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NATIONAL BANK OF THE REPUBLIC OF KAZAKHSTAN

MONETARY POLICY  
**STRATEGY**  
OF THE REPUBLIC OF KAZAKHSTAN  
2030

## **Chapter 1. Purpose and vision of the Monetary Policy Strategy of the Republic of Kazakhstan 2030**

The Monetary Policy Strategy of the Republic of Kazakhstan 2030 (“the Strategy”) has been prepared in execution of the instruction of the President of the Republic of Kazakhstan Mr. Tokayev K.K. following the session devoted to the country’s social and economic development as dated October 15, 2019, and based on the results of hearing of the National Bank’s Report for 2019.

The Strategy is aimed at increasing transparency of the policy of the National Bank of the Republic of Kazakhstan (“the National Bank”) with a view to strengthen the capacity of ensuring the price stability and reinforcing the basis of the inflation targeting regime in Kazakhstan. The Strategy sets key priorities and principles for the monetary policy implementation, thus enabling to raise public awareness and understanding of the National Bank’s activities.

Since 2015, as part of transition to the inflation targeting regime, the National Bank implemented four key elements (Annex 1):

- 1) adherence to a free floating exchange rate;
- 2) interest rate policy toolkit;
- 3) the decision-making process on the basis of macroeconomic analysis and forecasting system;
- 4) transparent communication of the monetary policy.

However, due to a moderate impact of the monetary policy on inflation processes, the existing inflation targeting regime may be characterized as a transitory one (lite inflation targeting). The following factors still represent constraints for the monetary policy: susceptibility of the domestic economy to external shocks as a result of its unbalanced structure, heavy dependence on imports in the presence of a wide raw material base, a pro-cyclical fiscal policy, government subsidies for lending to the economy on non-market conditions.

The Strategy provides for steps to be taken to overcome such constraints and develop the monetary policy frameworks in order to attain the full-fledged inflation targeting regime by 2030.

To ensure a further reinforcement of inflation targeting fundamentals, it is important to emphasize key principles of the National Bank’s role as part of the regime. These include the principle of operating, instrumental and administrative independence, which is manifested primarily in that the National Bank acts as a special institution possessing an exclusive right of the monetary policy implementation. In pursuing the communication policy, the principles of transparency and accountability must be observed. Hence, measures envisaged under the Strategy will be aimed at preserving and consolidating these principles.

### **Vision**

Completion of the transition to a full-fledged inflation targeting will allow creating favorable conditions for a sustainable growth of diversified economy which include high degree of confidence in the monetary policy pursued and, consequently, in the domestic currency; stabilization of inflation expectations as well as maintenance

of a floating exchange rate setting to promote a stable balance of payments and sufficient level of international reserves.

The monetary policy as one of the elements of the government's macroeconomic policy will be serving the purposes of maintaining and improving well-being of the population. It will continue to ensure a steady functioning of the economy and to attain the country's overall economic goals.

The highest-priority of the monetary policy will remain to ensure the price stability and to smooth cyclical fluctuations in economic activity through the impact of interest rates on the demand. The price stability will be achieved not only by reducing the actual inflation but also by stabilizing its long-term dynamics. A stable and low inflation will enable preserving the value of assets of the population and businesses as well as reducing the associated public costs. The second significant goal of the National Bank will be to ensure financial stability. Should risks for the financial system arise, the monetary policy will be aimed at increasing its stability (Annex 2).

It should be noted that the National Bank's reorganization by separating the Agency of the Republic of Kazakhstan for Regulation and Development of Financial Market ("the Agency"), during which functions and authorities were redistributed, enabled the National Bank to focus on its main goal – ensuring the price stability. One of the Agency's functions became to assist in ensuring the stability of the financial system. Therefore, there is no additional conflict between the objectives of the National Bank.

### **Inflation Targets**

As part of the task of ensuring price stability, it is important to set a medium-term inflation target. The medium-term goal (target) makes it clear what inflation to expect in the future, and thereby fulfills the task of reducing uncertainty for economic entities.

The monetary policy target from 2023 is to maintain annual inflation close to 5% in the medium term (Appendix 2-1).

Efforts to ensure the sustainable formation of annual inflation near the established target will contribute to increasing the trust of economic agents in the conducted monetary policy and help the medium-term target become a reliable benchmark for shaping expectations regarding future price growth.

International experience of countries demonstrates that an inflation targeting regime allows for successfully reducing inflation and maintaining it at a consistently low level. The majority of central banks that target inflation has achieved their set goals. Even when facing a situation where inflation deviated significantly from the target, central banks have managed to bring it back to the desired level. In countries with a long history of implementing inflation targeting, inflation, on average, remains close to the established target.

## **Chapter 2. Constraints for Effective Functioning of Inflation Targeting**

Effectiveness of the monetary policy instruments is largely dependent on the effectiveness of the monetary transmission channels that transmit the National Bank's signals of influence on the domestic economic processes including inflation. One of the key challenges for the National Bank's monetary policy at the current stage is the insufficient impact of the base rate on macroeconomic parameters. Most of the monetary transmission channels in Kazakhstan are not functioning effectively for certain reasons (Annex 3).

Efficiency of the interest rate channel is limited at two parallel stages: when the financial market rates are transmitted on the cost of banking products and when changes in short-term money market rates are transferred to interest rates on long-term instruments. The effect of the interest rate policy on the cost of banking products is limited by the presence of excess liquidity in the money market, which reduces incentives for banks to change the cost of their products (Annex 4). In addition, there is a distortion of the fair value of resources in the lending market. Building of a yield curve through a planned and regular issuance of government securities in the domestic market will enable to form a fair price benchmark of the cost of borrowing. Nonetheless, the interest rate channel, despite the factors limiting its efficacy, is still a key channel of the monetary policy impact on inflation processes. In this regard, most of the measures envisaged in the Strategy will be focused particularly on increasing the effectiveness of this transmission mechanism channel.

The effect exerted by the foreign exchange channel, i.e. by the exchange rate on inflation is asymmetric. Accordingly, depreciation of the tenge as opposed to its appreciation has a more considerable influence on consumer prices.

Functioning of the credit channel, which acts through the regulation of the volumes of bank reserves and, as a consequence, the change in their supply of loans, is currently distorted by a low lending activity and high credit risks. From 2016 to 2019, percentage of loans to the gross domestic product ("the GDP") decreased from 27% to 20%.

The inflation expectation channel is unstable due to a short duration of the period, during which a stable actual inflation is formed, and susceptibility of the expected inflation to short-term shocks in the external sector and in the domestic commodity markets.

The speed, extent and nature of impulses transmitted from the National Bank's instruments to inflation are determined by the economic environment in Kazakhstan, the financial system's structure and the degree of its development, and behavior of the economic entities.

In order to make the interest rate channel of the transmission mechanism more effective, a number of objectives for surmounting the existing constraints in the economy need to be achieved.

### **2.1. Unbalanced Structure of the Economy**

The structure of the economy of Kazakhstan is dominated by the mining industry and the service sector. The main portion of exports is accounted for by hydrocarbon

raw materials. In 2019, the share of primary exports in Kazakhstan reached 72.9% while the share of manufactured commodities went down to 19.9%. A low diversification of exports is also proved by 6.6% share of finished goods.

As a result, economic cycles have a close correlation with world prices of raw commodities. Along with that, volatility of their prices as well as the amount and frequency of shocks in the terms of trade have increased considerably over the last 20 years. The correlation between the oil price and exports accounts for 82%.

The dependency of the economy on raw materials exports leads to a significant volatility of export revenue affecting key macroeconomic indicators: the revenue side of the state budget, the country's balance of payments, the domestic foreign exchange market. As a result of the fall in world oil prices, a deficit on the current account of the balance of payments is expanding. In addition, a decline in the output of goods in the manufacturing industry and reduction of their exports serve as a side effect of an excessive concentration of exports in the primary sector ("the Dutch disease").

Shocks in the global commodity markets lead to the exchange rate fluctuations and influence the domestic prices through the pass-through effect. The increase in inflation, in turn, limits the effectiveness of the monetary policy instruments and results in the necessity to apply more rigid measures by the National Bank.

## **2.2. High Degree of Dollarization**

High financial dollarization reflects a low confidence in the implemented policy and is a consequence of the vulnerability of the national currency to external shocks leading to high inflation and devaluation expectations.

External shocks affecting the national currency lead economic agents to prefer foreign currency as a means of saving. Consequently, despite the decrease in the dollarization of deposits from 70% at the end of 2015 to 37.3% in December 2020, its level remains unstable and high. This creates a systemic imbalance in the demand and supply of foreign currency in the domestic foreign exchange market.

Dollarization reduces the effectiveness of the monetary policy, since the change in the base rate has a limited impact on the saving and investment decisions as well as on inflation because of a relatively low money supply in tenge, which is influenced by the monetary policy instruments.

In addition, the high level of dollarization increases the risks to the country's financial system (credit risk, foreign exchange risk, interest rate risk, default risk of borrowers, liquidity risk and others), limits lending in the national currency due to dominance of foreign currency resources in the funding base.

## **2.3. Insufficient Level of the Financial System Development**

Effectiveness of the transmission mechanism of the monetary policy in terms of the strength and speed of its impact on the economy and inflation is largely determined by the level of the financial sector development.

In Kazakhstan's economy, the financial market continues to develop owing to the increasing financial literacy of the financial service consumers, a broad implementation of new technologies, improvement of banking regulation, expansion of the range of financial services and increasing their affordability.

At the same time, the major portion of resources in the economy are currently distributed by banks. Therefore, the banking sector dominates in the country's financial system, where bank assets accounted for 44.5% of GDP at the end of 2020. Assets of other segments of the financial sector have a much lower share in the country's economy – assets of insurance organizations account for 2.1% of GDP, assets of the professional securities market participants – 0.7%, non-banking organizations – 1.8%, microfinance organizations – 0.7%, mortgage organizations – 1.9%. To this end, there is a potential for further development and improvement of the channels for transmission of impulses from the monetary policy to the economy through the instruments of the stock and insurance markets.

In recent years, the banking sector has strengthened its financial stability significantly. The quality of bank loan portfolios has improved, insolvent banks had been removed from the system. However, persistent credit risks still constrain bank lending. A short-term nature of attracted resources, dependence on resources of quasi-government organizations, the decreased number of creditworthy borrowers and the falling demand for bank loans because of the coronavirus pandemic and the changing economic conditions exert an additional constraining effect on the supply of loans and, as a consequence, on the banks' ability to react to changes in monetary conditions.

The effectiveness of monetary policy is limited by the level of development of cost indicators in financing long-term projects. Efforts to increase the market component in the risk-free yield curve for government securities, which sets the benchmark for long-term financial instruments, require continued coordination between the National Bank, the Ministry of Finance of the Republic of Kazakhstan, and market participants.

Therefore, improving the effectiveness of the credit and interest rate channels of monetary policy is possible through the development of alternative funding sources, primarily the securities market and insurance organizations, diversification and increased stability of bank funding, including the development of the capital market, as well as reducing credit risks in the economy and forming a benchmark for long-term financial instruments.

#### **2.4. Anticipatory growth of budget expenditures**

Fiscal policy, under conditions of soft budget constraints, has a stronger impact on household demand formation and consumer inflation than monetary policy, which influences demand indirectly through the banking system. Therefore, in order to achieve sustainable inflation reduction and maintain it at a low level, a commitment to fiscal discipline is critically important, with a focus on stabilizing government expenditures and restraining their growth rates.

The possibility of attracting transfers from the National Fund of the Republic of Kazakhstan (NF) creates conditions of soft budget constraints, which, along with the procyclical nature of budget policy regarding NF funds utilization, allows for an increase in government expenditures regardless of economic cycles. For instance, during 2015-2020, transfers from the NF accounted for about 36.8% of all revenues of the national budget.

Expenditure growth that outpaces the growth of nominal GDP reduces the coordination of fiscal and monetary policy goals. Moreover, an acceleration in the growth rate of government expenditures, not supported by corresponding productivity growth, along with insufficient countercyclicality of fiscal policy, undermines macroeconomic stability and restricts the achievement of monetary policy goals.

