

Republic of Kazakhstan
National Bank

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Inflation Report
4th Qtr 2004

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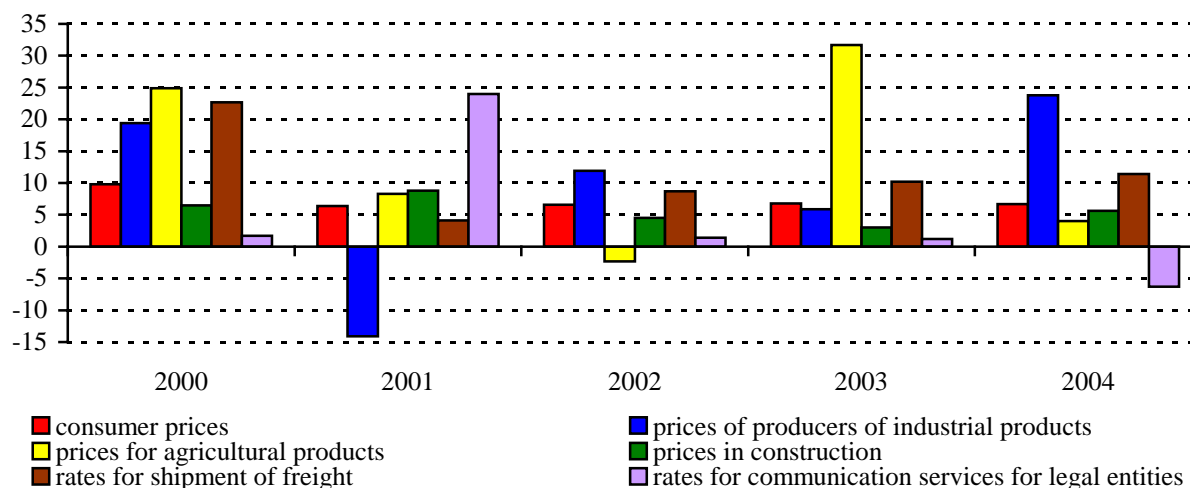
1. Inflation¹

On the whole, 2004 was characterized by retention of a significant inflation background in Kazakhstan's economy, and in individual sectors the price changes were the highest for the last several years. During this period (December 2004 compared to December 2003), consumer prices increased 6.7 percent (over the last four years, their growth was in the range of 6.4-6.8 percent). Price increases for producers of industrial products were at the highest level for the last five years and reached 23.8 percent. The increase in rates for freight shipments was 11.4 percent (highest level in last four years). Prices for agricultural products increased 4.0 percent; construction prices increased 5.6 percent. The only area in which prices decreased was in providing communication services to legal entities – 6.3 percent (Diagram 1).

Diagram 1

Dynamics of Price Indexes, %

(December of the corresponding year compared to December of the previous year)



Source: Statistical Agency of the Republic of Kazakhstan

In the 4th Qtr 2004, significant price movement was observed in the consumer goods sector, in industrial production (increases of 2.8 percent and 2.6 percent, respectively), and in communication services for legal entities (a decrease of 6.6 percent); in other sectors, price changes did not exceed 1.0 percent.

a. Consumer Prices

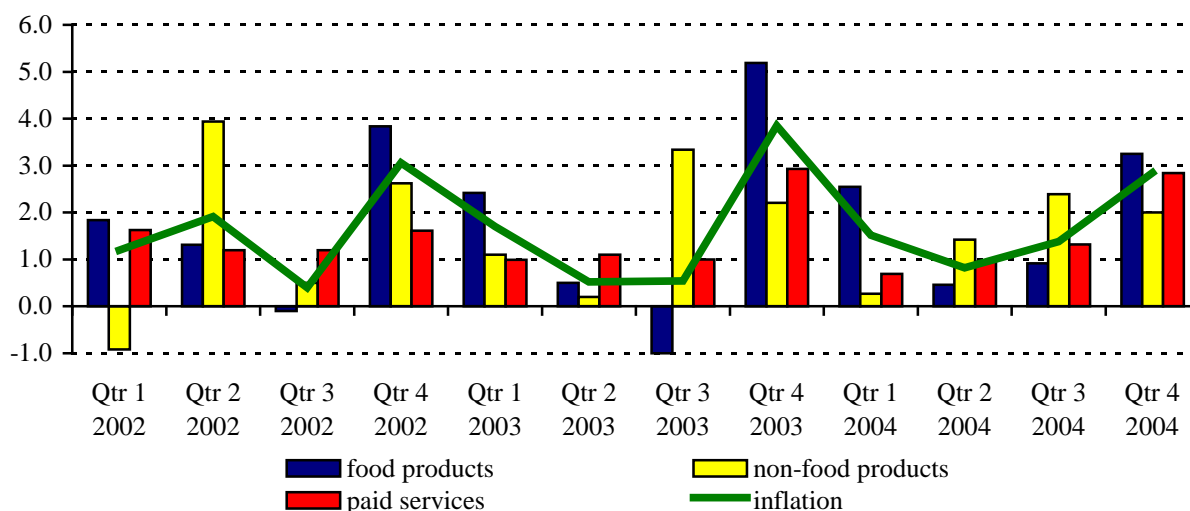
In the 4th Qtr 2004 (September to December 2004), consumer prices increased 2.8 percent, which fully corresponded to expectations. For the last six years, this level is one of the lowest for this quarter. Lower inflation was noted only in the 4th Qtr 2001 (2.6 percent).

In the inflation structure in October-December 2004, food products increased in price by 3.3 percent; non-food products by 2.0 percent; and paid services by 2.8 percent (Diagram 2).

¹ According to data of the Statistical Agency of the Republic of Kazakhstan.

Diagram 2

Dynamics of Inflation and Its Components (% of previous month)



Source: Statistical Agency of the Republic of Kazakhstan

In the structure of food products, prices increased the most for eggs (21.7 percent), milk and dairy products (14.7 percent), and fruits and vegetables (7.9 percent). The dynamics of higher price increases for these goods compared to other CPI components is typical for this period; a similar situation was also observed in previous years. It should be noted that prices for cereal products and rolled products in the 4th Qtr 2004 virtually did not change (increase of 0.3 percent), while in the 4th Qtr 2003 the 6.3 increase in prices for these outpaced the inflation dynamics during this period.

Despite a decrease in prices in December 2004, gasoline increased in price by 2.9 percent during the 4th Qtr 2004 as a whole. Clothing prices also increased considerably (2.2 percent) in October-December 2004.

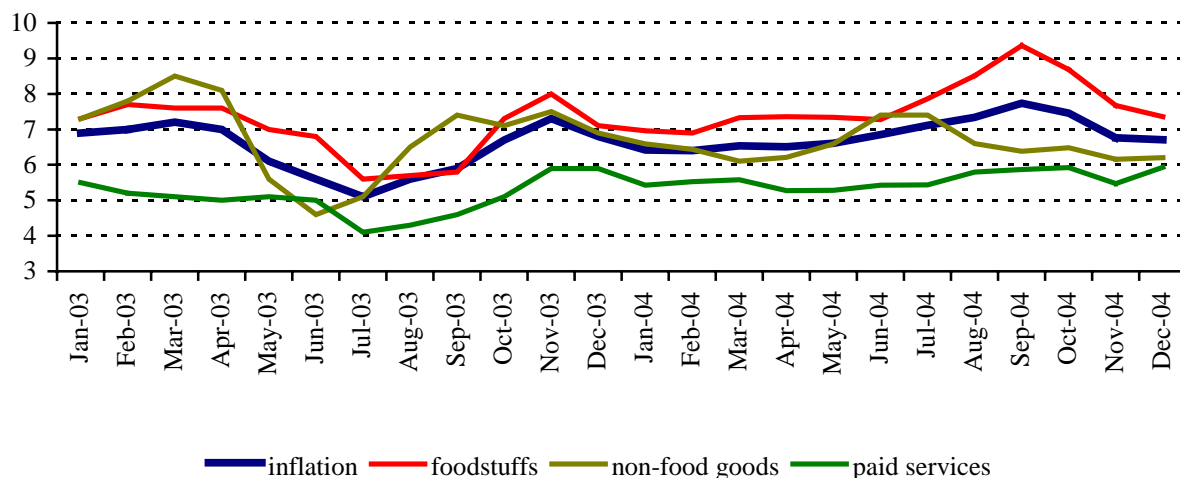
Primarily services regulated by the government determined the price dynamics among paid services: communication services (12.7 percent) and housing and utilities (1.6 percent) due to the increase in prices for gas (6.0 percent). Among services whose price formation is not regulated by the government, passenger transport prices increased considerably (5.9 percent).

