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## **MONETARY POLICY GUIDILINES OF THE REPUBLIC OF KAZAKHSTAN FOR 2012**

### **Foreword**

The trends in the global economy in 2011 showed that actions taken by central banks and governments of the EU members and the USA as well as by other countries that were mostly hit by the economic crisis resulted in the temporary mitigation of its implications but didn't lead to recovery from the crisis. Besides, taken actions which consisted in providing liquidity to commercial banks, led to logical outcomes of such policy, mainly in boosting the inflation.

Contrary to the initial recessionary impetus of 2007-2008 which stemmed from the USA, now the Eurozone countries may be regarded as the epicenter of recessionary "impulses". Due to deep correlation of financial and economic relations between the regions, negative economic developments in one region immediately cause a knock-on effect in other regions.

According to preliminary data, GDP increased by 0.2% in the area of circulation of the common European currency (Euro) in the 3<sup>rd</sup> quarter of 2011. This appeared to be its worst performance since recovery after the recession of 2009. Sovereign debts of the peripheral countries remain high and the prospects of bankruptcies at the level of countries are already becoming a reality.

In May 2010 the European Union member countries made the decision to establish the European Financial Stability Facility ("the EFSF") – a special purpose vehicle to address the European sovereign debt crisis. Its objective is to preserve financial stability in the European Union by providing financial assistance to euro area Member States if needed. The assistance is expected mainly from the Asian countries.

In September 2011 the European Central Bank ("the ECB"), in coordination with the US Federal Reserve, the Bank of England, the Bank of Japan and the Swiss National Bank announced about conducting three tenders on the US dollar liquidity-providing operations to prevent liquidity problems. This action was aimed at providing financial resources to European banks.

To avoid the non-payment crisis and encourage economic growth, the U.S. Federal Reserve System ("the U.S. FRS") implemented two mitigation programs in the amount of about US\$ 1.6 trln. in 2008-2011. The quantitative easing programs are used as a monetary policy instrument by the governments when the interest rate of the country is so low that makes it unfeasible to use it to decrease the national currency exchange rate and increase the money supply.

Discount rates of central banks in the developed countries still remain low. However, in April 2011 the ECB raised the Euro discount rate for the first time in the last two years. It was raised by 25 basis points to 1.25%. No similar steps were followed by central banks of the US and UK since there are concerns that the economies of the two countries will not sustain the increase in the bank interest rate and will be in danger of entering into recession. At the same time it's obvious that such monetary policy of the developed countries will logically result in high inflation rates.

Inflation risks increased also due to the inflation "surge" in China which boosted centralized investments in its economy with a view to re-orient from the exporting to the stimulation of the domestic demand. Tremendous growth in the government investments resulted in significant acceleration of inflation in China and forced the Chinese Government to tighten its financial policy, which may inevitably lead to the decreased Chinese demand in the global markets.

In the context of such recessionary developments in the global economy the following factors of influence on the further operation of the Kazakh financial system appear – the access to foreign borrowings for commercial financial entities will remain limited (former donor countries which used to provide credit resources now are in need of such resources themselves); stagflation trends in the global economy are increasing. In general economic terms it should be mentioned that favorable pricing environment for major items of the Kazakhstan's export may change unpredictably affected by implications of the crisis.

Stable development of the Kazakh economy was driven by the above-mentioned factor of favorable prices of export items as well as by implementation of the anti-crisis program of the Government of the Republic of Kazakhstan and the National Bank of the Republic of Kazakhstan. Stable operation of the financial sector and the deposit base growth represent key indicators in this aspect.

The credit growth in the banking sector is observed for the first time in the last three years. Slow pace of credits to the economy is driven by low confidence of creditors in potential borrowers as well as by poor quality of the loan portfolio of banks.

Monetary policy measures coupled with actions taken by the Government of the Republic of Kazakhstan allowed slowing down the rates of inflationary processes which accelerated in the first half of the year as a result of external shocks. Already at end-October 2011 the annual inflation rate was back within the target band of 6-8%.

The described developments in the aggravation of crisis in the developed countries didn't affect the stability of the domestic currency in Kazakhstan owing to the implementation of the monetary policy aimed at preventing dramatic fluctuations of the Tenge exchange rate.

