

**Approved  
by the Resolution of the  
Board of the National Bank  
of the Republic of Kazakhstan  
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**MONETARY POLICY GUIDELINES  
OF THE NATIONAL BANK OF THE REPUBLIC OF KAZAKHSTAN  
FOR 2008–2009**

**Introduction**

**(A) Change in the planning horizon**

In keeping with established practice, each year the National Bank of the Republic of Kazakhstan develops Monetary Policy Guidelines for the forthcoming 3 years; the Guidelines define inflation targets and the monetary policy measures to achieve them. The determination of strategic policy guidelines for the medium term increases the predictability of policy of the National Bank of the Republic of Kazakhstan and reduces the degree of uncertainty among financial market participants regarding the direction of market development.

In 2007, achievement of the objectives facing the National Bank of the Republic of Kazakhstan has been complicated by substantial uncertainty about prospects for development of the world financial market and, consequently, the domestic economy. In an environment demonstrating high risk that conditions in the world financial market may deteriorate further, central banks in the largest developed countries have begun to provide support for their banking systems in order to stabilize the situation.

In 2007, annual inflation (December-on-December) in the Republic of Kazakhstan was 18.8 percent (the highest level in the last 7 years). The defining feature of the current period is that in an environment characterized by rising inflationary pressure and a deteriorating situation on the financial market, the National Bank of the Republic of Kazakhstan, like other central banks, is facing a certain dilemma. On the one hand, it should provide for the achievement of price stability, and on the other hand, it needs to ensure stability of the financial system and maintain conditions for further economic growth.

Under these conditions, the National Bank of the Republic of Kazakhstan decided to develop Monetary Policy Guidelines for the coming two years, i.e. for the 2008–2009 period. Moreover, in addition to the implementation of its main objective, special attention has been paid to a package of measures to ensure banking system stability. As uncertainty decreases, the National Bank of the Republic of Kazakhstan intends to resume the practice of developing Monetary Policy Guidelines for a three-year period.

**(B) Some peculiarities in the development of the Kazakhstan economy in recent years**

Financial shocks in the global economy have demonstrated the vulnerability of the Republic of Kazakhstan economy to external risks. Fundamental special features of economic development which have been taking shape in the last several years have turned into some of the most important vulnerabilities. The revenue of raw materials industries, external borrowing by the banks, and the growth of state expenditures have continued to contribute to the economy's "overheating" and an increase in aggregate demand. The dearth of investment instruments coupled with an objective inability of the economy to rapidly meet demand for infrastructure services and real estate at a time of vigorously growing demand has led to real estate market "overheating" and higher yield in the sector of construction and other services. Real estate has become the most attractive sector for investments.

The growth of the financial sector in the Republic of Kazakhstan in recent years has been accompanied by a significant accumulation of risks in the banking system. Appreciation of the tenge, the increase in the sovereign credit rating of the Republic of Kazakhstan and the ratings of domestic banks, and the attractiveness of the banking sector for investors have facilitated the expansion of Kazakhstan's banks into external capital markets. While the growth of external borrowing and high rates of increases in lending volumes have been supported by a corresponding quality of the loan portfolio, the potential risk of asset quality deterioration has not been adequately assessed by banks.

On the one hand, the expansion of bank lending to the construction industry and real estate market has led to further price increases in the real estate market and made the banking sector even more vulnerable to credit risks. On the other hand, the construction sector has become practically totally dependent on bank financing.

For a number of years, the National Bank of the Republic of Kazakhstan and the Agency of the Republic of Kazakhstan for the Regulation and Supervision of the Financial Market and Financial Institutions have been taking steps to minimize risks arising in the banking system. In particular, they have taken measures to regulate the quality of the loan portfolio, improve the mechanism of minimum reserve requirements, develop new requirements aimed at ensuring a more adequate assessment of credit risk, creating provisions, and increasing the capital of the financial institutions, and set restrictions on the inflow of foreign borrowing.

At the same time, the problems arising on world financial markets have led to the emergence of accumulated risks in the banking system and an increase in vulnerability of the national economy to external financial shocks. External financing is an important source for replenishment of the resource base of Kazakhstan's banks, and the banks have run up against the problem of a current liquidity shortage. A decline in bank financing has led, first and foremost, to a decline in construction volumes, and also to a reduction in activities in other sectors.

A revaluation of risk and the funding difficulties in the financial system have led to a reduction of the sovereign credit rating of the Republic of Kazakhstan and the ratings of a number of domestic banks by the international rating agencies Standard & Poor's and Fitch. Nevertheless, a significant slowdown in the rate of economic growth had not occurred by the end of 2007.

## **1. The parameters of macroeconomic development in 2007**

### **1.1. The development of global financial and commodity markets**

The world economy was developing rapidly in the first half of 2007. According to IMF estimates, its annualized growth rate during that period was about 5 percent. Half of this growth was due to development of the economies of China, India, and Russia.

Moreover, in the first half of 2007, the world financial market witnessed gradual small increases in interest rates. These increases were the result of a tightening of monetary policy by central banks of some developed countries in response to rising inflation. The ECB raised its base interest rate twice during the year: in March to 3.75 percent and in June to 4 percent. The Bank of Japan increased its rate to 0.5 percent in February 2007. The base rate of the Federal Reserve System remained at a level of 5.25 percent until September 2007.