The significance of fiscal policy in macroeconomic stability and the need for measures from monetary policy are driven by the high share of the government in export revenues and the structure of aggregate demand. Insufficient countercyclicality of fiscal policy is exacerbated by the possibility of conducting quasi-fiscal operations that are not included in the budget perimeter. When the expansion of aggregate demand is not accompanied by sufficient growth in domestic aggregate supply, additional pressure on the balance of payments arises, thereby increasing the risks of exchange rate depreciation.

Thus, expansionary fiscal policy without an adequate level of discipline intensifies the risks of inflation increase (or insufficiently rapid reduction) and the failure to achieve target parameters.

Overcoming the aforementioned limitations can be achieved by enhancing both the declared and actual commitment to fiscal discipline through including all quasi-fiscal expenditures within the budget perimeter and implementing a formalized set of clear rules that neutralize fiscal policy deviations towards excessive spending and procyclicality, while ensuring the persuasiveness and predictability of the conducted policy. At the same time, fiscal policy should possess a sufficient level of flexibility to fulfill short-term budgetary obligations and adapt to unexpected sustainable shocks.

## **2.5. Government's Subsidy of Loan Interest Rates**

Another factor that reduces the effectiveness of the monetary policy is the inflow of a significant amount of liquidity to the economy at a rate below the base rate.

Reduction in the cost of money in the economy because of subsidies to certain categories of the business or to the population results in an uneven liquidity distribution in the economy, and creates unequal conditions in its access. An arbitrage in remuneration rates between the government and own funding sources appears resulting in the distortion of the cost of money. The impact of the monetary policy measures on the real sector becomes less effective, and efficiency of the interest rate and credit channels decreases.

The situation is aggravated by the fact that the National Bank is directly participating in these programs. In 2020, in view of the crisis caused by the coronavirus pandemic, the National Bank itself began to directly finance the economy at an alternative interest rate. This gives rise to a conflict of interest and bears significant risks for the monetary policy, including in terms of consistency of the policy pursued.

In the countries where the risk of deflation persists, central banks allow using non-standard monetary policy methods. However, these measures do not contradict to the policy implemented by such banks and do not create an alternative cost of money in the economy. In Kazakhstan, the risks that inflation might go beyond control and the specifics of the domestic economy limit the application of unorthodox measures and instruments. The implemented government economic support programs and

expenditures of the government and quasi-government sectors are largely generating an excess of short-term liquidity, which puts pressure on the money and foreign exchange markets. In these circumstances, the National Bank has to ensure effective binding of liquidity in the money market in order to prevent the overflow of resources to the foreign exchange market with a subsequent pressure on the exchange rate.

Given the growing government support, the market financing is going down. The government began to replace banks in lending to the economy. During 2015-2019, as part of various development and economic support programs, 6 trillion tenge had been allocated, of which 5.4 trillion tenge or 93% were funneled to financial support through the instruments of subsidies, guarantees and other facilities. Contracts worth 4.3 trillion tenge had been financed by subsidizing. The percentage of concessional loans in long-term loans to the business and small enterprises reached 30% of total loans provided.

The subsidizing of interest rates on bank loans reduces the efficiency of liquidity distribution and prevents both banks and the business from developing their own lending programs and creates unequal conditions for competition in the market.

## **2.6. Constraints on the Part of the Tariff Policy**

Since 2015, there is a tariff policy in the natural monopolies regarding the adoption of marginal long-term tariffs for 5 or more years that is aimed to ensure the balance of interests of consumers and holders of natural monopolies (“HNMs). At the same time, since 2018, measures have been taken to curb the planned growth in tariffs for regulated utility services to the population that was factored into the approved long-term 5-year tariffs by reducing the earlier planned non-priority arrangements of investment programs, introducing a temporary compensating tariff as well as differentiating the tariff based on consumer groups.

So, given the measures taken, since 2016, the actual contribution to inflation by tariffs for regulated services of HNMs had not exceeded the forecasting range.

Nonetheless, the curbing of tariffs for regulated services limits investment opportunities of HNMs, leads to an increased wear and tear of their PPE and represents a risk of inflation growth in future (risk of deferred inflation). Deferred growth of prices and tariffs, in turn, hampers a steady formation of inflation close to the established target reducing consistency and predictability of the National Bank’s policy.

In this regard, the Government is taking measures to ensure a phase-by-phase, well-balanced change of HNM’s for utility services to the population before the end of 2021. In the long view, in order to minimize risks of deferred inflation, it is necessary to ensure the annual observance of the band of the contribution to inflation from regulated services tariffs of HNMs.

## **2.7. High Share of Imports in the Consumption of Goods**

The dynamics of inflationary processes in Kazakhstan are significantly influenced by imports of goods whose share in the consumption has not been changed over several years. So, over the recent 5 years, the share of imports in the consumption of consumer goods has been ranging within 33-42% on average. The largest quantity



of imported goods is observed in the consumption of non-food products whose share increased from 63% in 2015 to 93% in 2019. At the same time, the share of imports in the consumption of foodstuffs increased from 16% in 2015 to 18% in 2019.

Despite the development and support of the domestic industrial enterprises engaged in food and beverages production, the demand for some consumer goods exceeds the domestic production and is partially covered by imported products. To a large extent, this is related to an insufficient level of food production with a high degree of processing, low productivity and yield in agriculture, a high percentage of private subsidiary farms (64% in meat production and 78% in milk production). Besides, scarce availability of modern vegetable storehouses, shortage of storage area, remoteness from production facilities and poor quality transportation lead to losses of agricultural production and its cost price increase.

The following phenomenon is observed in foreign trade of the manufacturing industry production: imports of processed goods from raw materials exported from the country. For instance, given the existence of a raw material base for the domestic production of finished products from ferrous metals, the potential for arranging the production chain within the country is not used. If the ratio between exports of ferrous metals and imports of their finished products was growing before 2017 and accounted for 2.44, it went down below 2 in the recent years.

### **Chapter 3. Key Priorities in Increasing Efficiency of the Monetary Policy**

This Chapter describes measures in three key areas that are required to build up a full-fledged inflation targeting regime in Kazakhstan:

- 1) reinforcing institutional and operational framework of the monetary policy for effective anchoring of inflation expectations;
- 2) enhancing the transmission of the monetary policy impulses through a sound and efficient financial sector;
- 3) and creating a favorable and structurally balanced macroeconomic environment supported by a strong fiscal discipline.

A successful and coordinated effort in these areas will promote a better efficiency of the monetary policy and, what is more important, will become the basis for sustainable development of Kazakhstan's economy.

#### **3.1. Reinforcing the Institutional Frameworks of the Monetary Policy Implementation**

##### **3.1.1. Establishing the Monetary Policy Committee of the National Bank**

Increasing the efficiency of the decision-making process is an important element in achieving transparency and predictability of the monetary policy. According to international experience of countries which set inflation targets, the level of policy interest rate is determined by a separate special-purpose body. The establishment of such body was recommended by the International Monetary Fund ("the IMF") as part of its mission in 2015 and was reflected in the IMF Staff Concluding Statement dated May 26, 2015.

In view of this objective, the Monetary Policy Committee of the National Bank was established in 2021. By the example of leading central banks, the main objective of the Committee is to make strategic decisions in the field of monetary policy – setting the base rate and its band. The status of the body was enshrined in law along with the National Bank’s Board and the Board of Directors.

In the medium term, the membership of the Committee will include independent experts, including experts from the academic community who specialize in the macroeconomics and monetary policy.

### **3.1.2. The National Bank’s Exiting from the Lending Programs Provided to the Economy**

In order to ensure that the National Bank’s monetary policy has a better effect on the economy, first of all, the problem of excess liquidity in the market that is often generated due to the government support of the economy needs to be resolved. It is necessary to refuse direct funding to the economy, for instance, by loan rate subsidizing while introducing alternative economic support measures, particularly, there is a need to shift the emphasis of the support measures from subsidizing to non-financial measures and guarantees in line with the international practices.

First, the National Bank needs to exit from the lending programs provided to the economy since its participation in such measures contradicts the main policy and emission financing and capitalization of subsidiaries not related to infrastructure development of the financial market limits opportunities of achieving the inflation targets. Moreover, the government financing of the economy must be implemented through the state budget or development institutes that do not belong to the National Bank.

The continued participation of the National Bank in lending programs creates risks of uncontrolled inflation growth, destabilization of the foreign exchange market and, as a result, leads to a decrease in long-term economic growth. Long-term international experience, taking into account the specifics of the central bank's activities and its functions, has shown that the best and high-quality contribution of any central bank to maintaining a balanced development of the economy and improving the welfare of society is to ensure low inflation rates. Lending to the economy should be formed as a natural process of interaction between the banking system and the real economy based on market conditions. The issuance of loans by the banking system depends on demand from the real economy, risk assessment by banks, profitability of potential borrowers and should be determined by banks' expectations regarding the profitability and solvency of borrowers.

From 2023, as long as the goals for diversification of exports and reduction of dependence on imports are attained, the National Bank will begin to gradually reduce its involvement in the government economic support programs. This process will be completed by 2025.

A successful development of financial markets is largely related to the formation of competitive environment where the cost of financial resources is determined on the basis of market principles. Therefore, it is important to eliminate distortions in pricing of financial resources by reducing the volumes of lending on concessional subsidized

interest rates.

In addition, in order to eliminate the existence of two parallel financial systems in the country, the practice of government financing of the economy and the business by institutions of the quasi-government sector should be ultimately stopped since the economy must be financed solely on the market-based principles through the financial sector in order to increase its efficiency, competitiveness and ensure a natural rehabilitation of the economy.

## **3.2. Enhancing Operating Framework of the Monetary Policy Implementation**

### **3.2.1. Strengthening the Floating Exchange Rate Regime**

With a view to strengthen the free floating exchange rate regime, the National Bank's presence in the foreign exchange market will be in line with market principles. These principles refer to the following operations:

1) operations with the Government of the Republic of Kazakhstan ("the Government") and on behalf of the NF. To ensure the allocation of resources from the NF to the state budget, the National Bank will continue to act on behalf of the NF in the foreign exchange market. In conducting operations with the NF's resources, the principle of market neutrality and transparency will be adhered. This implies regular and proportionate sales (or purchases) of foreign currency in the domestic foreign exchange market;

2) maintaining foreign exchange reserves at a sufficient level. The National Bank, based on the evaluation of adequacy of gold and foreign exchange reserves, may conduct foreign exchange operations in the market in order to maintain the reserves at a sufficient level. The institutional framework for such operations, including total earmarked volumes, the time-period and strict schedule for which they would be conducted will be presented in advance. Foreign exchange operations will be conducted on the basis of market principles that do not disrupt a normal functioning of the foreign exchange market;

3) smoothing volatility in the market. In exceptional cases, the National Bank may conduct one-time (single) operations in the domestic foreign exchange market with a view to smoothen sharp fluctuations of the exchange rate, restore confidence in the market and the pricing mechanisms. Foreign exchange interventions may be conducted in both directions on the basis of quantitative signals and indicators which control the quality of market operation and its liquidity. The National Bank will not be limiting reasonable volatility of the tenge. Interventions will be conducted to limit risks for financial stability when a sharp and significant movement of the exchange rate of the tenge can cause outflows of the tenge deposits and a liquidity overflow to the foreign exchange market, and to smoothen destabilizing short-term fluctuations of the exchange rate that do not have a fundamental basis;

4) all foreign exchange operations of the National Bank will be highlighted by public statements, press releases as well as regular publications. Depending on the nature of operations, information will contain the reasons, volumes and results of interventions.

The floating exchange rate policy will be resting upon the retention of a liberal foreign exchange regime promoting attractiveness of Kazakhstan's economy for foreign investors. Kazakhstan will keep adhering to its commitments to retain a liberal foreign exchange regime as part of the international agreements of the IMF, Eurasian Economic Union and the World Trade Organization. The National Bank will go on with its effort of increasing transparency of international transactions conducted in Kazakhstan.

### **3.2.2. Anchoring Inflation Expectations**

In 2016, the National Bank began to conduct monthly public polls of the population to assess their expectations. The results allow monitoring the consumer and saving behavior of the population, perception of price growth, expectations regarding inflation and their factors. Alongside with that, the National Bank also conducts a quarterly survey of enterprises in the real sector that includes questions about the expected inflation.