For 2004 as a whole, inflation in annual terms (December 2004 to December 2003) was at the level of 6.7 percent, decreasing slightly compared to 2003 (6.8 percent). Food products became more expensive by 7.4 percent (by 7.1 percent in 2003), non-food products – by 6.2 percent (6.9 percent), and paid services – by 5.9 percent (5.9 percent) (see Diagram 3). Average annual inflation was 6.9 percent (6.4 percent in 2004).

Among the typical characteristics in inflation dynamics in 2004, one can single out two aspects. First, the increase in prices for all groups of consumer goods and services was virtually uniform without any clearly expressed “leaders,” as was the case in previous years. A significant increase in prices was observed only for individual commodity positions and also in individual regions. Second, there was no seasonal price decrease during the summer months.

Diagram 3

Inflation Dynamics and Its Components (% of corresponding month of previous year)



Source: Statistical Agency of the Republic of Kazakhstan

Price dynamics in the 4th Qtr and for 2004 as a whole formed under the influence of both inflation of costs (increase in spending for wages and resources) and inflation of demand (income growth). Despite this, it was at an acceptable level, although the influence on it by a number of factors (growth of real GDP, increase in money supply, high world prices for raw material resources) exceeded both the previous year's indicators and expectations. According to the results of 2004, forecasts for virtually all basic macroeconomic indicators were exceeded.

Whereas the initial forecast for growth of real GDP for 2004 was 7 percent, and the updated forecast was 9 percent, according to operational data the increase is actually estimated at 9.4 percent.

Economic growth is accompanied not only by an increase in the population's purchasing power but also by the rate of its growth exceeding the rate of growth of GDP, which is expressed in an increase in price levels. In 2004, wages and monetary incomes of the population in real terms increased 13.9 percent and 13.2 percent, respectively. Excluding the oil component from growth of GDP and wages, the excess is estimated to be even greater.

Prices in industrial production increased unexpectedly strongly in 2004 – by 23.8 percent, mainly as a result of an increase in world prices for oil and metals. In agriculture, prices increased 4.0 percent. Since it is mainly these sectors that produce the bulk of consumer goods, price increases here have a considerable influence on inflation dynamics.

The considerable expansion of the money supply had a significant effect on inflation in 2004. Growth of money aggregates was ensured by the high rate of growth of the domestic economy and the favorable foreign environment for an inflow of foreign capital into Kazakhstan. Base money in 2004 grew by 82.3 percent, money supply – by 68.2 percent, and cash in circulation – by 59.0 percent.

A factor of no small importance that affected consumer prices remains the “import” of inflation, which is manifested through two multidirectional avenues: through high world prices for oil and a slight increase in the cost of imported products.

Despite the fact that in the 4th Qtr 2004, compared to the previous quarter, the increase in world prices for oil slowed down (6.3 percent versus 17.2 percent), they continue to remain at a very high level. On the average for 2004, world oil prices increased 32.5 percent.¹ Expressed in an increase in domestic prices for gasoline and fuels and lubricants, they create a significant inflation potential for an increase in prices for other goods and services in the future.

Prices for prepared food products imported into Kazakhstan during 11 months of 2004 increased by 3.0 percent, and textile products decreased in price by 2.7 percent, which to a certain extent is holding back inflation.

As is known, since January 1, 2004, the goal of the National Bank has been to ensure price stability. In this regard, in implementing monetary policy, the National Bank is taking all the necessary measure to prevent excessive price increases regardless of what factors are influencing the inflation dynamics (monetary or non-monetary).

b. Base Inflation²

The seasonal increase in inflation in the 4th Qtr 2004, compared to the previous quarter, was accompanied by a simultaneous increase in base inflation, calculated by all methods (Table 1).

Table 1
Inflation and Base Inflation in 2004³
(% of previous period)

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	at end of year	average for year
Inflation	1.5	0.8	1.4	2.8	6.7	6.9
Base inflation						
1. not counting price increases for fruits and vegetables, oil, and coal	1.4	1.0	1.5	2.6	6.6	6.5
2. not counting price increases for fruits and vegetables, regulated services, and energy resources	1.6	1.1	1.8	2.4	7.1	7.1
3. not counting the five highest and five lowest price changes	1.6	1.0	1.1	2.3	6.2	5.9
4. trimmed mean	1.2	1.0	1.0	1.6	4.9	5.9
5. CPI median	0.7	0.7	0.6	1.0	3.0	4.1

Source: Statistical Agency of the Republic of Kazakhstan

¹ Prices for Brent crude oil. According to IMF data.

² Calculation of base inflation is calculated from 2004.

³ The National Bank uses as the main methods of calculating base inflation:

- the consumer price index, excluding fruits and vegetables, gasoline, and coal;
- the consumer price index, excluding the five highest and five lowest price changes.

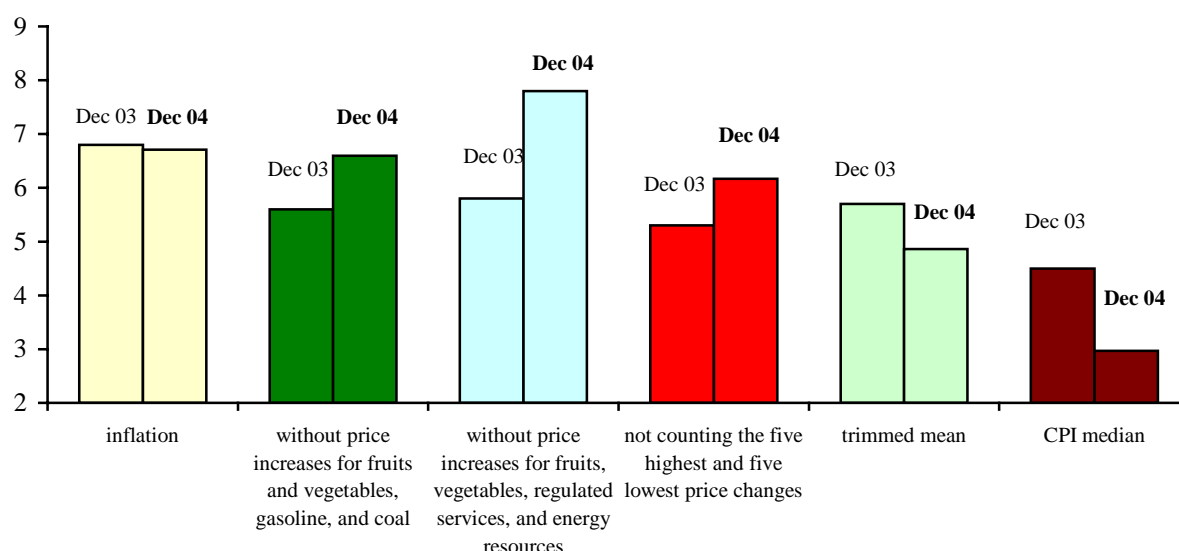
The increase in prices for eggs, dairy products, fish, meat, and also rates for passenger transport services had a considerable influence on the increase in base inflation in the 4th Qtr 2004 according to variants 1 and 2. The lower base inflation under variant 2, compared to variant 1, has to do with the fact that in variant 2, besides the above-listed components, the increase in rates for communication services (12.7 percent) is excluded from the calculation.

Base inflation under variant 3 in the 4th Qtr 2004 demonstrated a value close to variants 1 and 2, while base inflation under variants 4 and 5 was much lower.

More significant differences, both in values and in trends of the base inflation, are observed in the indicators for 2004 as a whole. Whereas inflation in 2004 virtually did not change compared to 2003 (6.7 percent and 6.8 percent), the base inflation indicators under variants 1, 2, and 3 increased, while they decreased under variants 4 and 5 (Diagram 4). In this regard, one cannot unequivocally assert that the direction of the inflationary process were toward an increase or a decreases.

Diagram 4

Inflation and Base Inflation (% in annual terms)



Source: Statistical Agency of the Republic of Kazakhstan

The increase in base inflation in annual terms, calculated under variants 1 and 2, is explained, above all, by the lower rate of price increases in 2004 compared to 2003 for those goods and services that are excluded in its calculation. In 2004, prices for fruits and vegetables increased by 5.9 percent (22.3 percent in 2003), for gasoline – by 14.1 percent (20.7 percent), for housing and utilities – by 3.0 percent (5.1 percent), and only the rates for communication services in 2004 increased more strongly – by 13.3 percent (1.3 percent in 2003).

It must be noted that the Statistical Agency does not provide the National Bank detailed information on goods and services that are excluded in calculations of base inflation under variants 3, 4, and 5, in connection with which it is quite difficult to analyze their dynamics.

c. Prices in the Real Sector of the Economy

Prices in Industrial Production

In the 4th Qtr 2004, prices for products and services of industrial enterprises increased 2.6 percent (7.9 percent in the 3rd Qtr). Products of intermediate consumption increase in price by 2.6 percent, consumer goods – by 1.8 percent, means of production and industrial services – by 0.6 percent.