The foreign exchange markets saw the continuation of 2006 trends, which were characterized by depreciation of the US dollar, strengthening of the euro and pound sterling, and a slow appreciation of the Chinese yuan.

In the second half of 2007, the growth rates of the developed economies declined. The deceleration of growth in Europe and Japan was associated with the appreciation of their domestic currencies and a decline in the inflow of investments.

In the USA, the deceleration of growth was the result of the sub-prime mortgage crisis and a subsequent drop in consumer confidence. In August 2007 the crisis in the mortgage market in the USA, which first arose in early 2007, turned from a local crisis to a global one. As a result, volatility in financial markets increased. The collapse of the sub-prime mortgage market in the USA and uncertainty about the risk and the size of final losses led to a subsequent liquidity crisis on global financial markets.

Increasing risks led to the withdrawal of capital from developing markets by portfolio investors. As a result, most developing markets effectively lost access to external borrowing.

A number of central banks, in particular the Federal Reserve System and the European Central Bank, responded to the emerging crisis with credit interventions aimed at supporting the liquidity of banking systems in their countries. Under such conditions, interest rates in international markets became more volatile. The LIBOR rate for 3-month dollar deposits increased from 5.36 percent as of end-July 2007 and on September 7, 2007 it

reached its highest level in 2007—5.73 percent. After the injection of liquidity by the European Central Bank, in December 2007 the LIBOR rate decreased to 4.73 percent (as of December 28, 2007).

Overall, the global economy has entered a period of great uncertainty, whose main source is volatility in world financial markets. Although the situation stabilized in later months, the largest banks are still writing off assets invested in securities related to sub-prime mortgages. Central banks in the leading world economies (USA, European Union, United Kingdom, Canada, and Switzerland) announced in December 2007 that they were joining their efforts to overcome the liquidity crisis.

In addition to instability in financial markets, the global economy has encountered the problem of substantial growth of prices in commodity markets. In an environment where reserve capacity to produce oil is limited, the demand for oil is steadily growing, particularly in rapidly developing economies, and geopolitical risks are rising, there has been a steady growing trend in oil prices beginning from early 2007. Thus, according to IMF data, in December 2007 the average price of Brent oil had increased 46.8 percent compared to the beginning of the year and comprised US\$91.45 per barrel.

In 2007, the prices for basic metals and foodstuffs also continued to increase. According to IMF estimates, the index of prices for non-fuel exchange-traded commodities, which includes foods and industrial goods, increased by 6.1 percent in the first 9 months of 2007. At the same time, the index of metal prices increased by 1.5 percent and the index of food prices—by 18.2 percent.

A poor harvest in countries which are main producers of grain crops and an increase in world production of alternative fuels made from plants (bio-ethanol) led to a decline in the supply of corresponding commodities in the world market, resulting in price increases for them.

According to IMF data, the world price of wheat (Canada) in 2007 increased twofold, while the prices of sunflower oil, according to the data of the US Department of Agriculture, increased by 91.9 percent in January–November 2007.

Negative trends in international financial and commodity markets have led to increased inflation in many countries of the world. Thus, in the USA annual inflation (over the last 12 months) increased from 2.5 percent in December 2006 to 4.3 percent in November 2007, while in the euro-zone countries it increased from 1.9 to 3.1 percent, including in Germany from 1.4 to 3.1 percent.

## **1.2. The balance of payments of the Republic of Kazakhstan and the tenge exchange rate**

Rising prices in international commodity markets made possible further increases in export income of the Republic of Kazakhstan. According to customs statistical data, exports

of goods for the first nine months of 2007 increased by 19 percent compared to the same period in 2006 and amounted to US\$33.8 billion. Continued high world prices for energy resources facilitated the inflow of foreign direct investments in the development of infrastructure for oil fields. Foreign borrowing of the banking sector was generally the source for high rates of growth in the non-raw materials sector.

As in previous years, income from current transactions (mostly income from exports of goods) did not cover expenditures for imports and for the payment of income to nonresidents for financial and labor resources attracted from them. In 2007, these trends intensified and led, as a result, to a further increase of the current account deficit. The BOP current account deficit for the first 9 months of 2007 amounted to US\$5.3 billion and is expected to reach US\$7 billion for 2007 as a whole (compared to US\$1.8 billion for 2006).

A substantial net inflow of foreign direct investments (close to US\$6 billion in the first 9 months of 2007) led to an increase in expenditures of joint ventures for imports, particularly imports of international services. For the first 9 months of 2007, the balance of international services showed a deficit in the amount of US\$5.7 billion, which was 28.5 percent higher than in the same period in 2006.

The amounts repatriated by foreign direct investors comprise the bulk of current account expenditures. For the first 9 months of 2007, they amounted to US\$6.9 billion, which is a 23.6 percent increase over the same period in 2006.

The increase in the current account deficit is also the result of higher interest payments on the external debt of the banking sector. For the first 9 months of 2007, that amount was US\$2.3 billion (which was a twofold increase over the same period in 2006).