An important direction of monetary policy in the long term will be to influence inflation through managing inflation expectations and anchoring close to the medium-term target of 5%. Anchoring refers to managing the expectations of economic agents in such a way that the perceived (past) and expected (future) level of inflation is close to the target objective. The smaller the gap between actual inflation and inflation expectations, the higher the effectiveness of the conducted monetary policy and the lower the social costs of inflation.

The importance of anchoring the inflation expectations as part of the inflation targeting is that they are one of the factors for future pricing dynamics. The influence on inflation expectations will be achieved in two ways. First, this implies consistent and timely decisions on the monetary policy, which will help to decelerate the actual inflation. Second, an active and transparent communication policy aimed at increasing the confidence of the population and businesses to the National Bank's actions. These actions will promote gradual reduction of inflation expectations along with the dynamics of actual inflation. However, only stable maintenance of inflation close to the medium-term target of 5% can become a reliable long-term benchmark for the expectations of the population and enterprises.

### **3.2.3. Improving the Monetary Toolkit**

The monetary policy implementation implies the management of bank liquidity with a view to influence the money market rates and their convergence to the National Bank's base rate that is a key monetary policy instrument, determines the cost of resources in the economy and serves as a benchmark for market rates. In order to strengthen the role of the base rate, the National Bank has taken measures to enshrine its status in the legislation of the Republic of Kazakhstan.

Other National Bank's instruments will be used as add-on instruments in accordance with the policy's signals transmitted through the base rate. In order to regulate the bank liquidity, the National Bank will still consider credit and deposit auction operations carrying out the transmission of the base rate signal in the market as its priority instruments. These operations will be aimed to eliminate the liquidity

imbalance and are based on the forecast of the demand for cash balances. Standing facilities, together with the mechanism of the base rate band, will be limiting interest rate volatility in the money market and will be furthering their approximation with the base rate.

The National Bank will also get on with fine-tuning the minimum reserve requirement framework (“the MRR”). The fine-tuning of MRR framework will allow improving the quality of liquidity management.

### **3.2.4. Strengthening the Communication Policy Framework as Part of the Forward-looking Guidance**

With a view to improve confidence in the implemented monetary policy and foreign exchange policy, the National Bank has built quite an extensive communication system that increases transparency of its policy and instruments. Transparency, in turn, means a greater responsibility for achieving the inflation targets.

As part of the designed communication policy, the decisions about the base rate are highlighted in detail, including the reasons underlying each decision made, such as an expected inflation path, determinant factors and risks. The National Bank’s specialists hold meetings with the market experts; press releases with explanations of main decision-making factors. On a quarterly basis, the National Bank publishes its analytical review – Inflation Report, which contains the analysis of key macroeconomic factors influencing inflation as well as the forecast of macroeconomic parameters in the short- and medium-term perspective.

A detailed insight into the situation in the money market as well as other segments of the financial system is disclosed in monthly press releases about the situation in the financial market, and a quarterly analytical publication of the National Bank – the Financial Market Outlook.

Description of the situation in the foreign exchange market is provided. The data on the National Bank’s interventions is published on a monthly basis. When foreign exchange interventions are conducted, the information with the explanation of reasons, factors, the goal and volumes of interventions is published. In addition, from August 2019, the factors regarding the change in international reserves, foreign exchange flows and the factors governing the exchange rate formation are explained. The Overview of Currencies of Certain Developing Countries with the dynamics of the exchange rate of the tenge and currencies of other countries is published on a weekly basis with the explanation of reasons and factors for their change.

The National Bank conducts an active communication at the official web-site, in social networks and the mass media. Responses to questions regarding the National Bank’s activities are provided.

In future, the National Bank intends to proceed with the process of increasing openness and improving communications.

The National Bank sets ensuring confidence in the domestic currency and the financial system stability, enhancing the understanding of the National Bank’s measures by the population and the business, increasing accountability to the public, reducing uncertainty and information asymmetry, enhancing flexibility in the economy’s reaction to shocks as its key goals and objectives in improving the

communication policy. In its communications, the main emphasis will be made on covering the public at large since their expectations for price increase have a significant influence on future inflation. Hence, greater public awareness regarding the implemented monetary policy will enable the National Bank to have a better control of inflationary processes through the inflation expectations channel.

The existing list of information and analytical materials will be extended with the use of all information space available. This refers to materials that accompany the decisions about the base rate, quarterly analytical publications on inflation and the financial market, to highlighting of the situation in the foreign exchange market, information messages as part of activities on improvement of the monetary policy toolkit, interviews, and other publications.

In addition to extension of the published information, the National Bank will be considering the fine-tuning of its quality characteristics. In case of changes in the format of existing materials and preparation of new materials to publication, such aspects as clarity, simplicity of presentation, relevance, analytical value as well as compliance with the current trends in the economy will be taken into consideration.

As part of this effort, in 2020 the National Bank had updated the format of the Inflation Report as regards the extension of the section devoted to the monetary policy and regulator's actions and proceeded with the publication of the Monetary Policy Report ("the Report"). As appropriate, in the Report the National Bank will be providing a detailed explanation of the reasons for actual inflation to deviate from the target.

The purpose of the Report is a more detailed explanation to the expert community and the general public of the purport of measures taken in the field of the monetary policy. Such practice will enable to have a better understanding of the National Bank's policy, its goals and measures taken, which will help to strengthen the regulator's communication policy. In turn, understanding and confidence in the measures taken are important for increasing their efficiency.

In order to improve the communication policy, the National Bank will also rely on the international experience introducing effective practices of different central banks on a step-by-step basis. So, many central banks, in order to strengthen communication and ensure better transparency, began to use the so-called forward-looking guidance, which represents a disclosure of possible dynamics of the central bank instruments. The forward-looking guidance aims to match market expectations with the central bank's actual prospective intentions.

The National Bank has already implemented the elements of forward-looking guidance. Specifically, the medium-term forecasts of inflation and real GDP are published. Decisions on the base rate are accompanied with the explanations about intention to maintain the real interest rate at a level comparable with a long-term potential rate of the economic growth.

The National Bank is going to increase transparency of its policy providing the forecasts of a further monetary policy stance, which influences expectations of the economic entities and, as a consequence, the monetary conditions in the long-term perspective. Taking account of the degree of development and deepening of the financial market, after 2025 a formulation of the monetary policy in line with the

forward-looking guidance providing insight into the further dynamics of interest rates to the economic entities will be considered.

### **3.3. Financial Market**

#### **3.3.1. Developing an Efficient Financial Market**

This effort will be corresponding to the measures undertaken as part of implementation of the Concept Paper for the Development of the Financial Sector of the Republic of Kazakhstan 2030.

Diversification in financing of the economy through development of the stock market and insurance market including through the involvement of retail investors and including the reform of pension asset management will enable to expand the channels of monetary transmission mechanism.

Effective functioning of the banking sector will be promoted by the development of regulation of the financial system on the basis of risk-focused supervision with implementation of best international practices and based on the results of the conducted asset quality review (AQR). Along with that, prudential regulation of banks will be designed taking into account its liberalization required for the banking sector development and the balance between the coverage of risks arising in the course of lending to the real sector of the economy.

The process of financial technology development and digitization will be accelerating. At present, the financial market in Kazakhstan, being influenced by new technologies, is undergoing the digital transformation. Non-cash settlements will be used more extensively.

In this area, the National Bank, jointly with the Government, will be engaged in developing the national payment system and digital technologies in the payment market, expanding capacity in the use of services of non-bank organizations to increase efficiency and availability of payment services.

The National Bank, jointly with the stakeholders from the government authorities, will be working on the relevant legislative regulation to ensure the possibility for providing financial services in the digital format. Measures will be based on increasing the availability of financial services for the population and the business.

The development of financial technologies and digitization will create a new vector in the development of the financial market in Kazakhstan, providing conditions for innovations and a stronger competition in the financial market, reducing costs for the population and business entities as well as reducing the shadow economy.

#### **3.3.2. Increasing the Role of the Money Market as a Benchmark for Pricing of the Financial Market Products**

The efficiently functioning money market will be the foundation for the developed financial markets. It enables to fix the short-term segment of the yield curve and, consequently, reduce the interest rate volatility. Money markets ensure a consistent pricing of financial products and facilitate in setting a reference risk-free interest rate, which is necessary for designing floating rate instruments and financial derivatives.

The National Bank will continue to actively develop the money market, facilitating in setting a risk-free yield curve in the local financial markets. This work also includes the fine-tuning of the legal environment for repo and financial derivative markets, adoption of standard general agreements governing the collateral and marginal profit management.

The process of opening local financial markets for foreign investors will get on, by improving communication with global central securities depositories. The government program for privatization of Kazakhstani blue chips is also expected to promote the development of financial markets through attraction of foreign portfolio investments, the increase of liquidity and of the number of financial instruments.

### **3.3.3. Increasing Confidence in the Domestic Currency**

The next pre-requisite for an efficient monetary policy will be the growing confidence in the domestic currency, which is specifically reflected in a low level of dollarization.

The experience of developing countries shows that macroeconomic stability is one of the main factors for dedollarization. In order to strengthen the role of the tenge in the economy and to ensure an overflow of investors into the domestic currency securing a low inflation rate is paramount. To ensure a more effective achievement of the price stability, a transition to the inflation targeting was accomplished in conjunction with a flexible exchange rate. The monetary policy pursued on the principles of inflation targeting enables to effectively reduce inflation and maintain it at the level implying the price stability.

A flexible exchange rate with a focus on a low and stable inflation allows fighting dollarization in an efficient manner. It ensures consistency of the cost of tenge with internal and external fundamental factors, absorbs shocks and enables to avoid accumulation of imbalances in the economy.

To increase confidence in tenge and reduce the level of deposit dollarization, since September 2019 the “Kazakhstan Deposit Insurance Fund” JSC (“the KDIF”) has been fine-tuning the regulation mechanism of retail deposit rates, whereby the maximum rates on non-term deposits and also on short-term and saving deposits are set depending on the base rate of the National Bank of Kazakhstan, and rates on long-term deposits are determined depending on the market values. With a change of the methodology, interest rates in the retail deposit market over a short period reflect the interest rate that corresponds to the present value of money in the market, which helps improving transmission thus allowing banks to respond more quickly to existing macroeconomic conditions.

In future, deliberate work will be continued as part of a further dedollarization of the economy with a view to increase sustainability of the tenge and its role in the economy, which implies elaboration of concrete and effective measures in this area.

### **3.3.4. Making the Government Securities Market More Efficient**

In order to strengthen the interest rate transmission channel in terms of the yield curve of government securities, it is important to go on with normalization of the public borrowing market in the medium-term segment. It will help to form investor



expectations in the segment up to 5 years and will allow launching the process of market-based financing of long-term projects.

To increase liquidity of the government securities market, the National Bank is engaged in a joint and consistent effort with the Ministry of Finance. From 2020, the Ministry of Finance increased the volume of government securities issues with maturities from one to three years. This set in motion the process of a gradual rebalancing of the government securities market from the National Bank's notes towards government securities of the Ministry of Finance.

In general, development of the government securities market needs to be based on a consistent policy of the public debt management aimed to optimize the structure and predictability of government securities issues. The issuance of government securities must be carried out on market conditions with the reflection of the base rate level at key sections of the curve and ensuring an adequate depth of the market. Measures to develop and refine the framework of market makers and primary dealers have to be taken. Entry of government bonds into international indices will create prerequisites for attracting an inflow of global investments and developing the financial sector. The government securities market will be developing in close connection with the budget parameters while maintaining the country's debt sustainability.

In order to increase globalization of the securities market, a joint Action Plan for including government securities into international indices for 2020-2022 was designed. An active communication effort is underway. The process of integration of the local infrastructure into global financial markets is important for the monetary policy transmission mechanism and the domestic market development. It is the arbitrage facilities between the yields on equivalent domestic and foreign instruments that exert effect on the exchange rate channel of the transmission mechanism.

The improvement of the public debt management policy will remain a priority for building the risk-free yield curve, which serves as a benchmark for the corporate sector, and the interest rate channel of the monetary policy transmission.

The National Bank intends to get on with building a short-term segment of the yield curve and the Ministry of Finance – its medium-term and long-term sections through government securities placements. The buildup of the market-based yield curve will be achieved by 2025 through joint efforts of the two government agencies.

