

**National Bank
of the Republic of Kazakhstan**

**Inflation Report
Q3 2006**

Contents

Contents

Basic terms and concepts

List of figures, tables, and boxes

1. Inflationary processes

- 1.1. Consumer prices
- 1.2. Core inflation
- 1.3. Prices in the real sector of the economy
 - 1.3.1. Prices in industry
 - 1.3.2. Prices in agriculture
 - 1.3.3. Enterprise monitoring
- 1.4. Inflationary factors

2. Fiscal policy

3. Monetary policy

- 3.1. Money supply
 - 3.1.1. Base money
 - 3.1.2. Money stock
 - 3.1.3. Credits to the economy
- 3.2. Monetary policy instruments and operations
 - 3.2.1. Minimum reserve requirements
 - 3.2.2. Attraction of deposits
 - 3.2.3. Issuing of short-term notes
 - 3.2.4. Provision of loans
 - 3.2.5. Exchange rate
 - 3.2.6. Rediscounting of bills

4. Inflation forecast

- 4.1. Estimated inflation forecast for Q3 2006
- 4.2. Inflation forecast for Q4 2006
- 4.3. Inflation forecast for 2007
 - 4.3.1. Inflation forecast for Q1 2007

Basic terms and concepts

In section 1. Inflationary processes

Inflation in the Republic of Kazakhstan is calculated based on a consumer price index (CPI) that characterizes the change in the overall level of prices for goods and services acquired by the population for personal consumption in the cities of Astana and Almaty, all the oblast centers, and a sample set of cities in rayon centers. The consumer basket for calculating inflation reflects the structure of household expenditures and comprises 508 goods and services making up the largest proportion in the population's consumption.

Core inflation consists of inflation excluding short-term irregular price changes influenced by certain factors of an administrative, one-off, or seasonal nature.

Since 2004 the Agency of Statistics of the Republic of Kazakhstan has been calculating core inflation using five different methodologies:

- inflation excluding price increases for vegetables, fruits, gasoline, and coal (variant 1);
- inflation excluding price increases for vegetables, fruits, regulated services, and energy resources (variant 2);
- excluding the five maximum and five minimum price increases (variant 3);
- trimmed mean (variant 4); and
- median CPI (variant 5).

In its implementation of monetary policy the National Bank is oriented toward two basic indicators for core inflation, calculated according to variants 1 and 3.

In the framework of the **Enterprise monitoring** carried out by the National Bank since 2002, the inflationary expectations of enterprises of the real sector are surveyed. This survey covers qualitative assessments of managers of the surveyed enterprises (“will rise,” “will fall,” and “will remain unchanged”) with regard to production activities of the enterprises, including demand for and prices of finished output and for raw and other materials used in production for the preceding and the upcoming quarters.

The diffusion index is presented as the number of “will rise” responses and half of the “unchanged” responses. This index represents a summary indicator characterizing the dynamics of change in the indicator being examined. An index figure above 50 signifies a positive change in the indicator, and a figure lower than 50 represents a negative change.

In section 2. Fiscal policy

Budget receipts include revenue (tax receipts, nontax receipts, and receipts from the sale of fixed capital), the repayment of budget credits, and receipts from the sale of financial assets of the state.

Budget expenditures comprise expenses (current and capital), budget credits, and acquisition of financial assets.

In section 3. Monetary policy

Base money (reserve money) includes cash released into circulation by the National Bank excluding cash in cash departments of the National Bank (cash outside the National Bank), transferable and other deposits of second-tier banks, and transferable deposits of nonbank financial and current accounts of state and nonstate nonfinancial institutions in tenge with the National Bank.

Narrow base money represents base money excluding other deposits of second-tier banks with the National Bank.

The money stock is determined based on consolidation of accounts of the balance sheets of the National Bank and second-tier banks. It consists of cash in circulation and transferable and other deposits of resident legal entities and resident households in the domestic and foreign currency.

Transferable deposits are all deposits that: 1) can at any moment be turned into money at face value without penalties or restrictions; 2) are freely transferable using a check, bill of exchange, or draft; 3) are widely used for making payments. Transferable deposits are part of the narrow money stock.

Other deposits pertain, for the most part, to savings and time deposits that may be withdrawn only at the expiration of a defined time period or are subject to various restrictions that make them less convenient for use in common commercial operations and generally are subject to requirements set on savings mechanisms. In addition, other deposits also include nontransferable deposits denominated in foreign currency.

List of figures, tables, and boxes

Figures

- Figure 1. **Dynamics of inflation and its components, as a percentage of the previous period**
- Figure 2. **Dynamics of inflation and its components, as a percentage of the same month in the previous year**
- Figure 3. **Inflation and core inflation, as a percentage of the previous period**
- Figure 4. **Inflation and core inflation, percentage in annual terms**
- Figure 5. **Diffusion indices for changes in demand and prices**
- Figure 6. **State budget tax receipts**
- Figure 7. **State budget expenditures**
- Figure 8. **Execution of the state budget**
- Figure 9. **Dynamics of monetary aggregates**
- Figure 10. **Dynamics of the money multiplier**
- Figure 11. **Dynamics of credits to the economy and interest rates on them**
- Figure 12. **Dynamics of credits to legal entities**
- Figure 13. **Dynamics of credits to the population**
- Figure 14. **Limits of the National Bank's rate corridor**
- Figure 15. **Balances on correspondent accounts of banks with the National Bank**
- Figure 16. **Balance of National Bank operations on the domestic market**
- Figure 17. **Achievement of minimum reserve requirement norms**
- Figure 18. **Volume and interest rates for deposits attracted by the National Bank**
- Figure 19. **Volume of unpaid liabilities of the National Bank for deposits attracted from second-tier banks**
- Figure 20. **Volume of placement of short-term notes and their yield**
- Figure 21. **Short-term notes in circulation**
- Figure 22. **Dynamics of the nominal exchange rate of the tenge against the U.S. dollar**
- Figure 23. **Dynamics of the official tenge exchange rate against the euro and the Russian ruble**
- Figure 24. **Volume of trading on the domestic currency market, billions of U.S. dollars**
- Figure 25. **Indices of real exchange rates of the tenge**
- Figure 26. **Inflation, actual and forecast in 2006**

Tables

- Table 1. **Dynamics of changes in National Bank assets and liabilities**
- Table 2. **Dynamics of money stock changes**
- Table 3. **Balance of cash disbursements and receipts through banks' cash departments**
- Table 4. **Dynamics of changes in resident deposits**

Boxes

- Box 1. **Change in the mechanism for the operation of the Republic of Kazakhstan National Fund**
- Box 2. **Changes made to the mechanism for generating and meeting minimum reserve requirements**

Box 3. Changes in policy that influenced the increase in demand for foreign exchange on the domestic market

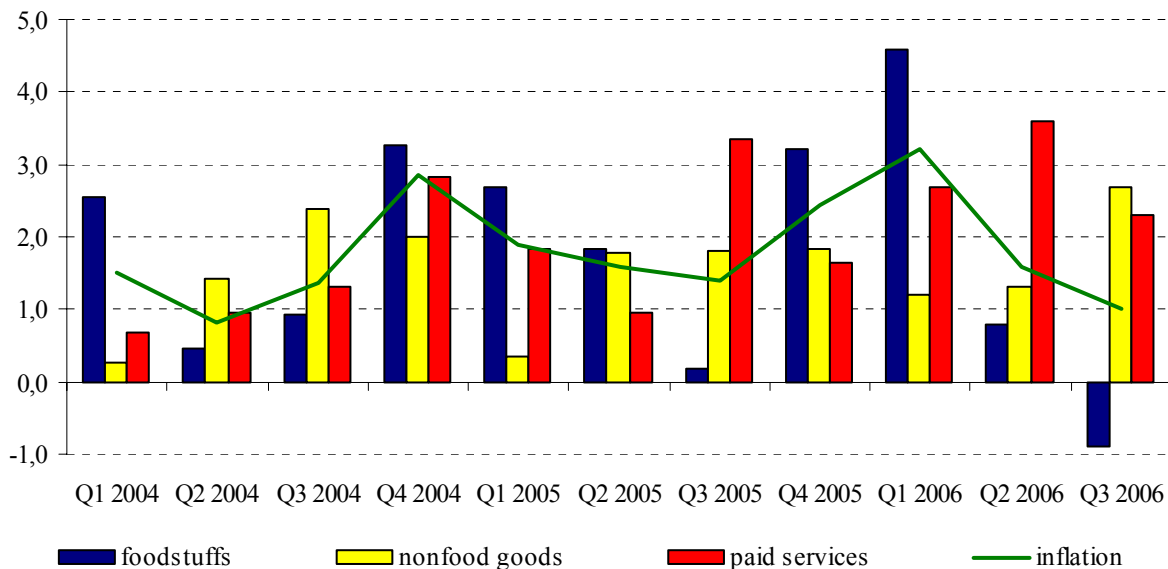
1. Inflationary processes

1.1. Consumer prices

The trend of slowing growth of prices on the consumer market continued in Q3 2006. The growth of consumer prices was lower both by comparison with the previous quarter and by comparison with the same period last year. In July–September 2006 the inflation rate was 1.0 percent.

Within the structure of consumer prices, nonfood goods and paid services increased in price by 2.7 percent and 2.3 percent respectively. For the first time in the last three years, there was a quarterly decline of 0.9 percent in prices for foodstuffs (Figure 1).

Figure 1
Dynamics of inflation and its components
(as a percentage of the previous period)



Source: the Agency of Statistics of the Republic of Kazakhstan

Consumer prices in Q3 2006 were affected to a great degree by the situation on the fuel and lubricant materials market, certain services for the population, and also a seasonal factor.

In Q3 2006 the price for gasoline increased by 22.7 percent, services of educational institutions—by 10.2 percent, and transport services—by 5.2 percent. These three groups alone contributed slightly more than 0.8 percent to inflation in this period, according to National Bank estimates.

An increase in gasoline prices in Q3 is traditional, given that it has occurred over the period of several years. In July–September 2006, however, gasoline prices grew at a higher rate than in the previous two years (in Q3 in 2004–2005 the price increase did not exceed 13.0 percent).

An increase in fees for services of educational institutions in Q3 2006, especially in September, is associated with the beginning of the new school year, whereas the increased cost of transport services was partially caused by the increase in prices for fuel and lubricant materials.

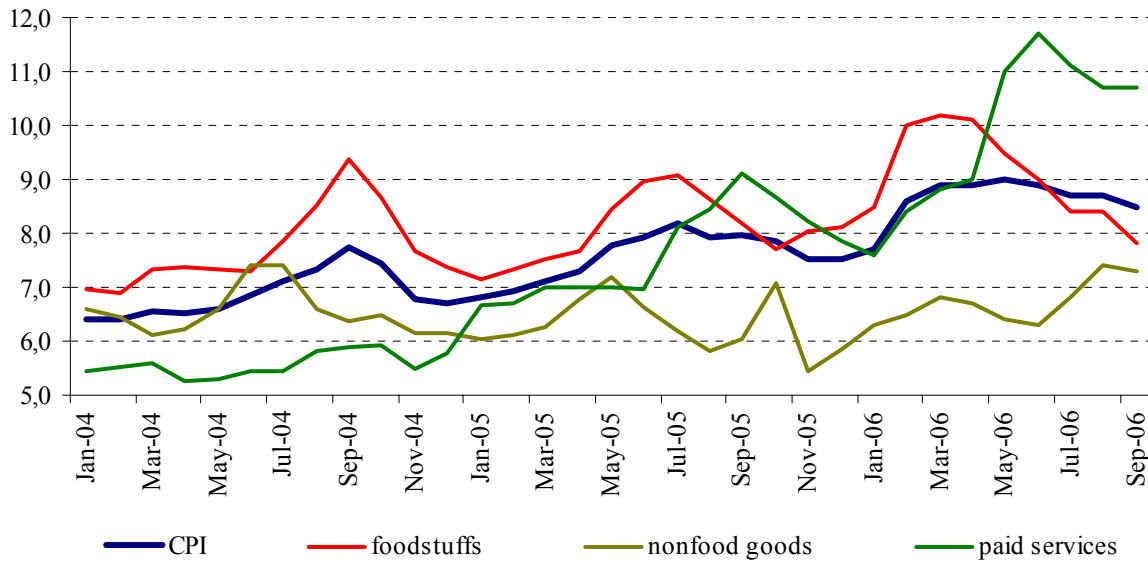
The effect of the seasonal factor contributed to a decline in prices for fruits and vegetables (by 10.3 percent), which slowed down inflation by 0.5 percent according to National Bank estimates.

During the first 9 months of 2006 (September 2006 against December 2005) inflation comprised 5.9 percent compared to 5.0 percent for the same period in 2005.

Annual inflation, which reached a maximum for the last five years in May 2006 (9.0 percent), demonstrated a declining trend in Q3: at the end of September 2006 it was at 8.5 percent. For the year, foodstuffs increased in price by 7.8 percent, nonfood goods—by 7.3 percent, and paid services—by 10.7 percent (Figure 2). Expressed annually, sugar, fruits and vegetables, gasoline, transport services, and services of educational institutions demonstrated the greatest increase in prices.