The payment of dividends to foreign direct investors and expenditures for international services are financed to a fair degree from export income and direct investments received by joint ventures. Meanwhile, capacity for financing all other BOP transactions determining the outflow of capital from the country (servicing and repayment of external debt) directly depend on the access of Kazakhstan residents to international capital markets and amounts of foreign assets accumulated by residents.

Thus, in the first half of 2007, net inflows of financing secured through external borrowing of the banking sector amounted to US\$12.1 billion compared to net inflows of US\$5.2 billion in the first half of 2006. The inflow of foreign capital into the country was substantially above the level required to finance current payments and was not offset by the growth of foreign assets in the private sector. An excessive supply of foreign currency created as a result of BOP financial account transactions exerted a substantial strengthening pressure on the tenge exchange rate, which was countered by operations of the National Bank of the Republic of Kazakhstan on the domestic currency market.

In the first half year, the gold and foreign exchange reserves of the National Bank of the Republic of Kazakhstan increased by US\$3.2 billion, including US\$1.1 billion from

transactions conducted on the Kazakhstan stock exchange (KSE) and the interbank market. The nominal exchange rate rate, which was T 127 per US dollar at the end of 2006, appreciated to T 120.1 per US dollar in April 2007 and comprised T 122.31 per US dollar at the end of June 2007.

The global crisis in capital markets has led to a substantial deterioration of conditions for attraction of external resources by Kazakhstan banks since August 2007, and as a result conditions for the functioning of the Republic of Kazakhstan economy have also changed.

In the third quarter of 2007 banks attracted long-term external loans (with maturities over 1 year) totaling US\$4.2 billion, whereas the amount of borrowing in the first and second quarters was US\$6.9 and 6.2 billion respectively. Incorporating the repayment of principal on previously attracted long-term debt and a net repayment of short-term loans, the net inflow of resources for external loans of the banking sector was only US\$0.2 billion in the third quarter of 2007.

In an environment of declining supply of foreign currency, an increase in demand was financed from the gold and foreign exchange reserves of the National Bank of the Republic of Kazakhstan.

The shortage of foreign currency liquidity in banks which followed the events in the world capital markets gave rise to a panic attitude among the people with respect to future exchange rate dynamics. In August, the exchange rate weakened to T 126.25 per US dollar at the end of the month. Interventions conducted by the National Bank of the Republic of Kazakhstan to stabilize the situation in the foreign exchange market and measures taken to restore confidence in the banking system helped stabilize the tenge exchange rate. As of end September 2007, the exchange rate was T 120.96 per US dollar, and at the end of December 2007, it stood at T 120.30 per US dollar. The gold and foreign exchange reserves of the National Bank of the Republic of Kazakhstan during the period from August to December of 2007 decreased by US\$6.0 billion and comprised US\$17.4 billion at the end of December.

Taking into consideration the existence of fundamental factors determining a strengthening of the tenge against the US dollar in the medium term, the prevention of abrupt changes of the tenge exchange rate is a substantial component for ensuring financial system stability.

### **1.3. Macroeconomic and financial indicators**

Economic development of the Republic of Kazakhstan in 2007 was characterized by a continuation of the high rates of growth that have persisted over the last 7 years. According to the results for the first nine months of 2007, real GDP growth was 9.7 percent, slowing down slightly compared to 2006 (10.7 percent). The main growth was associated with the high rate of development of such sectors as the processing industry, real estate transactions, construction, and trade. Investments in fixed capital increased by 10.5 percent during January–November 2007 (11.1 percent in 2006).

Employment continues to grow in the economy. According to the results of the first 11 months of 2007, employment growth in the economy was 2.4 percent (2.0 percent in 2006). As a result, the unemployment level declined from 7.8 percent in December 2006 to 7.4 percent in November 2007.

Nevertheless, in Q3 of 2007 a slowdown in the rate of growth was observed in such economic sectors as the mining industry, construction, and financial activities. A reduction in production output is seen in virtually all sectors of the mining industry.

Developments in the financial sector, primarily in the banking segment, were characterized during 2007 by trends in a variety of directions. During January–July 2007, we saw a further expansion of banking activities, and bank assets and liabilities increased at a considerable pace. Despite the gradual increase of interest rates on the world market during this period, their level enabled domestic banks to continue their policy of attracting external borrowings. Bank liabilities to nonresidents during January–July 2007 increased by 32.9 percent (19.5 percent for the corresponding period in 2006).

A considerable portion of the resources being attracted were used for expanding crediting of the domestic economy. During the first seven months of 2007, the increase in credits for the economy was 46.6 percent (27.7 percent for the corresponding period in 2006).

Against the background of the events taking place, the population's deposits, as the indicator reacting the most sensitively to the change in the situation in the financial sector, declined by 4.7 percent during the period August–October 2007. Nonetheless, their volume in these months exceeded the volume in June 2007, and during November–December 2007 deposits of the population increased by 3.5 percent according to preliminary data.

During 2007 deposits of residents in the banking system increased by 25.9 percent according to preliminary data; growth of deposits of the population was 40.5 percent.

