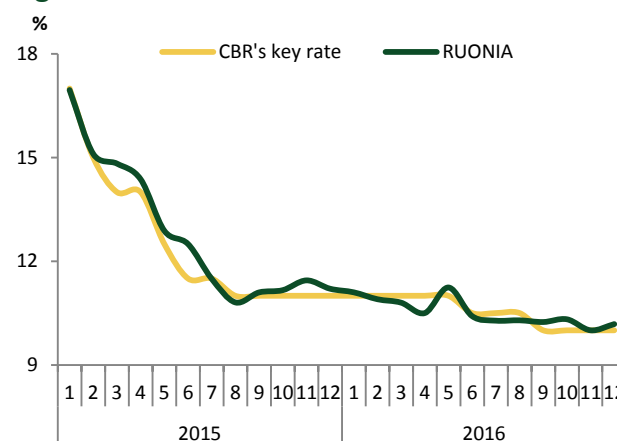
By the end of the fourth quarter of 2016, the annual inflation in Russia accounted for 5.4%, which is by 1 pp lower than in the previous quarter (Figure 18). The decrease in annual inflation was caused by a feeble consumer and investment demand, appreciation of the exchange rate of the ruble as well as an abundant harvest of the agricultural produce.

With a view to support the trend of decelerating inflation to the target level of 4% by the end of 2017 as well as to retain the savings incentives, the Bank of Russia continued to pursue a moderately tight monetary policy,

while retaining its key rate at the existing level (Figure 19). The risks of non-achieving the inflation goals include a higher level of inflationary expectations and their volatility, the decreasing propensity to save, and deteriorating conditions in foreign markets.

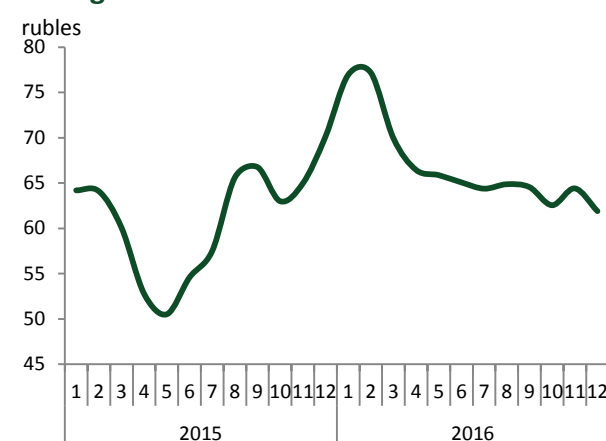
The exchange rate of the Russian ruble against the US Dollar was demonstrating a divergent pattern during the fourth quarter (Figure 20). So, in October the exchange rate appreciated by 3.1% versus September, in November it mounted a comeback and in December it appreciated to RUB 61.90 per 1 USD; such behavior was driven by the behavior of oil prices to a larger extent. In addition, payouts of external debt, budget revenues from export proceeds as well as the growing attractiveness of Russian assets given the economy's recovery represent divergent factors for the exchange rate behavior in December. Major risks for depreciation of the ruble include the declining price of oil as well as the market response to foreign exchange purchases by the Ministry of Finance as part of the transitional budget rule.

**Figure 19. Rates in Russia**



Source: Reuters

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



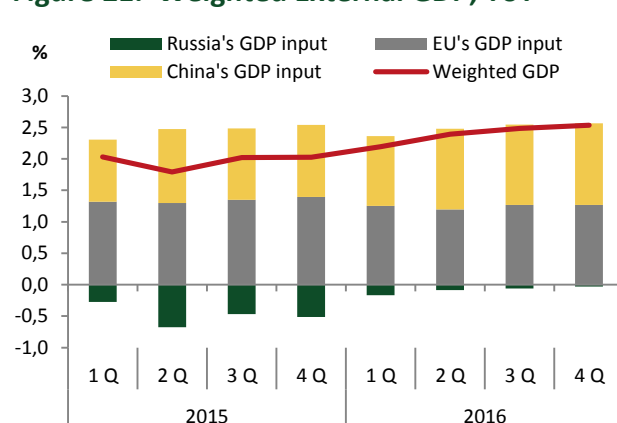
Source: Reuters

#### 1.3.4 Aggregated External GDP and Inflation

Aggregate external GDP which is calculated on the basis of the data about Kazakhstan's international trading structure and is characterizing the demand for Kazakhstani exports had increased by 5 basis points in the reviewed period (Figure 21). Such minor improvement was observed as a result of a slowing downturn in Russia and some acceleration in the Chinese economy. A minor growth of the external aggregated GDP of countries-main trading partners speaks for a feeble improvement in the external demand indicator in the fourth quarter of 2016.

In the fourth quarter of 2016, the aggregate external food price index which is calculated based on the share of main trading partners in Kazakhstan's imports demonstrated a decline of 30 basis points (Figure 22). Such

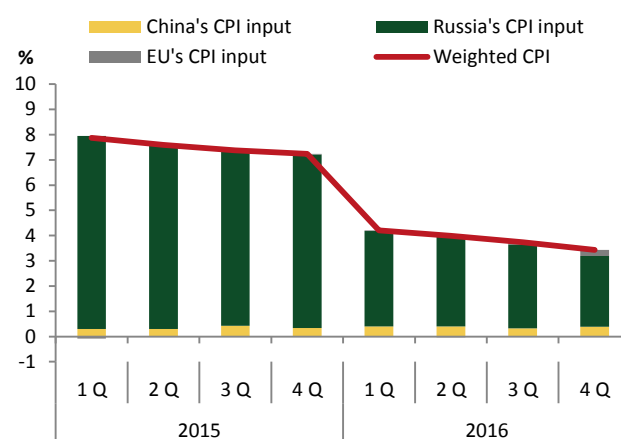
**Figure 21. Weighted External GDP, YoY**



Source: NBRK's calculations

decline is caused by deceleration of annual inflation in Russia whereas inflation in the EU and China had accelerated. As a result, the decline in the indicator reflects a continuing weakening impact of the external inflationary background 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

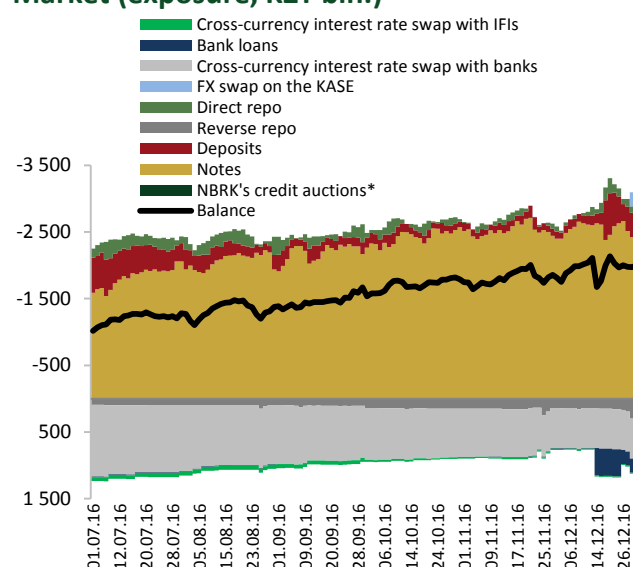
In the fourth quarter of 2016, there was still a structural surplus of the tenge liquidity in the money market. In this environment, volumes of the National Bank's operations for absorbing excess liquidity were growing. The main part of liquidity in the money market was absorbed via open market operations through issuing the National Bank's short-term notes with maturities of 7, 28, 91, 182 and 364 days, their average share accounted for 91.5% in the overall volume of liquidity absorption (83.7% in the third quarter of 2016). Along with that, in December the demand for the National Bank's deposits also increased. The average daily volumes of attracted deposits, after their longstanding decrease, came back to the level of July 2016 (Figure 23).

During the fourth quarter of 2016, the National Bank continued to ease monetary conditions by reducing its base rate. So, on October 3, 2016 it was reduced from 13% to 12.5%, and on November 14 – to 12%, while preserving the band of +/-1%. Such decisions were determined by a downward inflation pattern in line with the forecast track, persisting rates of dedollarization of bank deposits as well as by the decreasing inflationary expectations of the population.

In November-December 2016, as part of the ongoing process to build a risk-free yield curve (its medium-term segment) specialized auctions were conducted to sell government securities from the National Bank's own portfolio. As a result of conducted auctions, market expectations about lowering interest rates for the term of up to 5 years were defined.

In the fourth quarter of 2016, the TONIA rate was maintained at the floor of the interest rate band, despite the fact that the National Bank reduced its participation in the overnight repo market. However, the cases of interest rate volatility were often observed in the market. So, in the period of tax payments (end-

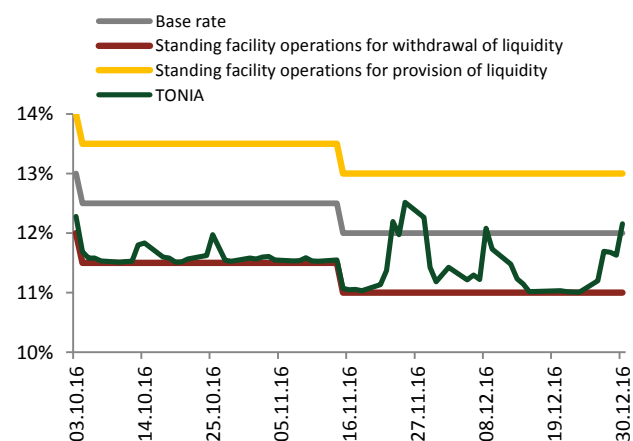
**Figure 23. NBRK's Operations in the Domestic Market (exposure, KZT bln.)**



\* NBRK's securities buy/sell back auction

Source: NBRK

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

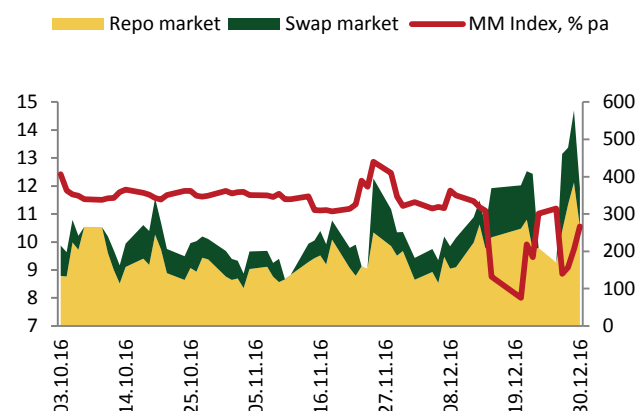


Source: NBRK, KASE

November – beginning of December) the demand for liquidity was increasing; as a result, an interest rate was formed at a level above the base rate. The growth of interest rates at the end of December 2016 resulted from the increased demand for the tenge liquidity by some banks (Figure 24).

During the fourth quarter of 2016, the Money Market Index was ranging between 8.00% and 12.86%. The weighted average MMI for the fourth quarter of 2016 was 11.11% (in the third quarter – 12.34%). The major share fell on the repo market (Figure 25).