Figure 2

**Dynamics of inflation and its components
(as a percentage of the same month in the previous year)**

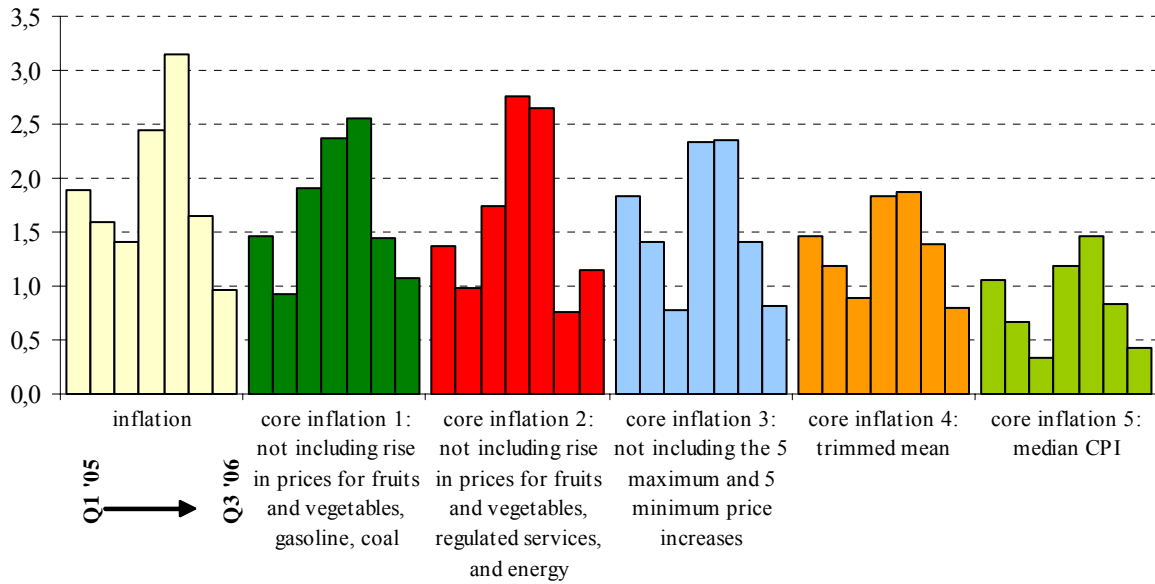


Source: the Agency of Statistics of the Republic of Kazakhstan

1.2. Core inflation

In Q3 2006 the dynamics of core inflation trended in different directions. Core inflation calculated according to variants 1, 2, and 4 declined by comparison with indicators for the same period of the previous year; according to variant 3 it remained unchanged, and according to variant 4 it increased (Figure 3).

Figure 3
Inflation and core inflation
 (as a percentage of the previous period)



Source: the Agency of Statistics of the Republic of Kazakhstan

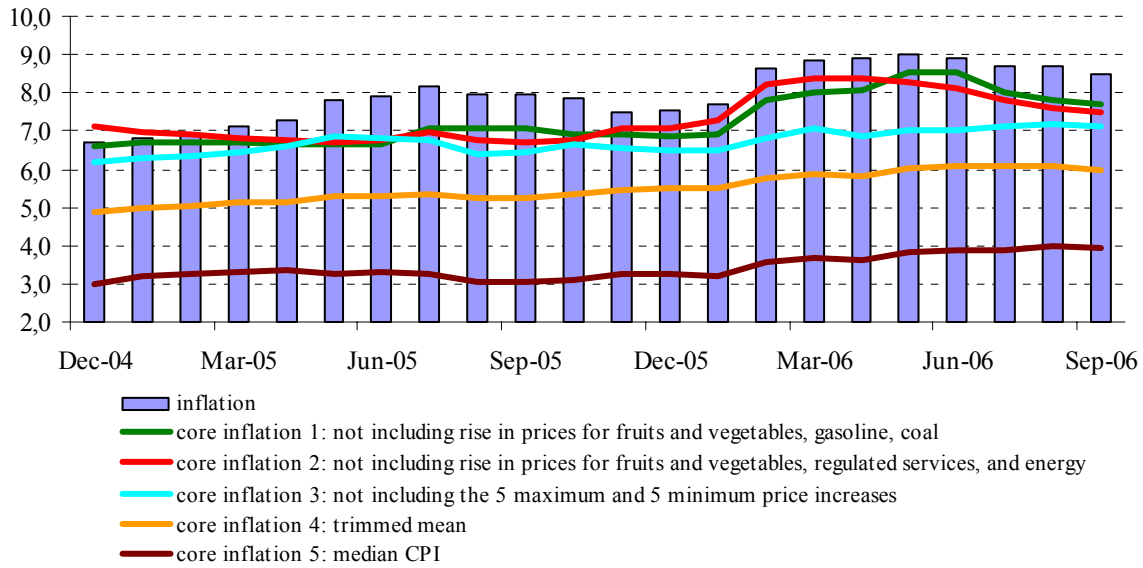
In July–September 2006 overall inflation was at a lower level by comparison with the indicators for core inflation according to the first and second methodologies. This situation was caused by a drop in prices for fruits and vegetables over the entire period.

In Q3 2006 there was a drop in prices for fruits and vegetables, eggs, and sugar and also a significant increase in prices for gasoline, transport services, and education services. Given that these components of the consumer basket are excluded from calculation of core inflation under variants 3, 4, and 5, their level was lower in July–September 2006 by comparison with the overall inflation indicator.

In the first six months of 2006 there was a clear trend toward an increase in overall inflationary pressure in the economy, as demonstrated by the increase in the core inflation indicator. In Q3 2006 inflationary processes stabilized, and there was a slight decline in inflationary potential.

Thus, the core inflation indicators in annual terms for all methodologies in September 2006 remained at a level not exceeding the overall inflation indicator. In Q3 there was a decline in the level of core inflation (Figure 4). This is demonstrated by the decline in the core inflation level as calculated according to variants 1, 2, and 4.

Figure 4
Inflation and core inflation
(percentage in annual terms)



Source: the Agency of Statistics of the Republic of Kazakhstan

1.3. Prices in the real sector of the economy

1.3.1. Price in industry

According to data of the Republic of Kazakhstan Statistics Agency, in Q3 2006 there was a substantial slowdown in the rate of growth of prices of enterprises producing industrial output by comparison with both the previous period and the same period in 2005. Thus, the increase in prices was 2.7 percent against 8.8 percent in Q2 2006 and 12.9 percent in Q3 2005. Manufactured output was 2.8 percent more expensive, which was caused by higher costs for output of intermediate consumption by 3.1 percent and for consumer goods—by 0.6 percent, with a decline in prices for the means of production by 0.4 percent. Services of an industrial nature of enterprises producing industrial output increased in cost by 1.1 percent.

In July–September 2006 prices of enterprises of the mining industry increased by 2.7 percent (in Q3 2005—by 21.1 percent). One of the causes for a decline in the growth of producer prices was a decline in prices for energy and other raw materials products. Thus, the increase in prices for extraction of oil in Q3 2006 was 2.7 percent (in the same period in 2005—26.6 percent), and prices for gas condensate increased by 6.4 percent (39.4 percent), for natural gas—by 4.5 percent (0.8 percent), and for coal—by 2.1 percent (0.4 percent). Overall, in the period from July to September 2006 energy resources increased in cost by 3.0 percent.

The increase in prices in the processing industry was 2.8 percent, which was primarily influenced by the current price situation for metals: prices for rolled ferrous metals grew by 14.0 percent. Petroleum products increased in cost by 2.6 percent.

Food products produced by the Republic’s enterprises increased in price by 0.1 percent. Prices for poultry increased by 14.6 percent and for hulled and rolled products—by

1.7 percent, even as sugar decreased in price by 1.3 percent and dairy products—by 0.2 percent, and prices for tea remained unchanged.

Prices of domestic producers for shoes increased by 0.6 percent and for textile products—by 0.5 percent, while prices for pharmaceuticals decreased by 4.1 percent.

Prices and tariffs in the production and distribution of electricity, gas, and water in Q3 2006 increased by 0.9 percent (in Q3 2005 prices remained unchanged).

In annual terms (September 2006 against September 2005) the increase in prices in industrial production was 13.9 percent.

1.3.2. Prices in agriculture

According to data of the Republic of Kazakhstan Statistics Agency, in Q3 2006 prices for agricultural products increased by 0.6 percent (in the same period in 2005—by 0.5 percent). Price dynamics were influenced to a great degree by a 1.3 percent increase in prices for livestock products. Crop output increased in cost by 0.2 percent.

A seasonal decline in prices for livestock products observed in Q2 (by 1.3 percent) was replaced by increasing prices in Q3 2006. The increase in prices in the livestock sector was the result of an increase in prices for beef and poultry by 2.7 percent, even though prices for eggs and milk declined by 0.5 percent and 2.6 percent respectively.

An increase in prices for crop products occurred against the backdrop of an increase in prices for vegetables—by 1.7 percent, and for grains—by 0.2 percent.

We should point out the decline in the growth of prices in agriculture in annual terms. At the end of Q3 2006 prices in agriculture in annual terms declined by 0.8 percent (in December 2005—a 0.4 percent increase).

1.3.3. Enterprise monitoring

In accordance with a survey, in Q3 2006 by comparison with the previous quarter 35.1 percent of the surveyed enterprises noted an increase in demand (37.6 percent in Q2); in addition, there was a decline in the share of enterprises noticing decreased demand for their output (from 10.3 percent to 9.8 percent). As a result, the diffusion index for change in demand for finished output of the sector for Q3 2006 was 62.6, having declined by comparison with the previous quarter. An index figure over 50 signifies that the economy is showing positive trends and expectations with respect to demand for finished output.

In Q4 2006 29.8 percent of enterprises participating in the survey anticipate an increase in demand and 11.1 percent of enterprises expect a decline in demand for finished output. As a result, the diffusion index for change in demand for finished output in Q4 2006 will continue to fall to 59.2 percent (Figure 5).

In Q3 2006 by comparison with Q2 2006 relative stability of prices for finished output was maintained. This was declared by 69.1 percent of enterprises, whereas in the preceding quarter their proportion was 67.2 percent. This increase occurred due to a decline in the share

of enterprises where prices for output increased, from 27.2 percent to 26.5 percent. The diffusion index for the change in prices for finished output increased insignificantly to 61.1.

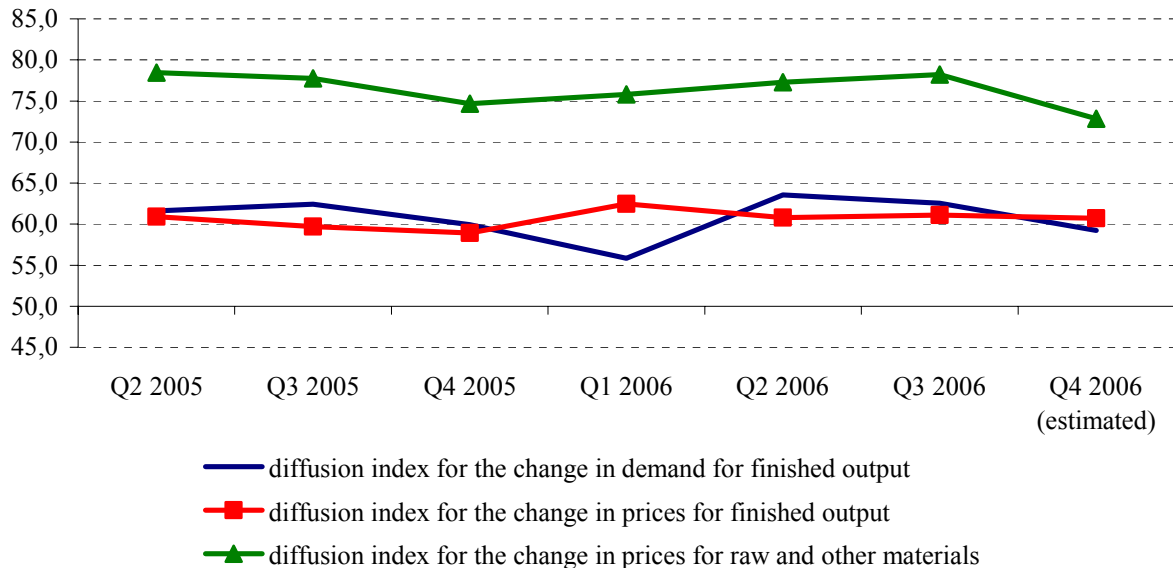
In Q4 2006 we anticipate preservation of price stability: the share of enterprises forecasting an increase in their prices fell to 23.9 percent, and only 2.2 percent of enterprises expect a decline in prices for their own finished output. The diffusion index for the change in prices for finished output will decline to 60.7 (Figure 5).

The situation deteriorated somewhat for prices for raw and other materials in Q3 2006 (by comparison with Q2). The share of enterprises noting an increase in prices increased from 58.1 percent to 59.6 percent, and 37.0 percent of the surveyed enterprises noted price stability whereas their share in the previous quarter was 38.1 percent. The share of enterprises which noted a decline in prices for raw and other materials declined from 1.9 percent to 0.9 percent. As a result the diffusion index for the change in prices for raw and other materials increased to 78.2.

The share of enterprises anticipating an increase in prices for raw and other materials in Q4 2006 will decline to 49.0 percent, and the share of enterprises anticipating a decline in prices is 1.0 percent. As a result, the diffusion index was 72.9 (Figure 5).

Thus, the expectations of surveyed enterprises with regard to further increases in prices remains negative. This is demonstrated by the relevant diffusion indices, whose values significantly exceed 50.

Figure 5
Diffusion indices for changes in demand and prices



Source: Republic of Kazakhstan National Bank

1.4. Inflationary factors

Among the main factors influencing inflation in 2006, we should emphasize the increase in aggregate demand, the inflow of foreign currency, a substantial increase in wages,

an increase in budgetary expenditures, an increase in production costs, and the low level of competition at certain markets of goods and services.

An increase in aggregate demand, associated with an increase in income of the population, business units, and also the state, is expressed in the continuing boom in consumption, the increase in demand for investments and credit resources, and the increase in budgetary expenditures.

In Q3 2006 by comparison with the same period in 2005, income of the population in real terms increased by 8.1 percent, and since the beginning of the year—by 11.9 percent. As a result the increase in volumes of retail turnover in July–September 2006 by comparison with the same period in 2005 was 14 percent.

The increase in volumes of investments in fixed capital in Q3 2006 by comparison with Q3 2005 was 12.6 percent.

In January–September 2006 the largest investments went toward extraction of crude oil and natural gas—35 percent of the total volume of investments in fixed capital, toward real estate transactions—21 percent, and toward development of transport and communications—14.5 percent.

The technological structure of investments in fixed capital remains practically unchanged. The largest portion is represented by investments in buildings and structures—47.2 percent during January–September 2006 (an increase of 0.7 percentage points by comparison with the same period in 2005). The proportion of investments in the asset portion of capital stocks declined somewhat (35.5 percent against 35.9 percent). This situation will to a certain degree restrain the growth of labor productivity and ultimately contribute to the accumulation of inflationary potential in the economy.