Despite the limits on access to external borrowings, the increase in interest rates on world financial markets, and also a certain outflow of deposits, domestic banks did not stop crediting of the economy. During August–December 2007 credits to the economy increased by 5.5 percent according to preliminary data.

## **2. Monetary policy of the National Bank of the Republic of Kazakhstan in 2007**

### **2.1. Assessing achievement of inflation targets**

According to official data of the Republic of Kazakhstan Statistics Agency, *inflation* for the year 2007 was 18.8 percent (December 2007 against December 2006), which is 10.4 percentage points higher compared to indicators for 2006. Foodstuffs increased by 26.6 percent in price; nonfood products by 10.5 percent, and paid services by 15.4 percent.

*Core inflation* (inflation not counting price increases for fruits and vegetables, gasoline, and coal), which reflects the overall trend in the dynamics of inflationary processes, increased to 17.3 percent in annual terms according to the results for November 2007 (7.3 percent in 2006).

In 2007, inflationary processes were multidirectional in nature.

At the beginning of the year, a certain decrease in the rate of growth of inflation was noted: annual inflation decreased from 8.4 percent according to the results for December 2006 to 7.6 percent according to the results for May 2007.

In the second half of 2007, inflationary processes in the Republic of Kazakhstan's economy intensified. In September–November 2007 alone, price increases reached 9.7 percent, which is more than 50 percent of the total price increase for 2007.

As a result, the annual inflation level according to the results for 2007 reached a seven-year high (18.8 percent), and the average annual inflation was 10.8 percent.

The increase in inflationary pressure in 2007 was caused not so much by the influence of fundamental factors, whose effect continues for a number of years, as by the effect of external factors having the nature of a shock.

The fundamental factors for inflation in 2007 continued to be the inflow of foreign currency, the high rate of growth of aggregate demand, an increase in the money supply in 2006, low labor productivity, and an insufficient level of competition in certain markets of goods and services.

As was noted above, in August 2007 a sharp increase in prices for a number of foodstuffs occurred in the world markets (wheat, vegetable oils). This was reflected with some lag in the prices for corresponding goods and goods from their processing within the Republic of Kazakhstan. In particular, prices for such products as bread, flour, and sunflower oil increased significantly in September–November 2007.

Given that the increase in prices for these products had a multiplying effect on other foodstuffs as well, then according to National Bank estimates annual inflation in 2007 without incorporating the increase in prices for foodstuffs in the September–November period would have been at 14.8 percent instead of the actual 18.8 percent.

Thus, as a result of the action of these factors, the National Bank of the Republic of Kazakhstan's forecast for inflation for 2007 did not hold up.

In accordance with the Monetary Policy Guidelines for 2007–2009, the inflation forecast for 2007 was determined according to three scenarios for economic development



("moderate oil prices with a moderate inflow of capital", "moderate oil prices with a high inflow of capital", and "high oil prices").

The results of 2007 demonstrate that the "high oil prices" scenario was realized, in which the forecast for average annual inflation was determined in the range of 8.2–9.2 percent. The average price for Brent crude in 2007 was US\$72.70 a barrel.

## **2.2. Measures of the National Bank of the Republic of Kazakhstan to maintain price stability**

In the first six months of 2007, the National Bank of the Republic of Kazakhstan's monetary policy was aimed at implementing a policy to increase rates for monetary policy transactions, and also at taking steps to absorb banks' liquidity overhang.

Liberalization of exchange arrangements helped to regulate liquidity overhang in foreign currency. Effective January 1, 2007, the Republic of Kazakhstan Law "On Foreign Exchange Regulation and Foreign Exchange Control" completely eliminated restrictions on capital transactions between residents and nonresidents.

The main monetary policy instrument for the first half of 2007 was the issuance of short-term notes. In January–July, the volume of short-term notes issued was T 3.8 trillion (2.1 times more than in the corresponding period of 2006). The weighted average yield on the notes increased from 4.69 percent in December 2006 to 5.64 percent in December 2007.

Beginning March 1, 2007, the National Bank of the Republic of Kazakhstan began issuing notes with a circulation period of up to 1 year (prior to March 1, notes with a term of only 28 days were issued). Notes were issued with periods of circulation of 28 days (1 month), 3 months, 6 months, and 1 year.

In January–July 2007, deposits amounting to T 4.1 trillion were attracted from second-tier banks, which is 34.5 percent less than in the corresponding period of 2006. Balances of bank deposits with the National Bank of the Republic of Kazakhstan decreased by 86.2 percent to T 18.2 billion by the end of July 2007. The decline in bank deposits with the National Bank of the Republic of Kazakhstan was caused by a decline in their attractiveness compared to short-term notes.

On the domestic currency market in January–July 2007, the National Bank of the Republic of Kazakhstan acted predominantly as a foreign currency buyer. Nevertheless, the amounts of net purchases of foreign exchange were insignificant -- US\$291 million.

With the aid of the issuance of short-term notes, the National Bank of the Republic of Kazakhstan not only completely absorbed the tenge liquidity acquired by banks as a result of the National Bank of the Republic of Kazakhstan's operations on the domestic currency market (T 40.8 billion) and as a result of a decrease in the balances in bank deposits with the

National Bank of the Republic of Kazakhstan (T 113.4 billion) but also a portion of the banks' liquidity overhang (by T 163.4 billion).