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



Source: KASE

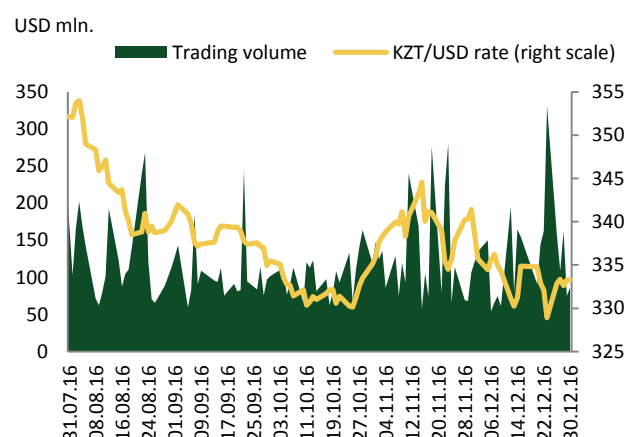
### 2.1.2 Foreign Exchange Market and Foreign Exchange Operations of the National Bank

In the fourth quarter of 2016, the situation in the foreign exchange market was characterized by a volatile behavior of the tenge exchange rate, which was mainly determined by the movement in the oil prices and the Russian ruble. The main factors that affected volatility of the exchange rate of the tenge were negotiations about the reduction of oil production by oil exporters, the hike of the US Fed's official rate as well as election of a new US President.

During that quarter, the exchange rate of the tenge was fluctuating within the range of KZT 328.91-344.56 per 1 USD. If in October and December 2016 fundamental factors encouraged the appreciation of tenge, the growing uncertainty in the global markets and declining oil prices caused depreciation of the tenge in November 2016. However, at the end of the quarter the tenge had appreciated as compared to the previous quarter by 0.6% to KZT 333.29 per 1 USD (Figure 26).

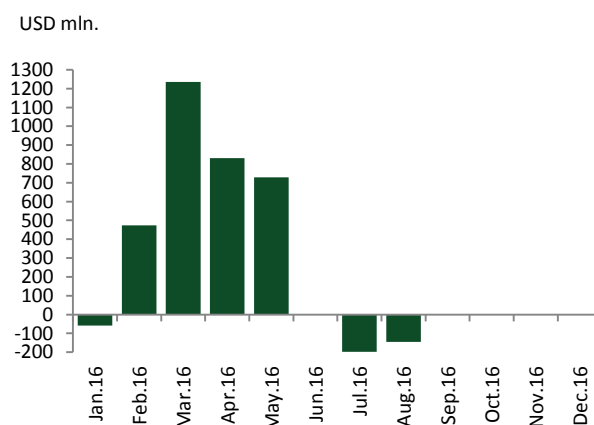
Throughout the fourth quarter of 2016, the National Bank was adhering to the free floating exchange rate regime of the national currency and did not conduct any FX interventions (Figure 27). The impact of the NBK on the fundamental trend of the foreign exchange rate was equal to zero. The tenge exchange rate moved to the equilibrium under the impact of external and internal factors.

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



Source: KASE

**Figure 27. Net NBRK's Interventions in the Domestic Foreign Exchange Market**



Source: NBRK

### 2.1.3 Deposit Market

In the fourth quarter of 2016 as compared to the third quarter, the volume of bank deposits increased by 3.0% and amounted to KZT 18.2 trln. (Figure 28). This was due to stabilization of the foreign exchange market after depreciation of the tenge in the third quarter. A slowdown of inflationary expectations and a gradual recovery of the macroeconomic situation also conditioned the increase in savings.

In the structure of deposits of individuals, the rates of growth in the domestic currency deposits have recovered – 23.9% in the fourth quarter (5.3% in the third quarter). The inflow of deposits of individuals in foreign currency remained virtually the same as in the previous quarter and accounted for 1.3% (1.0% in the third quarter).

The inflow of the domestic currency deposits was also observed in the structure of corporates deposits – 6.2% in the fourth quarter (2.4% in the third quarter). Corporates deposits in foreign currency decreased by 7.4%, whereas in the third quarter their 10.7% increase was recorded (against the backdrop of the tenge depreciation).

As a result, the share of all foreign currency deposits in December decreased to 54.6% from 58.3% in September 2016.

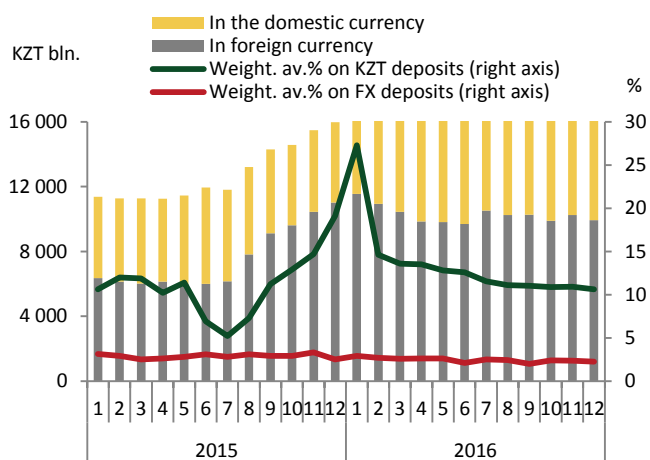
In the fourth quarter of 2016, interest rates on deposits in the domestic currency decreased insignificantly (from 11.0% to 10.6%), and interest rates on foreign currency deposits increased from 2.0% to 2.2%. Interest rates on the tenge deposits of individuals exceeded corresponding rates for corporate deposits. The pressure on banks on the part of legal entities that was observed in the first half of the year had decreased significantly. As a result, interest rates on deposits were generally decreasing.

### 2.1.4 Credit Market

In the fourth quarter of 2016, the credit market continued to recover.

During the quarter, the lending volume increased by 1.4% (Figure 29). The growth of lending was mainly secured by the increase in

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



Source: NBRK

loans to corporate entities (by 2.3%), whereas retail lending decreased by 0.6%.

As per the currency structure, credits in the domestic currency are growing (by 3%). Rates of foreign currency lending are decreasing (by 1.7%). In December 2016, the relative share of all loans in the tenge accounted for 67.4% (in September 2016 – 66.4%).

In the fourth quarter, medium- and long-term loans demonstrated the growth of 0.5%. The relative share of medium- and long-term loans in December 2016 accounted for 81.9% (in September – 82.5%).

The largest contribution to the growth of lending was made by the sector of trade where loans increased significantly – by 5.4% (in the third quarter – the growth of 0.2%). Lending to the industry slowed down to 5.2% because of the slump in lending to the mining sector. Lending to the construction sector decreased significantly (Figure 30).

Lending to small enterprises increased by 11% and amounted to KZT 3.1 trln., which is virtually equal to one fourth of volumes of all credits to the economy.

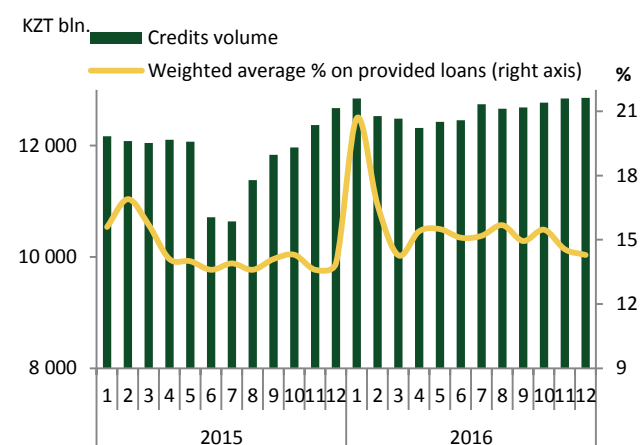
Stabilization of situation in the money market and foreign exchange market, gradual increase in the deposit base of banks in the tenge promoted a further decline in interest rates on loans. In December 2016, the weighted average interest rate on loans in the domestic currency was 15.5% (in September 2016 – 16.3%).

### 2.1.5 Monetary Aggregates

In the fourth quarter of 2016, the annual growth rate of monetary aggregate M3 (money supply) continued to go down and accounted for 15.7% at the end of December. The growth rates of monetary aggregates M0 (cash in circulation) and the reserve money increased and accounted for 41.4% and 8.7%, respectively, at the end of December (Figure 31).

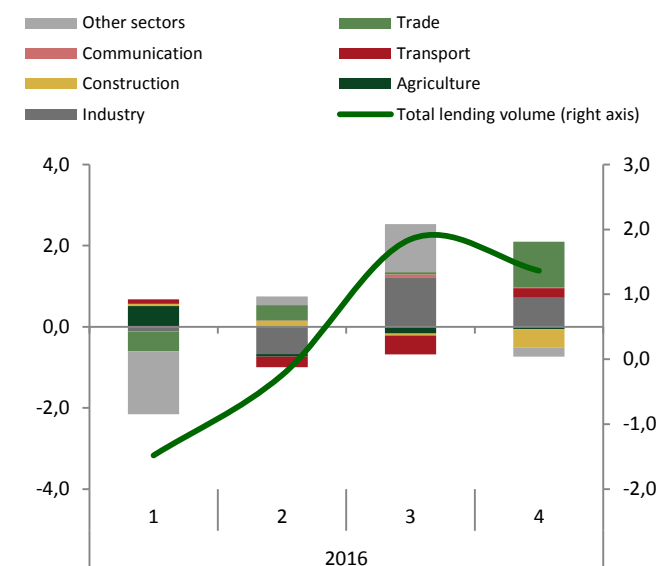
The main factor for a slowdown in the money supply growth had been vanishing of the effect of re-evaluation of foreign currency components in the end of 2016, namely claims

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



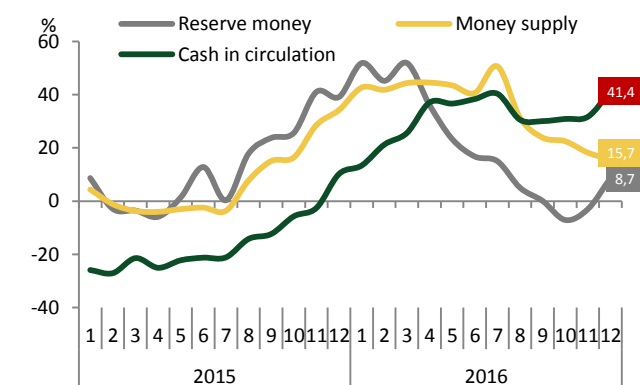
Source: NBRK

**Figure 30. Contribution to Growth Rates of Lending by Sectors**



Source: NBRK

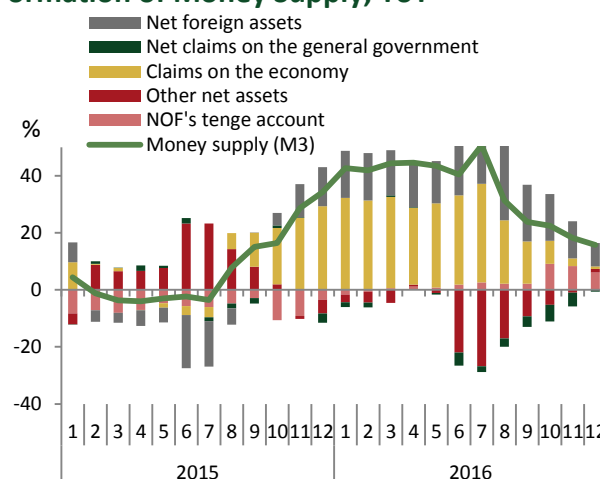
**Figure 31. Growth in Monetary Aggregates, YoY**



