



National Bank of the Republic of Kazakhstan

INFLATION REPORT

April 2019

Almaty, Kazakhstan

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

The Report is published in electronic format on the official internet website of the National Bank in Kazakh, Russian and English languages.

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I. MONETARY POLICY: DECISIONS ON THE BASE RATE

Since the time of the previous Inflation Report, the National Bank has made 4 decisions on the base rate, two of which were extraordinary. Such decisions were associated with dramatic changes in the external economic environment. The out-of-schedule decisions were made by many central banks, which is proved by the fast-moving developments.

On February 3, 2020, the National Bank retained its base rate at 9.25%. The decision was made based on the expected short-term rise in the annual inflation rate to the upper boundary of the target range this February in the environment of the growing gasoline excise duties as well as the exhausted effect of the lower base of prices for regulated services to the population. In the months that followed, inflation was anticipated to decelerate to the level closer to the mid-point of the target range of 4-6% this year and to subsequently go down to the medium-term inflation target of 4%.

At the end of February 2020, the situation in the global economy changed dramatically. The spread of Covid-19 turned into a global pandemic. Concurrently, world oil prices fell as a result of the growing oil production and its decreasing consumption.

In order to prevent a spill-over of negative effects of the external shock onto the country's economy and to ensure macroeconomic stability, the National Bank tightened the monetary conditions. On March 10, 2020 an extraordinary decision to increase the base rate to 12% with an expansion of the interest rate band to +/- 1.5 pp was made. This measure allowed maintaining the balance in the market of tenge assets and limiting the uprise in the inflation expectations, reducing the pressure on the exchange rate and mitigating the depreciation of the tenge. In the scheduled decision-making about the base rate which was made on March 16, 2020, the base rate was left unchanged.

Introduction of the state of emergency in the country from March 16, 2020 and of the

lockdown in large cities of Kazakhstan as a result of the increasing number of individuals infected with the coronavirus led to considerable reduction of the business activity, shutdowns of industrial facilities, and to the drop in employment. Against this background, in order to mitigate the negative effects, the President of the Republic of Kazakhstan had initiated 2 packages of anti-crisis measures to safeguard social and economic stability in the country.

As part of the anti-crisis measures, the key fiscal policy parameters have been revised, and significant expenditures for implementation of these measures have been provided for. Thus, taking account of the limiting effect on the economic activity by maintaining the base rate at 12% during a lengthy period of time, on April 3, 2020 the National Bank made an extraordinary decision to reduce the base rate to the level of 9.5% per annum and to expand the interest rate band to +/- 2 pp.

This decision is one of a number of the National Bank's measures aimed to safeguard the financial stability, limit risks for the domestic economy and adapt it to the changed external and internal environment. Reduction of the base rate, in conjunction with other measures, including expansion of the "Simple Things Economy" Program to KZT 1 trln. and adoption of the Concessional Lending Program for small and medium-sized businesses in the amount of KZT 600 bln., will allow smoothing the effects of coronavirus on Kazakhstan's economy and supporting the economic activity.

II. PROSPECTS OF THE DEVELOPMENT OF THE ECONOMIC SITUATION

Amidst the deteriorating situation in the global economy in connection with a massive spread of Covid-19, retention of geopolitical risks and tensions in trade relations between the US and China, uncertainty about the further dynamics of both the external demand and prices for Kazakhstan's key export items is growing.

At the beginning of 2020, world oil prices had been gradually declining. In December 2019, the price of oil was 65.3 US Dollars per barrel on average, in February 2020 the price went down to 55.5 US Dollars per barrel.

On March 9, 2020, after a failure to reach an agreement by OPEC+ countries about reduction of oil production volumes, the world oil prices dropped off to 33-34 US Dollars per barrel reaching the minimum of \$24.5.

At the same time, a massive spread of Covid-19 outside China poses threats to the further globalization, disturbing production chains and undermining global trade, investment and tourist flows. Assessments about the economic development of the main trading partner countries – the EU, China and Russia based on the results of 2020 – were revised towards slowdown or reduction.

Given the deteriorating development prospects for the global economy, the reducing demand and the increasing volatility in the world commodity markets, the National Bank had revised the level of Brent prices which is used as the baseline scenario from 60 US Dollars per barrel to 35 US Dollars per barrel.

According to the National Bank's assessments, in 2020 the economic activity in Kazakhstan will be slowing down and will be accompanied by a moderate growth of the domestic demand against the decreasing net exports.

In 2020, the fiscal policy will retain its social focus, in view of that the household demand will be supported by the growth in

real income of the population and the government employment programs. General government consumption will continue making a weakly positive contribution to the GDP growth. Gross formation is anticipated to moderately grow while investment projects in the industry are being implemented. In this environment, the growth rates of real imports will be more modest as compared to 2019. Moderate dynamics of real exports will be supported by a sluggish demand on the part of China and the EU which are major consumers of Kazakhstan's export products. The situation with pricing in the global commodity markets will serve as yet another negative factor for the dynamics of exports.

In 2021, the GDP growth will slightly accelerate. The consumer activity will be supported by a moderate rise in the real income of the population and the consumer lending. The investment activity will be recovering as a result of the growing domestic and external demand as well as due to implementation of large-scale infrastructure projects, projects in the oil and gas sector and in residential construction. A gradual recovery of the external demand amidst higher GDP growth rates in countries-Kazakhstan's trading partners will be conducive to the expansion of exports. Imports will be demonstrating moderate growth rates as a consequence of the recovering consumer and investment demand.

In 2020, inflationary processes are expected to accelerate. A decline in world oil prices and depreciation of the exchange rate of the tenge at the beginning of March 2020 increased the risk that inflation would go above the upper boundary of the target range. The largest exchange rate pass-through is expected to be on the prices of non-food products due to a high share of imports in their consumption.

Two divergent factors will be exerting influence on the dynamics of annual inflation in 2020. On the one hand, the cost of imports will be growing. On the other hand, the

slowdown of price growth in the market of meat products and bread and bakery as a result of the fact that an upswing in prices of these products was removed from the calculation of annual inflation, will be reducing a negative impact of the above external factors.

An upward pressure on inflation will be put by the increasing import prices and the disturbance in the supply chains against the backdrop of the spread of a new virus.

In the medium term perspective, inflation will be gradually slowing down as a result of the fact that an upswing in prices of non-food products was removed from the calculation of annual inflation once the effect of the exchange rate pass-through onto the domestic prices is exhausted. An additional disinflation effect will be exerted by the moderate dynamics of domestic demand.

At the same time, the recovering growth of utility prices and the rise in world food prices will be restraining disinflation processes in the economy.

According to the forecasts made by the UN Food and Agriculture Organization, in the agricultural season of 2019–2020 world cereal stocks will decline given an anticipated reduction in the stocks of coarse grain crops and rice. This may lead to the growth in the world cereal prices making a constraining effect on the disinflation dynamics of food inflation in Kazakhstan.

The emerging imbalances between the demand and supply in certain commodity markets whose risk intensified in the environment of possible disturbance in supplies of consumer and interim imports from China should be attributed to internal uncertainty factors.

Alongside with that, the risk of a further unanchoring of inflation expectations amidst the possibility that inflation may stay above the target range remains significant.

Because of the anticipated slowdown in the economy, in connection with the fall in oil prices, the risk of inflationary pressure on the part of the domestic demand reduced. However, given the persisting social support

of the population by the government and an ongoing implementation of infrastructure and residential projects, such risk remains.

The change of the existing conditions in the global economy as well as in the mineral markets is characterized by high volatility and uncertainty about the further development. In this environment, the National Bank, within the framework of the medium-term forecasting, will continue to analyze the unfolding situation and will present its forecasts in the next Inflation Report scheduled for June 15, 2020.

III. EXTERNAL ENVIRONMENT

3.1 External Economic Situation

The outbreak of Covid-19 in China and in many other countries sent the global economy into recession.

At the end of 2019, given the cooling of tension in the trade relations between the US and China as well as due to the decreasing uncertainty around Brexit, the first signs of stabilization had outlined in the global economy. According to the IMF estimates, the growth rates in the global economy will accelerate from 2.9% in 2019 to 3.3% in 2020 and 3.4% in 2021.

The situation had deteriorated significantly with the advent of a new type of virus in China and its further spread to other countries. Retail sales, the sphere of services, and transportations reduced significantly. The industrial sector also declined because of the shutdown of plants for the quarantine and the shortage of labor force. The disturbance of supply chains and the decreasing exports to China are observed. Due to the uncertainty about duration of the epidemic and the actual economic losses, international organizations anticipate a significant downturn of the global economy.

In the EU countries, the spread of Covid-19 becomes increasingly extensive resulting in the border closures and restrictions of movements across countries. The dynamics of leading indicators indicate a potential beginning of recession in the Eurozone. Business activity has reduced dramatically in all sectors of the economy but the strongest drop is observed in the sphere of services. In the nearest time, indicators may deteriorate in view of the stricter policy of the EU countries in fighting the coronavirus, which may lead to a further decline in the consumer and investment activity. In 2020, the IMF expects the 7.5% economic contraction in the EU. The decline will be demonstrated by all large EU economies: Germany, France, Italy, and Spain.

In 2021, a rapid recovery is anticipated, and the annual economic growth in the EU may reach 4.7%.

In China, the dynamics of leading indicators in March 2020 points to the recovering growth of the business activity after its collapse in February. Despite the positive statistics, the economic growth rates in China, according to the IMF latest forecasts, will slow down to 1.2% in 2020. The growth will be constrained by a feeble external demand amidst the persisting pandemic in the world, by anticipated bankruptcies of a part of the business and the growing unemployment. Also, high risks are associated with a possible second epidemic wave. In 2021, a dramatic upsurge to 9.2% is expected.

The economic growth rates in Russia during 2020-2021 are anticipated to accelerate as a result of investment of additional resources in infrastructure projects. Meantime, because of the spread of coronavirus, the business activity in the country dropped off. According to the IMF estimates, in 2020 Russia's GDP may decrease by 5.5% given the persistently low world prices of oil and a feeble external demand because of sluggish economies of importing countries. The anticipated large government expenditures may partly offset the expected downturn. In 2021, a moderate economic growth of 3.5% is projected.

3.2 External Inflation Dynamics

The external inflationary pressure on consumer prices in Kazakhstan will generally remain moderate. It will be only by the end of the forecast period that it will somewhat intensify in view of the expected acceleration of inflationary processes in the Russian Federation.

Inflation in the EU will be decelerating and will stay at relatively low levels. This will be promoted by weaker dynamics of world energy prices as well as a relatively stable exchange rate of the European currency against the US Dollar.

Inflation in China will slow down given the exhausting effect of high meat prices, stable dynamics of the exchange rate of the Yuan against the US Dollar and a sluggish domestic demand. The annual inflation will be staying below the targeted level. Nonetheless, the factor of Covid-19 creates additional risks for inflationary processes in China in terms of possible disruptions of supplies and the rise of prices for medications and the reduced demand for many goods and services.

Inflation in Russia, given the expected slight depreciation of the ruble, including in sign of a possible easing of the monetary policy, can go above the 4% target far in advance of the expectation. A constraining effect may be made by weaker dynamics of the domestic and external demand in the midst of the pandemic.

3.3 Monetary Conditions in the External Sector

In the environment of increased uncertainty because of COVID-19 and sluggishness of the global economy, central banks of the largest economies undertake a number of stimulative measures and keep adhering to soft monetary policy conditions.

In March 2020, the US Fed out-of-schedule reduced the target zone of interest rate to 0-0.25% and informed of its willingness to maintain the rate at the existing level until the situation around the spread of Covid-19 and its negative effect on the US economy stabilizes. Also, the US FED announced about a number of additional economic support measures associated with the launch of the \$700 billion quantitative easing program, limit-free quantitative easing in relation to government bonds and mortgage-backed securities, corporate bond repurchases and credit support to the business in the amount of 300 billion US Dollars. Also, the US FED expressed its willingness to repurchase lower-rated corporate bonds.

In order to protect the economy from a negative influence of the coronavirus, the

ECB announced about a new bond purchase program of 750 billion Euros. The ECB is also actively buying up government bonds of the countries which were mostly affected by the pandemic (Italy, Spain).

The People's Bank of China, with a view to support the economy, continues to ease its monetary policy. At the April session, it announced the reduction of the base rate from 4.05% to 3.85% per annum. Interest rates on medium-term loans were also reduced by 20 bp to 2.95% per annum, and the rate on 5-year loans was lowered from 4.75% to 4.65% per annum.

