NATIONAL BANK OF KAZAKHSTAN

MONETARY POLICY REPORT

November 2023

To design this issue of the November 2023 Monetary Policy Report, the art works of the National Bank employees – winners of the art competition dedicated to the 30th anniversary of the tenge – were used:

Darzhanova Assel
Khassenova Botakoz
Zhanibek Saule
Aktanbayev Yerbolat

CONTENTS

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

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

The forecast and analysis of macroeconomic indicators was prepared on the basis of statistical information as at **November 15, 2023**

STATEMENT BY THE GOVERNOR OF THE NATIONAL BANK OF THE REPUBLIC OF KAZAKHSTAN ON THE BASE RATE DATED NOVEMBER 24, 2023

The Monetary Policy Committee of the National Bank decided to lower the base rate by 25 bp to 15.75%. Our decision is based on updated forecasts for inflation and economic growth, as well as on the results of an analysis of actual data and the balance of risks.

In the current conditions, given the base effect, previously made decisions on the policy rate and measures taken by the Government and akims, we still face a dynamic deceleration in inflation. Let me remind you that last year inflation was very high, and this affects a more balanced slowdown in annual inflation this year. It is now moving closer to the lower bound of our previous forecast, and core and seasonally adjusted inflation indicators are showing signs of stabilization. In the coming months, the annual inflation rate is expected to move into the single-digit zone.

Meantime, the role of individual factors and risks that require attention is increasing, including rising food prices, inflation in the Russian Federation as our key trading partner, the dynamics of inflation expectations and fiscal expenditures.

At the same time, the dynamic decline in annual inflation and its lower forecasts until the end of 2023 allowed us to lower the base rate as part of the current decision. In the future, the trends we monitor in inflation expectations, fiscal policy parameters and the external environment continue to require that we maintain moderately tight monetary conditions.

Next, I will move on to the factors of the decision we made.

First. <u>Dynamics of Inflation and Inflation Expectations</u>.

Inflation continues to slow down steadily for the eighth consecutive month. In October of this year, annual inflation stood at 10.8%. Actual inflation is moving closer to the lower bound of the previous forecast range, mainly due to a more restrained than expected rise in prices for utility services, as well as a moderate increase in prices for non-food products. If we look at inflation in the context of its components, the annual growth in prices for food products slowed to 10.4%, YoY. Annual inflation of non-food products decreased to 11.1%, YoY. The growth in prices for services went down to 11.0%, YoY.

Monthly inflation in October was 0.7%, in line with its historical average. At the same time, given the decelerating annual inflation, we are seeing stabilization of core inflation (*0.6% for the second month in a row*) and a slowdown in seasonally adjusted inflation. This indicates an emerging trend towards stabilization of inflation processes. Nevertheless, the dynamics of the sustainable part of inflation is still above the target. Inflation expectations, despite the positive dynamics of actual inflation, are still high and remain sensitive to changes in the situation in certain commodity markets. Main factors include the rise in prices for fuel and lubricants and the dynamics of food prices.

Second. Trends in the Domestic Economy.

The economy of Kazakhstan in January-October 2023 has been showing the growth of 4.9% YoY. The expansion of business activity is driven by a steady domestic demand, implementation of infrastructure projects and recovery of the oil sector.

Growth in the production of goods amounted to 3.8% YoY, business activity in the services sector increased by 5.4% YoY. The sectors of construction (*12.5%, YoY*), trade (*10.4%, YoY*), and information and communication (*8.0%, YoY*) continue to demonstrate the highest growth rates. Agricultural output fell by 8.6% YoY, which poses risk to food inflation in the future.

The dynamic growth of economic sectors is ongoing, driven primarily by the recovery in oil production and government spending. This indicates the risk of overheating and is a significant pro-inflationary factor.

Similarly, stable consumer demand of the population, which is reflected in trade growth by 10.4%, YoY, in January-October 2023, can be attributed to pro-inflationary factors. Its stable dynamics are also confirmed by the data on consumer lending and imports of consumer goods.

Over 9 months of 2023, imports of non-food consumer goods increased by 36.7%. Such growth rates show that domestic demand exceeds the capabilities of domestic supply. Along with this, domestic demand is supported by expansion of investment activity by 12.6%, YoY, and an increase in real wages of the population by 3.5%, YoY.

Third. External Economic Environment.

In the external sector, we continue to see a decline in inflationary pressure driven by the impact of tight monetary policy, positive food price movements, as well as the recent short-term slowdown in energy prices.

Nevertheless, in the short term, we expect that the effect of pro-inflationary factors will somewhat increase, which is mainly dictated by the dynamics of inflation in Russia and the expected rise in world food prices. In the future, as the situation in trading partner countries stabilizes, we expect the target values to be achieved and pro-inflationary pressure from external factors to soften.

Inflation in Russia, as our key trading partner, is accelerating. In October, it amounted to 6.7% versus 6.0% in September and has been higher than previous forecasts. The growing domestic demand and the weakening ruble remain as the key drivers. At the same time, given sharp successive tightening of monetary policy by the Bank of Russia, we expect that in 2025 inflation in Russia will return to the forecast corridor. Price growth in the EU continued to slow from 4.9% in September to 3.6%, YoY, as a result of the expiry of last year's high base. In 2024, according to updated forecasts, inflation in the EU will be slightly higher than expected. However, the policy of maintaining a high key rate for a long time will allow the EU to reach the target in 2025. In China, another main trade and economic partner, deflation is observed due to weak current economic performance.

World food prices continue to decline amid falling prices for all types of food, with the exception of sugar. The current decline in grain prices is stemming from a seasonal increase in supply. However, by the end of 2023 and early 2024, it is expected that prices may begin to rise as a result of lower grain supplies from Ukraine.

The oil market is showing signs of stabilization, having consolidated at around US$80 per barrel. On the supply side, upward pressure on oil prices is exerted by OPEC+ decision to cut production before the end of the year, as well as the risks of further escalation of the conflict in the Middle East. With this in mind, our baseline scenario assumes a Brent price of US$85 on average in 2024 and US$80 in 2025.

The inflation forecast for the current year has been improved to 9.3-10.3%. The revision of the forecast for this year is associated with a more moderate than expected increase in tariffs for housing and communal services and a more restrained increase in prices for non-food products. In the medium term, the reduction in inflation will be facilitated by a further weakening of pressure from the external environment and a moderately tight monetary policy. The forecast for 2024 remained at the level of 7.5-9.5%, for 2025 – at the level of 5.5-7.5%.

Among the main risks of the inflation forecast for this period, we highlight increased fiscal stimulus, unanchored inflation expectations, a possible increase in food prices as a result of the effect of a low harvest in 2023, as well as direct effects from an increase in tariffs for utility services.

Please note that our inflation forecast does not take into account the increase in VAT in 2025 as discussed by the Government. We will be able to assess its effect on inflation once the parameters of this tax reform are absolutely clear, since a possible increase in VAT is a one-time factor and does not require a monetary policy response. We will closely monitor secondary effects and respond accordingly should they occur.

Forecasts regarding Kazakhstan's GDP growth for this year remained unchanged in the range of 4.2-5.2%; the medium-term forecasts have been revised. The 2024 forecast has been revised downward to a range of 3.2-4.2%. The revision is related to the possible postponement of the start of ramp-up of production at the TCO to the end of 2024 or to 2025. Therefore, the forecast for 2025 was increased to 5.5-6.5% due to a possible failure to achieve the previously planned oil output and, thus, lower GDP growth rates in 2024.

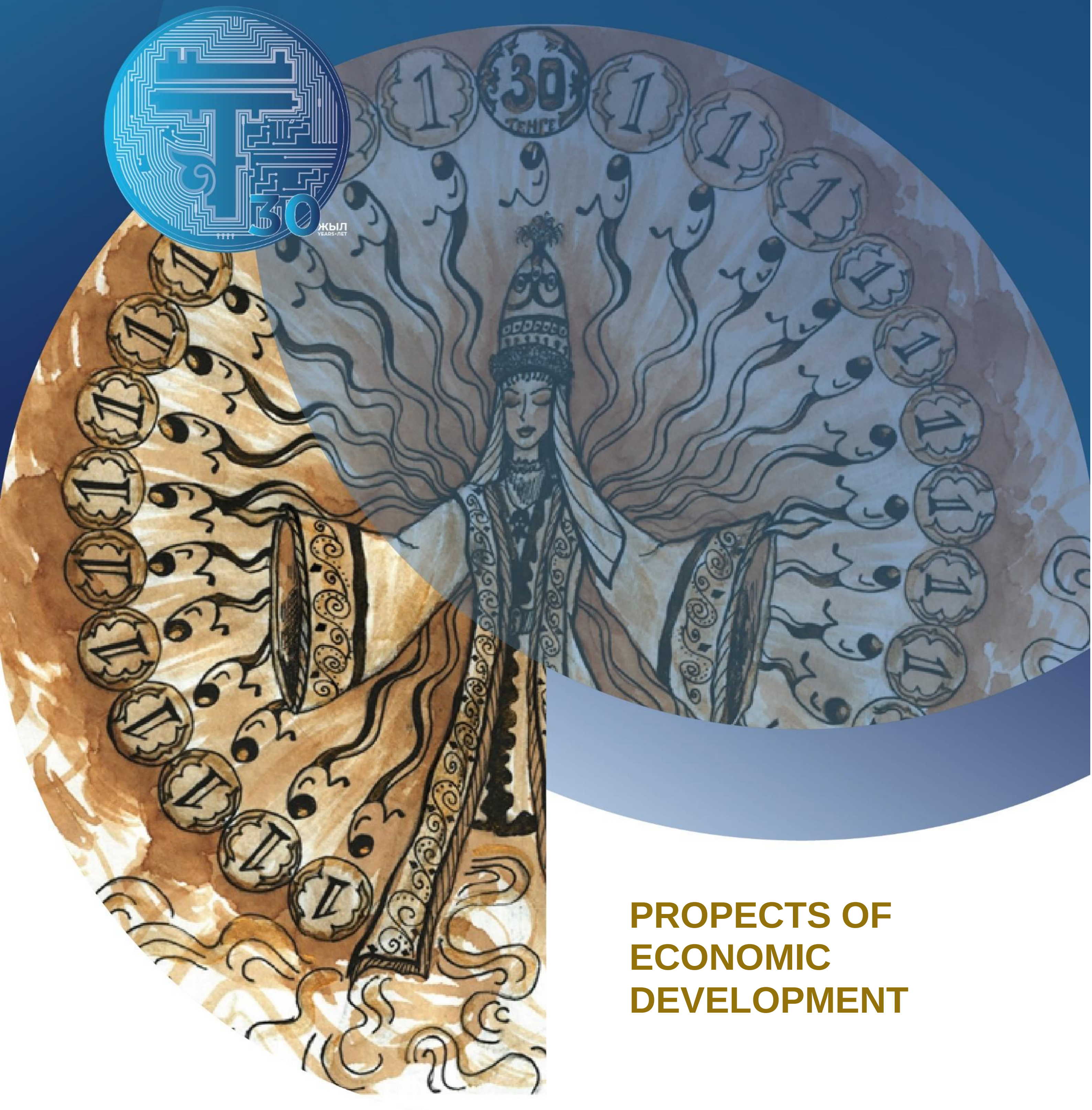
The dynamic deceleration of annual inflation and its lower forecasts by the end of 2023 created space for lowering the base rate. Subsequent decisions on the base rate will depend on consistency of inflation dynamics with the projected path.

With a further slowdown in inflation in 2024, the National Bank will consider if gradual lowering of the rate is feasible, taking into account the need to maintain moderately tight monetary conditions in the medium term. The goal is to return inflation to the 5% target and anchor inflation expectations. At the same time, we do not exclude the possibility of pauses in changing the base rate to accumulate data and monitor the balance of risks.

The main task of the National Bank is to ensure price stability. This means that all our efforts will be aimed at achieving the established inflation target of 5% in the medium term.

Governor of the National Bank of the Republic of Kazakhstan
Timur Suleimenov

NATIONAL BANK OF KAZAKHSTAN



PROPECTS OF ECONOMIC DEVELOPMENT

I. PROPECTS OF THE DEVELOPMENT OF THE MACROECONOMIC SITUATION

1.1. Forecast Assumptions

The global economy, under the pressure from ongoing tight monetary policy as well as the growing uncertainty due to high inflation and intensified geopolitical risks will develop at a moderate pace during the forecast period.

According to the IMF updated forecasts[1], the global economy, after growing at 3.5% in 2022, is expected to slow to 3.0% in 2023, with a further slowdown to 2.9% in 2024. Many large European countries will grow at a weaker pace than previously expected. At the same time, the US economy, despite the tight monetary policy pursued, will develop according to a more “soft landing” scenario. Estimates for the US economic growth have been raised from 1.8% to 2.1% in 2023, from 1.0% to 1.5% in 2024. Updated forecasts for many developing countries suggest stronger economic growth, driven by high current commodity price quotations.

Expected feeble economic growth in the EU and China could reduce the demand for Kazakhstan's exports, while high inflation in Russia could increase external inflationary pressure on consumer prices in Kazakhstan.

Compared to the August 2023 forecasting round, forecasts for economic growth in China and the EU were lowered (Graph 1). Projections about China's economic growth have been revised downward due to weak current macroeconomic indicators and persisting problems in the real estate market. The EU countries will develop at an even slower pace than previously expected because of the tight monetary policy pursued, reduced production in the industrial sector as well as weak external demand for exported products. In turn, forecasts regarding the economic growth in Russia for this year have been raised given the rapid growth in domestic demand as well as increased investment activity and high fiscal stimuli, while estimates for 2024-2025 remained unchanged at 1.5% (Graph 1) (Table 1).

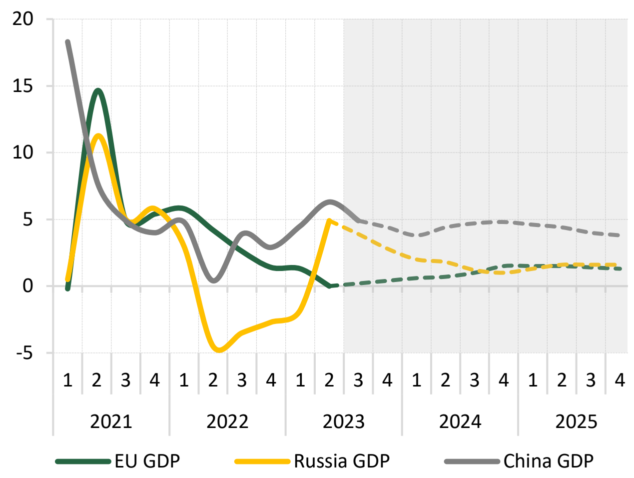
Inflation forecasts for China and the EU, taking into account the current dynamics, were slightly revised. According to forecasts, inflation in Russia will remain above the target level until almost the end of 2024. At the same time, annual inflation in all trading partner countries is expected to return to target values by the end of the forecast period (Graph 2).

Sustained high inflation leads to the persistence of tight monetary conditions in the world. Along with this, the uncertainty of further inflation dynamics again results in that a start in the interest rate cut cycle is shifted to a later date, which increases the likelihood of heightened volatility in financial markets and increased pressure on the tenge exchange rate.

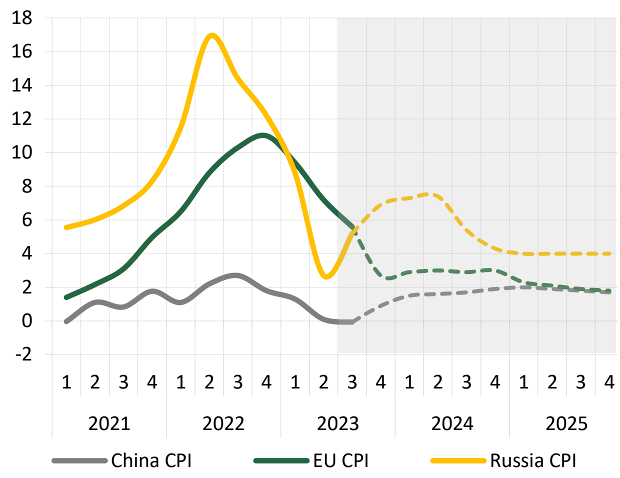
Compared to the “August 2023” forecasting round, the assumptions regarding external monetary conditions have somewhat deteriorated. Core inflation across countries has stabilized; however, it is still significantly above targets. In some countries, consumer and business activity remain resilient to the ongoing tight monetary policy. It is expected that a restrictive monetary policy of the US Federal Reserve and the ECB will be in effect for a longer time than previously expected. In the medium term, the anticipated policy easing by major central banks should have a positive impact on foreign exchange markets, including the exchange rates in Kazakhstan’s trading partner countries.

[1] *IMF World Economic Outlook, October 2023*

Graph 1. GDP Growth Rates, YoY, %



Graph 2. Inflation, YoY, %



Source: Eurostat, National Bureau of Statistics of China, Rosstat, Consensus Ecs., CB RF, NBK estimate

Table 1. Forecast Assumptions under the Baseline Scenario

	2023	2024	2025
GDP, YoY, %			
China	**5.0** (5.5)	**4.4** (4.8)	**4.2** (4.6)
EU	**0.5** (0.7)	**1.0** (1.3)	**1.4** (1.5)
Russia	**2.5** (2.0)	**1.5** (1.5)	**1.5** (1.5)
Inflation, YoY, %			
China	**0.9** (1.7)	**1.9** (2.0)	**1.7** (2.2)
EU	**2.7** (3.1)	**3.0** (2.7)	**1.8** (2.0)
Russia	**6.9** (5.8)	**4.3** (4.0)	**4,.0** (4.0)

Source: Consensus Ecs forecasts, NBK computations

** –the preceding forecast as part of the "August 2023" forecasting round is shown in the parenthesis*

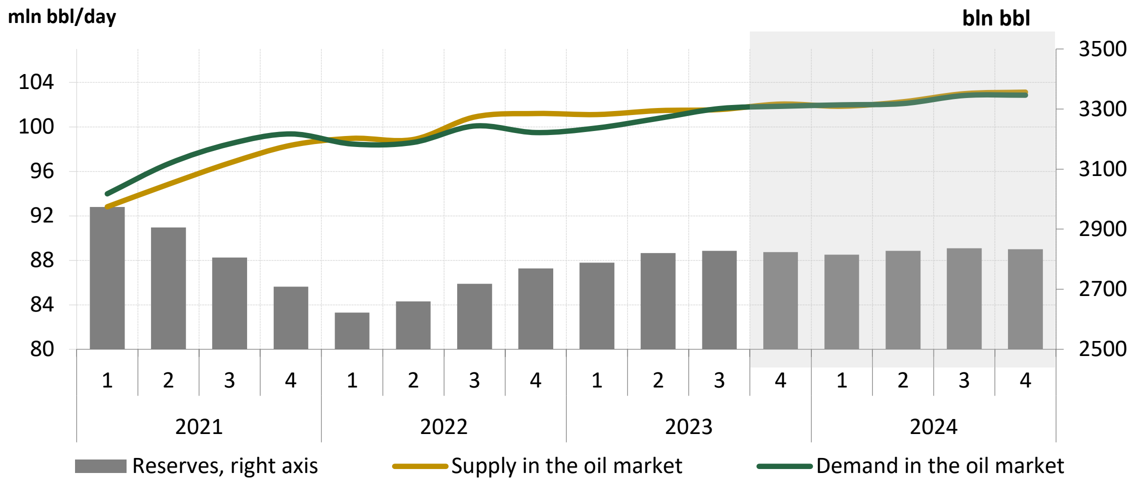
Escalation of geopolitical risks in connection with the situation in the Middle East has caused oil prices to rise above US$80 per barrel from the beginning of October this year. At the same time, in the medium term, a decline in world oil prices is expected against an increase in oil supply from non-OPEC+ countries and feebler development of the global economy.

Compared to the previous "August 2023" forecasting round, oil market assumptions have been slightly revised upward as a result of currently high oil prices. Oil prices are expected to stabilize at US$90 per barrel by the end of the year. This will be facilitated by the extension of production cuts by Saudi Arabia and Russia in the amount of 1.3 million barrels per day until the end of this year. Thus, a slight market shortage will build up in the fourth quarter of 2023 (Graph 3). Next year, oil prices are expected to gradually decline due to increased production by non-OPEC+ countries, as well as reduced demand for energy, which is associated with the prospect of weak global economic growth. Along with this, according to EIA estimates[2], gasoline consumption in the United States is

[2] *EIA STEO November 2023 Report*

expected to decline in 2024 to its lowest level in the last two decades, which will also result in the weakening demand for oil (Graph 4).

Graph 3. Dynamics of the Global Oil Market



Source: EIA

Given high uncertainty in the oil market, as well as the prospect of sluggish demand next year, the baseline scenario assumes that Brent prices will fall to US$80 per barrel by the end of 2024 and remain at this level in 2025. At the same time, the situation in the Middle East is a significant factor of uncertainty, including from the point of view of energy price dynamics. The assumptions for the optimistic and pessimistic scenarios are set at US$100 and US$60 per barrel, respectively (Table 2).

Table 2. Forecast Assumptions Regarding the Oil Price

	2023	**2024**	**2025**
Pessimistic Scenario	**83.0** (74.9)*	**64.6** (50.9)	**60.0** (50.0)
Baseline Scenario	**84.0** (80.0)	**85.0** (80.0)	**80.0** (77.3)
Optimistic Scenario	**84.3** (84.2)	**98.4** (109.0)	**100.0** (110.0)

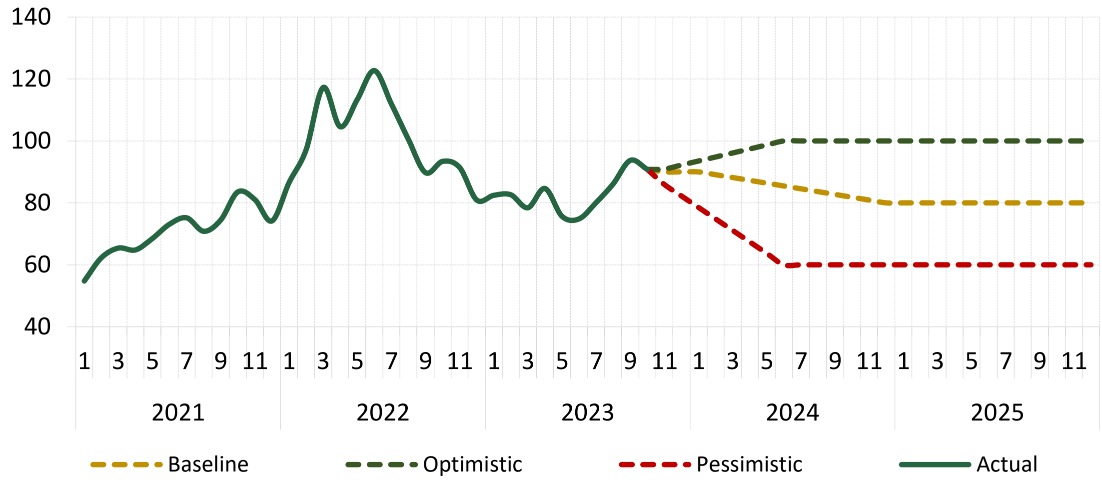
Source: NBK computations

** –the preceding forecast as part of the "August 2023" forecasting round is shown in the parenthesis*

Due to logistics problems in exporting countries, global grain prices are expected to return to early 2022 levels by mid-2024, with a gradual slowdown thereafter.

The FAO grain index in annual terms has continued to decline since March of this year, which is due to the presence of a significant export supply of wheat and corn in the global market. However, from the end of this year to mid-2024, prices are expected to rise due to a reduction in supplies from Ukraine. Along with this, one of the risks of a reduction in the supply of grain in the global market is a possible ban on the export of durum wheat from Russia in the first half of 2024. Logistics problems in the US (given the low water levels on the Mississippi River) may put upward pressure on grain prices. Beginning in mid-2024, grain prices are expected to gradually decline as global supply increases.

Graph 4. Scenarios Regarding the Brent Oil Price, US$/bbl



Source: EIA, NBK computations

1.2. Prospects of the Development of the Economic Situation under the Baseline Scenario

The GDP growth rate, after a slight slowdown by the third quarter of 2023 due to poor harvesting, quickly returned to its previous path, and at the end of 10 months of 2023, the dynamics of economic development unfolded according to the NBK's baseline scenario. According to forecasts, GDP will be 4.2-5.2% in 2023, 3.2-4.2% in 2024, and 5.5-6.5% in 2025 (Graph 5) (Table 3).

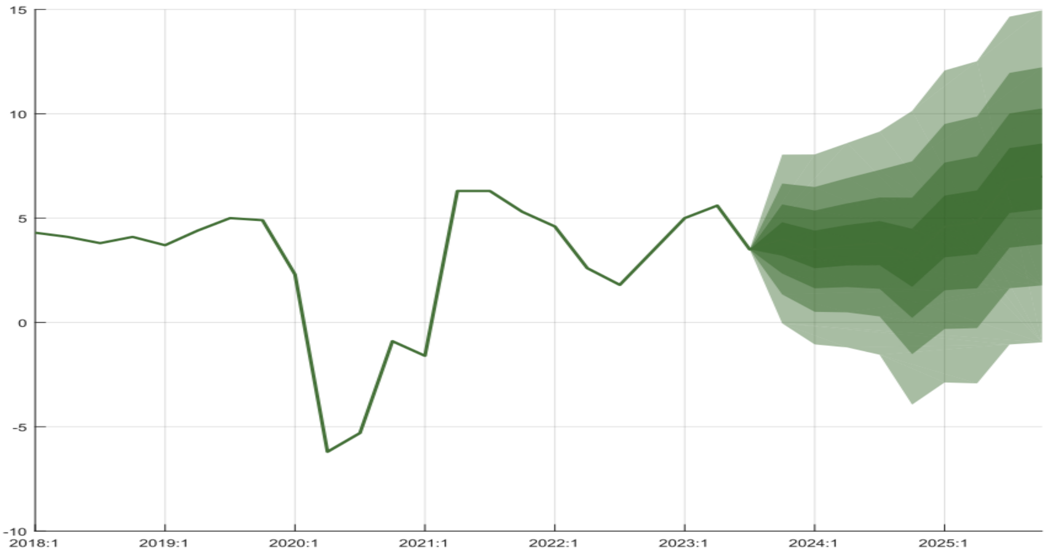
The risks associated with the accident at the MAEC, as previously expected, did not have a significant impact on oil production, and its production is in accordance with the NBK expectations. In conditions of increased domestic demand, significant growth in production and services continues. Thus, the basic forecast and assumptions of the National Bank have not changed, and by the end of the year, the GDP growth is expected to be **4.2-5.2%.**

At the same time, economic development forecasts for 2024-2025 have undergone significant changes due to the postponement of the implementation of the FGP/WPMP project at the TCO to 2025. The assumption for fiscal stimulus remains the same, as previously expected to maintain positive fiscal momentum. Thus, more restrained economic growth is expected in 2024, with acceleration by 2025.