Source: NBRK

to economy. The growth in money supply was provided by factors which were also the main sources for the growth in the reserve money: growth in net foreign assets and resources of the National Fund transferred to the national budget (Figure 32)

**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

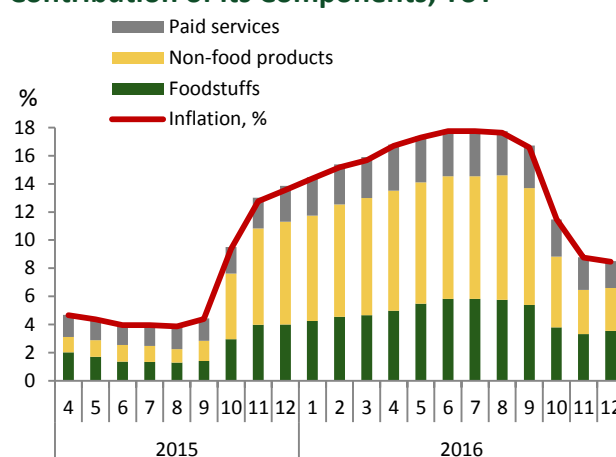
The annual inflation decreased from 16.6% in September to 8.5% in December 2016, being slightly above the National Bank's target (Figure 33).

The inflation pattern was influenced by a sharp decline in prices of non-food products due to the diminishing effect of the exchange rate pass-through as well as by a moderate growth in prices of paid services.

The largest contribution to the annual CPI growth was made by the increase in prices of food products that accounted for 4.5% in the fourth quarter of 2016. In general, prices of food products have increased by 9.7% over the year. A sharp increase in prices of eggs, vegetables as well as dairy and meat products contributed to the price growth. The main reasons are the reduced supply of goods due to shutdowns of some enterprises as well as increased producer costs. The analysis of the deseasonalized inflation also proves that, in addition to seasonal factors, the food inflation was influenced by other factors. The food CPI excluding the seasonality increased to 2.9% from 1.8% in the previous quarter.

In the structure of non-food inflation, prices of petroleum products were growing, being caused by shutdowns of industrial facilities and the increased cost of domestic and imported products. In general, given that other

**Figure 33. Annual Inflation and the Contribution of its Components, YoY**



Source: CS MNE RK

components were growing at moderate rates, the deseasonalized non-food CPI decreased from 1.7% in the previous quarter to 1.1%.

A moderate growth at the end of the fourth quarter of 2016 was demonstrated by the inflation of services which increased by 6.1% in annual terms and by 0.9% in quarterly terms. This was fostered by the slowing growth rates in the utilities sector which takes the largest weight in this CPI group. So, the growth in regulated services had not exceeded 0.7% over the last two quarters of the year.

In December 2016, the core inflation excluding prices of fruit and vegetable production, regulated services and energy resources was slightly above the headline inflation (by 0.4 pp) and accounted for 8.9% (Figure 34).

### 2.2.2 Producer Price Index

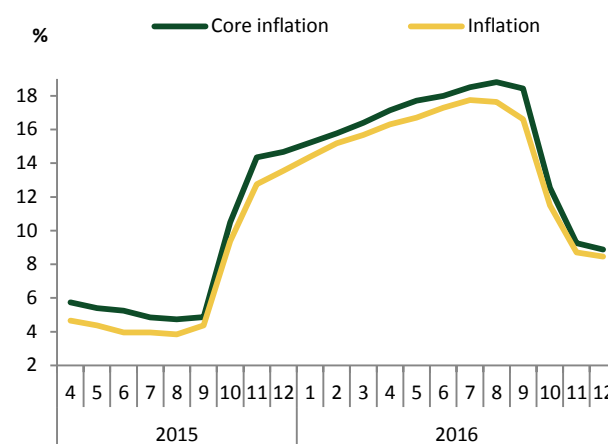
Annual producer prices declined from 26.1% at the end of the third quarter to 15.5% in the fourth quarter of 2016 (Figure 35). In annual terms, prices of industrial production declined from 28.4% in September to 16.8% in December 2016. The decline in the price index was caused by the slowing rates of growth in producer prices both in the mining and in the manufacturing industry.

During the fourth quarter, the producer price index increased insignificantly (0.9%). Along with that, producer prices for products sold to Kazakhstani enterprises had increased by 2.4% over the quarter and by 20.6% in annual terms.

In the structure of industrial production sold in the local market, the prices of following goods increased: petroleum products and metals, construction materials, paper packaging as well as meat and dairy products and tobacco.

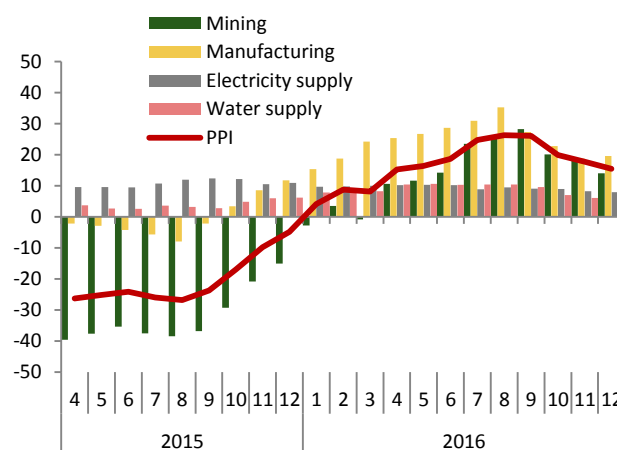
The cost of purchased resources increased by 3.3% during the fourth quarter of 2016 because of the increase in prices of products from the CIS countries along with the decline in prices of products purchased from other countries. However, the growth in prices of products from the CIS countries remains high – 19.6%.

**Figure 34. Core Inflation, YoY**



Source: CS MNE RK

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



Source: CS MNE RK



### 2.2.3 Agricultural Producer Price Index

The growth in prices of agricultural producers had demonstrated a further decline in annual terms (to 7.5% in December from 9.8% in September 2016). The decline in the annual price index was caused by the slowing rates of growth in prices of plant production and agricultural production (Figure 36).

At the same time, during the fourth quarter the price of animal production was growing at higher rates as compared to plant production (5.6% versus 1.9%), thus the annual price growth in this type of production appeared to be higher. The growth in agricultural producer prices occurred in such types of products as milk and eggs.

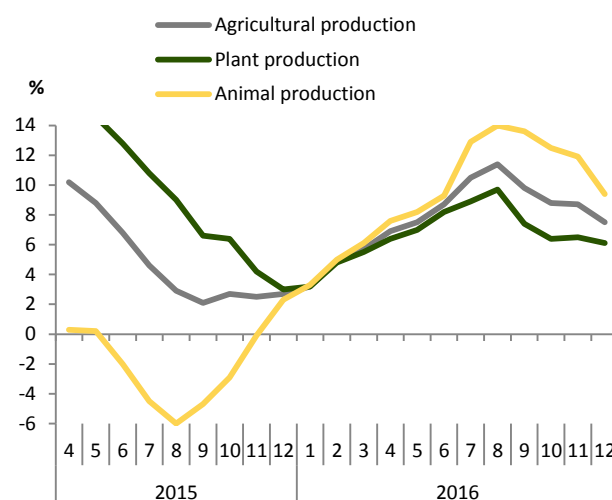
Price growth rates of agricultural production in the fourth quarter remained moderate, which was driven by the increased gross volume of production and yield of crops in 2016. The growth in prices of certain vegetables, cotton, and tobacco was observed.

### 2.2.4 Inflationary Expectations

The households survey outcomes for the fourth quarter of 2016 demonstrate that the majority of respondents still note the price growth over the year. The percentage of respondents who noted high rates of growth among prices of consumer goods and services over the recent 12 months decreased and was the smallest as compared to previous quarters of 2016.

In the fourth quarter, the increase in the percentage of respondents who anticipate the price growth in the next 12 months from 35% to 42% was secured by the increased number of the interviewed who believe that the price growth rates will remain at the existing level (Figure 37). At the same time, the percentage of those who assume that the price growth rates will slow down decreased from 21% to 16%. Such changes in the distribution of responses seem to be fully justified, since the actual inflation has decelerated by 8.1 pp over the fourth quarter. This speaks for some stabilization of expectations among the households regarding long-term perspectives of

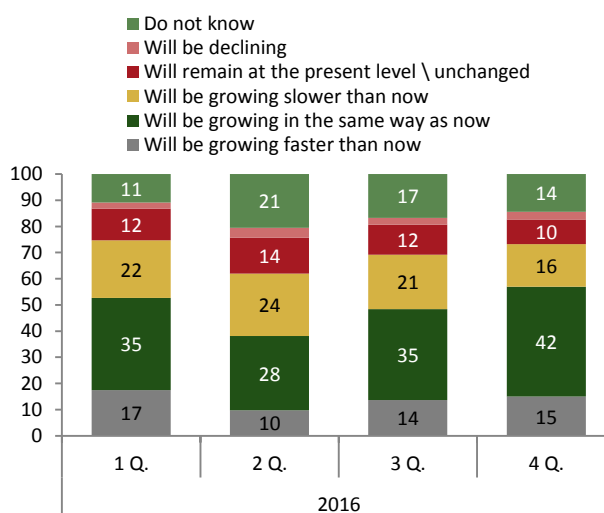
Figure 36. Price Changes in Agriculture, YoY



Source: CS MNE RK

Figure 37. 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

the price growth rates for foodstuffs, non-food products and paid services.

### 2.3 Real Sector Development

In the third quarter 2016, given relative stabilization of external and internal conditions, the real GDP was turning positive, which was driven by a significant reduction in a negative contribution made by exports.

#### 2.3.1 Domestic Demand

During 9 months of 2016, the GDP by the final consumption method GDP increased by 0.3% due to the growth in household consumer spending and gross formation.