Sustainability of the Kazakh economy to possible upsurges of the global economic crisis is supported by the "safety margin" denominated in gold and foreign currency reserves of the country and the National Fund of the Republic of Kazakhstan.

## **1. Macroeconomic Development and Monetary Policy of the Republic of Kazakhstan in 2011**

### **1.1. Macroeconomic Development in 2011**

Since 2010 the Kazakh economy has been demonstrating fairly high growth rates. According to the operative data, real growth of GDP during 2011 accounted for 7.5%. In 2011 such sectors as agriculture, trade, and communication became the leaders in terms of growth rates of the physical volume.

A favorable pricing environment for major items of the Kazakhstan's export promoted the increase in the foreign trade volumes. According to preliminary data, in 2011 the current account balance ended with a profit of US\$ 13.6 bln. (or 7.3% of GDP). Foreign direct investments continue to inflow into Kazakhstan, with their volume amounting to US\$ 13.1 bln. by the end of 2011.

In 2011 the development of inflationary processes was characterized by some acceleration of inflation in the first half of 2011. Nonetheless, coordinated and efficient measures of the Government of the Republic of Kazakhstan and the National Bank of the Republic of Kazakhstan allowed bringing back the annual inflation rate to its target band of 6-8% established for 2011. By the end of 2011 the annual inflation was at 7.4% (in December 2010 – 7.8%).

The major reasons for acceleration of inflation in 2011 were caused by a number of problems and factors among which the unstable situation in the global commodity markets, growth of world prices for raw materials and food, inefficient pricing mechanism, and low competition in certain markets of goods and services appeared to be the most significant ones.

Moreover, the functioning of the Customs Union at this stage puts pressure on the pricing within Kazakhstan. In this respect, if the situation in the consumer market in Belarus doesn't have a significant impact on Kazakhstan due to small volumes of mutual trade, the Russian consumer market has certain impact on the inflation in Kazakhstan.

The monetary policy of the Republic of Kazakhstan was balanced in attaining the established targets. This was accompanied by maintaining money supply at a low level. By the end of 2011 the reserve money expanded by 10.3%, and growth rates of the money supply accounted for 15.0%, which is lower than nominal growth rates of the economy.

Positive dynamics in the development of the banking sector is observed that is accompanied by a gradual recovery of lending activity of banks. Banks repaid a major portion of their foreign debt. In this connection the domestic banks have low reliance on the external sources of credit resources.

After almost a three-year stagnation in the lending activity of banks, some credit growth was observed in 2011. So by the end of 2011 the volume of credits amounted to KZT 8.8 trln., having increased by 15.7% over the year. Credits in the domestic currency increased by 29.6% to KZT 5681.6 bln., and in foreign currency – decreased by 3.4% to KZT 3099.7 bln.

In 2011 deposits of residents which demonstrated positive dynamics were virtually the only source of funding for banks. So, during 2011 the volume of deposits of residents increased by 14.3% to KZT 8385.4 bln., where deposits of legal entities increased by 10.2%, and deposits of individuals – by 24.1%. During 2011 foreign currency deposits increased by 2.8% to KZT 2629.7 bln., and deposits in the national currency – by 20.5% to KZT 5755.7 bln.

With a view to improve sustainability of the domestic sources when building up the funding base of banks, ensuring stability of the financial system and protecting interests of depositors, in 2011 the National Bank of the Republic of Kazakhstan increased the capital of the Kazakhstan Deposit Insurance Fund by 10% to KZT 133.1 bln.

The enactment of the law on risk minimization in financial organizations will further strengthen confidence of the public in the financial sector. The law provides for retaining as permanent the guaranteed payout on deposits of individuals in the amount of KZT 5 mln. that was in effect until January 2012.

## **1.2. Monetary Policy of the Republic of Kazakhstan in 2011**

In 2011, the main objective of the National Bank of the Republic of Kazakhstan was to ensure the price stability in the country and to keep the annual inflation within 6-8%.

Monetary policy measures of the Republic of Kazakhstan allowed preserving the stability in the country's consumer market. By the end of 2011 the annual inflation was within the target range of 7.4%.