The main contribution to GDP growth in 2024 will come from the domestic demand, supported by high budget expenditures. In particular, fiscal stimuli will be aimed at the construction of educational facilities and infrastructure projects, as well as the modernization of utility facilities. Investment projects are expected to continue in the oil sector and other branches of the real sector of the economy due to the persisting positive dynamics of demand. The fiscal policy will continue to be socially-focused, which, together with the growth of real wages, will support consumer demand in the medium term. As a result, the updated forecast for 2024 is **3.2-4.2%.**

In 2025, fiscal stimulus will weaken somewhat, but the more restrained fiscal impulse will be offset by accelerated exports due to the launch of the FGP/WPMP project, which will significantly increase oil production at the TCO field. Exports will be supported by external demand, which will remain stable over the forecast horizon. Due to a faster growth of exports over the dynamics of domestic demand and more moderate imports, the GDP growth in 2025 will be **5.5-6.5%.**

Graph 5. GDP, YoY, %



Source: NBK forecast

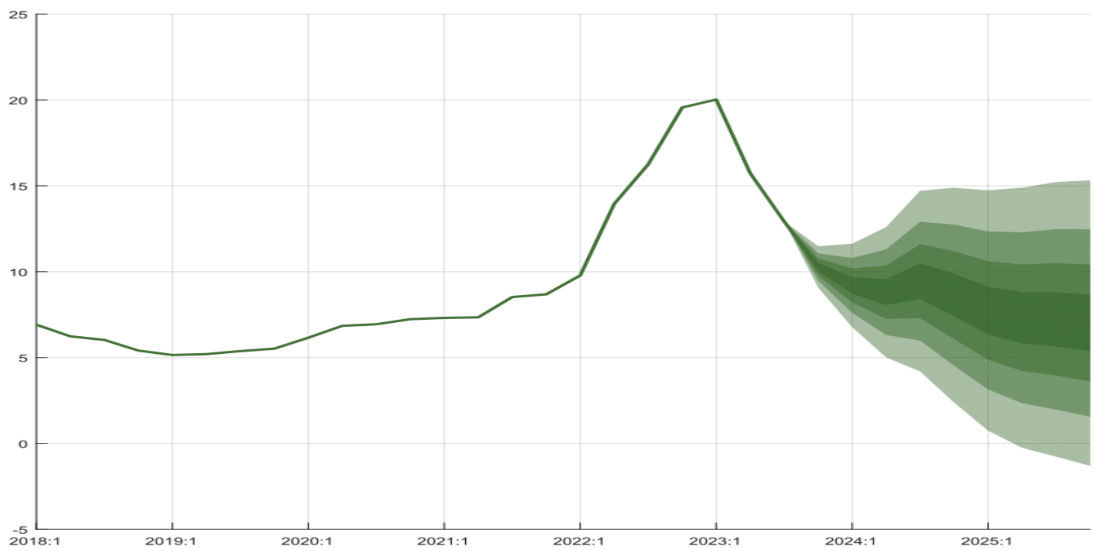
The output gap will remain positive throughout the forecast horizon with a gradual closing by the end of 2025. The positive domestic demand gap will narrow slightly by 2025. Imports, as a function of domestic demand, will show similar dynamics. A near-zero export gap is expected in 2024, with significant growth by 2025. A small positive gap in 2024, with a trend towards zero in 2025, is expected for government consumption. Overall, the output gap will move towards closing, but at a slower pace compared to previous forecasts, due to revisions in export dynamics.

The inflation forecast for 2023 was revised downwards due to the emerging lower current inflation. In 2024-2025, inflation will continue to slow down; the assumptions and path of forecast dynamics have not undergone significant changes. Inflation in 2023 will be 9.3-10.3%%, in 2024 – 7.5-9.5%, in 2025 – 5.5-7.5% (Graph 6) (Table 3).

At the end of 2023, inflation dynamics will be subject to several important factors. Prices for regulated services will continue to rise, leading to an acceleration of the service component of inflation. At the same time, the increase in prices for the regulated part of the service component affected only some utilities in certain regions. Thus, the accumulated increase in prices for regulated utility services from January to October 2023 amounted to 11.8%, and the contribution to inflation was 0.67 percentage points, which is lower than previously expected. In November-December of this year, the growth in prices for utility services will continue, but given the emerging lower dynamics, the growth rate of prices for regulated services and the expected contribution to inflation will be lower than expected in the preceding forecasting round.

At the same time, given the growth in real income of the population and a corresponding increase in demand (sales and New Year holidays), high monthly rises in prices for non-food products and market services are also expected at the end of this year.

Graph 6. Inflation, YoY, %



Source: NBK forecast

In the first half of 2024, food inflation is expected to be higher than previously forecast, due to the impact of the weak 2023 harvest in Kazakhstan and faster growth in the FAO grain price index. At the same time, in the future, as world food supplies gradually normalize and the FAO index decreases, coupled with moderate dynamics of prices of domestic producers, food inflation will begin to slow down faster. Within the CPI structure, service inflation will decelerate more slowly than other components, which will be associated with unregulated services, where there is currently a catch-up price increase (since the beginning of 2023), as well as with a rise in prices for regulated services, due to the continuation of reforms in the utility services sector that are included in the forecast path of the service component. The inflation forecast also does not take into account the increase in the VAT in 2025 as discussed by the Government of the Republic of Kazakhstan.

In general, annual inflation will continue to slow down in the medium term against the backdrop of the restrictive nature of monetary conditions, leading to the stabilization of inflation expectations. The gradual return of inflation in Kazakhstan's trading partner countries to their target values and the general trend towards lower world food prices will also help reduce inflation in Kazakhstan. At the same time, despite the above disinflationary factors, fiscal stimulus and weaker real exchange rate dynamics will restrain inflation from rapidly returning to its target level. Thus, by the end of 2024 inflation will be in the range of **7.5-9.5%** with a decline by the end of 2025 to **5.5-7.5%**.

Table 3. Forecasts under the Baseline Scenario

	2023	2024	2025
GDP, *YoY, %*	**4.2-5.2** (4.2-5.2)	**3.2-4.2** (4-5)	**5.5-6.5** (4-5)
CPI, *Dec. to Dec. of the preceding year, %*	**9.3-10.3** (10-12)	**7.5-9.5** (7.5-9.5)	**5.5-7.5** (5.5-7.5)
Brent Oil, *in US$/bbl, yearly average*	**84** (80)	**85** (80)	**80** (77.3)

Source: NBK forecasts

1.3. Alternative Forecast Scenarios

In the light of persisting uncertainty regarding the development of the global economy against the backdrop of an unstable geopolitical situation, the National Bank, in addition to the baseline scenario, also considered other alternative scenarios – pessimistic (Table 4 (a)) and optimistic (Table (4b)) when making a decision on the base rate.

If the pessimistic scenario is realized, oil prices are expected to gradually decline to US$60 per barrel and remain at this level until the end of 2025. This scenario will correspond to a possible slowdown in global economic growth due to an unfavorable geopolitical situation, the termination of the OPEC+ deal regarding oil volumes produced and a strong increase in oil production outside the OPEC.

In case of developments according to a pessimistic scenario, the demand for Kazakhstan's export commodities, primarily oil, will be dampened. This factor, together with a lower oil price, will limit business activity in the extractive industries, which will also negatively affect related sectors of construction, transport, trade and other services, and overall investment in the economy. Feebler economic activity will lead to lower household income and a corresponding weakening of consumption. In addition, as economic agents adapt to the new level of oil prices and the low base effect as well as to the persistence of the assumption about the increase in oil production at the TCO, the economic growth in 2025 will approach the numbers included in the baseline scenario. As a result, GDP growth rates will be 4-5% in 2023, 2.5-3.5% in 2024 and 5-6% in 2025.

Under the pessimistic scenario, inflation will slow down at a slower rate than under the baseline scenario. Despite lower economic activity, the weaker real effective exchange rate of the tenge and higher inflation expectations will lead to increased inflation pressure. In 2023, inflation will be **9.5-10.5%, in 2024 – 8.5-9.5%, in 2025 – 6-8%.**

If the global economy develops according to the optimistic scenario, it is assumed that oil prices will gradually increase to US$100 per barrel and remain at this level until the end of the forecast horizon. Increases in oil prices and commodity prices in general will be nurtured by faster growth of the global economy against the reduced geopolitical tensions, the restoration of active trade relations and easing monetary conditions due to a faster slowdown in inflation in developed and developing countries while maintaining moderate global oil production.

High world prices for raw materials and strong external demand will have a greater impact on business activity in Kazakhstan compared to the baseline scenario. **The economic growth in 2023 will be 4.5-5.5%, in 2024 – 3.5-4.5%, and in 2025 – 5.8-6.8%.**

Under the optimistic scenario, inflation will decline to target values faster than under the baseline scenario. This will be facilitated by strong dynamics of the tenge exchange rate and lower external inflationary pressure. **In 2023, inflation will be in the range of 9.3-10.3%, in 2024 – 7-9%, and in 2025 – 5-7%.**

Table 4 (a). Forecasts under the Pessimistic Scenario

	2023	2024	2025
GDP, *YoY, %*	**4-5** (4-5)	**2.5-3.5** (3.5-4.5)	**5-6** (4-5)
CPI, *Dec. to Dec. of the preceding year, %*	**9.5-10.5** (12-14)	**8.5-9.5** (9-11)	**6-8** (7-9)
Brent Oil, *in US$/bbl, yearly average*	**83**	**64.6**	**60**

Table 4 (b). Forecasts under the Optimistic Scenario

	2023	2024	2025
GDP, *YoY, %*	**4.5-5.5** (4.5-5.5)	**3.5-4.5** (5-6)	**5.8-6.8** (4.5-5.5)
CPI, *Dec. to Dec. of the preceding year, %*	**9.3-10.3** (9.5-11.5)	**7-9** (7-9)	**5-7** (5-7)
Brent Oil, *in US$/bbl, yearly average*	**84.3**	**98.4**	**100**

Source: NBK forecasts

1.4. Risks in the Medium Term

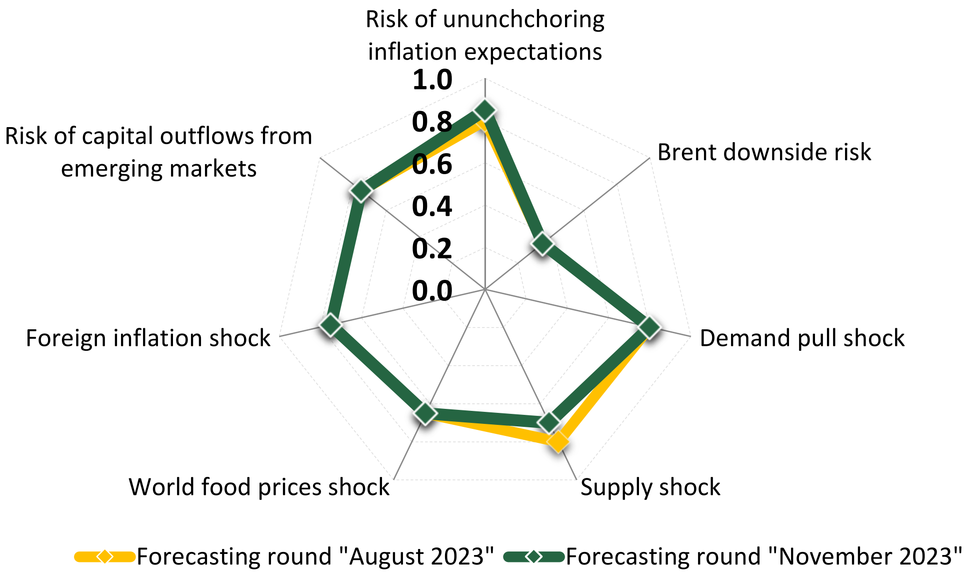
Compared to the preceding forecasting round, the overall balance of risks due to the increased fiscal stimulus and inflation expectations is shifted to a slightly pro-inflationary side. At the same time, risks from external factors remain at the same level with some change in internal factors (Graph 7).

In comparison with the preceding forecasting round, the risk of importing high global food inflation remains because of restrictions on trade routes in the Black Sea, limitation on the global trade and a possible drop in global harvests. Although at this moment the trend towards a general decline in prices continues, possible restrictions on supplies via the Black Sea or other traditional routes in the medium term could lead to a shortage of food in the world and a corresponding rise in prices. In addition, the changing climate may become a significant factor in reducing the yields of many agricultural crops and cause a strong increase in food prices in the world. These external risk factors, together with the consequences of an adverse harvest in Kazakhstan, could lead to a significant growth of food prices in Kazakhstan.

The risk of importing external inflation is still high. Core inflation, which reflects a steady price growth in the economy, continues to be above the target in many countries, which could mean faster inflation in the future. In addition, in Russia, one of Kazakhstan's main trading partners, due to the recent weakening of the ruble, the excess of domestic demand over supply in the economy, as well as the ongoing restructuring of industrial relations, significant acceleration in inflation is possible. However, tightening monetary conditions on the part of the Central Bank of Russia and a decreased share of Russia in Kazakhstan’s imports, together with a less pronounced rise in prices in China and the EU, may limit the negative consequences of this factor.

The risk of capital outflow from emerging markets in favor of advanced ones also remains high. Thus, due to persistent inflationary pressure in the world, central banks of developed countries may continue to pursue tight monetary policies, thereby increasing the pressure on exchange rates in emerging markets.

Graph 7. Risk Map Based on the Expert Judgment



Source: NBK computations

The Brent downside risk remains less pronounced as a result of the expected excess of demand for oil over its supply, which is associated both with the actions of OPEC+ to reduce oil production, rising tensions in the Middle East, and the continued growth of the global economy. At the same time, deceleration in the global economic growth amid the severance of traditional trade links and growing problems in the financial sector may cause a decline in prices for oil and other commodities.

As for internal risk factors for inflation, changes in their intensity are multidirectional.

Thus, supply shocks have decreased slightly, although they remain high. Low dynamics of producer prices in the agricultural and manufacturing sectors somewhat reduce the risks of increasing producer costs. However, the effect of these factors may further unfold against the expected increase in prices for regulated utility services, increased transportation costs, and negative consequences of the current year's low harvest.

At the same time, the risk of inflation expectations anchoring at numbers exceeding the inflation target has increased, which is associated with their current increased dynamics. Despite the tough monetary conditions, in the future their approach to the target value may be hampered by the adaptability of inflation expectations and their sensitivity to the dynamics of prices for food, fuel and lubricants and utility services.

The domestic demand-pull shock remains high amid increased fiscal stimulus. Considering the periodic upward revision of government spending in previous years, insufficient tax collection, reflecting a significant non-oil budget deficit, it is possible that budget parameters may be further revised towards expanding expenditures and/or increasing the budget deficit, which could become an additional source of pro-inflationary pressure in the economy.

Among the risks of forecast for the economic growth, the main and significant factor is the uncertainty regarding oil production parameters in 2024-2025.

1.5. Forecast of the Current Account of the Balance of Payments

According to the baseline scenario, in the medium term, the current account of the balance of payments will be formed in the deficit zone. The current account deficit in 2023-2025 is expected to be the result of significant volumes of imports of goods and a downward adjustment of high commodity prices of 2022.

The anticipated transition of the current account of the balance of payments from a surplus of (+)3.1% of GDP in 2022 to the deficit values of (-)3.5% of GDP in 2023, (-)2.9% of GDP in 2024 and (-)2.1% of GDP in 2025 will be the result of the following factors (Graph 8).

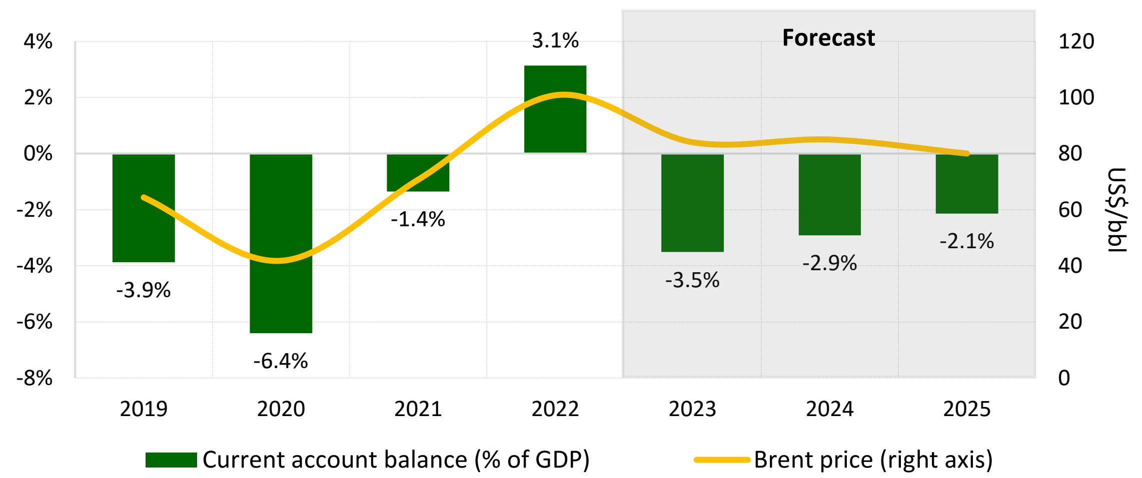
Import of goods according to the balance of payments methodology will continue to grow significantly over the forecast horizon, exceeding the historical maximum of US$50.6 billion in 2022. The growth will be due to the insufficiency of domestic production volumes to cover the growing needs of the households and businesses, the high import component in Kazakhstan's production chains, as well as the implementation of government programs and initiatives to support the economy. Steady demand for imports will be financed by fiscal expenditures, as well as own and borrowed funds of the households and businesses.

Export of goods according to the balance of payments methodology over the forecast horizon will continue to be characterized by significant exposure to fluctuations in world commodity prices. Exports will be supported by relatively stable oil production volumes, a scenario-based increase in uranium prices, plans to increase its production and expected introduction of new ferroalloy capacities. However, exports will be constrained by a gradual scenario-based decline in oil prices to US$80 per barrel by 2025, redirection of gas for domestic consumption and scenario-based adjustment of high prices of 2022 for such commodity groups as ferrous and non-ferrous metals, gas, coal, grains and petroleum products.

The deficit of income balance will remain at high levels due to the significant share of foreign participation in the commodity sector of the economy. In addition, accrued interest payable will reach a historical high in 2023 and will begin to decline from 2024 due to the gradual easing of monetary policy by major central banks.

The deficit in the balance of services over the forecast horizon will increase due to the outpacing growth rates of imports of services over their exports. Export of services will grow due to the travel given the increase in the number of foreign citizens entering the country, as well as moderate growth in transport services as the shipments of goods through the territory of Kazakhstan increases. In turn, import of services will increase owing to an increase in freight due to the growing volumes of imports of goods and larger tourist flows abroad in connection with the introduction of a visa-free regime with a number of countries and the popularization of installment-based travels.

Graph 8. Current Account of the Balance of Payments



Source: NBK forecast.

NATIONAL BANK OF KAZAKHSTAN

MONETARY POLICY

II. MONETARY POLICY

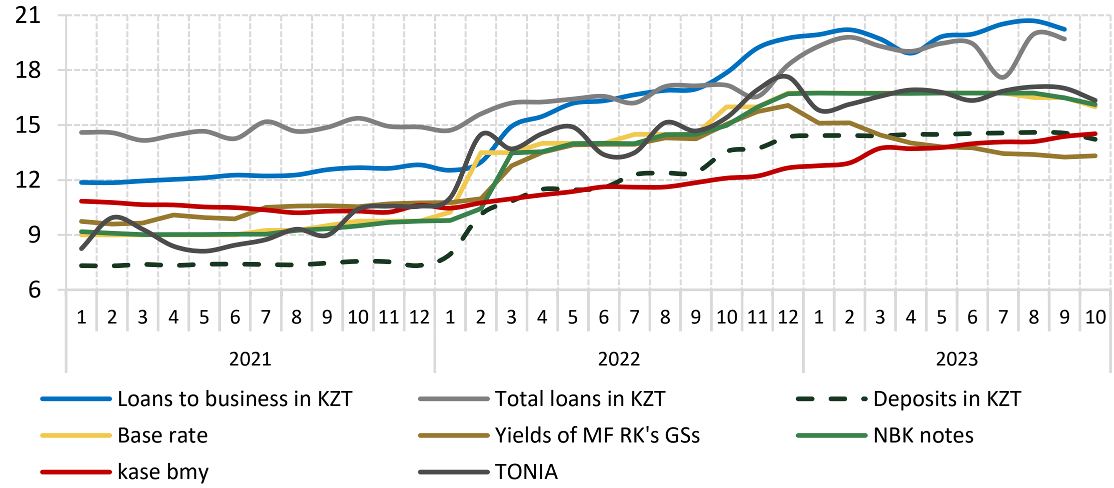
2.1. Monetary Conditions

As the base rate decreases, the value of financial assets gradually declines. The weighted average yield of government securities placed by the Ministry of Finance of the Republic of Kazakhstan in October 2023 went down by 11 bp compared to the July value and had set by 2.7 pp below the base rate. The yield on issued NBK notes decreased from 16.74% in July to 16.12% in October.

Weighted average rates on deposits in the national currency decreased from 14.6% to 14.2%. Meanwhile, the weighted average rate on loans in the national currency showed a minor increase: from 19.5% in June to 19.7% in September, including the business loan rate – from 20.0% to 20.2%.

The corporate bond yield index (KASE_BMY) increased from 14.08% in July to 14.53% in October. The spread between the TONIA rate and the general rate on the tenge deposits decreased from 228 bp in July to 213 bp in October.

Graph 9. Dynamics of Change in the Base Rate and Market Rates, %



Source: NBK, KASE

2.2. Money Supply

The growth rate of money supply in August-October 2023 kept slowing down in annual terms. At the same time, the credit and fiscal channels continued to make a positive contribution to the increase in the money supply. The reserve money continued to contract in annual terms in October.

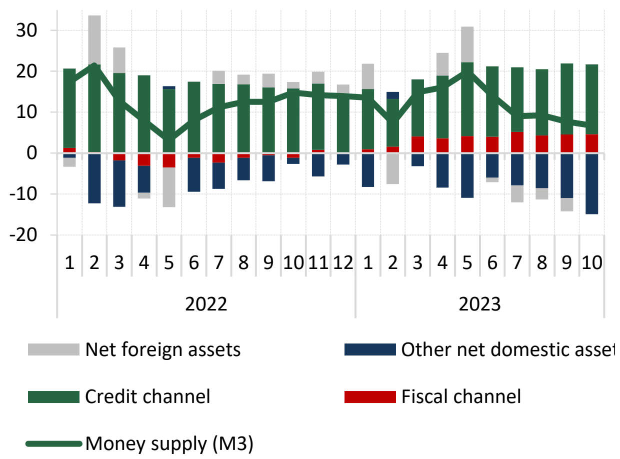
Money supply growth continued to slow down; in October 2023, the YoY growth rate was 6.8%. The total volume of money supply in October amounted to 35.6 trillion tenge (Graph 10). The slowdown in growth rates was due to the withdrawal of the positive contribution of external assets.

At the same time, the expansion of the credit and fiscal channel continues to support the growth of the money supply. The credit channel contributed to the growth of the money supply to a greater extent through lending to the population (contribution of 11.7 pp) and to a lesser extent to businesses (contribution of 2.3 pp), the fiscal channel (contribution of 4.7 pp) – due to the increase in the issuance of government securities by the Government.

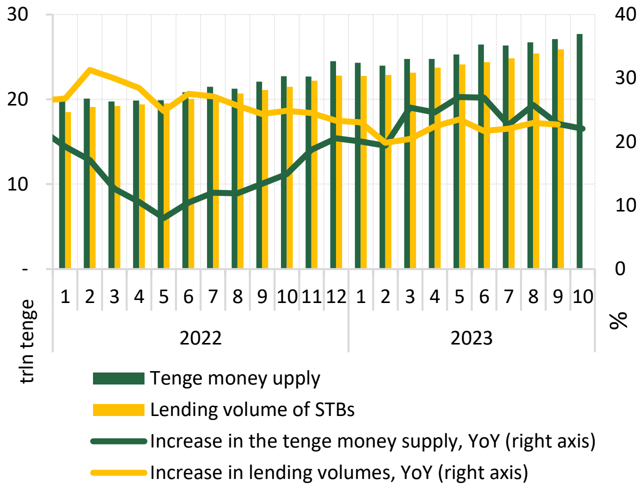
Despite the slowdown in the growth rate of money supply, the annual growth of the tenge supply continues to remain high, in October the growth amounted to 22.1%, YoY (Graph 11). However, as of June 2023, the growth rate of the tenge money supply remained higher than the growth rate of nominal GDP by 5.9 pp (increase in the tenge money supply, YoY – 26.9%, nominal GDP – 21%).

The reserve money contracted by 22.3% in October, YoY. This was mainly driven by the increase in funds in Government accounts. In the structure of reserve money in October, YoY, the volume of bank deposits at the NBK went down significantly by 40%, while cash showed a positive growth of 5%.

Graph 10. Money Supply, YoY, %



Graph 11. Tenge Money Supply and Lending Volumes of STBs



Source: *NBK*

2.3. Money Market

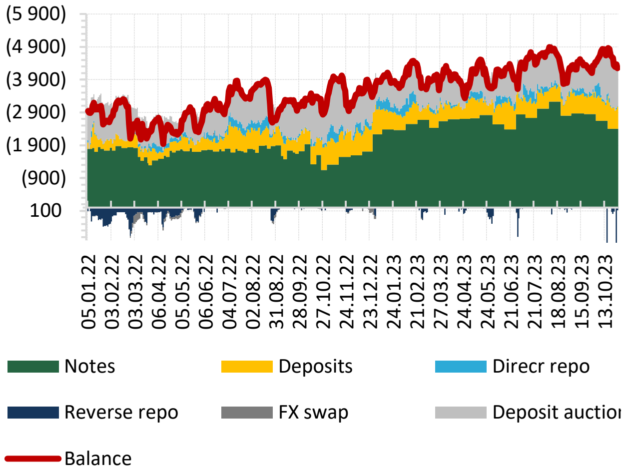
In October 2023, th balance of open position (liquidity surplus) amounted to 4.3 trillion tenge. Money market rates in August-October were setting around the base rate, with the exception of certain periods in October 2023.

As of the end of October 2023, the balance of NBK operations increased by 43.4%, YoY. The main volume of liquidity on average in August-October was withdrawn through notes worth 2.8 trillion tenge, deposit auctions – 1 trillion tenge and deposits – 0.6 trillion tenge (Graph 12).

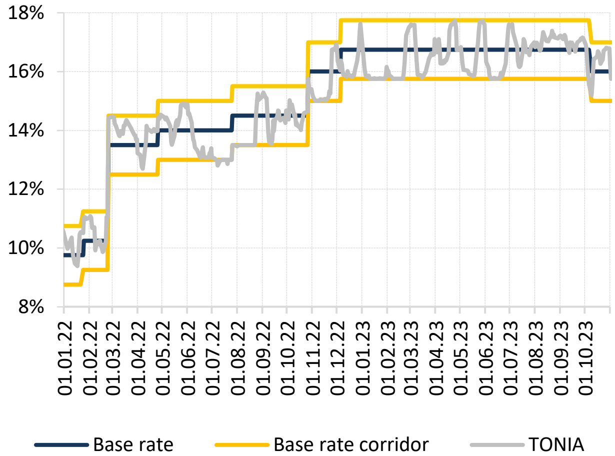
The money market rate – TONIA – in August and September was setting primarily near the base rate.