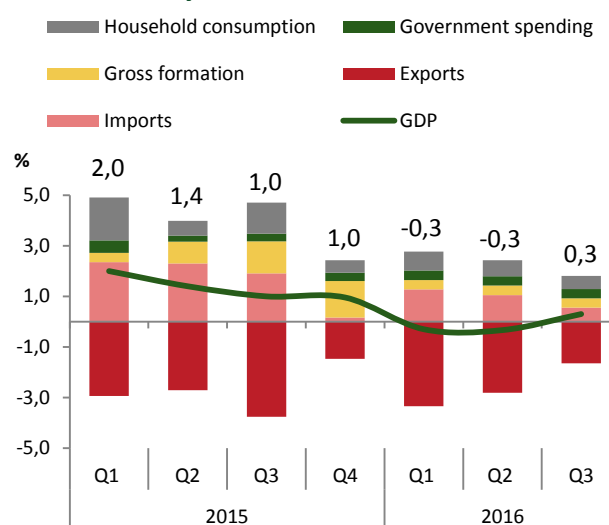
In addition, a negative contribution made by exports decreased (Figure 38), which was related to stabilization of the pricing environment in the global commodity markets as well as to existing competitive advantage of domestic producers against depreciation of the real effective exchange rate. The growth in gross fixed capital formation accounted for 4.0%. Such growth was secured by the 17.3% increase in fixed capital investments in the mining industry and the 50.9% increase in the agricultural sector, as well as by the improved financial standing of enterprises in the real sector of the economy (Box 1).

Based on performance for nine months of 2016, the decline in imports slowed down significantly as a result of the decreasing downward trend in imports of investment and non-food products.

Based on performance for nine months of 2016, household spending on final consumption increased by 1.0% (Figure 39). The growth in consumer demand is related to the increased expenditures for foodstuffs. At the same time, real cash income of the population decreased by 4%, thus limiting expansion of consumer demand. In the third quarter of 2016, the largest contribution to the growth in consumer spending was made by the increased expenditures for foodstuffs (Figure 40).

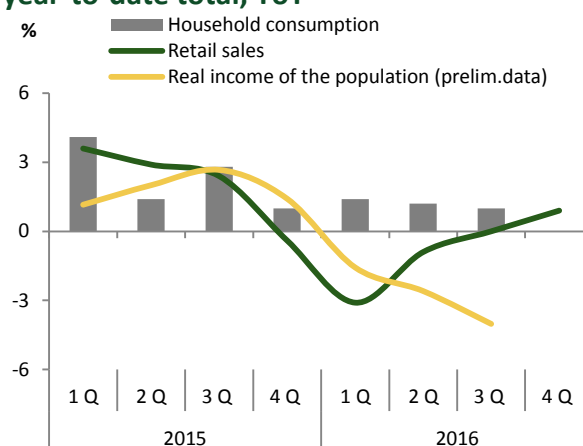
Based on performance in 2016, there was a moderate growth in retail sales against their reduction in 2015 (Figure 41). In the fourth quarter of 2016, the growth rates of food sales

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



Source: CS MNE RK, NBRK's calculations

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

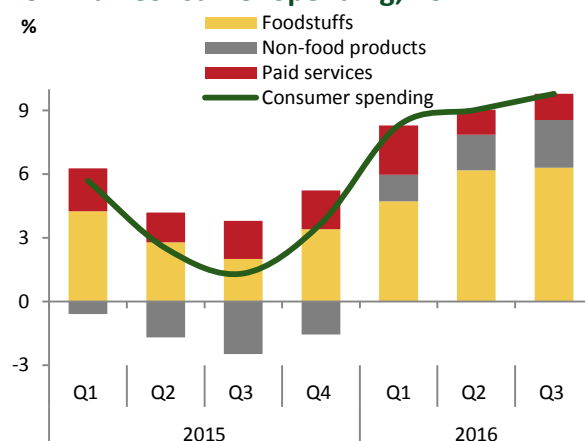


Source: CS MNE RK



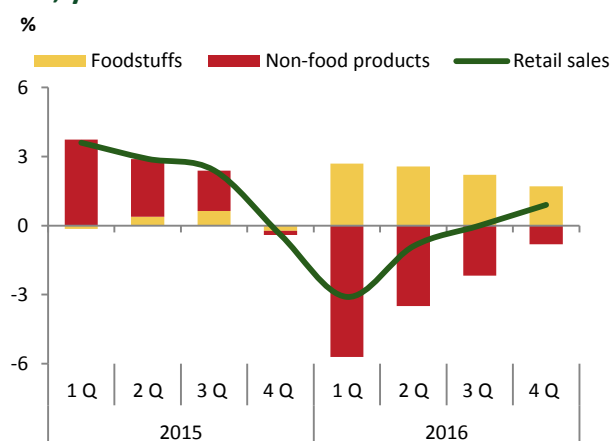
slowed down just as the rates of reduction in sales of non-food products. The main contribution to the growth in retail sales was made by the increased volumes of goods sold by retail outlets (by 3.4%), and the volumes of sales by individual entrepreneurs decreased (by 2.9%).

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



Source: CS MNE RK, NBRK's calculations

**Figure 41. Structure of Growth in Retail Sales, YoY, year-to-date total**



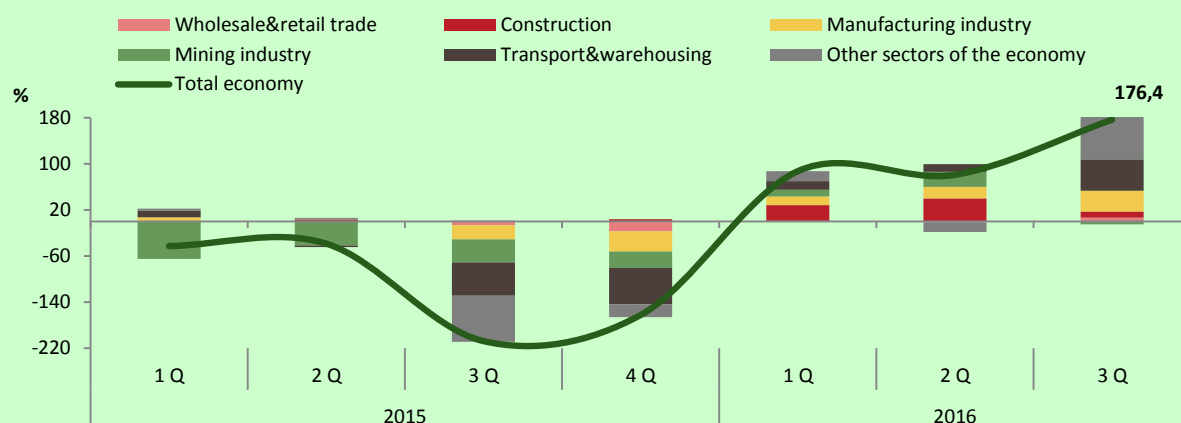
Source: CS MNE RK, NBRK's calculations

#### Box 1

##### Financial Standing of Large and Medium-Sized Enterprises in the Real Sector of the Economy in the Third Quarter of 2016

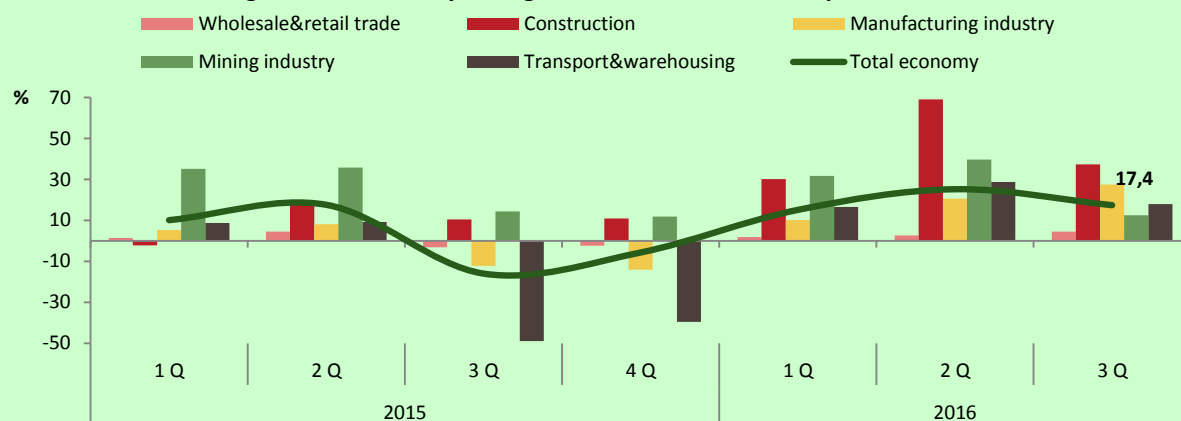
In 2016, a gradual recovery of business activity is observed. It is accompanied by the improving financial standing of enterprises in Kazakhstan's real sector.

In January-September 2016, profits before tax\* of large and medium-sized enterprises were growing, whereas during 2015 enterprises were making losses. So, in the third quarter of 2016 as compared to the corresponding period of the previous year, profits before tax increased by 176.4%. A significant increase in profits of large and medium-sized enterprises in the economy is associated with the growth in profits in such sectors as transport (by 117.2%), manufacturing industry (by 293.2%) and in other sectors (by 118.8%). The growth in profits in the transport sector took place given implementation of large infrastructure projects in the economy. In the manufacturing industry, the growth in profits is associated with the increasing competitiveness of domestic producers owing to a moderately stable exchange rate behavior and a moderate growth of the domestic demand. The main contribution to the growth in profits of other sectors was made by the professional, scientific and technical activities where profits increased by 118.8%. In the mining industry, profits were decreasing (by 26.8%) (Figure 1).

**Figure 1. Profit before tax of large and medium-sized enterprises, YoY**

Source: CS MNE RK

In the third quarter of 2016, the overall profitability level\*\* of large and medium-sized enterprises in the economy as a whole was 17.4%. Among major sectors of the economy, the largest profitability was demonstrated by the construction sector (37.4%). In the manufacturing industry (27.5%) and in the professional, scientific and technical activities (24.8%) profitability was above its overall value in the economy. Despite stabilization of external pricing environment, profitability in the mining industry decreased and accounted for 12.4%. Profitability in the sector of trade has been showing a moderate growth starting from the first quarter of 2016. So, in the third quarter of 2016, profitability in the sector of trade was 4.5%. In the third quarter of 2016, profitability in the transport sector decreased and had been at the level close to the overall value in the economy (17.9%) (Figure 2).

**Figure 2. Profitability of large and medium-sized enterprises, YoY**

Source: CS MNE RK

In the third quarter of 2016, the share of profit-earning enterprises in the total number of large and medium-sized enterprises accounted for 67.5%. In an industry-based breakdown, the largest share of profitable enterprises operated in the sectors of construction (73.3%) and trade (72.6%). In the mining industry, despite the decreased profitability, the share of profitable enterprises increased (70.5%). In the manufacturing industry, the share of profitable enterprises was 65.7%. In the sphere of real estate operations, starting from the first quarter of 2016, the share of profitable enterprises had reduced from 70% in the first quarter of 2016 to 67% in the third quarter of 2016. However, on the economy-wide basis, in 2016 the share of profitable enterprises has been increasing and the share of loss-making enterprise has been decreasing. This speaks for a gradual recovery of business activity and adaptation of economic agents to new economic conditions.

\*Profit (loss) before tax is calculated as a sum of profit (loss) for the period from ongoing operations and profit (loss) from

discontinued operations.

\*\* Profitability is a measure of enterprise performance which is calculated as profit (loss) before tax to costs of production and sale of goods (works, services) including non-production expenses.