In the structure of industrial production sectors, mining sectors accounted for the bulk of the price increases – by 4.4 percent; in the processing industry and in the production and distribution of electric power, gas, and water, prices increased by 0.8 percent and 0.6 percent, respectively.

The slowdown in the rate of price increases in the extraction of crude oil and natural gas in the 4th Qtr 2004, compared to the previous quarter (4.3 percent versus 17.3 percent) became of the possible reasons for the slowdown in the rate of price increases for gasoline in October-December 2004 (by 2.9 percent versus 17.2 percent in the 3rd Qtr).

However, price increases in oil and gas extraction in the 4th Qtr 2004 contributed to an increase in the costs in the sectors for its distribution, which in the final analysis led to an increase in prices for gas supply services in the structure of paid services to the population (by 6.0 percent).

Among sector of the processing industry, price increases in the production of food products in the 4th Qtr 2004 were 1.4 percent (0.6 percent in the 3rd Qtr), which had the effect of increasing pressure on price formation in the food market.

Prices in Agriculture

Agricultural products in the 4th Qtr 2004 became cheaper by 0.1 percent, while the prices for plant products decreasing by 7.0 percent and the prices for animal products increasing 9.5 percent.

The decrease in prices for plant products, primarily for grain crops (by 6.7 percent), was virtually not reflected in the level of prices on the food market. This is connected to the fact that the products of these sectors require additional processing, and this decrease should be reflected with a certain lag.

At the same time, the increase in prices for animal products (eggs, milk, cattle and poultry meat) manifested themselves virtually simultaneously in price increases for food products.

Monitoring Enterprises

Monitoring data of enterprises of the real sector of Kazakhstan's economy, which is done by the National Bank for all sectors of the economy, showed a decrease in the 4th Qtr 2004, compared to the previous period, in demand for the products of the enterprises surveyed. Thus, the percentage of enterprises, the demand for whose products decreased in the 4th Qtr 2004, was 15.4 percent (10.9 percent in the 3rd Qtr); 31.1 percent (36.1 percent) of

the enterprises reported an increase in demand; and 53.5 percent (53.1 percent) of the enterprises reported that product demand was unchanged.

As a result, there were virtually no significant changes in prices for finished products of the enterprises surveyed. Thus, 68.4 percent of the enterprises reported stability in their prices (68.2 percent in the 3rd Qtr); 25.6 percent (25.8 percent) had price increases; and only 6.0 percent of the enterprises (6.0 percent) had price decreases.

At the same time, 55.5 percent of the enterprises stated that in October-December 2004, the cost of raw materials and supplies increased (57.3 percent in July-September); costs did not change for 42.3 percent (40.2 percent) of the enterprises participating in the survey; and prices decreased for 2.2 percent (2.5 percent) of the enterprises.

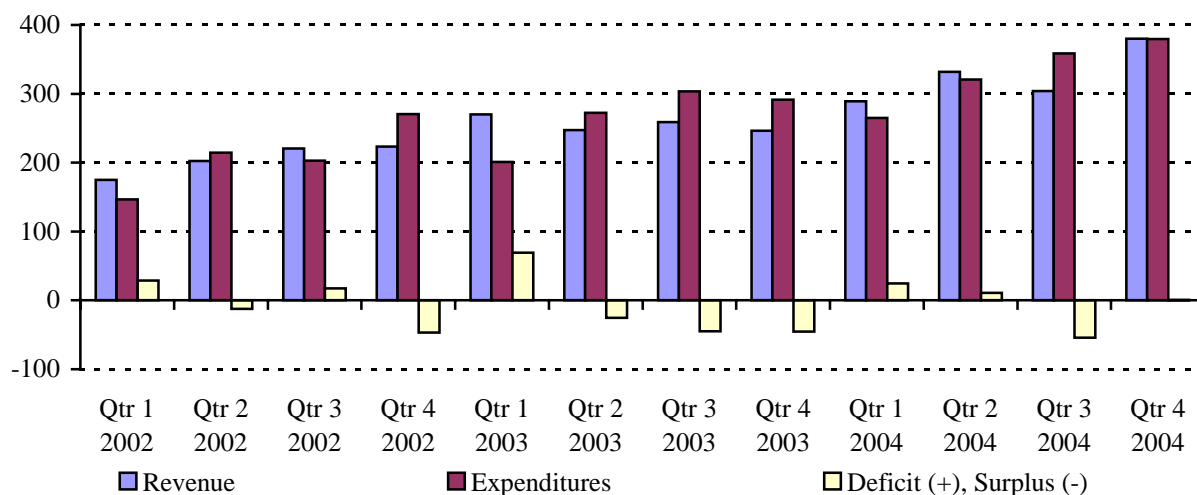
2. Fiscal Policy¹

The state budget in the 4th Qtr 2004, not counting the accounting period, had a surplus of T 0.5 billion, while in the 4th Qtr 2003 there was a deficit in the amount of T 45.3 billion. For 2004 as a whole, the state budget deficit was estimated at T 18.7 billion (T 46.2 billion in 2003).

State budget revenues for the 4th Qtr 2004 were T 380.0 billion, and expenditures were funded in the amount of T 379.5 billion. Compared to the indicators of the same period of the previous year, revenues increased 54.3 percent, and expenditures increased 30.1 percent (Diagram 5).

Diagram 5

Execution of the State Budget, billion tenge



Source: Ministry of Finance of the Republic of Kazakhstan

Tax revenues, primarily corporate income tax, VAT, social tax, and revenues for the use of natural resources, accounted for the bulk of the state budget revenues (92.6 percent) according to the results of the 4th Qtr 2004.

In the structure of state budget expenditures, current expenses in the 4th Qtr 2004 increased 26.9 percent compared to the same period of 2003. The acquisition of services (28.1 percent), current transfers to individuals (23.2 percent), and wages (21.1 percent) occupy the main share in their structure. Budget capital expenses increased 77.3 percent; credits, on the contrary, were reduced by 58.9 percent.

Financing of the possible state budget deficit in the 4th Qtr 2004 through internal sources was T 45.9 billion. Foreign financing developed as a negative value (-46.3 billion tenge) through higher amounts of repayment of foreign loans compared to the amounts of revenue from them. As a result, The Government's accounts in the National Bank at the end of 2004 had T 77.1 billion of available funds.

¹ According to data of the Ministry of Finance of the Republic of Kazakhstan.

Government domestic debt in the 4th Qtr 2004 declined by 9.4 percent and reached T 231.1 billion; foreign debt decreased by 9.9 percent to \$2.7 billion.

3. Implementing Monetary Policy

a. Money Supply

Money Base

In the 4th Qtr 2004, the money base expanded 43.0 percent to T 577.9 billion. A similar trend in the money base dynamics is typical of the same periods of previous years, but in 2004, the pace of its expansion was much higher than in 2002-2003 (13.3 percent and 7.6 percent, respectively). A considerable increase in net international reserves of the National Bank is the main reason for the increase in the money base during the period in question.

In order to prevent the negative influence of short-term and speculative fluctuations in the tenge exchange rate on inflationary processes, in the 4th Qtr 2004 the National Bank purchased foreign exchange on the domestic exchange market. In addition, during this period the foreign exchange revenues to accounts of the Ministry of Finance increased. As a result, the net exchange reserves increased 39.4 percent in October-December. Gold assets during this period increased 7.7 percent in connection with the National Bank conducting operations and an increase of 6.2 percent in gold prices on the world markets. Thus, by the end of 2004, the National Bank's net international reserves were \$9,277.0 million dollars, increasing 35.9 percent during the quarter (Table 2).

Table 2

Dynamics of Changes in the Money Base (% percent of previous year)

	Qtr 1 2004	Qtr 2 2004	Qtr 3 2004	Qtr 4 2004
Money Base	2.7	19.3	3.7	43.0
Net international reserves	10.4	14.6	1.5	31.3
Net domestic assets	-15.6	-12.1	2.2	-2.9
net claims against the Government	-48.8	-79.7	-5.6	47.0
claims against financial organizations	-36.0	-17.9	5.2	-24.4
claims against the rest of the economy	35.6	61.8	-9.7	18.1
other net domestic assets	21.7	41.2	3.3	-8.3

Source: National Bank of the Republic of Kazakhstan

Against the background of an increase in claims against the rest of the economy and the significant increase in net claims against the Government, caused by the traditional increase in government expenditures towards the end of the year, National Bank operations to sterilize surplus liquidity hindered the growth of its net domestic assets, thereby not permitting the money base to expand at a more significant pace.

Monetary Survey of Second-Tier Banks

In the 4th Qtr 2004, the total assets of second-tier banks increased 18.4 percent to T 1,315.0 billion. As in previous quarters, this increase was caused by the increase in domestic assets of second-tier banks, while their net foreign assets decreased (Table 3).