In addition, investments in fixed capital during this period were financed to a great degree from enterprises' own resources—56.5 percent of the overall volume (in January–September 2005—57.6 percent). The proportion of borrowed resources increased noticeably: from 4.9 percent in January–September 2005 to 8.1 percent in January–September 2006.

An increase in consumer demand of the population and the share of borrowed resources in investment demand of enterprises is underpinned by increased access to credit resources. The volume of credits to the economy in Q3 2006 increased by 22.8 percent, including for nonbank legal entities—by 18.4 percent, and for individuals—by 32.9 percent (see 3.1.3. Credits to the economy).

In Q3 2006 receipts and expenditures of the state budget were at a low level—17.4 percent and 18.9 percent of GDP, which is the minimum quarterly level since 2003. The decline in indicators for budget execution against the background of significant growth of the economy is explained by the change effective July 1, 2006 of the system for the operation of the National Fund of the Republic of Kazakhstan (see 2. Fiscal policy).

Nonetheless, during the first 9 months of 2006 the 24.2 percent increase in state budget receipts by comparison with indicators for the same period in 2005 provided for a 36.6 percent increase in expenditures, which is greater than the increase in nominal GDP (34.9 percent).

The rate of aggregate supply, as indicated by real GDP growth, somewhat outpaced the expansion of aggregate demand in the reference period. During Q3 2006 by comparison with the same period in 2005 real GDP growth is estimated at 12.6 percent. Nonetheless, during the first 9 months of 2006 real GDP growth was 10.6 percent by comparison with the same period in 2005, which is somewhat lower than the rate of expansion of the components of aggregate demand.

The inflow of foreign currency is the result of high world oil prices as well as borrowing operations of banks. In Q3 2006 there was an 8.9 percent decline in world oil prices for Brent oil; nonetheless, for the first 9 months of 2006 prices rose by 10.7 percent (according to data from the International Monetary Fund). Net liabilities of second-tier banks to nonresidents during Q3 2006 increased by 20.8 percent, and for the first 9 months of 2006 as a whole—by a factor of 2.0.

As a result of the substantial inflow of foreign currency we are observing an expansion of monetary aggregates. During Q3 2006 base money expanded by 13.0 percent and the money stock expanded by 12.9 percent (see 3.1. Money supply).

An increase in wages is leading to increased inflationary pressure on the economy in the event that it is not supported by a corresponding or greater increase in labor productivity. This situation has been observed in the Republic of Kazakhstan since the beginning of 2004. During the first 9 months of 2006 by comparison with the same period in 2005 the increase in real wages was 11.8 percent whereas productivity increased by 8.3 percent.

However in Q3 2006, as opposed to preceding quarters, the increase in labor productivity outpaced the increase in real wages. Thus, in Q3 2006 the rate of growth of labor productivity against the same period of the preceding year was 10.5 percent, while real wages grew by 7.8 percent.

Thus, the action of inflationary factors in Q3 2006 substantially weakened by comparison with previous quarters. As a result, these trends have led to a slowdown of inflationary processes, which has resulted in the lowest level of quarterly inflation in the last two years.

2. Fiscal policy

According to Republic of Kazakhstan Ministry of Finance data, state budget receipts in Q3 2006 totaled T 470.1 billion or 17.4 percent of GDP. Compared to the indicators for the same period of the previous year, this marked a decrease of 11.1 percent, and to the indicators for the previous quarter—by 32.5 percent.

The main decline was associated with a drop in tax receipts, including for corporate income tax and receipts for use of natural and other resources. The cause for this is the change effective July 1, 2006 in the mechanism for the operation of the Republic of Kazakhstan National Fund (Box 1).

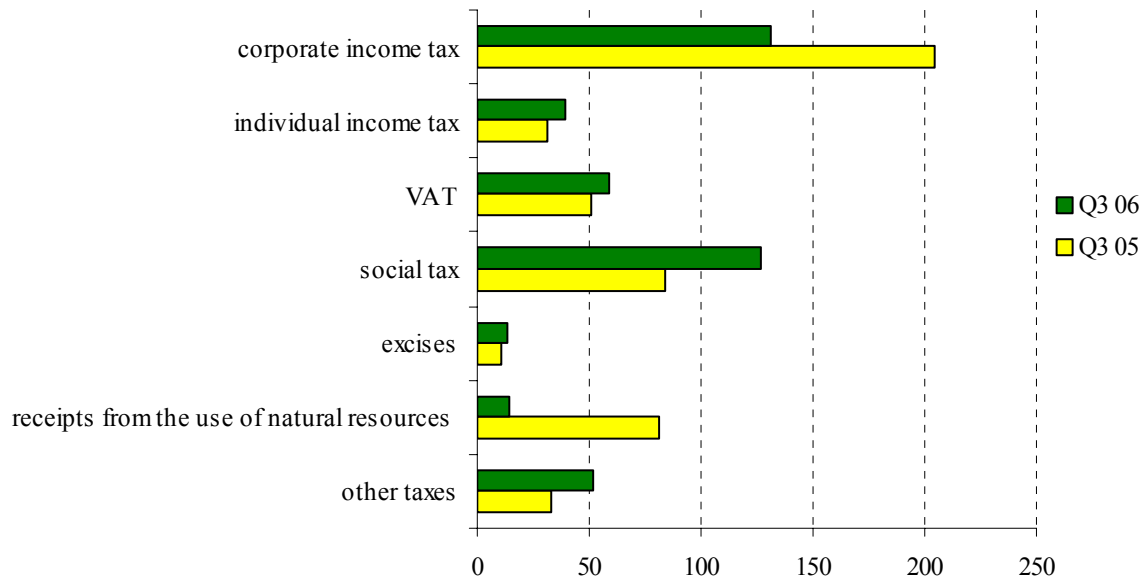
As estimated by the National Bank, in Q3 2006 by comparison with Q3 of the previous year state budget receipts in terms comparable with 2005, e.g. incorporating receipts credited to the National Fund, increased by 29.1 percent.

In Q3 2006 T 212.8 billion were credited to the National Fund in receipts from direct taxes of enterprises of the oil sector.

Within the structure of tax receipts in the reference period, receipts for other types of taxes increased by comparison with Q3 2005, which is associated with an increase in production and income (Figure 6).

Figure 6

State budget tax receipts, billions of tenge



Source: Republic of Kazakhstan Ministry of Finance

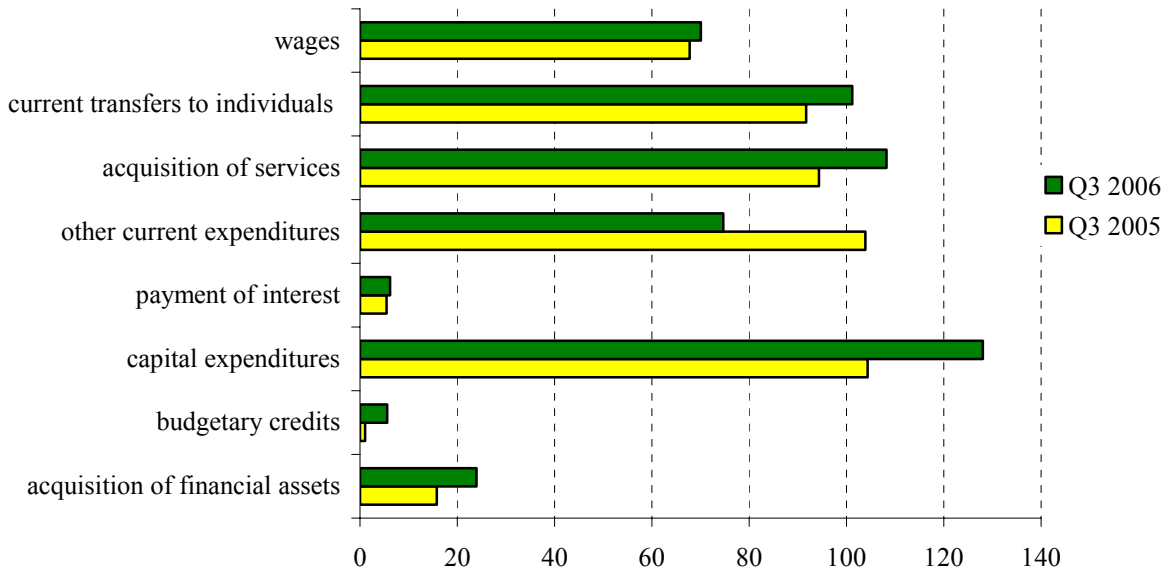
Other types of state budget receipts representing a small proportion in Q3 2006 (7.4 percent of receipts) increased slightly in the reference period by comparison with the same quarter of the previous year—by a total of 4.4 percent. Receipts from the sale of fixed capital increased by a factor of 2.3, whereas nontax receipts declined by 23.7 percent, receipts from

repayment of budgetary credits—by 31.0 percent, and receipts from the sale of financial assets of the state in Q3 2006 comprised only 2.9 percent of the Q3 2005 volume.

In Q3 2006 state budget expenditures comprised T 512.2 billion or 18.9 percent of GDP (Figure 7). By comparison with the indicators for the same period in 2005, there was an increase of 7.0 percent; but by comparison with indicators for the previous quarter, they fell by 27.4 percent.

Figure 7

State budget expenditures, billions of tenge



Source: Republic of Kazakhstan Ministry of Finance

This decline is associated with the change in the mechanism for operation of the Republic of Kazakhstan National Fund (Box 1). As a result, current transfers were not shifted from the state budget to the National Fund in Q3 2006.

In Q3 2006 the guaranteed transfer from the National Fund to the budget did not take place.

According to the National Bank's estimate, in Q3 2006 by comparison with Q3 of the previous year state budget expenditures in terms comparable to 2005, e.g. incorporating transfers to the National Fund, increased by 51.5 percent.

Current state budget expenditures were financed in the amount of T 354.2 billion. By comparison with indicators for the same period in the previous year, they declined by 1.0 percent.

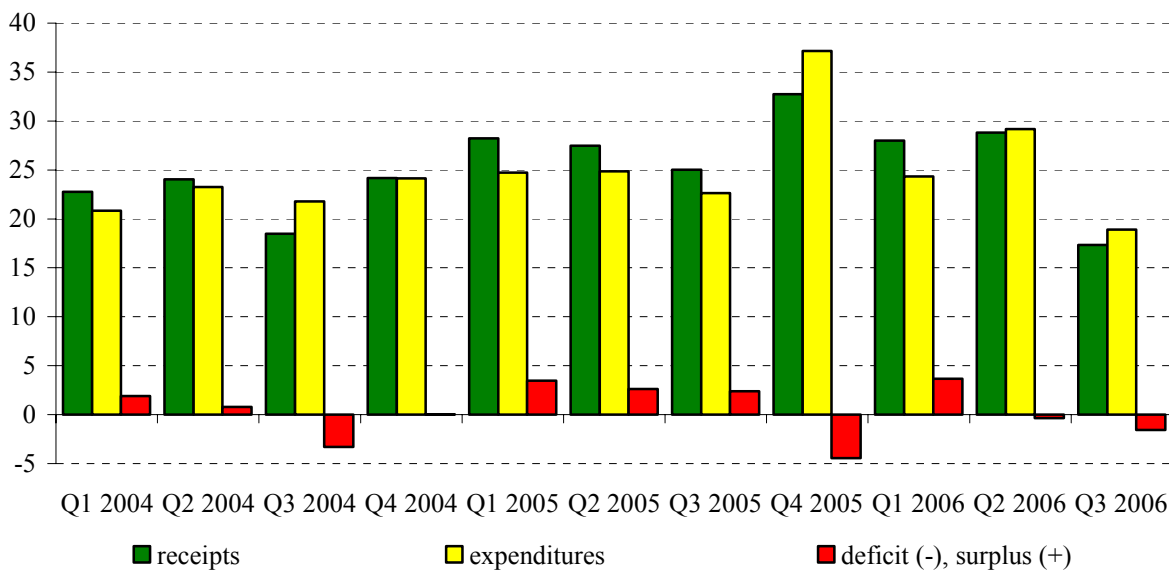
Within the makeup of current expenditures of the state budget, expenditures on the acquisition of goods fell whereas all other types of current expenditures increased, including for wages, for the acquisition of services, current transfers excluding transfers to the National Fund, and for payment of interest on loans.

Capital expenditures of the state budget in Q3 2006 increased by 22.7 percent by comparison with the same period in 2005, which was mainly associated with an increase in expenditures on financing construction of buildings, structures, and highways.

Volumes of budgetary credits in Q3 2006 by comparison with the same period in 2005 increased by a factor of 5.3, and expenditures on the acquisition of financial assets—by 51.7 percent.

In Q3 2006 the state budget had a deficit of T 42.1 billion or 1.6 percent of GDP, whereas in the same period in 2005 there was a surplus in the amount of T 50.3 billion or 2.45 percent of GDP (Figure 8).

Figure 8
Execution of the state budget, as a percentage of GDP



Source: Republic of Kazakhstan Ministry of Finance

Loans in the amount of T 71.3 billion were attracted to finance the state budget deficit in Q3 2006; repayments on loans comprised T 18.7 billion, and as a result balances of budget resources increased by T 10.4 billion.

The deficit was financed exclusively from domestic sources in the amount of T 52.0 billion; with regard to external financing sources, repayments exceeded attraction by T 5.8 billion.

As a result government domestic debt in Q3 2006 increased by 18.0 percent to T 368.8 billion by comparison with the previous quarter, and external debt declined by 3.4 percent to US\$1.8 billion.

Box 1

Change in the mechanism for the operation of the Republic of Kazakhstan National Fund

In accordance with the system previously in operation, the sources for generation of the National Fund were:

- 1) official transfers from the republican budget, as determined by actual receipts to the republican budget from organizations of the raw materials sector in excess of their annual volumes as approved in the law on the republican budget for the corresponding fiscal year. Receipts from organizations of the raw materials sector comprised budget receipts for corporate income tax, VAT, windfall profits tax, bonuses, royalties, and the Republic of Kazakhstan's portion under production sharing for contracts concluded;
- 2) official transfers from the republican budget as determined from receipts from privatization of state property under republican ownership and pertaining to the mining and processing sectors;
- 3) official transfers from the republican budget calculated in the amount of 10 percent of amounts of republican budget receipts planned in the republican budget from organizations of the raw materials sector;
- 4) official transfers from the local budget as determined from receipts from the sale of land plots for agricultural use;
- 5) investment income from management of the National Fund; and
- 6) other receipts and income not prohibited by legislation of the Republic of Kazakhstan.