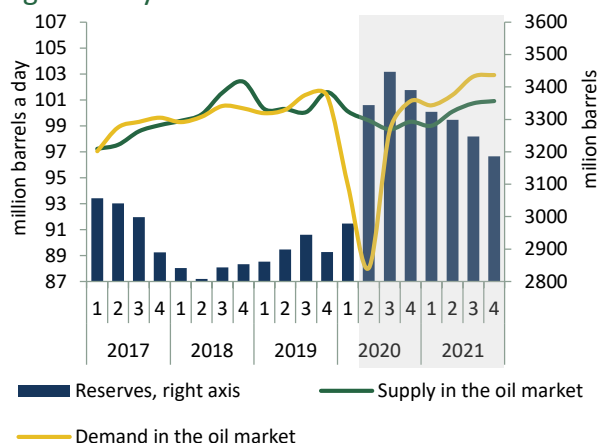
In March 2020, the Central Bank of Russia retained the interest rate at 6.0% per annum. Due to the projected downturn of the Russian economy, the market is in expectation that the rate will be reduced at the next session. Moreover, the decision to reduce the interest rate may be made even along with the expected rise in inflation.

3.4 Commodity Markets

The spread of COVID-19 and a projected downturn of the global economy are expected to result in a strong reduction in the global consumption of energy resources. An anticipated decline in the demand for oil and the persistently positive dynamics of the global oil production will be conducive to a systemic buildup of oil reserves and the feeble dynamics of oil prices. By 2021, the demand will be growing at a faster pace as compared to supply thus contributing to reduction of the increased reserves and to a minor rise in prices (Figure 1).

At the end of March 2020, the world price of oil (Brent) was 31.9 US Dollars per barrel. In April 2020, despite the OPEC+ transaction, the oil price went down below 30 US Dollars per barrel, being influenced by the growing concerns about a further decline in the demand for oil because of the pandemic and the release of negative scenarios about the global economy.

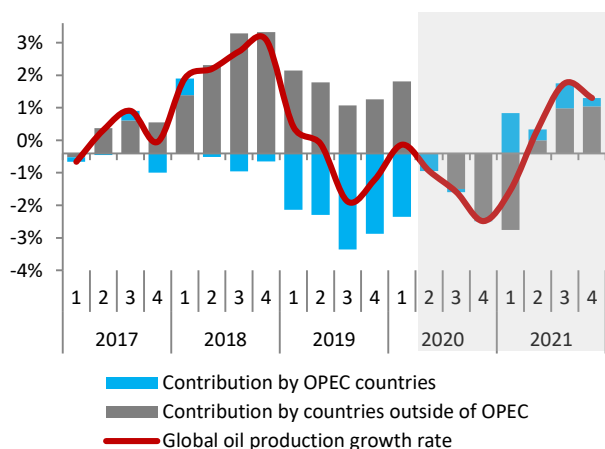
Figure 1. Dynamics of the Global Oil Market



Source: EIA

According to forecasts made by the EIA, in the near term the global oil production will be kept approximately at the rate of the first quarter of 2020. Reduction in oil production because of the feeble dynamics of world oil prices will take place in the US, Canada, Argentina and Mexico. Nonetheless, such reduction will be offset by the growth of oil production in Brazil and Norway (Figure 2). OPEC+ countries will be downsizing their production within the frame of quotas set forth by a new agreement on quotas up to the beginning of 2022. An additional contribution to reduction in the production in OPEC+ countries will be made by a voluntary decline in production in the UAE and Kuwait as well as persistently low performance in oil production in Iran, Libya and Venezuela.

Figure 2. Global Oil Production, YoY

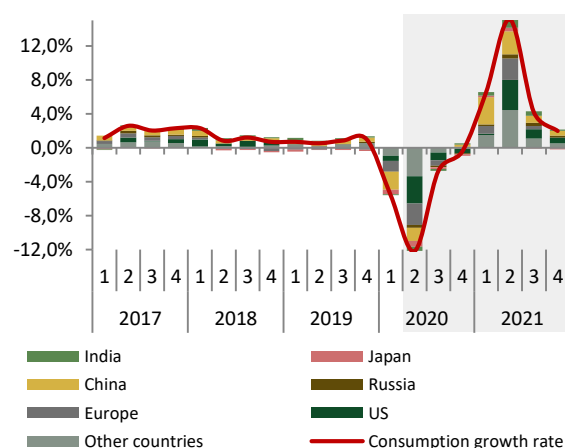


Source: EIA

According to the EIA's updated projections, given the continuing spread of

COVID-19 and an anticipated decline in the growth rates of the global economy, world oil consumption at the end of 2020 as compared with 2019 will go down by 5.2%, which is comparable with 5.2 million barrels a day. According to expectations, the largest drop in the demand is projected in the EU, Canada, US, China and India. A negative impact of coronavirus on the demand will decrease by the beginning of 2021 only. After that, the demand will start increasing (Figure 3).

Figure 3. Global Oil Consumption, YoY



Source: EIA

In the nearest term, a risk of uncertainty about a further spread of the pandemic in the world will remain as the most severe risk in the global oil market. Also, analysts believe that because of a large supply-demand gap, the agreed volumes of decline in the oil production within the OPEC+ framework may appear to be insufficient to make the market balanced. Risks from a weak effect of the OPEC+ agreement are also seen in the policy pursued by the Saudi Arabia which continues to sell its oil at reduced prices. A negative impact on the oil market may be also made by persistently high rates of oil production in countries outside of OPEC due to the unwillingness to lose their market share and because of high expenses related to a re-start of oil fields after their conservation.

Box 1. Viral Infections and their Impact on the Economy

This year, the global economy encountered new risks associated with the spread of coronavirus Covid-19 in China and in other countries.

It should be noted that epidemic viral outbreaks happen nearly every year and global outbreaks occur approximately every 10-30 years (Table 1). However, given the global economy's development and, respectively, the development of global trade and tourism, transmission of various viral diseases becomes more massive.

Table 1

Examples of Viral Diseases over the Last 20 years

| Name of Virus | Year | Country of Origin | Number of Affected Countries | Duration | Number of Deaths, Mortality Rate | Number of Infected Individuals |
|---------------------|------|-------------------|------------------------------|---------------|----------------------------------|--------------------------------|
| SARS | 2002 | China | 29 | about 2 years | 774 (9.6%*) | 8.1 thous. |
| Swine flu | 2009 | Mexico | 214 | 1 year | 284.5 thous. (17.4%) | 1 632.3 thous. |
| New bird flu | 2012 | Vietnam | 28 | 1 year | 858 (34.4%) | 2.5 thous. |
| MERS | 2012 | Saudi Arabia | 27 | 3 years | 858 (35.8%) | 2.4 thous. |
| Ebola | 2014 | West Africa | 10 | 3 years | 11.3 thous. (39.5%) | 28.6 thous. |
| MERS | 2015 | South Korea | 3 | 3 months | 36 (19.4%) | 186 |
| Zika | 2015 | Brazil | Over 20 | about 2 years | Data not available | 3.7 thous. |
| Ebola | 2018 | Congo | Neighboring countries | 1 year | 2.3 thous. (67.6%) | 3.4 thous. |

Source: the WHO, information from the mass media, rating agencies and data analyst companies

When analyzing the macroeconomic situation development in the periods of viral outbreaks, one may note that in the countries where the outbreak is observed there is a sharp decline in retail sales, in the number of trips, a reduction in the volumes of services in the tourism sphere, volumes of imports, exports, and the growing social tension among the population. A negative effect exerted by viruses is also traced in the reduction of jobs and productivity which is one of the factors of a weaker growth in the industrial sectors.

According to the World Bank's assessments, annual global expenditures directed to fight moderately severe and severe viral infections amount to about 570 billion US Dollars or 0.7% of the global income. In considering individual cases, for instance, SARS viral infection in China cost the economy 40 billion US Dollars. The Ebola fever had considerably undermined the economic condition and further development in Guinea, Liberia and Sierra-Leone where overall losses amounted to 2.2 billion US Dollars. In South Korea, because of MERS, apart from financial losses, the change in the consumer behavior pattern was observed which was expressed in the reduced rate of visits to restaurants, theaters and other public places. In order to support the economic growth, the authorities of these countries resorted to various support measures: abatement of taxes and key interest rates, additional liquidity injections, and the increased government expenditures.

At this stage, it is difficult to assess how a new virus would affect certain countries or the global economy as a whole since there is uncertainty regarding its duration and the extent of viral spread. At the same time, in prior years the viral diseases were developing in a more favorable macroeconomic environment. During the SARS outbreak in the 2000s, the global economy was going out of the downturn and the demand for Chinese exports was only increasing. This helped the Chinese economy to quickly recover from the aftermath of epidemic. In current conditions, the economies of China and Italy accumulated a lot of structural problems related to a sluggish domestic demand and a high debt in the face of which it would be much more difficult to cope with the adverse effects of the virus.

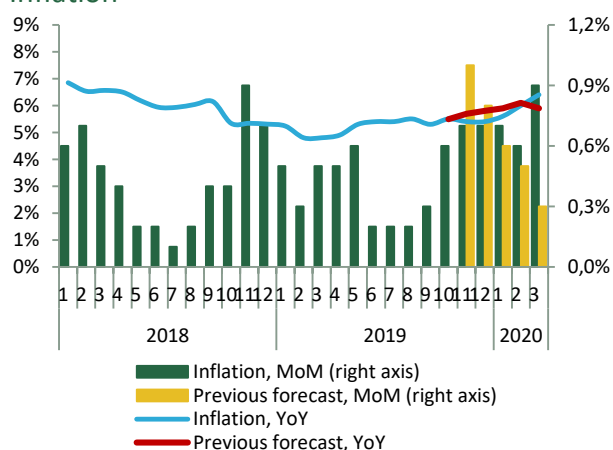
IV. PRICING AND INFLATION EXPECTATIONS

4.1. Inflation

The inflation dynamics in November-February 2020 was generally consistent with the National Bank's expectations. In March 2020, the annual inflation had been above the target range.

In March 2020, the annual inflation accelerated to 6.4%, while the forecast was 5.9% (Figure 4). A more significant growth in prices of foodstuffs was observed as compared to the National Bank's assessments, this was related to the introduction of the state of emergency and the lockdown in certain regions of Kazakhstan.

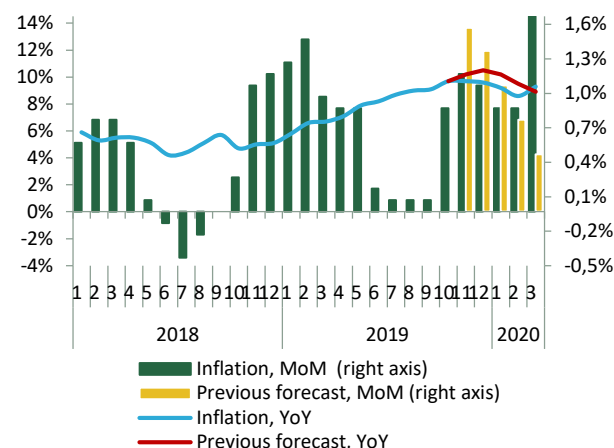
Figure 4. Dynamics of Actual and Forecasted Inflation



Source: CS MNE, NBRK's forecasts

In March 2020, the growth in prices for **foodstuffs** accelerated to 9.3% against a forecast of 8.9% (Figure 5). Monthly food inflation showed its maximum over the last three years, accounting for 1.7%. It was driven by a soared demand for foodstuffs given the announced lockdown in the second half of March; this is indirectly proved by the rise in prices for socially important foodstuffs by 2.7% from March 17 to March 31. From March 17 to March 31, the growth in their prices accounted for 0.7%.

Figure 5. Actual and Forecasted Food Inflation



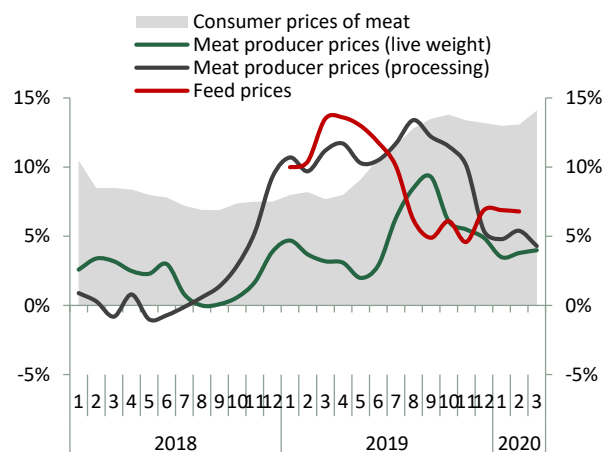
Source: CS MNE, NBRK's forecasts

The largest revaluation of food inflation occurred in November-December 2019, which was caused by a more rapid slowdown in prices for meat products, vegetables and the decline in prices of sugar.

From November 2019, a monthly price growth of meat slowed down to below 0.7% (from April to October 2019, the rise in prices of meat products accounted for 1.4% on average) (Figure 6). This happened amidst the imposition of a ban for exports of pedigree stock to Uzbekistan for six months from November 2019¹, leading to a slowdown in the export price growth (in April-October 2019, the average price growth accounted for 40.3%, in December 2019 – 13.9% in annual terms). At the same time, in January 2020, exports of meat went up by 57.1% (including a two-fold increase in the exports of beef). Based on that, the MoA once again imposed a ban on exports of all bovine cattle and small cattle which will be in force from February 10 to April 22, 2020.