Table 3
Monetary Survey of Second-Tier Banks
 (% of previous year)

	Qtr 1 2004	Qtr 2 2004	Qtr 3 2004	Qtr 4 2004
Net foreign assets	-11.0	-25.1	-7.4	-17.3
Domestic assets	7.9	13.9	10.2	18.1
claims against the National Bank	22.9	14.7	-3.9	75.8
net claims against the Government	10.7	15.2	21.1	-21.5
claims against the economy	6.5	13.3	12.7	11.6
other net domestic assets	-14.0	-12.3	-15.4	-8.8
Liabilities	6.9	10.2	11.3	18.4

Source: National Bank of the Republic of Kazakhstan

In the structure of net foreign assets of second-tier banks, in the 4th Qtr 2004 there was an increase in claims against non-residents by 29.8 percent due to an increase in deposits placed abroad and credits to non-residents. Obligations to non-residents increased 23.3 percent in connection with an increase in non-residents' deposits in accounts of Kazakhstan's banks. However, the excess, in absolute value, of the increase in obligations to non-residents over the claims against non-residents resulted in a decrease in net foreign assets by 17.3 percent.

The increase in demands against the National Bank, as the result of a 2.7-fold increase in their transferable and other deposits in the National Bank, accounted for a considerable contribution to the absolute increase in the banks' domestic assets in the 4th Qtr 2004. In addition, the high pace of the banks' crediting the economy remained. In the 4th Qtr 2004, second-tier banks' claims against the sectors of the economy increased 11.6 percent.

As a result, despite a 21.5 percent decrease in net claims against the Government and an 8.8 percent decrease in other net domestic assets, the domestic assets of second-tier banks increased 18.1 percent.

Money Supply¹

During the 4th Qtr 2004, the increase in money supply by 24.6 percent to T 1,634.7 billion occurred against a background of an increase in both net foreign assets of deposit organizations and their domestic assets (Table 4).

The increase in net foreign assets of deposit organizations for the period in question was caused by the increase in gold exchange assets of the National Bank, since the net foreign assets of second-tier banks decreased.

The excess of amounts of repayment of issued securities of the Ministry of Finance over their placement in the 4th Qtr 2004 was caused a 20.5 percent decrease in claims on the part of deposit organizations against the Government. At the same time, obligations of deposit organizations to the Government decreased by 44.0 percent in connection with a decrease in

¹ Since January 1, 2004, the survey of broad money supply (M3), besides accounts of the National Bank and second-tier banks, has includes accounts of credit companies. Therefore, when conducting a factorial analysis of the changes in money supply, it will be a question of a monetary survey of deposit organizations, which include a consolidated survey of the National Bank, second-tier banks, and credit companies.

Government deposits. As a result, all this led to a significant increase in claims against the Government.

Table 4

Dynamics of Changes in the Money Supply in 2004
(% of previous period)

	Qtr 1 2004	Qtr 2 2004	Qtr 3 2004	Qtr 4 2004
Money supply	8.5	13.9	9.3	24.6
Net foreign assets	10.1	8.0	-2.8	42.7
Domestic assets	7.2	18.9	20.0	11.9
net claims against the government	-22.8	-93.8	780.2	127.8
claims against the economy	6.6	13.4	12.7	11.6
other net domestic assets	-3.5	-1.1	-8.0	-15.1

Source: National Bank of the Republic of Kazakhstan

The continuing increase in volumes of crediting of the non-financial sector of the economy remains an important factor in the increase in the money supply during the period in question. The increase in claims of deposit organizations against the economy during the 4th Qtr 2004, compared to the previous year, was 11.6 percent. As a result, the domestic assets of the banking system and credit companies during this period increased by 11.9 percent.

In the 4th Qtr 2004, the outpacing of the rate of growth of residents' deposits in the banking system and credit companies, compared to the rate of growth of cash in circulation, caused a decrease in the latter's share in the structure of the money supply from 23.8 percent to 23.2 percent (Table 5). The outpacing of the rate of expansion of the money supply, compared to the rate of growth of the money supply, resulted in a decrease in the value of the money multiplier from 3.26 to 2.83.

Table 5

Dynamics of Changes in Money Supply Components in 2004
(% of previous period)

	Qtr 1 2004	Qtr 2 2004	Qtr 3 2004	Qtr 4 2004
Money supply	8.5	13.9	9.3	24.6
cash in circulation	2.6	15.0	10.9	21.5
residents' deposits	10.4	13.5	8.8	25.5

Source: National Bank of the Republic of Kazakhstan

– **Cash in Circulation**

Cash in circulation in the 4th Qtr 2004 was T 379.3 billion, and its rate of increase compared to the previous quarter was 21.5 percent. Although the high rate of growth of cash in circulation is typical for this period of the year, in the current year it was somewhat higher than in 2002-2003 (14.4 percent and 9.4 percent, respectively).

The increase in cash in circulation in the period in question is basically explained by the seasonal increase in the population's income, including as a result of an increase in state budget expenditures for payment of wages. In fact, in the 4th Qtr 2004, compared to the

previous quarter, state expenditure for payment of wages increased 14.5 percent (in the 4th Qtr 2002-2004 it was 26.9 percent and 12.6 percent, respectively).

The population's low demand for cash dollars at the end of 2004 had a certain influence on the increase in cash in circulation. The net sale of dollars by exchange counters in the 4th Qtr 2004 compared to the previous quarter decreased 15.6 percent, which is not typical for this period of the year. By comparison, conversely, during the same period of 2002-2003, an increase of 41.4 percent and 51.9 percent in these net sales, respectively, was observed. In addition, in the 4th Qtr 2004, compared to the previous quarter, the net import of dollars by banks decreased 38.8 percent, while for the same periods of 2002-2003 there was an increase of 26.4 percent and 36.7 percent, respectively. That is, there is a decline in attractiveness to keep savings in dollars and a decrease in the dollar's purchasing power on the domestic market in conditions of a strengthening tenge. As a result, the population has begun to purchase less and sell more cash dollars, changing them for cash tenge.

The money turnover at cash departments of banks and AO Kazpochta confirms the impact of the increase in the monetary incomes and drop in demand for cash dollars on the increase in cash in circulation (Table 6).

Table 6

Balance of Payments and Receipts of Cash Through Bank Cash Departments

	Qtr 4 2003 billion tenge	Qtr 4 2004 billion tenge	Qtr 4, 2004 to Qtr 4, 2003 %
Goods, services, and work performed issued for payment sales proceeds	-41.9 178.2 220.1	-48.6 229.8 278.4	-16.0 29.0 26.5
Wages (counting money in ATMs)	192.7	244.3	26.8
Agricultural products*	50.9	25.9	-49.1
Foreign exchange operations	-126.2	-90.2	28.5
payment for purchase of exchange by banks to their own exchange counters	72.5	96.1	32.5
proceeds from the sale of exchange by bank exchange counters	198.7	186.4	-6.2
Deposits of individuals	-5.2	-21.5	-310.7
Pensions and benefits*	59.6	48.8	-18.2
Other items	-84.7	-68.6	19.0
Total balance of payments and receipts of cash	45.2	90.0	99.3

* payment of cash from bank cash departments

** counting pensions and benefits paid through Kazpochta broken down by EKNP codes

Source: National Bank of the Republic of Kazakhstan

In the 4th Qtr 2004, compared to the same period the previous year, the net payment of cash from bank cash departments and Kazpochta for wages, counting ATMs and current accounts of individuals, increased 26.8 percent, and the net payment for purchase of exchange by bank exchange counters increased 28.5 percent.

– Residents' Deposits

The progressive growth of deposits in the banking system and credit companies remained typical for of 2004. In the 4th Qtr 2004, residents' deposits increased 25.5 percent, reaching T 1,255.4 billion tenge (Table 7).

In the structure of residents' deposits, retention of the high share of residents' other deposits is assessed positively, being one of the main sources of crediting of the real sector. Thus, at the end of the 4th Qtr 2004, this share was 70.7 percent, and transferable deposits accounted for the remaining 29.3 percent.

Table 7

Dynamics of Changes in Residents' Deposits (% of previous period)

	Qtr 1 2004	Qtr 2 2004	Qtr 3 2004	Qtr 4 2004	Share, % ¹
Residents' deposits²	10.4	13.5	8.8	25.5	100.0
Transferable deposits in tenge of the population	14.2	16.2	9.5	18.2	23.8
of non-banking legal entities	-1.5	16.6	4.9	22.8	3.5
Other deposits in tenge of the population	17.5	16.1	10.3	17.5	20.2
of non-banking legal entities	13.6	8.9	13.9	38.3	33.3
Transferable deposits in foreign exchange	28.5	12.9	12.5	32.7	16.9
of the population	1.2	4.7	15.4	44.6	16.4
of non-banking legal entities	25.6	22.1	-0.7	-32.0	5.5
Other deposits in foreign exchange of the population	-4.6	23.9	-7.3	-2.1	1.1
of non-banking legal entities	33.1	21.8	0.5	-37.0	4.4
Other deposits in foreign exchange of the population	1.8	13.1	7.3	36.7	37.5
of non-banking legal entities	-5.5	3.8	-0.9	-9.6	13.6
	18.8	30.2	19.2	93.3	23.9

Source: National Bank of the Republic of Kazakhstan

Deposits of non-banking legal entities made the bulk of the contribution to the increase in residents' deposits in the period in question (about 84 percent). A slowdown in the rate of growth of deposits in foreign exchange is a typical characteristic of the structure of deposits of non-banking legal entities in the 4th Qtr 2004. This is possibly associated with the fact that enterprises are trying not to subject themselves to exchange risk in conditions of considerable variability of exchange rates for world currencies. The need for the existence of a specific number of exchange deposits is associated, in all likelihood, with the execution of future operations with non-residents or repayment of bank loans in foreign exchange.