Thus, the receipts to the National Fund cited in items 1) - 4) were reflected as both receipts and expenditures of the state budget.

The National Fund, in accordance with the previous system, could make expenditures:

- 1) to compensate losses of the republican budget, determined as the difference between approved and actual amount of receipts to the republican budget from organizations of the raw materials sector for the current fiscal year as a whole;
- 2) in the form of earmarked transfers moved from the National Fund to the republican budget for purposes defined by the President of the Republic of Kazakhstan;
- 3) to cover expenditures associated with management of the National Fund and the conduct of an annual audit.

In accordance with the new system, which went into effect on July 1, 2006, the sources for generation of the National Fund are:

- 1) budget receipts directed to the National Fund consisting of:

- direct taxes from enterprises of the oil sector, comprising corporate income tax, windfall profits tax, royalties, bonuses, the portion under production sharing, and rent tax on exported crude oil and gas condensate;

- receipts from the privatization of state property under republican ownership and pertaining to the mining and processing sectors; and

- receipts from the sale of land plots for agricultural use;

2) investment income from management of the National Fund; and

3) other receipts and income not prohibited by legislation of the Republic of Kazakhstan.

In addition, these types of receipts are credited directly to the National Fund without being reflected either in the revenue or expenditure portions of the state budget.

The National Fund makes expenditures on the following:

1) in the form of a guaranteed transfer from the National Fund to the republican budget for implementation of budgetary development programs (subprograms);

2) in the form of earmarked transfers that are moved from the National Fund to the republican budget for purposes defined by the President of the Republic of Kazakhstan;

3) to cover expenditures associated with management of the National Fund and the conduct of an annual audit.

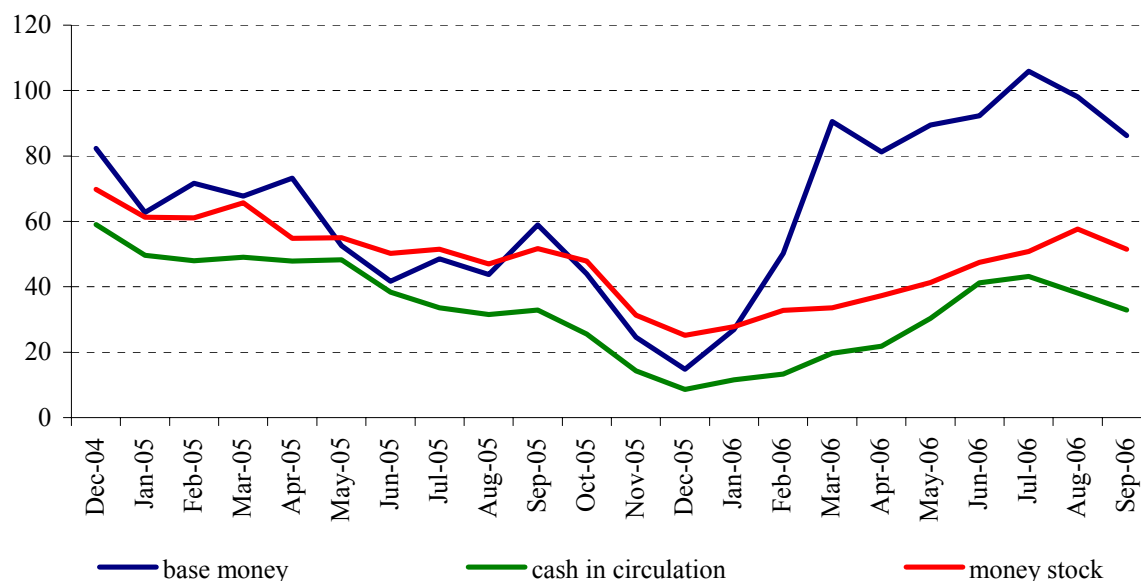
3. Monetary policy

3.1. Money supply

The dynamics of indicators for money supply over Q3 2006 demonstrated high annualized growth indicators. Nonetheless, after significant growth in the first half of 2006, base money and cash in circulation in August and September and the money stock in September demonstrated a trend toward slowing rates of growth (Figure 9).

Figure 9

Dynamics of monetary aggregates
(as a percentage against the same month in the previous year)



Source: Republic of Kazakhstan National Bank

The slowdown in the annual rate of expansion of base money is explained by a tightening of the mechanism of minimum reserve requirements (see 3.2. Monetary policy instruments and operations), while growth of the money stock slowed as a result of the growth of liabilities of second-tier banks to nonresidents.

3.1.1. Base money

Base money at the end of September 2006 comprised T 1,196.2 billion. During Q3 2006 the expansion of base money totaled 13.0 percent (in Q3 2005—16.7 percent). Narrow base money expanded during Q3 2006 by 36.6 percent.

In September 2006 by comparison with September 2005 expansion of base money reached 86.2 percent (Table 1). This expansion resulted from the growth of net international reserves of the National Bank as a consequence of an active policy on the domestic currency market, as well as the growth of balances of second-tier banks on correspondent accounts in foreign currency.

Net domestic assets of the National Bank declined due to an increase in liabilities of banks, chiefly for short-term notes, which is explained by the tightening of the mechanism of minimum reserve requirements (see 3.2. Monetary policy instruments and operations).

Table 1

**Dynamics of changes in National Bank assets and liabilities
(as a percentage of the same period of the previous year)**

	Q4 2005	Q1 2006	Q2 2006	Q3 2006
Net international reserves	-21.5	15.8	43.3	54.0
Net domestic assets	47.0	37.8	7.2	-1.1
Net claims on government	40.2	5.9	31.2	38.4
Claims on financial institutions	58.0	53.6	-47.9	-25.6
Claims on the rest of the economy	378.0	-23.5	-62.5	-87.8
Other net domestic assets	-20.5	14.1	147.1	-31.7
Base money	14.7	90.5	92.3	86.2
Cash outside the National Bank	11.6	21.9	40.3	35.6
Transferable deposits of banks	29.3	158.3	207.7	410.2
Other deposits of banks	10.3	398.0	415.5	-40.3
Narrow base money	15.4	41.6	65.3	104.5

Source: Republic of Kazakhstan National Bank

The result of the tightening of the mechanism of minimum reserve requirements, which entailed an increase in balances on correspondent accounts of banks with the National Bank and in cash in the cash departments of banks, was an expansion of narrow base money. In addition, temporarily free money of banks held in deposits with the National Bank declined significantly.

3.1.2. Money stock

During Q3 2006 money stock expanded 12.9 percent (in Q3 2005—10.0 percent) to T 3,053.1 billion. Net external assets of the banking system declined by 61.0 percent, and domestic assets increased by 24.9 percent.

In September 2006 by comparison with September 2005 money stock growth comprised 51.5 percent as a result of a significant increase in domestic assets of the banking system while net external assets declined (Table 2).

Within the structure of net external assets of the banking system, net international reserves of the National Bank increased by 54.0 percent, while net external assets of second-tier banks declined by a factor of 3.4. The decline in external assets of banks is associated with the substantial increase in liabilities to nonresidents, especially with respect to credits attracted from them (by a factor of 2.5).

The increase in domestic assets of the banking system was the result of continued high growth of volumes of credits provided to the economy (see 3.1.3. Credits to the economy). Claims of the banking system on the government grew due to an increase in securities of the Ministry of Finance in circulation, as well as a decline in balances on accounts of the Ministry of Finance with the National Bank.

Table 2

Dynamics of money stock changes
(as a percentage of the same period of the previous year)

	Q4 2005	Q1 2006	Q2 2006	Q3 2006
Net external assets	-83.8	-45.4	-43.5	-80.1
Domestic assets	112.7	92.2	89.6	115.8
Claims on government	63.6	127.9	96.0	142.0
Claims on the economy	73.1	67.8	63.8	80.1
Other net domestic assets	-25.8	-37.4	-31.1	-43.2
Money stock	25.2	33.6	47.6	51.5
Cash in circulation	8.6	19.6	41.2	32.8
Deposits of residents	30.2	37.3	49.2	56.3

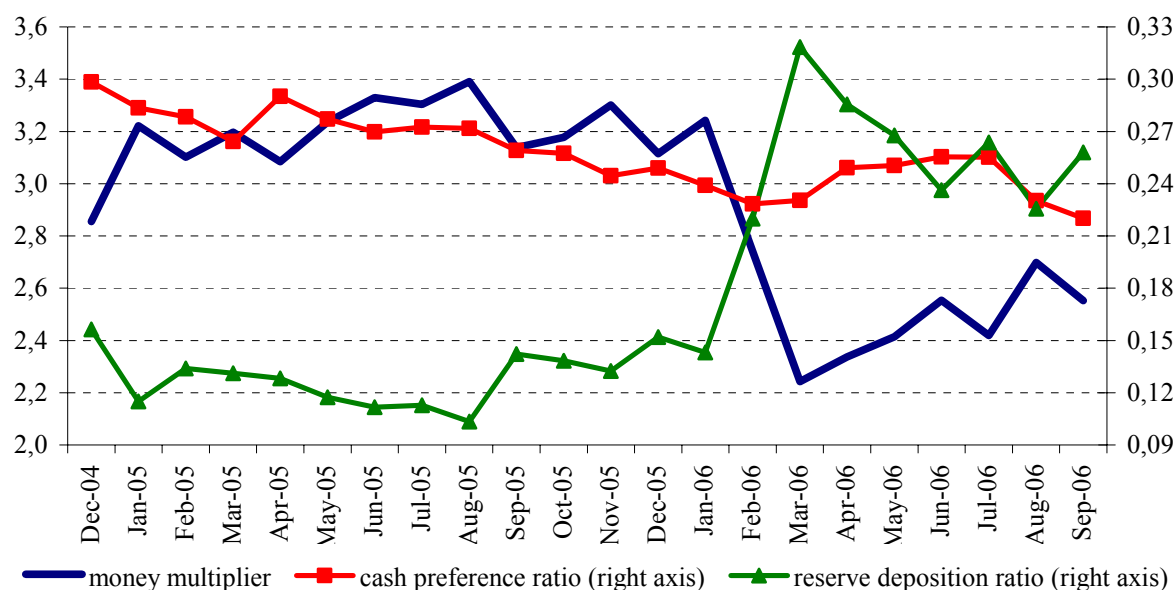
Source: Republic of Kazakhstan National Bank

An analysis of the dynamics of the main components of the money stock shows that the growth of deposits of residents in the banking system outpaced the increase in cash in circulation. As a result, according to the results for September 2006 the share of deposits of residents within the structure of the money stock increased to 82.0 percent from 79.4 percent in September 2005.

More significant rates of expansion of base money by comparison with rates of growth of the money stock caused a decline in the money multiplier from 3.14 in September 2005 to 2.55 in September 2006 (Figure 10). The decline in the multiplier was caused by significant growth in volumes of both required and excess reserves of banks in the form of balances on accounts with the National Bank, which reduces capacity of banks with respect to increasing the money supply in the economy.

Figure 10

Dynamics of the money multiplier and its components



Source: Republic of Kazakhstan National Bank

— Cash in circulation

Cash in circulation increased during Q3 2006 by 0.2 percent (in Q3 2005—6.5 percent) and comprised T 550.9 billion at the end of September. In September 2006 by comparison with September 2005 growth of cash in circulation reached 32.8 percent.

The increase in disbursements of cash tenge from the cash departments of banks for payment of wages and pensions, payment for agricultural products, disbursements against deposits and loans granted, and also for other expenditures was effectively compensated by cash receipts into banks' cash departments from transactions with foreign currency and payment for goods, work, and services (Table 3). In Q3 2006 by comparison with the previous quarter cash disbursements from banks' cash departments increased by 7.8 percent to T 1,763.5 billion, and receipts into banks' cash departments increased by 15.5 percent to T 1,721.7 billion. As a result, net disbursements from banks' cash departments was T 41.8 billion (in Q2 2006—T 144.9 billion).

Table 3

Balance of cash disbursements and receipts through banks' cash departments (as a percentage of the previous period)

	Q4 2005	Q1 2006	Q2 2006	Q3 2006
Goods, services, and work performed	4.1	-51.0	3.1	-30.7
disbursed for payment	15.6	-24.9	33.8	6.1
receipts from sales	11.3	-10.6	22.1	12.3
Wages (including cash in automatic teller machines, demand deposits, and current accounts of individuals)	19.3	-16.9	30.6	6.3
Agricultural products	87.8	-59.0	80.3	2.3
Transactions with foreign currency	-54.7	58.1	-40.6	-101.2
disbursed for purchase of foreign currency	-14.5	21.7	8.9	-10.6
receipts from sale of foreign currency	29.8	-39.1	25.6	55.2
Time deposits of individuals	- a factor of 58.5	-429.7	-35.2	120.5
disbursed from deposits	6.9	10.4	43.5	22.5
placed in deposits	13.2	34.0	41.7	-7.9
Loans to individuals and legal entities	188.5	-247.9	414.3	2.9
loans disbursed	127.9	-30.0	48.3	8.9
loans repaid	74.5	-11.3	-17.8	15.4
Pensions and benefits	-1.1	3.2	5.0	0.2
Other items	-30.5	17.4	21.0	43.0
Overall balance of cash disbursed and received	-66.9	168.3	233.3	-71.1
expenditures from banks' cash departments	16.1	-12.7	30.6	7.8
receipts going into banks' cash departments	19.6	-14.7	23.3	15.5

Source: National Bank of the Republic of Kazakhstan

The increase in disbursements of cash from banks' cash departments to pay for wages is explained by the increase in average monthly wages in the economy.

The increase in disbursements of cash against deposits of the population and the decline in receipts on them is associated with the overall decline in rates of their growth.