¹ The Joint Order of the Minister of Agriculture of the Republic of Kazakhstan of October 10, 2019 No.1118 and the First Deputy Prime Minister of the Republic of Kazakhstan – the Minister of Finance of the Republic of Kazakhstan of October 10, 2019 No.368 "On Certain Issues Pertaining to Exports of Live-Stock Animals".

Figure 6. Consumer Prices and Meat Producer Prices, YoY



Source: CS MNE

Alongside with the limitation of meat exports, from August 2019 meat producer prices were slowing down (in live weight and in slaughtered weight) against a more moderate growth in prices of forage (according to the CS MNE, during 2018 expenses for forage account for 75% in the net cost of meat producers).

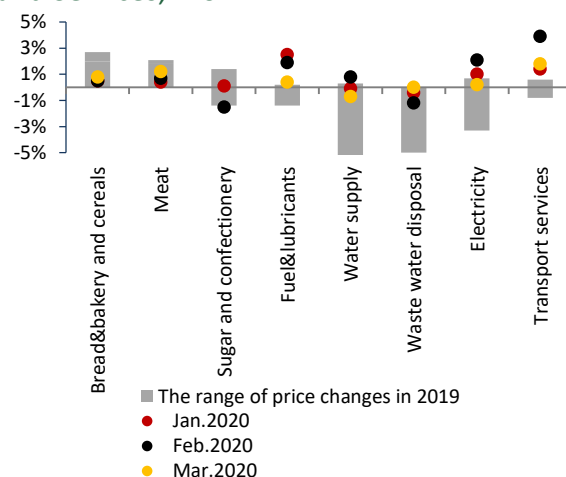
In January-March 2020, a monthly growth in prices for bread and bakery and cereals also slowed down to 0.6% on average, whereas throughout 2019 an average monthly price growth accounted for 1.2% (Figure 7).

In March 2020, fruit prices increased by 9.6% in annual terms. Appreciation in price of fresh fruits has been observed since October 2019 after a seasonal fall in fruit prices in July-September. The annual price growth in March 2020 was recorded among all types of fresh fruits included into the CPI.

A restraining effect on the annual inflation was made by the dynamics of prices for fresh vegetables whose annual growth accounted for 1.5% in March 2020. In the structure of vegetable production, there was a decline in prices of cucumbers (by 8.1%) and tomatoes (by 10.1%) given a larger harvest in 2019, including those grown under cover. So, in 2019 gross production of greenhouse tomatoes went up by 32.2%, and of greenhouse cucumbers – by 12.5% given the 6.3% increase in acreage of greenhouses.

The dynamics of sugar prices keep putting a disinflation pressure on prices of foodstuffs (Figure 7). In March 2020, sugar prices in annual terms went down by 14.8%. The decline in producer prices in Russia (by 32.4% in January 2020, YoY) served as the main factor, in view of surplus production and accumulation of stock in the country. Russian sugar accounts for a significant portion in import of refine sugar in Kazakhstan (in 2017 – 66%, in 2018 – 56%, and in 2019 – 76%).

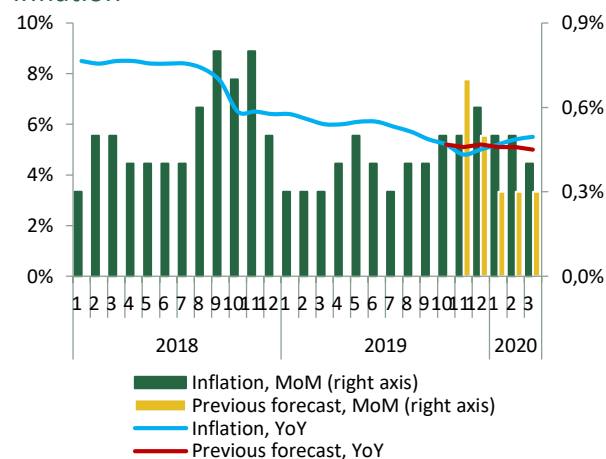
Figure 7. Change in Prices for Some Goods and Services, MoM



Source: CS MNE

Actual growth in prices of **non-food products** has been slightly above the National Bank's projections (Figure 8). So, in March 2020 the price growth accounted for 5.5%, while the forecast was 5.0%.

Figure 8. Actual and Forecasted Non-Food Inflation



Source: CS MNE, NBRK's forecasts

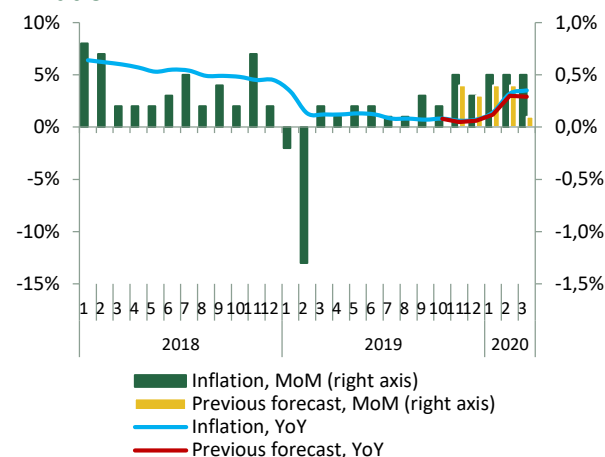
Acceleration of the non-food component of inflation in January-March 2020 was to a larger extent driven by the rise in prices of fuel and lubricants and solid fuel. So, in 2018-2019, given the market saturation with the domestically produced gasoline, prices in the consumer market were going down except for a minor growth of 0.1%-0.2% in some months. Starting from January 2020, the prices of gasoline started to grow (on the year-to-date basis the growth made up 5.5%, and 3.9% in annual terms) because of the increase in excise duties from KZT 10 500 to KZT 24 435 per ton for wholesale realization by gasoline producers, which is equivalent to the growth of KZT 10 per liter².

The shift in the trend of consumer preferences of the population towards cheaper imported goods served as a constraining factor for the growth in prices for durable goods. So, according to the CS MNE, in 2019 as compared to 2018, physical volumes of non-food imports (clothes, footwear, medications, home furniture and household utensils) were growing faster than the value imports. Along with that, imports from China and Russia in the country structure of imports increased significantly.

A low inflation in Russia – 2.5% in March 2020 with the CBR's target of 4% - was fostering overall disinflation processes. Given a large share of imports of Russian goods in the consumption of non-food products, deceleration of inflationary processes in Russia has a favorable influence on the domestic pricing.

The dynamics of prices and tariffs for **paid services to the population** slightly exceeded the National Bank's estimates (Figure 9).

Figure 9. Actual and Forecasted Service Inflation



Source: CS MNE, NBRK's forecasts

In March 2020, the annual service inflation accounted for 3.5%, while the forecast was 2.9%. In the structure of service inflation, a negative input of regulated services continued to go down in the environment of exhausting positive effect from administrative lowering of prices for regulated services at the end of 2018 and beginning of 2019 and the raising of electricity tariffs. Apart from that, the input by non-regulated services was increasing as a result of significant growth of prices for transport services (air, railway and road transport). So, in January, public transport fees rose by 2.9% (in monthly terms) due to the raising of tariffs in Turkestan region by 40%, in February 2020 a 2.3% monthly increase in prices of air transport was observed, and in March 2020 railway transport services appreciated by 5.5% in terms of price.

Among regulated services, electricity tariffs increased by 3.2% in January-March 2020 because of the decision made by the Ministry of Energy to raise marginal tariffs of energy producing companies by 15.7% on average from November 1, 2019.

A deceleration trend in the core inflation (excluding prices of fruits, vegetables, regulated services and fuel and lubricants) which was observed in November 2019 – February 2020, was interrupted in March 2020 (Figure 10). However, the core inflation is still exceeding the headline inflation; this is

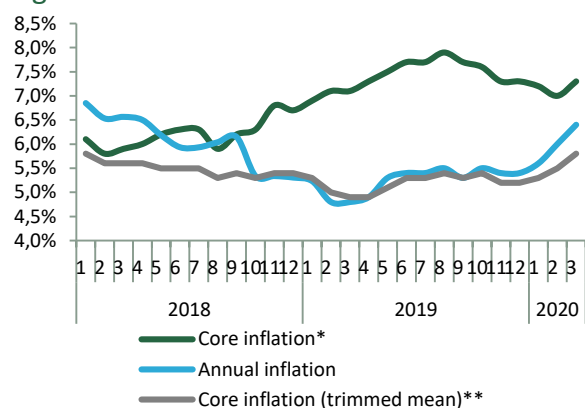
² On changes to the Governmental Decree of the Republic of Kazakhstan of April 6, 2018 No.173 "On approval of excise duty rates for gasoline (except for aviation gasoline) and diesel fuel and repealing certain resolutions of the Government of the Republic of Kazakhstan"

related to low growth rates of prices for goods excluded from the calculation.

The growth rates of trimmed mean core inflation (while excluding eight percent of maximum and minimum changes of prices) are still below the headline inflation. In March 2020, it accelerated to 5.8% in annual terms.

Starting from October 2018, trimmed mean core inflation does not virtually differ from the headline inflation, which is related to comparable effect of pro-inflation and disinflation factors on the headline inflation.

Figure 10. Inflation and Core Inflation*



Core inflation

* Excluding prices of fruits and vegetables, utilities (regulated services), railway transport, communication, gasoline, diesel fuel and coal

** All goods and services, excluding price changes of eight percent of maximums and minimums

Source: CS MNE, NBRK's forecasts

Box 2. Assessment of the Pass-Through Effect of the Exchange Rate Dynamics on Inflation.

In order to assess the pass-through effect of dynamics of the nominal exchange rate of the tenge against the Russian ruble and the US Dollar on inflation in Kazakhstan, vector autoregression models were constructed.

The following indicators were selected as endogenous factors: nominal exchange rate of the tenge against the Russian ruble and the US Dollar, broad money, price index in the manufacturing industry, physical index of industrial production, industrial producer price index, general CPI, food price index, non-food and services price index as well as the price index of 36 commodity groups.

The following indicators were used as exogenous factors: price index for imports, Brent oil price, Russia's CPI, and FAO Price Index. In designing the models, the time series which is presented by monthly data for the period from January 2011 to December 2019 was used.

To identify a possible change in the degree to which the exchange rate dynamics impact inflation, the expanding window strategy was used. When using this strategy, econometric models are estimated at different periods, where subsequent periods include the preceding ones. This allows estimating an evolution of coefficients of explanatory variables overtime. In our case, the VAR model was estimated at periods: (i) January 2011 – August 2016, (ii) January 2011 – December 2019.

The obtained results prove the existence of the effect of exchange rate pass-through on inflation; however, its gradual diminution is worth mentioning. The accumulated effect in 12 months from depreciation of the exchange rate of the tenge against the US Dollar on the annual inflation made up 0.16 pp before August 2016. The pass-through effect for the period including 2019 was 0.11 pp (Tables 1-2).

Table 1. The Pass-Through Effect (January 2011 - August 2016)

| Commodity groups | January 2011 - August 2016 | | | | | | | | | | | |
|------------------------------|----------------------------|------|------|------|------|------|------------------------|------|------|------|------|------|
| | Russian ruble | | | | | | US Dollar | | | | | |
| | Months after the shock | | | | | | Months after the shock | | | | | |
| | 1 | 2 | 3 | 6 | 9 | 12 | 1 | 2 | 3 | 6 | 9 | 12 |
| All goods and services (CPI) | 0.00 | 0.06 | 0.09 | 0.12 | 0.13 | 0.13 | 0.00 | 0.06 | 0.11 | 0.14 | 0.15 | 0.16 |
| Foodstuffs | 0.00 | 0.04 | 0.07 | 0.10 | 0.11 | 0.11 | 0.00 | 0.04 | 0.10 | 0.14 | 0.15 | 0.14 |
| Non-food products | 0.00 | 0.08 | 0.18 | 0.17 | 0.18 | 0.21 | 0.00 | 0.12 | 0.26 | 0.27 | 0.29 | 0.29 |
| Services | 0.00 | 0.02 | 0.03 | 0.05 | 0.05 | 0.05 | 0.00 | 0.01 | 0.03 | 0.04 | 0.05 | 0.05 |

Table 2. The Pass-Through Effect (January 2011 - December 2019)

| Commodity groups | January 2011 - December 2019 | | | | | | | | | | | |
|------------------------------|------------------------------|------|------|------|------|------|------------------------|------|------|------|------|------|
| | Russian ruble | | | | | | US Dollar | | | | | |
| | Months after the shock | | | | | | Months after the shock | | | | | |
| | 1 | 2 | 3 | 6 | 9 | 12 | 1 | 2 | 3 | 6 | 9 | 12 |
| All goods and services (CPI) | 0.00 | 0.04 | 0.07 | 0.11 | 0.11 | 0.11 | 0.00 | 0.02 | 0.04 | 0.09 | 0.11 | 0.11 |
| Foodstuffs | 0.00 | 0.04 | 0.06 | 0.10 | 0.10 | 0.10 | 0.00 | 0.02 | 0.04 | 0.08 | 0.10 | 0.10 |
| Non-food products | 0.00 | 0.07 | 0.12 | 0.16 | 0.16 | 0.16 | 0.00 | 0.06 | 0.11 | 0.19 | 0.21 | 0.21 |
| Services | 0.00 | 0.00 | 0.01 | 0.03 | 0.04 | 0.04 | 0.00 | 0.00 | 0.00 | 0.01 | 0.02 | 0.02 |

A shock from depreciation of the nominal exchange rate on inflation is realized from the second month on. Maximum effect of the shock falls on the first year-half, followed by its exhaustion.