In October, the TONIA rate showed increased volatility. In the first ten days of October, TONIA decreased to the lower bound of the band due to the growing liquidity of market participants, and increased towards the end of October due to tax payments. The average TONIA value in August-October was 16.8% (Graph 13). The spread between TONIA and the base rate on average during August-October 2023 was at the level of 0.3 pp.

Graph 12. Exposure on the National Bank's Operations, Bln Tenge



Graph 13. Interest Rate Band and TONIA



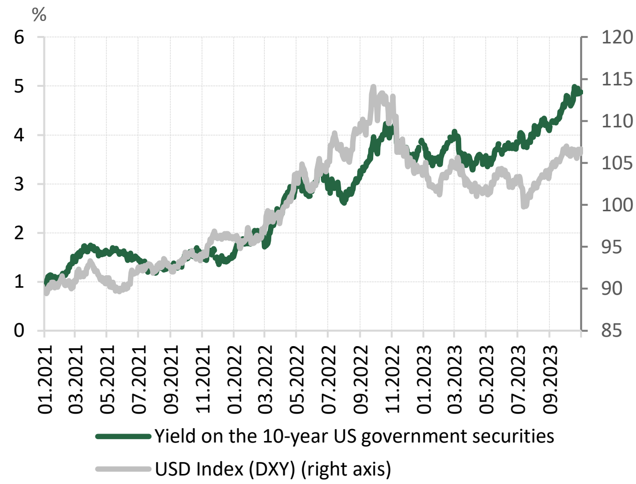
Source: NBK

2.4. Foreign Exchange Market

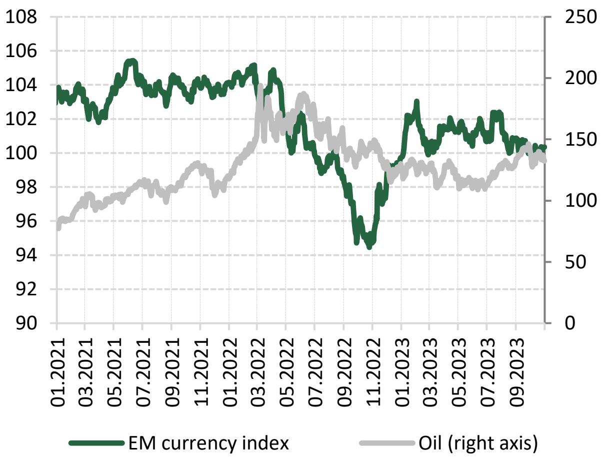
In August-October 2023, the tenge exchange rate depreciated by 5.3% to 469.6 tenge per US dollar. This was driven by the global strengthening of the US dollar amid the persisting tough rhetoric by the US Federal Reserve, an increase in seasonal demand from importers, the abolition of requirement for mandatory sale of foreign exchange proceeds of the quasi-government sector from August of this year, as well as the lowering of the base rate by the National Bank.

Given that inflation stood above the target, the US Fed, based on two meetings in September and November of this year, retained the policy rate at 5.25-5.5% and expressed the need to keep rates high for a long time, allowing for future increases. Against this background, the global risk sentiment deteriorated. The US Treasury yields rose from 4% to 4.9% in August-October and reached multi-year peaks, causing capital outflow from risky assets (Graph 14).

Graph 14. Yield on the 10-Year US Treasuries, DXY



Graph 15. Dynamics of the EM Currency Index, and of the Price of Gold and Oil (31.12.2019=100))



Source: Refinitiv

Due to the Fed's tough rhetoric, the DXY – global US dollar index – rose by 4.7% in August-October (Graph 14), while the emerging market currency index fell by 1.9% (Graph 15). The Bank of England, ECB and Bank of Switzerland also kept interest rates unchanged at 5.25%, 4.5% and 1.75%, respectively.

The tenge was supported by oil quotes, which at the end of August-October 2023 increased by 2.2% from 85.6 to 87.4 US dollars per barrel[3] (Graph 15). There was an increased exchange rate volatility in the domestic foreign exchange market in August-October 2023, associated with the seasonal increase in demand from importers as part of the active use of budget funds, the suspension of the requirement for the mandatory sale of foreign currency proceeds by the State Property Committee and the lowering of the base rate by the National Bank by a total of 75 bp from 16.75% to 16%.

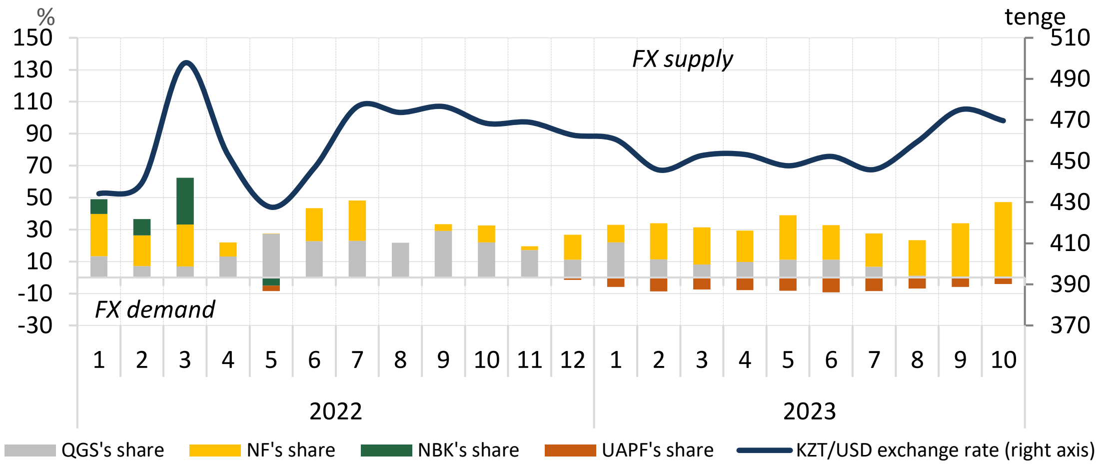
As a result, at the end of August-October 2023, the tenge exchange rate depreciated by 5.3% from 445.9 to 469.6 tenge per US dollar. The range of exchange rate movements in August-October expanded to 444-482 tenge per US dollar (in May-July 2023 the range was 441-454 tenge per US dollar) (Graph 16).

The average daily trading volume in August-October 2023 ramped up by 1.5 times, YoY, and amounted to US$157.83 mln (in May-July 2023 – US$138.3 mln, in August-October 2022 – US$102.6 mln).

Depreciation of the exchange rate was partially offset by the sale from the National Fund as part of the transfer to the budget[4]. During August-October, their participation share on average accounted for 34.5% of the total trading volume (Graph 16).

During August-October, the National Bank's operations, including sales from the National Fund and purchases in order to maintain the foreign currency share of the UAPF pension assets at 30%, were carried out in line with pre-announced volumes. The volume of foreign currency purchases for the UAPF in August-October amounted to US$572 million or 5.7% of the total trading volume (Graph 16). At the same time, no currency interventions were conducted in August-October.

Graph 16. The Share of Certain Market Participants in the Currency Purchase/Sale, YoY, %



Source: KASE, NBK

2.5. Stock Market

In August-October 2023, the volume of placements of the MF RK's government securities in the primary market went down after the record placements in the 2nd quarter of this year. Meanwhile, the trading volume in the secondary market remains at a high level.

---

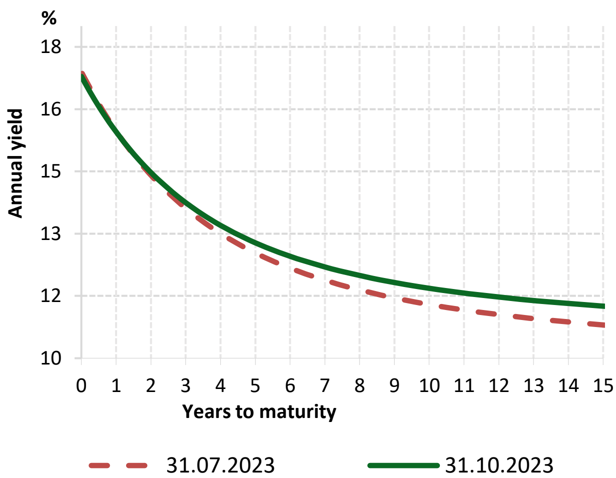
[3] Factor affecting the dynamics of oil quotes are described in Section 3.1.
[4] When conducting operations with the National Fund's monies, the National Bank of the RK adheres to the principle of market neutrality. This implies conducting regular and proportional sales of foreign currency. This practice allows minimizing the impact of conversions from the National Fund on the foreign exchange market and over a long period does not affect the money supply and reserve money.

Despite the easing of monetary conditions, there was no significant change in the risk-free yield curve in the short-term segment. In connection with expectations for further easing of monetary policy, the curve retains its “inverted” (reverse) form.

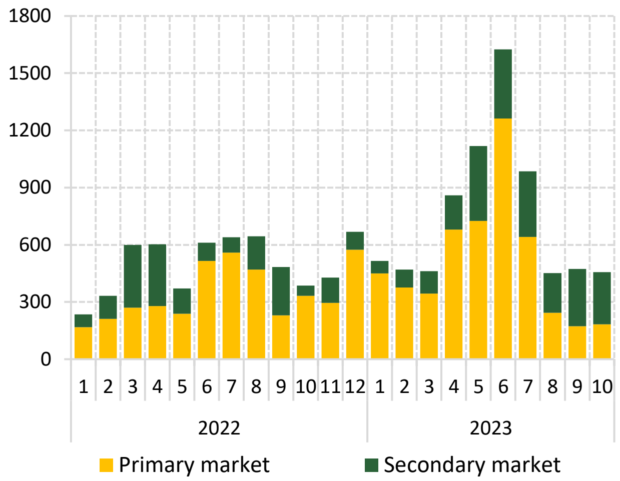
Yields in the medium-term (1 to 5 years) and long-term segments (5 years and above) increased slightly. So, as of the end of this October, the yields on government securities in the segment from 1 year to 5 years increased by an average of 19 bp relative to the end of this July, and in the segment from 6 years and above – by 28 bp (Graph 17).

As of November 1, 2023, government debt (traded on the KASE) has decreased over the past three months by 500.2 billion tenge and amounted to 24.9 trillion tenge. Such dynamics are partly associated with the reduced placements of government securities of the MF RK in August-October of this year (Graph 18). During 10 months of 2023, after record volumes of attraction in June of this year, the Ministry of Finance of the RK is ahead of its issuance schedule of securities by 44.6 bln tenge.

Graph 17. Risk-Free Yield Curve, %



Graph 18. Transaction Volume in the GSs Market, Bln Tenge



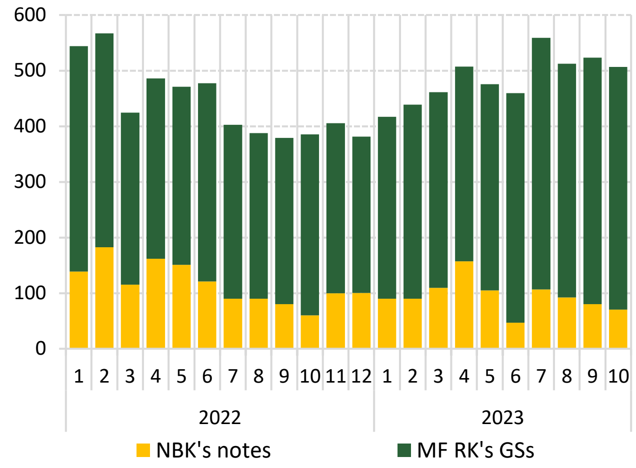
Source: KASE

The share of government securities holding by non-residents decreased slightly from 2.6% in July to 2.4% in October. Investments of non-residents in government securities of the MF RK remained at a level above 400 billion tenge, while investments in the NBK notes decreased from 106.4 billion tenge in July to 70.5 billion tenge in October (Graph 19).

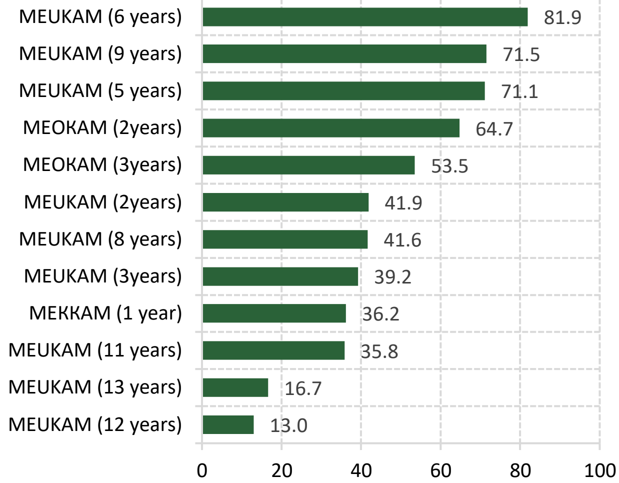
The main volume of placements in the primary government securities market during August-October fell on the segment from 1 year to 5 years with 270.5 billion and the yield in the range of 13.29%-14.28%. Long-term securities with maturity from 5 to 9 years were also placed amounting to 195.1 billion tenge and with the yield of 12.5%-13.2%, from 10 years – 65.5 billion tenge with a yield of 11.7%-12.15 %. The volume of short-term government securities of the MF RK equaled 36.2 billion tenge in October (Graph 19).

The main volume of placements in the primary government securities market during August-October fell on the segment from 1 year to 5 years with 270.5 billion and the yield in the range of 13.29%-14.28%. Long-term securities with maturity from 5 to 9 years were also placed in the amount of 195.1 billion tenge with the yield of 12.5%-13.2%; from 10 years – 65.5 billion tenge with a yield of 11.7%-12.15%. The volume of short-term government securities of the MF RK equaled 36.2 billion tenge (Graph 20).

Graph 19. Volumes of GSs Holding by Non-Residents, Bln Tenge



Graph 20. Placed GSs of the MF RK, by Remaining Maturities, during August-October 2023, Bln Tenge



Source: KASE

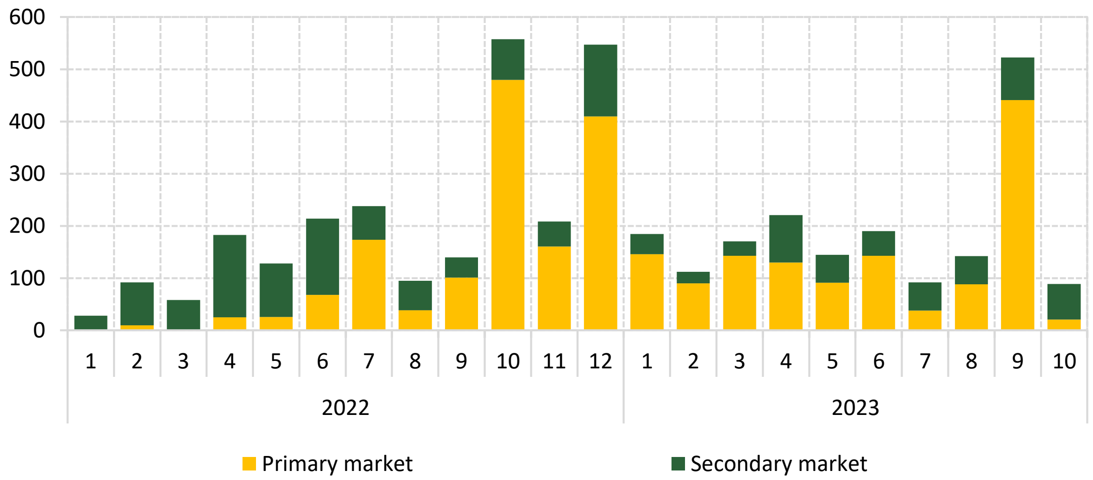
In August-October, the most active players in the primary market were banks with a share of about 50% of the total trading volume; the share of other institutional investors was about 35%. At the same time, the share of banks has decreased slightly since the beginning of the year.

Banks were the main player in the secondary market, as well as other legal entities (their share was over 80%). In addition, the share of participation of non-residents in the secondary market increased from 4.9% in May-July to 14.2% in August-October of this year.

The corporate bond yield index (KASE_BMY) has increased by 187 bp since the beginning of 2023, and by 45 bp since July to 14.53 points.

In August-October, trading volume in the corporate bond market increased by 76.7% on a quarter-on-quarter basis. The sharp increase in trading is associated with the placement of four bonds of "Bereke Bank" JSC in September of this year. The volume of transactions in the primary market doubled, while in the secondary market it went up by 31.7% (Graph 21).

Graph 21. Transaction Volume in the Corporate Bond Market, Bln Tenge



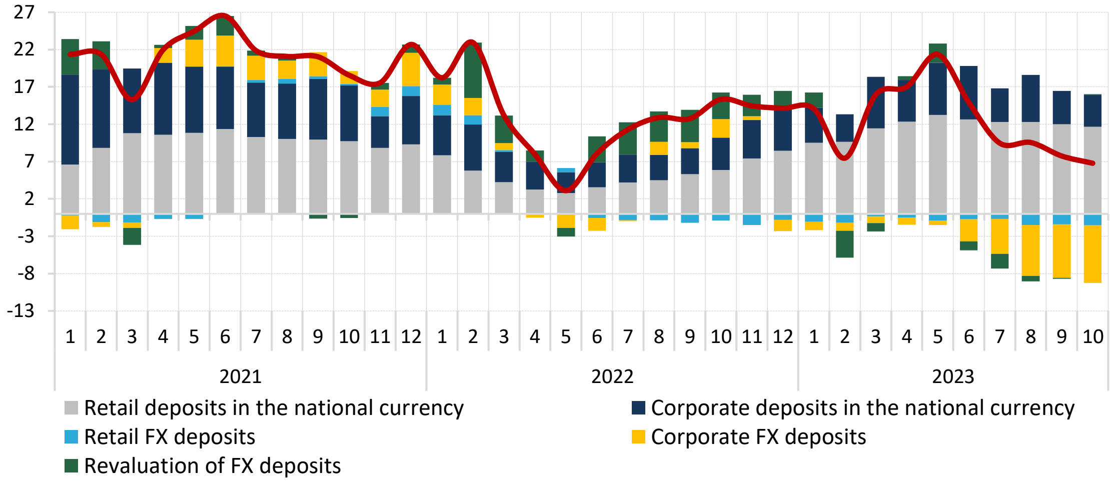
Source: KASE

2.6. Deposit Market

In October 2023, the total volume of deposits continued to grow in annual terms due to an increase in deposits in the national currency. Deposits in foreign currency decreased significantly, mainly because of the outflow of foreign currency deposits of legal entities.

In October 2023, the annual growth of total deposits accounted for 6.8% (in October 2022 – 15.3%) (Graph 22). The structure of deposits demonstrated an increase in the tenge deposits, while foreign currency deposits decreased.

Graph 22. Deposits of Residents at Depository Organizations, YoY, %



Source: NBK

In October, deposits in the national currency increased by 24.7%, YoY, both due to deposits of individuals (an increase of 35.8%) and deposits of legal entities (by 13.4%). The growth of tenge deposits of individuals was nurtured by the persistent high differential rates between the tenge and foreign currency deposits.

Deposits in foreign currency decreased by 26.0%, YoY (in foreign currency equivalent, the overall decrease was 26.2%). Over the year, foreign currency deposits of legal entities went down by 36.9%, and those of individuals – by 10.4%. The reduction in foreign currency deposits is influenced by both the low interest rates on foreign currency deposits and relatively high rates on the tenge instruments, which leads to a partial shift to the tenge-denominated assets, as well as the preference of investors for other types of financial instruments for investing and saving funds.

Within the structure of retail deposits (including non-residents), non-term deposits accounted for a major portion of the tenge deposit base at end-October[5] – 56.8% (in October 2022 – 52.5%); the share of savings deposits increased to 10.6% compared to the last year (in October 2022 – 9.9%). The annual growth in volumes of non-term deposits in the tenge was 48.3%, YoY. Savings deposits are also demonstrating a considerable increase (46.5%, YoY).

Overall dollarization in the banking system continued to decline to its lowest level over the past 16 years due to a reduction in dollarization on deposits of both legal entities and individuals (a minimum for over 25 years).

In October 2023, deposit dollarization continued to decline to 24.5% (in July 2023 – 25.6%) (Graph 23).

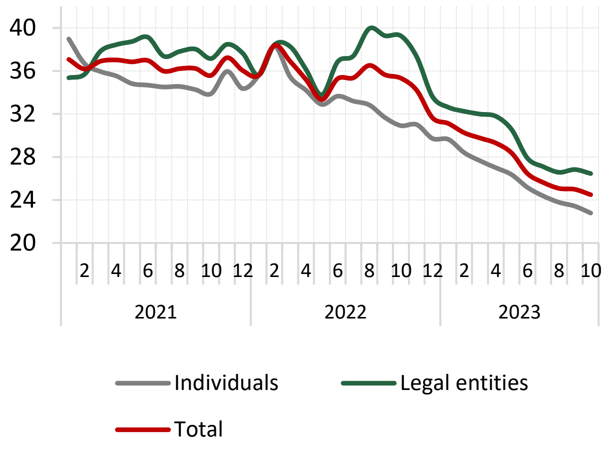
Dollarization of corporate deposits entities decreased on a QoQ basis from 27.1% in July to 26.5% in October 2023, and that of retail deposits – from 24.4% to 22.8%, reaching a minimum in more

[5] *According to the KDIF methodology for calculating and setting maximum rates on retail deposits*

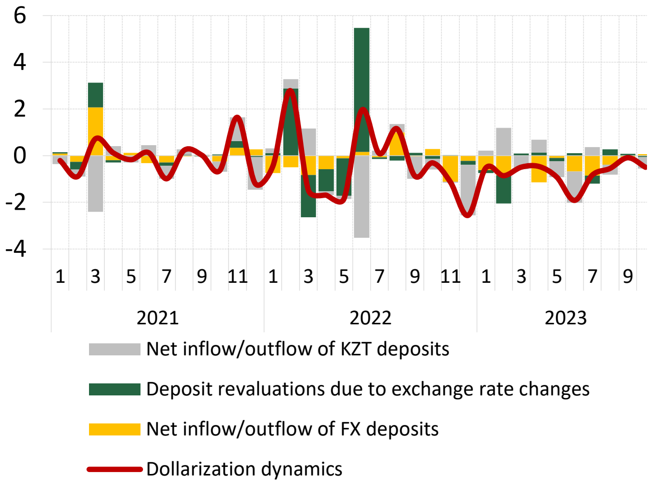
than 25 years (Graph 23). It is worth mentioning that the decline in dollarization was accompanied by both a net inflow of new tenge deposits and a net outflow of foreign currency deposits (Graph 24).

Dollarization of retail deposits (including non-residents) declined virtually in all segments in terms of amounts.

Graph 23. Deposit Dollarization, %



Graph 24. Factors Causing the Change in Dollarization in the Banking System, MoM, %



Source: NBK

It is noteworthy that alongside with the growth of retail deposits, the share of the savings-making population is increasing[6] from the minimum in June 2022 – from 15.6% to 20.5% at end-October.

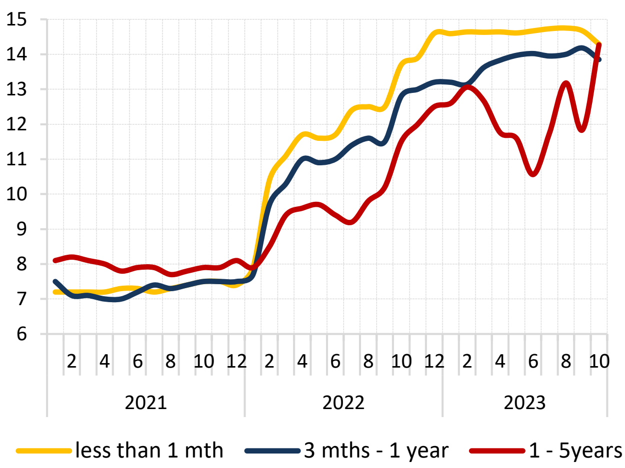
Interest rates on deposits have demonstrated multidirectional dynamics.

Given the lowering of the base rate, in October compared to July, market rates (according to monetary statistics) on corporate deposits in the tenge decreased for deposits with a term of less than 1 month (the share – 85.4% of all corporate time deposits in the tenge) by 0.44 pp to 14.3%, and with a term from 3 months to 1 year (the share – 10.1%) to 13.9%. Interest rates on long-term deposits with a term of 1 to 5 years (the share – 2.2%) increased to 14.3% (Graph 25).

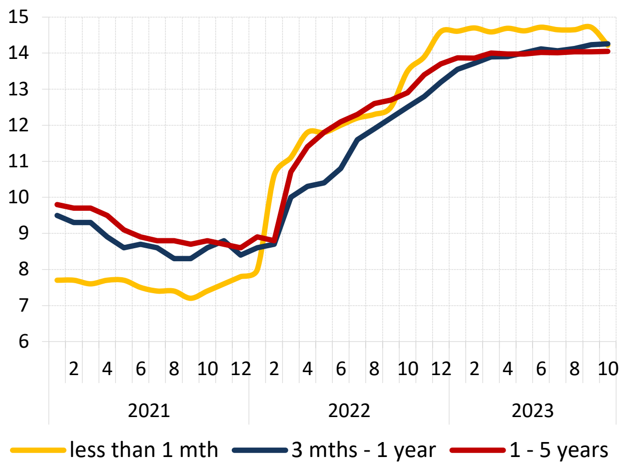
Interest rates on retail deposits with a term of less than 1 month (the share – 16.7% of all retail term deposits in the tenge) over the same period have showed a reduction to 14.2% in October 2023; rates on deposits from 3 months to 1 year (the share – 33.3%) increased slightly to 14.3%, and on deposits with a term of 1 to 5 years (the share – 45.6%) remained virtually unchanged and amounted to 14.1% (Graph 26).

[6] According to the results of the survey on inflation expectations

Graph 25. Interest Rates on Corporate Deposits, %



Graph 26. Interest Rates on Retail Deposits, %



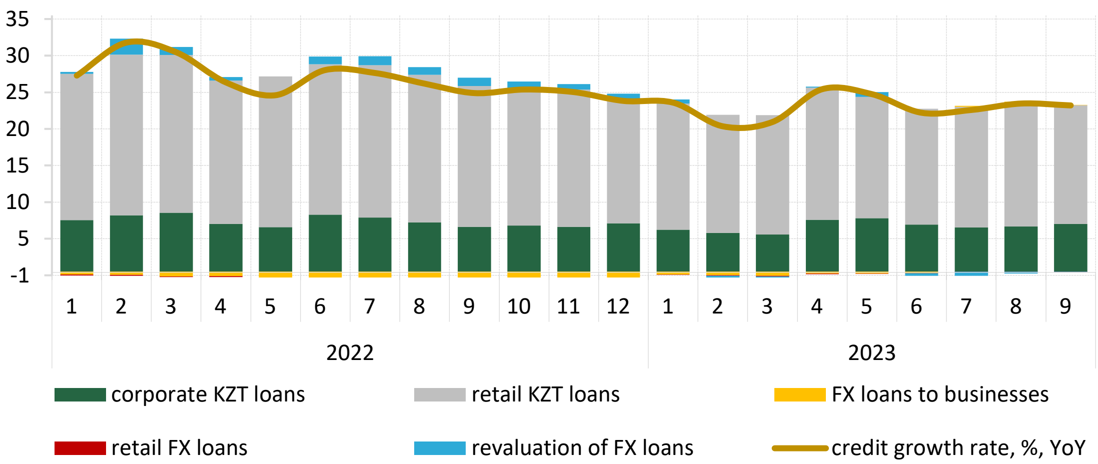
Source: NBK

2.7. Credit Market

Bank lending to the economy (balances) increased in the third quarter of 2023 amid persistently high rates of growth in retail loans and the accelerating growth of loans to businesses.