Operations with foreign currency had a substantial influence on volumes of cash; in Q3 2006 they were characterized by a decrease in volumes of disbursements of cash from cash departments for the purchase of foreign currency by banks and an increase in volumes of receipts of cash tenge to cash departments of banks as a result of an increase in volumes of sales of foreign currency by banks. This trend is explained by a decline in the tenge's exchange rate against the U.S. dollar (see 3.2.5. Exchange rate), given that the U.S. dollar occupies a predominant role in the structure of transactions of exchange bureaus.

— Deposits of residents

As of the end of September 2006 deposits of residents reached T 2,502.2 billion. In Q3 2006 they grew by 16.2 percent (Table 4). Deposits of legal entities increased by 17.6 percent, and of individuals—by 13.4 percent.

Table 4

Dynamics of changes in resident deposits (as a percentage of the same period of the previous year)

	Q4 2005	Q1 2006	Q2 2006	Q3 2006
Resident deposits	30.1	37.3	49.2	56.3
Transferable tenge deposits	28.6	47.9	46.1	71.2
of the population	28.2	47.6	42.5	73.5
of nonbank legal entities	30.1	50.1	69.8	57.1
Other tenge deposits	36.4	56.3	84.1	77.4
of the population	52.8	81.2	87.1	63.7
of nonbank legal entities	20.3	32.6	80.9	94.3
Transferable foreign currency deposits	91.8	5.2	-1.9	28.7
of the population	99.7	2.7	-2.5	30.7
of nonbank legal entities	58.9	24.1	1.5	16.4
Other foreign currency deposits	15.7	20.9	29.1	33.1
of the population	-2.0	13.0	45.2	36.7
of nonbank legal entities	47.4	34.3	8.5	27.3

Source: Republic of Kazakhstan National Bank

A few trends should be noted in the dynamics of deposits. First, there has been a substantial increase in the annual rate of growth of transferable deposits, while growth of other deposits, which are one of the main sources of banks' credit resources, has slowed. In all likelihood this trend in the dynamics of other deposits is associated with a seasonal factor: this period was the time for vacations, which leads to a reduction in savings in favor of current consumption.

Second, within the structure of other deposits the growth rate of deposits in foreign currency accelerated while tenge deposits showed a slowdown in their growth. This trend is explained by a decline in the exchange rate of the tenge against the U.S. dollar (see 3.2.5).

Exchange rate), which gave rise to an increase in the attractiveness of deposits in foreign currency.

3.1.3. Credits to the Economy

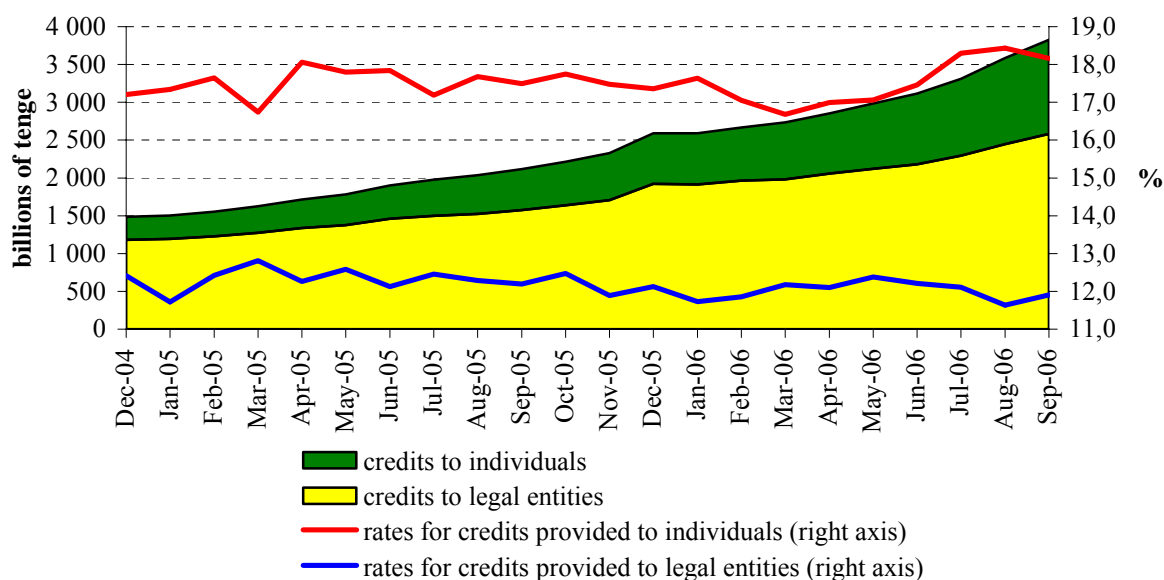
The high rates of credit expansion of second-tier banks in the economy of Kazakhstan were maintained in Q3 2006. During this period credits to the economy increased by 22.8 percent and reached T 3,825.5 billion. Credits to the population grew by 32.9 percent, and to legal entities—by 18.4 percent. Nonetheless, credits to legal entities comprised 67.5 percent of the volume of credits to the economy in September 2006 (Figure 11).

In September 2006 by comparison with September 2005 the growth of credits to the economy reached 80.6 percent.

Interest rates on issued credits are demonstrating trends in varying directions. The average-weighted rate for credits to legal entities declined in July and August and demonstrated insignificant growth in September. Nonetheless, the level of that interest rate has been fluctuating in a range of 11.6–12.8 percent over the period of the last two years (Figure 11).

The average-weighted rate for credits to individuals fell in March 2006 to its minimum value in the last 4 years (16.7 percent); in subsequent months the indicators rose. In September it declined slightly (Figure 11).

Figure 11
Dynamics of credits to the economy and interest rates on them



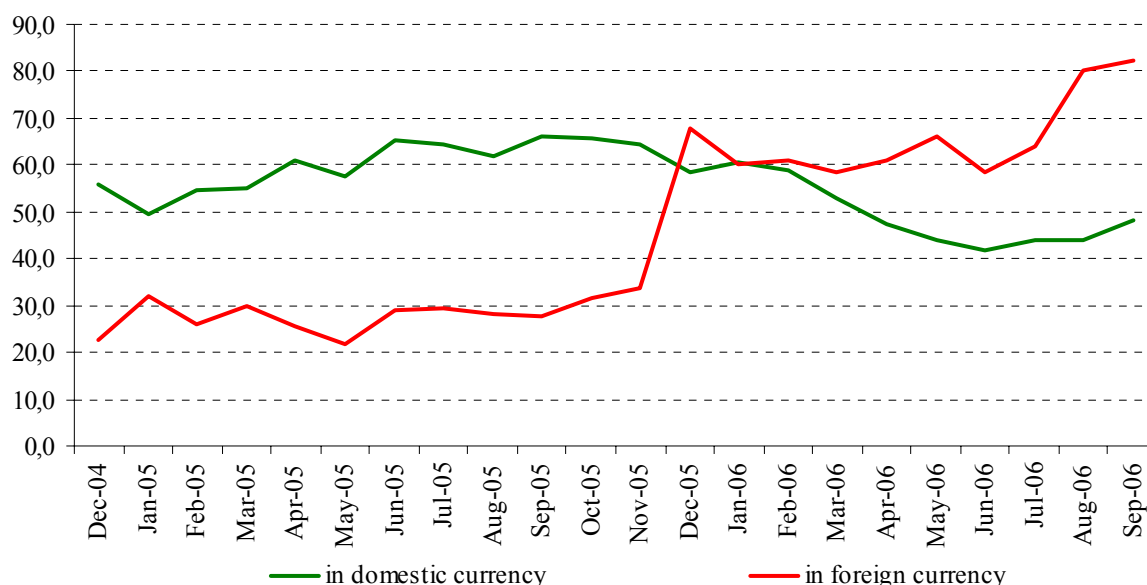
Source: Republic of Kazakhstan National Bank

— **Credits to legal entities**

In September 2006 by comparison with September 2005 credits to legal entities grew by 64.0 percent. In addition, in Q3 2006 there was a minor acceleration in the annual rate of their growth.

The trend of growth rates of credits in foreign currency outpacing growth of credits in domestic currency that has been noted since the beginning of 2006 was maintained in Q3 2006 (Figure 12).

Figure 12
Dynamics of credits to legal entities
 (as a percentage of the same period in the previous year)



Source: Republic of Kazakhstan National Bank

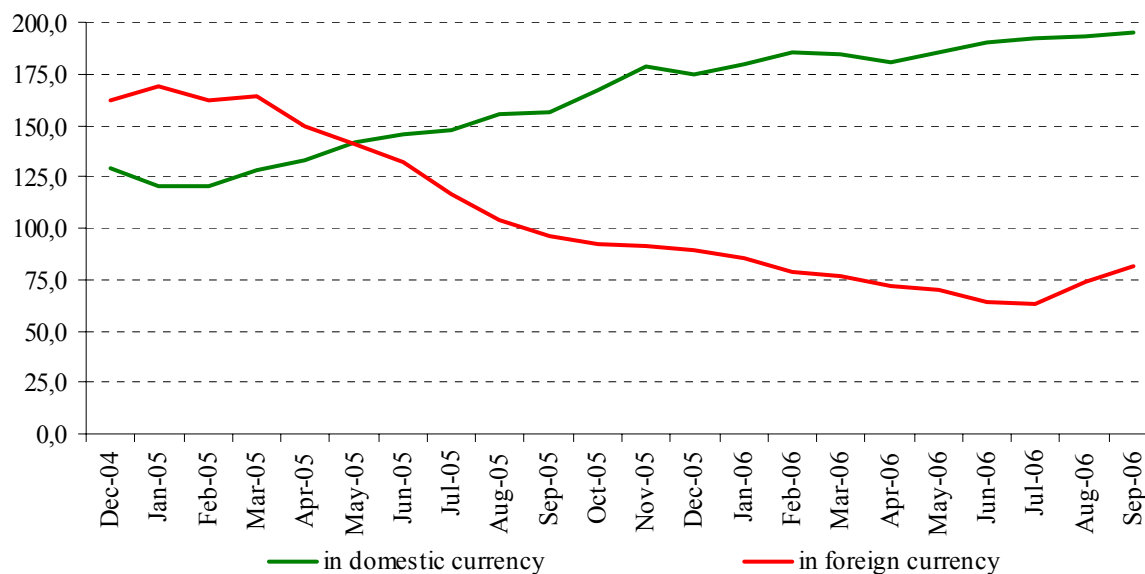
A possible cause for this trend is the expectations of borrowers that the tenge will strengthen over the medium-term, which will lead to a decline in the credit burden denominated in tenge. The proportion of medium- and long-term credits within the volume of credits to legal entities at the end of September 2006 was 64.7 percent.

Within the structure of credits to legal entities, the largest share at the end of September 2006 consisted of credits for acquisition of working capital (48.0 percent), capital stocks (14.6 percent), and new construction and reconstruction of facilities (13.7 percent).

— **Credits to the population**

The dynamics of credits to the population demonstrate trends that are the opposite of trends in the dynamics of credits to legal entities. In September 2006 by comparison with September 2005 they increased by a factor of 2.3 with the growth rate of credits in the domestic currency outpacing the growth rate of credits in foreign currency (Figure 13)

Figure 13
Dynamics of credits to the population
 (as a percentage of the same period in the previous year)



Source: Republic of Kazakhstan National Bank

These dynamics of credits to the population in all likelihood reflects the purposes for which the credits are being taken. Within the structure of credit to the population, credits for consumer goals occupied 50.7 percent in September 2006. It may be that costly consumer goods are being purchased with foreign currency whereas less costly goods are purchased with domestic currency.

The proportion of credits to the population for construction and acquisition of housing was 35.5 percent in September 2006.

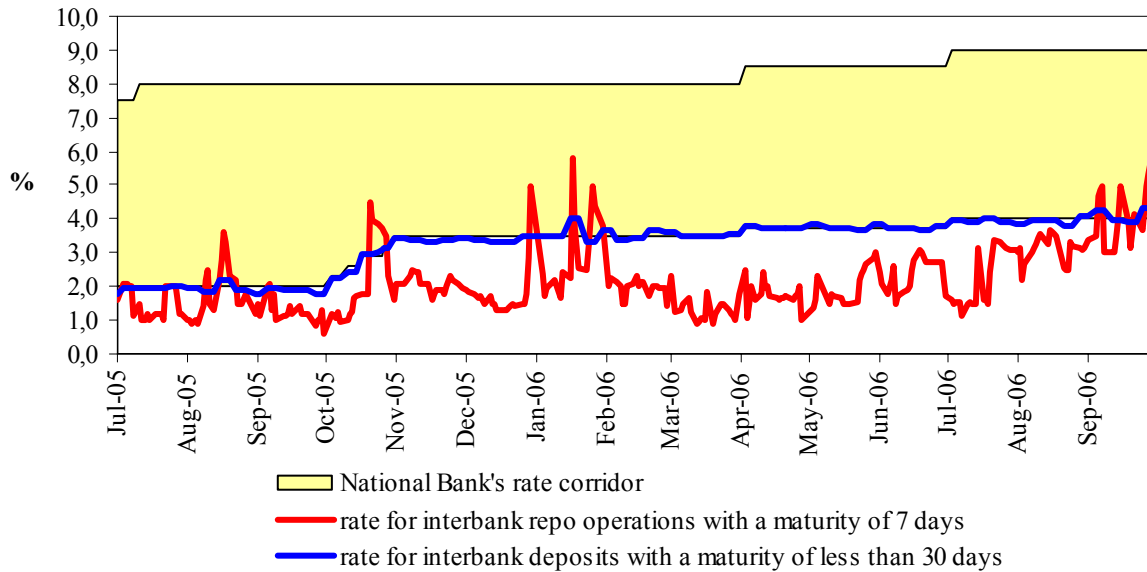
3.2. Monetary policy instruments and operations

In Q3 2006 National Bank policy was direct at a further tightening of monetary regulation measures. During this period the limits on the National Bank's rate corridor were raised, and the mechanism for calculating and meeting minimum reserve requirements was tightened.