The strongest reaction to the exchange rate shock is on non-food products, which is related to a larger share of imports of non-food products in the consumption compared to foodstuffs (according to the CS MNE PK, in January-November 2019 the share of imports of non-food products accounted for 59.5%, and foodstuffs – 21.9%).

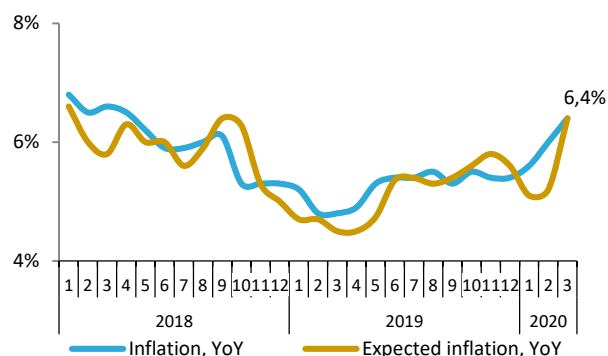
Based on the results of assessment (January 2011 – December 2019), a reaction from shock (in 12 months) by commodity groups was to a greater degree observed among such items as: oils and fats (0.27 pp), coffee and tea (0.19 pp), footwear (0.35 pp), medications (0.32 pp), upper garments (0.3 pp), home furniture (0.28 pp), household appliances (0.27 pp). Alcohol and tobacco products are the least elastic to the exchange rate shock because their pricing is to a larger extent dependent on the excise duty rates.

4.2. Inflation Expectations

In March 2020, inflation expectations of the population increased.

In March 2020, a quantitative quantified assessment³ of inflation one-year ahead made up 6.4%, having increased from 5.1% in January 2020 (Figure 11).

Figure 11. Expected inflation

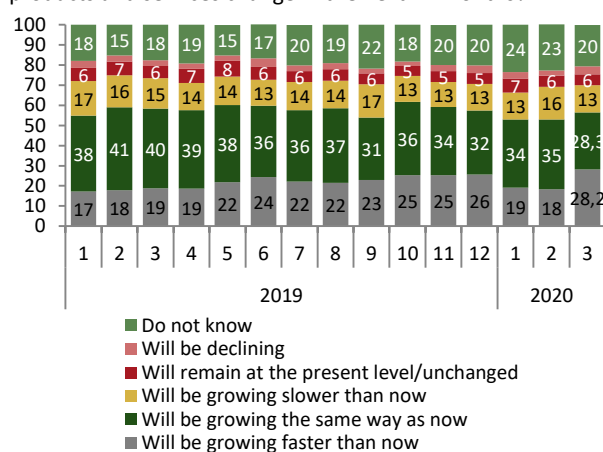


Source: CS MNE, FusionLab

According to the public poll, 56.5% of respondents anticipate that the existing price growth rate will persist and will go up (Figure 12).

Figure 12. Assessment of the Price Growth in a Year

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



Source: FusionLab

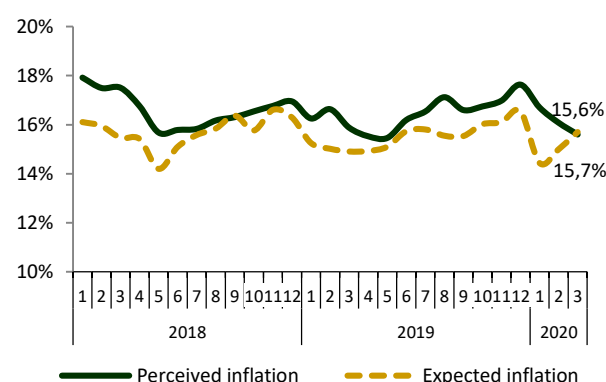
³ The Methodology for calculation of quantification of inflation expectations is published on the National Bank's Internet resource in the "Monetary Policy" – "Inflations and Inflation Expectations" Section

Perceived inflation⁴, which is generated based on the subjective basket of goods of an individual decreased from 17.0% in November 2019 to 15.6% in March 2020.

In the inflation assessment for the past month there is still a high percentage of respondents who noted a more rapid growth of food prices (in March 2020 – 86%). The majority of interviewed individuals point to the rise in prices for bread and bakery and cereals, meat, fruits and vegetables, and dairy products.

Expected inflation went down⁵ from 16.1% in November 2019 to 15.7% in March 2020 (Figure 13).

Figure 13. Assessment of Quantitative Price Growth over the Last and in the Next 12 Months



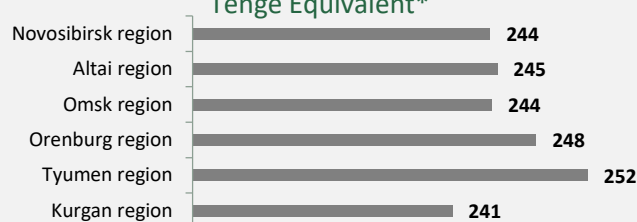
Source: FusionLab, NBRK's calculations

⁴ The median of the results of answers to the question "In your opinion, how much have prices for goods and services grown over the past 12 months?" is used as perceived inflation.

⁵ The median of the results of answers to the question "In your opinion, how much will prices for goods and services grow in the next 12 months?" is used as expected inflation.

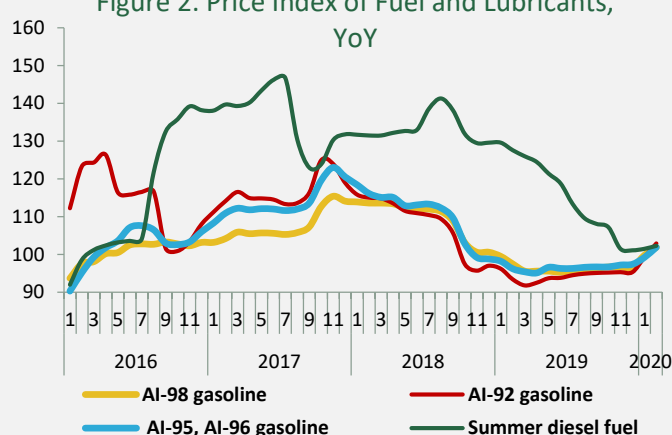
Box 3. Pricing in the Petroleum Product Market of Kazakhstan

Figure 1. Average Retail Price of AI-92 Gasoline in the Cross-border Regions of Russia in 2019 in the Tenge Equivalent*



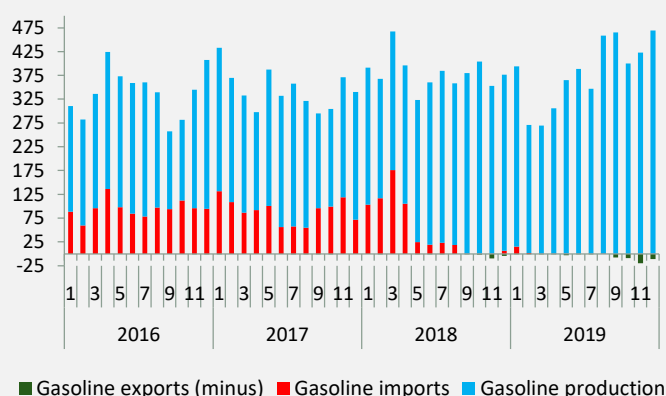
*average annual exchange rate of KZT/RUB at end-2019

Figure 2. Price Index of Fuel and Lubricants, YoY



Source: CS MNE

Figure 3. Production, Exports and Imports of Gasoline in Kind (thous.tons)



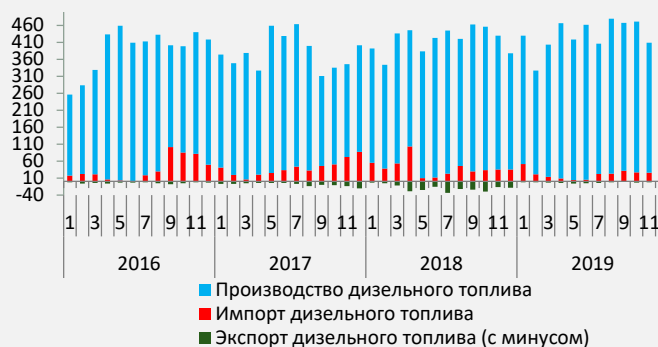
In the last few years, the supply factor acted as a key factor which exerted influence on the price dynamics of fuel and lubricants in Kazakhstan. Insufficient domestic output which did not allow satisfying the domestic demand to the full extent was increasing the reliance of internal pricing for fuel and lubricants on imports, primarily from Russia. So, in 2016-2017 consumption of gasoline was covered by the domestic production by 72-75% only. Meanwhile, the shortage of gasoline and diesel fuel within the country was covered by imports from Russia where the price had historically been higher than the price of domestic petroleum product. So, in 2016-2017 the share of Russian gasoline in total imports accounted for over 90%. In the cross-border regions of Russia, the price of gasoline is equivalent to KZT 240-250 per liter on average, which is by 1.5 times higher than in Kazakhstan (Figure 1). The existence of price disparity between Kazakhstan and Russia creates additional risks for the price growth in the domestic market. So, in 2016 prices of gasoline rose by 7.0%, and in 2017 – by 17.6%.

Starting from 2018, prices of fuel and lubricants began to go down. In 2018, gasoline prices declined by 2.8%, and in 2019 – by 4.6% (Figure 2). This resulted from the fact that the domestic demand was fully secured with the domestically-produced petroleum products after modernization of the Atyrau, Pavlodar and Shymkent oil refineries. Production of diesel fuel in the country increased from 4.2 million tons in 2016 to 4.9 million tons in 2019. Production of motor gasoline of different grades nearly doubled from 2.9 million tons in 2016 to 4.5 million tons in 2019. As a result, already in 2019 the domestic consumption was fully secured with the domestic gasoline (Figure 3).

Due to a gradual increase in production of petroleum products within the country, imports of both gasoline and diesel fuel dropped off in the second half of 2018. In addition, it also enabled to slightly build up export volumes of petroleum products outside the EAEU. By the end of 2019, exports of gasoline to Tajikistan, Afghanistan and the Netherlands demonstrated a minor growth.

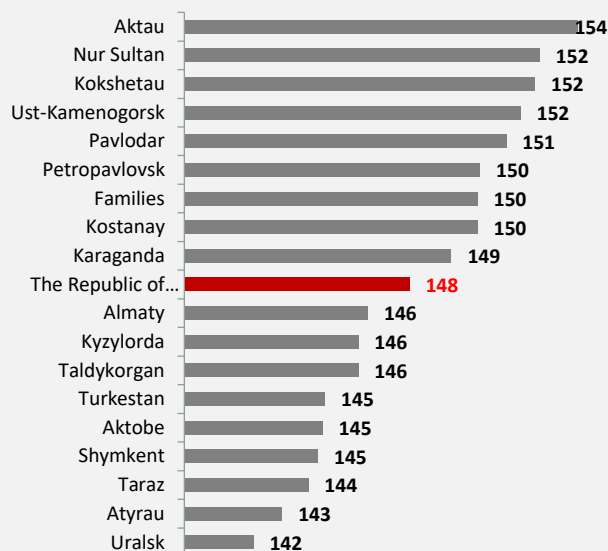
A similar situation was observed in the market of diesel fuel where production volumes went up by 7.2% YoY in 2019. The increase in domestic production helped to cut imports by 47.2% YoY in 2019. Along with that, in 2019 exports had been minimal amounting to 43.8 thous.tons versus 236.9 thous.tons in 2018 (an 81.5% decline) (Figure 4). At the same time, the price of gasoline sold in the country varies significantly from region to region. In 2019, the highest price for gasoline of AI-92 grade was in Aktau – KZT 154 per liter (average price in 2019). The cheapest gasoline is sold in Atyrau and Uralsk – KZT 143 and KZT 142 per liter, respectively (Figure 5).

Figure 4. Production, Exports and Imports of Diesel Fuel in Kind (thous.tons)



Source: CS MNE RK

Figure 5. Average Retail Price of AI-92 Gasoline in Regions in 2019



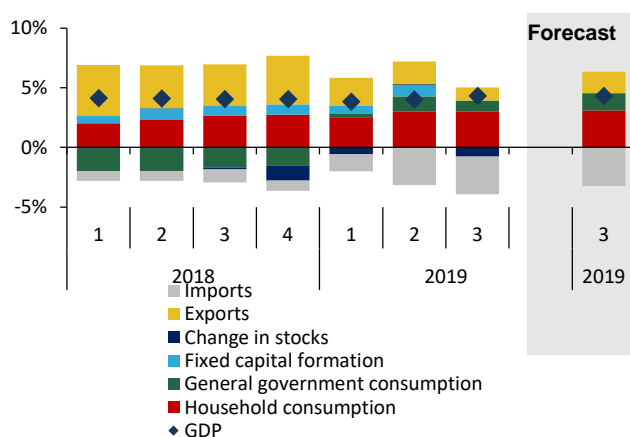
V. ECONOMIC DEVELOPMENT

5.1. Domestic Demand

In 2019, the domestic demand was supported by a significant growth of household demand given a considerable fiscal impulse and implementation of large investment projects. The expansion of domestic demand in 2019 put a pro-inflationary pressure in the economy.