The annual growth of bank loans to the economy (balances) accelerated slightly from 21.7% in June to 22.7% in September (Graph 27). Loans to households continued to make the main contribution to the growth of total lending. The contribution of business to the increase in total lending volumes was also significant due to an active growth of loans to small businesses.

Graph 27. Bank Loans to the Economy (Balance), YoY, %

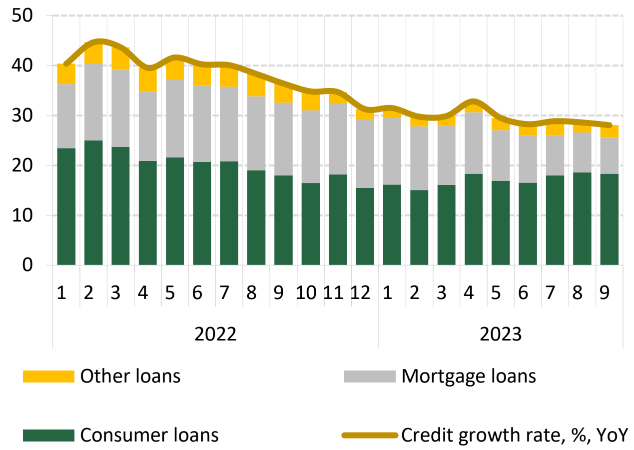


Source: NBK

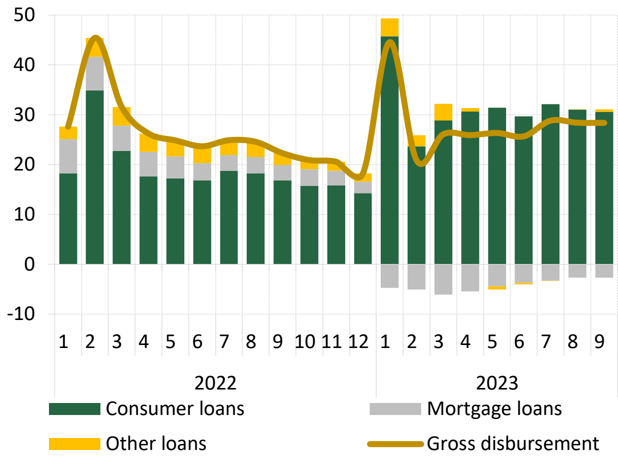
Despite the slowdown in growth rates in the third quarter, retail loans continue to remain the main driver of overall loan growth. In the structure of lending to the population, there is a significant deceleration in the growth rate of mortgages owing to normalization of demand in the real estate market and current monetary conditions. Consumer lending continues to accelerate its growth due to a widespread adoption of installment plans.

The growth of retail loans (balances) in annual terms slowed from 28.2% in June to 28.0% in September, mainly because of deceleration in the growth rate of mortgage loans – from 27.7% to 21.2% (Graph 28). At the same time, the origination of new mortgage loans during 9 months of 2023 decreased by 15.7%, YoY (Graph 29).

Graph 28. Retail Loans from STBs (the Balance), YoY, %



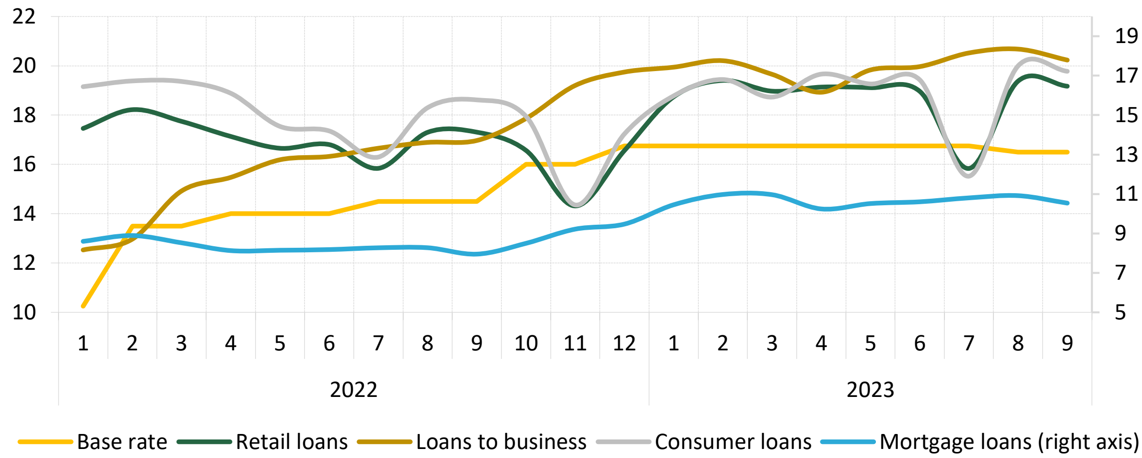
Graph 29. New Retail Loans Provided by STBs, YoY, %, Year-to-Date



Source: NBK

The slowdown in mortgage lending is observed against the "7-20-25" program limits in force since the beginning of this year, the previously realized significant demand for residential real estate, as well as current monetary conditions. At the same time, the rate on mortgage loans decreased slightly from 10.6% in June to 10.5% in September (Graph 30).

Graph 30. Rates on Loans in the National Currency, %



Source: NBK

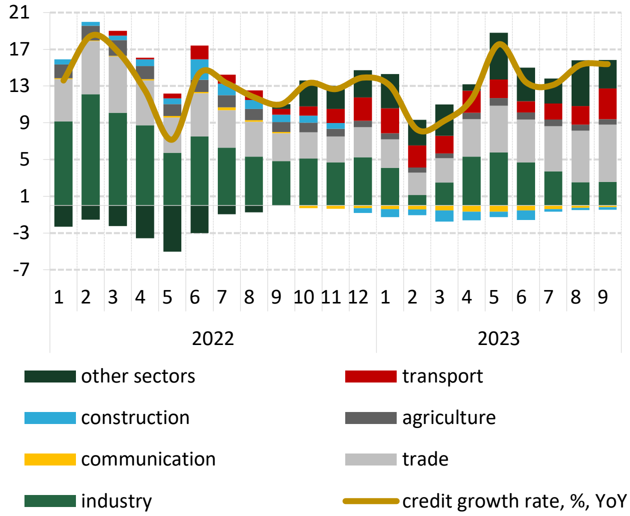
Growth in the consumer loan portfolio accelerated from 28.0% in June to 31.1% in September (Graph 28). Widespread installment plans and high inflation expectations continued to drive consumer loan growth in the third quarter. The weighted average rate on consumer loans increased from 19.4% in June to 19.8% in September (Graph 30).

Loans to businesses increased mainly due to the dynamic growth of lending to small businesses. In terms of economic activity, loan growth was observed in all branches, except communication and construction.

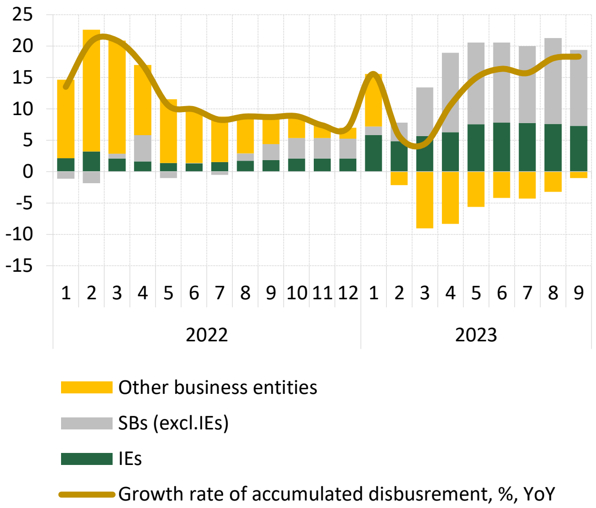
Year-on-year growth in loans to businesses (balances) accelerated from 13.4% in June to 15.4% in September (Graph 31). At the same time, growth was recorded in all major industries, except communications (-8.3%) and construction (-3.9%). Loans to industrial and trade entities, which account for the bulk of business loans, have grown over the year by 8.2% and 27.0%, respectively.

Annual growth in loans to businesses (balances) continued to remain at a double-digit level, primarily due to loans to small businesses. In particular, loans to individual entrepreneurs are growing dynamically – an increase of 62.1% over the year in September. The origination of new loans to individual entrepreneurs during 9 months of 2023 compared to the same period in 2022 increased by 99.4%, to other small businesses (except for individual entrepreneurs) – by 47.5% (Graph 32).

Graph 31. Loans to Businesses from STBs (the Balance), YoY, %



Graph 32. New Loans to Businesses from STBs, YoY, %, Year-to-Date



Source: NBK

In September, the outstanding debt on loans to large and medium-sized businesses increased by 6.8% and 9.0%, YoY, respectively. The origination of new loans to medium-sized businesses during 9 months of 2023 compared to the same period of the last year increased by 17.9%, and loans to large businesses decreased by 6.4%. At the same time, in September the growth rate of new loans to large and medium-sized businesses accelerated by 27.0% and 22.7%, YoY, respectively.

As at the end of the third quarter, pricing terms of lending had not undergone significant changes.

There was an increase in interest rates on loans to businesses in terms of business entities for medium and small businesses – from 18.4% in June to 19.7% in September of this year and from 21.4% to 21.9%, respectively. As for loans to large businesses, the rate remained virtually unchanged compared to June, remaining at the same level of 18.9%.

Loans to the economy in a broad definition have increased by 10.1% since the beginning of the year to 31.9 trillion tenge as of September 1 of this year. Over the same period, loans to businesses (non-financial legal entities and individual entrepreneurs who received loans for business purposes) have increased by 4.6%, while loans to the population increased by 15.7%. Banking sector loans as of October 1, 2023 increased by 19.6%, YoY, while loans from the Development Bank of Kazakhstan decreased by 12.3%, and loans from second-tier banks went up by 22.7%.

Box 1. A Quantitative Assessment of How Effective is the Bank Lending Channel of the Monetary Policy Transmission Mechanism in Kazakhstan

Bank lending is a key element of the transmission mechanism of the monetary policy of countries with a predominant share of bank lending in the sources of financing of the economy. The operation of the bank lending channel is inextricably linked with the interest rate channel. In accordance with the economic theory, it is assumed that there is a negative dependence of credit activity in the economy on market interest rates. When monetary policy is tightened under the influence of rising market rates, the demand for credit resources decreases since their attractiveness and availability declines. In the event of easing monetary conditions, lending to the economy expands under the influence of increased attractiveness of borrowed funds.

As part of the analysis of how effective is the bank lending channel in Kazakhstan, an assessment was made of the transmission of weighted average rates on loans to business and households (separately for mortgage loans and consumer lending) to the volume of new loans provided by second-tier banks. The analysis was carried out using vector autoregression models based on monthly data during the inflation targeting period – from the beginning of 2016 to July 2023. To improve the structure of the model, the change in the tenge/US dollar exchange rate, monthly seasonally adjusted inflation and a short-term economic indicator were additionally included as endogenous variables, along with interest rates and loan volumes.

1. Loans to the Population. In analyzing the functioning of the bank lending channel, the transmission of interest rates on loans to the population was looked at in the context of two main areas of lending: consumer loans and mortgage loans.

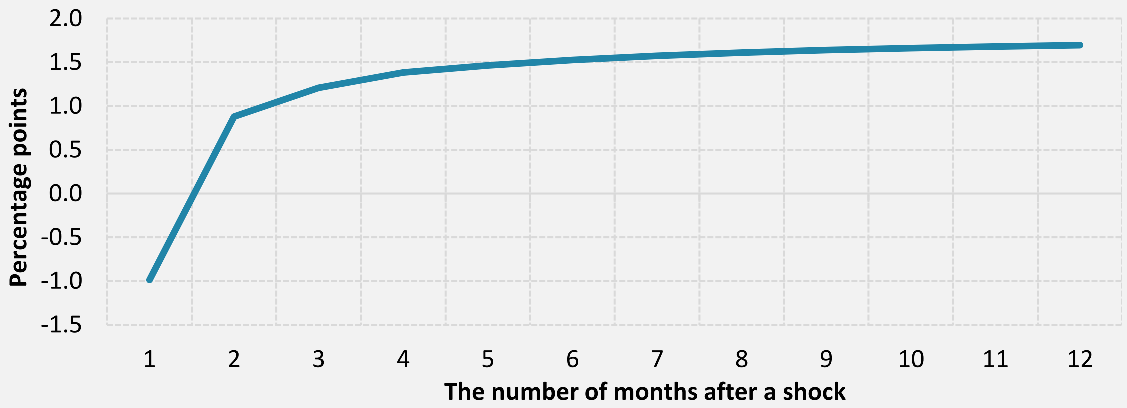
To obtain a more realistic effect, loans from one large second-tier bank specializing in consumer lending were excluded from a number of data in the assessment of consumer lending due to the high share of installment plans in its portfolio, causing significant distortions in the total cost of lending to second-tier banks.

When assessing the cost of mortgage loans provided on market terms and conditions, loans from a specialized bank with the government participation that implements the housing construction savings framework were excluded from the data series. The dynamics of its rates as a whole do not reflect changes in the base rate and money market rates.

1.1. Consumer Loans. The results of modeling an interest rate shock confirm the presence of a short-term effect of rates on the volume of consumer loans, with a further weakening of the impact. Impulse responses show that an increase in the weighted average rate by 1 pp leads to a decrease in the volume of new loans provided only in the first period (month) of the shock – by 0.99 pp during the period of inflation targeting (Graph 1). In subsequent periods, the shock effect is offset – the accumulated impulse responses move into the positive zone, which contradicts the theoretical functioning of the transmission mechanism. These discrepancies may be associated with the high influence of economic, social and psychological factors on the population's demand for consumer loans. The low-income categories of the population retain high demand for credit resources, regardless of the economic situation, especially in the environment of strong growth in inflation expectations. At the same time, the most rational thing for the category of population with a higher income level is to increase free cash on deposits and simultaneously purchase goods in installments (according to statistics, this applies to consumer loans). Such behavior of potential borrowers with both low and high income is most rational in the context of high inflation expectations and current inflation. Moreover, the widespread use of installment plans reflects the massive digitalization of banking services, a significant increase in accessibility to obtaining loans and is a structural shift in the consumption of banking services.

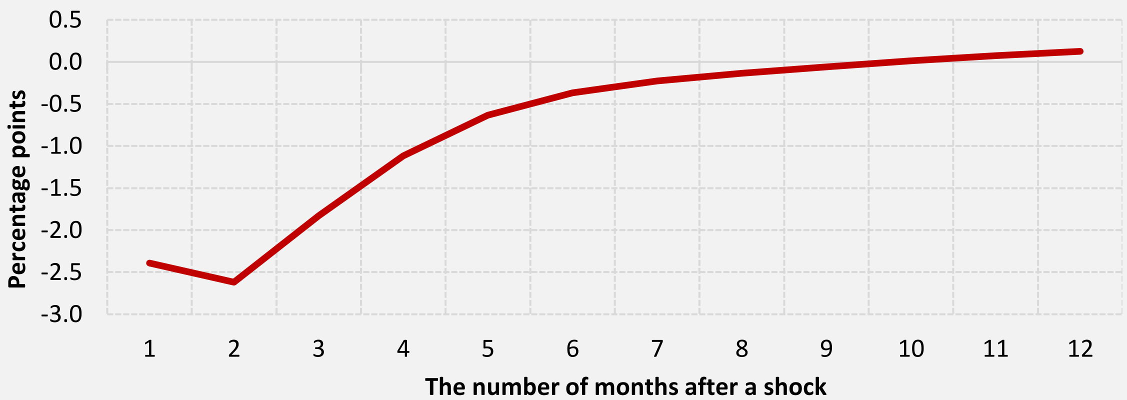
It is worth mentioning that despite the exclusion of one bank, the transmission results may have been affected by the persistence of installment loans (zero-rate loans) in loans of individual banks that are weighted to arrive at the weighted average interest rate considered in the model estimates. Thus, taking into account installment plans, the overall consumer lending rate for all second-tier banks is lower compared to the rates on classic consumer loans that are not installment plans.

Figure 1. Accumulated Impulse Responses of Consumer Loan Disbursement Volumes to a 1 pp Shock of the Corresponding Interest Rate



1.2. Mortgage Loans. During the period of inflation targeting, a quantitative assessment of the bank lending channel in the segment of mortgage loans points to the presence of a strong short-term effect of mortgage rates on the volume of mortgage loan origination. Thus, the shock of an increase in the weighted average rate by 1 pp leads in the second period to a decrease in the rate of change in volumes of mortgage loan origination by **2.62 percentage points** (Graph 2). In subsequent periods, the effect of the interest rate shock decreases and in the tenth period, the accumulated impulse responses move into the positive zone, which contradicts to the theoretical influence within the framework of the transmission mechanism. Such impact of the interest rate on the volume of mortgage lending is probably related to the existence of concessional mortgage programs with rates significantly below the market levels ("7-20-25", "Baspana Hit", etc.) and discretionary decisions that significantly affect the mortgage market (an example: withdrawal of funds from the UAPF) and reduce the effectiveness of the monetary policy pursued.

Figure 2. Accumulated Impulse Responses of Mortgage Loan Disbursement Volumes to a 1 pp Shock of the Corresponding Interest Rate



It is worth mentioning that an increase in the base rate and money market rates occurs during a period of accelerating inflation and rising inflation expectations. Against this background, the interest rate under concessional programs remains unchanged in nominal terms, but the real rate becomes significantly lower than the value before the acceleration of inflation, and the differential between the market mortgage rate and the preferential rate widens. In these conditions, against the backdrop of rising inflation expectations, the demand for concessional mortgage programs is increasing, thereby further reducing the overall impact of mortgage rates on the growth rate of mortgage lending. In general, the effect of mortgage rates on mortgage lending volumes is significant.

2. Loans to Business. The impact of interest rates on loans to businesses on lending volumes was looked into in the context of business entities (medium and large businesses in total, small businesses), as well as by tenor (short-term loans – with a tenor of less than one year and long-term loans – with a tenor of over one year).

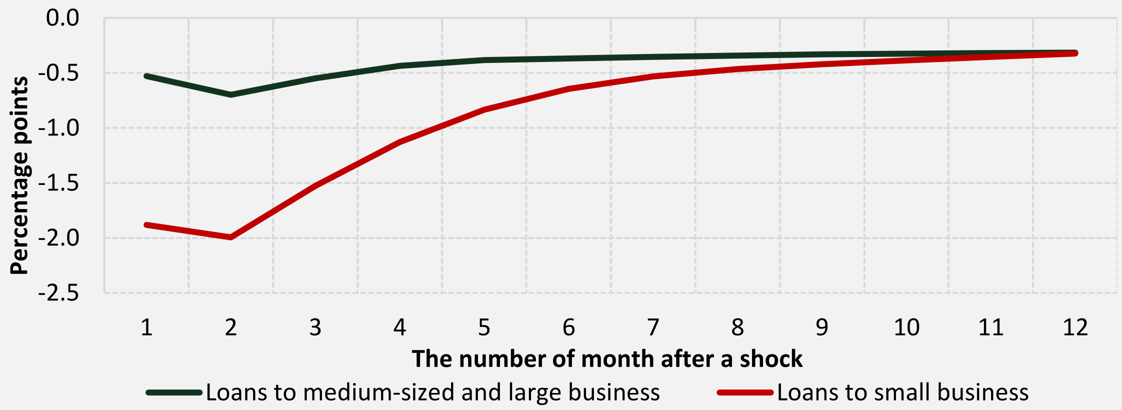
2.1. In Terms of Business Entities. Impulse responses show the strongest effect on small business loans in the second period: in response to a positive interest rate shock of 1 percentage point the growth rate of loans to small businesses decreases by **2.0 pp**; however, from the third month, the impact of the shock begins to weaken (Graph 3).

Lending to large and medium-sized businesses, compared to small businesses, reacts less to the shock of changes in interest rates: a 1 pp of the interest rate shock leads to deceleration in the growth rate of loan origination by **0.7 pp** (Figure 3).

It is noteworthy that in the period before the inflation targeting – from 2010 to 2015, medium-sized and large businesses accounted for the main share of loan originations (80% on average), while the share of loans provided to small businesses has increased significantly since the beginning of the pandemic – by more than 2 times (from 21% in December 2019 to 47% in July 2023).

Thus, a significant impact of changes in interest rate on origination of business loans is observed in the first two periods after the shock, and then the accumulated effect scales down, while continuing to be in the negative zone.

Figure 3. Accumulated Impulse Responses of Disbursement Volumes of Loans to Businesses to a 1 pp Shock of the Corresponding Interest Rate

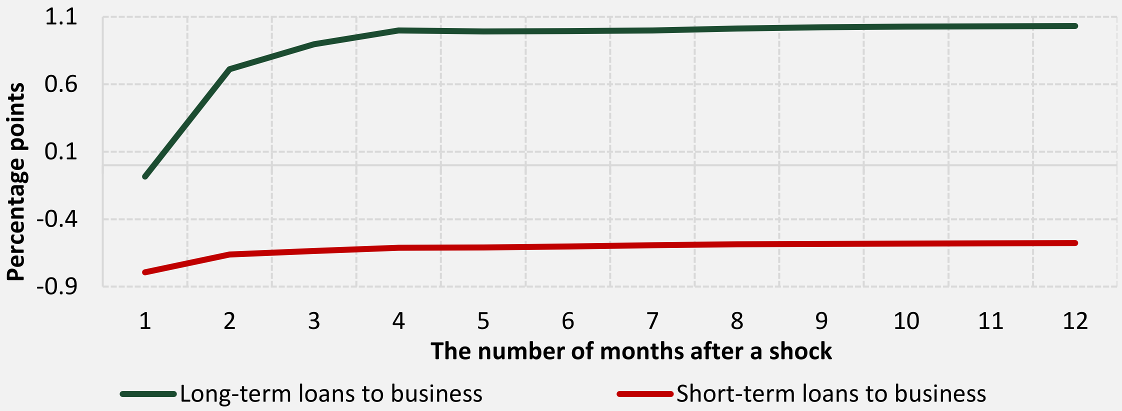


2.2. In terms of Tenors. Short-term loans, which make up more than a half of all issued loans (56.3% in July 2023, in December 2022 – 71.5%) show a higher impact of the interest rate on the change in loan origination. An increase in interest rate by 1 percentage point leads to a reduction in the volume of provided short-term loans by **0.8 pp** in one month. Then the effect gradually weakens to 0.6 pp after four months (Figure 4). When dividing short-term loans to businesses by business entity, the pass-through effect is more noticeable for short-term loans to small businesses – the rate increase of 1 pp leads to a reduction in lending volumes by **2.7 pp** with a further scale down in the effect and staying in the negative zone.

In relation to **long-term loans**, the effect of a change in the interest rate brings the change in volumes only at the initial stage (a decrease in the rate of change by 0.1 percentage point in the first month after the shock), with a further transition to the positive zone (Figure 4). That is, after an increase in rates, lending volumes go up. The results obtained are probably related to the predominance of long-term loans in government programs to subsidize loan rates, similar to mortgage lending. As a rule, such programs (through DAMU, support for agribusiness, the "Economy of Simple Things" program, etc.) are aimed at stimulating long-term lending.

For reference. *The share of public financing of the economy is very high and contributes to the replacement of second-tier banks in lending to the economy and shifting the market financing. During 2015-2019, 6 trillion tenge was allocated as part of various programs for economic development and support, of which 5.4 trillion tenge or 93% were allocated for financial support through subsidizing instruments, guarantees and other frameworks. Contracts worth 4.3 trillion tenge were financed through subsidies.*

Figure 4. Accumulated Impulse Responses of Disbursement Volumes of Loans to Businesses by Tenors to a 1 pp Shock of the Corresponding Interest Rate



All the above considered, rates on loans to households (consumer and mortgage loans) and businesses have a correct, in terms of directionality, impact on origination of new loans within two months after the shock. At the same time, the impact of the corresponding rates on mortgage lending is more pronounced compared to consumer lending.

A more significant negative effect to a positive 1pp shock can be seen in short-term loans and loans to small businesses. The main factors weakening the monetary policy transmission mechanism are likely to be *a high share of government programs with preferential rates, certain discretionary decisions stimulating the demand in certain credit markets (for example: withdrawal of funds from the UAPF), unanchored inflation expectations of the population, a structural shift in digitalization of bank lending (massive development of installment plans*), etc.

NATIONAL BANK OF KAZAKHSTAN

MACROECONOMIC CONDITIONS

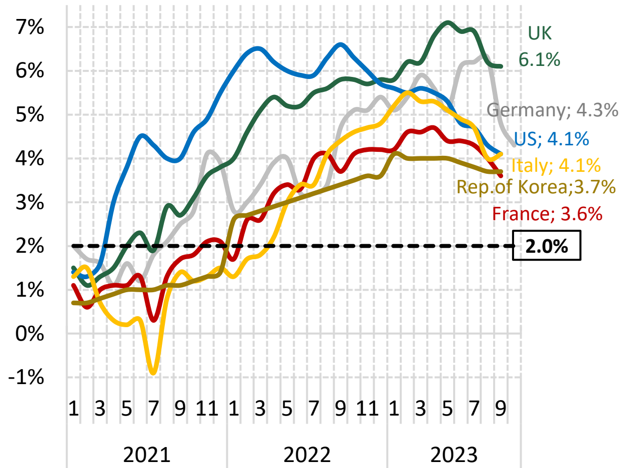
3.1. External Sector

Being affected by a tight monetary policy, the price growth keeps decelerating in many countries; however, in spite of this fact, inflation is still above the targets.

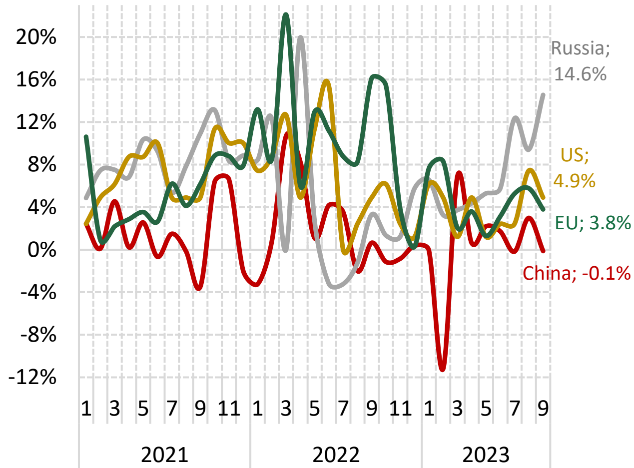
Consumer inflation in countries continues to gradually slow down. However, core inflation remains noticeably above target (Graph 33). Seasonally adjusted annualized inflation rates in most countries also exceed inflation targets and indicate the persisting inflationary pressure (Graph 34).

