

I. MONETARY POLICY GUIDELINES FOR 2005-2007

Approved by Resolution of the Board
of the National Bank of the Republic of Kazakhstan
No. 10 of January 29, 2005

Monetary Policy Guidelines of the National Bank of the Republic of Kazakhstan for 2005-2007

The year 2004 was the first year of the functioning of Kazakhstan's financial sector in an environment of reform of state regulation, namely since 2004 all regulating and supervisory functions in the financial market have been performed by the Agency of the Republic of Kazakhstan for Regulation and Supervision of the Financial Market and Financial Organizations.

The demarcation of regulating and supervisory functions determined the special status of the National Bank of the Republic of Kazakhstan, which is the only central bank in the CIS whose activity is focused entirely on functions inherent to a classic central bank.

The new realities caused a shift of emphasis in the policy of the National Bank of the Republic of Kazakhstan. After January 1, 2004 the main goal of the National Bank of the Republic of Kazakhstan became ensuring price stability, for whose accomplishment the National Bank of the Republic of Kazakhstan continued the realization of the following objectives:

- 1) developing and conducting state monetary policy;
- 2) ensuring the functioning of payment systems;
- 3) performing foreign exchange regulation and foreign exchange control;
- 4) facilitating the assurance of financial system stability.

In this environment, considering the positive trend of the development of the country's economy as a whole, the National Bank of the Republic of Kazakhstan shall determine the priority areas of activity for the coming three years.

The following two factors were taken into account during the adoption of the Monetary Policy Guidelines of the National Bank of the Republic of Kazakhstan.

Firstly, with the development of the financial market in Kazakhstan one observes a weakening of the relation between monetary aggregates and inflation. Therefore, projections of monetary aggregates are not targeted, and the limits of an increase are not rigidly set for them, particularly in an environment of the introduction of inflation targeting principles in Kazakhstan. Nevertheless, they remain an important reference point for the market and are being taken into account during the preparation of the Monetary Policy Guidelines for 2005-2007.

Secondly, the inflation that will result in 2005 will be impacted by measures performed in 2004, while monetary policy in 2005 will exert an influence on the 2006 results.

Therefore, the Monetary Policy Guidelines of the National Bank of the Republic of Kazakhstan present projections as a whole for three years in advance with a description of measures primarily for 2005, and at the end of each year the indicators for the next year shall be revised based on its results.

Preliminary Results for 2004. Over the course of the last several years, inflation has remained at a relatively low, stable level—within the range of 6 to 7 percent calculated at year end (6.4 percent in 2001, 6.6 percent in 2002, 6.8 percent in 2003). Inflation also stabilized within this range at the end of 2004 and was 6.7 percent.

The maintenance of inflation within this range is promoted by significant economic growth, accompanied by high consumer demand and investment activity. During the period from 2000 through 2004, real GDP rose 63 percent according to estimates during a 60- percent rise of real wages and a more than 5.5-fold rise of investments in fixed capital.

Among characteristic features in the inflation dynamics in 2004, a practically uniform rise of prices for all consumer goods and services stood out without clear-cut “leaders” as was the case in previous years, along with the absence of a seasonal price decline during the summer months.

A factor hindering a price reduction is the “import” of inflation, which is manifested through high global prices for oil and a higher rise of consumer prices in neighboring main trading partner countries.

The persistence of the inflationary background in the economy was promoted by a considerable rise of monetary aggregates. The increase of the net international reserves of the National Bank of the Republic of Kazakhstan led to an 82.3-percent expansion of the monetary base to T 577.9 billion during 2004. The active credit policy conducted by second-tier banks caused a 68.2-percent rise of the money supply to T 1,634.7 billion during 2004. During this same period, cash money in circulation rose 59 percent to T 379.3 billion, mainly due to a rise of consumer demand.

A considerable influx of foreign exchange into Kazakhstan from exports and borrowings in global capital markets helped to moderate the decline of inflation. Record indicators of goods exports fully offset residents’ current account expenditures, which are rising at high rates, and on the whole ensured a positive current account balance. According to the results for nine months of 2004, the positive current account balance was over US\$232 million.