As at the end of nine months of 2019, GDP by demand side grew by 4.3% in real terms, which is in line with the National Bank's forecasts (Figure 14).

Figure 14. Actual and Forecasted GDP by Demand Side. GDP Decomposition Broken Down by Component Contributions, YoY, cumulative



Source: CS MNE, NBRK's forecasts

As per components, actual dynamics of household consumption and imports was in line with expectations (the growth of 6.0% and 10.8% against a forecast of 6.2% and 11.0%, respectively). However, there was a discrepancy between actual and forecasted growth rates of exports, general government consumption and gross formation. Deceleration of exports and general government consumption was offset by a higher growth of gross formation.

Household spending on consumption supported by the growing real income of the population and consumer lending made the main contribution to the economic upturn. During 9 months of 2019, spending on

consumption increased by 6.0% in annual terms.

As at the end of 2019, the rise of real income accounted for 5.5%, and of real wages – 8.9%.

A positive contribution to the GDP growth was also made by the increase in general government spending on consumption⁶ of 10.2% as at the end of 9 months of 2019 (forecast – 15%). The growing expenses for labor compensation of the general government employees and spending on the purchase of goods and services acted as key drivers.

In the third quarter of 2019, there was a discrepancy between the dynamics of general government consumption and its proxy – current government spending. When current government spending grew by 22.6% (in nominal terms), general government consumption in the SNA (system of national accounts) showed a slowdown from 24.3% in the second quarter to 4.8% in the third quarter of 2019. Current government spending includes the budget spending on labor compensation and budget spending on the purchase of goods and services. Since the beginning of the year, current spending has been gradually accelerating due to the rise in salaries and wages in the public sector and with the recovery of the budget spending on the purchase of goods and services after its long-lasting contraction in 2018 amidst measures undertaken to cut the budget deficit. As at the end of 9 months of 2019, the growth of real exports slowed down to 2.5% against a forecast of 4.1%. In designing the forecasts, it was assumed that in the environment of recovering oil and gas condensate production in the third quarter of 2019 (the growth of 2.7% on the quarter to the corresponding quarter of the previous year basis), exports will retain their current growth rates.

⁶ According to the NSA, general government consumption includes current government spending: labor compensation and purchase of goods and services.

However, despite the growing oil production volumes, exports of oil and gas condensate went down in values terms and in kind by 10.8% and 3.1% as at the end of 9 months of 2019, respectively.

Besides, a slowdown in exports was also caused by the cut-back in exports of ferrous metals (a 17.4% reduction in value terms as at the end of 9 months of 2019). The dynamics of exports were supported by the increased exports of non-ferrous metals and grain (the growth in value terms as at the end of 9 months of 2019 by 4.0% and 9.6%, respectively).

Positive dynamics of consumer and investment demand predicated high growth rates of imports of goods and services which made up 10.8% in real terms as at the end of 9 months of 2019.

According to the official balance of payments statistics, negative dynamics of net exports persisted in 2019. Exports in value terms went down by 3.4% because of decreased exports of oil, ferrous and non-ferrous metals. Imports retained high growth rates and increased by 13%. In the structure of imports, all groups of goods were demonstrating uprise, except for interim goods.

According to the CS MNE, in January-February 2020 external trade turnover declined by 4.4%, where exports decreased by 8.3%. Imports showed a growth of 4.2%. It should be noted that cutbacks in exports occurred in January 2020 (19% decline), while in February exports recovered their growth (ramp-up of 5.3% versus February 2019).

At the end of January-February 2020, the decline of oil exports in physical volume by 2.7% was observed in the commodity structure, including to Italy – by 7.7%, France – by 62.4%, Switzerland – by 25.3%, and South Korea – by 42.3%. At the same time, exports to the Netherlands were recovering (the 48% growth), where 12% of exported oil was delivered.

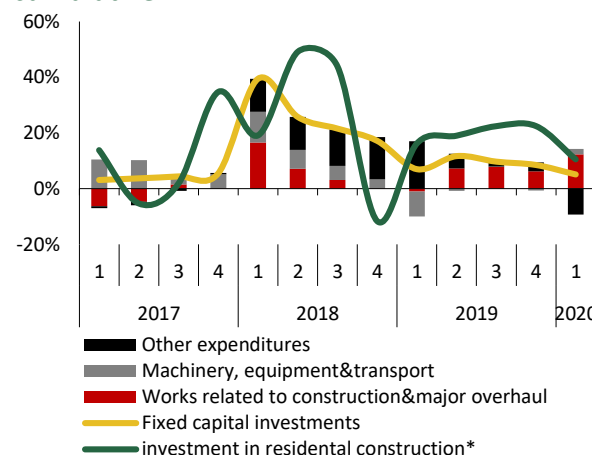
Also, in January-February 2020 exports of non-ferrous metals (physical volumes) declined: copper – by 14.6%, aluminum – by

35.1%, and zinc – by 90%. Although China remains as the main consumer of Kazakhstani non-ferrous metals, the current cutback was related to the reduction in exports of copper to Turkey and the UAE, as well as of aluminum to Italy.

In February 2020, imports slowed down their growth rates (the growth of 2.3%) as compared to the beginning of the year (in January 2020 – the growth of 6.7%). In the commodity structure, value imports of construction materials, timber, machinery, equipment, motor vehicles, as well as of clothes and footwear showed decline.

Gross formation as at the end of 9 months of 2019 went up by 8.9% against a forecast of 4.2%. A significant ramp-up of gross formation was observed as a result of a rise in fixed capital formation (by 12.9%). During 2019, a high investment activity persisted in the economy being secured by implementation of large infrastructure projects in the industry, transport sector, by the growth of construction works and residential construction. Growth of fixed capital investments as at the end of the year accounted for 8.5% (Figure 15).

Figure 15. Investment Activity Indicators, YoY cumulative



Source: CS MNE, NBRK

*- January 2020

Deviation of the projection from actual number on gross formation was caused by deceleration of fixed capital investments during the year (in the first half of 2019 the growth of 11.7%, over 9 months of 2019 – by

9.7%). An ongoing considerable reduction of stocks in the economy served as a constraining factor for the increase in gross formation. According to the NBRK's estimations, stocks were decreasing in agriculture, in the mining and manufacturing industries. Apart from that, in 2019 investments in machinery, equipment and transport declined by 2.4% and volumes of property, plant and equipment put into operation decreased by 61.6% as compared to 2018. This was related to the decline in the commissioning of property, plant and equipment in the mining and manufacturing industries.

In January-March 2020, growth rates of fixed capital investments slowed down to 5.1% as a result of lower growth rates of investments in the mining industry (6.9%) and reduction of investments in construction (by 53.3%), transport (by 35.6%), the manufacturing industry (by 9.7%) and trade (by 27.2%). In turn, a positive contribution was made by the rise of investments in the public administration and defense sector (by 4.3 times), water supply (by 2.4 times), real estate operations (by 57%), information and communication (by 24.6%).

As per the costs of fixed capital investments, given the advancement in the construction sector, the main contribution was made by expenditures on construction and major overhaul of buildings and structures (by 30.4%). Investments in machinery, transport and equipment recovered (by 7.6%); in this setting, the growth of new property, plant and equipment put into operation accounted for 74%, including in the mining industry – by 2.4 times, and in the manufacturing industry – by 3.7 times. However, all other expenditures which were making a significant contribution in 2019 demonstrated negative dynamics (the decline by 27.8%).

Investments in residential construction keep increasing actively and in January 2020 the rise of investments made up 10.5%.

In 2019, KZT 1423 bln. were allocated for housing construction, which is by 16.9% greater than in 2018.

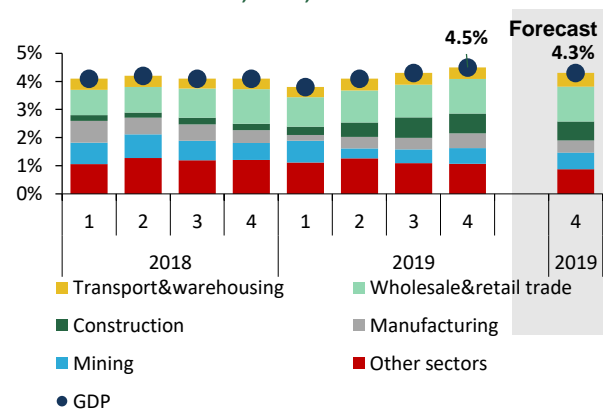
In 2019, 13.13 million sq.m of total space area of residential buildings were commissioned, which is by 4.9% greater than in 2018. In 2019, commissioning of housing was growing in all regions except the city of Nur-Sultan where this indicator fell by 24.6% in annual terms.

5.2. Domestic Supply

In 2019, Kazakhstan's economy continued to demonstrate a steady growth. The production structure has not changed considerably; the service sector continues to be a key driver for the economy.

At the end of 2019, the actual GDP dynamics had been above the National Bank's expectations by 0.2 pp, being driven by acceleration in growth rates of construction works and output in the branches of the manufacturing industry (Figure 16).

Figure 16. Actual and Forecasted GDP by the Production Method. GDP Decomposition by Economic Sectors, YoY, cumulative

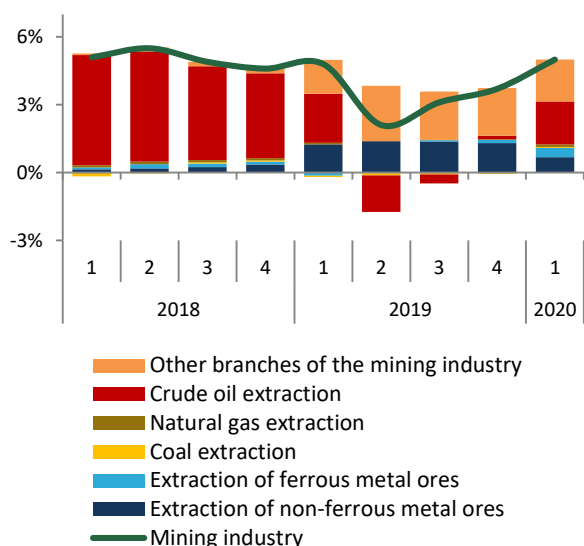


Source: CS MNE, NBRK's calculations

In 2019, production in the mining industry decelerated as compared to 2017-2018, first of all because of a slowdown in the growth of crude oil extraction. The main reason was the start of operations at the Kashagan oil field at the end of 2016; this enabled to significantly build up oil output in 2017-2018.

During January-March 2020, growth rates in the mining industry accounted for 5.0%. A positive contribution to the upturn of the mining industry was made by the increase in output of crude oil and gas condensate by 2.4% and 4.3%, respectively. In addition, the growing volumes of coal and lignite production (for the first time since January 2019 the growth has made up 1.8%), of metal ores, namely iron ore (the growth of 22.2%) and ores of non-ferrous metals (by 8.1%) also had a positive effect on the mining industry (Figure 17).

Figure 17. Decomposition of the Mining Industry. Contribution by Sectors to the Growth, YoY, cumulative

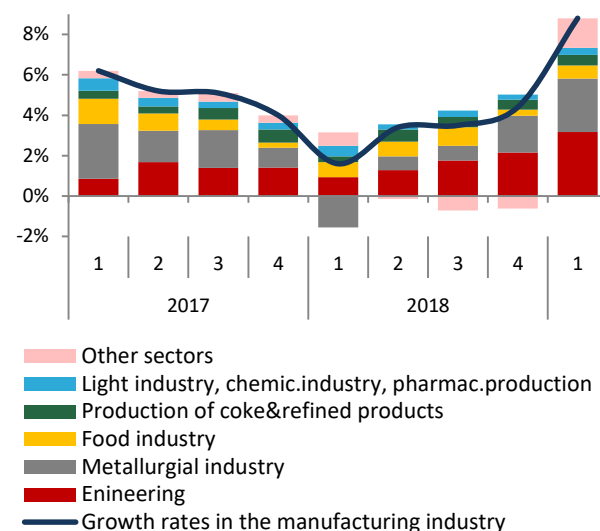


Source: CS MNE, NBRK's calculations

Other branches of the mining industry; Crude oil extraction; Natural gas extraction; Coal extraction; Iron ores extraction; Extraction of ores of non-ferrous metals; Mining industry

The manufacturing industry during January-March 2020 advanced by 8.8%. The main contribution to the growth was made by the increase of output in the engineering industry (by 30.4% due to a ramp-up of car production, full trailers and semitrailers). The upturn of 2.2% was observed in the food production after its decline at the end of 2019. There was an increase in output of construction materials (by 22.7%), metal structures (by 31.6%), pharmaceutical products (by 32.2%), paper and paper products (by 19.6%) (Figure 18).