### Personal Income

In November 2016, the growth in nominal cash income slowed down (to 2.3%). The increasing income from employment and retirement benefits continues to make a positive contribution to the growth in nominal cash income of the population (Figure 42).

In the third quarter of 2016, income from self-employment and entrepreneurship increased. Nonetheless, their contribution to the growth in nominal cash income remains insignificant. The largest growth in nominal cash income of the population was noted in the Atyrau oblast, East Kazakhstan and Akmola oblast.

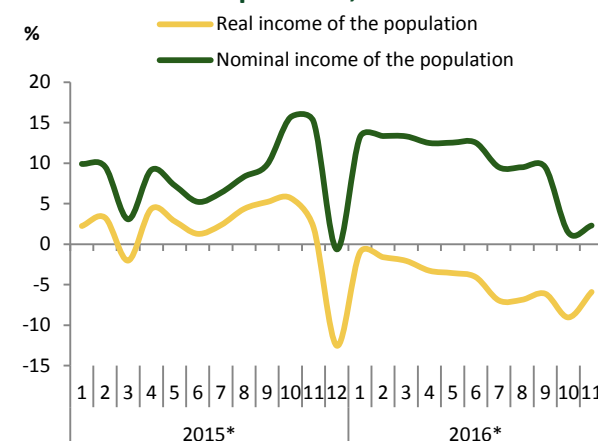
The downward pattern in the real cash income is gradually slowing being associated with deceleration of annual inflation that has been observed since August 2016. As per a regional breakdown, real cash income of the population decreased to the largest extent in Astana, and in Zhambyl and Almaty oblasts.

### Investment Activity

In the fourth quarter of 2016, the investment activity in the real sector improved. Fixed capital investments increased by 7.0% as compared to the corresponding quarter of the previous year. Based on performance in 2016, the investment volume amounted to KZT 7.7 and increased by 5.1% as compared to the previous year (Figure 43). The share of domestic investments in the total investment volume accounted for 69.8%, and the share of external investments – for 30.2%.

As per the industry-based breakdown, the maximum growth in fixed capital investments was recorded in the sphere of administrative and ancillary service (based on performance in 2016, the growth accounted for 52.9%); this is associated with arrangement of trade exhibitions as part of preparations for EXPO-2017 in Astana. In addition, construction of hotels, restaurants and other facilities for

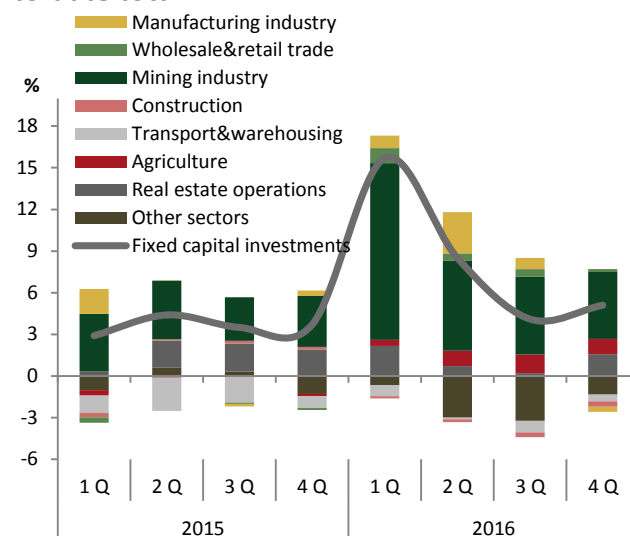
**Figure 42. Indices of Nominal and Real Cash Income of the Population, YoY**



\*-preliminary data

Source: CS MNE RK

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



Source: CS MNE RK, NBRK's calculations

temporary accommodation and catering within the framework of EXPO-2017 was conducive to the growth of investments into the sector of accommodations and catering services (44.6%).

Fixed capital investments in agriculture keep growing at high rates (46.7%); this is to a larger extent driven by governmental support programs for agricultural producers, by expansion of production capacities and ramping up production.

Based on performance for nine months of 2016, gross inflow of foreign direct investments amounted to USD 14.5 bln. and grew by 27.3% as compared to the corresponding period of the previous year. However, in the industry-based breakdown, primary industries, geological exploration and metallurgical industry retained their priority.

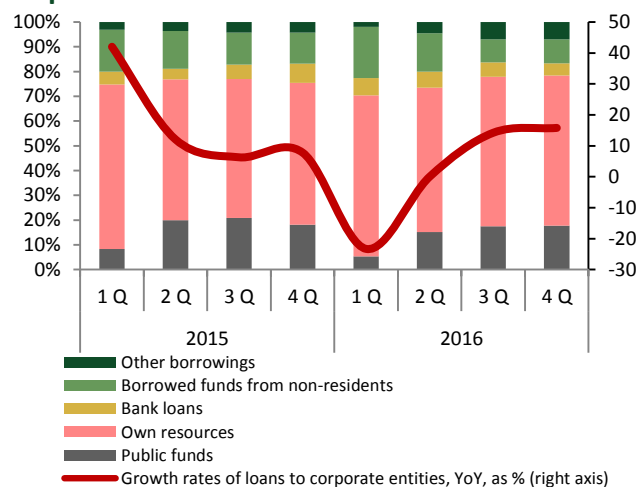
Own funds of enterprises still represent the main source of fixed capital investments (Figure 44). Despite a positive trend in loans to corporate entities, short-term loans provided for working capital financing account for a large portion in their structure (77% based on performance in 2016). Lending for investment purposes remains limited in terms of volume and is rather selective.

### 2.3.2 Domestic Production

Given that foreign economic environment was improving and the situation in the country's domestic market was stabilizing, in the second half of 2016 the economic activity continued to recover. Based on performance for nine months of 2016, the real GDP growth accounted for 0.4% versus the corresponding period of the previous year (Figure 45).

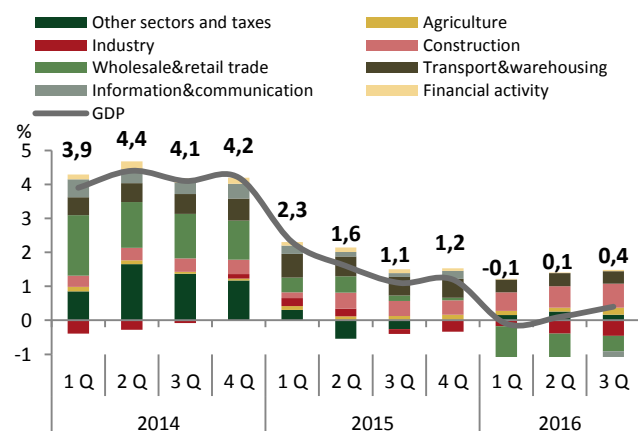
In the fourth quarter of 2016, the short-term economic indicator increased by 3.1% as compared to the fourth quarter of the previous year (Figure 46). Positive trends were observed in all sectors of the economy. The volume of construction works increased by 12.7%, there was an increase in agricultural production (11.1%) and transport service (3.1%) and the production volume in the manufacturing industry also increased (0.4%).

**Figure 44. Fixed Capital Investments, by Funding Sources and Growth Rates of Loans to Corporate Entities**



Source: CS MNE RK, NBRK

**Figure 45. GDP Decomposition. Contribution by Economic Sectors to the GDP Growth, YoY, year-to-date total**



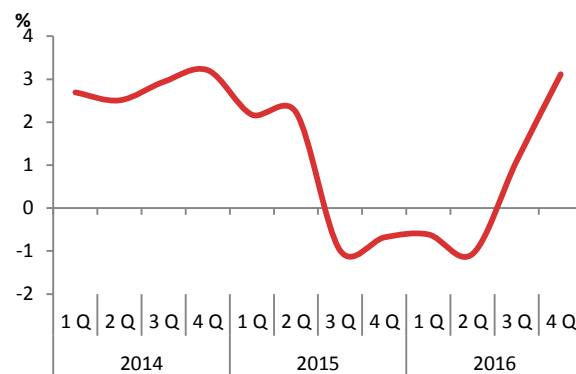
Source: CS MNE RK, NBRK's calculations

Alongside with that, the start of crude oil production in the Kashagan oil field in October 2016 promoted the increase in the production volumes of the mining industry. A positive contribution was also made by the expansion of copper ores extraction in the Aktogay and Bozshakol deposits. As a result, in the fourth quarter of 2016, the mining industry demonstrated the 2.1% growth as compared to the fourth quarter of 2015.

Stabilization of the exchange rate of the tenge, the declining slump in real cash income of the population and gradual recovery of the consumer demand caused the growth in retail sales (4.2%). Services by telecommunication agencies increased by 1.2%.

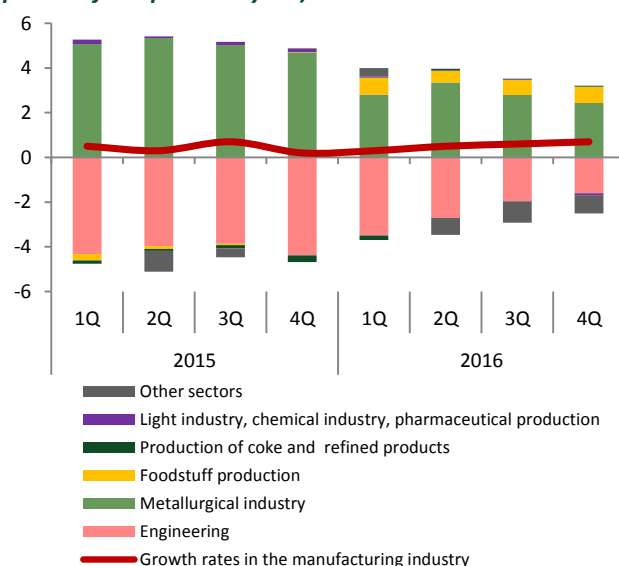
The increased external demand together with modernization of physical infrastructure and automation of the production process factored the increase in agricultural production. The growth in production volumes in the manufacturing industry is still weakly positive as a result of divergent trends and inhomogeneity in various sectors (Figure 47). So, the metallurgical industry accounts for a major share in the structure and makes a positive contribution. Production growth rates in the non-ferrous and ferrous metallurgy based on performance in 2016 accounted for 8.5% and 3.3%, respectively. Processes of imports substitution and development of non-primary industries are ongoing. Production volumes in the food industry increased by 3.9% and production of major pharmaceutical products and manufacturing of electric equipment increased by 2.5%, and production of textile goods and furniture manufacturing – by 1.3%. A negative trend in the engineering industry, particularly in the manufacturing of vehicles because of the decreased demand, makes a negative contribution to development of the manufacturing industry. At the same time, rates of decline in the sector are slowing and they accounted for (-)15% based on performance in 2016; this process was supported by the government support measures for domestic manufacturers of engineering products.