During the first 11 months of 2007, the official refinancing rate remained at the 9.0 percent level, and the rates for deposits attracted by the National Bank of the Republic of Kazakhstan from second-tier banks, which is set at a level of 1/2 of the official refinancing rate was 4.5 percent. On December 1, 2007, both rates were increased to 11.0 percent and 5.5. percent, respectively.

### **2.3. Measures of the National Bank of the Republic of Kazakhstan to ensure financial stability**

In the second half of 2007 the National Bank of the Republic of Kazakhstan, responding to a change in the situation and the emergence of a liquidity deficit in banks caused by the global crisis, took steps to ensure stability of the financial system by granting banks liquidity. The choice to ensure financial stability was the correct one, and many central banks, including in developed countries, followed this path.

To provide banks with short-term tenge liquidity, beginning in August 2007 the National Bank of the Republic of Kazakhstan increased volumes of performance of reverse repo transactions and began conducting currency swap operations secured by foreign exchange and also secured by balances in banks' correspondent accounts with the National Bank of the Republic of Kazakhstan in freely convertible currency. The National Bank of the Republic of Kazakhstan also resumed the practice of early redemption of its own short-term notes.

In addition, the National Bank of the Republic of Kazakhstan instituted a new form of refinancing loans, namely short-term loans secured by balances in banks' correspondent accounts with the National Bank of the Republic of Kazakhstan in the domestic currency. These refinancing operations were conducted with a term of 7 days.

From August through December 2007, the National Bank of the Republic of Kazakhstan conducted reverse repo operations in the amount of T 723.9 billion and currency swap operations in the amount of T 4,043.1 billion. As of the end of December 2007, the volume of indebtedness to the National Bank of the Republic of Kazakhstan not repaid by banks was T 4.0 billion for reverse repo operations and T 123.8 billion for currency swap operations.

Beginning in August 2007, the demand for short-term notes on the part of banks declined considerably, as a result of which notes with a term of circulation of only 28 days were issued. The volumes of operations of the National Bank of the Republic of Kazakhstan to attract deposits were conducted in insignificant amounts. This was related to the banks' lack of "free" liquidity.

As a result, the volume of notes in circulation declined to T 228.9 billion (the decrease for 2007 as a whole was 57.1 percent), and the volumes of banks' deposits with the National Bank of the Republic of Kazakhstan declined to T 9.9 billion (the decline for 2007 as a whole was 92.4 percent).

On the domestic foreign exchange market in August–December 2007, the National Bank of the Republic of Kazakhstan acted predominantly as a foreign currency seller. The volume of net foreign currency sales reached US\$6.5 billion.

The result of the National Bank of the Republic of Kazakhstan's operations on the domestic market was the replenishment of the liquidity of second-tier banks by T 58.2 billion during August–December 2007.

In August, the National Bank of the Republic of Kazakhstan revised the minimum reserve requirement mechanism. The changes were aimed at reducing the base of reserve liabilities and expanding the structure of reserve assets, which enabled banks to free up an estimated additional T 150 billion. These changes entered into force on October 9, 2007.

In addition, in July 2007 changes were made to the norms for minimum reserve requirements. In accordance with the changes, the norm for domestic liabilities was reduced from 6 percent to 5 percent, and the norm for other (including foreign) liabilities was increased from 8 percent to 10 percent. Considering that the volume of other liabilities in the structure of second-tier banks' liabilities exceeds the volumes of domestic liabilities, the intent of these changes is to additionally "tie up" a part of the liquidity overhang of banks. The introduction of these standards was scheduled starting August 2007.

However, taking into account the emergence of the banks' problems with liquidity, the deadline for these new minimum reserve requirement norms to enter into force was postponed to July 1, 2008.

A result of the National Bank of the Republic of Kazakhstan's measures in 2007 was a significant slowdown in the rate of money supply growth. During 2007 reserve money contracted by 2.5 percent (in 2006, it expanded by 126.4 percent) to T 1,464.3 billion. According to preliminary data, for 2007 the money supply increased by 25.5 percent (it increased by 78.1 percent in 2006) to T 4,613.7 billion, and cash in circulation increased by 23.1 percent (by 45.9 percent) to T 739.7 billion.

### **3. Objectives and priorities of the National Bank of the Republic of Kazakhstan's monetary policy for 2008–2009**

#### **3.1. Priorities of the National Bank of the Republic of Kazakhstan**

The National Bank of the Republic of Kazakhstan's main priority is to continue work on the transition to inflation-targeting principles. Inflation targeting fully meets the National

Bank of the Republic of Kazakhstan's main objective of reducing inflation and, in view of the increased transparency of the objective, ensures greater confidence of market participants.

At this stage, it is not advisable to apply alternative principles for conducting monetary policy or shifting emphasis to the area of money targeting or exchange rate targeting.

Within the framework of transition to inflation-targeting principles, the National Bank of the Republic of Kazakhstan will adhere to a floating exchange rate policy; in other words, the exchange rate of the tenge will be established based on supply and demand for foreign currency on the domestic market.