¹ As of January 1, 2005.

² **Transferable deposits** - these are all deposits, which: 1) at any time can be turned into money at par without penalties and restrictions; 2) are freely transferred using checks, drafts, or endorsement orders; 3) are widely used for making payments. Transferable deposits are part of a narrow money supply. **Other deposits** include, basically, savings and time deposits, which may be withdrawn only upon expiration of a specific period of time, or have different restrictions, which make them less convenient to use in the usual commercial operations and, basically, meeting the requirements imposed on savings mechanisms. In addition, other deposits include other kinds of deposits expressed in foreign exchange.

In the 4th Qtr 2004, compared to the previous period, other deposits of the population in tenge increased 32.7 percent, while other deposits of the population in foreign exchange, conversely, decreased 9.6 percent. This attests to the fact that the population basically prefers to keep savings in the national currency than in foreign exchange.

b. Instruments and Operations of the Monetary Policy

In the 4th Qtr 2004, the trend of an increase in liquidity of second-tier banks continued, typical for all of 2004. The average daily balances in correspondent tenge accounts of second-tier banks in the National Bank in October-December increased 45.6 percent compared to the 3th Qtr 2004, and compared to the 4th Qtr 2003 they virtually doubled, increasing 95.0 percent.

Such a situation in the financial market predetermined an increase in influence measures of the National Bank, aimed at controlling inflation.

Standard of Minimum Reserve Requirements

The standard of minimum reserve requirements in the 4th Qtr 2004 did not change and was 6 percent of the banks obligations, the repayment term of which, partially or completely, falls within the current or next months.

The number of banks fulfilling the minimum reserve requirements by the first method,¹ as of the end of the 4th Qtr 2004 had increased from 33 to 34.

The high liquidity of second-tier banks ensured the availability of a considerable volume of surplus reserves. On the average for the 4th Qtr 2004, reserve assets exceeded by a factor of 3.3 the necessary volume of reserves (in the 3rd Qtr it was a factor of 2.4). One of the reasons for the increase in surplus reserves in the 4th Qtr was the increase in interest of second-tier banks on deposits in the National Bank, which are used in calculating reserve assets.

The volume of obligations of banks fulfilling the standard of minimum reserve requirements according to the second method² was an insignificant value (their share as of the end of December 2004 was about 0.04 percent of the deposit obligations of banks fulfilling the standard of minimum reserve requirements according to the first method) and, consequently, did not have any effect on liquidity of the banking system.

Issuance of Short-Term Notes

In the 4th Qtr 2004, placement of short-term notes of the National Bank was T 199.7 billion, which is one of the highest volumes of note issuance (it was more only in the 2nd Qtr 2004 when it was T 203.1 billion). Compared to the 3rd Qtr 2004, note placement increased two-fold.

Such a significant volume is explained not only by the high liquidity of banks, but also by the virtually complete lack of new issues of government securities of the Ministry of

¹ Placing the bank's money in reserve assets.

² Depositing the bank's money in the National Bank.

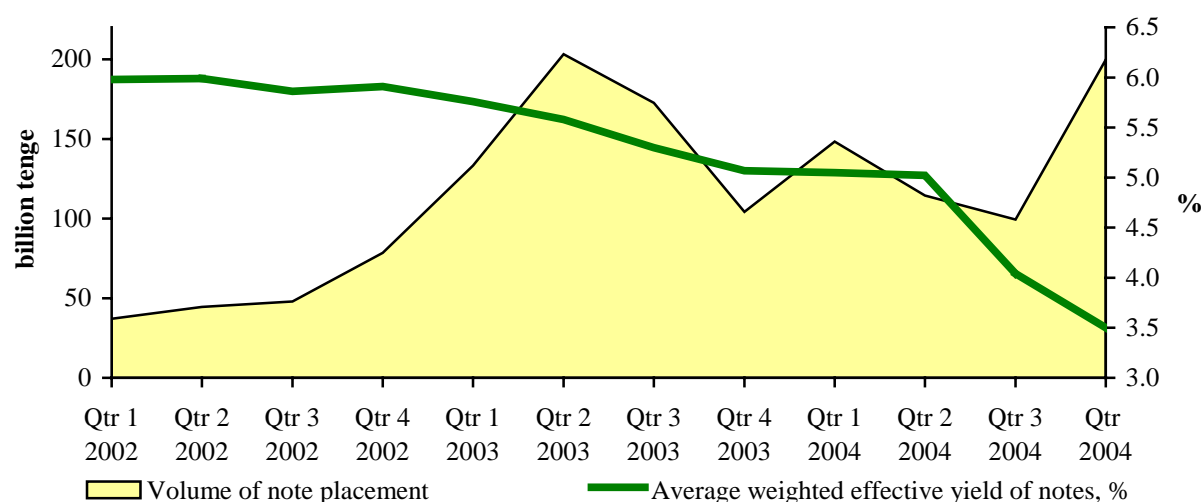
Finance. In the 4th Qtr 2004, only one auction was held for their placement in the amount of T 7.8 billion, which is 7.4 times less than the volume of the previous quarter.

The increase in the volume of short-term note placement was accompanied by a decrease in their effective yield. The average weighted effective yield of short-term notes, according to the results of the 4th Qtr 2004, was at 3.5 percent, while in the 3rd Qtr it was 4.04 percent (Diagram 6).

It must be noted that the policy of increasing the terms of circulation of short-term notes, which was pursued in 2003, was replaced by a policy of reducing them in 2004. This is associated, first of all, with the goal of reducing the attractiveness of notes as an instrument for investing pension assets and, secondly, with the fact that the National Bank intends to shift the emphasis when issuing short-term notes to regulating short-term interest in the financial market instead of regulating the liquidity of second-tier banks. Regulating the cost of loan resources is a more effective lever for influencing inflation than regulating liquidity.

Diagram 6

Placement of Short-term Notes of the National Bank and the Average Weighted Yield on Them (during the period)

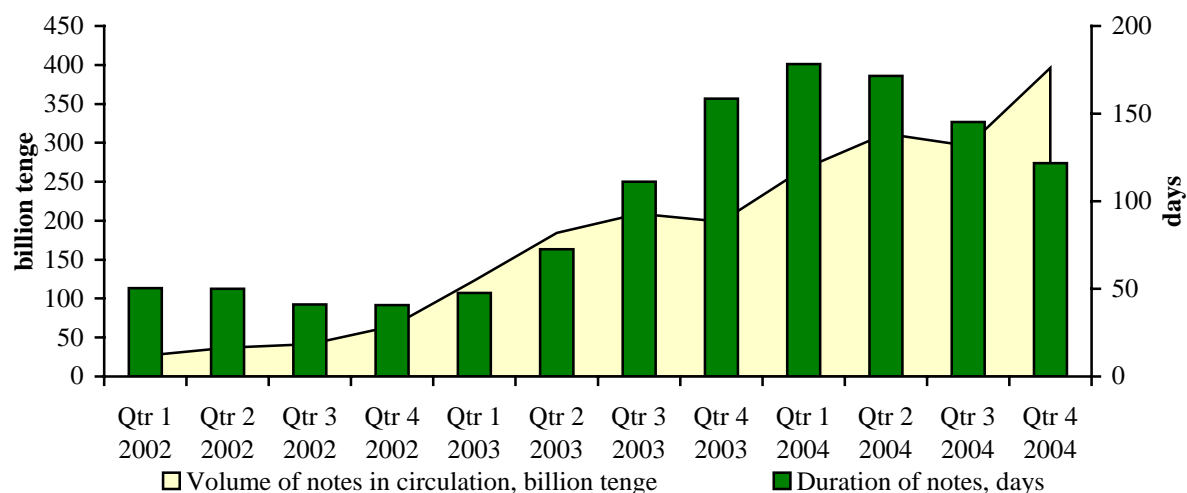


Source: National Bank of the Republic of Kazakhstan

As a result, the average term of issued notes in the 4th Qtr 2004 was 178.00 days versus 249.62 days in the 3rd Qtr 2004.