**Figure 46. Short-Term Economic Indicator (a quarter versus the corresponding quarter of the previous year)**



Source: CS MNE RK, NBRK's calculations

**Figure 47. Decomposition of the Manufacturing Industry. Contribution by Sectors to the Growth, YoY (a period versus the corresponding period of the previous year)**



Source: CS MNE RK, NBRK's calculations

The aggregate composite indicator, which summarizes the assessment of the existing situation and expectations of CEOs of companies in the real sector of the economy, in the fourth quarter of 2016 continued to grow. This trend indicates a gradual recovery of the business activity and transition of the economy to the recovery growth phase. The increased demand for their products is noted by enterprises in the manufacturing industry, agriculture as well as enterprises – producers of consumer goods and services. At the same time, in other sectors the growth remains moderate. Respondents positively assess stabilization of the exchange rate of the tenge against currencies of main trading partners. According to the opinion poll, in the fourth quarter of 2016 the share of enterprises that were negatively affected by the changes in the exchange rate of the tenge decreased significantly. Assessment methods based on the filtration principles showed the existence of negative values of the output gap at the end of the fourth quarter of 2016. However, the gap begins to shrink indicating that deflationary pressure in the economy is gradually decreasing (Figure 48).

### 2.3.3 Labor Market and Unemployment

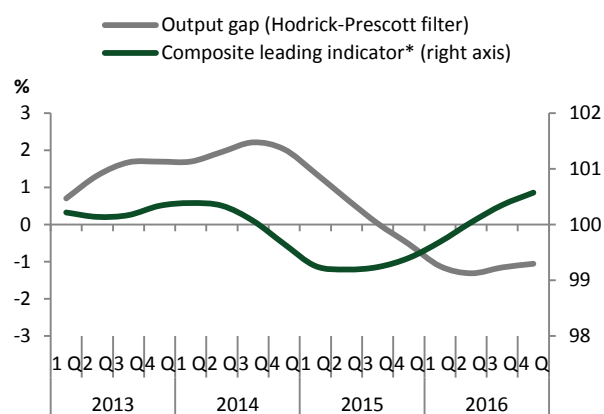
In the fourth quarter of 2016, nominal wages grew by 13.7%.

In the fourth quarter of 2016, for the first time since the second quarter of 2015, real wages turned positive (Figure 49). The growth of real wages occurred against the improved financial performance of enterprises in the real sector of the economy as well as the increase in salaries and wages in the sector of education (by 13.7%) and healthcare and social services (by 9.9%).

In the fourth quarter of 2016, the real wage index in the construction sector and trade was at about zero and in the professional, scientific and technical activities the decline in real wages accounted for 2.1%.

In the third quarter of 2016, the trend of a moderate growth in labor productivity in the economy continued (the growth of 1.1%). The

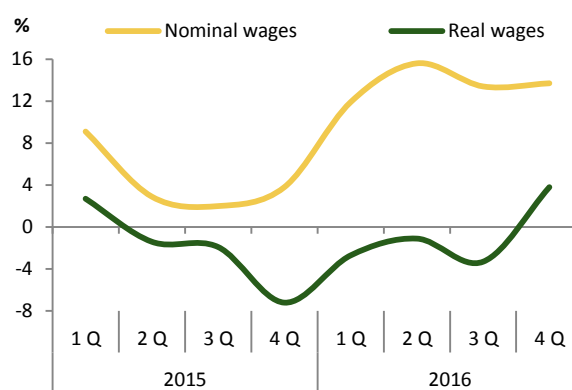
**Figure 48. Behavior of the Composite Indicator, Cyclical Component of GDP and Output Gap**



Source: NBRK

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

**Figure 49. Nominal and Real Wage Indices, YoY**



Source: CS MNE RK



growth in labor productivity was observed in the production of goods (by 4.9%) and the decline – in the production of services (by 1.3%). At the same time, labor productivity indices broken down by sectors show a divergent pattern. A significant growth in labor productivity was observed in the financial and insurance activities (by 13.1%) and in agriculture (by 20.0%). The growth in labor productivity in agriculture is way above the growth in real wages, thus not creating any prerequisites for the increasing inflation risks. However, such trend is observed not in all sectors of the economy. Particularly, in such sectors as trade, provision of communication services and in the manufacturing industry, recovery of real wages is not accompanied by the growth in productivity, which, in its turn, points to the possibility of the increasing inflation risks.

The outstripping growth in nominal wages versus GDP weakened the trend of the decline in labor compensation unit costs (Figure 50). So, the decline in labor compensation unit costs during nine months of 2016 was 5.0% (during six months of 2016 – (-7.8%)).

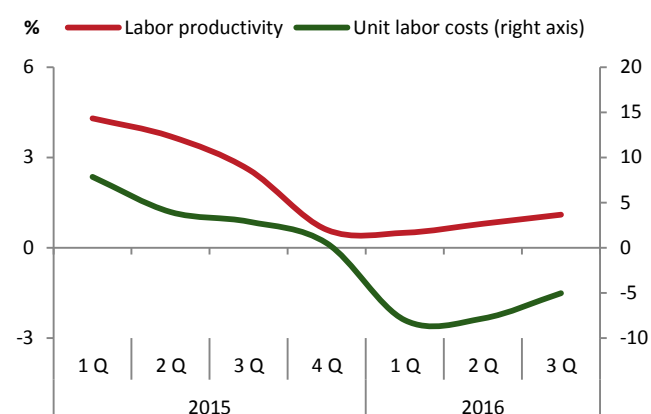
In the third quarter of 2016, the decrease in the number of the employed population slowed down (to 0.6%). There is still an upward trend in the number of the employed population (by 0.8%) and a downward trend in the number of self-employed (by 1.3%) (Figure 51).

A relatively stable unemployment rate is explained by new jobs being created as part of implementation of the government's employment and economic stimulus programs, by persistence of positive financials and by the growth in the number of profitable enterprises in the real sector.

In the third quarter of 2016, the number of the employed population in agriculture decreased (by 13.5%).

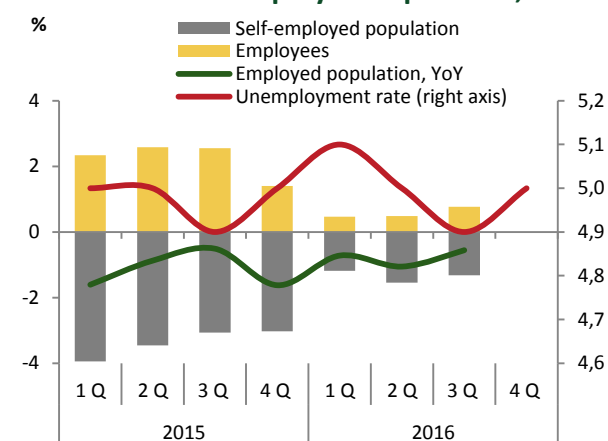
The growth in the employed population in the manufacturing industry (by 10%) and in the construction sector (by 5.7%) was based on positive rates of growth in the production volumes as well as measures for economic

**Figure 50. Labor Productivity and Unit Labor Costs, YoY, year-to-date total**



Source: CS MNE RK, NBRK's calculations

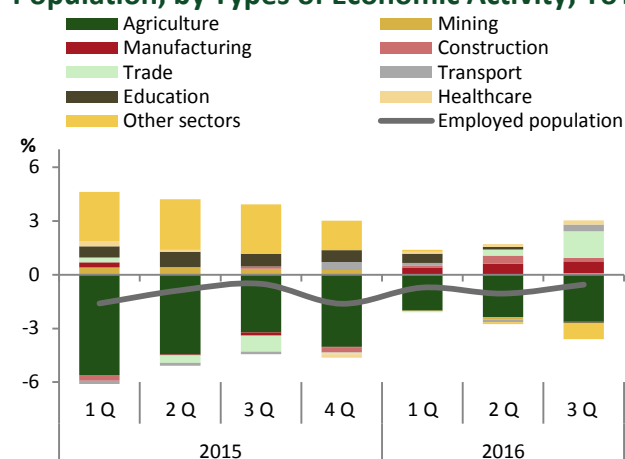
**Figure 51. Unemployment Rate, Growth Structure of the Employed Population, YoY**



Source: CS MNE RK, NBRK's calculations

development and employment support as part of the government program implementations. Recovery of the wholesale turnover and the exit of the retail sales from the negative zone promoted the growth in employment in trade (by 2.5%) (Figure 52).

**Figure 52. 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 fourth quarter of 2016, the two thirds of the state budget revenues were comprised of tax revenues (63.7%) and one third – of transfers (33.0%) (Figure 53).

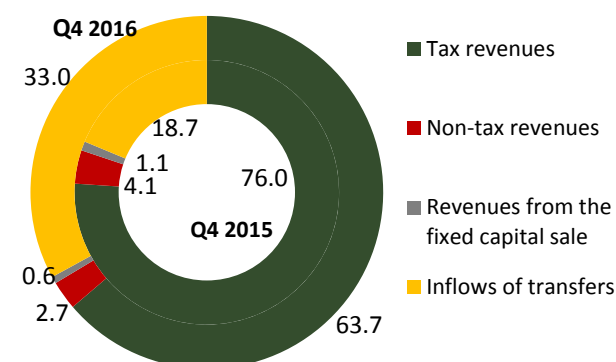
In nominal terms, budget revenues increased by 23% as compared to the corresponding period of 2015 and accounted for 19.6% of GDP (in the fourth quarter of 2015 – 16.8% of GDP). As compared to the fourth quarter of 2015, tax revenues increased by 3.1%, non-tax revenues decreased by 20%, and revenues from the fixed capital sale – by 30.9%; transfers increased by 2.2 times.

A major portion in tax revenues was traditionally comprised of corporate income tax (28.4%), value-added tax (22.9%) and personal income tax (9.9%).

In the fourth quarter of 2016 as compared to the fourth quarter of 2015, the state budget spending increased by 27.3% in nominal terms and accounted for 22.8% of GDP. Mainly, the growth occurred due to the increased expenditures for education, healthcare and social security. Expenditures related to purchases of financial assets in the fourth quarter tripled as compared to the corresponding period of 2015. Resources were mainly channeled to increase equity of the National Welfare Fund “Samruk-Kazyna” and the National Management Holding Company “KazAgro”.

In the fourth quarter of 2016, the state

**Figure 53. Structure of State Budget Revenues**



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



budget had a deficit of KZT 381.7 bln. or 2.7% of GDP (in the fourth quarter of 2015 the deficit accounted for 1.6% of GDP). In general, this was related to the decreased tax revenues and expanded government spending aimed to maintain socio-economic stability in the economy. In the fourth quarter of 2016, non-oil budget deficit was still high – 9.2% of GDP (Figure 54).

In general, in 2016 the state budget deficit amounted to KZT 737.7 bln. (1.6% of GDP), with actual transfers from the National Fund being lower than the budgeted amounts. So, the guaranteed transfer to the budget amounted to KZT 2 110 bln. instead of KZT 2 880 bln.; as for the target transfer, KZT 420.8 mln. were transferred back to the National Fund from the national budget.