The transition to inflation-targeting principles presupposes a strengthening of methodological work to improve the monetary policy. The National Bank of the Republic of Kazakhstan is concentrating its efforts on improving existing forecasting models and developing new models.

### **3.2. Scenario variants for economic development of the Republic of Kazakhstan**

Taking into account what was set forth in Chapter 1, the Republic of Kazakhstan's economic development in 2008–2009 will differ fundamentally from the forecasts which were made for that period in previous years. This is the result primarily of the change in the situation on the world financial market. In this regard, the approaches to development of development scenario variants were completely revised.

For the first time in recent years the Republic of Kazakhstan has encountered a situation where a significant slowdown in economic growth is occurring. Therefore, this document does not examine scenarios assuming continued high rates of real GDP growth. It also does not examine a variant in which there is a decline in world oil prices, since it is not very likely that it and a scenario of high economic development in the Republic of Kazakhstan will be realized in the next two years.

The existing uncertainty with respect to the prospects for world economic development will, according to estimates, remain high for the foreseeable future. Its sources are volatility on the world financial and commodity markets and uncertainty of the geopolitical situations in the main oil-producing regions of the world.

In this connections it is expected that world prices for the main headings of Kazakh exports (oil, metals) will remain at a high level, and sharp fluctuations on the world food markets will not occur. We also do not expect to see an improvement in borrowing conditions for developing markets.

Such a situation will, on the one hand, help to preserve significant receipts of export proceeds in the Republic of Kazakhstan. On the other hand, the attraction of external

borrowing by domestic banks in the volumes of previous years will be problematic, at least for the next 1–2 years.

Thus, despite the relative increase in income from raw materials exports, the current account balance of the Republic of Kazakhstan's balance of payments in 2008 and 2009 will remain a deficit. A continued considerable deficit for current operations will be caused by the domination within the structure of payments for current operations of expenditures associated with enterprises' activities with foreign direct investments (imports of goods and services and payment of income, including dividends) and payments to service external debt of the banking sector.

In an environment of a pricing situation that is favorable for exports of energy resources and other raw materials, a net inflow of foreign direct investments will ensure financing of current expenditures associated with them. At the same time, the limited access to attraction of resources on international capital markets and the need to make payments to repay and service accumulated external debt, which according to estimates will be about US\$12 billion in 2008, gives rise to a shortfall in the attraction of resources from abroad to cover requirements for financing current and financial accounts. Limits on the attraction of foreign resources will require banks to change medium-term development strategies and where they aim the flows of financial resources.

In these conditions, the volume of crediting of the economy by the banking sector of the Republic of Kazakhstan will slow down significantly, which will ensure moderate economic growth. The main slowdown in economic growth is expected to be at the expense of the non-raw materials sectors, which in recent years have made a significant contribution to real GDP growth.

Further economic development of the Republic of Kazakhstan will also be ensured by implementing the Plan of Priority Actions To Ensure Stability of the Socioeconomic Development of the Republic of Kazakhstan, as approved by a resolution of the Government of the Republic of Kazakhstan dated November 6, 2007.

Even so, we cannot rule out a variant whereby the situation on the world markets will continue to deteriorate. In that event, economic development of the Republic of Kazakhstan will correspond to a more negative variant.

In this context, two scenarios for economic development are being examined: a **base** scenario and a **pessimistic** scenario.

Under the *base scenario*, we expect to maintain a considerable deficit with respect to current operations (more than US\$5 billion). We assume that banks will not be able to use new external borrowing to refinance all debts to nonresidents coming due in 2008 and 2009. We anticipate that banks' external assets will decline in these conditions.

Within the framework of this scenario, we anticipate that real GDP growth will be 5 percent in 2008 and 6.3 percent in 2009.

The slowdown in the rate of economic growth will contribute to a reduction in the need for imports of goods and to a decline in domestic demand as a whole, which will provide for an adjustment in the balance of payments situation by 2009. As a consequence, in 2009 the balance of payments is expected to be in balance, which assumes that the volume of international reserves of the National Bank of the Republic of Kazakhstan will remain at the 2008 level and the nominal tenge exchange rate will be stable.

Given the assumptions made relative to the future dynamics of indicators for the real sector and the balance of payments for this scenario, the following forecasts were obtained for 2008–2009. The average annual growth will be 11–15 percent for the reserve money, 17–19 percent for money supply, 16–18 percent for credits to the economy, and 15–17 percent for deposits in the banking system. (Attachment 1).

Under the *pessimistic scenario*, we assume that banks' liabilities to nonresidents will be met by a decline in banks' external assets in the absence of new borrowing from abroad. This will entail a reduction in volumes of domestic investments and a slowdown in the growth of domestic savings. A reduction in domestic investment and consumer demand will result in a decline in expenditures on imports and will limit expansion of the current account deficit in 2008 and 2009.

In the absence of access to external resources, the need to service external debt obligations will result in a net-outflow of capital from country.

This will exert great pressure on the tenge exchange rate in the direction of weakening it.

Under this scenario we do not expect to observe economic growth in the Republic of Kazakhstan in 2008 and 2009.