For the 4th Qtr 2004 as a whole, the volume of short-term notes in circulation increased 33.8 percent and at the end of December 2004 was T 396.1 billion. The duration of short-term notes in circulation had decreased to 121.66 days by the end of December 2004 from 145.17 days at the end September 2004 (Diagram 7).

Diagram 7
Short-term Notes in Circulation
 (at end of period)



Source: National Bank of the Republic of Kazakhstan

Repo and Reverse Repo Operations

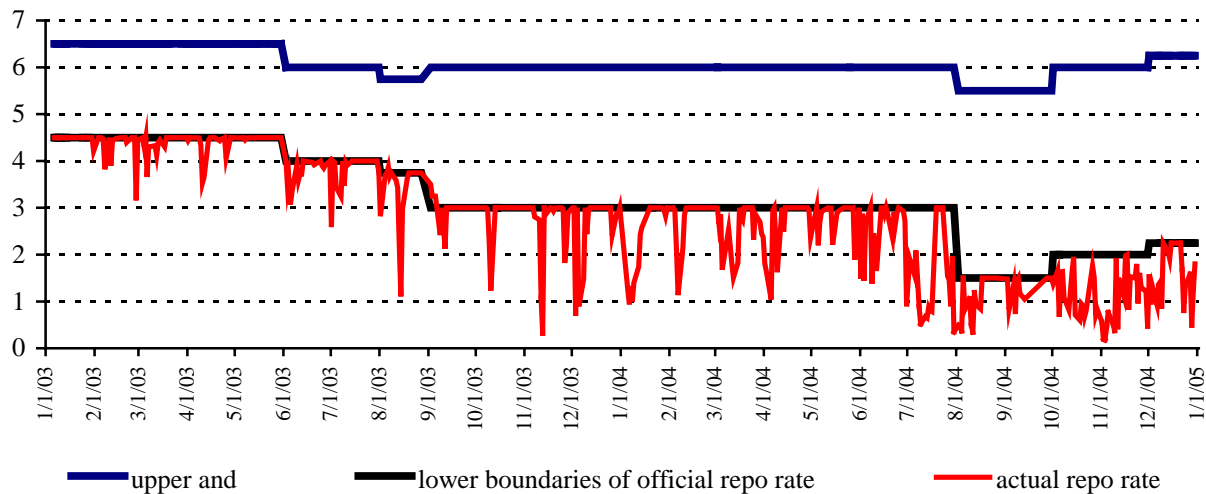
The official repo rate of the National Bank in the 4th Qtr 2004 increased twice: from 3.5 percent to 4.0 percent in October and to 4.25 percent in December; the width of the band of permissible fluctuations remained at +/-200 basis points.

In October-December 2004, the volume of repo operations conducted by the National Bank was T 230.5 billion, which was 45.0 percent more than the volume of the 3rd Qtr 2004. The average weighted rate for these operations increased slightly from 1.20 percent in the 3rd Qtr 2004 to 1.24 percent in the 4th Qtr 2004. All operations were conducted with an “overnight” term, that is, with repayment on the next business day.

In December 2004, the National Bank increased its own portfolio of government securities by 15 percent. Despite this, the portfolio volume remains insignificant for effective regulation of short-term market rates. The National Bank continues to play a minor role in the inter-bank repo market, holding less than 30 percent of the volume of this market’s operations. As a result, the National Bank is unable to hold the average weighted rate for repo operations within the official repo rate band (Diagram 8).

In order to make up for the liquidity in the market in the 4th Qtr 2004, for the first time since September 2003, the National Bank conducted reverse repo operations. The volume of these operations was T 26.0 billion with a yield of 4.95 percent.

Diagram 8

Dynamics of Average Weighted Repo Rates for National Bank Operations, %

Source: National Bank of the Republic of Kazakhstan

Deposit Operations

In the 4th Qtr 2004, the National Bank attracted deposits in tenge from second-tier banks in the amount of T 437.6 billion, which is 4.5-fold more than in the 3rd Qtr 2004. Despite the fact that the terms of the deposits attracted by the National Bank may reach 1 year, their actual terms do not exceed 1 month. The urgency of the deposits attracted in the 4th Qtr 2004 was one week, two weeks, and one month.

The significant increase in the volume of deposits attracted by the National Bank from second-tier banks is explained by several reasons. First, a considerable volume of “free” short-term liquidity is concentrated in the banks, which in conditions of a shortage of financial instruments is restricted in investment directions. Second, the yield on deposits attracted by the National Bank increased from 2.14 percent in the 3rd Qtr to 2.27 percent in the 4th Qtr 2004 and exceeded the yield on 30-day deposits placed in the inter-bank market, which decreased from 2.38 percent in the 3rd Qtr to 1.87 percent in the 4th Qtr 2004. Third, the volume of deposits that the National Bank may attract is virtually unlimited, unlike other monetary policy operations (the volume of repo operations is limited by the National Bank’s portfolio; the volume of emission of short-term notes is limited by the cut-off price and also by the degree of satisfying non-competitive tenders).

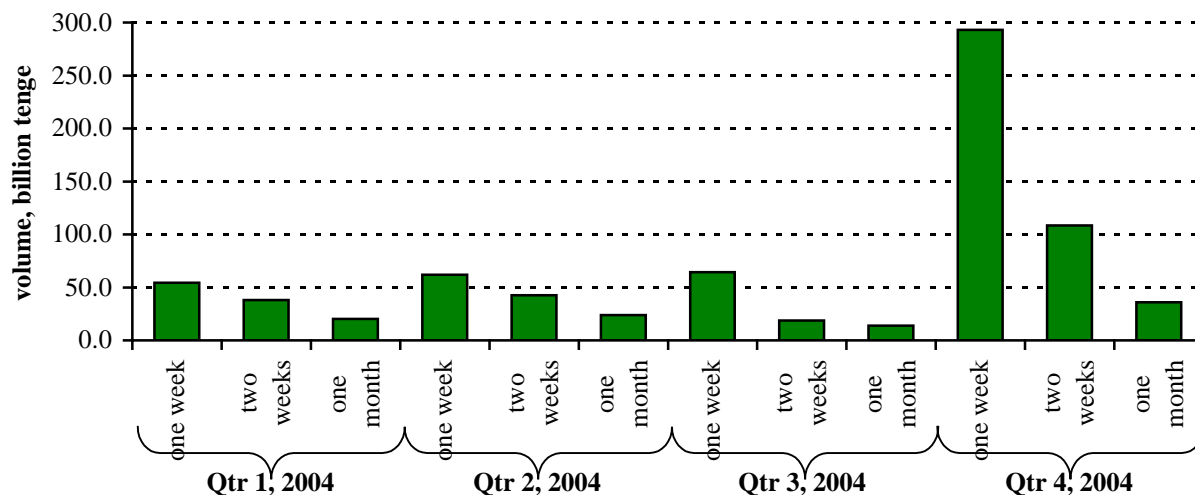
One-week deposits remain the most popular, which accounted for two-thirds of the total volume of attracted deposits in the 4th Qtr 2004 (as well as in the 3rd Qtr). Monthly deposits remain the least used. Despite the fact that in the 4th Qtr 2004 the volume of these deposits, in terms of par value, increased 2.6-fold, their share in the structure of deposits attracted by the National Bank decreased from 14.2 percent in the 3rd Qtr to 8.2 percent in the 4th Qtr 2004 (Diagram 9).

The increase in yield for attracted deposits in the 4th Qtr 2004 was associated with its increase for one- and two-week deposits in conditions of a consistent increase in the official repo rate. Thus, the yield increased from 1.86 percent in the 3rd Qtr to 2.15 percent in the 4th Qtr for one-week deposits, and from 2.04 percent to 2.27 percent for two-week deposits. The

yield for one-month deposits, conversely, decreased slightly from 2.47 percent in the 3rd Qtr to 2.46 percent in the 4th Qtr.

Diagram 9

Volume of Deposits Placed in the National Bank: Volumes and Time Periods



Source: National Bank of the Republic of Kazakhstan

Granting Loans

In December 2004, the National Bank's official rate on "overnight" loans was increased from 8.0 percent to 8.5 percent. For the 4th Qtr 2004 as a whole, the volume of "overnight" loans granted was T 1.0 billion.

Other types of loans, such as day loans, special-purpose loans, and also loans granted as a lender of last resort, were not granted by the National Bank in the 4th Qtr 2004 to second-tier banks.