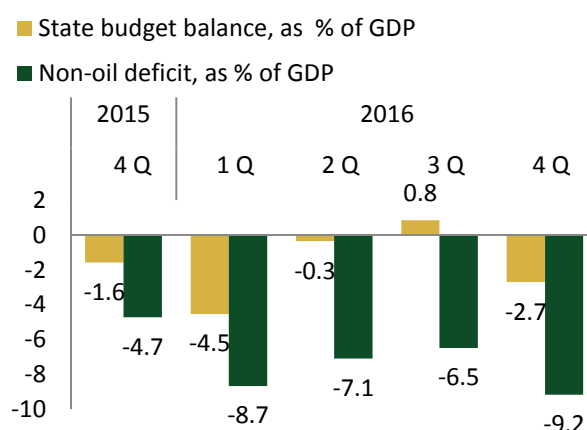
Nonetheless, the state budget deficit financed with transfers from the National Fund speaks for a stimulative nature of the fiscal policy that is aimed at giving both a direct and an indirect impetus to the growth in aggregate demand and the country's economic development. However, such nature bears the risks of the increasing inflationary pressure in the economy that may be offset by the accelerated rates of production of goods and services and by creating a cumulative effect of positive shifts in the business activity.

### 2.5 Balance of Payments

In the third quarter of 2016 as compared to the third quarter of 2015, the current account of the balance of payments was characterized by the outstripping rates of reduction in imports over exports and the growth in payouts on secondary income. The current account deficit as well as the resulting net capital inflow on the financial account became the cause for an overall deficit of the balance of payments of USD 0.3 bln. in the third quarter of 2016 (Figure 55).

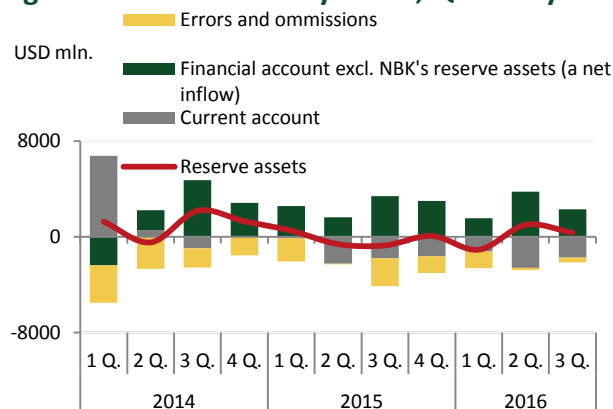
Reduction in current expenditures in the third quarter of 2016 as compared to the same quarter of 2015 resulted in the 10.9% decrease in the current account deficit to USD 1.8 bln. (Figure 56).

**Figure 54. State Budget Balance, as % of GDP**



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

**Figure 55. Balance of Payments, Quarterly**



Source: NBRK

Shrinking of the current account deficit is associated with a slowdown in the consumption of imports (Figure 57) and payouts on secondary income in favor of non-residents in the third quarter. A positive signal about a narrowing spread between the rates of reduction in imports and exports that was observed in the second quarter of 2016 was confirmed in the reviewed period.

The decline in the value of exports is mainly affected by relatively lower prices almost for all groups of export goods except ferrous metals. Being impacted by the price factor, exports of mineral products decreased by 20.5% (exports of oil and gas condensate decreased by 20.7%). As for exports of non-ferrous metals, the decline occurred to a greater extent because of reduction in the volumes of physical delivery (by 5.5%). Grain exports decreased because of the decline in contractual prices while physical volumes were growing (by 14.6%). The 12.3% growth in exports of non-ferrous metals was caused by a more than one fourth increase in the volumes of physical delivery.

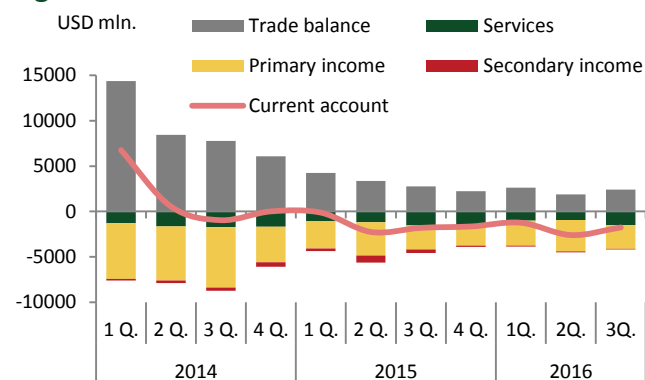
The decline in the value of imports (by 17.7%) was also mainly driven by the reduction in contractual prices, including a replacement of expensive consumer goods and investment goods by their cheaper substitutes. The largest reduction in imports occurred in consumer non-food products – by 25.5% and investment goods – by 20.4%.

Shrinkage of imports of goods is observed in respect of main trading partners – Russia (by 10.7%) and China (by 32.1%). Having said that, if reduction in imports from Russia is related mainly to the decline in contractual prices, reduction in the volumes of imports from China occurred as a result of reduction in the physical volumes of imported goods.

Relatively low prices of export goods and negative effect made on imported goods by depreciation of the exchange rate of the tenge against currencies of Kazakhstan's main trading partners caused deterioration in the aggregate terms of trade index (Table 1).

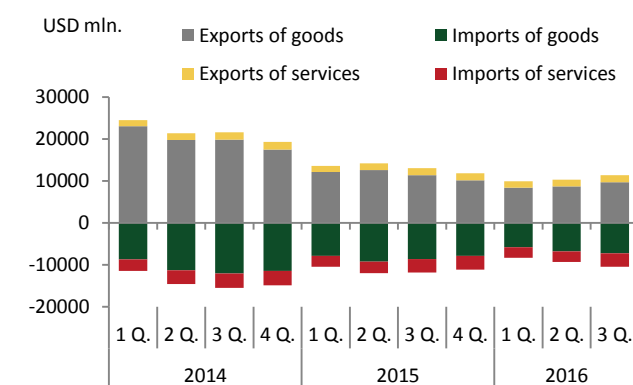
During the third quarter of 2016, the real

**Figure 56. Current Account**



Source: NBRK

**Figure 57. Exports and Imports of Goods and Services**



Source: NBRK

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

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

	Q2 15	Q3 15	Q4 15	Q1 16	Q2 16	Q3 16
Export prices	-41	-39	-42	-36	-31	-21
Import prices	-7	-9	-2	7	-5	16
<b>Terms of trade</b>	<b>-36</b>	<b>-33</b>	<b>-41</b>	<b>-41</b>	<b>-27</b>	<b>-32</b>
including:						
<b>Euro zone countries</b>						
Export prices	-46	-46	-49	-41	-34	-18
Import prices	17	-15	-43	15	-10	14
<b>Terms of trade</b>	<b>-53</b>	<b>-36</b>	<b>-10</b>	<b>-48</b>	<b>-27</b>	<b>-28</b>
<b>Russia</b>						
Export prices	-19	-30	-20	-14	-23	-14
Import prices	-22	-31	-23	-13	-8	25
<b>Terms of trade</b>	<b>3</b>	<b>2</b>	<b>4</b>	<b>-1</b>	<b>-16</b>	<b>-31</b>

Source: NBRK

effective exchange rate index of the tenge had depreciated by 25.6% in annual terms. The tenge had depreciated against the CIS-currencies basket by 26.1%, and against other currencies basket – by 24.7%.

In the reviewed period, the tenge depreciated in real terms against the US Dollar by 28.0%, against the Euro – by 28.8%, against the Russian ruble – by 27.3%, and against the Yuan – by 23.7% (Figure 58).

The pressure on the current account is decreasing due to contraction in the negative balance of services (by 6.2%). Reduction in the volumes of foreign trade operations and imports of consumer services had driven reduction in the deficit of trade in services.

A negative balance on primary income had insignificantly changed and amounted to USD 2.6 bln. Nevertheless, the deficit in the balance of investment returns slightly increased, mainly because of the increased payout of returns to direct investors. At the same time, since the debt of residents on issued Eurobonds decreased, payouts of returns on portfolio investments declined.

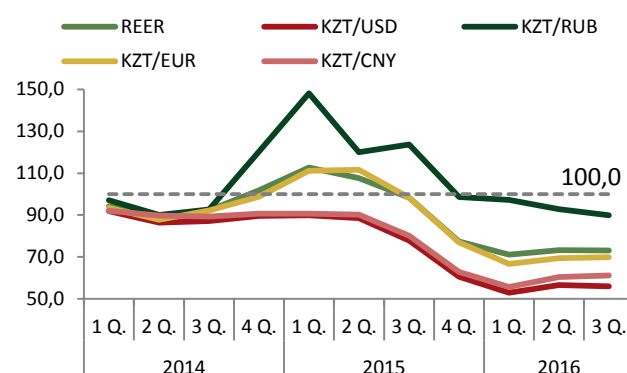
There was a negative balance on the financial account less reserve assets (a net inflow of capital of USD 2.3 bln.) because of higher rates of growth in liabilities with a less significant increase in assets.

A net inflow of financial resources was secured by the inflow on direct and portfolio investments that was partially offset by the outflow related to repayment of medium- and long-term loans of the corporate sector as well as to the growth in assets of residents with foreign accounts (Figure 59).

As for foreign direct investments, there was a record-high net inflow of foreign direct investments (FDIs) of USD 6.3 bln. in the third quarter of 2016 (USD 1.4 bln. in the third quarter of 2015), mainly secured by the intercompany borrowing in international financial markets. Primarily, these FDIs were aimed to finance oil and gas projects.

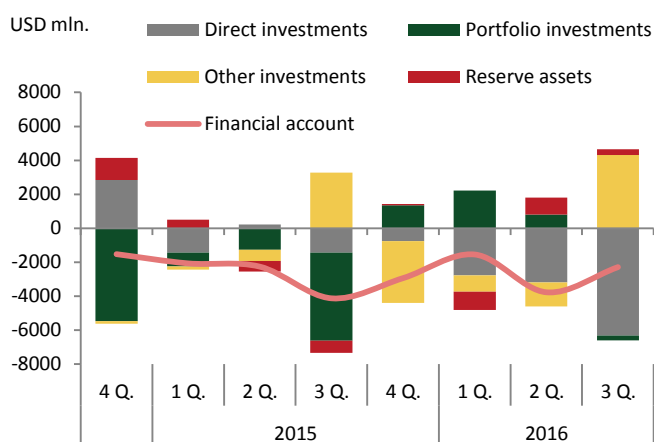
As for portfolio investments, a net inflow resulted from reduction in the National Fund's

**Figure 58. Real Effective Exchange Rate Index (December 2013 = 100%)**



Source: NBRK

**Figure 59. Financial Account**



Source: NBRK

assets. At the same time, the reduced liabilities on the Kazakh debt securities helped decrease the inflow on the balance of portfolio investments which eventually amounted to USD 0.3 bln.

As for medium- and long-term investments as well as short-term investments, a net outflow of USD 0.5 bln. and USD 3.8 bln. was driven by reduction in liabilities on loans and advances to businesses in the non-bank sector as well as by placements with foreign accounts of banks and non-bank organizations including a part of resources borrowed to finance large investment projects.