Since July 1, 2006 the official refinancing rate (the upper limit on the National Bank's rate corridor) was raised from 8.5 percent to 9.0 percent, and the rate for deposits attracted from banks (the lower limit of the rate corridor) was raised from 3.75 percent to 4.0 percent.

The increase in National Bank rates served as one of the reasons for an increase in yields on the financial market, particularly for operations that are comparable in terms of maturity. The rate for interbank deposits with maturities less than 30 days fluctuated in the region of the lower limit of the National Bank's rate corridor. The rate for interbank repo operations with a maturity of 7 days remained below the limit of the National Bank's rate corridor up to August 2006 but demonstrated a steady increasing trend over all of Q3 2006. In September 2006 the average weighed rate for those operations was for the first time at a level that exceeds the lower limit of the National Bank's rate corridor. (Figure 14).

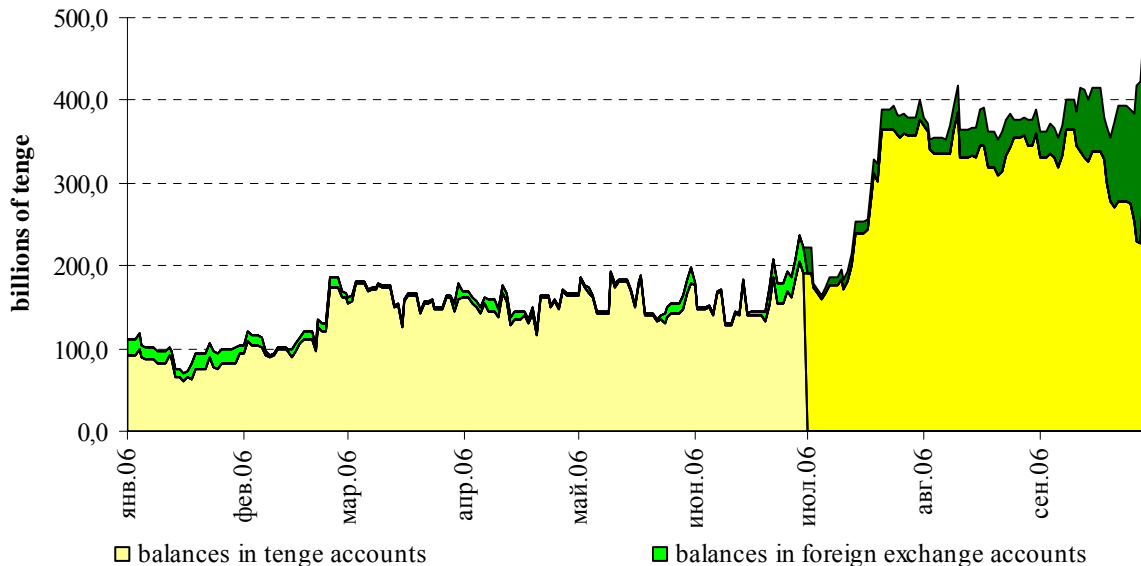
Figure 14
Limits of the National Bank's rate corridor



Source: Republic of Kazakhstan National Bank

Changes made in the mechanism for minimum reserve requirements (Box 2) resulted in a substantial increase in balances on correspondent accounts of second-tier banks with the National Bank in both the domestic and foreign currencies (Figure 15).

Figure 15
Balances on correspondent accounts of banks with the National Bank



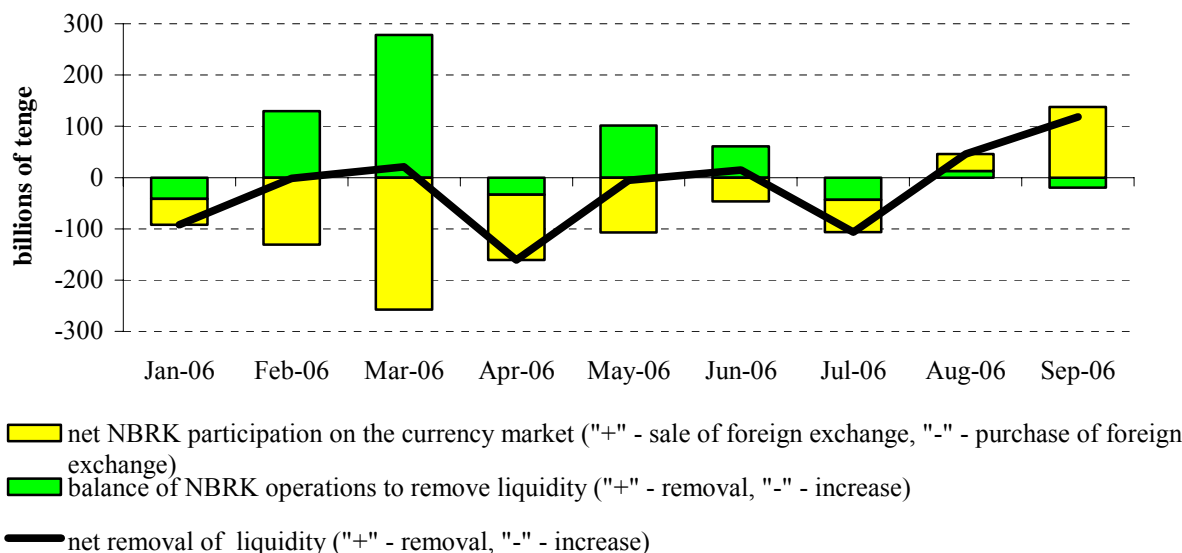
Source: Republic of Kazakhstan National Bank

In September 2006 there was a substantial increase in balances in correspondent accounts of second-tier banks with the National Bank in foreign currency with balances in tenge correspondent accounts offsetting them. On one hand, this helped banks meet minimum

reserve requirement norms; on the other hand, in an environment of a weakening tenge exchange rate against the U.S. dollar it helped compensate to some degree the income of banks lost due to the tightening of the mechanism for minimum reserve requirements.

As a consequence there was an increase in banks' demand for foreign currency, and the National Bank consequently acted on the domestic currency market as a net seller of foreign currency (see 3.2.5. Exchange rate). In addition, there was a substantial decline in demand on the part of second-tier banks for short-term notes and deposits. As a result, there was a drop in volumes of notes in circulation and balances on deposits with the National Bank (see 3.2.2. Attraction of deposits and 3.2.3. Issuing of short-term notes). Despite this, in terms of results for Q3 2006 as a whole, the balance of sterilized operations of the National Bank (the sum of changes in short-term notes in circulation and balances in deposits and correspondent accounts in the domestic and foreign currencies) was positive (Figure 16).

Figure 16
Balance of National Bank operations on the domestic market



Source: Republic of Kazakhstan National Bank

Box 2

Changes made to the mechanism for generating and meeting minimum reserve requirements

In Q1 and Q2 2006 work was done to improve methodology for calculating minimum reserve requirements. On May 27, 2006 the Board of the National Bank adopted Resolution No. 38 entitled “On Approval of Rules on Minimum Reserve Requirements” and No. 39 entitled “On Establishment of Norms for Minimum Reserve Requirements.” The changes went into effect as of July 12, 2006.

In accordance with the new Rules, the structure of a bank’s liabilities that are used for calculating minimum reserve requirements shall include the amount of the bank’s domestic liabilities and the bank’s other liabilities. A bank’s domestic liabilities are defined as the amount of liabilities to residents according to a strictly defined list regardless of their

maturity. A bank's other liabilities are calculated as the amount of the bank's liabilities to nonresidents and liabilities for debt-based securities regardless of residency designation.

When discounting reserve liabilities (both for domestic and for other liabilities), the calculation shall include the amount of the bank's liabilities with respect to principal, interest, and arrears.

Minimum reserve requirement norms shall be met via the generation by banks of reserve assets, which shall include cash tenge in the cash department and money on correspondent accounts with the National Bank in the domestic and freely convertible foreign currencies.

The bank shall place money in reserve assets in such a fashion that the average amount of the reserve assets during the period of generation of reserve assets will not be less than the average amount of the minimum reserve requirements for the period of determination of minimum reserve requirements.

The period of generation of reserve assets shall comprise 14 calendar days and shall begin from the first Thursday of the week in which a period for determination of minimum reserve requirements begins and end on the Wednesday of the week in which a period for determination of minimum reserve requirements begins.

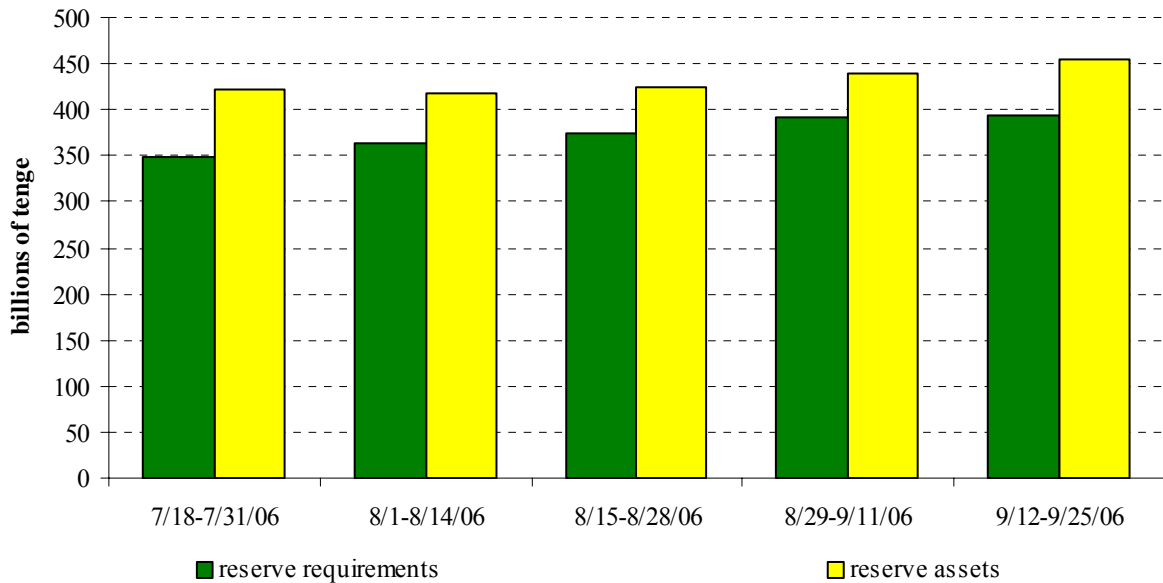
A period for determination of minimum reserve requirements shall comprise 14 calendar days and begin from the first Tuesday of the week and end with the last Wednesday of the 14-day period for determination of minimum reserve requirements.

Minimum reserve requirement norms for second-tier banks were established in the amount of 6 percent for a bank's domestic liabilities and 8 percent for a bank's other liabilities.

3.2.1. Minimum reserve requirements

In Q3 2006, following the change to the mechanism for generating and meeting minimum reserve requirements (Box 2), excess liquidity of second-tier banks was substantially reduced. As an average for the period, reserve assets exceeded the necessary volume of reserve deposition by almost 15 percent (Figure 17).

Figure 17
Achievement of minimum reserve requirement norms

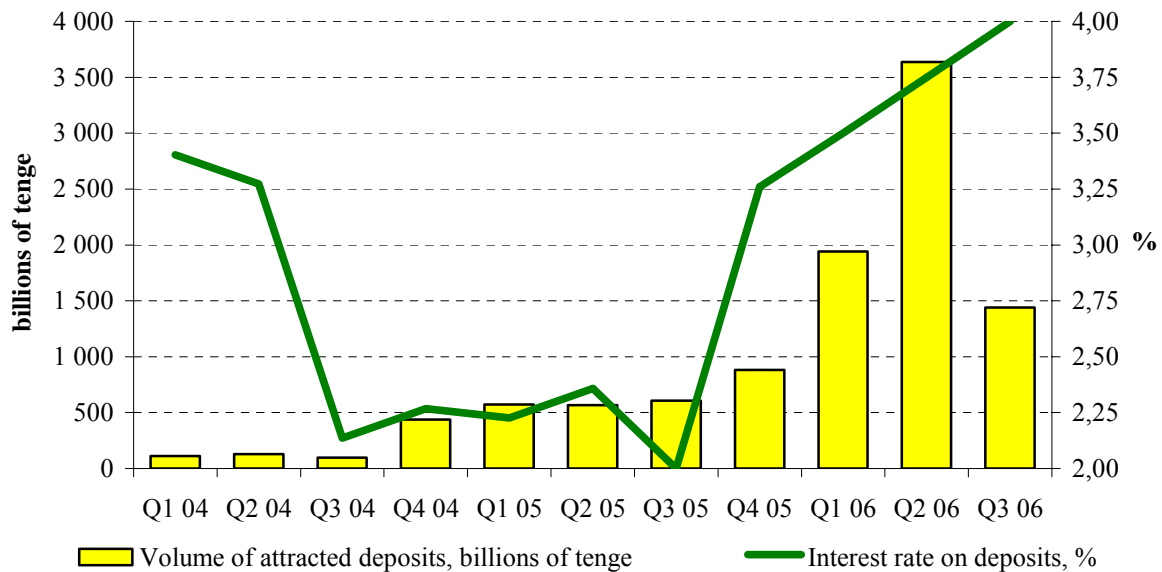


Source: Republic of Kazakhstan National Bank

3.2.2. Attraction of deposits

In Q3 2006 the National Bank attracted T 1,439.2 billion in tenge deposits from second-tier banks. By comparison with the previous quarter the volume of attracted deposits declined by a factor of 2.5. The period of attraction of deposits was 7 days. The interest rate for attracted deposits in Q3 2006 was 4.0 percent (Figure 18).