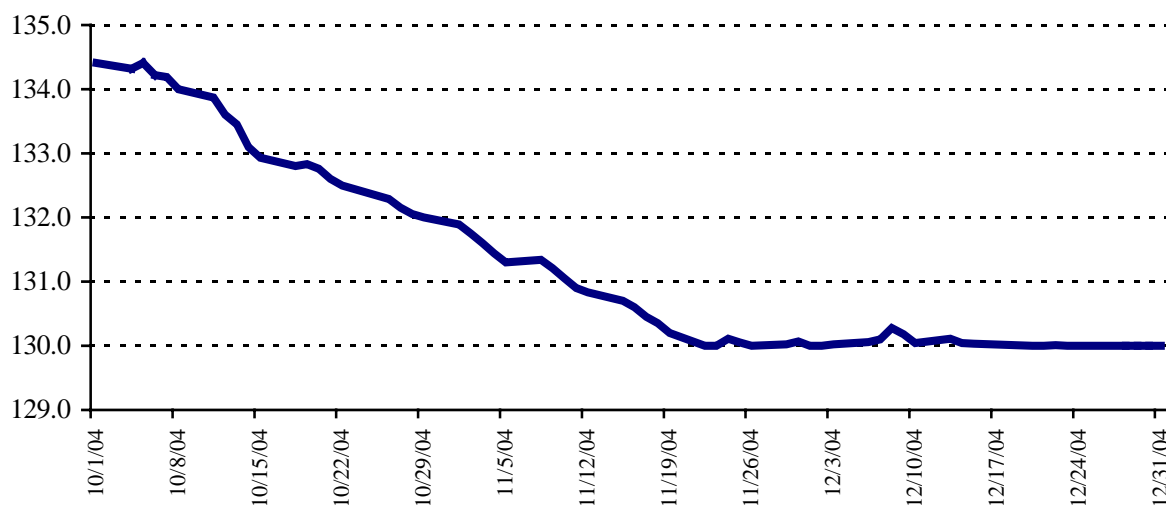
Exchange Rate

In the 4th Qtr 2004, as in previous quarters of 2004, the situation in the domestic exchange market continued to take shape under the pressure of revenues of large volumes of export earnings, strengthening of the euro's positions in the international markets, and also attraction of a significant volume of borrowed foreign capital by Kazakhstan's banking and corporate sectors.

For the quarter as a whole, the tenge market exchange rate decreased by 3.20 percent relative to the US dollar to T 130.00:US\$1 (9.30 percent since the beginning of the year). The average weighted tenge exchange rate during the 4th Qtr 2004 was T 131.24:US\$1. Throughout the quarter, the tenge:US dollar exchange rate varied in the range of T 130.00-134.41:US\$1 (Diagram 10).

The trend of strengthening the tenge with respect to the U.S. dollar ended at the end of November when the average weighted exchange rate for the tenge reached T 130:US\$1. During the period from November 22 to December 31, the exchange rate on the domestic foreign exchange market fluctuated in a narrow range of T130.00-130.28:US\$1.

Diagram 10

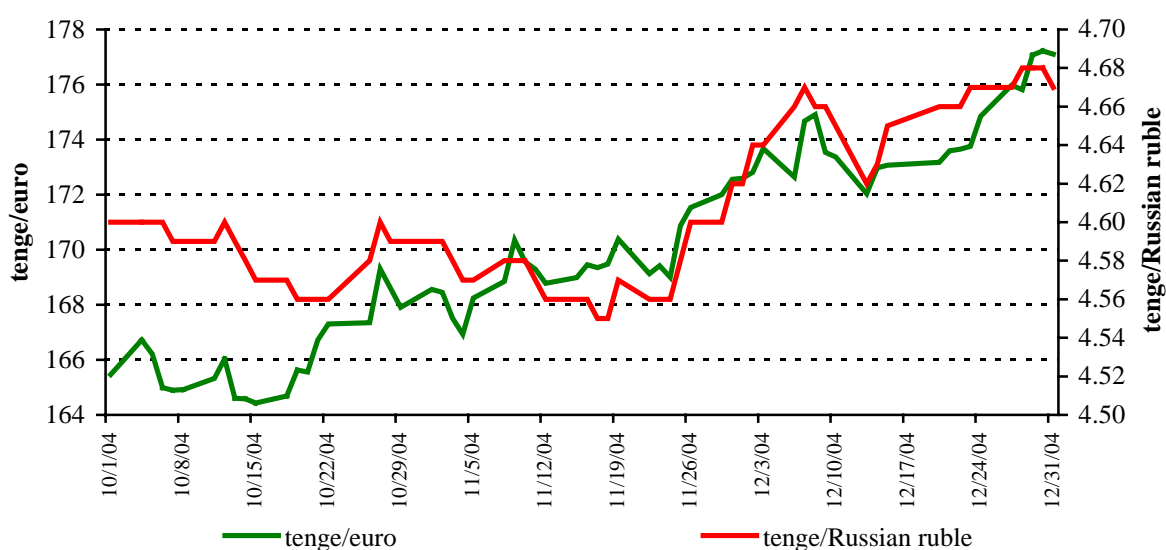
Dynamics of the Nominal Tenge:US Dollar Exchange Rate

Source: National Bank of the Republic of Kazakhstan

The situation of a unified European currency on the international financial market as well as stabilization of the tenge:US dollar exchange rate affected the dynamics of the tenge exchange rate relative to the European currency on the Kazakhstan market. During the 4th Qtr 2004, the official tenge:euro exchange rate was devalued by 6.85 percent and by the end of the period was T 177.10:1 euro (Diagram 2).

The dynamics of the Russian ruble:tenge exchange rate was determined primarily by the Russian Central Bank's policy regarding the Russian ruble:US dollar exchange rate. Thus, during the 4th Qtr 2004, the official tenge:Russian ruble exchange rate was devalued by 1.30 percent (Diagram 11).

Diagram 11

Dynamics of Official Exchange Rate of Tenge to the Euro and Russian Ruble

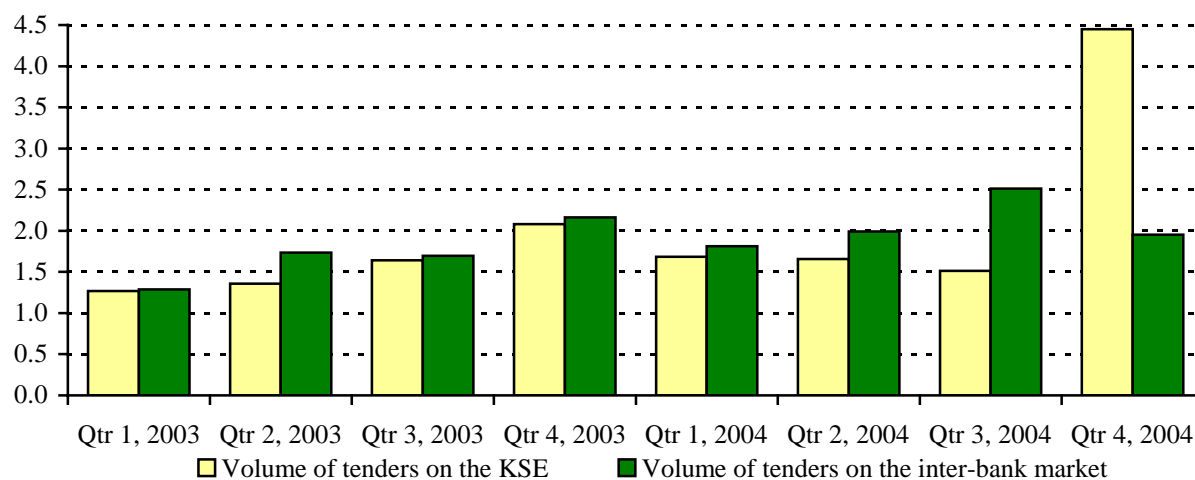
Source: National Bank of the Republic of Kazakhstan

In the 4th Qtr 2004, we saw a significant increase in the volume of tenders on the exchange segment of the Kazakhstan Stock Exchange. During this period, the volume of exchange tenders in the dollar position was more than US\$4.45 billion, which is more than twice the indicator of the same period in 2003.

In the over-the-counter foreign exchange market, the volume of operations during the 4th Qtr 2004 decreased by 9.7 percent compared to the same indicator the previous year and was US\$1.95 billion. The least amount of operations was seen in October, and the most in December (Diagram 12).