If the assumptions made with respect to the future dynamics of the real sector and balance of payments indicators are fulfilled, then in 2008–2009 there will be a decline in the money supply in the economy due to a decline in external and domestic assets of the banking system and, accordingly, an outflow of deposits. During this period the average annual contraction of the reserve money will be 2–4 percent, money supply will decline by an average of 6–7 percent, credits to the economy will decline by 4–5 percent, and deposits in the banking system will decrease by 3–4 percent. (Attachment 1).

It should be noted that realization of both scenarios assumes a substantial slowdown of annual inflation. Whereas annual inflation was 18.8 percent at the end of 2007, at the end of 2008 and 2009 it will decline into the single digits. Such a slowdown in inflation is associated with a decrease in the influence of objective factors such as a decline in the

growth of money supply, limited growth of aggregate demand, and the absence of expectations of external shocks.

**The primary objective of monetary policy of the National Bank of the Republic of Kazakhstan for 2008–2009 will be to restrain annual inflation (December compared to December of the previous year) within the limits of 7.9–9.9 percent in 2008 and 7.5–9.5 percent in 2009 in the event of realization of both the base and pessimistic scenarios. This corresponds to average annual inflation within the limits of 16–18 percent and 8.0–10.0 percent respectively.**

It is also important to bear in mind that if GDP, government expenditures, and other indicators within the jurisdiction of the Government of the Republic of Kazakhstan are revised, the inflation forecast also may be revised. In addition, indicators of money supply and other monetary policy indicators are indicative, that is, it is not mandatory that they be achieved in the event of a change in the conditions for the functioning of the economy.

#### **Insert 1**

##### **Special features in the calculation of average annual inflation**

In 2008, average annual inflation will remain at a high level even with a significant decrease in annual inflation (December compared to December of the previous year). To a great extent, this is associated with the method of calculating average annual inflation.

When calculating average annual inflation, the dynamics of inflationary processes during the last two years are taken into account. In essence, average annual inflation shows a change in the average cost of a basket of goods and services used to calculate the consumer price index in the current year compared to its average cost in the previous year.

Thus calculation of average annual inflation assumes coverage of 24 consecutive months; that is, the change in consumer prices during the last 12 months, calculated to the base period, is averaged with respect to their change in the corresponding period of the previous year. Thus, the average annual inflation level in 2008 will depend both on inflation in 2008 and also in 2006 and 2007.

The increase in inflationary pressure in the second half of 2007 will also have an effect on the rate of inflation in 2008. It is expected that, provided there is a more favorable situation in the consumer market in 2008 compared to past years, the annual inflation rate will begin to slow down by the second half of the year. However, the average annual inflation rate over the course of all of 2008 will show a high rate of growth, and we should expect it to slow down somewhat only towards the end of the year.

#### **4. Monetary policy measures for 2008**

The National Bank of the Republic of Kazakhstan's actions will be determined depending on realization of the base or pessimistic scenario for development of the economy.

Upon realization of the base scenario, ensuring price stability will remain a priority. Realization of the pessimistic scenario will require changes in policy priorities in favor of ensuring stability of the financial sector in order to prevent a further worsening of the economic situation in the country.

Reacting to the change in the situation that has taken shape in the world and domestic economies, the National Bank of the Republic of Kazakhstan will depart from pursuing a "strict" monetary policy. As was already noted above, the central banks of many countries, including the largest countries, are re-examining approaches to the pursuit of monetary policy, placing the main emphasis on supporting development of their own banking systems. We believe that in an environment of a slowdown in economic growth in the Republic of Kazakhstan, such a policy by the National Bank of the Republic of Kazakhstan is the most preferable.

**- Monetary policy measures in the event of the realization of both scenarios**

In 2008 the National Bank of the Republic of Kazakhstan will continue to work to improve monetary policy instruments, primarily with respect to increasing the role of interest rates for the National Bank of the Republic of Kazakhstan's operations.

The official refinancing rate will be set depending on the situation in the money market and the level of inflation in such a way that it will be the upper level for rates in the money market for short-term instruments. The rate on deposits attracted by the National Bank of the Republic of Kazakhstan from second-tier banks will be set at 1/2 of the official refinancing rate and will represent the lower level of the band of rates of the National Bank of the Republic of Kazakhstan.

The National Bank of the Republic of Kazakhstan will continue to provide second-tier banks with refinancing loans in the form of the performance of reverse repo operations secured by government and agency securities. Currency swap operations and also the provision of short-term loans secured by balances on banks' correspondent accounts with the National Bank of the Republic of Kazakhstan will be carried out only upon the execution by banks of an Agreement on Cooperation and Interaction on matters of the provision of bank loans by the National Bank of the Republic of Kazakhstan.

The practice of conducting rediscounting operations with commercial bills will be stopped completely. In this regard, the conferring upon enterprises of the status of first-class bill issuers will be discontinued.

The National Bank of the Republic of Kazakhstan will carry out operations to convert and reconvert assets of the National Fund of the Republic of Kazakhstan by buying or selling foreign currency on the domestic market and also using gold and foreign exchange assets. The increase in the time frame during which the National Bank of the Republic of Kazakhstan can carry out conversion operations to 6 months (prior to November 2007—1



month) will contribute to a reduction in additional demand for foreign currency on the domestic market.