### **3.3.5. Reducing Credit Risks in Lending**

The basis for improving lending activity and strengthening the implemented monetary policy transmission into the banking sector is reducing the uncertainty in the economy that is factored into the cost of lending resources in the form of a risk premium.

The existence of high credit risks is one of the factors that restrain lending. Credit risks in the economy are still high. Reduction of credit risk on the part of banks was occurring due to contraction of the volume of loans with a high default risk and due to the improving loan decisions.

The following arrangements will help reducing credit risks:

a transition to the risk-focused supervision from 2019, with the right to apply a motivated judgment which will allow enhancing requirements to the internal risk management systems;

a well-established practice and methodology for assessment of asset quality of commercial banks which will strengthen and increase the quality of monitoring process over the banking sector's soundness;

An important area in reducing credit risks in the economy is to decrease the debt overburden of the real sector since it remains the main barrier for the credit growth. It's important to note that lending given the existing level of debt overburden in the economy is not the constraining factor for its growth. To a larger extent, it's restrained by the shortage of owner's equity of enterprises.

The majority of enterprises in the real sector, especially in the small and medium-sized business sector ("the SMB"), are in desperate need of the equity capital increase, have a high debt burden, a low level of liquidity and of return on investments. A stable solution to this systemic problem requires creating conditions for effective rehabilitation of enterprises in the real sector. Deficiencies of the business environment in the field of corporate bankruptcy need to be eliminated, and rights of entrepreneurs have to be reinforced. It is necessary to develop the frameworks for corporate insolvency, create conditions for its effective resolution in the interests of creditors and within the framework of the law.

At present, banks are not interested in initiating the bankruptcy procedures due to the length of procedures, the existing risk of a loss of collateral after the entry into such procedure. It is necessary to undertake further work in this area to ensure that the practice of enterprise rehabilitation and bankruptcy is in line with the best international standards. The key decisions in the bankruptcy procedure should be made by the creditors' meeting and the secured lender must have a priority right to take over the collateral.

The fine-tuning of the bankruptcy procedures will enable to remove insolvent companies from the market. An effective bankruptcy procedure will help reducing credit risks and the rate of non-performing loans, returning the secured property to the economic turnover and increasing affordability of lending.

In order to prevent the growth of bankrupt enterprises, inefficient companies should be limited in their access to a cheap borrowing. Government programs of concessional loans to MSBs should be reduced and requirements to the substantiation of government support should be increased. Concurrently, transparency of enterprises should be enhanced by introducing the information disclosure requirements, particularly of those, which received the government support including by using the stock market instruments.

It is also important for banks to increase the quality of credit underwriting so they could make well-considered decisions in providing loans to their borrowers. A further improvement of risk management and internal control systems of banks as well as strengthening responsibility of both the bank shareholders and managers for defaulting loans to their related parties will increase the quality of assessment and transparency of the decision-making thus enabling to reduce possible credit risks. As a result, addressing the set of specified problems will help to pursue a more effective

monetary policy through a sounder financial and real sector of the economy that is able to react to changes in monetary conditions in a timely fashion.

In the environment of unstable funding base, when depositors have an opportunity to withdraw their deposits earlier and deposit money at new, higher interest rates, banks have to control interest rate risks and liquidity risks. However, banks are not in a position to demand the repayment of disbursed loans ahead of schedule, which leads to the gaps in liquidity and interest rates. The existence of such gaps forces banks to provide a short-term financing that does not allow financing long-term investment projects of enterprises.

In order to encourage long-term investments, a stable funding base needs to be built with fixed maturities of liabilities through issuance of securities including bonds. This will enable banks to engage in a more long-term planning and investments into “long” projects.

### **3.4. Strengthening the Fundamentals of the Macroeconomic Policy**

Implementation of a responsible and consistent macroeconomic policy will become an important pre-requisite not only for an efficient monetary policy but will also ensure the growth of confidence of the economic entities in the domestic currency and reduction of dollarization. This requires implementation of systemic measures aimed at ensuring macroeconomic stability in the transition from an uncomplicated and low-productive GDP structure to the self-sufficient and diversified one.

#### **3.4.1. Diversification of Exports.**

Low diversification of Kazakhstan’s economy determines sensitivity of the balance of payments to external shocks. One of the main solutions of this problem is to build up non-primary exports with a focus on goods with a high value added.

Potential goods for building up non-primary exports include metal goods, products of the chemical industry, fuel and lubricants, construction materials, foodstuffs, products of the engineering industry, textiles, clothes and footwear, jewelry and haberdashery. These goods are characterized by existence of potential demand, pricing advantage and logistical accessibility of target markets.

The work on the buildup of non-primary exports and incorporation of enterprises into the global value-added chains must include consolidation and concentration of the government support measures on a new line of priority goods; a comprehensive work on development of the institutes of standardization, certification and quality control; strengthening the protection of interests of Kazakhstani business in the countries which have highest priority in terms of exports; assistance in finding trade partners and a help in conducting commercial negotiations.

#### **3.4.2. Reducing Dependence on Imports**

In order to make the balance of payments more viable, another structural problem that lies in a heavy dependence on imports needs to be addressed.

The domestic production is concentrated in the primary sector and does not fully satisfy the needs of the business and the population for finished goods. As a consequence, dependence of the Republic of Kazakhstan on imports is observed even

for relatively simple consumer goods that could be manufactured domestically in case of efficient and rational use of resources.

Potential commodities for import substitution include products from ferrous and non-ferrous metals, conductor products, construction materials, rubber ware, household cleaning products, toys for children, footwear, headwear, bags, sugar, vegetable oil, poultry meat, sausages, cheese, cottage cheese, apples, and fish. Availability of the raw material base, steady domestic demand and undeveloped product niches create pre-requisites for the substitution of imports of such products.

A full-scale reduction of dependence on imports, similar to diversification of exports, requires consolidation and concentration of the government support measures on the producers of priority products. The government support must be provided solely to competitive enterprises with a focus on greater innovations and production efficiency. The priority of the government programs should be to facilitate the access of Kazakhstani producers to large trading networks through improvement of infrastructure and reduction of transport and logistics costs of businesses.

Reduction of dependence on imports will allow filling up the domestic market with everyday products and will strengthen economic safety of the country. The pressure on macroeconomic indicators such as the current account on the balance of payments, exchange rate, inflation, GDP will decrease and the balance in the domestic foreign exchange market will be restored.

### **3.4.3. Improving the Fiscal Discipline and Counter-Cyclicality of Expenditures**

A well-balanced fiscal policy based on the fiscal discipline is one of the conditions for ensuring sustainable economic growth, allowing to better cope with cycles of growth and decline in the business activity, preventing the over-heating and avoiding the recession.

An optimal fiscal policy is determined by a formalized set of precise rules that determine main goals, which ensure credibility and predictability of the pursued policy. The policy must have a sufficient level of flexibility, both for ensuring the fulfillment of budgetary obligations over a short-term horizon and the possibility of adaptation to unexpected steady shocks.

In accordance with the Strategic Development Plan of the Republic of Kazakhstan until 2025, from 2021 the Government will implement fiscal rules that will contribute to a gradual decrease in non-oil deficit and limit the growth in government spending. In addition, in order to increase the productivity and develop the non-oil sectors of the economy, the structure of government spending needs to be optimized, while ensuring the priority of investment expenses.

The mechanism of counter-cyclical fiscal rules will be regulated by the Budget Code of the Republic of Kazakhstan and applied in the formation of the national budget for 2023. The counter-cyclical nature of the fiscal rules will enhance the economy's sustainability and ensure financial stability. The fiscal rules will also allow to formalize the rules and plans for conversion of the NF funds increasing transparency of the National Bank's operations in the foreign exchange market.

The construction of the fiscal rules should be subject to an on-going review and improvement, i.e. it should meet the requirements of the changing external and internal economic conditions.

#### **3.4.4. Transition to the Market-Based Government Support Measures**

A gradual exit from subsidizing the loan interest rates will increase the efficiency of resource allocations in the economy promoting the development of new banking products and reducing the dependence of the economy on the government support.

Stimulation of the economic growth through the government programs requires a revision of the existing support mechanisms with the reorientation of their goals and objectives. Those programs that have not been proven to be effective should be terminated. The government support can be temporarily provided to new enterprises at the stage of their establishment, but should in no way be a permanent window of access to cheap loans for them.

In the future, the development of competitive enterprises, which are not in need of a direct support from the government, requires the creation of conditions, i.e. enlargement of indirect business support instruments through fiscal stimulus, development of the business infrastructure, increase in investments in education and other non-targeted forms of support to the priority sectors.

From 2021, a stage-by-stage transition to indirect measures is planned to be initiated with the implementation of clear criteria for the government support to the business.

In order to increase the competitiveness of business, the practice of corporate governance in companies and businesses, commercial law and competition policy should be approximated to international standards in line with the guidelines of the Organization for Economic Cooperation and Development.

All of these measures will contribute to a significant improvement of effectiveness of the interest rate and credit channels of the transmission mechanism. This will allow improving the potential for easing the monetary policy as excess liquidity decreases and the market funding rises.

#### **3.4.5. Developing the Market-Based Tariff-Setting**

Creation of stable financial conditions for enterprise functioning is impossible without an adequate tariff policy and decisions on problems of pricing closely related to such policy. This creates basic premises for exchange and money distribution that exert influence on the economic development and the price growth.

Hence, in order to achieve a balance between the qualitative and sustainable growth and persistently low inflation, it is necessary to improve the anti-monopoly regulation, mechanisms of tariff pricing and competition protection aimed at ensuring the quality and reliability of services, control and verification of justification of expenditures with a sole purpose of protecting the interests of consumers and taxpayers.

The tariff regulation of natural monopolies must be carried out under the principle of ensuring the market returns and control over the operational and investment efficiency.

In order to enable suppliers to upgrade their capacities, a stage-by-stage and predictable change in tariffs is required while increasing the efficiency of the use of funds. At the same time, the rise in prices of regulated services should not put pressure on inflation. In this regard, the Government needs to take measures for effective control over implementation of investment programs with a view to provide an opportunity to earn a market- return on invested capital concurrently with the creation of incentives to reduce the prime cost of regulated services.

The Law of the Republic of Kazakhstan “On Natural Monopolies” provides for a stimulative method of tariff-setting aimed at encouraging entities to reduce operating costs, increasing the efficiency of operations, the quality and reliability of services they provide.

The essence of the method consists in abandoning the binding to actual costs and encouraging entities for innovations.

The tariff for services of natural monopoly entities is approved for five or more years depending on the increased efficiency of their operations and compliance with the quality standards of services, which, in turn, creates incentives for the enterprises to be cost-saving and to increase their efficiency.

The use of the stimulative method of tariff-setting will help to attract private investments into the housing and utility sector. In addition, the method will ensure transparency, predictability of tariffs both for the natural monopoly entities themselves and for enterprises in the industrial sector where utilities account for a significant portion in the prime cost of their products. At the same time, it is worth mentioning that the application of the stimulative method will be possible only in case of the economic and technical preparedness of the entities.

The above measures will result in a decreased volatility of the cost of paid services to the population. A smooth, anticipated growth of tariffs will help to reduce inflation expectations and slow down the overall inflation rate

#### **Chapter 4. Expected Outcomes**

Implementation of a full-fledged inflation targeting regime is a complex task, which requires measures to be taken not only by the National Bank, but also by the Government and the Agency. Therefore, in order to coordinate the monetary, fiscal and prudential policy, the National Bank, the Government and the Agency will communicate on a regular basis within the framework of trilateral agreement aimed at coordinating the macroeconomic policy measures.

The Strategy will be aimed to continue forming the inflation targeting system. The key elements of inflation targeting – the targets, modeling and forecasting system, the relevant toolkit, and the communication policy – have already been implemented.

Owing to the increased openness of the monetary policy, building of the dialogue with the public, achieving the stated objectives that underlie the inflation targeting regime, trust-based relationship between the public, the market and the National Bank will be established. This achievement will become one of the key outcomes in the implementation of a full-fledged inflation targeting regime.

In 2021, it is expected that inflation will stabilize after the shock of coronavirus epidemic and support for economic growth. From that time on, the National Bank and other state bodies will start their comprehensive effort on overcoming constraints for transition to a full-fledged inflation targeting regime.