Figure 18
Volume and interest rates for deposits attracted by the National Bank

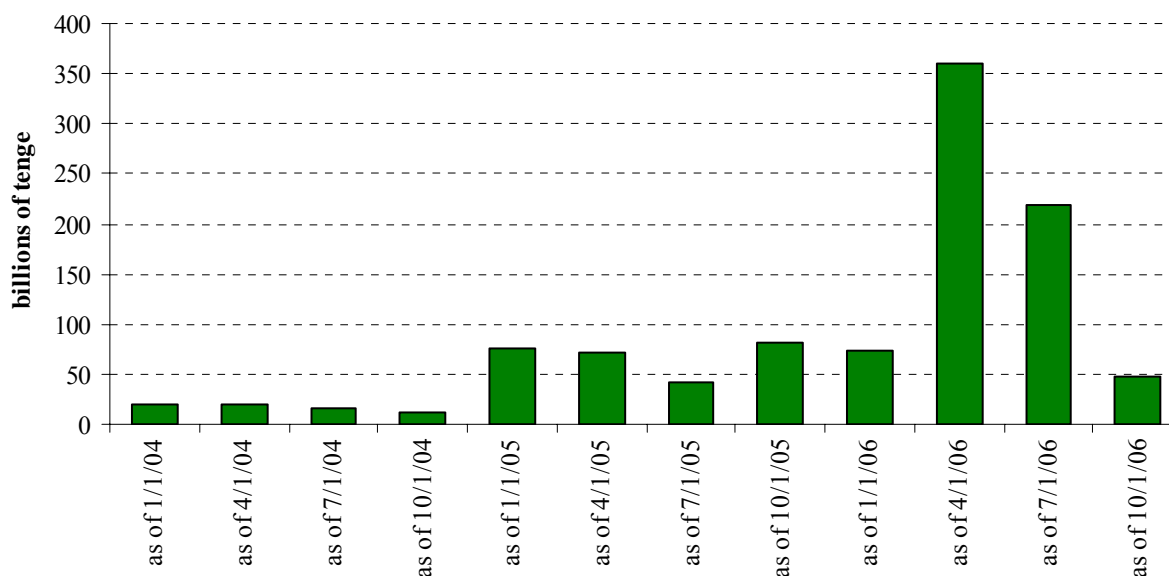


Source: Republic of Kazakhstan National Bank

A decline in volumes of attraction of deposits from second-tier banks in Q3 2006 led to a drop in the volume of unpaid liabilities of the National Bank with respect to them by a factor of 4.5 to T 48.3 billion (Figure 19).

Figure 19

Volume of unpaid liabilities of the National Bank for deposits attracted from second-tier banks



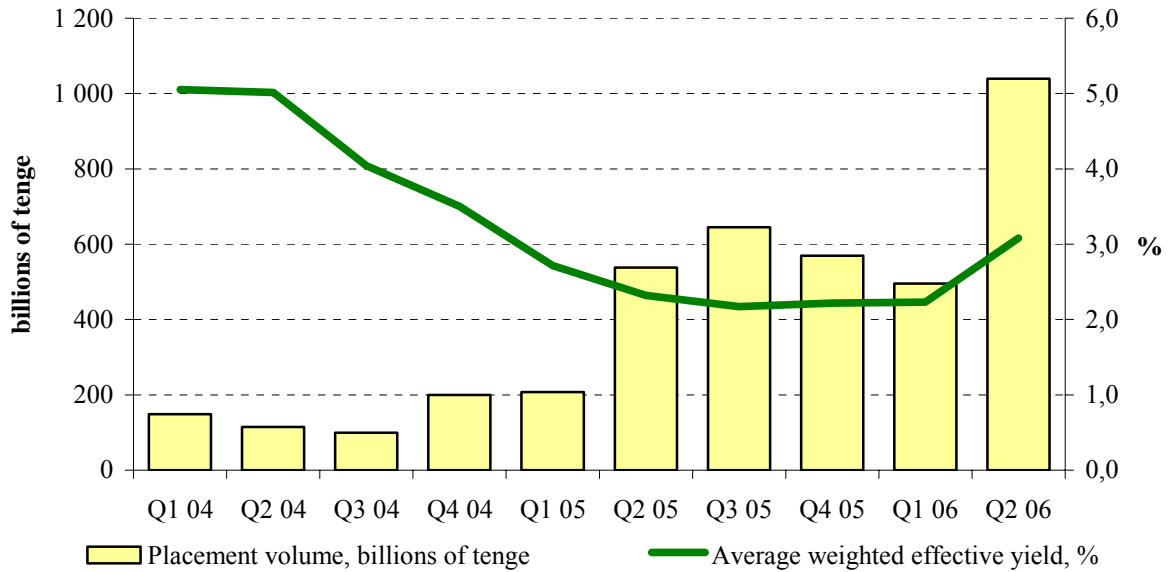
Source: Republic of Kazakhstan National Bank

3.2.3. Issuing of short-term notes

In Q3 2006 placement of short-term notes of the National Bank reached an historic maximum and totaled T 1,002.1 billion, or 3.6 percent less than the volume of the preceding quarter. The notes were issued with a maturity of 28 days. The average-weighted yield for the placed notes increased from 3.08 percent in Q2 2006 to 3.80 percent in Q3 2006 (Figure 20).

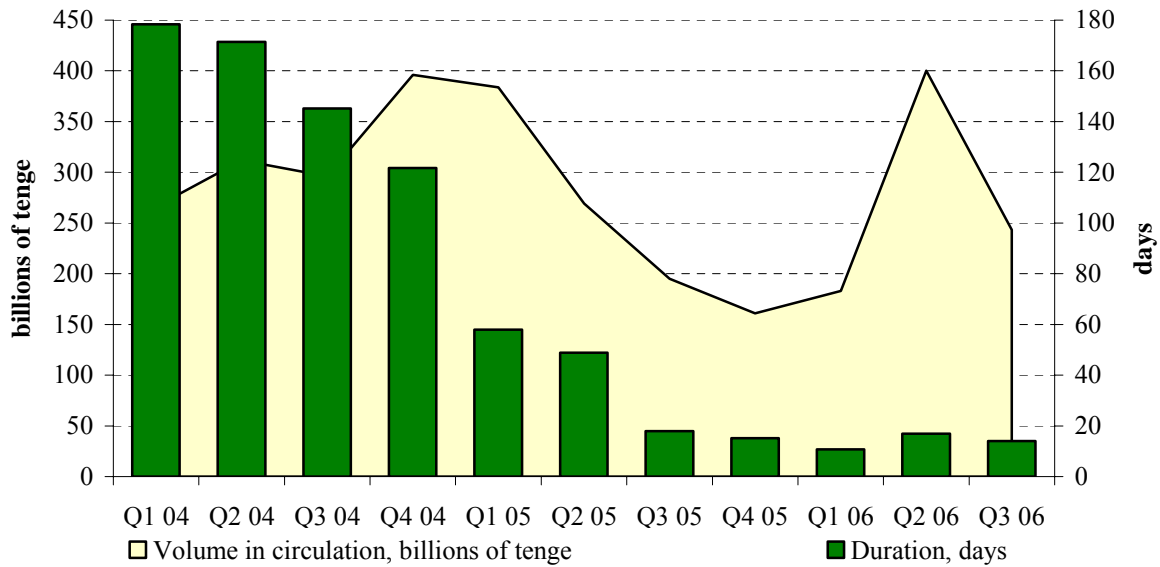
At the end of September 2006 the volume of short-term notes in circulation was T 243.4 billion, which is 39.2 percent less than the volume at the end of Q2 2006. The duration of notes in circulation at the end of Q3 2006 declined to 14 days (Figure 21).

Figure 20
Volume of placement of short-term notes and their yield
 (for the period)



Source: Republic of Kazakhstan National Bank

Figure 21
Short-term notes in circulation
 (as of the end of the period)



Source: Republic of Kazakhstan National Bank

3.2.4. Provision of loans

In Q3 2006 the National Bank did not provide any refinancing loans or special purpose loans.

3.2.5. Exchange rate

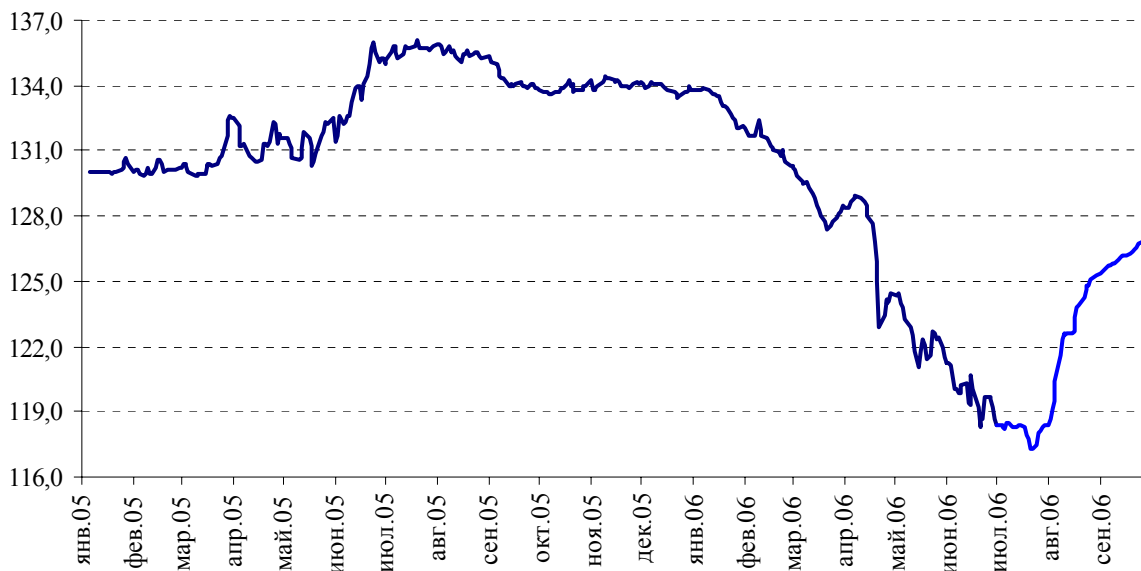
In Q3 2006 there was a change in the dynamics of the tenge's exchange rate against the U.S. dollar on the domestic currency market. Altogether, based on results for the quarter, the exchange rate of the tenge depreciated against the U.S. dollar by 7.4 percent—from T 118.41 per dollar to T 127.22 per dollar.

In July 2006 the nominal market exchange rate of the tenge to the U.S. dollar was unchanged (at the end of July, as at the end of June, it was T 118.41 per dollar). In August the nominal exchange rate of the tenge to the U.S. dollar depreciated by 5.8 percent, and in September—by 1.5 percent.

The average-weighted exchange rate of the tenge for Q3 2006 was T 122.42 per dollar, having strengthened by 0.2 percent by comparison with the indicator for Q2 2006. During the quarter the tenge changed against the dollar within a range from T 117.25 – T 127.22 per dollar (Figure 22).

Figure 22

Dynamics of the nominal exchange rate of the tenge against the U.S. dollar

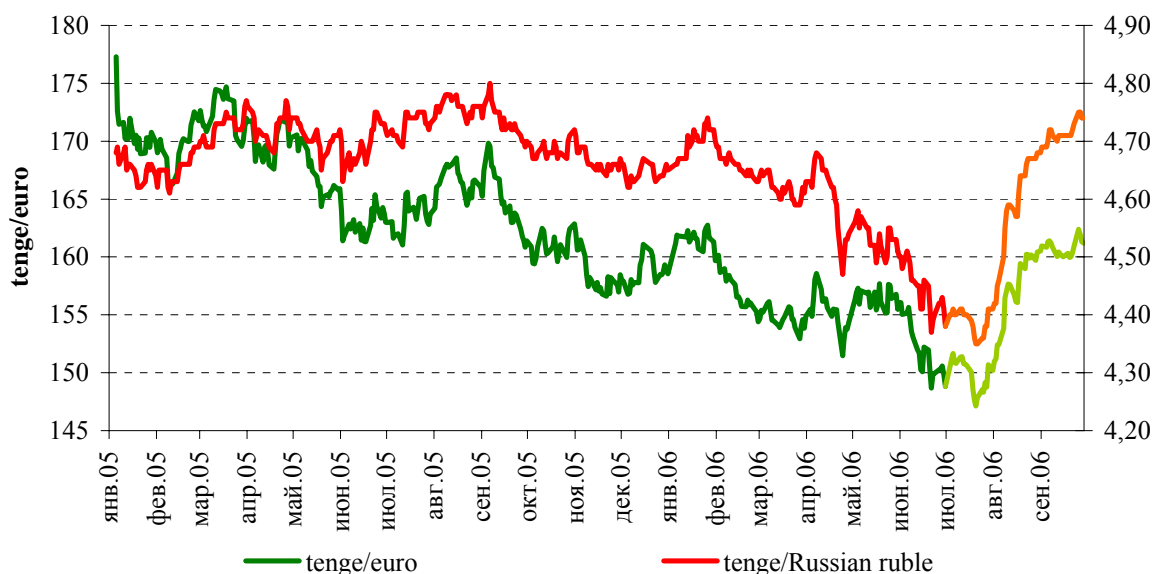


Source: Republic of Kazakhstan National Bank

Given that volumes of transactions with Russian rubles on the exchange segment of the domestic currency market remains insignificant, and that no transactions were carried out with the euro at all in Q3 2006, the exchange rate of the tenge against those currencies is calculated on the basis of a cross-rate against the U.S. dollar. Correspondingly, the dynamics of the tenge exchange rate against the euro and the Russian ruble was determined by the dynamics of the tenge exchange rate against the U.S. dollar, the position of the single European currency on the international financial market, and policy of the Central Bank of Russia with respect to the exchange rate of the Russian ruble against a basket of currencies.

During Q3 2006 the official tenge exchange rate against the euro and the Russian ruble depreciated by 8.4 percent (Figure 23).

Figure 23
Dynamics of the official tenge exchange rate against the euro and the Russian ruble



Source: Republic of Kazakhstan National Bank

In Q3 2006 the domestic currency market developed under the influence of a number of factors. External factors (prices for energy resources, the world foreign exchange market) put upward pressure on the tenge even as the action of domestic factors led to a reduction of that pressure. In fact, domestic factors had a greater influence on the market than external, and as a result there was a nominal weakening of the tenge.

