

**Monetary Policy Guidelines
of the National Bank of the Republic of Kazakhstan for 2006–2008**

Preliminary results for 2005. In recent years, Kazakhstan’s financial sector has been developing in a stable manner. This is facilitated by the favorable external economic environment and a high, steady rate of macroeconomic development in Kazakhstan over recent years.

According to preliminary estimates, during 2005 by comparison with the same period in the previous year external trade turnover of goods and services grew by 33.8 percent to \$55.4 billion, exports of goods and services grew by 34.5 percent to \$30.4 billion, and imports of goods and services grew by 32.9 percent to \$25.0 billion.

According to data of the Statistics Agency of the Republic of Kazakhstan, during 2005 real GDP growth was 9.4 percent by comparison with 2004. An increase in real production output is observed in all economic sectors: in industry—by 4.6 percent, in agriculture—by 7.3 percent, and in construction—by 37.8 percent; the volume of transportation services increased by 7.0 percent, of communications services—by 27.7 percent, and of trade services—by 9.3 percent. Growth of investments in fixed capital reached 35.7 percent in 2005 compared with 2004.

In 2005 compared with 2004 the increase in monetary income of the population in real terms was 12.0 percent. As a consequence, the volume of retail trade turnover in 2005 increased by 12.4 percent.

In 2005 inflation reached 7.5 percent (December 2005 over December 2004). Over the several preceding years, in an environment of increasing inflationary pressure, inflation remained at a relatively low stable level—within the limits of 6–7 percent as calculated at the end of the year (in 2002—6.6 percent, in 2003—6.8 percent, and in 2004—6.7 percent).

During 2005 food products increased in cost by 8.1 percent, non-food products—by 5.9 percent, and for-pay services—by 8.0 percent. The greatest increases occurred in prices for the supply of gas—by 34.5 percent, for fruits and vegetables—by 23.1 percent, for services of educational institutions—by 19.5 percent, for rice—by 18.3 percent, and for meat and meat products—by 12.5 percent.

A number of factors, including an increase in economic activity, resulted in stronger inflationary pressure in 2005. During the year, prices continued to grow for basic Kazakhstani exports on world commodity markets. In 2005 compared with 2004 world prices for Brent crude oil grew by 40.8 percent, and for natural gas—by 42.5 percent. This led to increases in prices by domestic producers for relevant goods on the domestic market.

Expenditures of the state budget continued to grow in 2005. Whereas expenditures were 23.9 percent of GDP in 2004, in 2005 they increased to 27.9 percent of GDP. This stimulates economic activity, but it also contributes to an increase in inflationary pressure.

In 2005 inflationary expectations caused by the increase in income of the population became an additional inflationary factor.

Prices of enterprises producing industrial output increased by 20.3 percent during 2005 (December 2005 compared to December 2004). Data from monitoring of enterprises of the real sector conducted by the National Bank of the Republic of Kazakhstan confirm a continuing trend of price increases over practically all of 2005 (on average more than 25 percent of surveyed enterprises expect steady price increases for finished goods, and about 55 percent—for acquired raw materials and materials).

The growth of demand for money caused by the increase in income and heightened economic activity had its own effect on the formation of consumer prices.

The growth of demand for money resulted in the expansion of monetary aggregates. The growth of domestic lending resulted in an increase in the *money supply* in 2005 by 25.2 percent to T 2,065.3 billion (during 2004—by 69.8 percent). Credits to the economy grew by 74.7 percent in 2005.

The higher rate of growth of nominal GDP (by 27.0 percent) by comparison with the rate of money supply expansion resulted in a decline in the level of monetization of the economy from 28.1 percent at the end of 2004 to 27.7 percent at the end of 2005.

During 2005 *cash in circulation* grew by 8.6 percent to T 411.8 billion, whereas growth was 59.0 percent during the same period in 2004. During 2005 the *monetary base* grew by 14.7 percent to T 663.0 billion (during 2004—by 82.3 percent). The monetary multiplier grew in 2005 from 2.86 to 3.12 as a consequence of the speedy rate of growth of the money supply by comparison with the rate of expansion of the monetary base.