The upward trend of the tenge exchange rate relative to the US dollar continued in 2004. Last year it rose 9.3 percent in nominal terms, which promoted a slowdown of inflationary processes.

In order to prevent a considerable rise of the tenge’s real exchange rate and also to smooth exchange rate fluctuations, the National Bank of the Republic of Kazakhstan participated as a purchaser in the domestic foreign exchange market. In all, the volume of net purchases of foreign exchange by the National Bank of the Republic of Kazakhstan was \$3.6 billion during 2004. As a

result, the net international reserves of the National Bank of the Republic of Kazakhstan rose 87.1 percent to \$9.3 billion during 2004.

Purchases of foreign exchange by the National Bank of the Republic of Kazakhstan for the purpose of preventing a rise of inflation were sterilized mainly by the issuance of short-term notes, the performance of repo operations, and borrowing of deposits from banks. During 2004 the volume of notes in circulation practically doubled (rose 99.5 percent) to T 369.1 billion; the volume of performed repo operations rose 60.1 percent to T 782.4 billion; the volume of borrowed tenge deposits rose 2.5 fold to T 775.7 billion.

In order to restrain the inflation growth rate, in 2004 the National Bank of the Republic of Kazakhstan took steps to increase the regulating effects of official rates. In particular, in order to enhance the refinance rate's economic role, since 2004 notes have been discounted in accordance with the official refinance rate during the simultaneous development of the note circulation system itself.

A policy of a systematic reduction of official rates, characteristic of previous years, was followed by a policy of their stabilization and increase in an environment of a non-decline of inflation. The official refinance rate (7 percent) and the minimum reserve requirement ratio (6 percent) were maintained at the level at the end of 2003. The official rate for repo operations had a multidirectional dynamic during 2004. In August its level was lowered from 4.5 percent to 3.5 percent during a simultaneous expansion of the corridor of permissible deviations from +/- 150 base points to +/- 200 base points, and from October through December this rate was gradually raised to 4.25 percent while the corridor of permissible deviations was held at +/- 200 base points. The official rate for "overnight" loans was raised from 8.0 percent to 8.5 percent.

Guidelines for Activity of the National Bank of the Republic of Kazakhstan for 2005-2007

In the field of monetary policy. The primary goal of the National Bank of the Republic of Kazakhstan will be the assurance of price stability.

Recent trends in global markets have been exerting a positive influence on Kazakhstan's macroeconomic development and at the same time have been causing a number of problems. One of them consists in excess liquidity in the banking system caused, among other things, by external borrowings of real sector enterprises and commercial banks, which will result in a rapid increase of bank credits to the economy. For example, it is anticipated that GDP will rise 26.4 percent during the period 2004 through 2007, and bank credits to the economy will more than double. The situation is exacerbated by a considerable influx of foreign investments and also by rising budget expenditures in recent years. In this environment, a threat of "overheating" of the economy is possible.

During the development of projections of basic macroeconomic indicators of monetary policy, three economic development scenarios were examined, depending on the change in the situation in external and internal markets: a base variant (a variant of moderate prices for oil), a high oil price variant, and a low oil price variant.

Despite the fact that a change of the dollar/euro correlation does to a considerable degree influence the tenge's exchange rate dynamics relative to the US dollar, because of the complexity of

projecting global exchange rates, during all the projection scenarios the National Bank of the Republic of Kazakhstan assumed the persistence of the dollar/euro parity at the level of the end of 2004.

The Base Scenario

During the development of the base variant, the projections were based on the assumption that on the whole in 2005 the situation in the external and internal markets will remain the same as in 2004. The persistence of high levels of prices for primary Kazakhstani exported goods is anticipated. Thus, in 2005 the average global price for Brent oil is anticipated at the level of \$35 per barrel with a subsequent decline to \$30 in 2006 and the persistence of such a price level in the global oil market in 2007. A gradual rise of global interest rates from 2.5 percent to 3.0 percent is anticipated in 2005; from 3.5 percent to 4.0 percent from 2006 to 2007. Despite this, their relatively low level in comparison to domestic rates will promote the persistence of large volumes of external borrowings by banks and enterprises. Thus, in the base variant the persistence of an influx of foreign exchange in considerable quantities is anticipated, which leads to an increase of the international reserves of the National Bank of the Republic of Kazakhstan and the assets of the National Fund of the Republic of Kazakhstan (Table 1). The persistence of macroeconomic stability in the country along with favorable foreign economic factors will promote the maintenance of high rates of economic growth during 2005-2007.