Figure 18. Decomposition of the Manufacturing Industry. Contribution by Sectors to the Growth, YoY, cumulative



Source: CS MNE, NBRK's calculations

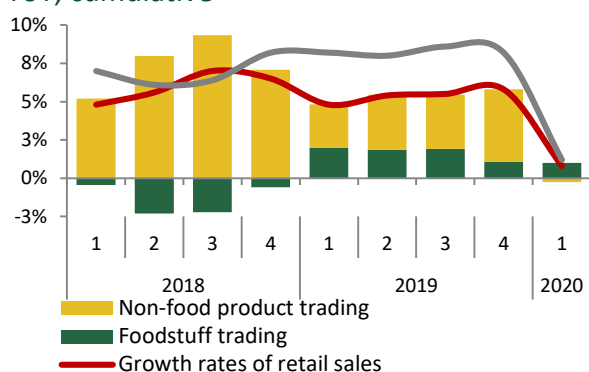
Other sectors; Light industry, chemical industry, pharmaceutical production; Production of coke & refined products; Food industry; Metallurgical industry; Engineering; Growth rates of the manufacturing industry

During January-March 2020, volumes of construction works went up by 11.7% in real terms. High growth rates are largely related to construction and renovation of industrial facilities, residential buildings and engineering structures. Based on a regional breakdown, the maximum growth in the amount of construction is observed in the Karaganda (the growth of 50.8%), West Kazakhstan (22.9%) and Atyrau (by 19.3%) Regions.

The COVID-19 pandemic has already had its partial effect on the service sector. The imposed quarantine measures and restrictions caused a deceleration in the wholesale and retail trade. So, during the first quarter of 2020, the growth rates in trade slowed down to 1% in annual terms.

The growth in volumes of retail trade in the first quarter of 2020 slowed to 0.8%. Retail trade declined in the cities of Nur-Sultan by 7.4%, and in Almaty, in Atyrau Region the growth was minimal – by 0.1%. At the same time, retail trade of foodstuffs grew by 3.0%, while retail sales of non-food products decreased by 0.4%.

Figure 19. Growth Structure of Retail Sales and Growth Rates of Wholesale Turnover, YoY, cumulative



Source: CS MNE, NBRK's calculations

Non-food product trading; Foodstuffs trading; Growth rate of retail turnover

Wholesale trade advanced by 1.2%, where foodstuffs trading decreased by 12.5%, and non-food product trading increased by 5.9% (Figure 19).

During January-March 2020, the volume of transport services declined by 1.3%. In the structure of transport, the freight turnover based on the assessment of freight turnover of individual entrepreneurs engaged in commercial transportations decreased by 1.4%. The 4.1% reduction in the passenger turnover at transport was driven by contraction of passenger traffic in the road transport and the railway transport.

5.3. Labor Market

In the fourth quarter of 2019, employment performance improved as a result of growth in the number of employees and reduction in the number of unemployed population. At the same time, acceleration of wage growth against lower growth rates of the labor productivity creates pro-inflationary risks in the economy.

In the fourth quarter of 2019, the growth rate of labor force made up 0.7% owing to an incurrent increase in the employed population (by 0.7%) and reduction of the unemployed population (by 0.1%). A restraining effect on the labor force growth is exerted by an ongoing contraction in the able-bodied population at the age from 25 to 34 years old (by 6%). Such dynamics is

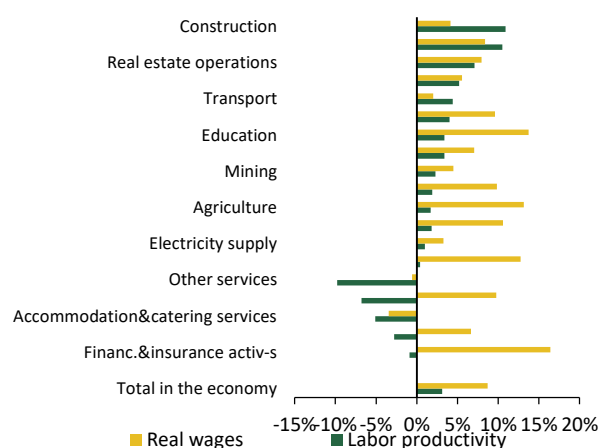
related to the specifics of demographic processes, namely because the scarce population born in the 1990s joined the labor force.

Employees dominate in the structure of the employed population. In the fourth quarter of 2019, their share accounted for 76%, of which 57% were employed at large and medium-sized enterprises. The number of employees at large and medium-sized enterprises in the fourth quarter of 2019 grew by 1.1% in annual terms due to the increase in the number of workers in such sectors as trade, construction, healthcare and education. However, the number of employees working at large and medium-sized enterprises in agriculture, forestry and fishery, and public administration continued to go down. In the economy as a whole (including small enterprises) the numbers of employees in the fourth quarter of 2019 grew by 0.5%.

The numbers of the self-employed population have increased by 1.3% in annual terms. Along with that, the number of productively employed population is growing and the number of unproductively employed population is slightly decreasing.

In the fourth quarter of 2019, the growth of real wages (excluding small enterprises) accelerated to 9.9%, being driven by a 1.5 times raise of the minimum wage, by expansion of the budget spending for the increase of salaries to the public sector employees and by a 12% buildup of the payroll fund in the real sector. The main contribution to the wage growth is made by the increasing budget spending on remuneration to the public sector which went up by 30.4% in the fourth quarter of 2019. In term of sectors, reduction in real wages was observed only in the sectors engaged in provision of other types of services.

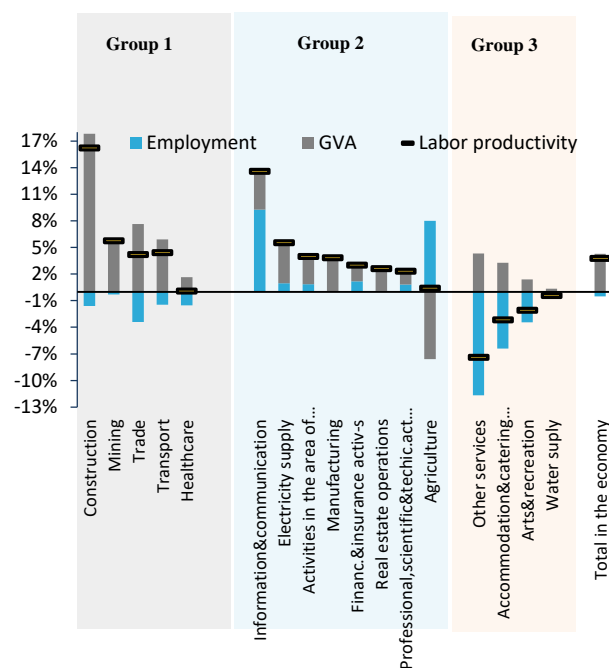
Figure 20. Real Wages and Labor Productivity, as at the end of 9 months of 2019, YoY cumulative



Source: CS MNE, NBRK

As at the end of 9 months of 2019, the trend of the outstripping growth rates of wages over growth rates of the labor productivity in the economy persisted (Figure 21). The labor productivity increased by 3.8%, including in the sectors engaged in manufacturing of goods – by 4.3% and in the service sectors – by 2.4%.

Figure 21. Contribution by the Change of Employment* and Gross Value-Added in the Labor Productivity over 9 months of 2019



Source: CS MNE, NBRK

*- Rates of change in employment were taken with an opposite sign since the increase in employment with the GVA remaining unchanged results in decline of labor productivity

The growth of productivity was driven by the increase in gross-value added in the

sectors while the number of employees remained unchanged or decreased (Figure 21). So, in the first group of sectors (construction, the mining industry, trade, transport and healthcare) there was an outstripping growth of gross value-added with the employment in the sector going up.

In the second group of sectors (information and communication, electricity supply, financial and insurance activities, the manufacturing industry) the growth in labor productivity was accompanied by the increase in gross value-added against the decline in employment.

In the third group, the labor productivity was declining as a result of outstripping growth rates of employment over the growth rates of gross value-added.

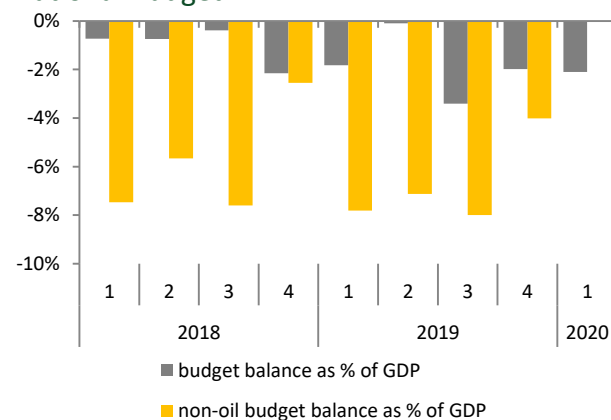
5.4. Fiscal Policy

In the first quarter of 2020, the fiscal impulse was positive indicating a persisting pro-inflationary pressure in the economy.

Higher growth rates of the budget spending furthered the increase in the budget deficit to KZT 276.5 bln. or 2.1% of GDP (Figure 22).

The rise in the budget deficit, in the first instance, stems from the outstripping growth of spending over revenues in annual terms.

Figure 22. Overall and Non-Oil Balance of the National Budget



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

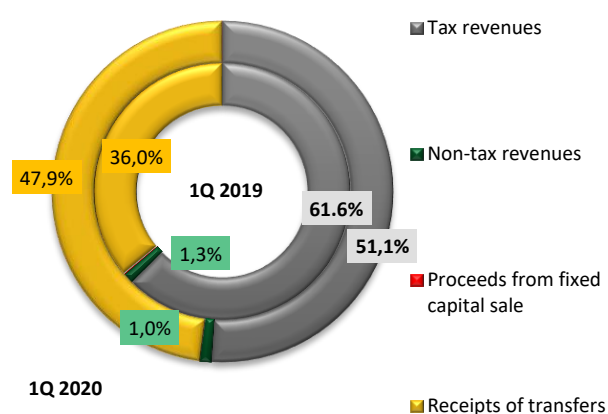
During January-March 2020, receipts of official transfers to the national budget made

up KZT 1 288 bln., whereas in 2019 transfers amounted to KZT 882.6 bln.

During the first quarter of 2020, the national budget revenues went up by 9.8% as compared to 2019 and amounted to KZT 2.7 trln. or 20.4% of GDP (Figure 23). The main reason for such growth was a 46% increase in official transfers (the share in the budget revenues accounted for 47.9%).

In the first quarter of 2020 as compared to the corresponding period of 2019, there was a drop in tax revenues (by 10.3%) and non-tax revenues (by 14.0%) given the imposed restrictive measures undertaken to prevent the spread of coronavirus.

Figure 23. Structure of the National Budget Revenues



Source: Kazakhstan's Ministry of Finance

During January-March 2020, the national budget spending went up by 14.0% as compared to 2019 and amounted to KZT 2.8 trln. The fiscal policy was largely focused on expansion of the current demand as evidenced by the outstripping growth of current expenditures over budget capital expenditures.

The main contribution to the rise in the national budget spending was made by such items as healthcare – the growth by 13.9% (the share of total spending – 13.4%), social welfare and social security – by 14.9% (the share – 30.1%), debt service – by 16.3% (the share – 7.5%) and education – by 42.7% (the share – 7.6%).

VI. FINANCIAL MARKET

6.1. Money Market

The increasing surplus of the tenge liquidity keeps influencing the money market rates. Along with that, deterioration of macroeconomic situation in March in the environment of a dramatic decline in energy prices and the spread of coronavirus pandemic led to an upswing of demand for the tenge liquidity in the money market. Nonetheless, the National Bank's operations of liquidity regulation allowed maintaining the money market rates within the base rate target band.

The development of situation in the money market continued to be influenced by a structural liquidity surplus. The growth of excess liquidity at the beginning of 2020 was related to a seasonal inflow of temporary available budget resources to banks. Excess liquidity is withdrawn via short-term notes, direct repo as well as deposit operations including deposit auctions.

In March 2020, given volatility of the foreign exchange market, expansion of conversions in favor of the US Dollar resulted in the heightened demand for the tenge liquidity in the money market.

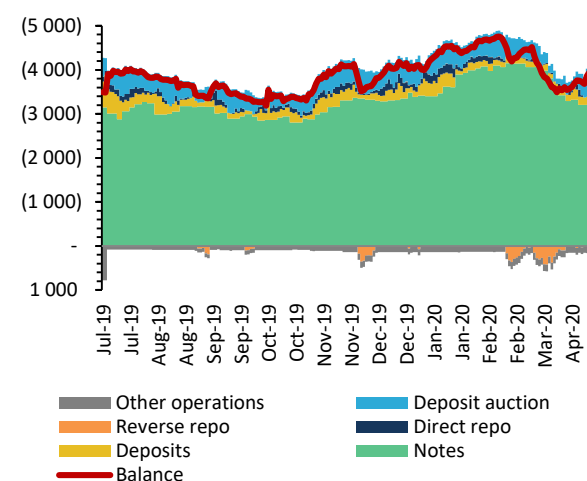
Reduction in the volume of notes because of the increased demand for the tenge liquidity in March was conducive to a downswing of exposure on the National Bank's operations.