In the countries that are trading partners of Kazakhstan, the inflationary background is evolving in different directions. In the EU, inflation remains significantly above the target. In Russia, there is an acceleration of inflationary processes in the context of expanding domestic demand and a minor depreciation of the ruble exchange rate. In China, after a slight rise in prices in August and unchanged prices in September, deflation was observed again this October.

Graph 33. Dynamics of Core Inflation, YoY



Graph 34. Annualized Seasonally Adjusted Inflation, MoM



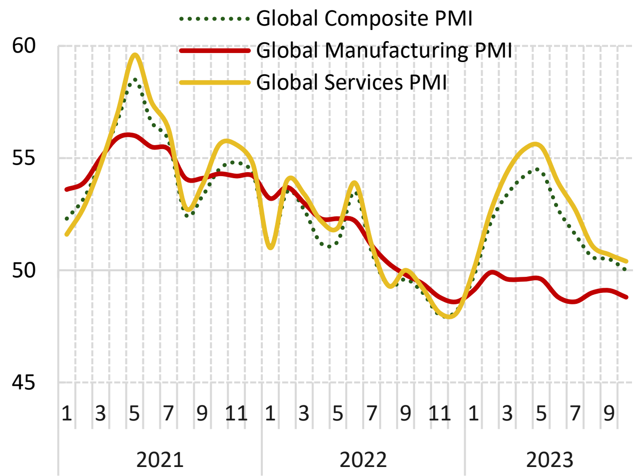
Source: national statistical offices, NBK computations

Global business activity in industry remains weak amid tight monetary policies pursued by central banks; the slowdown trend in services continues.

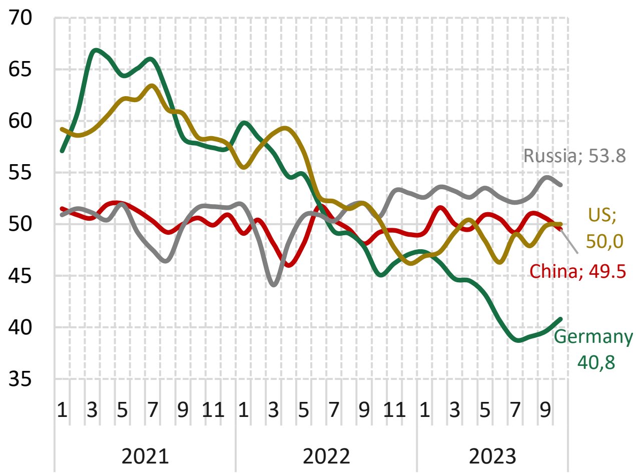
In October 2023, global industrial business activity continued to show weak dynamics (Graph 35). Production volumes and new export orders continue to decline. The lowest industrial indicators remain in European countries, including Germany, France, and Italy. At the same time, industrial growth was recorded in the USA, India and Thailand. The expansion of business activity in industry is also noted in Russia, with PMI indicators showing maximum values since 2017. Weaker external demand led to a lower industrial activity in China (Graph 36).

Volumes in the services sector continue to slow down after strong growth in the first half of the year. The growth rate of output decelerates just as new export orders. The main factors behind the slowdown in services were weaker demand amid tight monetary policies pursued by many central banks, as well as the increasing uncertainty.

Graph 35. Global Business Activity*



Graph 36. Global Business Activity in the Context of Countries



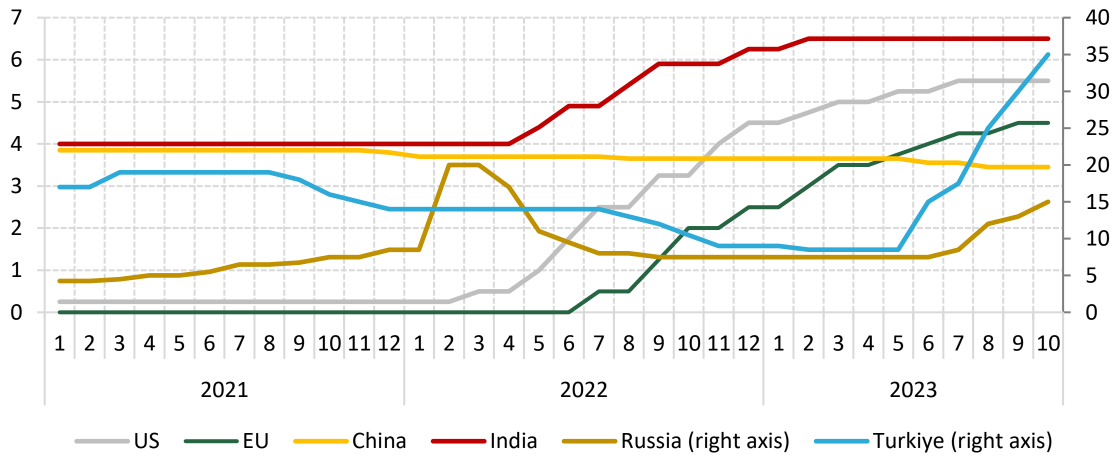
Source: PMI by S&P Global

** The index greater than 50 means the growth of the indicator, less than 50 – its decline, equal to 50 – its invariance*

The US Fed and many other large central banks continue to pursue a tight monetary policy in order to bring down inflation to its targets.

At the end of October 2023, in developed countries, key rates were left at the same levels. Meanwhile, the rhetoric of central banks in view of persistently high inflation remains tough. Moreover, the US Fed does not rule out another rate increase in the near future in order to reduce inflation and somewhat cool consumer and business activity in the country. The ECB intends to continue its tight monetary policy. The CB RF raised the rate by 200 bp at its October meeting to 15.0% per annum, and also did not rule out that the monetary policy would remain tight for a long time. For its part, the People's Bank of China, after lowering the key rate in August of this year, maintained the rate at 3.45% per annum (Graph 37).

Graph 37. Key Interest Rates, YoY, %

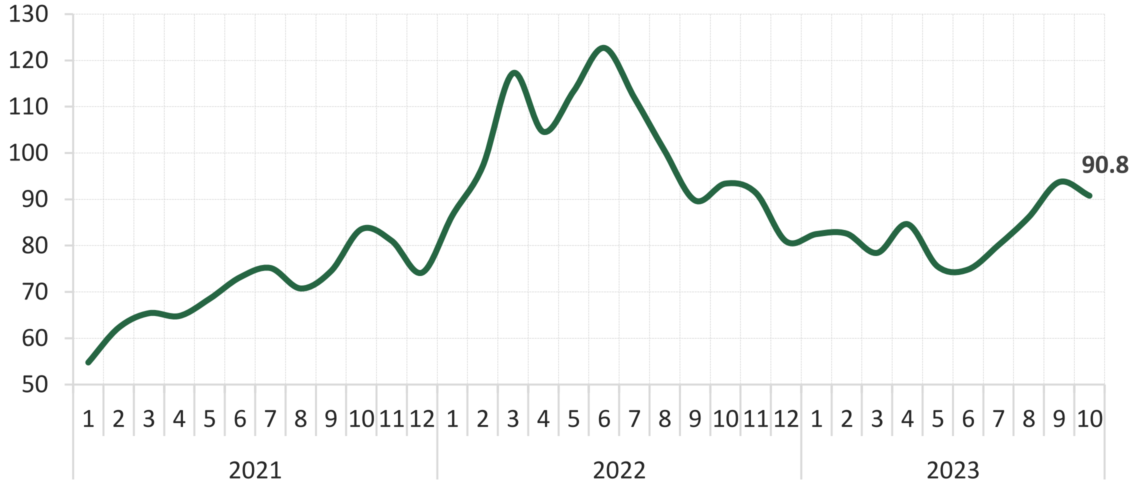


Source: Refinitive

In the third quarter of this year, an upward trend prevailed in the global oil market due to the extension of the OPEC+ agreement to extend voluntary oil output cuts. Another factor in the growth of oil prices was uncertainty regarding military operations in the Middle East.

Since the end of the last "August 2023" forecasting round, the world Brent oil price has been characterized by increased dynamics. In July-October 2023, oil prices rose from US$80 per barrel on average in July to US$90 per barrel on average in October 2023 (Graph 38). This price dynamics was driven by a reduction in oil supply from Saudi Arabia and Russia, as well as by more moderate demand for oil from large importing countries, including the United States and China. However, it is worth mentioning that in October of this year, Brent oil prices fell slightly since the concerns regarding military conflict in the Middle East, as well as weaker economic development indicators in China have eased.

Graph 38. Dynamics of Brent Oil Prices, US$/Bbl



Source: EIA

Box 2. Non-Standard Challenges for Central Banks in an Environment of Unprecedented Uncertainty[7] (2020-2022)

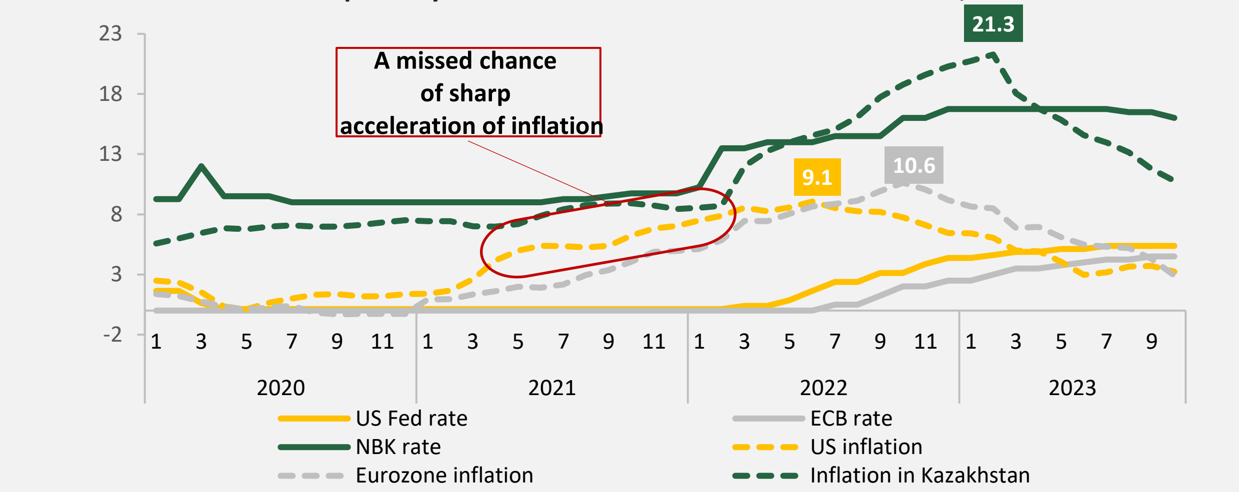
In 2020-2022, central banks of many countries faced unprecedented and unusual challenges and crises, whose potential impact on the economy and inflationary processes has not been fully studied. The initial “diagnosis” of the economy determined the policy in favor of containing the impact of shocks on economic activity through fiscal and monetary stimuli. However, disruptions in supply chains with simultaneous large-scale stimulation of demand led to the fact that the world central banks were unable to “cope” with the dramatic acceleration of inflation during the pandemic.

In 2021, when the global inflation rose sharply and approached “alarming” levels, according to the IMF[8], many leading central banks and experts perceived this as a temporary phenomenon and expected that the factors that caused the temporary surge would cease. The long-term “belief” in the short-term growth of inflation resulted in that the US Fed began to tighten the monetary policy only in March 2022, when annual inflation reached 6.6%, and the ECB did it in July 2022, when the growth in consumer prices in the Eurozone accelerated to 9 .1% with an inflation target of 2%.

The cycle of base rate hikes by the world’s largest central banks in 2022 was the highest in the last 20 years. Thus, the Fed rate during 2022 increased from 0.25-0.5% to 4.25-4.5% (Graph 1). In the context of the monetary tightening by central banks, inflation began to decline from the end of 2022 globally, while its base level until now remains high.

[7] *https://econs.online/articles/monetarnaya-politika/pochemu-tsentrobanki-upustili-inflyatsiyu-4-versii/*
[8] *https://www.imf.org/en/Publications/WEO/Issues/2022/10/11/world-economic-outlook-october-2022*

Graph 1. Dynamics of the Base Rate and Core Inflation, %



Source: Reuters

More detailed reasons for allowing such surge in inflation and why central banks did not take timely measures are analyzed by leading experts and financial regulators. The publication by the Bank of International Settlements (BIS)[9] provides four possible reasons for untimely response of central banks to the rise in inflation in 2021-2022 and what follows from that, based on the example of the US Fed and ECB:

1. A mistake in diagnosing strong shocks

The rise in inflation in 2021, after 25 years of price stability and post-pandemic economic recovery, was not obvious and seemed temporary. Tightening the monetary policy was considered unnecessary, and inflation above the target was believed to be not critical and temporary. The choice to maintain accommodative monetary conditions was made in the face of great uncertainty about the real-time state of the economy and the nature and persistence of shocks affecting inflation. Among these pro-inflationary shocks, three of them can be distinguished, which were realized in a short period of time and were underestimated by central banks while preserving a soft monetary policy

➢ There was **a rapid recovery as a result of** unprecedented **monetary and fiscal stimuli**, which, due to the unavailability of goods and services, first channeled into savings and later led to an increase in deferred expenses. Between the minimum in the second quarter of 2020 and the end of 2021, real GDP rose sharply, by 14.9% in the US and 17.5% in the Eurozone. Over the same period, the unemployment rate in the United States had decreased by more than 10 pp from 14.7% to 4.2% at the end of 2021[10].

➢ **A supply-side shock** increased the bargaining power of producers and resulted in lower than potential output level. At various times during 2021, seaports were congested, chip manufacturing capacity was in short supply, and global value chains were disrupted as new waves of the pandemic led to restrictions being imposed. Nevertheless, the central banks of developed countries interpreted all these price shocks as temporary. Thus, they concluded that they should not change the expansionary stance of their monetary policies and jeopardize the economic recovery. That being said, the standard monetary policy prescription for dealing with a temporary price shock is to allow inflation to rise above the target level even if actual output exceeds potential levels.

➢ **A rise in energy prices** in 2021 appeared to be the third shock and worsened against the backdrop of events in Ukraine at the beginning of 2022. This factor was also perceived as temporary and did not affect the rhetoric of central banks of developed countries. Therefore, their desire to avoid the mistakes of the past, when spikes in oil prices led to rising inflation, to the tightening of monetary policy and subsequently caused a recession, was justified. However, such decision is considered appropriate only with anchored inflation expectations.

[9] *https://www.bis.org/publ/work1060.htm*
[10] *https://www.bis.org/publ/work1060.htm*

All three shocks, which occurred in a short time, contributed to acceleration of inflation and were perceived as temporary by central banks and were not accompanied by the tightening of monetary conditions. Moreover, in all three cases there was a risk of a rather strong and persistent inflation growth, which became a reality after the fact. Such number of errors in one and the same direction indicates the presence of systemic problems. These problems are mentioned in the 3 factors below.

2. Unanchoring inflation expectations. In 2021, regulators not only made a mistake in assessing the nature of the shocks, but also overestimated the anchoring of inflation expectations. Only in 2021 it became clear that inflation expectations in the US and Europe were not anchored as previously. The unanchoring of inflation expectations turned a temporary inflation shock into a sustainable one.

3. Confidence in the regulator – this is an assessment of the compliance of the target value with expected long-term inflation: if the regulator is able to convince economic agents that in the long-term inflation will be equal to the target, then the monetary tightening may not be necessary. Regulators, including through their own authority, allowed inflation to grow above the target.

4. A steady decline in the **equilibrium real rate** also caused acceleration of inflation. Estimates showing that the real interest rate has fallen reflect a determination to combat low inflation and raise tolerance to above-target inflation. A potential policy revision to allow higher inflation has been held back by weak determination to implement it.

The above mistakes of the world central banks indicate that correct diagnosis and timely measures from macroeconomic policies are important to curb inflation. In addition, inflationary effects in any country will be stronger if, with limited supply, aggregate demand is further stimulated. In this regard, the IMF emphasizes the need for coordinated actions on the part of fiscal and monetary policies, in other words, fiscal policy should not contradict the efforts of the monetary authorities to curb inflation.

Otherwise, the decline in inflation to target levels will be significantly delayed. This will lead to an unanchoring of inflation expectations, increased financial instability and falling living standards of the population.

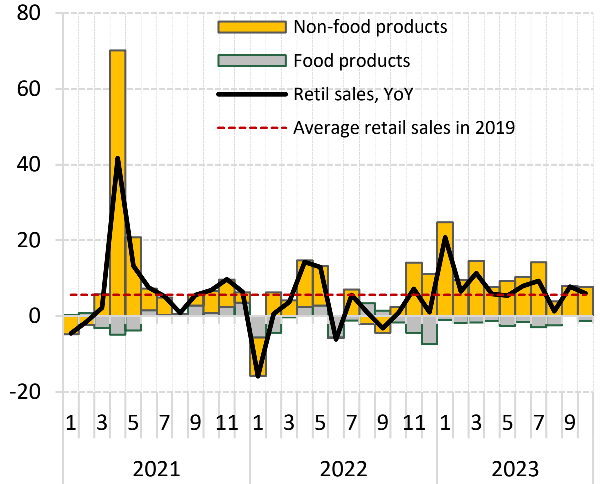
3.2. Internal Sector

The domestic demand in the economy remains steady being supported by the growth of real wages of the population and by implementation of infrastructure projects.

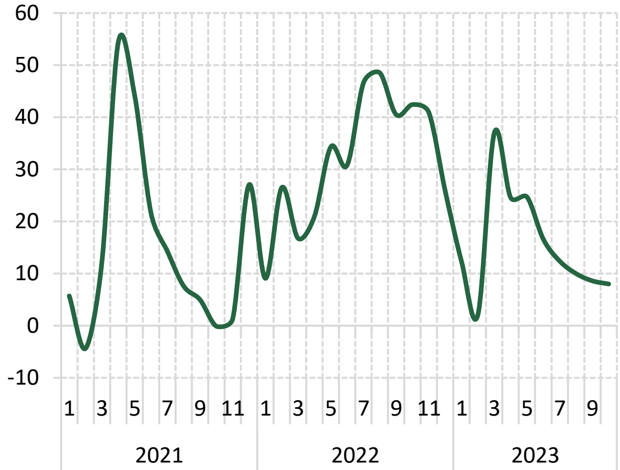
The dynamics of indirect indicators show an ongoing active realization of consumer demand in the third quarter of this year. The volume of retail turnover in the third quarter of 2023 increased by 6.1%; in January-October 2023, the growth rate of retail sales of goods accelerated to 6.9% in annual terms (Graph 39).

The main contribution to trade growth continues to be made by the sale of non-food products, the increase of which amounted to 14.7% (YoY) based on the results of ten months of this year. At the same time, the downward trend in retail trade in food products persisted. This may be driven by a change in consumer preferences towards the consumption of services. Thus, despite the slowdown in growth rates this February, the volume of services provided in the area of catering in January-October 2023 increased by 8.0% (Graph 40).

Graph 39. Retail Sales, %



Graph 40. Public Catering Services, YoY, %

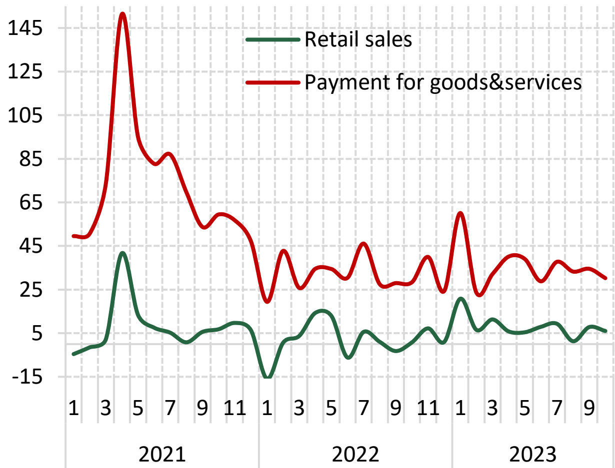


Source: BNS ASPR, NBK computations

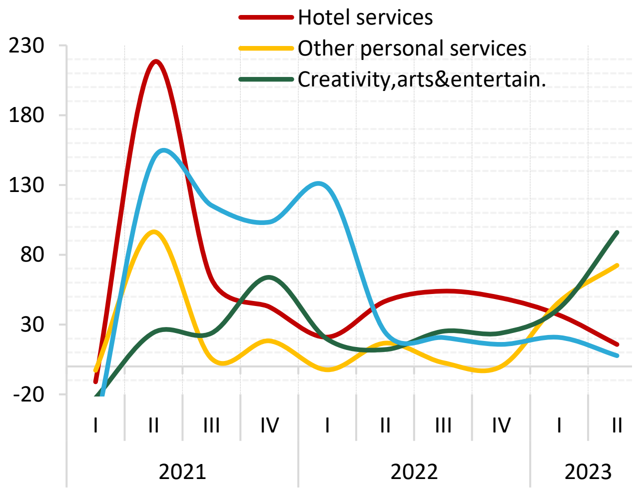
The steady positive dynamics of growth in retail turnover are accompanied by similar positive dynamics in the growth of transactions for payment for goods and services using electronic payment cards of the population (Graph 41).

Along with catering services, there is an increase in the volume of services provided to the population. Based on the results of the first half of 2023, significant annual growth rates in the physical volume of services are observed among other personal services (hairdressing/beauty salon/dry cleaning services) and among activities in the field of creativity, arts and entertainment. However, there is a slowdown in the growth rate of the physical volume of hotel services and activities in the field of sports, leisure and entertainment (Graph 42).

Graph 41. Retail Sales and Cash Flows across Payment Cards of the Population, in the 2010 Prices, YoY, %



Graph 42. Providing Various Types of Services, YoY, %



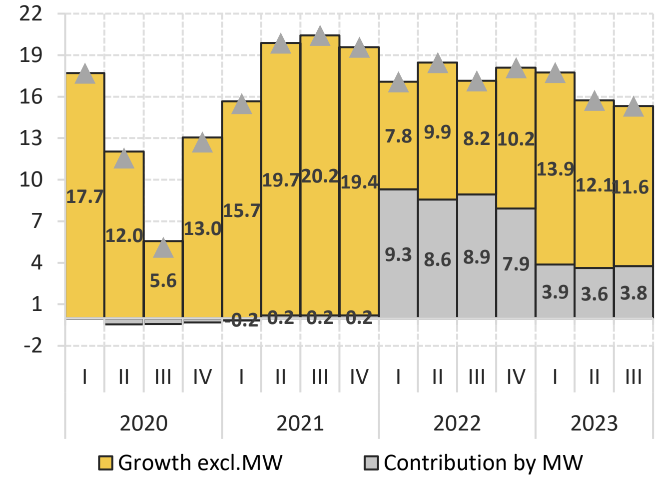
Source: BNS ASPR, NBK computations

Consumer demand this year was supported by high annual growth rates of consumer lending in real terms, an increase in the minimum wage (MW) and a recovery in real wages amid slowing annual inflation.

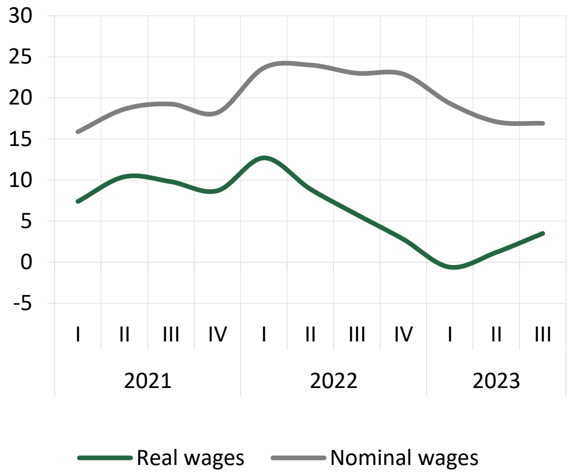
The annual growth rate of the payroll fund in nominal terms is slightly lower than in 2022. The contribution of the increase in minimum wage in 2023 to the growth of the nominal payroll fund was about 3.8 percentage points (Graph 43).

In the third quarter of 2023, real wages continued to recover as annual inflation was decelerating and increased by 3.5% relative to the third quarter of 2022 (Graph 44). The largest growth in real wages in the third quarter of 2023 is seen in electricity supply, water supply, information and communication. It is worth noting that the above sectors are experiencing the highest rates of investment growth this year. The decline in real wages in the third quarter of 2023 is observed in agriculture, education and accommodation and catering services.

Graph 43. Contribution by MW to the Payroll Fund, %, pp



Graph 44. Wages, %, YoY



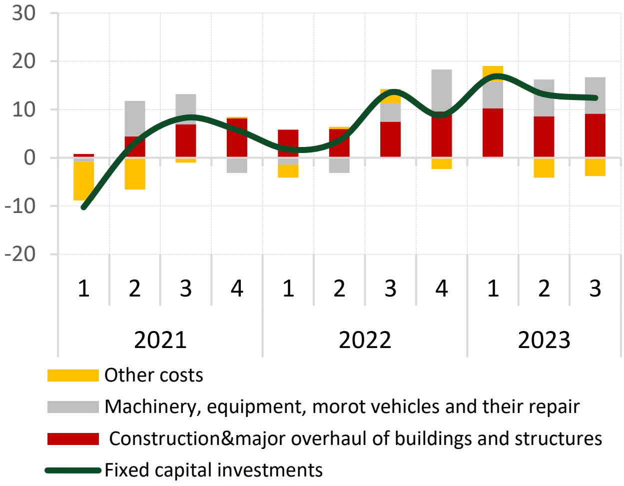
Source: BNS ASPR, NBK computations

Investment activity is characterized by stable growth dynamics given implementation of infrastructure projects in many sectors of the economy. A significant contribution to the growth of investments is observed in the sectors providing public services in the context of implementation of the "Tariff in Exchange for Investment" government program. The increased investment demand is largely observed on the part of firms; investment activity of the population shows a tendency to slow down during this year.

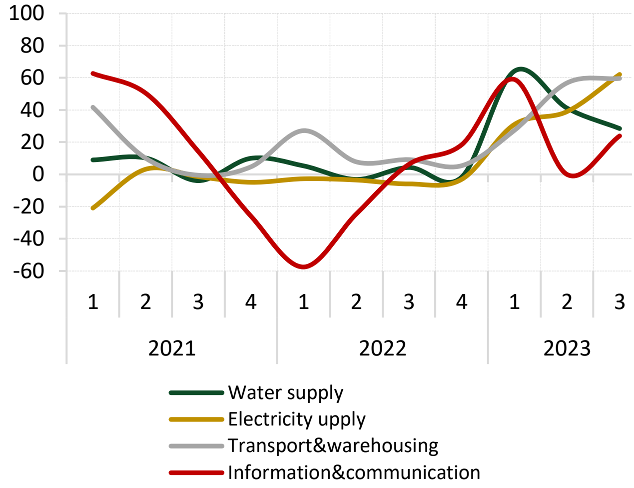
Investments in fixed assets in the third quarter of 2023 grew by 10.8% on the year on year basis (Graph 45). The main contribution continues to be made by construction and installation works. In terms of sectors, there has been a significant increase in investment in the electricity supply, water supply, transport and warehousing, as well as information and communication sectors (Graph 46).