Diagram 12

Volume of Tenders on the Domestic Foreign Exchange Market, million US dollars



Source: National Bank of the Republic of Kazakhstan

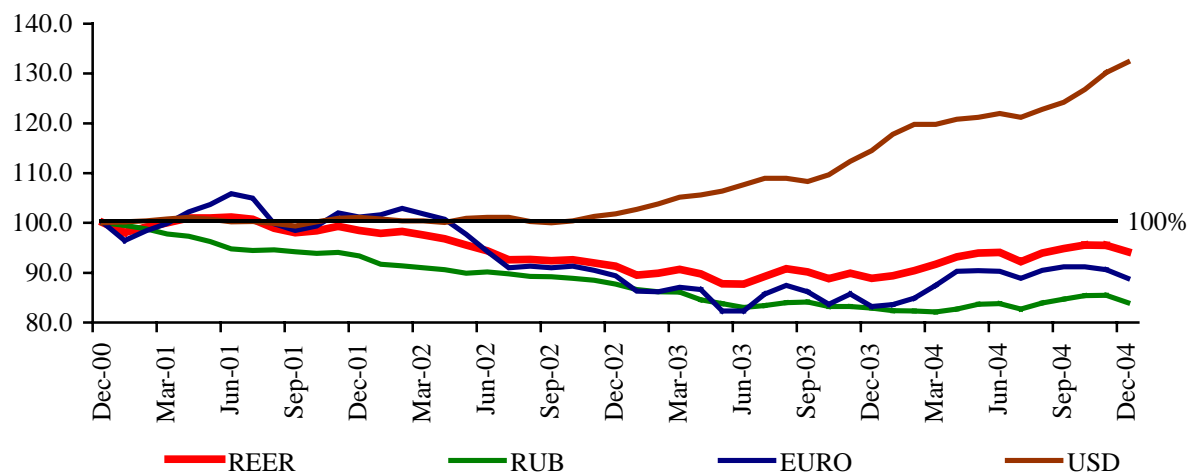
In the situation that developed, the National Bank strove to maintain a balance between supply and demand on the domestic exchange market, buying foreign exchange during periods of heightened pressure on the tenge exchange rate. The coefficient of the National Bank's participation in the domestic exchange market in the 4th Qtr 2004 was about 35 percent.

According to preliminary data, the index of the real effective exchange rate for the tenge increased 5.9 percent in December 2004 relative to December 2003. During 2004, the real strengthening of the tenge with respect to the U.S. dollar was 15.3 percent, 7 percent to the euro, and 1.3 percent to the ruble.

Despite the significant rate of strengthening of the tenge to the main currencies, on the whole, the foreign competitiveness of Kazakhstan's exporters was maintained at a more favorable level than in 2001 and 2003 (Diagram 13).

Diagram 13

Indexes of Real Exchange Rates, %
(December 2000=100%)



Source: National Bank of the Republic of Kazakhstan

Rediscounting Bills

In the 4th Qtr 2004, the official refinancing rate, according to which rediscounting of bills is accomplished, remained at the level of 7 percent annually.

During the period in question, 104 bills, amounting to T 1.7 billion, were accepted for rediscounting. As of January 1, 2005, the National Bank's portfolio had bills in the amount of T 2.2 billion.

As a result of the insignificant volume of the bill rediscounting operations it conducted, the National Bank did not affect the liquidity of second-tier banks in the 4th Qtr 2004.

4. Inflation Forecast

a. Assessing the Inflation Forecast for the 4th Qtr and for 2004 as a Whole

The actual level of inflation that developed in the 4th Qtr 2004 (2.8 percent) corresponded completely to the forecast for this period (2.8-3.0 percent). This was largely the result of more complete and correct accounting of the effect of factors on inflation. As a consequence, the National Bank's measures to control the inflationary processes were adequate for the developing situation.

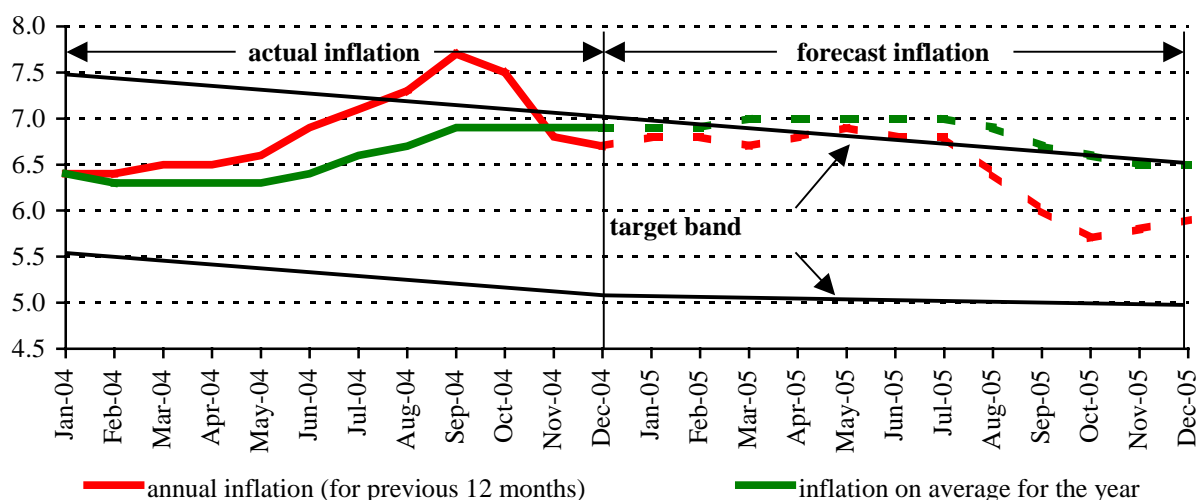
In addition, according to the results of 2004, the average annual inflation (6.9 percent) was also within the forecast limits (5.0-7.0 percent).

b. Inflation Forecast for 2005

In 2005, it is expected that inflation will decrease compared to 2004, and its average annual level will be within 4.9-6.5 percent, closer to the upper boundary of the band (Diagram 14).

Diagram 14

Actual and Forecast Annual Inflation



Source: National Bank of the Republic of Kazakhstan

On January 29, 2005, the Board of the National Bank of the Republic of Kazakhstan approved the Basic Directions of Monetary Policy of the National Bank of the Republic of Kazakhstan for 2005-2007. This document reflects inflation factors, whose effect is expected in 2005 and measures which the National Bank intends to take to fulfill its main goal – ensure price stability.

In 2005 as a whole, it is assumed that the dynamics of inflation will be determined by high economic growth and a significant inflow of foreign exchange. In addition, a high increase in producer prices in 2004 may be a determining factor in an increase in consumer prices in 2005.

The National Bank will take steps to increase pressure on money market rates by a flexible changing of its own official rates, increasing its own securities portfolio, and developing new financial instruments. Bank deposits in the National Bank will become the main instrument in sterilizing surplus liquidity. Circulation of short-term notes will be reduced to influence short-term liquidity, and longer-term liquidity will be regulated by using minimum reserve requirements.

Inflation Forecast for the 1st Qtr 2005

For the 1st Qtr, a certain slowdown in the consumer price increases compared to the previous quarter is typical. Inflation is determined by the dynamics of food prices. Although their pace is developing at a lower level than in the 4th Qtr, they are sufficiently high compared to the 2nd and 3rd Qtr 2004. In addition, January, as a rule, accounts for the main increase in rates for services of natural monopolies. On the other hand, non-food goods usually contribute to a decrease in inflation.

A lower consumer demand, which increases only towards March, and also the insignificant amount of state budget expenditures ensure a certain suppression of inflation in the 1st Qtr compared to the 4th Qtr.

The continuing high liquidity in the economy will contribute to an increase in inflation in the 1st Qtr 2005. In all likelihood, the active credit policy of second-tier banks will continue, and the high world prices for raw material resources will ensure a considerable inflow of foreign exchange into Kazakhstan.

To stabilize the inflation level in the 1st Qtr 2005, the National Bank undertook a number of steps in late 2004 and early 2005. On December 1, 2004, the official rate for repo operations was increased from 4.00 percent to 4.25 percent. On January 1, 2005, given the unalterability of this rate, the band of its permissible deviations was narrowed from 200 basis points to 175 basis points, which actually signifies an increase in the lower boundary from 2.25 percent to 2.5 percent. On February 1, 2005, the repo rate was increased to 4.5 percent. Effective December 1, 2004, the official rate for “overnight” loans was increased. On February 1, 2005, the official refinancing rate was increased from 7.0 percent to 7.5 percent.

On the whole, according to the results of the 1st Qtr 2004 [sic], it is expected that inflation will develop in the range of 1.5-1.7 percent. This level corresponds to inflation in annual terms of 6.7 percent and 7.0 percent in average annual calculation as of the end of March 2005 (Diagram 14).

Inflation Forecast for 2nd Qtr 2005

Inflation in the 2nd Qtr 2005 will decrease compared to the previous quarter as a result of the effect of seasonal factor and is forecast at a level of 1.0 percent (in the 2nd Qtr 2004 – 0.8 percent). The certain increase compared to 2004 is explained by the fact that the volume of the accumulated “critical mass” of inflation factors is becoming more significant. Nevertheless, considering that the effect of monetary policy instruments on inflation occurs with a delay, an increase in the National Bank’s official rates will entail a decrease in inflation beginning with the end of the 2nd Qtr 2005.

In all probability, in the 2nd Qtr 2005, as in the 1st Qtr, the average annual inflation will “exit” the forecasted framework. However, in the future, according to our estimates, inflation will decrease, which will ensure it stays in the target band according to the results of 2005.