The development and implementation of fiscal rules is planned to be completed already in 2021, which will allow synchronizing the monetary and fiscal policies within the framework of ensuring macroeconomic stability and supporting the economic development.

From 2021, work aimed at reducing dependence on imports and promoting the domestic products to foreign markets by integrating them into the global value-added chains is planned.

In addition, from 2021, a set of measures aimed at developing the financial system and the government securities market will start to be implemented. The building of the market-based yield curve as a result of joint measures of the National Bank and the Ministry of Finance will become a long-term benchmark for the cost of borrowing in the financial market, thus leading to the growth in the share of market investors in placement of government securities up to 30% by 2025. The affordability of credit resources will also increase, the cost of which will depend more on the dynamics of the base rate. By 2030, the loan portfolio of the banking sector will reach 40% of the country's GDP.

In 2021-2023, initiatives aimed to reduce the government's role in the economy will be realized. First, this initiative will include a stage-by-stage transition from the administrative regulation of tariffs for regulated services to the market pricing based on interests of consumers and suppliers. Second, there is a plan of gradual shift in the programs for subsidizing interest rates on loans towards non-financial support and guarantee measures, thus reducing the reliance of the economy on the government support. The National Bank will initiate the process to stop participating in the government loan programs from 2023 and will accomplish the process by 2025.

By 2025, the objectives of reducing the non-oil deficit up to the level not exceeding 6% are expected to be met. The National Bank will concentrate on building the market dynamics of the exchange rate that will support competitiveness of local producers furthering the development of various sectors of the economy.

By 2025, as a result of successful joint macroeconomic policy measures, the volume of non-primary sector will increase by 1.8 times and that in the manufacturing industry – by 1.5 times.

An important achievement of the National Bank's policy will be the reduction of inflation to 5% and its maintenance close to this level.

The National Bank's goal is also to anchor inflation expectations close to the inflation target. The National Bank will contribute to a gradual decrease and further stabilization of the level of inflation as perceived and expected by the population and enterprises. Not only a successful policy of reducing the actual inflation, but also a more active communication policy will serve as an important condition to achieve that goal. As a result of the measures taken, the expected inflation will be formed at the level of 5%.

A successful implementation of the entire set of measures and the attainment of main objectives will enable to form all necessary elements of the inflation targeting, which, in turn, will strengthen control over inflation processes and will make the formation of inflation at the target level a common thing. It will create a predictable environment for long-term investments in Kazakhstan's economy, lead to its development and will promote the well-being of the population.



## **Key Principles of Inflation Targeting Implemented Since 2015**

### **Floating Exchange Rate**

In the environment of openness and Kazakhstan's integration into the global trade, the policy of the free floating exchange rate of the tenge remains an important condition for sustainable economic development. Movements in the nominal exchange rate of the tenge allow offsetting negative external shocks and their spreading to the domestic economy, prevent the occurrence of imbalances in the economy, make a positive contribution to the country's export potential and impede depletion of international reserves. A flexible nominal exchange rate amid a persistently negative differential between inflation in Kazakhstan and in trading partner countries enables to minimize risks of an excessive appreciation of the real exchange rate ensuring its retention at a competitive level.

At the same time, due to the preserving high importance of the exchange rate for the economic entities as an indicator of changes in asset value and, respectively, the level of well-being, availability of a high portion of savings in foreign currency, dependence of the country's economy on the external world by reason of a significant volume of foreign trade turnover, the National Bank retains its presence in the domestic foreign exchange market, conducting direct foreign currency purchases or sales, if necessary. The National Bank's operations allow balancing the demand and supply for foreign currency, limiting the excessive movements of the exchange rate that are not caused by changes in fundamental factors<sup>1</sup>.

### **Interest Rate Policy Toolkit**

The National Bank has built an efficient toolkit, which may be successfully used both under normal conditions and in the event of a crisis.

The main instrument is the base rate and its interest rate band. Their establishment allows achieving the inflation target in the medium term and provides information about the direction of the monetary policy.

The presence of an interest rate band means that the National Bank on a permanent basis guarantees the access for banks to the short-term liquidity in tenge at a rate equivalent to the upper bound of the interest rate band of the base rate, and the ability to place funds on a deposit at a rate equal to the lower bound of the interest rate band.

The bank liquidity is regulated through the open market operations (short-term notes, deposit and credit auctions), standing facilities (deposits, direct repo operations and FX swap at the "Kazakhstan Stock Exchange" JSC ("the KASE")), and the MRR framework.

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<sup>1</sup> In the first half of 2016, the National Bank was primarily buying foreign exchange by cause of dedollarization of deposits. In 2017-2018, in certain months the National Bank was acting as a seller of foreign exchange due to a negative impact on the exchange rate from the foreign sector. Foreign exchange sales in February-March 2020 were intended to support the exchange rate in the environment of a dramatic decline in the global demand for oil and in oil prices.

An operating benchmark of the National Bank's operations in the money market is indicator TONIA (the weighted average interest rate on opening overnight repo transactions concluded on the stock exchange in the automatic repo market with government securities).

### **The Decision-Making Process on the Basis of the Macroeconomic Analysis and Forecasting System**

The National Bank has developed and implemented a flexible mechanism of changing the level of the base rate for a rapid adjustment to the changing environment.

Decisions on the base rate are made 8 times a year in accordance with the predetermined schedule, including 4 times – based on the results of the forecasting rounds. If necessary, the National Bank can make decisions on the base rate outside of the normal schedule<sup>2</sup>.

Decisions on the base rate are based on the results obtained by the National Bank as part of the Analysis and Forecasting System, which is intended for information and analytical support for the decisions to be made. Comprehensive analysis is conducted and main macroeconomic indicators, primarily inflation, are forecasted.

The central place in the system is occupied by the Quarterly Projection Model, which generates medium-term forecasts of the main macroeconomic indicators. The key advantage of this model is a possibility to study the consequences of the monetary policy implementation.

The National Bank publishes an inflation forecast for the next two years on a quarterly basis. The forecasting period is defined on the basis of assessment that over a two-year period the monetary policy signals are fully transmitted to the economy. The inflation forecast is indicative in the decision-making and is based on the assumption that the economy will be developing in line with the baseline scenario. This means that the National Bank does not react mechanically to changes in the inflation forecast, but considers a wide range of inflation factors.

### **Transparent Communication of the Monetary Policy**

The communication policy of the National Bank is focused on building a dialogue with the market and consists in ensuring transparency of the monetary policy pursued. Behind the transparency of the National Bank is a clear explanation of reasons underlying the decisions made, presentation of projections about the path of changes in key macroeconomic indicators, publication of statistical, analytical and research materials, thus enabling to reduce uncertainty and information asymmetry in the financial market, and generating rational expectations among the economic entities. Ultimately, a transparent communication policy is reflected in the ability of markets to correctly anticipate future monetary policy decisions, thereby increasing its predictability for the markets.

The communication policy emphasizes the priority of price stability in the activities of the National Bank, the importance and advantages of a flexible exchange

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<sup>2</sup> In March and April 2020, two extraordinary decisions had been made being driven by a drastic change in the situation in the global economy and the need for a rapid response from the National Bank.

rate, as well as risks that the economy of Kazakhstan might face and the expected reaction of the National Bank in case of their realization.

## **The National Bank's Role in the Country's Economic Development**

### **Achieving the Price Stability**

The main objective of the monetary policy implemented by the National Bank of Kazakhstan is to ensure the price stability in the Republic of Kazakhstan.

The stability means retaining a real value of assets by attaining and maintaining a low inflation rate which effectively anchors inflation expectations of the population and the business community. A low inflation helps to retain the purchasing capacity of earnings and attractiveness of long-term savings in the domestic currency. As a result, the trade-off between consumption and saving in the economy, and in case of saving – between the type of asset and the currency of saving, will depend on personal preferences of individuals. With a low inflation, a business can plan long-term investments and the cost of funding goes down. A steadily low inflation reduces the degree of asset dollarization, encourages pricing in the domestic currency, and decreases uncertainty in the economy.

The monetary policy allows achieving inflation goals. However, among its measures and instruments there are none that would have a direct impact on the economic growth or serve as a direct stimulus for such growth. On the contrary, a long-term trend of the economic growth is determined by fundamental structural factors on which the monetary policy has a limited influence.

The monetary policy measures are efficient for smoothing deviations from long-term tendencies in the economy that occur under the impact of various economic shocks. Therefore, the role of the National Bank's monetary policy is a stabilization i.e. the smoothing of macroeconomic fluctuations in order to support a stable growth without the overheating and recession: during the growth phase, stabilization does not allow the economy to overheat, and during recession, it stimulates the economic activity.

Under the conditions of a relatively stable environment in the external and internal sector, the National Bank will be ensuring the achievement of inflation targets on an on-going basis. Despite this, short-term deviations in the actual inflation from the target, both upward and downward, are allowed and do not mean that there are errors in the implemented policy. Volatility of inflation, especially in case of a small open economy and its vulnerability to external shocks, is natural. Such deviations will not necessarily require a response from the monetary policy since it may exert a serious negative effect on the economic growth prospects.

The National Bank in its activities will be taking into account the Government's economic policy and will facilitate its implementation unless it contradicts to the achievement of inflation targets.

Despite the fact that the monetary policy goal is to ensure the price stability, this goal cannot be achieved by sole efforts of the National Bank. Control over inflation processes is a complex task that requires measures to be taken by the Government and local executive authorities aimed to reduce the impact of a number of factors on the

part of demand and supply, which cannot be influenced by the National Bank through the implemented monetary policy.

### **Maintaining Financial Stability**

Monetary policy effective implementation is possible only if there is a stable functioning financial market and financial institutions. In doing so, macroprudential measures are the main tools for ensuring financial stability. The impact of the base rate on the financial sector is not a priority factor in monetary policy decisions. Nonetheless, in case of threats to the banking system operation, the monetary policy can be used to stabilize the situation in financial markets and promote reduction of risks to financial stability. This objective will be accomplished by using all necessary instruments of the National Bank that do not interfere with the monetary policy focus.

In general, the financial sector sustainability requires a well-balanced macroeconomic policy with an emphasis on ensuring the price stability. This also requires an adequate capitalization of banks. It will allow banks to effectively use their capital for making loans to the economy and absorb risks associated with lending. However, without an effective supervision, financial organizations tend to take on excessive and unjustified risks, which lead to unproductive lending, accumulation and intensification of risks.

The National Bank and the Agency are taking measures to rehabilitate the banking sector. Under this direction, work on banking risk management system development will be continued, in particular, the transition of the current regulatory regime to the Basel III principles is expected to be completed in terms of the capital adequacy and liquidity requirements. Besides, rehabilitation of the banking sector will be continued through the clean-up of bank balance sheets from non-performing loan and, if necessary, banks will be re-capitalized by their shareholders.

In addition to working with individual banks, the National Bank also monitors and assesses systemic risks of the banking system and develops measures (including prudential measures) aimed to reduce such risks. Successful implementation of this objective is based on the effective collaboration of the National Bank with the Agency and other state bodies. In this regard, the role of the Council for Financial Stability of the Republic of Kazakhstan as a collective body of interdepartmental cooperation on financial stability and reduction of systemic risks has been strengthened by law since 2020.

To minimize systemic risks, on an annual basis the National Bank classifies financial organizations as systemically important based on conducted assessment.

In addition, in order to maintain the financial sector's stability, the National Bank is ready to implement its function as the lender of last resort. The framework and principles for providing loans of last resort ("the LLR") were reinforced by the joint Resolution of the National Bank and the Agency. The lender-of-last resort framework implies an urgent provision of liquidity to an individual solvent bank which faces a liquidity shock, for example, as a result of a massive deposit withdrawal by panicking depositors.

## **Inflation target refinement**

The National Bank continuously conducts research to assess the compliance of the parameters of the monetary policy pursued with the structural features of inflationary processes in Kazakhstan. This becomes more relevant within the frame of dynamic global processes and a changing macroeconomic landscape.