However, investment activity of the population continues to decline in the third quarter. Thus, investment in housing construction in the third quarter of this year decreased by 2.2%, YoY. The reason for this decrease may be a reduction in the limits on the maximum amount of consumer lending under the "7-20-25" program from 400 billion tenge in 2022 to 100 billion tenge in 2023. However, despite the decline in investment in housing construction, the number of purchase and sale transactions continues to increase and in the third quarter significantly exceeds the average level of 2018-2020, which indicates a persistently high demand for homes in 2023 (Graph 47).

Graph 45. Fixed Capital Investments and Components, YoY %, pp

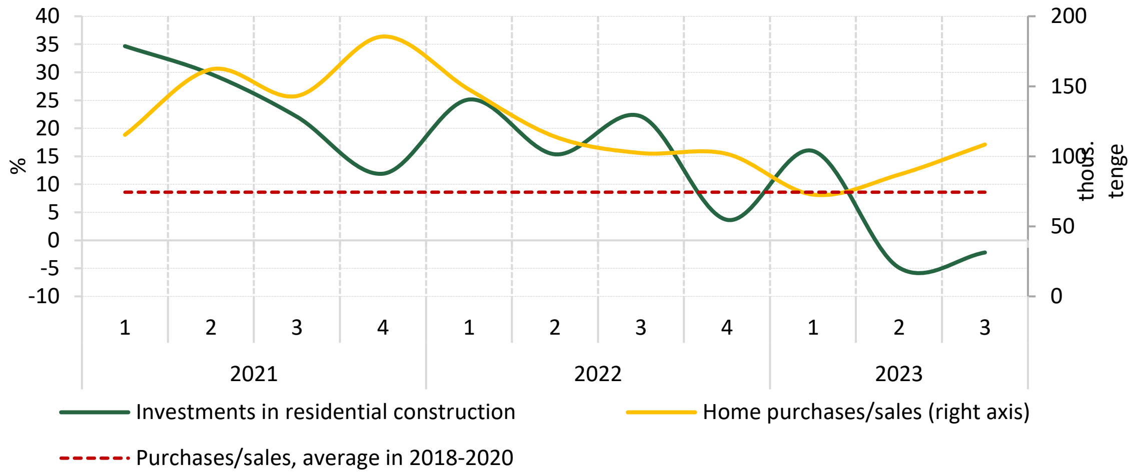


Graph 46. Infrastructure Investments, YoY



Source: BNS ASPR, NBK computations

Graph 47. Investments in Residential Construction and Activity in the Real Estate Market



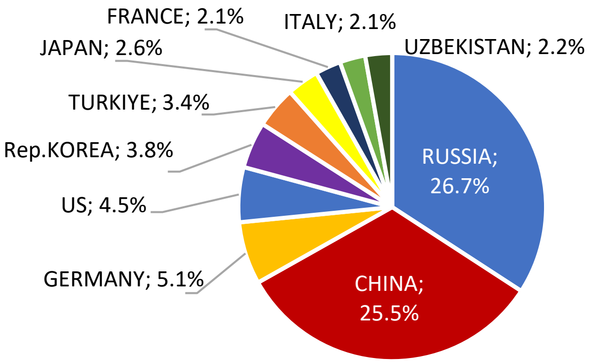
Source: BNS ASPR, NBK computations

As a result of growth in consumer and investment demand, there will be a significant increase in imports for all main groups of goods in 2023. At the same time, the structure of imports by country has undergone some changes.

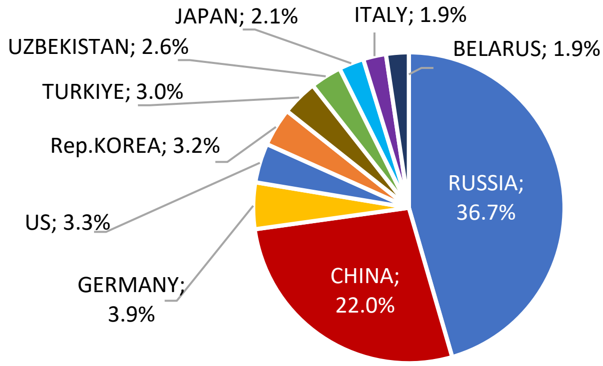
In January-September 2023, import value increased by 25.0%, YoY, and amounted to US$44.5 billion. At the same time, there have been changes in the country structure of imports. Thus, Russia's share in imports decreased from 36.7% to 26.7%, with a concurrent increase in China's share from 22% to 25.5% (Graph 48 and Graph 49). Meantime, despite the decline in Russia's share of imports in general, there was an increase in volumes of some product items of Russian imports. This could be due to the strengthening of the nominal exchange rate of the tenge against the ruble starting from April of this year.

In the structure of imports of goods, there is a significant ramp-up in the volume of imports of clothing from China and Turkiye, detergents and cleaning products from the USA and Turkiye, home furniture from China, hygiene products and cosmetics from Russia, France and Egypt, cars from China, telephones from Vietnam.

Graph 48. Imports in January-September 2023, by Country



Graph 49. Imports in January-September 2022, by Country

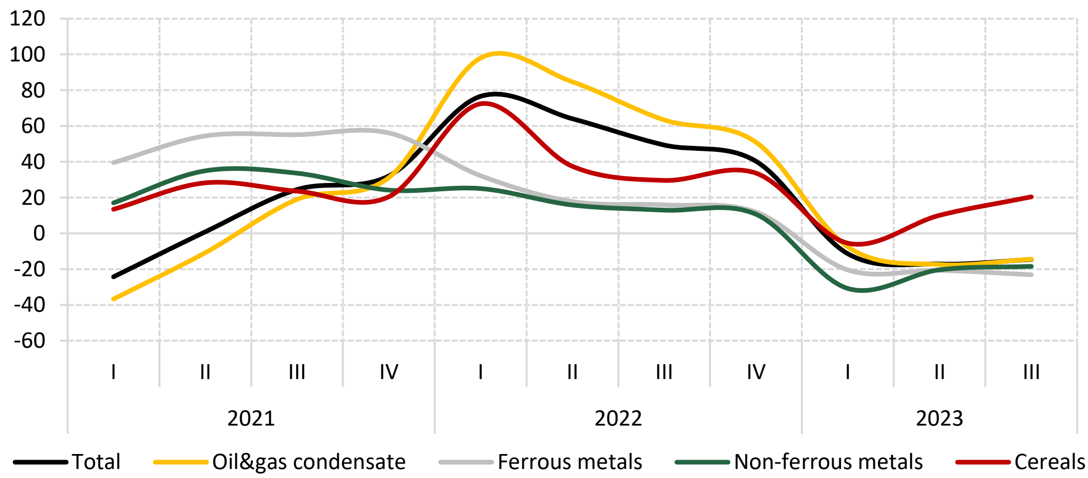


Source: SRC MF RK, BNS ASPR

Exports of goods in January-September 2023 decreased by 14.6%, YoY, in value terms and amounted to US$57.5 billion. A decrease is observed in all major groups of export goods, with the exception of grains.

Exports of oil and gas condensate decreased in January-September of this year by 14.5%, YoY. The main reason for the decline in oil exports was lower oil prices compared to 2022 and the high base of the last year. The decline in exports of non-ferrous and ferrous metals is stemming from lower metal prices, as well as weaker demand from China due to the slow pace of economic recovery. At the same time, as a result of the last year's good harvest, grain export supplies in January-September 2023 increased by 20.4%. YoY (Graph 50).

Graph 50. Exports by Major Groups of Goods, YoY, %



Source: BNS ASPR

Box 3. An Overview of Diesel Fuel Market in Kazakhstan

Diesel fuel is an oil product that plays an important role in the functioning of all sectors of the economy, including agriculture, industry, transport and logistics, and electric power.

The state of the diesel fuel market has a direct and indirect impact on inflation. The direct impact is related to the inclusion of diesel in the CPI basket (the share in the CPI basket in 2023 is 0.4%). The indirect impact occurs because the cost of a wide range of goods and services in the CPI basket depends on diesel prices.

Three large oil refineries account for about 95% of all of processed oil in Kazakhstan (Table 1).

Table 1. Information on Three Large Oil Refineries in Kazakhstan

	Construction Year	Owners	**Average estimated capacity** for oil processing (mln tons)	**Processing volume** of oil in 2022 (mln tons)	**Output** in 2022 (mln tons), incl. **the share of white oils**)	Share In the production of diesel in 2022	Prospective projects	Tariffs for oil processing in 2022 (tenge/ton)
Atyrau Oil Refinery (c.of Atyrau)	1945	99% KMG	5.5	5.2	4.1 (70.5%)	28.1%	increased output of white oils through residue conversion	42 515
Pavlodar Oil Refinery (c.of Pavlodar)	1978	100% KMG	6.0	5.5	4.2 (85.8%)	34.6%	winter diesel production, reduction of sulfur content in liquefied gas	23 240
Shymkent Oil Refinery (c. of Shymkent)	1985	50% KMG+ 50% CNPC (China)	6.0	6.2	5.4 (81.3%)	36.9%	increasing capacity to 12 mln tons	35 336

Source: KMG

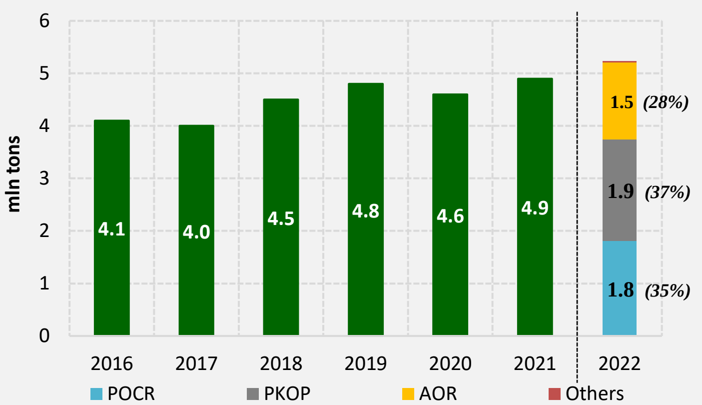
Three large refineries produce both white oils in the form of diesel fuel, gasoline, kerosene and liquefied gas, and black oils in the form of oil residue, vacuum gas oil, as well as petrochemical products in the form of benzene and paraxylene (Table 2).

Table 2. Processing and Production Volumes at Oil Refineries in 2022 (Mln Tons)

	petrochemical plant	refineries			
	Pavlodar Petrochemical Plant JSC (PPCP) in Pavlodar	**PetroKazakhstan Oil Products LLP** (PKOP) in Shymkent	**Atyrau Oil Refinery LLP (AOR)** in Atyrau		
Oil processed:	-	-	-	17.9	94.4%
Produced:	4.2	5.4	4.1	13.7	99.6%
diesel fuel	1.8	1.9	1.5	5.2	99.5%
gasoline	1.6	2.1	1.3	5.0	99.5%
oil residue	0.6	1.0	1.2	2.8	100.0%
kerosene	0.2	0.3	0.1	0.7	100.0%

Source: SAC FEC RK (Telegram Channel)

Graph 1. Diesel Fuel Production in Kazakhstan



Source: ME RK Telegram Channel "Energo_Official"

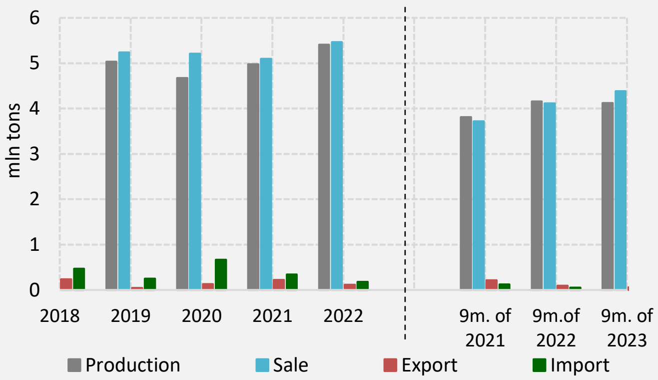
Consumption of a certain type of diesel fuel depends on the outside temperature. Kazakhstan produces such types of diesel fuel as summer, inter-seasonal, winter and arctic. Diesel is produced at all three large refineries. At the end of 2022, 5.2 million tons of diesel were produced in Kazakhstan, of which 1.9 million tons were produced at the Shymkent Oil Refinery, 1.8 million tons at the Pavlodar Oil Refinery, and 1.5 million tons at the Atyrau Oil Refinery (Graph 1).

The Shymkent Oil Refinery is mainly supplied with raw materials from the fields of the Kyzylorda and Aktobe regions. The Atyrau Oil Refinery is supplied with oil from the western regions of the country. Since oil from the Tengiz, Karachaganak and Kashagan fields is export-oriented, the Atyrau Refinery is supplied with oil from western fields that do not include the above three projects.

The Pavlodar refinery is supplied with West Siberian oil from Rosneft on the basis of a contract agreement between Kazakhstan and Russia. Russian oil is sent through the Omsk-Pavlodar pipeline to the Pavlodar Oil Refinery and becomes the property of Kazakhstan. At the same time, equivalent volumes of Kazakh oil are loaded into the Atasu-Alashankou pipeline and transferred to Russian ownership. This type of contractual agreement is called a “swap operation”, in which the parties have the opportunity to deliver oil from point “A” to point “B” through the exchange of volumes, bypassing the need for real physical transportation.

Oil is funneled to production of petroleum products, including diesel fuel, in line with the devised plan for the supply of crude oil to refineries in accordance with the law “On the Government Regulation of Production and Turnover of Certain Types of Petroleum Products.” Refineries accept the following types of oil from suppliers: self-produced; received as taxes in kind; self-imported; purchased directly from a connected subsoil user; purchased from the entity that carried out the coming-in, including imports, into the territory of Kazakhstan. In addition, refineries can purchase oil on their own from subsoil users for subsequent sale of petroleum products. After receiving crude oil, refineries process the oil according to processing tariffs and return the resulting petroleum products to the owners of the oil. The resulting petroleum products can be sold by retailers, wholesale suppliers, or forwarded directly for wholesale distribution to end consumers, including producers of agricultural goods, Kazakhstan Temir Zholy, gas stations, enterprises of the mining and metallurgical complex, and a single operator of the armed forces of Kazakhstan. In addition, some volumes of petroleum products are sold through exchange trading.

Graph 2. Resources and Uses of Diesel Fuel



Source: stat.gov.kz

In general, Kazakhstan is almost completely self-sufficient in diesel fuel (Graph 2): in 2022, the share of imports in domestic diesel fuel consumption was 3.3%.

Kazakhstan mainly imports winter and summer diesel fuel (Graph 3). During the period from 2018 to 9 months of 2023, about 96.2% of imported volumes of these two types of diesel fuel were carried in from Russia, 3.6% from Kyrgyzstan, and the remaining insignificant volumes from Belarus and the US. At the same time, summer diesel fuel is produced at all three refineries, while winter diesel fuel is produced only at the Atyrau Oil Refinery.

Kazakhstan's diesel fuel export volumes are insignificant (Graph 2). Kazakhstan mainly exports other diesel fuel used for further processing and chemical transformations (Graph 4). During the period from 2018 to 9 months of 2023, export destinations were as follows: 23.2% to Russia, 19.8% to Kyrgyzstan, 19.3% to Azerbaijan, and 15.2% to Uzbekistan.

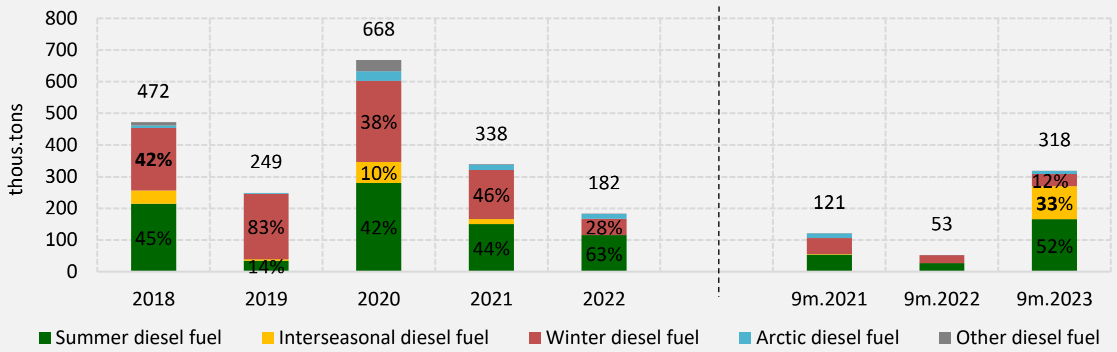
The difference between retail prices for diesel and the prices of diesel fuel producers is significant and is expanding from year to year (Graphs 5a and 5b). In 2022, the average retail price for summer diesel fuel exceeded producer prices by 1.8 times (retail price – 236.3 tenge/liter, producer price – 128.5 tenge/liter), while the average ratio for 2016-2021 was 1.5 times. In 2022, the average retail price for winter diesel fuel exceeded producer prices by 3.1 times (retail price – 429.5 tenge/liter, producer price – 139.8 tenge/liter), while this ratio for 2016-2021 on average was 1.9 times. The price differential, in addition to trade and sales margins, was stemming from value added taxes, excise taxes, and transportation costs associated with the delivery of products from the producer to the buyer.

In Kazakhstan, prices for diesel fuel are significantly lower than in border countries (Graph 6). This is related to non-market pricing due to the social and economic importance of diesel fuel. Thus, as of October 2023, diesel prices in Kazakhstan were at US$0.6 per liter, which is significantly lower than prices in China (US$1.1 per liter), Uzbekistan (US$0.9 per liter), Kyrgyzstan (US$0.8 per liter) and Russia (US$0.7 per liter).

In a sectoral context, rise in fuel prices, including prices for diesel fuel, will be most affected by increased costs for enterprises in the transport and warehousing sectors, as well as agriculture, forestry and fisheries

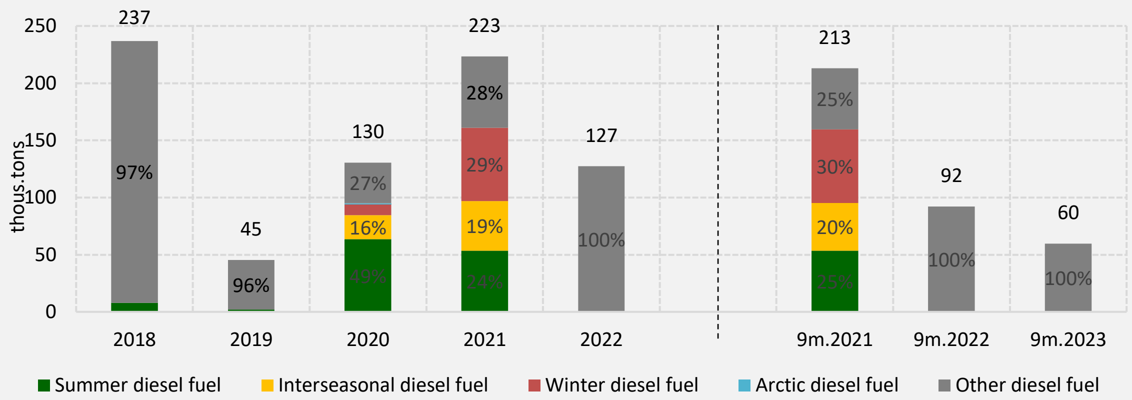
(Graph 7). At the end of 2022, the ratio of fuel costs to the cost of goods and services in the transport and warehousing sector was 10.5%, in the agricultural sector – 8.5%.

Graph 3. Structure of Diesel Fuel Imports



Source: stat.gov.kz

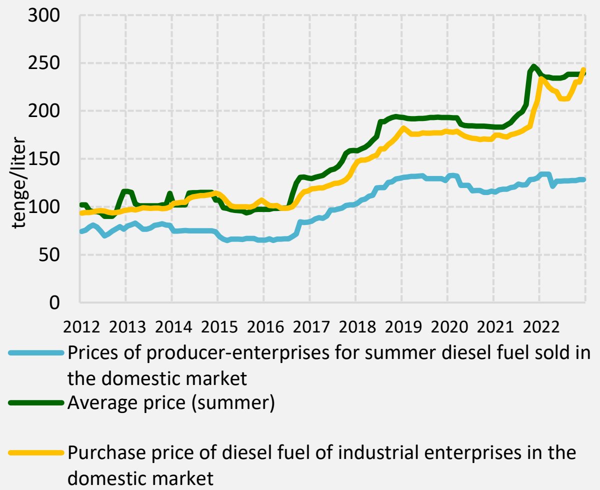
Graph 4. Structure of Diesel Fuel Exports



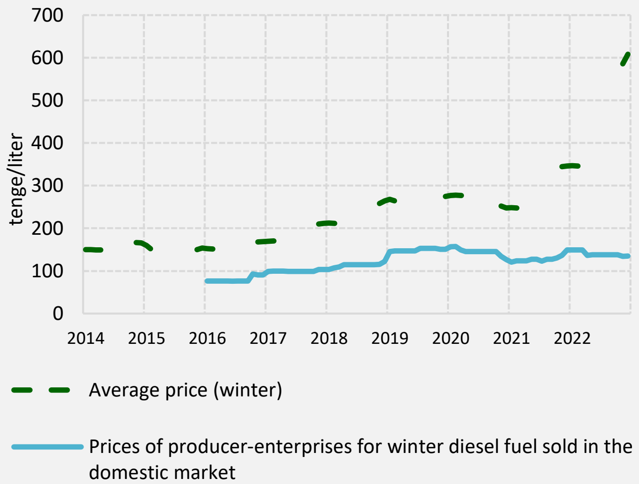
For reference. In 2020-2021, diesel was exported to the following countries: Uzbekistan - 35.1%, Russia - 20.5%, the Netherlands - 19.3%, Kyrgyzstan ¬ 15.7%, other countries ¬ 9.4%.

Source: stat.gov.kz

Graph 5a. Prices for Summer Diesel Fuel



Graph 5b. Prices for Winter Diesel Fuel

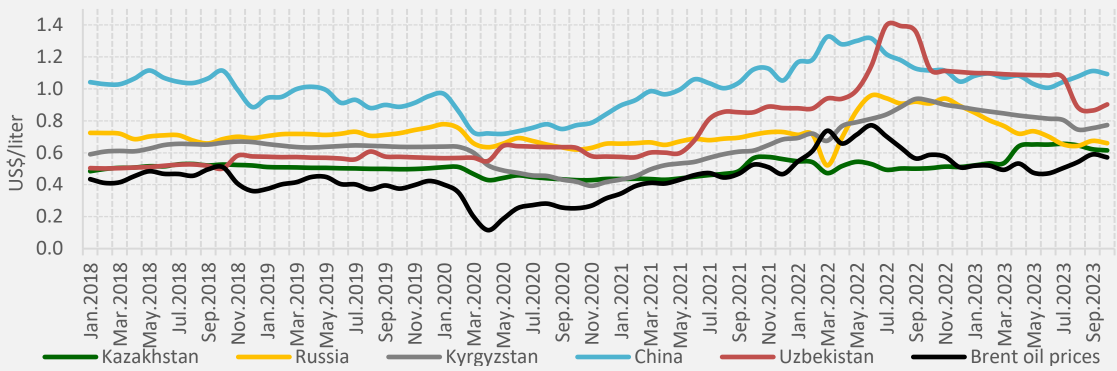


Note 1. Retail prices of "tenge/liter" were obtained based on the 1 ton+=13000 liters proportion.

Note 2. Registration of retail prices for petroleum products purchased by the population is carried out directly at the places of their sale. ***The producer price*** *is the price of a unit at the time it leaves the enterprise gates, excluding value added tax and excise taxes, trade and sales margins and transportation costs associated with the movement of products from the manufacturer to the buyer.* ***Purchase price*** *is the price including value added tax, transport, trade and sales, intermediary and other expenses.*

Source: stat.gov.kz

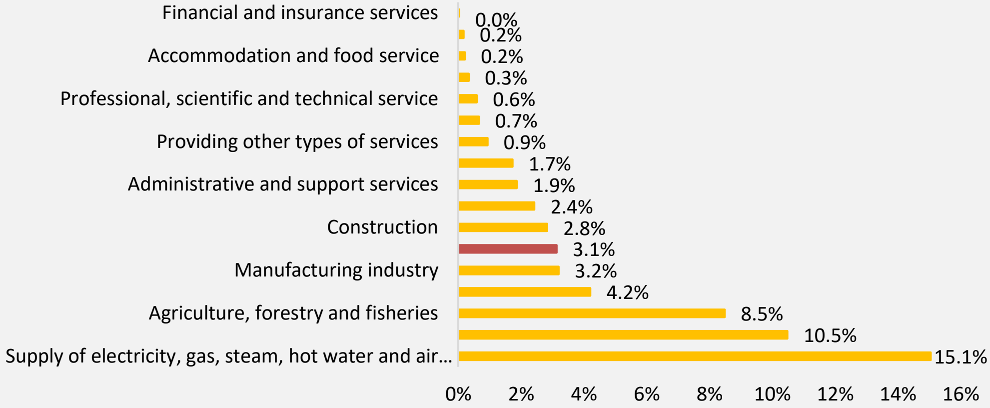
Graph 6. Retail Domestic Prices for Diesel Fuel



Note. A barrel of oil was converted into liters based on the 1 bbl =159 liters proportion.

Source: Kazakhstan, Russia and Kyrgyzstan – official statistical offices; Uzbekistan and China – open sources; Brent – EIA.

Graph 7. Expenses of Kazakhstani Enterprises for Fuel/Prime Cost of Goods and Services



Note. When assessing the greatest effect of the growing cots for fuel on economic sectors, the sector of "electricity, gas, steam, hot water supply and air conditioning" was not taken into account. This is because for most enterprises in this sector, diesel is not the main type of fuel.
Source: stat.gov.kz

It is expected that the EAEU agreement on the formation of common markets for oil and petroleum products will come into force in 2025. This will affect the alignment of diesel fuel prices in Kazakhstan with other EAEU member countries. Thus, diesel fuel prices will have a direct and indirect effect on increasing the cost of food and non-food goods and services included in the CPI basket.

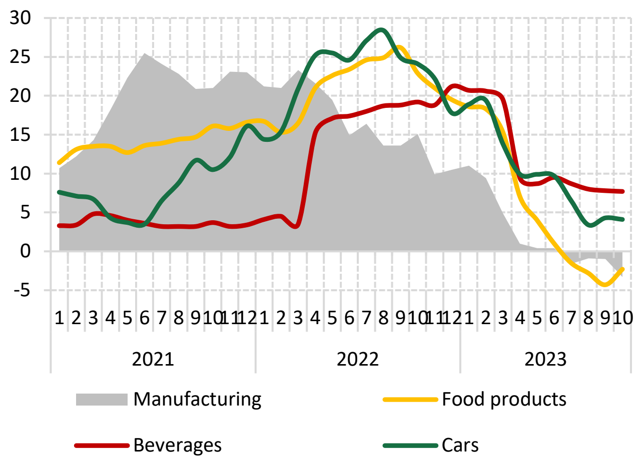
3.3. Production Costs

The downward trend in annual growth rates of prices of industrial and agricultural producers is persisting against the declining prices for forage and grain crops.