Net international reserves of the National Bank of the Republic of Kazakhstan at the end of 2005 were \$7,065.9 million, declining during the year by 23.8 percent. The country's international reserves as a whole (in current prices), including money of the National Fund of the Republic of Kazakhstan (\$8,014.7 million according to preliminary data) comprised \$15,084.4 million, increasing by 4.7 percent in 2005.

In 2005 measures were taken to tighten monetary policy in order to reduce the level of excess liquidity. The official refinancing rate was gradually raised from 7 percent to 8 percent, the base for calculating minimum reserve requirements was expanded, and the list of reserve assets was reduced.

Demand was slightly in excess of supply on the domestic currency market, which led to a nominal depreciation of the tenge against the U.S. dollar in 2005 by 2.9 percent (at the exchange rate on the exchange). This helped reduce participation of the National Bank of the Republic of Kazakhstan on the foreign exchange market.

In order to strengthen the influence of monetary policy on inflation, monetary policy tools were improved. Thus, effective July 1, 2005 changes were made to the monetary regulation mechanism which incorporate unification with respect to terms and rates of certain monetary policy operations such as deposit and lending operations, issuance of short-term notes, and repo operations. In order to reinforce the results of the unification, the provision of overnight and overdraft loans and the performance of direct repo operations were temporarily halted.

Despite an increase by a factor of 3.5 in volumes of emission of short term notes (T 1,960.2 billion), their volume in circulation declined during 2005 from T 396 billion to T 161 billion. This is associated with a significant reduction in maturities of notes issued (from an average of 243 days in 2004 to an average of 30 days in 2005).

Volumes of deposits attracted by the National Bank of the Republic of Kazakhstan from second-tier banks in 2005 increased by a factor of 3.4 to T 2,627.9 billion. The volume of unsettled liabilities of the National Bank of the Republic of Kazakhstan with respect to them grew in 2005 by 10.3 percent from T 78.8 billion to T 86.9 billion.

Despite measures taken by the National Bank of the Republic of Kazakhstan to achieve price stability, inflation calculated as an annual average was 7.6 percent, exceeding the 2005 target (5.2 percent to 6.9 percent).

This is the environment in which the National Bank of the Republic of Kazakhstan developed its Monetary Policy Guidelines for 2006–2008.

Activity Guidelines of the National Bank of the Republic of Kazakhstan for 2006-2008

The National Bank of the Republic of Kazakhstan specifies its priority activity as pursuing a monetary policy oriented on ensuring price stability.

In keeping with this, the work of going over to the principles of inflation targeting will be continued. This presumes making projections of the main parameters of monetary policy based on specific inflation targets.

Projections of the main macroeconomic indicators are presented for a 3-year period (2006-2008) together with the details of measures to be implemented in 2006, which underscores the medium-term orientation of this document. Indicators for subsequent years will be updated at the end of this year.

Two scenarios were examined by the NBK during development of monetary policy for 2006-2008. The level of world oil prices is the criterion by which the scenarios are distinguished (a moderate price scenario and a high price scenario). A low world oil price scenario is not entertained by the NBK because an abrupt decrease in market prices is improbable over the short term.

In the scenarios that are entertained, it is presumed that a high rate of economic growth, macroeconomic stability, and favorable foreign economic conditions will persist.

The experience of recent years demonstrates the significant influence the volume of external borrowing has on monetary policy. This will continue to be one of the significant factors in the

pursuit of monetary policy. This is connected with the fact that the volume of external borrowing by banks and enterprises will be considerable regardless of the interest rates on the internal and external markets.

Changes that will occur in the second half of 2006 in the way the Republic of Kazakhstan National Fund operates were not taken into consideration in the calculations.

The results of a model of the monetary policy transmission mechanism developed by the NBK were used to prepare the projections.

The *moderate oil price scenario* presumes that average world prices of Brent oil will stay within \$45-\$60 per barrel in 2006-2008, and that world interest rates will remain approximately at the current level. Given these assumptions, the anticipated average annual growth figures are within 8-9 percent for the economy, 12-38 percent for NBK international reserves, 24-35 percent for the money supply, and 20-42 percent for base money. The economy's monetization will rise to 32 percent in 2006 and 38 percent in 2008.