In 2023, at the initiative of the National Bank, the research community conducted a series of independent assessments of the inflation target. For a comprehensive discussion of the inflation target being set, on April 25, 2023, the III International Scientific and Practical Conference of the National Bank was held on the topic: “Strategic Issues of Monetary Policy. Challenges of the New Economic Reality”. The conference was attended by independent experts in the field of economics and finance, as well as representatives of the National Bank, academic community, research centers, financial and international organizations, and government institutions.

Comprehensive assessments were conducted to determine the optimal target for inflation in Kazakhstan using various methods. The research results indicated that for Kazakhstan, as a small open economy with an emerging market economy, the inflation target should be higher than the level set earlier in 2021. At the same time, the range of estimates of a possible inflation target varies from 4.2% to 7%.

As a result, the National Bank has decided to adjust the previously announced inflation targets from 2023 by replacing the interval values with a point target. The target of the National Bank's monetary policy is to maintain annual inflation close to 5% in the medium term.

### **1. Inflation Targeting Format**

Based on international experience of countries implementing inflation targeting, the following types of inflation target indicators are distinguished: an interval without a given midpoint, a point target, and a variation of the point target with a range of permissible deviations. Around 60% of countries with inflation targets use a point target for inflation. However, among those employing a point target with a range of permissible deviations, the majority set the width of this range at +/-1 percentage point (Figures 1-2).

The advantage of a point inflation target, including a point target with a range of permissible deviations, lies in its clarity and the transmission of a clear signal to the market regarding the central bank's objective. The point target format is preferable in terms of communication, convenience, and anchoring of inflation expectations because it:

- 1) reduces uncertainty, provides clarity and transparency for the population, businesses and professional market participants regarding the objectives of the central bank policy;
- 2) clearly signals the central bank's commitment to achieving a specific target, its responsibility, and determination in using all available tools to achieve it;
- 3) enhances trust in the central bank and its monetary policy by providing a clear and measurable inflation goal. This enhances the anchoring of inflation

expectations and creates a more stable environment for investment and growth.

Setting a range of permissible deviations around the point target allows for a balance between predictability and flexibility in conducting monetary policy and also makes the accountability process of the central bank more transparent. Furthermore, the symmetry of the deviation range around the target point implies that it is equally important for the central bank to avoid inflation exceeding the upper bound of the range as well as falling below its lower bound. It is considered that a point target with a range of permissible deviations better reflects the fact that inflation is influenced by various shocks and cannot consistently reach the precise target from month to month.

Figure 1. Type of inflation targets used by emerging market economies

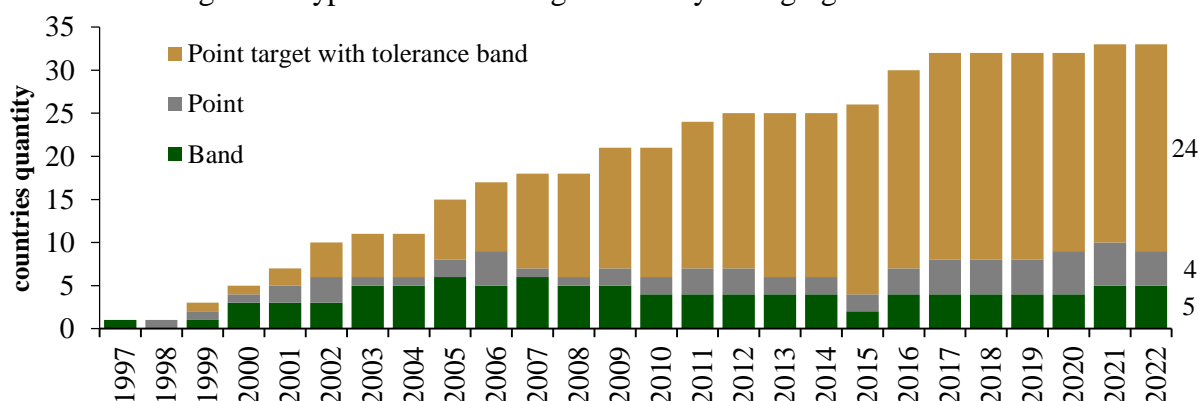
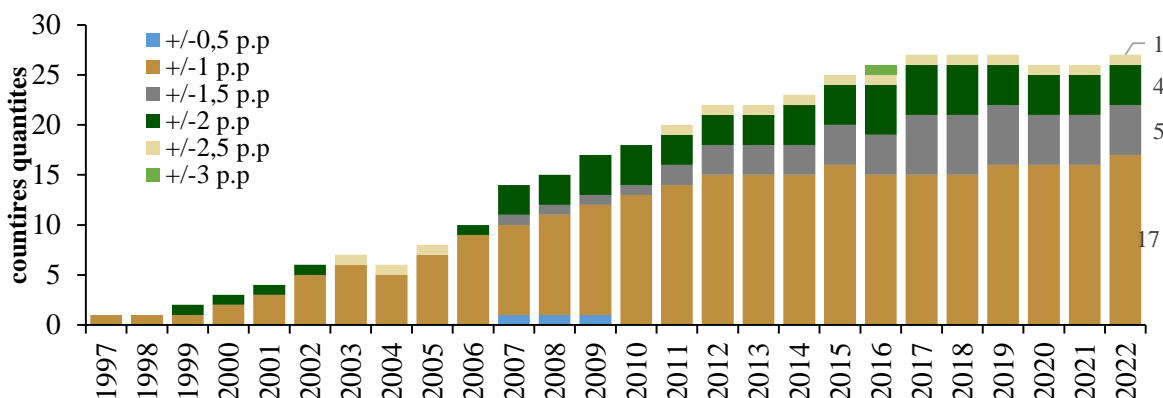


Figure 2. Type of inflation targets used by advanced economies



## 2. Results of studies on the assessment of possible inflation target

### 2.1. Model based on the size of the shadow economy

To account for the effects of the size of the shadow economy in estimating the inflation target for Kazakhstan, the model developed by Nicolini (1997)<sup>3</sup> was used. The model assumes a representative consumer who purchases goods from both the formal and informal sectors, with two types of goods. One type of goods requires cash payments, whereas the other type of goods uses non-cash methods. Goods purchased with cash in the informal sector are not subject to consumption tax, but in fact they are subject to inflation tax.

<sup>3</sup> Nicolini, J.P. (1998). "Tax evasion and the optimal inflation tax", *Journal of Development Economics*, 55(1), 215-232.

The Nicolini (1997) model was calibrated for Kazakhstan, based on the size of the informal economy, government expenditures in Kazakhstan, and the ratio of money supply to GDP. The key parameter is the relative intensity of cash usage in the informal and formal economy.

Based on the estimation results, the potential inflation level for Kazakhstan ranges from 4,2% до 6,5%<sup>4</sup>.

## 2.2 Model considering the heterogeneity of firms and products

The assessment of the inflation target level for Kazakhstan, taking into account the heterogeneity of firms and products, was carried out based on the methodology of Adam and Weber (2022)<sup>5</sup>. For most expenditure items in the consumer price index, the price of individual products decreases over the life cycle of a product, as measured relative to the average price of that expenditure item. This is closely related to the fact that there is significant product turnover. Typically, new products are initially expensive and become relatively cheaper over time. There is also high heterogeneity in the average rates of relative price decline over time, with some commodities declining more rapidly than others.

According to the results of the assessment, the level of the inflation target for Kazakhstan is estimated at about 5%<sup>4</sup>.

## 2.3 Price convergence according to the Balassa-Samuelson effect

The key implication of the Balassa-Samuelson effect is that countries with higher per capita income should experience higher relative price levels, which is well supported by empirical evidence.

At the same time, it is assumed that the inflation target level for developing countries will be higher than for the developed countries. Developing countries can demonstrate catch-up growth effects through higher rates of productivity growth utilizing land, labor, and capital. This effect leads to an increase in wages in both tradable and non-tradable sectors of the economy and ultimately to an increase in prices. Thus, in a developing economy experiencing high productivity growth rates, there is a faster per capita GDP growth, leading to higher inflation. In developed countries, productivity is already high, and increasing the pace of its growth is more challenging, therefore, GDP per capita grows at a slower rate, resulting in lower inflation. Estimations according to this method demonstrate the recommended inflation target level is about 5-6%<sup>4</sup>.

## 2.4. Model considering the level of financial development

To account for the level of financial development, a simple monetary model developed by Brunnermeier and Sannikov (2016)<sup>6</sup> was used to estimate the inflation target level for Kazakhstan, considering various assumptions about the level of financial development and idiosyncratic risk in the economy. In less developed financial markets, households and firms face greater uninsurable idiosyncratic (non-systematic) risk. Since money serves as a risk-free store of value, this can lead to

<sup>4</sup> «Economic Review of the National Bank of the Republic of Kazakhstan», Special issue, 2023

<sup>5</sup> Adam, K. & H. Weber (2022). «Estimating the optimal inflation target from trends in relative prices», American Economic Journal: Macroeconomics (forthcoming)

<sup>6</sup> Brunnermeier, M.K. & Y. Sannikov (2016). «On the optimal inflation rate», American Economic Review, 106(5), 484-489.



overinvestment in monetary savings and underinvestment in risky physical capital. The acceleration of money growth, which ultimately leads to higher inflation, reduces the incentive to hold money and increases the incentive to invest in riskier physical capital.

The model was evaluated using a 10% annual capital depreciation rate, a 5% annual time preference rate of households, and a 9% ratio of money to GDP for Kazakhstan. A key parameter of the model is the level of idiosyncratic, that is, non-systemic income risk faced by entrepreneurial households.

According to the results of the assessment, the inflation target level for Kazakhstan is estimated to be in the range of 6,5-7%<sup>7</sup>.

### **3. Inflation target**

Taking into account the research and analysis carried out, the National Bank has decided to adjust the previously announced inflation targets from 2023, replacing the interval values with a point target. The target of the National Bank's monetary policy will be to maintain annual inflation close to 5% in the medium term. In this case, the "medium term" takes into account the time lag in the transmission mechanism of monetary policy, since it takes some time for changes in monetary conditions to affect inflation. In the event of a significant deviation of inflation from the target, the National Bank will assess the causes and duration of the deviation and, based on this, take monetary policy measures to return inflation to the target. The trajectory of forecast inflation will be covered in the quarterly publication "Monetary Policy Report", which is published on the official website of the National Bank.

A point target without intermediate target levels will provide a clear and direct understanding of the goals of monetary policy. This will have a positive effect on anchoring inflation expectations and enhancing economic stability, as economic agents will have a clearer long-term orientation regarding the desired inflation level.

Efforts to achieve the inflation target will contribute to increasing the trust of economic agents in the conducted monetary policy and establishing the medium-term target as a reliable benchmark for shaping expectations regarding future price growth. To achieve the target and level the impact of monetary factors on inflation in the future, the National Bank will refrain from engaging in new emission financing for quasi-fiscal purposes (such as supporting the economy or banks). This will increase the probability of attaining the set objectives.

### **4. The Role of Inflation Forecasting in Monetary Policy**

The primary purpose of an inflation forecast is to communicate the medium-term trajectory of inflation, which is formed on the basis of current and expected base rate decisions aimed at achieving the inflation target. The forecast trajectory may change, while the target itself remains as a constant value.

In the period 2016-2019, as the inflation declined in line with the stated target trajectory, the inflation target performed its function of gradually anchoring inflationary expectations. However, as the gap between actual inflation and the target widened, the inflation forecast could inadvertently be interpreted as a target.

This approach created a situation where the official inflation benchmark was losing its power and receding into the background, while inflation targeting and

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<sup>7</sup> «Economic Review of the National Bank of the Republic of Kazakhstan», Special issue, 2023

inflation expectations were anchored on the path of the quarterly inflation forecast, which can change and is not a reliable anchoring point. At the same time, forecast communication is intended to indicate the trajectory and period during which inflation returns to the target.

The target will be permanent, understandable and achievable, creating the basis for anchoring inflation expectations by all economic entities.

Thus, the role of the inflation forecast as a tool for communicating the trajectory of achieving the inflation target in the medium term is outlined.

## **5. Communication Policy**

In 2022, within the frame of the development of the communication policy, the format of the press release on the establishment of the National Bank's base rate was improved. The role of the press release as a forward guidance tool was strengthened by emphasizing the National Bank's vision for the medium-term perspectives of monetary policy development. Press releases related to key decisions on the base rate (taken based on forecast rounds) were supplemented with essential macroeconomic forecasts presented in tabular form.