In this environment, the primary goal of monetary policy will become keeping inflation within the limits determined in the Mid-Range Plan for the Socioeconomic Development of the Country for 2005-2007.

In order to attain this goal, the National Bank of the Republic of Kazakhstan will increase corrective measures with respect to monetary policy operations and promote a further increase of the regulating role of its primary rates.

In the base variant it is anticipated that the primary factors promoting a rise of inflation in 2005, such as considerable economic growth and the large volume of the influx of foreign exchange into Kazakhstan, will retain their impact in 2005 as well. Furthermore, a high 23.8-percent rise of producer enterprises' prices in 2004 may become the determinant factor for a rise of consumer prices in 2005. In order to minimize the influence of these factors on inflation, the National Bank of the Republic of Kazakhstan will take steps to tighten monetary policy.

One of the steps may be raising the official refinance rate at the beginning of 2005. However, its gradual reduction is anticipated as the inflationary potential in the economy declines.

Short-term notes will be issued for the purpose of regulating the yield in the financial market; however, a considerable reduction of their maturities is anticipated. In this environment, banks' deposits in the National Bank of the Republic of Kazakhstan will become the main instrument for sterilizing excess liquidity, and therefore their volume will increase considerably.

The increase of banks' deposits in the National Bank of the Republic of Kazakhstan along with the overall upward trend of banking system liquidity will ensure a relatively high level (0.17) of the reserve ratio, that is, the ratio of banking system reserves to residents' deposits in the banking system.

This in turn will have a multiplying impact on the rise of monetary aggregates. It is anticipated that on the whole the monetary base and the money supply will increase by a factor of more than 2.1 during 2005-2007. However, such a considerable expansion of the monetary base will not exert inflationary pressure due to the downward trend observed in recent years in the influence of monetary factors on the formation of inflation and inflationary expectations. Nevertheless, in the long run for the purpose of preventing an accumulation of inflationary potential by means of monetary factors, the National Bank of the Republic of Kazakhstan will take steps to reduce the rate of expansion of the monetary base. During this period, the volume of operations of the National Bank of the Republic of Kazakhstan to sterilize excess liquidity may on average be more than T 600 billion.

The persistence of macroeconomic stability in the country, the stable development of the financial sector of the economy, and increased competition in the banking system will cause the rates of increase of deposits to overtake the rates of increase of cash money in circulation. This will lead to a reduction of the cash preference ratio, that is, the ratio of cash money in circulation to residents' deposits in the banking system. Thus, the money multiplier will gradually rise, which will lead to an increase of the supply of money. High rates of economic growth, an increase in business activity, a rise of the public's nominal and real monetary incomes, and also the persistence of low rates of inflation will promote an increase of demand for money. This will lead to a reduction of the velocity of the circulation of money and a rise of the level of monetarization of the economy to 37.8 percent in 2007.

The High Oil Price Scenario

In the high price scenario, it was assumed that global oil prices will continue the upward trend in the coming period, and the average price for Brent oil will be US\$45 per barrel in 2005-2007.

It is anticipated that global interest rates will remain at a low level within a range of 2.5 to 3.2 percent, and the net influx of banks' external borrowings will more than double in comparison to the base variant. When global prices for oil rise, the rates of economic growth will stabilize at a higher level than in the base variant.

High rates of economic growth and a rising influx of foreign exchange will lead to considerable growth of the international reserves of the National Bank of the Republic of Kazakhstan; in the high price scenario, their excess over the base variant will be from 1.5 fold in 2005 to threefold in 2006-2007. Despite an almost twofold increase of the volume of excess liquidity sterilization operations of the National Bank of the Republic of Kazakhstan in comparison to the base variant (in 2007, the volume of sterilization may be more than T 1,100 billion), the supply of money in the economy will increase, which will lead to higher rates of growth of monetary aggregates.