The bulk of liquidity is withdrawn via the National Bank's short-term notes, primarily 6- and 12-month notes. However, given the increase in exposures on 28-day notes, the share of 6- and 12-month notes decreased from 78% at the end of the third quarter of 2019 to 67% at the end of March 2020 (Figure 24).

An additional window for the tenge liquidity provision and withdrawal by the National Bank from October 2019 via swaps and repos helped to reduce the share of the National Bank's participation in the main session from 35% on average in October 2019 to 14% on average in January of this

year and, respectively, to make the interest rate setting more market-based. Along with that, from the end of February through March, with a view to stabilize the situation in the money market, the National Bank was mostly providing liquidity at the main session. During two months, the share of its participation accounted for about 25% on average.

Figure 24. Exposure on the NBRK's Operations in the Domestic Market

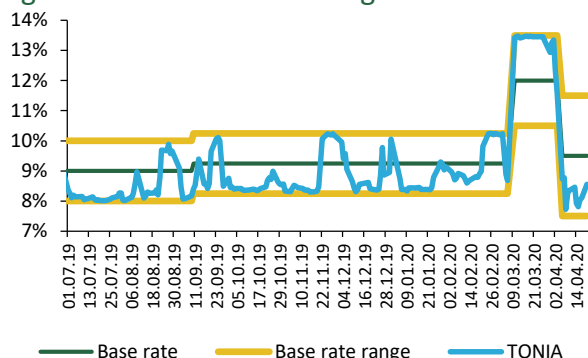


Source: NBRK

As a result of measures undertaken by the National Bank, TONIA was setting closer to the base rate level. Short-term periods when TONIA was exceeding the base rate level were associated with the increased demand for borrowings in the tenge in the period of tax payments.

The heightened demand for the tenge liquidity in March helped to set the TONIA rate near the upper boundary of the interest rate band. Once the situation in the domestic market stabilized, the demand for the tenge liquidity started to decrease. This resulted in reduction of interest rates in the money market. After the base rate was reduced to 9.5% from April 6 TONIA has been setting between the base rate and the lower boundary of the interest rate band (Figure 25).

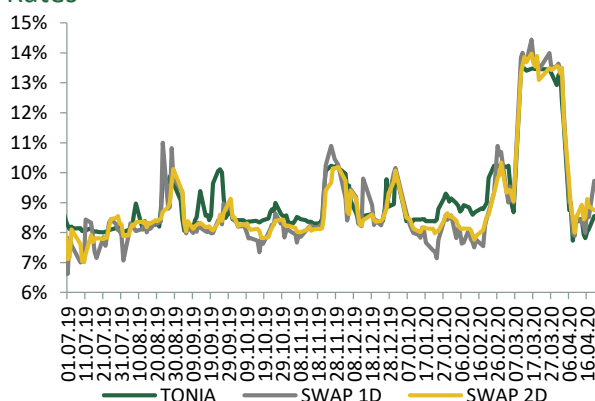
Figure 25. Interest Rate Range and TONIA



Source: NBRK, KASE

In October-December 2019, interest rates in the swap market were setting closer to the TONIA rate. However, during January-February 2020, the spread between TONIA and the swap rate was widening under the influence of the heightened demand for the tenge liquidity in the repo market. In March-April 2020, the spreads have narrowed (Figure 26).

Figure 26. Dynamics of the Money Market Rates



Source: KASE

The base rate impulse is transmitting in all segments of the money market at comparable rates. The National Bank's measures intended to increase effectiveness of the interest rate channel of the transmission mechanism have resulted in a reduced concentration of transactions conducted at TONIA rate around the lower boundary.

6.2. Foreign Exchange Market

In December 2019 – February 2020, the domestic foreign exchange market was under the impact of growing volatility in the

external sector given a concern about a negative effect of the Covid-19 pandemic on the global economy.

However, additional sources of foreign exchange in the form of inflow of portfolio investments in government securities from non-residents and operations on conversion of the National Fund's foreign currency assets for the guaranteed transfer allocations helped to stabilize the situation.

In March, the situation in foreign commodity markets and stock markets had aggravated because of controversies among countries-parties to OPEC+ regarding the terms and conditions of a transaction on reduction of oil production, which put pressure on the domestic foreign exchange market.

In January-February 2020, volatility in the international financial markets and commodity markets was increasing. The oil price dropped by 23.5% from 66 US Dollars per barrel at the end of 2019 to 50.5 US Dollars per barrel at end-February 2020. The growing concerns regarding a possible significant deceleration of the global economy also exacted a toll on the currency of countries – Kazakhstan's trading partners. During the reviewed period (January-February 2020), the Russian ruble depreciated against the US Dollar by 8.2%, against the Euro – by 1.7%, and against the Yuan – by 0.4%.

Internal factors have cancelled out the effect from external negative impact. Since December 2019, there had been an inflow of foreign exchange as a result of investments made by global investors into the tenge securities. At end-February 2020, portfolio investments of non-residents in the National Bank's notes amounted to KZT 273 bln. or 716.0 mln. US Dollars as compared to KZT 61.8 bln. or 159.3 mln. US Dollars at end-September 2019.

Operations on conversion of the National Fund's assets for guaranteed transfers served as another source of foreign currency. In January-February 2020, the volume of conversions at the Kazakhstan Stock

Exchange for transfer allocation was 951.9 mln. US Dollars or KZT 360.9 bln.

An additional support to the tenge was made by the sale of foreign exchange proceeds by exporters in order to discharge tax liabilities.

In December 2019 – February 2020, a stock exchange rate of the tenge was moving within the range from KZT 375.94 to KZT 387.37 per US Dollar, having appreciated against the US Dollar by 1.3%. The difference between the minimum and maximum exchange rate made up 3.0% (Figure 29).

At the beginning of March 2020, the absence of agreement to limit oil production among OPEC+ members resulted in a dramatic drop in the oil price. In March 2020, its quotations declined by 2.2 times to 22.7 US Dollars per barrel as at the end of March 2020. As a result, currencies of petroleum product exporters showed a significant depreciation, and specifically, the Russian ruble depreciated by 17.3% to 78.6 rubles per US Dollar.

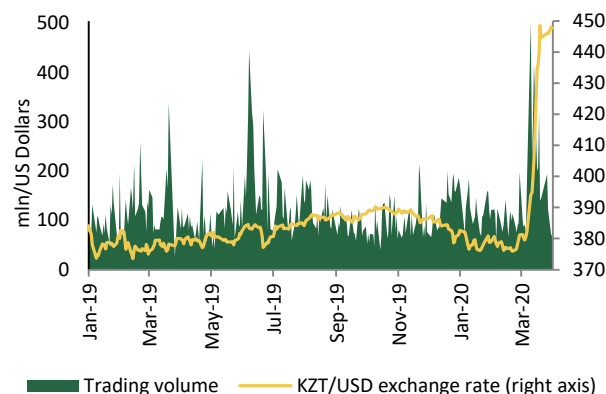
Deterioration of external conditions has put pressure on the domestic foreign exchange market. As at the end of March 2020, the exchange rate of the tenge was KZT 447.67 per US Dollar, having depreciated by 17.4% since the beginning of the month (on the year-to-date basis – by 17.0%).

In order to improve the balance between the demand and supply in the foreign exchange market, the National Bank, jointly with the Government, took a set of measures to increase the supply of foreign exchange. The undertaken measures included a mandatory sale of a part of export FX proceeds and a transfer of foreign currency deposits by entities of the quasi-government sector to accounts at the second-tier banks in Kazakhstan, and the tightening of requirements to foreign exchange purchase/sale by corporate entities.

In addition, with a view to safeguard financial stability and to restrict speculative transactions, in February-March 2020 the National Bank had to conduct FX

interventions of 94.8 mln. US Dollars and 1.5 billion US Dollars, respectively.

Figure 27. Exchange Rate Movements and Trading Volume in the Foreign Exchange Market



Source: KASE

In March of this year, the National Bank, jointly with the “Kazakhstan Stock Exchange” JSC, activated the Frankfurt method of FX trading for the first time. The instrument was designed in order to prevent a destabilizing effect of external factors on the domestic foreign exchange market.

From April 2020, the rise in world oil prices was observed against expectations about adjustment of imbalances in the global oil market. This, coupled with a set of measures on improving the balance in the domestic foreign exchange market, enabled the exchange rate of the tenge to appreciate by April 21 of this year by 3.8% to KZT 430.5 per US Dollar since the beginning of the month.

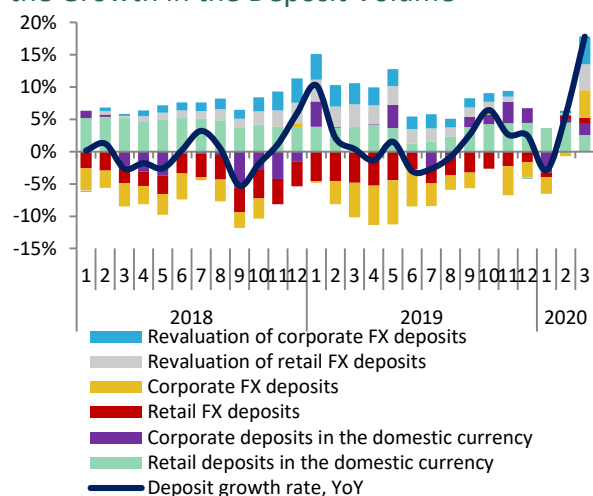
6.3. Deposit Market

As at the end of the first quarter of 2020, deposits demonstrated a significant growth. The main contribution to deposit growth was made by foreign currency deposits. Along with that, deposits in the tenge kept making a positive contribution to the growth of total deposits.

Deposit dollarization increased due to growth of foreign deposits.

In March 2020, deposits went up by 17.8% in annual terms to KZT 20.3 trln. (Figure 28).

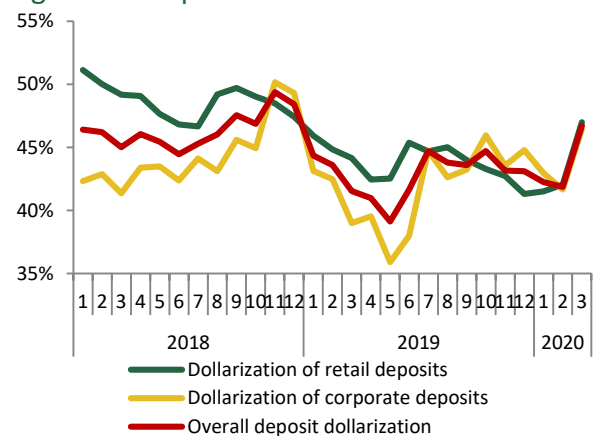
Figure 28. Contribution by Components to the Growth in the Deposit Volume



The increase in deposits is primarily related to FX revaluation because of the domestic currency depreciation in March 2020 as well as due to the low base in 2019. As at the end of the first quarter of 2020, foreign currency deposits went up by 32.5% in annual terms. Excluding FX revaluation, foreign currency deposits have grown by 12.5%.

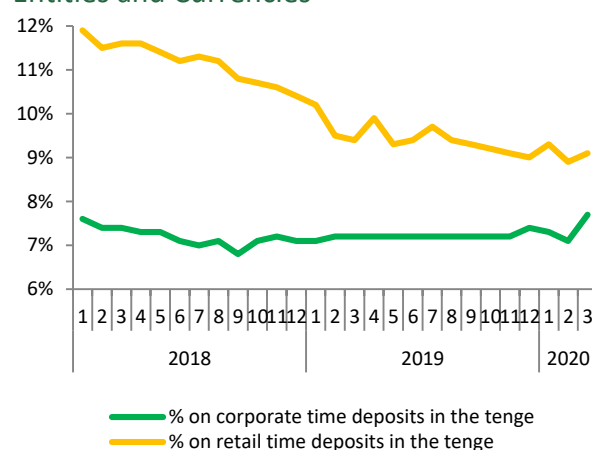
Over the year, deposits in the domestic currency have increased by 7.4%. Resulting from the overrun in the growth of foreign currency deposits versus the growth of the tenge deposits, deposit dollarization in the first quarter of 2020 went up to 46.7% (Figure 29).

Figure 29. Deposit Dollarization



The interest rate on corporate deposits in the tenge after the increase of the base rate in March 2020 went up by 60 basis points to 7.7%. The interest rate on retail time deposits in the tenge after its reduction to 8.9% in February 2020 grew to 9.1% in March 2020 (Figure 30).

Figure 30. Interest Rates on Time Deposits by Entities and Currencies



6.4. Credit Market

Retail lending remains a key growth driver for the credit market. Since September 2019, corporate deposits in the tenge keep making a positive contribution to the credit growth.