Since August 2022, the National Bank has been conducting and publishing a macroeconomic survey among professional market participants. The purpose of engaging in a dialogue with the professional expert community is to reduce the information asymmetry between the National Bank and the market. The respondents include professional market participants, research institutions, international organizations, as well as rating agencies involved in analyzing and forecasting macroeconomic indicators for Kazakhstan.

Regular meetings are held with both professional macro forecasters and media experts, during which the main factors of the taken decision and the vision of the professional expert community regarding the further development prospects of the economic situation are discussed.

The situation in the foreign exchange market is highlighted. Over the years of inflation targeting, the floating exchange rate has contributed to the softening and overcoming of the consequences of external shocks. Despite the initial tendency towards depreciation, the exchange rate dynamics, after the initial turbulence, began to play a stabilizing role in the economy. This factor played a significant role during the instability in the period of the COVID-19 pandemic. The initially increasing volatility has gradually transitioned to a new market equilibrium, allowing the Kazakhstani economy to remain on a sustainable growth trajectory.

Data on the National Bank's interventions are published on a monthly basis, and starting from 2023, detailed volumes of foreign currency purchases and sales are disclosed. Work has begun to improve communication quality with foreign investors by providing market information on Kazakhstan to international experts.

Furthermore, the focus of communication themes in the information field will be shifted from the exchange rate towards inflation, inflation expectations, and the base rate, and the main focus of communication efforts will be directed towards reaching a wide range of the population, as their price growth expectations significantly influence future inflation.

Also, the National Bank is improving its communication policy as part of the mission to enhance trust in the National Bank as an independent state institution pursuing a monetary policy capable of maintaining the attractiveness of the national currency, controlling inflation and inflation expectations.

### **6. Macroeconomic policy coordination**

Fiscal discipline is essential to macroeconomic stability in Kazakhstan. The presence of fiscal space allows the government to increase public spending and increase their role in the economy. Government spending, including quasi-fiscal and public sector spending, has a direct impact on aggregate demand and on the real exchange rate, much stronger than monetary policy, which operates indirectly through market institutions, historically weak and further weakened by fiscal intervention.

An increase in public sector spending at a rate that exceeds GDP growth and the inflation target inevitably leads to higher inflation than the target. Accordingly, the task of macroeconomic stabilization and inflation targeting in the conditions of Kazakhstan requires limiting the growth rate of government spending by the fiscal rule. Such a rule actually extends inflation targeting to fiscal policy and thus provides the minimum necessary level of coordination between fiscal and monetary policies, that is, at the target level.

Table 1

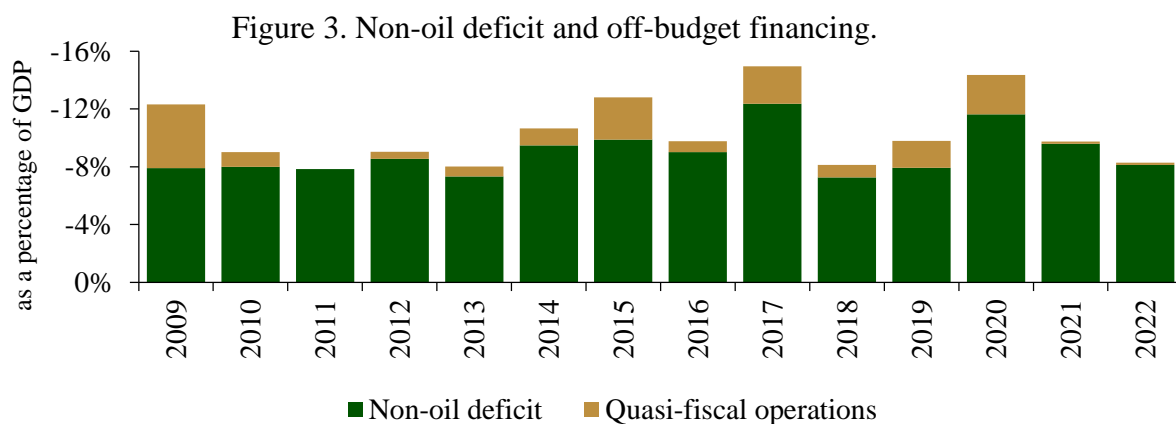
Republican budget expenditures in 2022

№	Period	Compound Annual Growth Rate
1	3 years	16,8%
2	5 years	15,4%
3	10 years	12,7%
4	15 years	14,1%

Under such conditions, the issue of coordination of fiscal and monetary policies comes to the fore on the macroeconomic agenda, and the prospects for macroeconomic stabilization depend on the validity and persuasiveness of fiscal rules and adherence to the adopted rules, the institutional environment that ensures their implementation, as well as the level of development of private property institutions, including fiduciary institutions of financial sector.

With a formal commitment to fiscal discipline, there are other sources of funding through the balance sheets of the public and quasi-fiscal sectors, which allow increasing spending outside the perimeter of the official budget (Figure 3). Operations of a quasi-fiscal nature have the same impact on aggregate demand and inflationary processes as budget expenditures. The choice of an insufficiently informative and inclusive method of consolidating public sector financial statements does not affect the actual level of aggregate demand, but may distort the idea of the role of quasi-fiscal operations, create additional degrees of freedom in the budget constraint, and weaken the effectiveness of fiscal rules and adherence to them. The maintenance of “soft budget constraints” in the future carries the risk of depleting the state’s net assets and,

as a result, reducing the possibilities for financing state obligations and the need to consolidate the expenditure side of the budget.



Sustainability and adherence to fiscal rules will require reducing dependence on oil revenues, improving the quality and predictability of tax administration, and increasing the transparency and accountability of quasi-fiscal operations.

These problems cannot be solved through administrative methods, they require understanding and agreement by a fairly wide range of stakeholders and, due to the high momentum of social processes, will require considerable time, which is the main factor in maintaining an increased inflationary background in the long term.

As part of the coordination of monetary and fiscal policy, in order to increase the efficiency of the government securities market, it is necessary to take measures to develop and improve the institution of market makers and primary dealers, include government bonds in international indices and further increase the globalization of the domestic government debt market, including through building an optimal settlement infrastructure with an international presence.

### 7. Fiscalization of bank losses

Financial regulation and supervision provide the conditions and environment without which a modern economy cannot function effectively. Supervisory efforts are primarily aimed at monitoring the quality of the loan portfolio of banks. Without proper supervision, bank lending activity becomes unproductive and dysfunctional. The weakening of supervision worsens the quality of credit decisions and the loan portfolio, leads to the loss of capital and deterioration in the quality of financial and regulatory reporting, bank losses and bank failures. Large-scale bank losses could lead to even greater losses throughout the economy, associated with unproductive activities of borrowers and inefficient allocation of other resources.

One of the consequences and manifestations of losses associated with the low quality of credit decisions of supervised banks is inflation. The most obvious mechanism for the formation of such inflation is the fiscalization (transfer of bank losses to the balance sheet of the public sector) of bank losses. Moral hazard, which manifests itself both in reducing the responsibility of shareholders and management of banks, and in the form of violations of financial discipline on the part of borrowers, ultimately worsens the quality and productivity of credit.

In turn, unproductive lending also has an inflationary effect through the growth of aggregate demand immediately after the loan is issued. Thus, reducing the risk of

bank insolvency and its effective resolution in case of insolvency are necessary conditions for macroeconomic stabilization.

### **8. Development of Market Tariff Formation**

Tariff regulation of natural monopolies should be based on the principle of ensuring market profitability and monitoring operational and investment efficiency.

However, over the past decades, investment in infrastructure has lagged far behind the needs of the economy. As a result, the reliability and quality of electricity, freedom of access to water, gas, information communications have deteriorated, the competitiveness and investment attractiveness of the economy have weakened.

The immediate cause of the deterioration of infrastructure was the low prices for the services of infrastructure companies. Infrastructure company prices should enable the company to earn market returns, but in practice are used to contain the contribution of regulated tariffs to inflation. However, as a result of the tariff policy pursued, the price of the basket of regulated services decreased relative to the price of the rest of the consumer basket and relative to the average salary.

As a result of chronic underinvestment in fixed assets, their depreciation and obsolescence have reached a critical level. Infrastructural companies are unable to update equipment in a timely manner, introduce new technologies, raise wages for employees, which reduces the quality and availability of services provided to the population and businesses. Poor quality and reliability of infrastructure is a form of hidden inflation, with more severe negative consequences for long-term human and economic development.

Eliminating the accumulated debt of deferred investments will require several years of increased investment spending from the sector and increase the inflationary background. Thus, in conditions of high pressure on the existing infrastructure, the increase in prices for regulated housing and communal services is a necessary measure and will be partially implemented within the framework of the new program of the Government of the Republic of Kazakhstan “Tariff in exchange for investment”. A stepwise increase in tariffs will partially and temporarily eliminate the accumulated price distortion, but is far from a systemic sustainable solution. In the medium and long term, administrative price regulation measures have a detrimental effect on the economy, both in terms of the development of industries and in terms of the formation of inflationary processes.

To return to their original positions, the relative price of regulated services must be increased. In addition to utility tariffs, there will be a transition to market pricing in the fuel and lubricants market. Amid the permanent disparity between domestic and foreign prices, primarily with neighboring countries, there is an outflow of oil products, which creates supply imbalances in the domestic market, creating upward pressure on prices.

The increase in regulated prices will certainly be inflationary on the supply side, but will eliminate long-standing distortions in the terms of trade between the regulated and unregulated sectors.

The inflationary effect will be temporary and will last during the adjustment of relative prices. Fuel and regulated utilities enter the consumer price basket on their

own, and increasing them would directly increase the cost of the basket. In addition, regulated goods and services affect the cost of almost all final goods and services.

The effect of rising relative prices will be more long-term and definitely healthy, as it will create conditions for attracting market financing to infrastructure, which will remove one of the barriers to growth.

Tariff regulation of natural monopolies should be based on the principle of ensuring market return on invested capital and controlling the validity of operating and investment costs. In order to fulfill this mandate, the regulation of infrastructure companies must be independent of the authorities responsible for macroeconomic stability, social protection tasks and other government bodies, and the efficiency and soundness of investment spending must be ensured as part of a long-term plan for the development of productive forces. To achieve a balance between high-quality and sustainable growth and sustainably low inflation, it is necessary to improve antitrust regulation, tariff pricing mechanisms and competition protection aimed at ensuring the quality and reliability of services, control and verification of the reasonableness of costs, with the main purpose of protecting the interests of consumers and taxpayers.

At the same time, the planned increase in regulated tariffs is not large enough and not sustainable enough to allow infrastructure companies to raise market capital to finance investment spending. Discretion, weak institutional support and extreme unpopularity of the decision indicate a high risk of a rollback to established tariff setting practices.

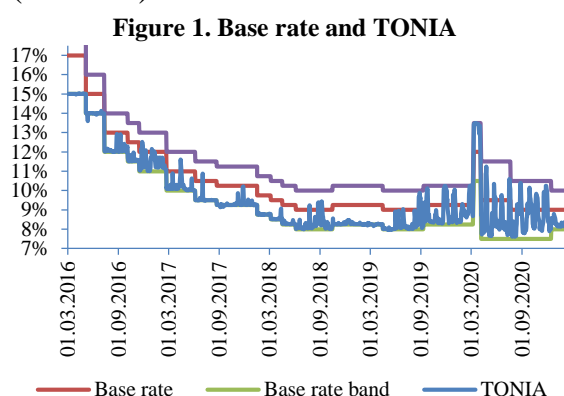
The National Bank will continue to adhere to the policy of ensuring price stability. Due to the fact that the direct effect of price increases in the respective categories of the consumer price index is predetermined and will be of a short-term nature, the main measures of the National Bank will be aimed at limiting the indirect effect and preventing excessive growth of inflationary expectations. Thus, in the medium term, the introduction of market pricing in the above sectors will ensure the stable functioning of the relevant enterprises and reduce price volatility.

## The Monetary Policy Transmission Mechanism in Kazakhstan

A key monetary policy instrument of the National Bank is the base rate, which affects the market rates through interest rates on the money market. Influence of the base rate on inflation and the economic activity consists of several stages and has a certain impact lag<sup>8</sup>.