The trend of the national currency appreciation which started at the end of 2009 also continued at the beginning of 2011. The fluctuation range of the Tenge exchange rate was much narrower and its values were not approaching the thresholds of the currency band which was expanded in February 2010. Thus, the existence of the currency band in 2010 didn't play a significant role. In this connection, at end-February 2011 the National Bank of the Republic of Kazakhstan switched to the managed floating exchange rate regime of the Tenge with the cancellation of the currency band.

In mid-2011 the volatility of the exchange rate increased caused by certain destabilization of the situation in the global markets and the decreased oil prices. Since May 2011, the trend of the Tenge depreciation has outlined which increased in August and September 2011.

In order to prevent significant jumps in the exchange rate and to maintain stability in the foreign exchange market, the National Bank of the Republic of Kazakhstan played in the market both as a buyer and a seller of foreign currency, depending on the situation.

In 2011 the interest rate band of the National Bank of the Republic of Kazakhstan was changed. The changes affected the upper boundary of the band – the official refinancing rate. Given the increased inflationary pressure at the beginning of

the year, the National Bank of the Republic of Kazakhstan made the decision to increase the official refinancing rate from 7.0% to 7.5% from March 9, 2011.

The rate on deposits attracted from banks which serves as a lower boundary of the band of short-term money market rates remained unchanged throughout 2011 and was 0.5% on 7-day deposits and 1.0% – on one month deposits.

Interbank market rates remained within the interest rate band of the National Bank of the Republic of Kazakhstan closer to its lower boundary, which was to a larger extent related to low activity and excessive liquidity of the market players.

The National Bank of the Republic of Kazakhstan regulated short-term liquidity in the money market through the issue of short-term notes and attraction of deposits from banks. Despite the decrease in interest rates to the minimal level, the demand for such instruments on the part of banks remained high throughout the year.

Upon requests of individual banks, the National Bank of the Republic of Kazakhstan provided refinancing loans to support their current liquidity. The term of such operations didn't exceed 1 month.

The mechanism of minimum reserve requirements hasn't changed in 2011. Since May 31, 2011 the ratios of minimum reserve requirements for banks have been raised from 1.5% to 2.5% on domestic liabilities and from 2.5% to 4.5% on other liabilities.

Owing to the anti-crisis measures taken by the Government of the Republic of Kazakhstan and the National Bank of the Republic of Kazakhstan as well as due to a favorable environment in the global commodity markets, the recovery of economic growth in the country continued in 2011. At the same time, the GDP growth rates will be moderate in the mid-term. Alongside with that, in the mid-term the government's economic policy will be aimed at diversifying the economy and ensuring its growth of about 7%.

## **2. Scenarios for the Development of the Economy of the Republic of Kazakhstan for 2012-2014**

The National Bank of the Republic of Kazakhstan while elaborating the Monetary Policy Guidelines of the Republic of Kazakhstan studied the scenario forecasts for the three subsequent years.

The scenarios are synchronized and coordinated with the estimates made by the Government of the Republic of Kazakhstan when building up the Forecast for the Socio-Economic Development of Republic of Kazakhstan for 2012-2016.

Given the extent of impact on the Kazakh economy, an annual average level of the world oil prices was determined as a key criterion for distinguishing between scenarios when formulating the monetary policy for 2012-2014. Three scenarios for the development of macroeconomic situation were reviewed, which assume the following oil prices (Table 1)

Table 1

	2012			2013			2014		
	I	II	III	I	II	III	I	II	III
Oil price, <i>US Dollars per barrel</i>	40	90	100	40	70	100	40	70	100

The forecasts for the key monetary policy indicators of the Republic of Kazakhstan are based on the forecasts of the balance of payments<sup>1</sup> that are quite conservative.

Scenarios were designed based on the data from the Ministry of Economic Development and Trade of the Republic of Kazakhstan in respect of increased expenditures of the republic budget for social security and public welfare during 2012-2014. Such expenditures mean the increase in the aggregate demand that should be balanced by the relevant aggregate supply. The latter should be ensured by the production sphere as well as by appropriate measures for creating favorable conditions for the output growth.

In 2012-2014 the inflation background is expected to remain unchanged. As before, the major risks of acceleration of inflation are underdeveloped domestic competitive market environment, high monopolization of the market, poorly developed trade infrastructure as well as unstable situation in the global commodity markets. As for the global commodity markets, economic interests of Kazakhstan are primarily dependent on the world oil prices and, accordingly, fuel and lubricants. The latter have a double impact on the inflation rate – both indirect impact through prices for fuel and lubricants and through prices for other goods and services whose costs invariably include the cost of fuel and lubricants.

