

## **Keynotes of Deputy Governor of the National Bank of Kazakhstan A. Baimagambetov Concerning Reasons Behind Increase in the Base Rate**

### **Concerning reasons behind increase in the base rate:**

The main goal of the National Bank is to maintain price stability in the country, and our main instrument is the base rate. Its rise was a logical response to acceleration of current inflation - in June it reached a record high of **7.9%**, **and need to lower inflation to the target range of 4-6% in 2022.**

I will point out right away that **growing inflation is not a local phenomenon**; in recent months, an increased pro-inflationary background has been reported globally. Growing inflation in Kazakhstan was caused by a negative impact of temporary and persistent internal and external factors.

### **Concerning internal and external factors that affected growing inflation**

First, prices for fuel and lubricants, electricity and certain food products have tangibly increased. With respect to a lot of items, growth pace of prices is calculated in double digits. Recovery in consumer demand has also urged forward the inflation.

Second, additional pressure on domestic prices is exerted by the so-called 'imported inflation' from Russia, one of our main trading partners. Prices are also rising rapidly in the neighboring country - inflation there accelerated to **6.5%**. This is the highest level for the last 5 years. In response to this, the Central Bank of Russia has raised the key rate several times over the past months, including the latest decision to raise the rate up to 6.5% at once by 100 bp.

Third, one of the most **global factors** affecting inflation in many countries is **growing global prices for raw materials and food products**. We have seen that the global food price index has been growing for about a year now, reflecting an active outstripping demand for all major food categories. According to the UN forecasts, this trend is expected to **continue in 2022 as well**.

Fourth, ongoing **fiscal stimulus** and **loose** monetary policy were also important factors behind rising prices. The world's central banks have cut their rates massively to provide an access to cheap financial resources to support economic recovery. Thanks to these financial incentives, easing quarantine restrictions, and large-scale vaccinations, business and consumer activity began to recover quickly. This led to a widespread increase in demand for goods and services and pushed prices up. Accordingly, inflationary expectations have also increased, hence is an extra pressure on prices.

On the whole, inflation dynamics is currently developing **above our forecasts**. The reason is imbalances in certain domestic food markets. Rising prices for non-food products and paid services, unfortunately, also develop slightly higher than we expect. Actively recovering consumer demand, including through the ongoing anti-crisis programs, supports the increased pro-inflationary trend. Thus, **growth of consumer imports** for 5 months of this year has already exceeded the

level of pre-covid **2019** by **30%**. And I compare not with the last 2020, in comparison with which we expect growth, but with the pre-crisis one that preceded it.

In these conditions, the National Bank raised the base rate in order to mitigate inflationary pressure. I would indicate that when we make monetary policy decisions, we take into account forecasts for formation of inflation and expect its return to the target corridor **4-6%** in **2022**.

#### **Concerning market expectations about decision on the base rate**

Outcomes of surveys conducted by business media reveal that respondents expected an increase in the rate. That is, experts rightly believed that tightening of monetary policy was inevitable in the current environment. That is why I believe that our solution met the market expectations.

It should be indicated here that the Monetary Policy Strategy 2030, adopted at the beginning of this year, stipulates that communication is an important component of the implementation of a policy of full-fledged inflation targeting. Therefore, we study the best practices, try them on to our realities and move towards greater transparency, consistency and predictability of our decisions to increase confidence in the National Bank. In our publications, we provide information about factors and prospects of inflation in Kazakhstan, present forecasts on which, in fact, decisions on monetary policy are based.

#### **Concerning response of Central Banks to growing inflation**

If we talk about situation in the global economy, it is still not so stable. Emergence of new coronavirus strains and uneven vaccinations around the world restrain recovery of the global economy.

However, many countries have already entered a positive growth zone, global demand is recovering, which accelerates the rise in prices amid limited supply.

Acceleration of price growth is observed in both emerging markets and developed countries, reaching **multi-year highs**. For example, in the United States, inflation reached **5.4%** for the first time since 2008. In the EU, with a target of 2%, inflation made **2.2%**, in China, after deflation at the beginning of this year, there is an acceleration of inflation (inflation accelerated to **1.1%**), in Russia, as I noted earlier, inflation reached record levels – **6.5%**.