### I. The pass-through of the base rate onto interest rates of the wholesale<sup>9</sup> money market.

The National Bank possesses a set of instruments through which it controls, depending on the level of the base rate, the operating target – an overnight repo rate (TONIA) at the KASE.



It is important to mention that the repo market accounts for a major part of operations (75% in 2020) at the KASE where virtually all transactions in the financial market of the Republic of Kazakhstan are conducted except interbank transactions and some operations in the primary market of liquidity (the share of the swap market accounts for 8%, and the foreign exchange market – 10%).

After a change of the base rate by the impact of instruments on the operating target (repo/TONIA overnight rate), the money market rates are changing.

Given a structural liquidity surplus, the TONIA is mainly formed between the lower boundary of the interest rate band and the base rate. Changes in the base rate are reflected on short-term money market rates quickly enough.

In turn, the pass-through of short-term money market rates onto the rates on longer-term instruments requires more time and is determined not only by an actual reduction or increase of short rate but also by other factors including expectations among the market participants regarding their future dynamics, the existing risks in the economy (the degree of uncertainty in the economy that generates the risk premium, the level of debt burden in the real sector, financial stability of enterprises, the level of capitalization and liquidity, return on investments at enterprises), and so on.

At this stage, the expectations channel for base rate changes is an important element that forms long-term interest rates in the securities market and, consequently, the yield curve, which determines the value of long funds. For instance, when the market participants anticipate the tightening of monetary conditions in the form of the base rate increase, the market participants will demand a higher yield from the

<sup>8</sup> According to studies performed by T. Havranek, M. Rusnak “Transmission lags of monetary policy: a meta-analysis” (2013, the Czech Central Bank), the lag in time of the monetary policy transmission in developing economies varies from 10 to 20 months.

<sup>9</sup> **Wholesale money market** is limited by companies and financial institutions, that provide loans and borrow in large amounts. In this context, the **retail market** implies the market of lending and borrowing by financial institutions in their communication with clients (the population and businesses) in relatively small amounts.

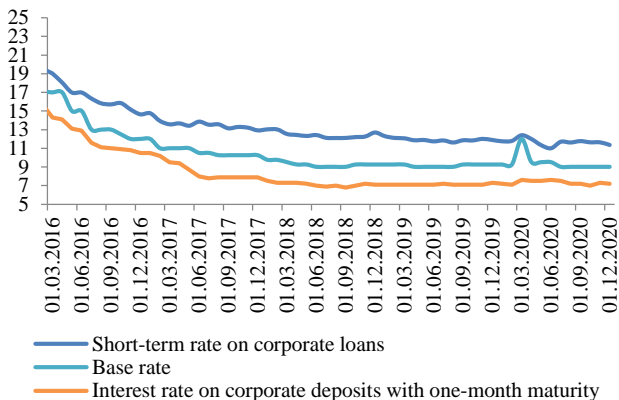
securities issuer, and, counter wise, expectations about an easing of the monetary policy result in a reduced yield on securities.

At present, the building of the yield curve in Kazakhstan is at the initial stage. Before transition to the inflation targeting, the curve was not a reliable reflection of investor expectations, market participants were forming their expectations about the cost of risk-free capital in isolation from interest rates in the short-term repo market. After the National Bank started to target short-term rates, a short-term segment of the curve had formed, thus allowing the market to build the yield curve based on interest rates on the National Bank's notes. However, in order to build a yield curve over one year, the medium-term and long-term securities with a market rate need to be placed.

## II Stage. Transmission of money (wholesale) market rates onto the value of various banking products (customer deposits and loans, corporate securities, and others).

At this stage, a pass-through of the money market rates onto the cost of retail financial products occurs by the pass-through of short-term interest rates onto rates on longer-term instruments.

Figure 2. Base rate and interest rates on loans, deposits



Since the banking sector dominates in the financial system of Kazakhstan with assets exceeding 40% of GDP, it is the banking sector that is playing an important role in the monetary policy transmission mechanism in the Republic of Kazakhstan (assets of insurance organizations to GDP account for 2.1%, assets of the professional securities market participants – 0.47%, of non-bank organizations – 1.8%, microfinance organizations – 0.7%, and of mortgage organizations – 1.9%).

In bank liabilities (26.5 trillion tenge as at 01.12.2020), customer deposits account for 79%, securities – for 7%, and other liabilities vary between 0.2-2.1%. This means that banks in the Republic of Kazakhstan are mainly funded with customer deposits.

After the change in the base rate, interest rates on bank deposits are gradually re-adjusted. As the base rate and TONIA decrease, the interest rate on corporate deposits in tenge declines. The National Bank, through its impact on the TONIA rate, influences more than 80% of deposits attracted in tenge on a monthly basis that is on the cost of the bulk of bank funding.

The cost of deposits, which represent the main source of bank funding, affects the loan pricing. Further, the pass-through of interest rates onto the cost of bank loans affects corporate loans.

Banks, given the decreasing cost of funding, reduce the interest rate on short-term corporate loans in the domestic currency, where their average share in 2020 accounted for 50% of loans in tenge. Therefore, the bulk of loans provided in the domestic currency was under the influence of the National Bank's instruments.



However, the strength and speed of the pass-through is decreasing as the loan tenors become longer.

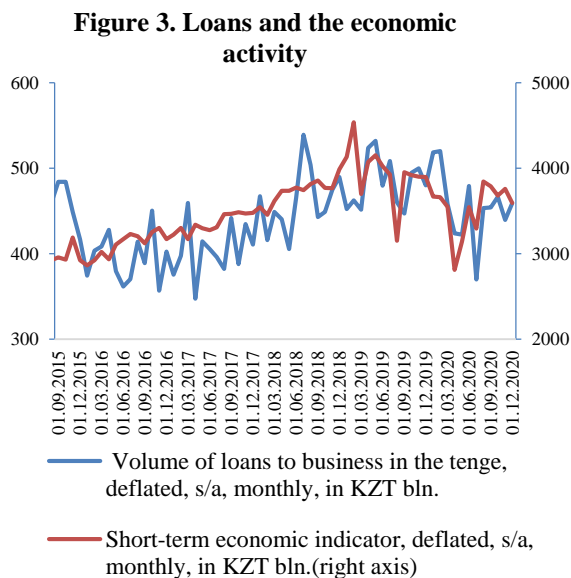
In the retail segment of the deposit market, the interest rate pass-through is limited because of a high-risk business model of banks. So, historically there has been a competition for depositors where unstable banks are leading by increasing the rates of deposit-taking. This leads to the fact that other banks also increase their rates in the pursuit of depositors.

However, when the KDIF developed the regulation of retail deposit rates from September 2019 by setting interest rates on non-term, term and savings deposits with short terms depending on the base rate of the National Bank, transmission as regards retail deposits has been improving.

In the retail segment of the credit market, interest rates are feebly reacting to changes in the money market rates due to the domination of consumer loans, which present more risks as compared to the corporate sector (unsecured lending) also because of a lack of collateral as well as low earnings.

### III. The pass-through of loan interest rates onto lending volumes and their subsequent transmission onto the economic activity and inflation

Further, a credit channel presents the pass-through of lending volumes onto the economic activity. Specifically, this element is one of the key elements in the monetary policy transmission mechanism.



The provision of loans in tenge to the real sector and the economic activity approximated through the short-term economic indicator (“the STEI”) have a close correlation.

However, the cause-and-effect analysis shows that on a horizon of up to one half-year, the STEI pre-determines the dynamics of loans to businesses and loans to businesses do not influence STEI.

This demonstrates, first of all, that the state of the economy which determines the demand for loans is important.

On a horizon exceeding a half-year period, this correlation becomes reciprocal. So,

half a year later, the issued loans are passed through onto the economic activity.

On the stocks side, the aggregate loan portfolio shows the same correlation with the real GDP. However, it should be noted that this correlation is moderate in terms of strength. Elasticity of the real GDP to the loan is low; this means that the economic growth is of little sensitivity to the change in the loan. On the contrary, loans are very sensitive to a change of the real GDP.

Therefore, there is a correlation between aggregate loans and the economic cycle. The economic activity, primarily, consumer demand which is fueled by loans may put pro-inflationary pressure.

A major portion of loans in tenge provided to the population is funneled to the consumer lending. At the same time, consumption in the Republic of Kazakhstan with a share in GDP of 63% (2019) is to a large extent secured with imports of goods (on non-food products it reaches 93%, food products - 18%). The payment for imported goods creates the demand for foreign currency which determines domestic prices through the foreign exchange channel. As a result, the exchange rate channel of the monetary policy remains as one of important transmission channels. The pass-through effect of depreciation of the exchange rate of tenge against the US Dollar onto inflation is assessed to be about 0.11 percentage point<sup>10</sup>, including on non-food products – 0.21 percentage point. In turn, the impact of interest rates on the nominal exchange rate of the tenge remains feeble due to a low capital mobility.

Unsteady funding (substitution of sustainable bonds for unstable deposits after the 2008-2009 crisis) and increased dependence of banks on resources of quasi-government organizations still remain the funding risks, which affect the credit channel.

Domination of loan contracts and deposits with a fixed interest rate represents a specific feature of the domestic financial system and leads to a lower sensitivity of the financial and real sector to changes in the monetary policy conditions.

In order to improve the functioning of the monetary policy channels, it is important to develop the financial system and the capital market with the formation of the yield curve, improve the institutional environment and regulation of financial organizations, increase the stability of funding, build up bank capitalization and improve the loan portfolio quality, reduce dependence on resources of quasi-government organizations as well as to rehabilitate the real sector.

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<sup>10</sup> Assessment of the pass-through effect of the exchange rate dynamics onto inflation based on the vector autoregression model, the model results were published in the Inflation Report, April 2020, <https://nationalbank.kz/ru/news/obzor-inflyacii/rubrics/1461>

## **Liquidity in the Money Market and Lending**

The money market in Kazakhstan has been functioning in the environment of structural liquidity surplus since 2016. The main factors for generation of excess liquidity in tenge include an active dedollarization process and reverse conversion of resources from foreign currency into tenge since 2016, a stimulative fiscal policy as well as arrangements for rehabilitation of the banking sector. As a result, the volume of liquidity withdrawal by the National Bank amounted to about 3.2 trillion tenge by the end of 2016, 3.8 trillion tenge – by the end of 2017, 4.3 trillion tenge – by the end of 2018 and 2019, and 4.8 trillion tenge – by the end of 2020.

There is an opinion that the existence of structural surplus in the money market restrains lending by distracting potential monetary resources from the real sector into the National Bank's instruments. However, this correlation is not always unambiguous.

First, it is related to the cash flow in the banking system. Cash disbursed by a bank as a loan ultimately comes back to the banking system in one way or another since the obtained loan is used for the working or fixed capital, which cannot be acquired without its further depositing on a bank account. Eventually, an overall bank liquidity does not change in the process of lending, only its holders in the person of banks are subject to change.

Second, banks do not funnel the attracted funding to lending immediately. Money supply in the economy is determined by expectations of banks about profitability and solvency of borrowers. Loans issuance by the banking system depends on the demand from the real economy, the assessment of risks and the revenue position of potential borrowers.

The National Bank's instruments are inferior to bank loans in terms of yield and are also shorter in terms of maturity. Therefore, in the presence of a good-quality project for lending, a bank directs excess resources to the project withdrawing funds from highly liquid instruments of the National Bank.

At the same time, it is important to mention that banks in Kazakhstan that are actively investing their resources in the National Bank's instruments are also leading in provision of credits to the economy.

Third, operations on provision and withdrawal of liquidity by the National Bank in the money market are aimed to regulate interest rates in the economy and represent an operating procedure. So, the National Bank, through its operations on provision or withdrawal of liquidity, controls the situation with liquidity in tenge in order to influence their cost.

Therefore, liquidity in the money market is generated in the amount that is necessary to achieve an operating target – to maintain the money market rate within the established band of the base rate. This is important for exerting influence on interest rates in the economy and thereby regulating the cost of money.

Should the National Bank stop conducting operations on liquidity withdrawal, risks of an overflow of such resources into the foreign exchange market and into

unsatisfactory growth of the loan portfolio would be high. These risks, consequently, have a potentially negative effect on inflation and financial stability.