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

The forecast of macroeconomic indicators was prepared on the basis of statistical information as of February 2, 2017.

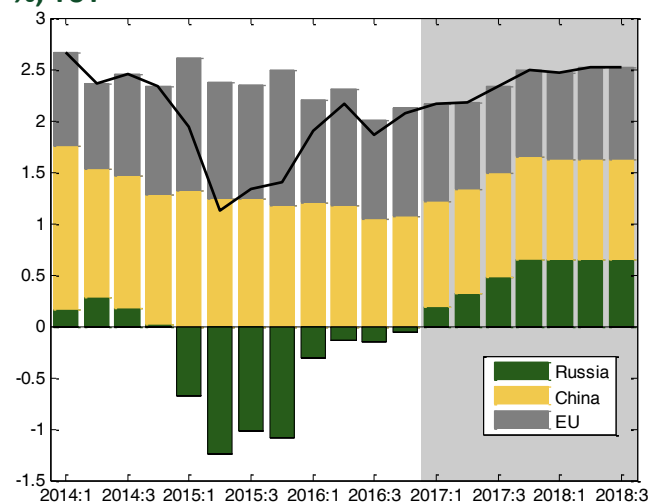
### 1. KEY ASSUMPTIONS FOR EXTERNAL FORECAST PARAMETERS

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 52.9% of the total foreign trade turnover of Kazakhstan in the third quarter of 2016 had not undergone dramatic changes as compared to previous forecasts presented in the Inflation Report for the third quarter of 2016. According to the National Bank's expectations which take into account estimates of international organizations, in the medium term the external demand will be recovering thus contributing to the recovery of the economic growth in Kazakhstan. To a larger extent, the external demand will be expanding owing to positive growth rates in the Russian economy that are expected starting from the first quarter of 2017, as well as due to a moderate growth in the Chinese economy around its potential and a feeble economic growth in the EU (Figure 60).

The inflationary background in countries-main trading partners is generally favorable, in the first instance due to a significant deceleration of inflationary processes in Russia and a stable inflation in China (Figure 61). Forecasts regarding inflation in the Russian Federation became more positive in connection with a high likelihood of achieving the 2017 inflation goal of 4%; moreover, potentially it can be below the designated target. There might be a negative inflationary pressure on the part of imported goods in view of anticipated growth of inflation in the EU, which will reach 1.4% by the third quarter of 2018.

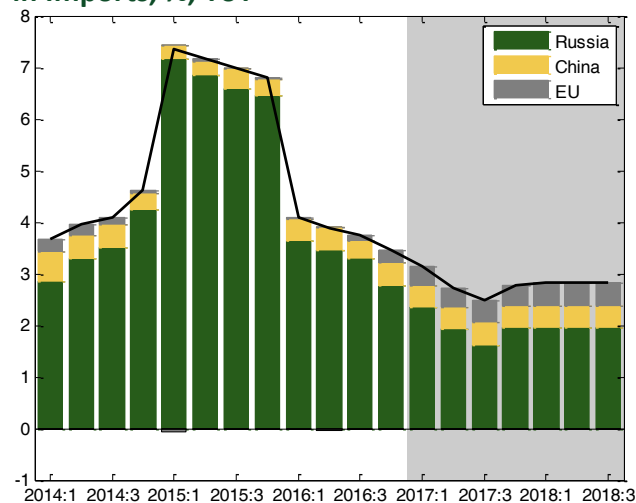
In the near term, world prices of foodstuffs are expected to slightly increase in connection with the outstripping growth rates of consumption as compared to the rates of production. Nonetheless, in the medium term,

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



Source: NBRK's calculations

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



Source: NBRK's calculations

world prices of foodstuffs are expected to come back to their existing levels. As a result, the impact of this factor on inflationary processes in Kazakhstan will be neutral.

In 2016, the average price of oil (Brent) was USD 43.5 per barrel. However, from December 2016 it had been above USD 50 per barrel. To this end as well as given positive expectations regarding the raw commodity market, the scenario assuming the price of oil at USD 50 per barrel was considered as the baseline scenario.

Expectations regarding external monetary conditions 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. In turn, this may lead to risks associated with possible depreciation of currencies in developing countries in connection with the capital outflow as well as may result in a more expansive funding in foreign markets.

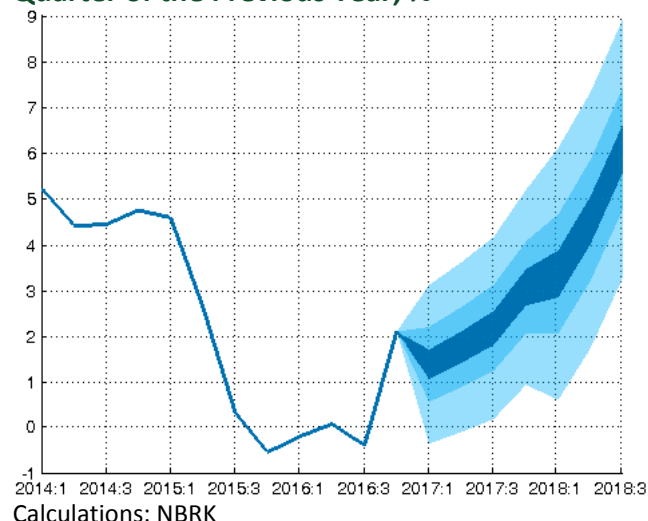
## 2. FORECAST UNDER THE BASELINE SCENARIO

With the oil price at USD 50 per barrel, the forecast of Kazakhstan's real GDP growth in 2017 exceeds 2%. The main driver for the economic growth would be the recovery of the domestic consumption against the growth in real wages, fixed capital investments and in the volumes of extraction and production of mineral resources. A long-term potential for the growth of the Kazakh economy is estimated to be still at 3-4%.

At the same time, a positive effect from recovery of the domestic consumption would be partially offset by the increase in imports, including due to the growth in investment imports. Apart from that, the domestic consumption would be slightly constrained by a positive real interest rate.

The economic growth during nine months of 2018 is estimated to be at about 4.7% (Figure 62). Further rates of the GDP growth will be driven by adaptation to the macroeconomic situation. In the long-term perspective, the GDP growth would be striving to its potential value which depends on effectiveness of governmental economic support programs,

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



institutional reforms and dedollarization of the economy.

According to the National Bank's expectations, the output will be above its potential level already in the fourth quarter of 2017.

Forecasts of real export and import indicators have significantly increased as compared to the Inflation Report for the third quarter of 2016. However, no significant change in net exports occurred. Thus, economic interpretation and assessment of contribution of net exports to the GDP growth has not changed.

Household consumption growth rates are expected to be moderate, as a result of adaptation to new economic conditions and the deferred demand for non-food products during prior periods. This fact is confirmed by statistics on the retail sales; according to such statistics, the turnover of foodstuffs has been increasing since 2015 while the turnover of non-food products has been decreasing.

According to the National Bank's estimates, gross formation will be growing based on fixed capital investments in branches of the mining industry and in real estate operations. There are improved financial opportunities for investment financing given the improved pricing environment for borrowing, namely for reducing the cost of funding.

Assumptions regarding the government consumption in the medium-term forecasts under which the non-oil deficit was expected to decrease and a generally neutral fiscal policy was anticipated generally have not undergone changes. Therefore, medium-term forecasts do not take into account the latest changes which relate to the increase in the national budget deficit and the increase in the target transfer for 2017 in connection with the date of trimming of statistical information used in the "January-February 2017" forecast round.

Under the baseline scenario, the inflation is expected to stabilize within its target band in 2017 and to decrease further in the medium term. The inflation may go below the boundary



of its target band in the third quarter of 2018 (Figure 63). The main reason for that includes the decreasing inflationary expectations, in the food component of the inflation, in the first instance. At the same time, inflationary expectations about the non-food inflation are expected to persist as a result of a share of imports.

Inter alia, a favorable inflationary background and an assumption about stability of prices of cereals that have a significant effect on the food inflation will be conducive to the deceleration of inflation in the medium term.

Given that the output gap will become slightly positive, in 2018 the monetary policy would be implemented in a new environment while before it was implemented in the environment of a negative GDP gap. No deflationary pressure on inflation on the part of the real economy will be expected.

Despite the downward trend of the base rate, in the medium term the monetary policy should be regarded as moderately constraining, taking account of the National Bank's operations for absorption of the tenge liquidity that has a structural nature.

### 3. RISKS IN THE MEDIUM-TERM

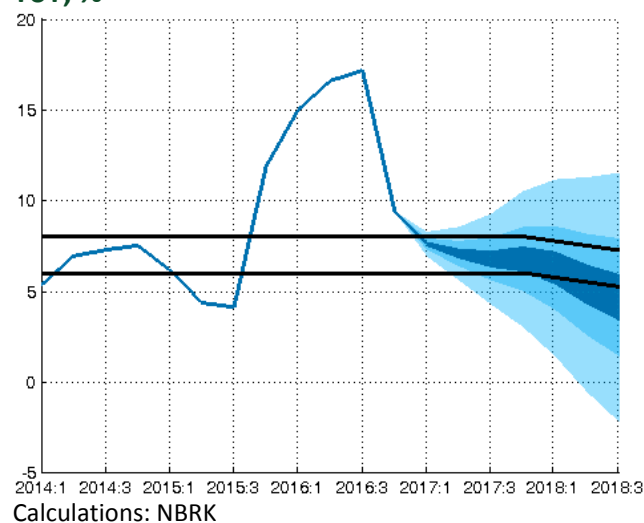
The key risk of the forecast is still the decline in oil price (Brent) throughout the entire forecast period.

There is a high degree of risk that the inflation would go beyond its target bands in 2017 and in 2018 if the pessimistic scenario of the oil price at USD 30 per barrel is realized. Under this scenario, the National Bank will be tightening its monetary policy.

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

- the growth in the state budget deficit might negatively affect inflationary processes since such growth would be occurring against a recovering phase of the business cycle;
- the scenario which assumes an oil price (Brent) at USD 40 per barrel in the medium term. The results of this scenario differ from the results of the previous forecasting round, given that because of the recovering economic

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





growth there is a high probability of the inflation going above the target band boundaries in the fourth quarter 2017, also due to a possible increase in prices of cereals in the short term;

- the rates of growth in real wages exceed the growth in labor productivity, both economy-wide and in certain sectors of the economy. It is worth mentioning the existence of such trend in the sectors of trade, information and communication based on performance for 9 months of 2016;

- 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;

- underestimation of impact by the monetary policy on the real economy and persistently high market rates may lead to a more sizable pressure on the domestic demand and, as a consequence, to a lower inflation, which is true in the opposite case;

- persisting inertia of expectations about the future inflation among the population may become a trigger for an immediate price growth, thus translating into the increased inflationary pressure;

- non-planned increase in regulated prices;

- a more rapid closure of the output gap and, respectively, finalization of the disinflation effect would entail a transition of the economic cycle phase to the pro-inflation path, thus causing the growth of risks on the part of the demand-pull inflation;

- 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.

## 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