At the same time, the impact of monetary factors on the buildup of inflationary processes in the Republic of Kazakhstan will be minor in 2012-2014. This will be ensured by maintaining the money supply at an adequate level by the National Bank of the Republic of Kazakhstan.

**In the implementation of all scenarios concerning the development of the Kazakh economy in 2012-2014 the main objective of the National Bank of the Republic of Kazakhstan is to ensure the price stability, which implies that the inflation will be kept within the band of 6.0-8.0%.**

**Scenario One** – assumes pessimistic projections in case of deterioration of the situation in the global commodity and financial markets in the mid-term.

With the implementation of this Scenario, an insignificant contraction of the Kazakh economy is expected in 2012 with subsequent recovery in real growth of the economy to 2% in 2014.

Under this Scenario, the reduced business activity, contracted aggregate demand, deteriorated balance of payments performance and decreased money supply are anticipated.

<sup>1</sup> When doing the forecast for the balance of payments for 2012-2014, assumptions and expectations of ministries and agencies of the Republic of Kazakhstan in respect of incoming foreign investments in large projects existing at July-August 2011 were also taken into account.

The worst case scenario of the balance of payments takes into account a significant reduction in the export of goods by 45.1% to US\$ 43.1 bln. in 2012 and its subsequent growth by 2.2% to US\$ 44.1 bln. in 2014 as compared to 2012. The import of goods is also expected to reduce during the forecast period as a result of a slowdown in the growth rates and decreased revenues in the economy, by 23.4% to US\$ 30.4 bln. in 2012 with its subsequent minor growth to US\$ 31.3 bln. in 2014. Concurrently, the reduced export of goods will be also offset by the decrease in revenues payable to non-residents. For which reason, the current account deficit is expected not to exceed 5% of GDP throughout the forecast period.

Global financial markets will be generally closed for foreign borrowings. Nonetheless, during the initial years of the forecast period significant volumes of foreign investments in Kazakhstan will be observed that will be mainly ensured based on the earlier contracts including those intended for project financing under the Government Program of Forced Industrial and Innovation Development. In the environment of decreasing net revenues to the National Fund of the Republic of Kazakhstan and retained level of the guaranteed transfer to the national budget, an inflow of resources from foreign assets of the National Fund of the Republic of Kazakhstan will be observed in the reviewed period. The combination of the above factors will allow decreasing the outflows on the capital and finance account.

In 2012-2014 the overall balance of payments deficit will be at 2.5% of GDP, which will allow preserving international reserves at an adequate level to finance the import of goods and services.

The decreased money demand in the economy will be accompanied by reduced money supply in 2012. In 2013-2014 money supply will slightly increase however, its growth rates will be limited.

Multi-directional dynamics of money supply would be conducive to some decrease in the degree of monetization (Appendix 1).

According to the estimate made by the National Bank of the Republic of Kazakhstan, a probability of this scenario's implementation is rather low.

**Scenario Two** assumes certain stabilization of the situation in the global commodity and financial markets.

Should the *second scenario* be realized, oil prices would be higher as compared to the first scenario but lower than the actual price level of 2011. As a result, growth rates of the Kazakh economy in 2012-2014 will slow down as compared to 2011.

With the world price of oil at US\$ 90 per barrel in 2012 and US\$ 70 in 2013-2014, a positive trade balance is expected to be within US\$ 20-26 bln., which will be partially offset by revenue payouts to foreign investors. In general, the current account is expected to be in the range between (-)1.5% and (+)0.5% of GDP in the forecast period.

In 2012-2014, with an annual decrease in the inflow of direct investments to Kazakhstan, mainly due to decreased investments in the North-Caspian Project and decreased growth rates of foreign assets of the National Fund of the Republic of

Kazakhstan, the capital and finance account deficit (including “Errors and omissions”) will be decreasing.

As a result, under this balance of payments scenario the overall balance is expected to be negative within the range between (-)2% and (-)0.5% of GDP and international reserves of the National Bank of the Republic of Kazakhstan will decrease accordingly. However, they will be maintained at a level higher than their minimal required volume covering at least 3 months of import of goods and services.