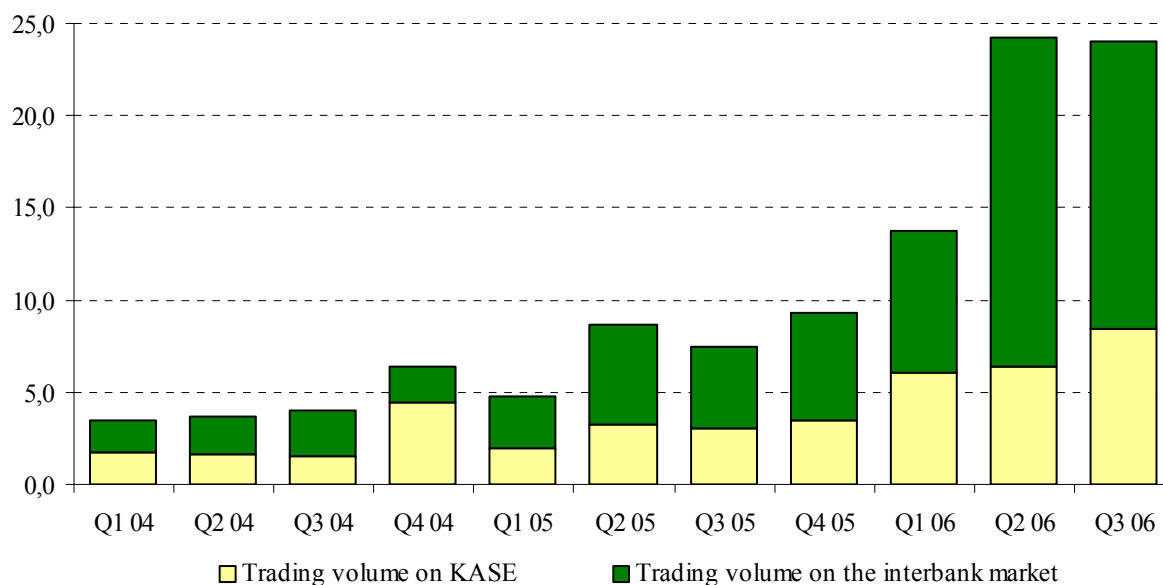
The shift in trends in the dynamics of the tenge exchange rate is associated with the action of several domestic factors leading to an increase in demand for foreign currency both on the part of the Government of the Republic of Kazakhstan for conversion of National Fund assets and on the part of banks to meet a number of requirements of the National Bank and the Agency for Regulation and Supervision of the Financial Market and Financial Organizations (Box 3).

These measures are directed at reducing the attractiveness of external borrowing for domestic banks, with the consequence that there should be a reduction in the rate of growth of external borrowing of banks. This in turn will lead to a decline in volumes of foreign currency receipts on the domestic market, and correspondingly to a decline in the upward pressure on the tenge.

Overall, during the quarter the situation on the domestic currency market was characterized not only by an increase in demand for foreign currency, but also by large trading volumes.

In Q3 2006 the volume of trading in dollars on the Kazakhstan Stock Exchange [KASE] was \$8.5 billion, which is 33.6 percent more than the volume in Q2 2006. On the over-the-counter currency market, the volume of operations in Q3 2006 declined by comparison with the previous quarter by 13.3 percent and comprised \$15.6 billion (Figure 24).

Figure 24
Volume of trading on the domestic currency market, billions of U.S. dollars



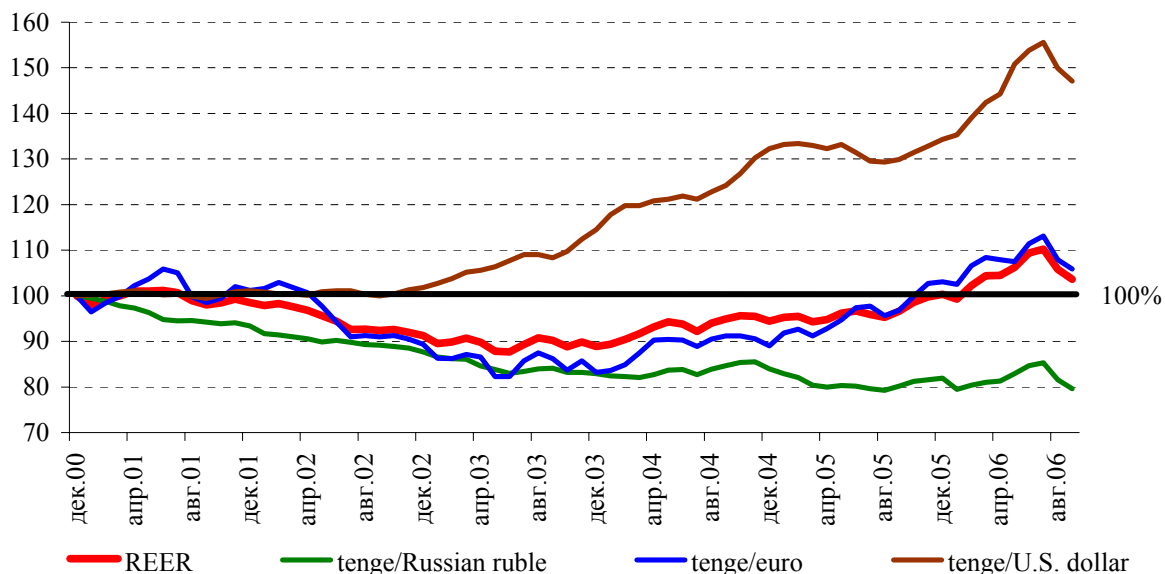
Source: Republic of Kazakhstan National Bank

In an environment where demand for foreign currency exceeded supply during the reference period, the National Bank was a net seller of foreign currency on the domestic market. In Q3 2006 the National Bank’s participation ratio on the KASE was 10.7 percent.

For purposes of the National Fund, in Q3 2006 the National Bank purchased \$315.8 million in foreign currency on the domestic market; in September—\$304.6 million.

Based on results for Q3 2006, the index of the real effective exchange rate (REER) for the tenge and the indices of the real exchange rate of the tenge against the main currencies declined. Thus, the REER index for the tenge declined by 5.3 percent, and in real terms the tenge depreciated by 4.4 percent against the U.S. dollar, by 4.9 percent against the euro, and by 6.0 percent against the Russian ruble (Figure 25).

Figure 25
Indices of real exchange rates of the tenge
 (December 2000 = 100 percent)



Source: Republic of Kazakhstan National Bank

Box 3

Changes in policy that influenced the increase in demand for foreign exchange on the domestic market

First, in conjunction with the introduction effective July 1, 2006 of the new mechanism for operation of the National Fund, the National Bank adopted the Rules for Conversion and Reconversion of Assets of the National Fund of the Republic of Kazakhstan. In accordance with the Rules, together with the sale of foreign currency for the National Fund from gold and foreign exchange assets the National Bank may also purchase foreign currency on the domestic market.

Second, new rules for minimum reserve requirements went into force in July 2006. The changes in the rules led to an increase in minimum reserve requirements, resulting in an increase in reserve assets, including reserve assets in foreign currency.

Third, the dynamics of the tenge exchange rate were also affected by measures to restrict external borrowings by second-tier banks adopted by the Agency for Regulation and Supervision of the Financial Market and Financial Organizations.

Effective July 1, 2006 a maximum limit was established on short-term liabilities to nonresidents in the amount of a bank's equity capital.

Effective September 1, 2006 limits were lowered on the open foreign exchange position (long and short) for foreign currencies of countries with a sovereign rating no lower than Standard & Poor's "A" level or a similar level rating from one of the other international rating agencies and for the euro—from 15 percent of a bank's equity capital to 12.5 percent,

and for a foreign exchange net position—from 30 percent of the bank’s equity capital to 25 percent.

3.2.6. Rediscounting of bills

In Q3 no operations for rediscounting and redemption of bills of exchange were carried out. As of October 1, 2006 the National Bank had T 1.0 billion in bills of exchange in its portfolio.

4. Inflation forecast

4.1. Estimated inflation forecast for Q3 2006

The actual level of inflation in Q3 2006 (1.0 percent) corresponds to the forecast for that period (0.9–1.1 percent) published in the previous issue of the “Inflation Report”. In terms of months, there was some divergence between the actual and forecast levels. For example, in July the actual level of inflation corresponded fully with the forecast; in August the forecast was exceeded by a bit; and in September actual inflation came in a bit less than the forecast.

The actual level of inflation in annual terms at the end of September 2006 exceeded the forecast slightly. Thus, in September 2006 it was at the level of 8.5 percent compared to a forecast of 8.4 percent.

4.2. Inflation forecast for Q4 2006

In Q4 2006 it is anticipated that inflation will be within 2.4–2.6 percent (in Q4 2005—2.4 percent), which corresponds to 8.5 percent in annual terms at the end of December 2006.

The period from October to December is characterized by an increase in demand on the consumer market as a consequence of the December holidays. As a result, during that period prices reach their highest level for the year.

After the seasonal price decline for fruits and vegetable in Q3 2006, a price increase is expected in October–December. In addition, prices will continue to rise for such goods as eggs, dairy products, and meat products. As a result, food products are expected to become more costly.

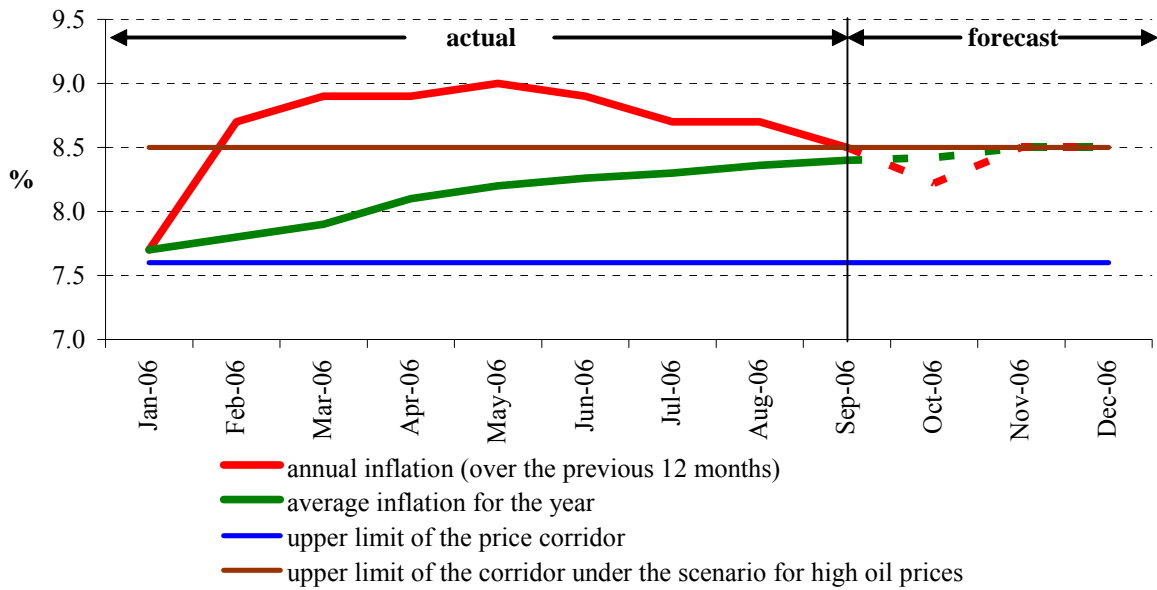
By the end of the year we expect some slowdown in the rate of growth of prices for fuels and lubricants. This situation should be facilitated by both a decline in demand on the domestic market and stabilization on world markets for energy resources

Measures taken by the National Bank to tighten monetary policy at the beginning of 2006 have already begun to have a restraining effect on inflation, which in annual terms declined from 9.0 percent in May 2006 to 8.5 percent in September 2006.

The National Bank is implementing policy to regulate inflation in accordance with the Monetary Policy Guidelines for 2006–2008; its development incorporated two scenarios for economic development depending on changes in world oil prices: a base scenario (a scenario with moderate oil prices) and a scenario with high oil prices.

Based on 2006 results, the National Bank anticipates that inflation both at the end of the year and as an average for the year will be at 8.5 percent, which corresponds to the inflation forecast under the scenario with high oil prices described in the Monetary Policy Guidelines for 2006–2008 and that we are observing in 2006 (Figure 26).

Figure 26
Inflation, actual and forecast in 2006



Source: National Bank of the Republic of Kazakhstan

For its part, the Government is continuing to adopt measures in 2006 to stabilize prices on the consumer market. In particular, measures are being taken to create conditions providing for a competitive environment and satiation of the market with consumer goods.

In addition, work is underway to prevent unjustified price increases for a main group of goods and services for the population, first and foremost food products, and especially meat, fruits, and vegetables, and measures are being developed to prevent price collusion and to identify and prevent dishonest competition and abuse of a dominant position by market entities.

4.3. Inflation forecast for 2007

Currently the National Bank is working on development of Monetary Policy Guidelines for 2007–2009, which will define targets for the near-term with respect to the inflation level in Kazakhstan.

In addition, in that document the National Bank will develop basic corrective measures for monetary policy on the financial market corresponding to the current economic situation. Possible measures may include increasing the volume of the National Bank’s open market operations, raising official rates, and raising minimum reserve requirements.

These measures will contribute to increases in market rates for short-term financial market instruments and, possibly, to a certain amount of increase in the cost of credit resources, which will help lower the growth rate of lending and the money supply, thereby affecting the level of aggregate demand and inflation.

The National Bank estimates that average annual inflation in 2007 will not exceed the 2006 indicators. Our estimates are based on the assumptions that the negative influence of

certain factors will continue and the influence of the National Bank's monetary policy operations on inflation will be felt after a certain amount of lag time.

4.3.1. Inflation forecast for Q1 2007

The inflation forecast for Q1 2007 is 2.0–2.3 percent. In general it corresponds to Q1 inflationary trends characteristic of previous years (with the exception of Q1 2006).

This forecast is based on certain considerations. First, there is the seasonality in the inflation dynamics which assumes a decline in inflation after the “high” Q4. Second, all the factors that affected inflation in 2006 will remain in place. Third, the measures taken by the National Bank in 2006 will contribute to a “braking” of inflationary processes.

It is estimated that the results for Q1 2007 will indicate annual inflation at the level of 7.5–7.7 percent.