Returning to your question, central banks of developed countries and emerging markets respond to acceleration of inflation in different ways. In developed countries, it is planned to reduce economic stimulus programs, in emerging markets, monetary conditions are gradually tightened.

All the EAEU countries, except for Kazakhstan, have already raised their policy rates in response to inflation - these are Russia, Armenia, Belarus, Kyrgyzstan. Since the beginning of the year, policy rates have been risen in many developing countries - Turkey, Brazil, Ukraine, Georgia and Tajikistan. In European

countries, rates were increased in Hungary and the Czech Republic. Overall, **18** central banks have raised policy rates since the beginning of the year.

### **Concerning timeliness of the decision to change base rate**

Decisions on the base rate are made 8 times a year. This allows us to regularly respond to changes in internal and external factors of inflation. Before making a decision, we always carefully analyze a macroeconomic situation in the country and in the external sector. Half of our decisions, they are called reference ones, are also made taking into account forecasts of macro indicators. We continuously look at how actual inflation is formed against its projected value.

For example, since the beginning of the year, actual inflation has been gradually decreasing and remained at the forecasted level. In particular, dynamics of food inflation gradually slowed down. Inflationary expectations of the population were also formed below actual inflation, giving stability to the balance of pro-inflationary risks. This stability allowed the National Bank to keep the base rate unchanged.

However, in recent months, inflation has significantly accelerated and in June this year reached its maximum value since February 2017 - **7.9%**, prospects for entering a target corridor of 4-6% worsened. This required taking actions on our part.

### **Concerning influence of monetary policy on prices and influence of administrative price regulation on inflation**

Monetary policy affects inflation through demand. The National Bank, by setting the base rate, influences consumer and savings behavior. For example, when rates go down, loans become more affordable and people start to consume and spend more. Opposite situation occurs when rates rise - deposits in tenge become more attractive and it is more profitable for people to save than to spend. This, in turn, will help reduce inflation.

Of course, I must admit that among inflation drivers that I listed at the very beginning of our interview, there are key factors on the supply side - imbalances in individual product markets - what we witnessed with vegetable prices, adjusting the economy and aligning gasoline prices with neighboring countries, and as a result, price for the entire segment of fuels and lubricants and others rose sharply. Of course, demand is actively recovering thanks to ongoing fiscal stimulus.

Therefore, the base rate is not a 'magic' wand, its increase will not eliminate factors of inflation growth on the supply side, systemic work of the Government, which is already underway, is important here. Along with that, in these conditions, an increase in the rate and a signal to the market about willingness to raise it further, if necessary, will help to maintain the level of deposit de-dollarization, support KZT exchange rate and cut off undesirable scenarios in the money and foreign exchange markets. As a result, excessive volatility of the KZT exchange rate will be eliminated which will have a stabilizing effect on inflationary processes.

As for administrative regulation of prices, in a period of significant short-term imbalances in supply and demand, indirect regulation methods can be useful. But these measures should be temporary. If administrative methods are long-term, then this discourages activity of producers, distorting price signals, an opposite effect may be achieved. In a market economy, price should be an indicator of the balance of supply and demand.

### **Concerning consequences of preservation of the base rate at the current level**

In current conditions, maintaining the base rate or lowering it would create significant pro-inflationary risks in the short and medium terms.

As an example I will mention the Central Bank of Turkey, which lowered its key rate to stimulate economic growth amid high inflation and the crisis onset. The decrease amounted to almost 16 pp from 24% to 8.25%. This led to further twisting of the inflationary spiral and the exchange rate weakening of the Turkish lira. All this actually negatively affected the economy: capital outflow from the country and the population welfare decline. The situation in the Turkish economy is still quite fragile and difficult. As a result, the rate had to be raised up to 19%.

I gave this example in order to demonstrate how consequences of an incorrectly chosen policy can be unpredictable and disastrous.

### **Concerning influence of the decision to increase the base rate on business activity amid tightening of quarantine restrictions**

Business activity in Kazakhstan is developing in line with expectations of the National Bank, and is recovering at a dynamic pace. Despite existing quarantine restrictions, in the second quarter of 2021, there was a positive trend in many industries and by the end of January-June of this year, the economy grew by **2.2%**. In general, we are moving in line with the forecast of **3.6-3.9%** at the end of 2021.