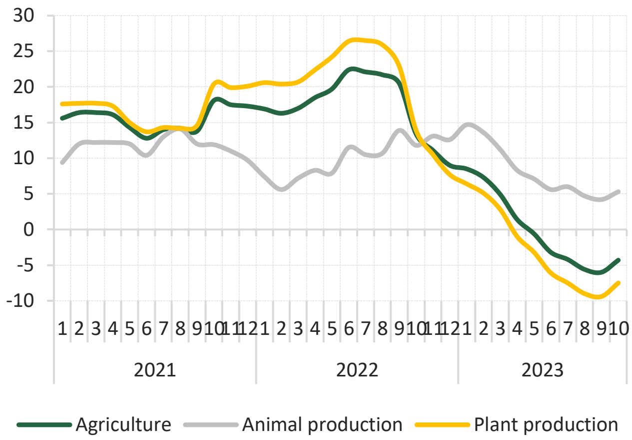
Since last year, the annual growth rate of prices for products of the manufacturing industry has gradually decreased. In the second half of this year, price dynamics in industry moved into the negative zone. In October of this year, food producer prices decreased by 2.3% in annual terms. There has been a decline in producer prices for flour and cereal products, oils and fats. The decrease in the growth rate of beverage prices was driven by a decline in prices of alcoholic beverage producers.

In the structure of non-food products, the growth in producer prices of enterprises producing textile products (by 2.3%, YoY), machinery and equipment (by 5.6%), as well as metallurgical products (by 10.6%) continued to slow down. (Graph 51).

Graph 51. Producer Prices in the Manufacturing Industry, %, YoY



Graph 52. Agricultural Producer Prices, %, YoY



Source: BNS ASPR

Similar dynamics are observed among agricultural producers. Since May of this year, prices in the industry have been declining due to lower prices for livestock products. At the same time, it is worth mentioning that in October the decline in producer prices in agriculture slowed to 4.3% in annual terms (Graph 52). Prices for plant production also continued to go down; however, in October of this year, a reversal of the downward trend was observed for the first time since the middle of the last year. This was due to a 2.4% (MoM) rise in grain prices because of lower grain harvests caused by unfavorable weather conditions in the main grain-growing regions of the country. In livestock farming, prices for live cattle and poultry have risen, while at the same time, there has been a slowdown in annual growth rates in prices for raw milk and eggs. Such slowdown may be caused by a reduction in prices for feed crops, which account for more than 50% of the costs of milk and egg producers.

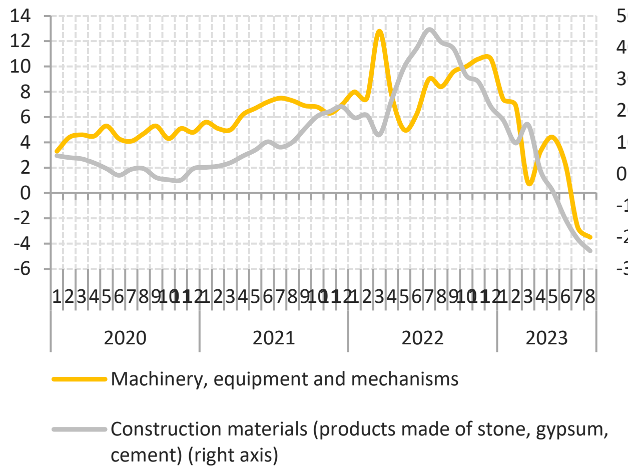
The pressure from domestic costs has continued to weaken since the beginning of this year; this, in turn, has a positive effect on deceleration in food inflation.

Import prices in annual terms kept declining due to the last year's high base effect, the strengthening of the nominal exchange rate of the tenge in the summer and deceleration in external inflation.

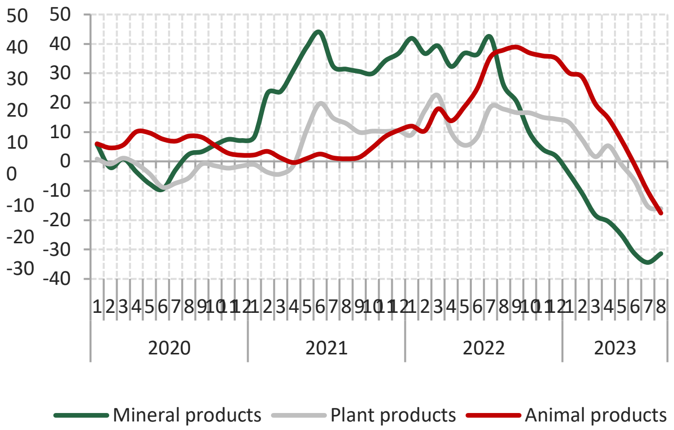
Among investment goods, import prices for construction materials continue to decline given lower prices in Russia, appreciation of the tenge/ruble exchange rate and a high base in June-August 2022 (Graph 53). In Russia, the annual growth rate of prices for manufacturers of construction products slowed down to 6.2% in September of this year (the peak was observed in April 2022 – an increase of 13.3%, YoY). In the structure of imports of construction materials, the main portion comes from Russia (January-September 2023 – 38.4%).

Following a surge in import prices for intermediate goods last year, rising global food prices and disrupted supply chains have seen deflation this year. The reduction in import prices for products of both plant and animal origin is associated with a decline in world food prices. Within the structure of import prices for mineral products, the producer price index of coal, oil and petroleum products reduced significantly (Graph 54).

Graph 53. Import Prices of Investment Goods, %, YoY



Graph 54. Import Prices of Intermediate Goods, %, YoY



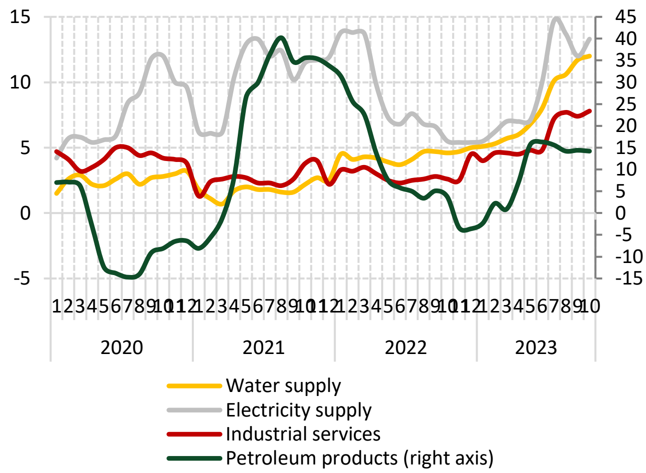
Source: BNS ASPR

Despite the decline in the import component, domestic production costs continue to rise. There is an increase in the cost of utilities and logistics costs, which may put upward pressure on prices for end consumers.

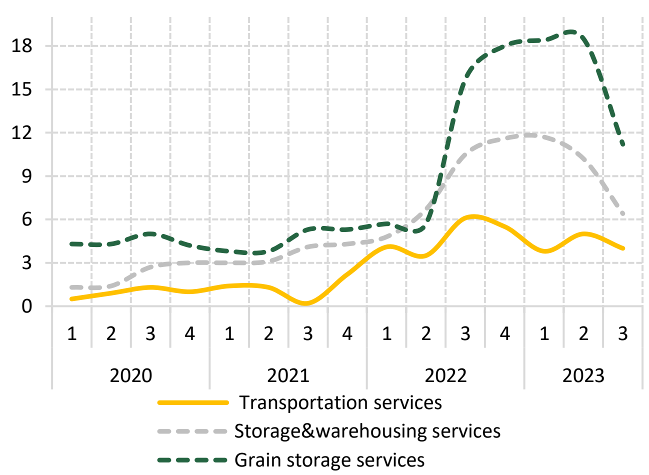
Prices of producers of industrial products and services in water supply, electricity supply, industrial services and petroleum products have shown an increase in annual terms since the beginning of this year. A significant growth in producer prices for water supply and electricity supply occurs against the implementation of the “Tariff in Exchange for Investment” government program (Graph 55). This program is aimed at attracting investments for modernization, reconstruction and renewal of existing generating capacities of TPPs, which require significant costs.

Along with this, since the second half of last year, there has been an increase in the cost of transport and storage services, in particular grain storage services. At the same time, the rate of growth in prices for storage services in the third quarter of this year slowed down due to the effect of the last year’s high base (Graph 56).

Graph 55. Producer Prices for Some Types of Industrial Products and Services, %, YoY



Graph 56. Producer Prices for Transportation and Warehousing Services, %, YoY



Source: BNS ASPR

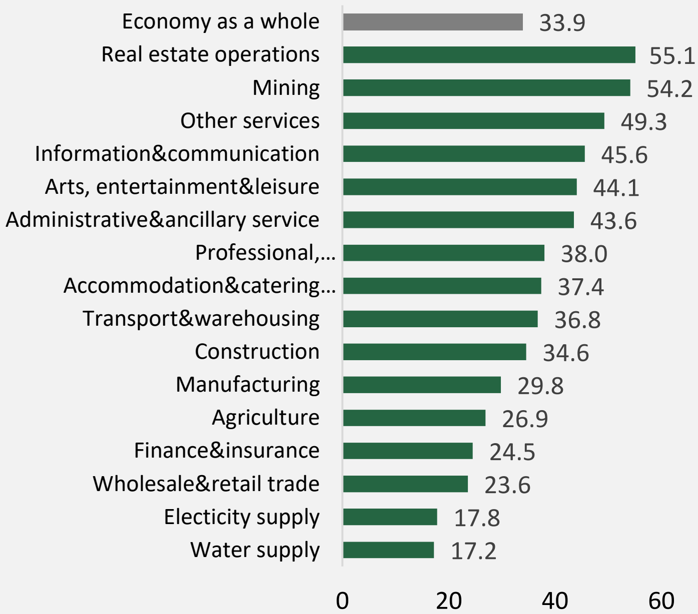
Box 4. Analysis of Firms' Margin in Kazakhstan

The growth of firms' margins is considered one of the potential factors influencing the increase in price levels in the country. Economists have been actively studying the idea that firms could use their market power to raise prices more than their costs increased. According to the theory, there are various ways and reasons why markups change over time. For example, margin[11] may change due to the decreased price sensitivity of consumer demand or increased monopoly power resulting from decreased competition. Alternatively, firms may increase margins in the current period if they expect higher marginal costs in the future and want to smooth out price increases over time rather than raise prices all at once. In this Box, we explore the assumption that changes in firms' margins could be a factor in changes in the price level in Kazakhstan.

To maximize profits, firms set prices above their marginal cost of production. The price, in turn, is set based on the firms' marginal costs and margins. Thus, changes in prices (inflation) can be divided into changes in production costs and markups, which can be passed on to consumers in the form of higher prices. This interdependence makes it possible to understand price dynamics by observing margin dynamics, for example during the periods of high inflation.

Analysis of the enterprise data shows that the margin level in Kazakhstan is about 33.9% on average for 2018-2023 (Graph 1). In terms of industry, high margins (over 50%) are observed in the mining industry and real estate transactions. High margins in the mining industry are associated with the low cost of extracted products, as well as a high demand for mined raw materials. In addition, low margins are observed in electricity and water supply. The level of margins in the manufacturing industry, agriculture, financial and insurance activities, and trade is on average below the general level in the economy and is in the range of 23%-30%.

Graph 1. Margin by Sector, Average in 2018-2023 (2 Quarters), %



Source: BNS ASPR, NBK computations

According to the enterprise survey conducted by the National Bank[12], the margin level of large firms is higher than that of medium-sized and small ones for the period from 2019 to 2023 (Graph 2). The main reasons for higher margins for large enterprises, first of all, include the effect of economies of scale. Firms can mnufacture products in large volumes, which allows them to reduce average costs per unit of output and thus increase margins. Second, large firms have access to a wider market and more customers and can have a monopoly in the market. At the same time, firms can more easily access capital and invest in innovation, marketing and business expansion, optimize production processes, which also increases margins.

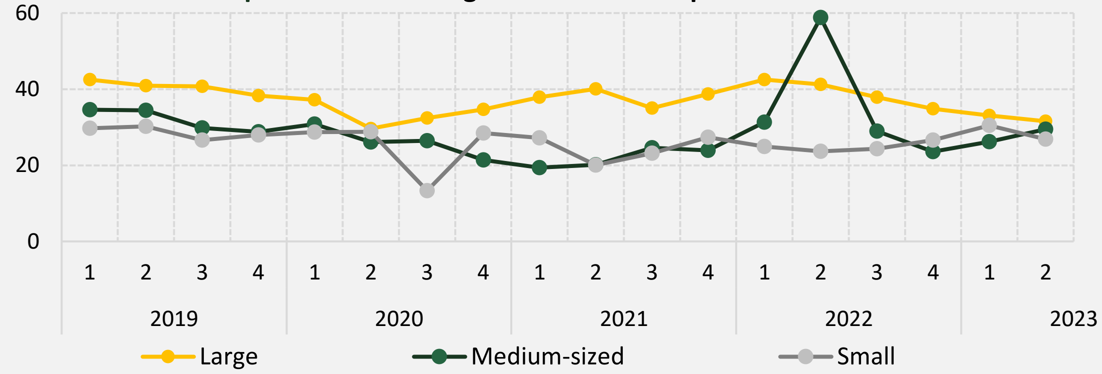
The dynamics of the margin show that its level decreased in 2020 during the COVID-19 pandemic, and, starting from the 2nd quarter of 2022, against the backdrop of geopolitical tensions in the world (Graph 3). On the contrary, margins in the manufacturing industry increased during the pandemic, while in agriculture and trade there was a visible decrease. One of the factors driving the margin growth in the manufacturing industry during the pandemic could be firms' expectations of higher cost increases in the future, which were built into the cost of manufactured products.

---

[11] Margin shows the level of markup on goods and is calculated as the difference between proceeds and variable costs.

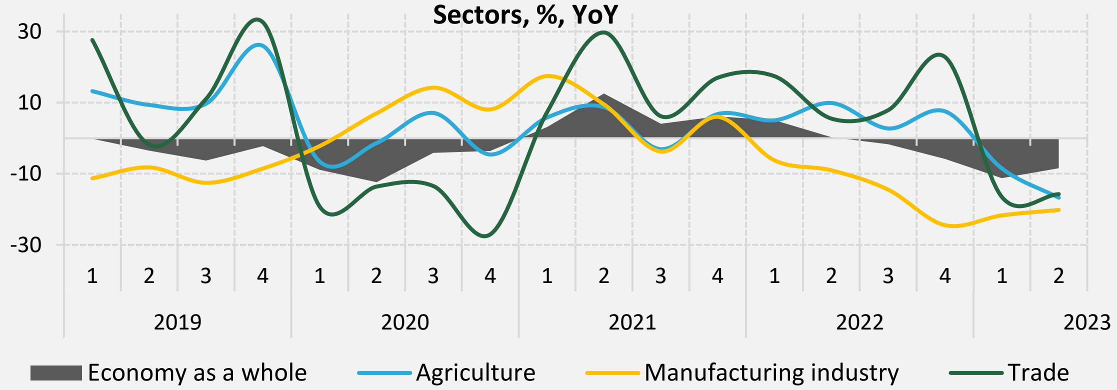
[12] *The survey of real sector enterprises is conducted quarterly. The representative sample consists of more than 3,000 enterprises from different regions of the country and of different sizes.*

Graph 2. **Level of Margin Based on Enterprise Size**



Source: BNS ASPR, NBK computations

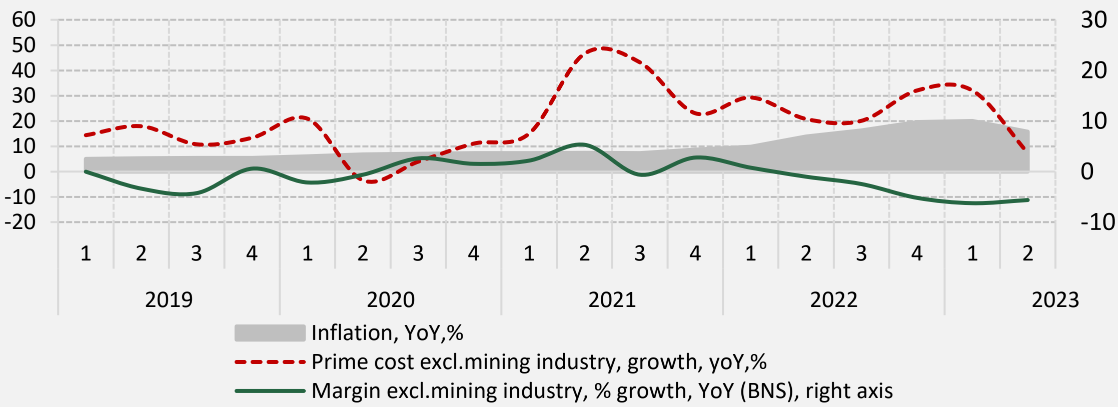
Graph 3. **Growth of the Margin Across the Economy and Individual Sectors, %, YoY**



Source: BNS ASPR, NBK computations.

A comparison of the dynamics of inflation, margin and cost enables to understand to what extent the increase in markups could contribute to the growth of inflation in the country (Graph 4). The year before the pandemic was characterized by relatively stable and moderate inflation and declining margins (excluding mining). The margin contraction occurred at the beginning of 2020 amid the most stringent measures related to the pandemic. A possible explanation for the reason is a decrease in demand from the population and the need for enterprises to reduce their prices in order to win the competition for consumers.

Graph 4. **Margin (Excl. the Mining Industry) and Inflation, , YoY**



Source: BNS ASPR, NBK computations.

However, when these restrictions were lifted in early 2021, inflation began to accelerate and rose significantly in 2022 during a geopolitical crisis in the world. At the same time, the increased margin given a recovery in demand and the low base of 2020 gradually slowed down its growth, and began to decline in the second half of 2022.

In 2021-2022, due to a significant increase in world food prices, import prices for a wide range of goods used in domestic production, and increased prices for logistics and transport services, the producer prime cost had increased significantly. However, the increase in margins during this period can be understood in the context of economic theory regarding firms' expectations and their pricing behavior. Firms increased their margins in anticipation of future increases in both their prices and their marginal costs. This behavior reflects their desire to smooth out price increases over time rather than sharply increase prices when higher prices and marginal costs are realized.

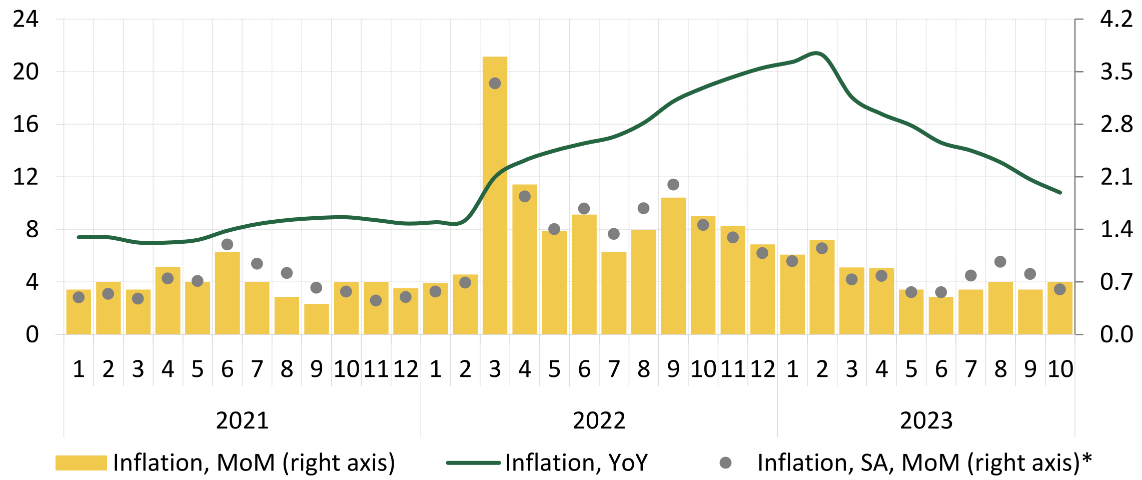
Thus, it is worth mentioning that production costs are an important factor in inflation. High inflation in 2021-2022 was fueled by high production costs. The dynamics of margin during this period, which after a gradual slowdown by mid-2022 began to decline, shows that from the third quarter enterprises do not pass on the increase in production costs entirely to consumers, but, on the contrary, offset greater price increases by reducing the level of their margins, owing, among other things, to the increased competition in the market. Thus, there is an increase in registered and operating enterprises with foreign participation by 66.3%, including from Russia – by 2.4 times, from China – 1.6 times, from Uzbekistan – by 1.9 times, and by 13.8% from Turkey (in September of this year compared to January 2022).

3.4. Inflation

Consumer inflation keeps declining; however, it is still above the target level of 5%.

In October 2023, annual inflation slowed to 10.8% (Graph 57). The slowdown in inflation occurs due to the expiry of the high base effect of 2022, lower world food prices, weakening global inflationary pressure, as well as the monetary policy pursued. Slower price growth was facilitated by lower production costs amid a slowdown in annual growth rates of producer prices in various industries and lower import prices for raw materials.

Graph 57. Dynamics of Inflation, %



Source: BNS ASPR, NBK computations

**Seasonal adjustment was performed by using X-12-ARIMA method from 2011 until present*

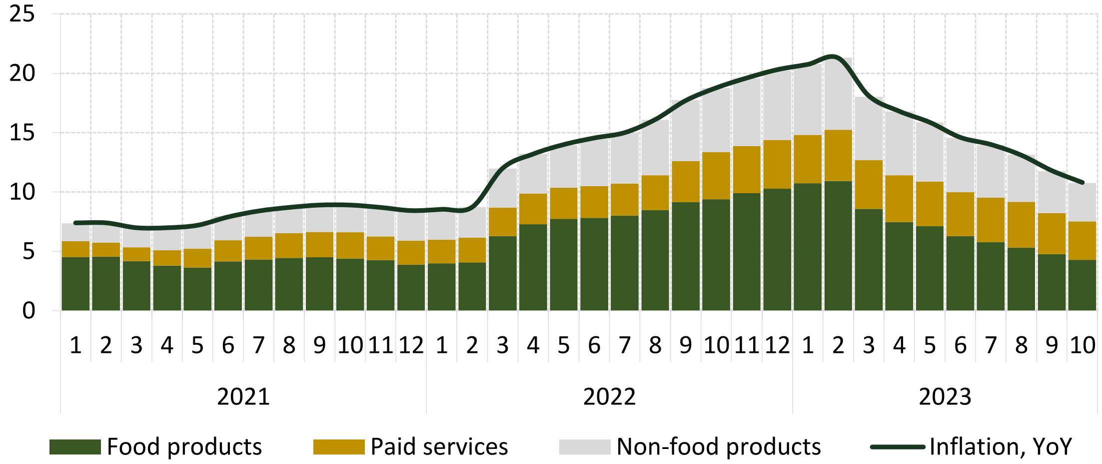
Monthly inflation in August-September of this year significantly exceeded the historical average. At the same time, in October 2023, monthly price growth slowed down, reaching the level of its average historical values (0.7%).

Indicators of seasonally adjusted inflation slowed in October of this year after an increase in July-September given a growth in tariffs for regulated utility services, as well as a smaller decline in prices for fruits and vegetables than typical for this period. A stronger slowdown in seasonally adjusted inflation in October was offset by a surge in prices for bread and bakery and cereals amid low grain harvests in the country this year.

The structure of inflation shows that the contribution of all main components decreased because of the slowdown in annual growth rates in prices for food, non-food products and paid services.

The main contribution to inflation continues to be the rise in prices of food products. However, its contribution is decreasing along with the increasing contribution of paid services for the population given a gradual increase in tariffs for regulated utility services and rising prices for certain types of market services (Graph 58).

Graph 58. Dynamics of Inflation and Contributions of its Key Components, %, PP



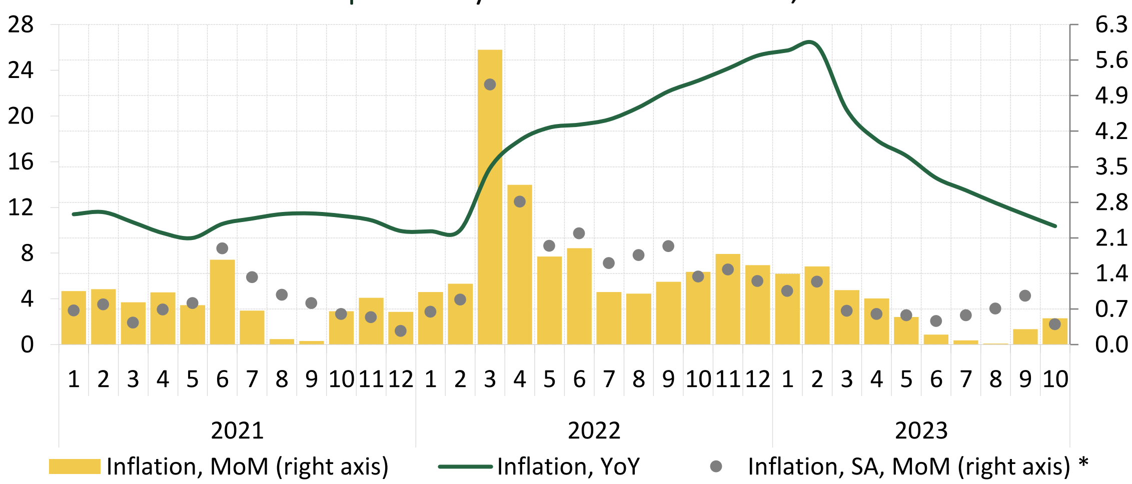
Source: BNS ASPR, NBK computations

The annual increase in prices for food products continued to slow down in August-October of the current year due to the withdrawal of high monthly inflation values of last year from the calculation and a decline in world food prices.

Despite the slowdown in annual food inflation, monthly food price increases continue to exceed the historical average for the period from 2017 to 2021.

After slowing down since March 2023, monthly food inflation accelerated in September-October of this year (Graph 59). Such price dynamics were formed due to acceleration in the monthly growth rates of food producer prices in the autumn months. The largest monthly increase in producer prices is observed in the production of flour and cereal products, which is associated with the low wheat harvest this year. Along with this, pro-inflationary pressure on food prices was exerted by the accelerated growth of import prices for food products in September by 5.8%, MoM, after a long decline since April of this year. At the same time, the presence of significant reserves of sunflower seeds, buckwheat and a new harvest of agricultural products was reflected in the continuing decline in prices for fruits and vegetables, cereals and sunflower oil.