In this environment, despite the efforts of the National Bank of the Republic of Kazakhstan, average annual inflation will exceed the limits established by the Mid-Range Plan for the Socioeconomic Development of the Country for 2005-2007.

In order to keep the primary official rates slightly positive in real terms and also for the purpose of sending market subjects a signal regarding the tightening of monetary policy, the

National Bank of the Republic of Kazakhstan will raise the official refinance rate in 2005 with a gradual reduction of it during a reduction of inflation and inflationary expectations in subsequent years.

In order to attain the goal with respect to inflation, the National Bank of the Republic of Kazakhstan will perform operations to eliminate excess liquidity, of which the primary ones will remain as before the issuance of short-term notes and borrowing of banks' deposits, and also will use the minimum reserve requirement mechanism.

The Low Oil Price Scenario

In the low price scenario, a reduction of global prices for oil to \$30 per barrel in 2005, \$24 in 2006, and \$19 in 2007 was assumed.

It is anticipated that global interest rates will rise appreciably in 2005 to 4.5 to 5.0 percent, and will reach the level of 5.5 to 6.0 percent by the end of 2007. The net influx of banks' external borrowing will have a more than 2.3-fold downward trend by the end of 2007 in comparison to the base variant due to a rise in the price of resources.

The international reserves of the National Bank of the Republic of Kazakhstan will increase negligibly in comparison to the base variant. It is anticipated that the annual rate of economic growth during the examined period will slow and will be lower than in the base variant. The volume of excess liquidity sterilization operations of the National Bank of the Republic of Kazakhstan may be about tenge 560 billion on average per year.

In this environment, the primary goal of monetary policy will become keeping inflation within the limits determined in the Mid-Range Plan for the Socioeconomic Development of the Country for 2005-2007.

In order to attain this goal, the National Bank of the Republic of Kazakhstan will adjust its primary rates, utilize the minimum reserve requirement mechanism, and perform monetary policy operations.

The base variant is recognized by the National Bank of the Republic of Kazakhstan as the most realistic of the examined variants. Thus, it is anticipated that most likely in the near future the objective of limiting the banking system's liquidity will continue to remain pressing.

In order to lessen the acuteness of the excess liquidity problem and for more flexible regulation of banks' liquidity, relevant changes will be made to the mechanism for the formation of minimum reserve requirements. Toward this end the National Bank of the Republic of Kazakhstan will examine various variants for determining the structure of banks' obligations for which they should observe the minimum reserve requirement ratio and also the procedure for their fulfillment and will select the most optimal variant for conducting effective monetary policy.

Despite the envisioned liquidity limitation measures, during the next three years annual increases of monetary aggregates will ensure the persistence of the existing rates of economic growth.

High rates of economic development and growth of monetarization will not present a threat of intensifying inflationary processes since it is anticipated that in 2005-2007 labor productivity will rise at higher rates than real wages. This excess will be ensured mainly through the industrial sector, where the process of capital accumulation for reinvestment in setting up the production of new types of products began. In case of a lag of economic growth behind the rates of growth of wages, growing consumer demand may lead to a certain rise of inflation.

Tightening of monetary policy assumes a change of the direction of the influence of official rates of the National Bank of the Republic of Kazakhstan on market rates on credits. Whereas in previous years measures of the National Bank of the Republic of Kazakhstan were directed toward accomplishing the objective of stepping up bank activity involving lending to the economy, including a rate reduction, in an environment of a need to prevent “overheating of the economy” the issue of a rate reduction is no longer raised as an end in itself.

The level of rates in the economy should be structured on a market basis adequately for the risks and factors that develop on the basis of the real situation. The practice of the establishment of maximum rates of compensation on individuals’ newly borrowed investments (deposits) whose return is guaranteed by a guarantee (insurance) fund for individuals’ deposits should be re-examined.

Cumulative pension funds, whose assets are steadily growing in an environment of a shortage of long-term investment instruments, contribute a considerable part of the assets to short-term notes of the National Bank of the Republic of Kazakhstan, thereby lessening the influence of monetary policy on bank liquidity. Therefore, the National Bank of the Republic of Kazakhstan intends to study the methodological aspects of pension asset accounting in an overview of the financial sector and their influence on monetary policy in order to take appropriate steps.