The rates of expansion in the money supply will be adequate to the growth rates of nominal GDP in 2012-2014. Alongside with that, a more favorable macroeconomic situation supported by positive dynamics of the economic growth will promote the growth in the level of monetization (Appendix 1).

Under *Scenario Three*, the economic growth rates in Kazakhstan in 2012-2014 are expected at a higher level as compared to the preceding scenarios.

Under this balance of payments scenario based on the assumption that the world oil price would be US\$ 100, a positive effect of the corrective measures in the global economy and the continuation of trends which commenced in 2011 are expected. In doing so, significant export revenues will be offset by the increased demand for imports and revenues payable to non-residents. Based on that, the current account profit will be within the range of 2.0-4.0% of GDP in 2012-2014.

In the capital and finance account (including “Errors and omissions”) the growth in the deficit is anticipated, mainly because of the increased growth rates of foreign assets of the National Fund of the Republic of Kazakhstan.

As a result, the overall balance of payments in the forecast period is expected to be within the range of (-)0.5% to (+)1.0% of GDP, which will allow preserving the international reserves of the National Bank of the Republic of Kazakhstan at the level of end- 2011.

The demand for money will also appear to be higher as compared to the preceding scenarios. Since in 2012 significant growth in real and nominal GDP is expected whose growth rates will stabilize in 2013-2014, the dynamics of money supply will be somewhat ahead of the dynamics of nominal GDP thus ensuring the growth in monetization in the forecast period (Appendix 1).

*The National Bank of the Republic of Kazakhstan believes that the third scenario of the development of the Kazakh economy is most likely to be implemented. Based on these assumptions, monetary policy measures for 2012 have been developed.*

### **3. Monetary Policy of the Republic of Kazakhstan for 2012**

Due to unstable developments in foreign markets as well as given a short-term nature of the monetary policy implemented by the National Bank of the Republic of Kazakhstan, the decision was made to formulate the monetary policy of the Republic of Kazakhstan for 2012 only. Key monetary policy and balance of payments indicators including monetary policy measures for the subsequent years will be specified based on the performance in 2012.



Ensuring the price stability i.e. maintaining a low rate of annual inflation adequate to the macroeconomic assumptions will remain as a top-priority area in the activity of the National Bank of the Republic of Kazakhstan in its monetary policy implementation in 2012.

Despite the fact that the National Bank of the Republic of Kazakhstan determined the price stability as the main monetary policy objective, the transition to the inflation targeting principles is postponed to a longer-run horizon. In the near-term the main efforts will be made to improve and enhance the efficiency of monetary policy instruments and to further increase the impact of taken measures on the condition of the money market.

The National Bank of the Republic of Kazakhstan while implementing the monetary policy of the Republic of Kazakhstan will take measures for flexible regulation of money supply in the economy. In the event of short-term liquidity squeeze in the money market, the National Bank of the Republic of Kazakhstan will increase the volume of liquidity operations.

At the same time, the National Bank of the Republic of Kazakhstan will be striving to maintain the monetary component at the optimal level and ensure that it doesn't put additional inflationary pressure.

Short-term notes and deposits of banks with the National Bank of the Republic of Kazakhstan will remain as the main instruments for sterilization of excessive bank liquidity as well as for interest rate regulation in the financial market.

In 2012 the situation with liquidity in the money market will not cardinally change. Therefore, the maturities of these instruments are expected to be kept at the existing level: for short-term notes of the National Bank of the Republic of Kazakhstan – 3, 6 and 9 months, and for deposits attracted from banks – 7 days and 1 month.

Measures taken by the National Bank of the Republic of Kazakhstan will be aimed at enhancing the regulatory role of the interest rate policy and maintaining market rates in the market of short-term instruments within the interest rate band of the National Bank of the Republic of Kazakhstan.

Also, the possibility of a more efficient use of open market operations is considered, and optimal parameters (volumes, maturities, types of collateral) of liquidity provided to banks are analyzed. To this end, the National Bank of the Republic of Kazakhstan studies the experience of developed countries to consider using the best foreign practice in future.

In general, this will allow increasing the efficiency of liquidity management and regulation as well as building the yield curve of financial instruments in the money market.