Graph 59. Dynamics of Food Inflation, %



Source: BNS ASPR, NBK computations

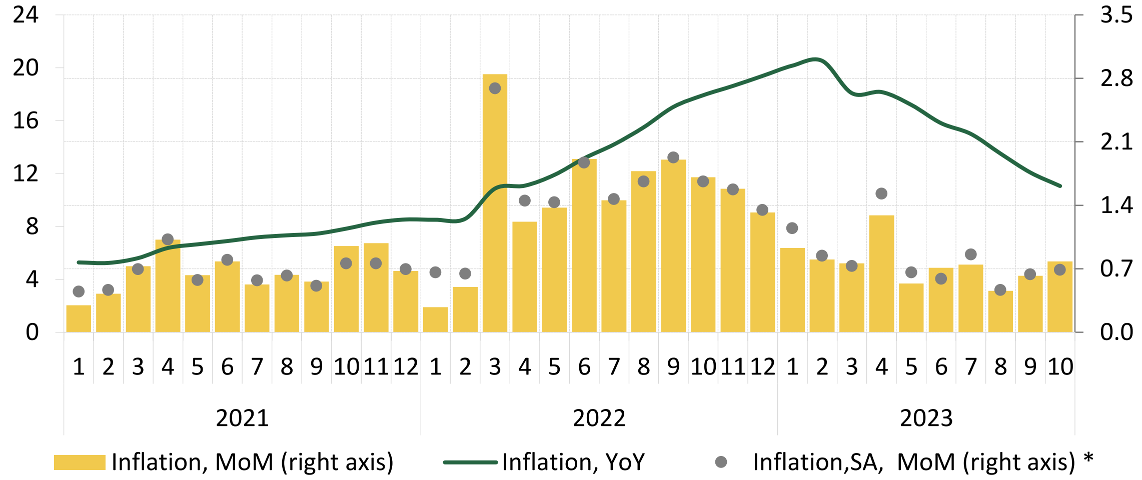
** Seasonal adjustment was performed by using X-12-ARIMA method from 2011 until present*

The contribution by fuel and lubricants within the structure of non-food inflation remains sustained.

The annual increase in prices for non-food products slowed to 11.1%. In the structure of non-food products, the overall contribution of all major product groups decreased. At the same time, the contribution of fuels and lubricants remains stable after its increase in April 2023 due to rising prices for fuels and lubricants as part of increasing marginal prices on the domestic energy market (Graph 60).

Monthly non-food inflation accelerates in the autumn months, but remains below historical averages in 2017-2021 (September – 0.7%, October – 0.9%, respectively). The beginning of the school year caused a rise in prices for information processing equipment. The onset of the autumn season has traditionally driven up the demand for clothing, footwear, and pharmaceutical products. In addition, the depreciation of the nominal exchange rate of the tenge in August-October of this year put upward pressure on the prices of imported non-food products.

Graph 60. Dynamics of Non-Food Inflation, %



Source: BNS ASPR, NBK computations

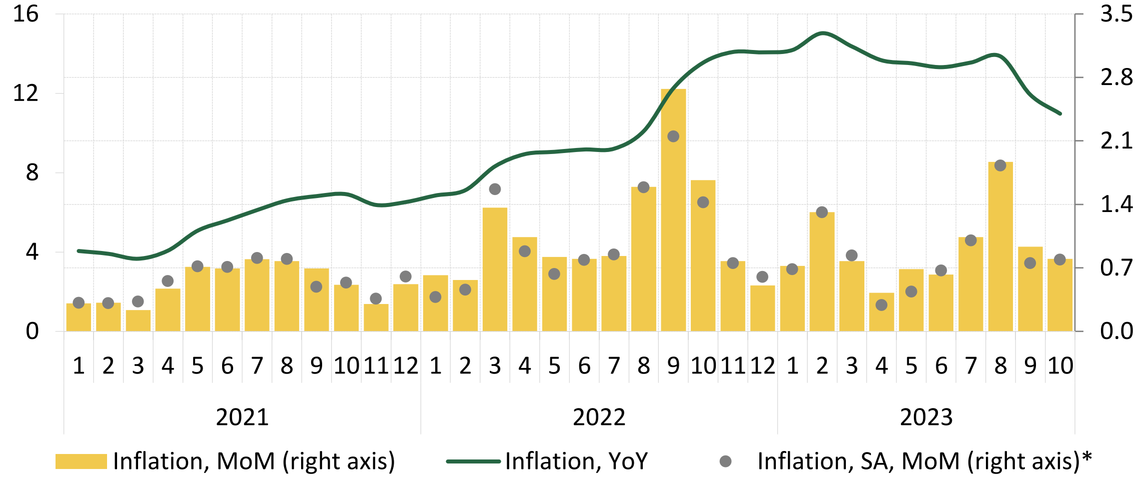
** Seasonal adjustment was performed by using X-12-ARIMA method from 2011 until present*

In August-October 2023, utility prices were steadily growing thus producing upward pressure on the service inflation.

The increase in prices for paid services for the population in October 2023 slowed to 11% in annual terms. Monthly price growth slowed from 1.9% in August to 0.8% in October (Graph 61). Within the structure of the service component of inflation, the price driver for paid services was the continuing increase in tariffs for regulated utilities given the implementation of the "Tariff in Exchange for Investment" program. The contribution of regulated utility services to inflation from January to October of this year amounted to 0.67 percentage points. Along with this, amid rising prices for fuel and lubricants, transport services have become more expensive. At the same time, due to the start of the school year, prices for education services have gone up.

It is worth mentioning that, unlike food and non-food products, the cost of unregulated paid services to the population has grown at a slower pace since the onset of the pandemic. The rise in prices for paid services during the pandemic was limited due to the lack of availability of most types of services. Starting from this summer, there has been a catch-up increase in prices for unregulated services relative to consumer goods.

Graph 61. Dynamics of Service Inflation, %



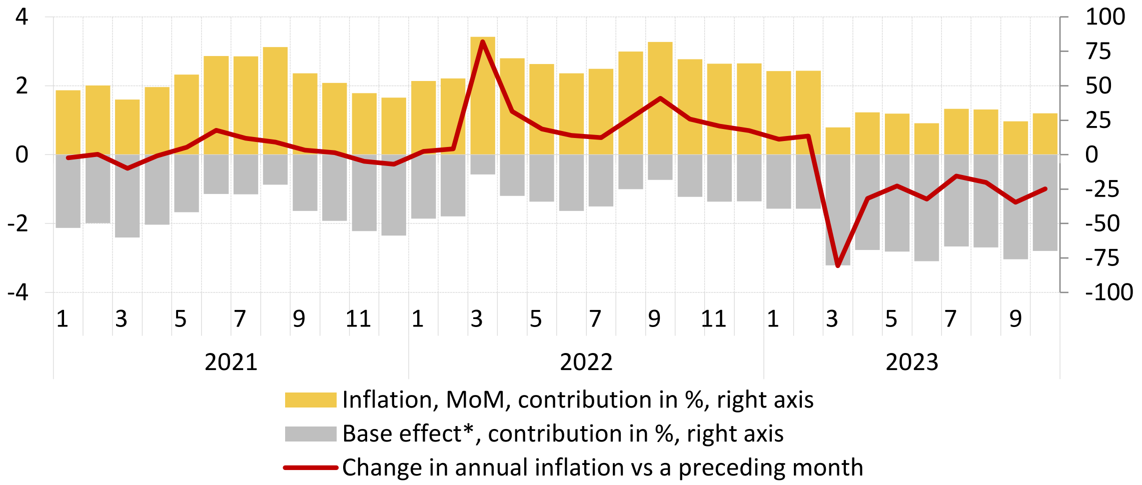
Source: BNS ASPR, NBK computations

** Seasonal adjustment was performed by using X-12-ARIMA method from 2011 until present*

The restrictive nature of the National Bank's monetary policy since the beginning of 2022 has made it possible to reduce current inflation, increasing the contribution of the last year's high base effect to deceleration of inflation.

Monetary policy measures aimed at tightening the monetary conditions since February last year have helped reduce inflation this year. Monthly inflation rates decreased significantly in 2023 compared to 2022 (Graph 62).

Graph 62. Contribution by the Base Effect to Inflation[13], %



Source: BNS ASPR, NBK computations

**Monthly inflation in the corresponding period of last year (when calculating annual inflation in the current month, monthly inflation for the current month is included and monthly inflation for the corresponding month of last year is excluded, i.e. there is the base effect).*

The withdrawal from the calculations of the high inflation base that formed last year, coupled with lower monthly inflation rate this year, led to deceleration in annual inflation. Thus, during March-May 2023, the contribution of the base effect to the slowdown in annual inflation averaged 2.3 pp (73% on average). Overall inflation in annual terms slowed from 21.3% in February to 15.9% in May 2023. The downward trend in inflationary pressure continued in the summer months, but in August of this year, monthly inflation accelerated to 0.8%, amid rising prices for services due to the implementation of the "Tariff in Exchange for Investment" program. In June-October of this year,

---

[13] Methodology based on the ECB Paper (2005) «Base effects and their impact on HICP inflation in early 2005», Monthly Bulletin January: 31-33

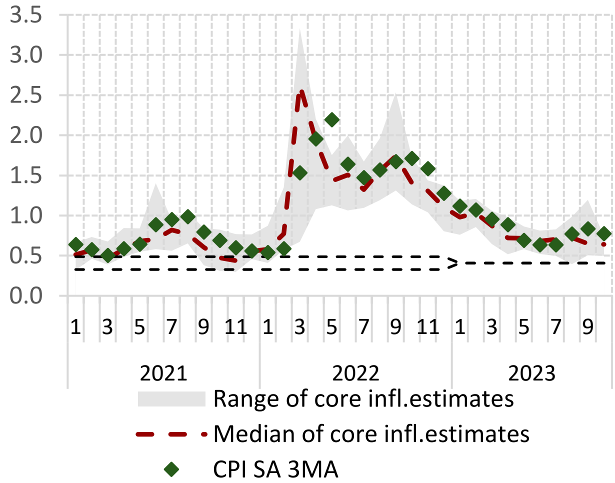
the contribution of the base effect to the slowdown in annual inflation averaged 1.5 pp (71.4% on average). Annual inflation slowed from 14.6% in June to 10.8% in October of this year.

Core inflation figures are still running above the target and reflect sustained price increases for a wide range of goods and services.

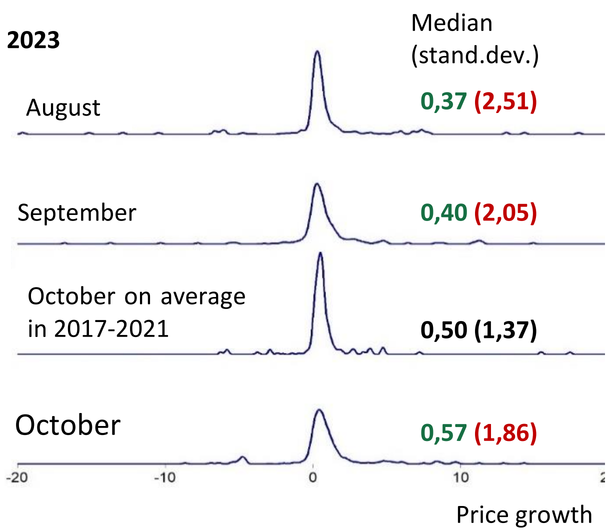
The median estimate of seasonally adjusted core inflation, after stabilizing at the same level since April of this year, slowed to 0.6%, characterizing a gradual deceleration in monthly price growth in the sustainable part of inflation (Graph 63). Along with this, the reduction in the variance (range) of estimates of seasonally adjusted core inflation from 0.4%-1% in August to 0.5%-0.7% in October of this year indicates a focus on stabilizing inflation processes.

The gradual stabilization of inflation processes in the country is evidenced by the October decrease in the standard deviation of the distribution of monthly price growth indicators for 508 goods and services included in the consumer basket (Graph 64). However, it exceeds the corresponding value for October in 2017-2021 just as the median.

Graph 63. Seasonally Adjusted Consumer Price Index and Core Inflation Estimates, %



Graph 64. Distribution of Price Growth for 508 Goods, Seasonally-Adjusted, MoM, %

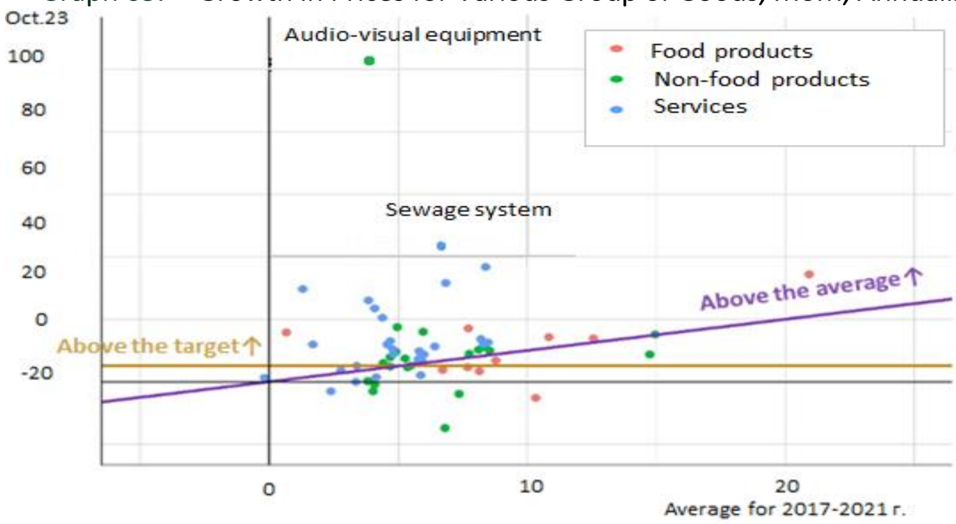


Source: BNS ASPR, NBK computations

Despite the slowdown in inflation processes, in October 2023 the growth of the main part of the CPI categories exceeds the inflation target. Prices of most goods are rising above their historical averages.

Seasonally adjusted annualized price growth for more than half of goods and services exceeds the inflation target and corresponding historical average growth between 2017 and 2021 (Graph 65). The weight of these categories of goods and services in the CPI is 55%. This indicates that prices for most of consumer goods and services are still rising at a high level. Among the goods and services that showed strong rates of growth are audiovisual equipment and wastewater disposal. At the same time, there are goods and services whose prices are rising below the historical average and target values or are declining. Similar trends are observed in the dynamics of prices for vegetables, oils and fats, higher education.

Graph 65. Growth in Prices for Various Group of Goods, MoM, Annualized, %

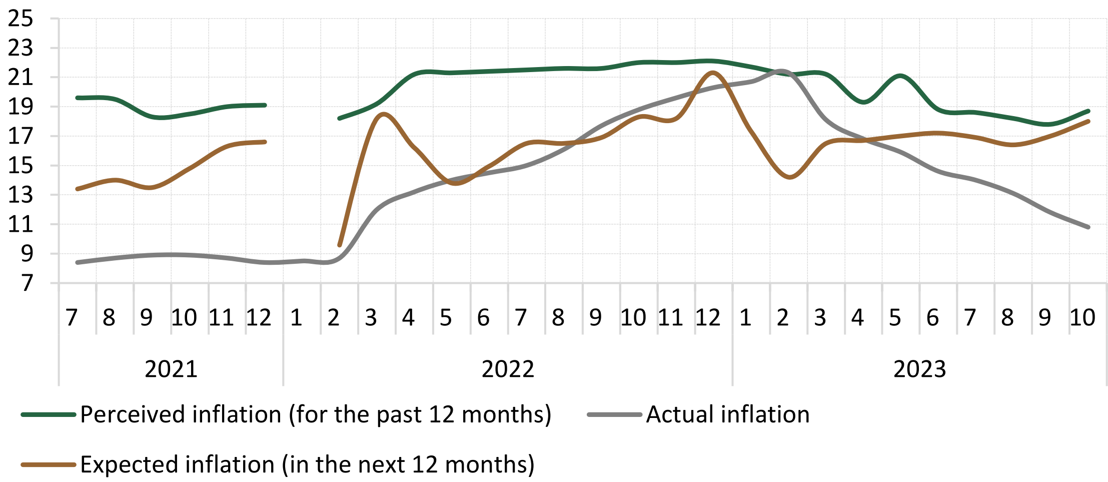


Source: BNS ASPR, NBK computations

Inflation expectations of the population remain heightened and sensitive to certain developments.

Despite the sequential slowdown in actual inflation, the median estimate of expected inflation over a one-year horizon increased from 16.4% in August to 18.0% in October 2023. At the same time, despite the slowdown from May to September 2023 (from 21.1% to 17.8%), the median estimate of perceived inflation increased in October, amounting to 18.7% (Graph 66).

Graph 66. Median Estimates of Expected and Perceived Inflation, YoY, %



Source: BNS ASPR RK, FusionLab: Public poll

The majority of respondents mention an increase in food prices, while they continued to grow from August to October 2023 (from 66% to 81%). Among the food products that, according to respondents, have become more expensive over the past month, dairy products, meat products, bread and bakery are worth mentioning. The low harvest figures for this year because of bad weather conditions affected the population's inflation expectations. Thus, in October 2023, the historically maximum number of respondents (46%) noted a faster increase in prices for bread and bakery over the past month.

Along with this, in October, as in July of this year, respondents again noted a faster increase in prices for housing utility services, which was due to another increase in tariffs for regulated services within the framework of the state program "Tariff in exchange for investments" (in October of this year, cold water supply, waste water disposal, and electricity supply have become more expensive).

The population also points to an increase in prices for unregulated services. In October of this year, the share of respondents who indicated a faster increase in prices for most market services (medical services, Internet and cellular communication services, catering and entertainment services, educational services) increased significantly compared to July. In addition, respondents also noted an increase in prices for pharmaceuticals and medications, household chemicals, clothing and shoes.

Price expectations among enterprises in the fourth quarter of 2023 continue to gradually slow down, but some sectors showed an increase.

According to the results of a survey of real sector enterprises conducted by the National Bank, in the third quarter of 2023, the growth rate of prices for products and services of enterprises in the economy decelerated; however, there is a noticeable increase in the growth rate of prices in water supply and agriculture. Manufacturing enterprises also noted a slight increase in price growth.

In the fourth quarter of 2023, enterprises in most sectors expect a further slowdown in price growth, while enterprises in the sector of housing utility services (water supply, electricity generation) and agriculture expect a minor acceleration.

For the vast majority of enterprises, the most important factors in setting prices for finished products are prices for raw materials (for 83.6% of enterprises), demand (82.7%) and labor costs (72.0%). According to enterprise estimates, the dynamics of average wages slowed down; other factors have remained virtually unchanged.

In the fourth quarter of 2023, enterprises expect a slowdown in the growth of prices for raw materials and imported products, as well as average wages; at the same time, enterprises expect a slight increase in demand for finished products.

3.5. Fiscal Policy

The fiscal policy continues to be stimulative, exerting a pro-inflationary effect in various sectors of the economy. This year there is an expansion of the state budget deficit.

The state budget deficit increased by 3.7 times over the 9 months of 2023 compared to the corresponding period of the last year, amounting to 2.2 trillion tenge, which was due to faster growth in expenditures compared to growth in revenues (Graph 67). Meantime, the non-oil deficit[14] increased by 20.3% and amounted to 6.6 trillion tenge. Given the increased deficit, borrowings increased by 72%, debt servicing went up by 48.6%, thus creating additional burden on the budget.

At the end of nine months of 2023, the state budget spending increased by 24% in annual terms, and there was an increase in all cost items (Graph 68). The main contribution to growth comes from the spending on education (the share in expenditures is 21.4%), social welfare (21.2%), debt servicing (8.8%) and utility services (5.9%). The growth of capital expenditures of the state budget amounted to 56% against investments in infrastructure projects at the local and national levels.

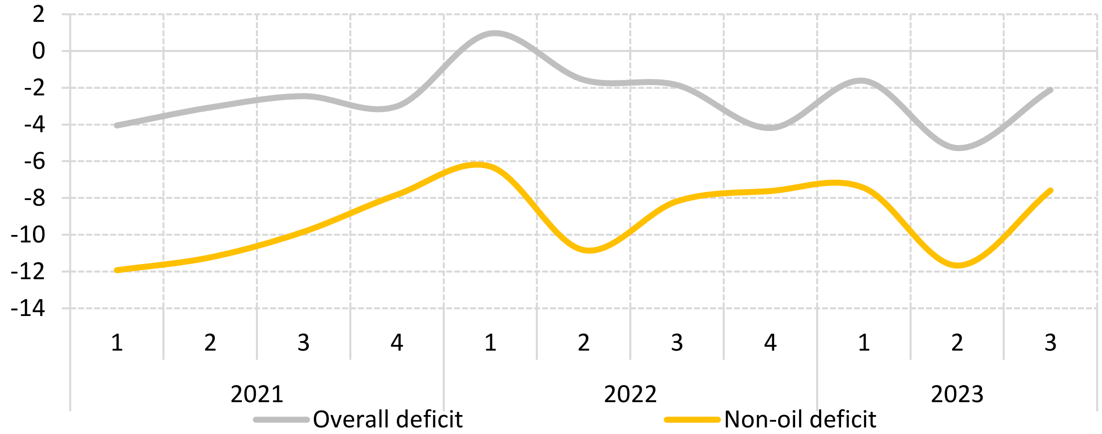
In addition, the costs associated with origination of budget loans are growing. Thus, the growth of lending funded by the budget amounted to 43.9% as a result of increased loans from the "National Welfare Fund "Samruk-Kazyna" JSC, from local budgets for microloans to the rural population and for investment projects in the agro-industrial complex.

Government revenues are growing at a more moderate pace than expenditures. Thus, the growth of state budget revenues during January-September 2023 amounted to 15.5%, which is driven by

[14] *Non-oil deficit is the budget deficit excluding transfers from the National Fund and export customs duties on crude oil*

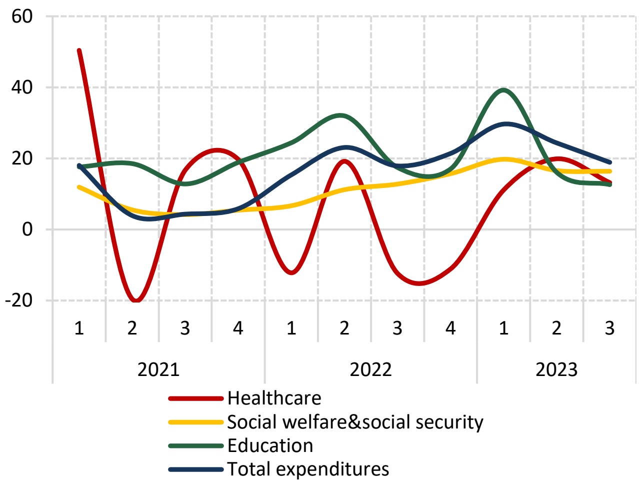
the growth of all types of basic tax revenues, primarily corporate income tax, personal income tax and value added tax (Graph 69).

Graph 67. State Budget Deficit, % of GDP

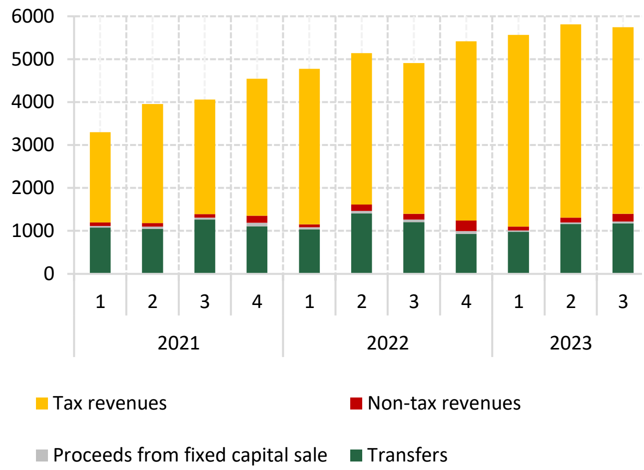


Source: MF RK, NBK computations

Graph 68. Expenditures on Key State Budget Items, YoY, %



Graph 69. State Budget Revenues, Bln Tenge



Source: MF RK, NBK computations

The increase in taxes was nurtured by the growing economic activity, a larger non-oil foreign and domestic trade turnover, as well as an expansion of the payroll fund. According to amendments to the Tax Code, the introduction of a new rate for the use of the radio frequency spectrum brought additional revenues in the amount exceeding 150 billion tenge. In addition, an increase in tax rates on the extraction of solid minerals (MET) and ramp-up in the production of certain metals replenished the budget by 101 billion tenge. In addition, the higher level of tax collection was also influenced by the development of digitalization, tax and customs administration.

Meanwhile, due to lower amounts of planned transfers compared to the corresponding period of the last year, revenues from the National Fund decreased. It is worth mentioning that oil revenues account for more than 30% of state budget revenues.Execution of the expenditure part of the state budget is proceeding according to the forecasts planned within the PSED framework as budgeted for 9 months of 2023. At the same time, the revenue inflow is below the planned level because of lower tax revenues (by 4.1%). A discrepancy with the planned values is observed among such items as corporate income tax from large business entities except the oil sector, value added tax on imported goods, mineral extraction tax except the oil sector and export customs duty on crude oil.

BASIC TERMS AND DEFINITIONS

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 as well as the basis to determine the purchasing capacity of currencies.

Consumer Price Index is the change over time in the average price level of a fixed basket of goods and services purchased by the population for personal consumption. The consumer basket in Kazakhstan for computation of inflation reflects the structure of household spending and includes goods and services, which have the largest relative share in consumption of the 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 preceding (base) period. The index is calculated by the Bureau of National Statistics of the Agency for Strategic Planning and Reforms of the Republic of Kazakhstan.

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.

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 national currency from the domestic money turnover, and acting as the means of saving, measure of value and the legal tender.

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 influence the domestic foreign exchange market in order to smooth out the volatility of the national currency exchange rate or to prevent its dramatic movements as well as to ensure the financial system stability.

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.

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 non-produced tangible assets; d) expenses in connection with the transfer of title for non-incurred costs.

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

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

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.

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

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 individuals in the national and foreign currency.

Output Gap is the 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.

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.

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 national currencies.

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 nongovernment non-financial organizations in the tenge at the National Bank.

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 accordance 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.

The base rate is a key monetary policy instrument of the National Bank that allows regulating nominal interbank interest rates in the money market. By establishing the base rate level, the National Bank determines a target value of key interbank money market short-term interest rate to achieve the goal of ensuring the price stability in the medium term.

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.

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. Transferrable deposits represent a part of the narrow money. Other deposits primarily include savings and term 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.

LIST OF KEY ABBREVIATIONS

bln – billion
BNS ASPR – Bureau of National Statistics of the Agency for Strategic Planning and Reforms
bp – basis point
CBRF – Central Bank of the Russian Federation
CPI – consumer price index
ECB – European Central Bank
EIA – Energy Information Administration
EM – emerging markets
EU – European Union
FAO – Food and Agriculture Organization of the United Nations
FGP/WPMP – Future Growth Project/ Wellhead Pressure Management Project
GDP – gross domestic product
GSs – government securities
IMF – International Monetary Fund
KASE – Kazakhstan Stock Exchange
KDIF – “Kazakhstan Deposit Insurance Fund” JSC
KSF – “Kazakhstan Sustainability Fund” JSC
MAEC – Mangistau Atomic Energy Complex
MED – Ministry of Economic Development of the Russian Federation
MF RK – Ministry of Finance of the Republic of Kazakhstan
mln – million
MNE – Ministry of National Economy of the Republic of Kazakhstan
MW – minimum wage
NBK – National Bank of the Republic of Kazakhstan
NFRK – National Fund of the Republic of Kazakhstan
OPEC – Organization of Petroleum Exporting Countries
pp – percentage point
PPE – property, plant and equipment
Rosstat – Federal State Statistics Service of the Russian Federation
SRC MF RK – State Revenue Committee of the Ministry of Finance of the Republic of Kazakhstan
TCO – Tengizchevroil
TEA – types of economic activities
thous. – thousand
trln – trillion
US Fed – US Federal Reserve System