In order to increase the efficiency of the process of taken decisions, the National Bank of the Republic of Kazakhstan will establish a consultative-advisory body for monetary policy with the participation of representatives of the National Bank of the Republic of Kazakhstan and involved state authorities, Parliament, scientific circles, and also the financial and real sectors of the economy. It is anticipated that this body will prepare recommendations for the Board of the National Bank of the Republic of Kazakhstan on the most important monetary policy issues.

In order to enhance the regulating properties of the official refinance rate, the National Bank of the Republic of Kazakhstan plans to put in practice the periodic (quarterly) re-examination and setting of the official refinance rate. The experience of central banks of developed countries shows the expediency of such a practice. By periodically re-examining the official refinance rate, depending on the overall state of the money market, the loan supply and demand, the level of inflation, and inflationary expectations, the National Bank of the Republic of Kazakhstan thereby gives the financial market actualized orientations with respect to anticipated trends in the financial sphere. In order to increase the public’s understanding of the intentions and assessments of the National Bank of the Republic of Kazakhstan, each re-examination of the official refinance rate will be accompanied by a corresponding explanation of taken decisions at press conferences and/or in press releases.

Furthermore, the National Bank of the Republic of Kazakhstan will focus its efforts on regulating the rates on various kinds of monetary policy instruments and increasing the regulating role of short-term rates. With the goal of increasing the accuracy of inflation forecasts, the National

Bank of the Republic of Kazakhstan will continue work on the development of a model of a transmission mechanism. Open market operations will be expanded, and steps will be taken to increase its own securities portfolio and to develop new financial instruments.

In an environment of a persistent excess of liquidity, the objective of regulating inflation increases the expenditures of the National Bank of the Republic of Kazakhstan on the performance of its sterilization. Therefore, an increase of the joint actions of the National Bank of the Republic of Kazakhstan and the Ministry of Finance of the Republic of Kazakhstan is required in the field of the issuance of government securities.

In the field of foreign exchange policy, the National Bank of the Republic of Kazakhstan intends to maintain the floating exchange rate regime without setting any long-range established corridor.

In the foreign exchange market, the National Bank of the Republic of Kazakhstan intends to take a so-called "passive stance," which implies a reduction of the presence of the National Bank of the Republic of Kazakhstan in the foreign exchange market. The actions of the National Bank of the Republic of Kazakhstan will be directed only at tempering the consequences of short-term and speculative exchange rate fluctuations.

Rate fluctuations will be caused by the correlation of the supply and demand for money. In an environment of global currencies' high volatility, the situation in the foreign exchange market may be determined largely by the situation in the global market.

In the field of foreign exchange regulation and foreign exchange control, a policy directed toward further liberalization of the foreign exchange regime in Kazakhstan will be continued. At present, a draft of a new Law of the Republic of Kazakhstan "On Foreign Exchange Regulation and Foreign Exchange Control" is under review in the Lower Chamber of Parliament. This draft law has been developed for the purpose of creating an effective base for a phased transition to principles of full convertibility of domestic currency.

At present, in accordance with the concept of the new draft law, the National Bank of the Republic of Kazakhstan is beginning the preparation of drafts of lawful regulations governing the procedure for the performance of foreign exchange operations, issues of the licensing and registration of foreign exchange operations, notification of foreign exchange operations, and foreign exchange export-import control procedures.

It is anticipated that beginning January 1, 2007 licensing of foreign exchange operations will be fully rescinded and a requirement to repatriate foreign exchange earnings will be established, depending on the time periods specified in foreign trade contracts, which will considerably simplify the procedure for performing foreign exchange operations and will reduce the costs of participants in foreign economic activity for fulfilling the requirements of foreign exchange legislation.

A reduction of state administrative interference in investment decision making by the private sector and the creation of an environment for more active expansion of Kazakhstani capital into foreign markets are anticipated.

One of the obligatory conditions of full liberalization of the foreign exchange regime is the presence of a system that restricts and tracks operations that have indications of their illegitimacy.