As necessary, the National Bank of the Republic of Kazakhstan will provide refinancing loans to support short-term liquidity of banks. These operations will remain as short-term. At the same time, the National Bank of the Republic of Kazakhstan doesn't expect the increase in demand for such resources. The term of these operations will not exceed one year.

In 2012 the National Bank of the Republic of Kazakhstan will continue to improve the mechanism of minimum reserve requirements in terms of increasing the efficiency of its application.

The foreign exchange policy of the National Bank of the Republic of Kazakhstan is intended for providing a balance between the domestic and foreign competitiveness of the Kazakh economy. When implementing its exchange rate policy, the National Bank of the Republic of Kazakhstan will not allow significant fluctuations in the real exchange rate of the domestic currency that could have negative impact on the competitiveness of the domestic output in the ever-changing global market environment.

The exchange rate policy will be adequately responding to changes in world prices and terms of foreign trade thus establishing the foundation for the development of domestic economy. The country may tap into the accelerated development path by strictly adhering to this policy in combination with such factors as the use of new technologies and equipment and improved quality of labor.

Depending on an economic situation, the National Bank of the Republic of Kazakhstan will strive to further reduce its involvement in the foreign exchange market with a view to strengthen flexibility of the exchange rate of the Tenge.

In case of a cardinal change in the economic situation, dramatic and significant drop in the world energy prices and their retention at such level for a long period of time as well as the currency devaluation in the countries – major trading partners of the Republic of Kazakhstan, a dramatic change in the exchange rate of the Tenge is possible.

Irrespective of the economic development scenario monetary policy measures will be aimed at keeping the annual inflation rate within 6-8%. The increase in excessive money supply that boosts the inflationary pressure will be adequately offset by the growth in sterilization operations of the National Bank of the Republic of Kazakhstan.

The National Bank of the Republic of Kazakhstan will be applying any given monetary policy measures and foreign exchange policy measures taking account of integration processes occurring as part of the Common Economic Space.

**FORECAST OF KEY MONETARY POLICY INDICATORS  
FOR 2012 - 2014**

**SCENARIO ONE***(end of period)*

	2011	2012	2013	2014
	actual	forecast		
<b>Inflation, %</b>	7.4	6.0-8.0	6.0-8.0	6.0-8.0
<b>Official Refinancing Rate, %</b>	7.5	6.0-8.0	6.0-8.0	6.0-8.0
<b>Reserve Money, KZT bln.</b>	2 836	2 970	3 143	3 362
<b>Money Supply, KZT bln.</b>	9 751	9 821	10 356	11 049
<b>Deposits of Residents, KZT bln.</b>	8 385	8 502	8 964	9 561
<b>Credits to the Economy, KZT bln.</b>	8 781	7 873	8 283	8 731
<b>Monetization of the Economy, %</b>	35.7	36.4	39.4	39.3

**SCENARIO TWO***(end of period)*

	2011	2012	2013	2014
	actual	Forecast		
<b>Inflation, %</b>	7.4	6.0-8.0	6.0-8.0	6.0-8.0
<b>Official Refinancing Rate, %</b>	7.5	6.0-8.0	6.0-8.0	6.0-8.0
<b>Reserve Money, KZT bln.</b>	2 836	3 451	3 778	4 226
<b>Money Supply, KZT bln.</b>	9 751	11 525	12 633	14 149
<b>Deposits of Residents, KZT bln.</b>	8 385	9 995	10 959	12 277
<b>Credits to the Economy, KZT bln.</b>	8 781	9 233	10 082	11 283
<b>Monetization of the Economy, %</b>	35.7	36.8	40.0	40.0

**SCENARIO THREE***(end of period)*

	2011	2012	2013	2014
	actual	forecast		
<b>Inflation, %</b>	7.4	6.0-8.0	6.0-8.0	6.0-8.0
<b>Official Refinancing Rate, %</b>	7.5	6.0-8.0	6.0-8.0	6.0-8.0
<b>Reserve Money, KZT bln.</b>	2 836	3 559	3 968	4 464
<b>Money Supply, KZT bln.</b>	9 751	11 891	13 326	15 014
<b>Deposits of Residents, KZT bln.</b>	8 385	10 316	11 571	13 045
<b>Credits to the Economy, KZT bln.</b>	8 781	9 212	10 263	11 532
<b>Monetization of the Economy, %</b>	35.7	39.9	40.1	40.2