Growth in economic activity is first of all connected with a significant increase in trade, with a slower pace of contraction in mining and transportation. Increased activity in the service sector is supported by growing consumer demand amid rising incomes and wages, fiscal stimulus, as well as improving the situation on the labor market.

Construction continues to see a double-digit growth. In January-June, it rose by **11.9%**. This was facilitated by implementation of infrastructure and housing projects.

It should be pointed out that large-scale fiscal and quasi-fiscal incentives play a significant role in rhythmic recovery of economic activity in Kazakhstan. But as always, there is a reverse side of a coin in the form of increasing inflation and accelerating consumer imports up to 30%, which negatively affects the current account of the balance of payments. Unfortunately, the set of goods produced in Kazakhstan is limited and mainly represented by raw materials. This leads to a

persistent current account deficit of the balance of payments, which has been reported since 2015. In this regard, a part of our fiscal support is essentially consumed by imports and does not yield a desired effect.

It is worth mentioning that risks for economic recovery, in fact, persist. In many countries of the world, another increase in COVID-19 incidence has been reported. Kazakhstan is no exception. Restrictive measures are resumed, which, in turn, negatively affects business activity in services and industry.

By the way, this is a reason for well-considered decision to raise the rate by mere **25 bp**. Our task in this case is to prevent the inflationary spiral from being unleashed, while preserving both prospects for economic growth and space for further actions of the National Bank.

Overall, we believe that the increase in the base rate will contribute to stable economic growth and reduce risks of overheating economic activity.

### **Concerning timeframe for return of inflation to the target corridor**

To return inflation to the target corridor, we need to act simultaneously in two directions.

First, these are efforts of the National Bank itself, which will be focused to achieve inflation targets in the medium term. In order to ensure a systematic decrease in inflation, the National Bank will continue its monetary policy with a main emphasis on interest rate policy. Interest rate policy of the National Bank will be aimed at keeping market rates within the interest rate band of the base rate. The National Bank has a whole set of monetary policy instruments to regulate interest rates in the money market. The base rate remains the key one. It should be noted here that influence of the interest rate channel on inflationary processes is currently still limited, and we are striving to improve its efficiency. In the Monetary Policy Strategy 2030, we have foreseen a number of initiatives aimed at strengthening monetary framework, developing the financial market and implementing structural reforms to improve the effectiveness of macroeconomic policy.

Second, as we have said, there are a number of factors, mainly on the supply side, that are beyond the scope of monetary policy influence. In this regard, achieving the inflation target requires systemic measures from the Government. Priority tasks are to diversify the economy, saturate the consumer market with domestic goods, expand non-resource exports, and improve fiscal discipline. Work on anti-inflationary response measures set adoption is already being carried out in accordance with an instruction of the Head of State, which was given at an extended meeting of the Government on July 10 this year.

The joint implementation of measures by the Government and the National Bank will strengthen control over price growth and reduce inflation to the level of the target corridor in 2022. At the same time, our medium-term task set by the Head of State is to achieve inflation of **3-4%** in 2025.

## **Concerning stance of the National Bank with respect to further toughening of monetary policy**

The main priority for the National Bank in the medium term is to return inflation to the target corridor.

Half of our base rate decisions are accompanied by a forecast round, where we conduct a comprehensive analysis of existing risks and update forecasts of key macroeconomic indicators. If the risks in the economy continue to accumulate, the National Bank will manage the base rate in order to compensate for them.

As part of the next decision, we will see the economy, money and foreign exchange market reaction to the already made decisions, Government actions effect and local executive authorities on implementation of anti-inflationary measures set. It will be important to understand the seasonality recovery in the food market – how significantly prices will decrease in on the consumer market, what will be the inflation dynamics of non-food products amid continuing recovery in demand. Accordingly, our forecasts will be updated, and various scenarios for events development in the medium term will be considered. If necessary, the National Bank will be ready to consider a scenario of further tightening of the monetary policy.

The National Bank always keeps its finger on the pulse and is ready to take necessary measures to achieve the inflation target.

Full version of the video interview of NBK Deputy Governor A.Baimagambetov is available on Kazinform's YouTube channel.