At present a draft law that includes a system of measures for building an anti-money laundering system is being reviewed by the Government of the Republic of Kazakhstan. It provides for the building of an effective anti-money laundering system with the participation of and taking into account the interests of all involved parties, including banks, since their information flows are the foundation of the created system.

For the purpose of timely steps to prevent “overheating of the economy,” the National Bank of the Republic of Kazakhstan will track the situation with respect to the influx of foreign exchange into the country and when necessary will examine the possibility of taking steps to reduce arising risks.

In the field of the assurance of the functioning of payment systems, further steps will be taken to ensure the efficient and reliable functioning of payment systems, to exercise supervision and control over the assurance of their stable functioning, to develop new kinds of payment instruments, and to implement the Program of the Development of the National Interbank System of Payment Cards on the basis of microprocessor cards.

General requirements for the functioning of the national system of payment cards have been stipulated by the draft law developed by the National Bank of the Republic of Kazakhstan in 2004, “On Amendments and Addenda to Certain Legislative Acts of the Republic of Kazakhstan on Issues of the Activity of State Authorities Performing the Regulation of the Financial Market.”

In 2005 particular attention will be devoted to the introduction of a national payment card, which is called upon to become an efficient payment instrument for performing cashless payments in the sphere of retail trade within the country, and a multifunctional card for the placement of various payment and nonpayment “applications” on it.

In addition, work will be continued on the creation of a unified national network for servicing payment cards and the expansion of the network of the acceptance of payment cards in trade (service) organizations.

In the field of facilitation of the assurance of financial system stability, the National Bank of the Republic of Kazakhstan will closely coordinate its activity with the Agency of the Republic of Kazakhstan for the Regulation and Supervision of the Financial Market and Financial Organizations.

Monetary policy will promote the persistence of financial market stability. The further development of the financial market in accordance with the Concept of the Development of the Financial Sector of the Republic of Kazakhstan for the Coming Three Years will be accomplished in the area of the approximation of all of its segments to international standards. The formation of a stable and efficiently functioning financial system that satisfies the needs of the real sector of the economy will be continued.

Within the framework of integration associations such as the EurAsEC and the CIS, the National Bank of the Republic of Kazakhstan will continue performing work on the organization of a common payment system and other areas of financial market integration.

Furthermore, the National Bank of the Republic of Kazakhstan intends to actively participate in the work of interstate and interagency groups on the formation of a Single Economic Space (YeEP), the Shanghai Cooperation Organization, and Central Asian Cooperation.

Table 1. Projection of Basic Indicators of Monetary Policy for 2005-2007 (Base Variant)

| | 2004 (Preliminary Results) | 2005 | 2006 | 2007 |
|--|----------------------------------|-----------|-----------|-----------|
| Inflation (on average for the period), % | 6.9 | 4.9-6.5 | 4.8-6.2 | 4.1-5.5 |
| Refinance rate (at end of period), % | 7.0 | 7.0 | 6.5 | 6.0 |
| Gross gold and foreign exchange reserves of the National Bank of the Republic of Kazakhstan, in billions of US\$ | 9.3 | 11.7 | 13.1 | 14.7 |
| change in % | 87.0 | 26.3 | 11.5 | 12.1 |
| Monetary base, in billions of tenge | 578 | 803 | 1022 | 1248 |
| change in % | 82.3 | 39.0 | 27.3 | 22.1 |
| Money supply, in billions of tenge | 1635 | 2123 | 2760 | 3470 |
| change in % | 68.2 | 29.9 | 30.0 | 25.7 |
| Residents' deposits, in billions of tenge | 1255 | 1590 | 2093 | 2677 |
| change in % | 71.2 | 26.6 | 31.6 | 27.9 |
| Banks' credits to the economy, in billions of tenge | 1484 | 1960 | 2520 | 3132 |
| change in % | 51.7 | 32.0 | 28.6 | 24.3 |
| Weighted average rate of compensation on individuals' tenge term deposits, in % | 9.3 | 8.3-10.3 | 8.0-10.0 | 7.5-9.5 |
| Weighted average rate of compensation on granted tenge credits to legal entities, in % | 13.7 | 13.2-15.2 | 12.7-14.7 | 12.2-14.2 |