**- Monetary policy measures in the event of the realization of the base scenario**

The National Bank of the Republic of Kazakhstan will pursue a moderately strict monetary policy. This will mean, on the one hand, taking steps to maintain rates for operations of the National Bank of the Republic of Kazakhstan at a level appropriate for the situation at hand and, on the other, conducting operations to provide banks with short-term liquidity.

The issuance of short-term notes, attraction of deposits of second-tier banks, and provision of refinancing loans will remain the main operations for the National Bank of the Republic of Kazakhstan's regulation of interest rates in the financial market and also the regulation of bank liquidity.

As necessary and in the event that demand emerges, the National Bank of the Republic of Kazakhstan will reconsider the question of resuming the issuance of short-term notes with a period of circulation of up to 1 year to establish a short-term yield curve. The National Bank of the Republic of Kazakhstan will monitor the short-term yield curve and make the appropriate decisions depending on the situation in the financial market.

Under conditions of pressure on the tenge exchange rate in the direction of a weakening, the National Bank of the Republic of Kazakhstan will not permit sharp short-term fluctuations in the tenge exchange rate; and tenge exchange rate anchors or bands will not be established.

A relative decline in domestic investment and consumer demand will ensure a correction in the balance of payments situation by reducing, first and foremost, expenditures on imports. At the same time, taking into account the time lag with which this may occur, in order to eliminate the imbalance between supply and demand on the domestic market the National Bank of the Republic of Kazakhstan may take measures in the short term to limit the demand for foreign exchange, including changing procedures for purchasing and selling currency on the domestic currency market.

**- Monetary policy measures in the event of the realization of the pessimistic scenario**

The National Bank of the Republic of Kazakhstan will pursue a supportive monetary policy.

This means the possibility of a significant decrease in existing minimum reserve requirement norms.

The National Bank of the Republic of Kazakhstan will refrain from granting banks long-term assistance in significant amounts. Nevertheless the National Bank of the Republic of Kazakhstan, together with the Agency of the Republic of Kazakhstan for Regulation and Supervision of the Financial Market and Financial Organizations and the Government of the Republic of Kazakhstan, plans to develop and actively use mechanisms for supporting the banking sector with the use of various indirect instruments (securitization of assets, operations with bonds and stocks of banks, provision of liquidity through development institutions, etc.).

Under conditions of higher pressure on the tenge exchange rate, the National Bank of the Republic of Kazakhstan will permit considerably more weakening of it compared to the base scenario in order to support gold and foreign exchange reserves at the level needed for the country to meet its international obligations.

Contraction of domestic investment and consumer demand will ensure adjustment of the balance of payments situation by reducing not only expenditures for imports but also payments to service external debt. At the same time, taking into account the substantial liquidity deficit in foreign currency and the threat of a sudden outflow of capital from the country, strict measures will be taken as needed to stabilize the situation on the domestic currency market. To this end, the National Bank of the Republic of Kazakhstan may take steps to restrict the outflow of capital and increase the supply of foreign exchange, including via the temporary introduction of exchange restrictions (special permission regime).

## Attachment 1

**FORECAST OF BASIC MONETARY POLICY INDICATORS  
FOR 2008–2009 (BASE SCENARIO)**

*at end of period*

	<b>2007 (actual)</b>	<b>2008 (forecast)</b>	<b>2009 (forecast)</b>
<b>Inflation, %</b>			
- at end of year, %	18.8	7.9–9.9	7.5–9.5
- average for year, %	10.8	16.0–18.0	8.5–10.5
<b>Official refinancing rate, %</b>	11.0	10.0	9.0
<b>Reserve money, billion tenge</b>	1464	1681	1878
<i>change in %</i>	-2.5	14.8	11.7
<b>Money supply, billion tenge</b>	4614*	4998	6173
<i>change in %</i>	25.5*	8.3	23.5
<b>Residents' deposits, billion tenge</b>	3874*	4167	5124
<b>Banks' credits to the economy, billion tenge</b>	7256*	8220	9848
<b>Level of monetization of the economy, %</b>	38.6*	31.6	33.1

**FORECAST OF BASIC MONETARY POLICY INDICATORS  
FOR 2008–2010 (PESSIMISTIC SCENARIO)**

*at end of period*

	<b>2007 (actual)</b>	<b>2008 (forecast)</b>	<b>2009 (forecast)</b>
<b>Inflation, %</b>			
- at end of year, %	18.8	7.9–9.9	7.5–9.5
- average for year, %	10.8	16.0–18.0	8.5–10.5
<b>Official refinancing rate, %</b>	11.0	8.0	6.0
<b>Reserve money, billion tenge</b>	1464	1410	1402
<i>change in %</i>	-2.5	-3.7	-0.6
<b>Money supply, billion tenge</b>	4614*	4088	4088
<i>change in %</i>	25.5*	-11.4	0.0
<b>Residents' deposits, billion tenge</b>	3874*	3384	3438
<b>Banks' credits to the economy, billion tenge</b>	7256*	6570	6656
<b>Level of monetization of the economy, %</b>	38.6*	28.0	25.6

\* according to preliminary data for 2007