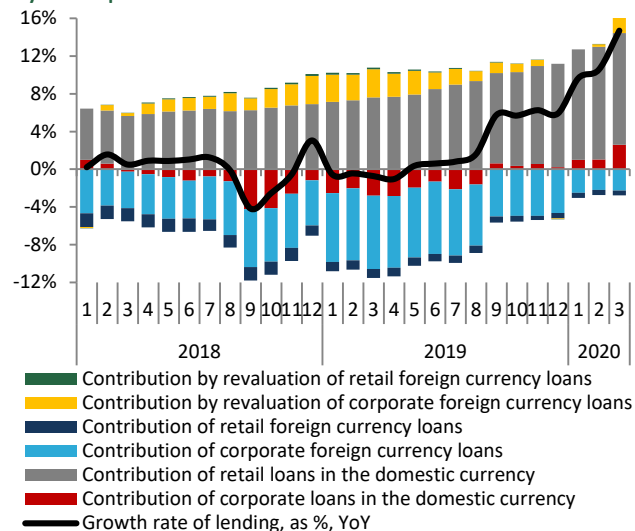
In March 2020, the bank loan portfolio expanded by 14.7% in annual terms to KZT 14.3 trln. (Figure 31).

Retail sector loans went up by 26.4% in annual terms, and reached KZT 6.9 trln. Their share in total loans reached 48.0%.

Consumer loans which comprise nearly 2/3 of the retail lending market still represent a key growth factor for expansion of loans to individuals. Mortgage lending is also expanding due to implementation of government housing programs.

Corporate loans went up by 5.7% or KZT 399.7 bln. in annual terms to KZT 7.4 trln., primarily due to the growth of loans in the domestic currency.

Figure 31. Contribution to the Loan Growth by Components



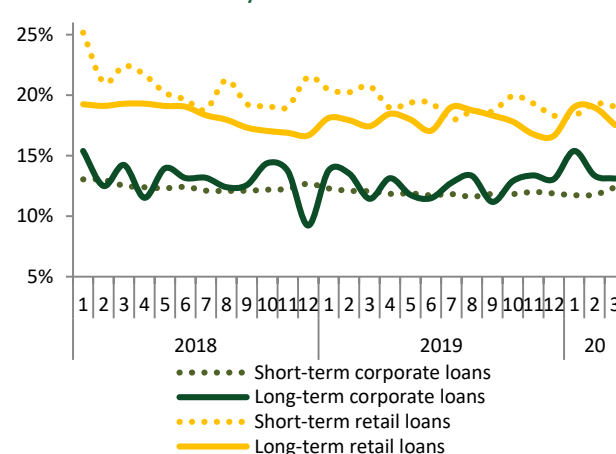
Source: NBRK

In the first quarter of 2020, new loans increased by 18.1% as compared to the same period of 2019, where the tenge loans went up by 19.9%.

The survey of banks devoted to lending shows that in the fourth quarter of 2019 the demand for loans on the part of businesses continued to go up, specifically from the small business entities. Banks were actively competing for borrowers: launched new products, occupied new niche markets, and made loan disbursement more convenient, refinanced loans provided by other banks.

In the first quarter of 2020, there was a minor growth of interest rates on short-term and long-term loans to businesses in the national currency. In March 2020, the weighted average interest rate on corporate loans in the domestic currency was 12.5%, which is by 0.5 pp higher than the last year interest rates (Figure 32). Weighted average interest rates on short-term loans increased from 12.1% to 12.4%, and the rate on long-term loans went up from 11.5% to 13.1%.

Figure 32. Interest Rates on Loans in the Domestic Currency

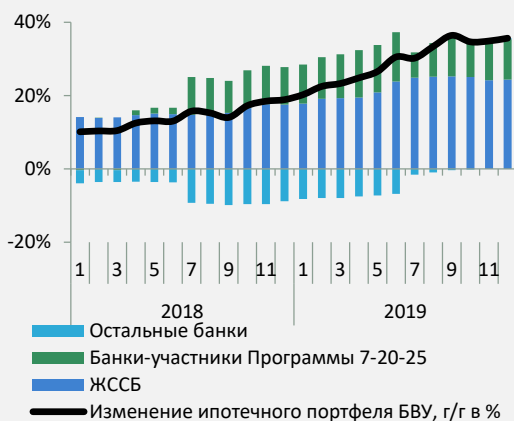


Source: NBRK

In the fourth quarter of 2019, there was a minor expansion in the spread between the actual interest rate on loans and the rate acceptable for enterprises (to 5.9 pp as compared to 5.4 pp in the third quarter of 2019) because of reduction of the rate acceptable for enterprises which made up 6.4% (7.0% in the third quarter of 2019).

Box 4. Mortgage Lending Market in 2019

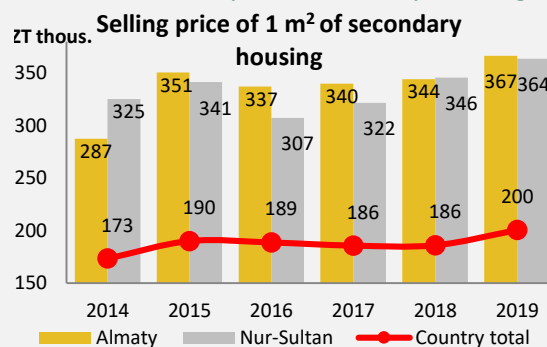
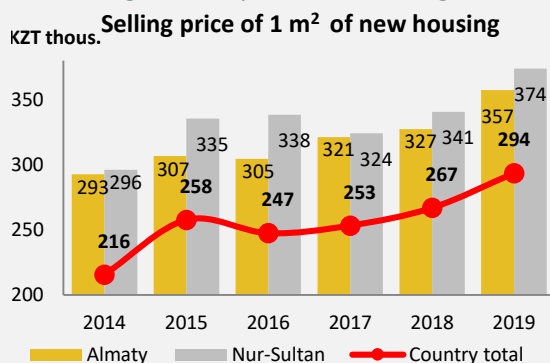
Diagram 1. Dynamics of the Mortgage Portfolio and Contribution of Banks to the Growth in Mortgage Lending



Source: NBRK

During 2019, the mortgage portfolio of banks went up by 35.6% to KZT 1.8 trln. Mortgage loans are growing due to expansion of the loan portfolio of "Zhilstroysberbank" and implementation of the "7-20-25" Mortgage Program (Diagram 1). As part of the "7-20-25" Program implementation, as at the end of February 2020 loans totaling KZT 156.6 bln. were provided. Alongside with the concessional lending programs for housing, a positive contribution to the demand has been also made by the growing real wages. Expansion of mortgage lending is also furthered by other government concessional lending programs such as "Bakytty Otbasyl", "Military Product", "Own Home", "Nurly Zher" and "Almaty Zhastary". Due to activation of mortgage lending, the number of purchase and sale transactions in the real estate market is growing. In 2019, the number of purchase and sale transactions increased by 21% to 320 012 compared to 2018. Given expansion of the mortgage market, also due to its active stimulation by the government, prices of primary and secondary housing are rising. During 2019, the selling price of one square meter of new housing went up by 10% to KZT 294 thous., and of secondary housing – by 7.8% to KZT 200 thous. In the cities of Nur-Sultan and Almaty, in 2019 the rise in price of a square meter of new housing exceeded 9%, and the increase in price of the secondary housing accounted for 6% (Diagram 2).

Diagram 2. Dynamics of Selling Prices of a Square Meter of Primary and Secondary Housing



Source: CS MNE

In total, in 2019 KZT 1 423 bln. was allocated for housing construction, which is by 16.9% greater than in 2018. Over the year, 13 134 000 sq.m of total space area of residential buildings have been commissioned, which is by 613 thous. sq.m greater compared to 2018. Average actual construction costs of 1 sq.m of total space area of residential buildings amounted to KZT 106.6 thous. (the growth by KZT 1.8 thous.), in residential buildings constructed by private developers – KZT 84.5 thous. (Figure 3).

Due to the increasing demand for housing which qualifies for the government concessional programs, there is a shortage of housing of the economy class and comfort class. In large part, developers build apartments with improved layout and bigger total space area with the price of such apartment exceeding the maximum amount set forth in the "7-20-25" Program (KZT 25 million). Also, the fact that the housing sells well at the construction phase on a shared basis causes the shortage of apartments.

In general, government housing programs have a positive effect on construction not only by stimulating the demand for housing but also by supporting it supply through stimulation of developers and the running of utility lines to land plots allocated for housing construction.

Diagram 3. Dynamics of Commissioned Residential Buildings and Construction Costs of 1 Sq.M²



Source: CS MNE

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. The base rate – is the National Bank's key monetary policy instrument which enables to regulate nominal interbank interest rates in the money market. By setting the base rate level, the National Bank determines a target value of the targeted interbank short-term money market rate in order to achieve the goal of ensuring the price stability in the medium term.

Gross Fixed Capital Formation – is the growth in non-financial assets which have been used in the process of 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 tangible assets; d) expenses in connection with the transfer of title for non-incurred costs.

FX Swap means a foreign exchange transaction which involves the concurrent purchase and sale of a certain amount of one currency in exchange of another currency with two different value dates.

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

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

financial organizations in the tenge at the National Bank.

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

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

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

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

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

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

downturns in the economy occur and change. A composite indicator is built on the basis of the outcomes of survey among enterprises which participate in the market research conducted by the National Bank.

Short-term economic indicator is calculated with a view to ensure efficiency and is based on the change in the output indices in key sectors: agriculture, industry, construction, trade, transport and communication accounting for over 60% of GDP. The indicator is built without recalculations for the unobservable economy and without other macroeconomic adjustments.

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

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

Reverse Repo is the purchase of a security with the commitment to sell it after a specific period of time and at a specific price. The National Bank conducts reverse repo operations with a view to provide the tenge liquidity to banks against the pledge of securities in line with the National Bank's list of collateral.

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

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

Transferrable Deposits refer to all deposits which: 1) can be converted into cash at face value at any moment in time without any penalties and restrictions; 2) are freely

transferable through a check, draft or endorsement orders; and 3) are widely used for making payments. Transferable deposits represent a part of the narrow money. Other deposits primarily include savings and time deposits that only can be withdrawn on expiration of a certain period of time, or can have different restrictions which make them less convenient for use in the ordinary commercial transactions and, mainly, meet the requirements established for saving vehicles. In addition, other deposits also include non-transferable deposits and deposits denominated in foreign currency.

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

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

Interest Rate Channel of the Monetary Policy Transmission Mechanism is the transmission mechanism channel which describes the impact of the central bank on the economy through the interest rate regulation.

Direct Repo is the sale of a security with the commitment to repurchase it after a specific period of time and at a specific price. The National Bank conducts direct repos with a view to withdraw excess liquidity in the tenge.

Free Floating Exchange Rate. According to the IMF's current classification, under the floating exchange rate framework a central bank does not establish any pegs including

operating ones for the level or the change in the exchange rate, allowing the exchange rate to be determined by the market factors. In doing so, the central bank reserves the opportunity to periodically intervene in the foreign exchange market in order to smooth out the volatility of the domestic currency exchange rate or to prevent its dramatic movements as well as to ensure the financial system.

Output Gap. Deviation in GDP expressed as a percentage of a potential output. Expresses the difference between an actual GDP and potential GDP for a certain time interval. Serves as an indicator which reflects the effectiveness of resources utilized in the country. If an actual output exceeds the potential one (a positive gap), other things remaining equal, the trend of acceleration in the price growth rates would be anticipated because of the overheating of the economy.

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

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

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

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

Fiscal Impulse means the difference of operating balances in periods t and $(t-1)$. If the operating balance at the time t is greater than the balance at the time $(t-1)$, the fiscal impulse in relation to the economic activity is negative (contractionary fiscal policy); if the operating balance at the time t is smaller than its previous value – the impulse is positive (stimulative fiscal policy). Where the balances at periods t and $(t-1)$ are equal thus implying their zero difference, there is no fiscal impulse.

LIST OF KEY ABBREVIATIONS

bp – basis point
GDP – gross domestic product
GPIID - the Government Program for Industrial and Innovation Development
EU – the European Union
ECB – the European Central Bank
CPI – consumer price index
CS MNE – the Committee on Statistics of the Ministry of National Economy of the Republic of Kazakhstan
KASE – the Kazakhstan Stock Exchange
KSF – the “Kazakhstan Sustainability Fund” JSC
NBRK – the National Bank of the Republic of Kazakhstan
VAT - value-added tax
OPEC – Organization of the Petroleum Exporting Countries
Rosstat – the Russian Federal State Statistics Service
REER – real effective exchange rate
IMF – the International Monetary Fund
bln. - billion
mln. - million
MNE – the Ministry of National Economy
MoA RK – the Ministry of Agriculture of the Republic of Kazakhstan
MED – the Ministry of Economic Development of the Russian Federation
thous.– thousand
TCO - Tengizchevroil
CB RF – the Central Bank of the Russian Federation
FAO – Food and Agriculture Organization of the United Nations
US Fed – the Federal Reserve System