The *high oil price scenario* presumes a further increase of world oil prices in the upcoming 3-year period. Under this scenario the average world prices of Brent oil are anticipated to exceed \$65 per barrel. Attainment of lower levels of global interest rates than in the moderate oil price scenario is presupposed. Under these assumptions, in 2006-2008 we anticipate higher average annual growth of the economy compared to the moderate oil price scenario. The growth projections for international reserves and money measures will be an average of 7-12 percentage points higher than in the moderate oil price scenario.

The main goal of NBK monetary policy will be to keep inflation within a 5.7-7.3 percent corridor in the *moderate oil price scenario* and a 6.9-8.5 percent corridor in the *high oil price scenario*.

The NBK believes the moderate oil price scenario to be the more realistic of the two scenarios.

Based on this, the NBK contemplated implementation of a number of measures, and among them, tightening monetary policy. This is connected with the fact that whatever the scenario, it is presumed that inflation pressure will persist in an environment of significant inflow of foreign capital, excess liquidity on the internal financial market, and increased spending from the state budget.

Should the high oil price scenario materialize, measures of monetary policy could be tightened to a greater degree.

In the area of monetary policy, in 2006-2008 the NBK will continue efforts to enhance the effectiveness of the use of monetary operations and to further intensify the influence of its measures on the condition of the money market.

The NBK will regulate the rates on its operations, including the official refinancing rate, depending on the situation on the money market and inflation. The most important issues will be examined at a meeting of the NBK Monetary Policy Council with the participation of deputies of the

RK Parliament and representatives from government authorities, academic circles, and the financial sector.

Deposits with the NBK by second-tier banks and issuance of short-term notes will remain the main instruments for the regulation of remuneration rates on the financial market and for sterilization of excess liquidity of banks. The NBK will not limit the volume of deposits attracted, but it will specify the rates thereon. Short-term notes will be issued with the goal of shaping the "yield curve" for short-term instruments, and for the purposes of developing other instruments of the financial market.

Efforts to increase NBK influence on market remuneration rates will be continued through the establishment of a rate band (with the rate on attracted deposits as the lower rate and the lending rate as the upper rate).

Within the context of improvements to the risk management system, the possibility will be considered for pegging the remuneration rate limits for new private deposits insured by the Kazakhstan Private Deposit Guarantee (Insurance) Fund to the official refinancing rate.

Improvements will be made in the model of the transmission mechanism of NBK monetary policy to permit assessment of the impact of the instruments of monetary policy on the main macroeconomic indicators, and inflation in particular.

To lower the severity of the excess liquidity problem, the NBK contemplates making further improvements in the mechanism for calculating minimum reserve requirements by broadening the scope of obligations of banks for which they will have to comply with the standards.

Notwithstanding the measures foreseen to contain liquidity, the money supply will provide for a sufficiently high rate of economic growth.

The NBK will continue its floating exchange rate policy, without specifying any set long-term band, and it will make interventions in the behavior of the foreign exchange rate only with the goal of mitigating the consequences of short-term and speculative fluctuations in the foreign exchange rate. Rate fluctuations will be governed by the ratio between money demand and supply on the exchange market. The flows of foreign currency will be monitored.

Enterprises of the real sector of the economy will continue to be monitored for the purposes of evaluating the trends and directions of development of the nonfinancial corporations sector, the prevailing economic conditions and the financial condition of enterprises, solvency and the need for attracting capital, the demand for credit resources, and investment policy of enterprises.

Measures to curb inflation will require stronger joint action by the National Bank of the Republic of Kazakhstan and the government of the Republic of Kazakhstan.

In the area of foreign exchange regulation and foreign exchange control, a policy aimed at further liberalization of the foreign exchange regime in Kazakhstan and development of new approaches to regulating capital movement risks will be continued. Improvements will be made in the foreign economic operations database, which will make it possible, starting in 2007, to support an efficient transition from a permit-based procedure of foreign exchange operations to a system of follow-up monitoring and selective control.

In the area of payment systems, further steps will be taken to enhance the efficiency and safety of payment systems, and to create an efficient system of risk management and payment system supervision. This system will include a system for control and supervision of service operators, hardware and software providers, and payment system users. Much attention will be devoted to furnishing payment systems with high information technologies and state-of-the-art equipment.

Efforts to create a new reserve center will be made for the purposes of ensuring trouble-free, continuous operation of payment systems and enhancement of their safety.

In the area of cash monetary circulation, in 2006 the NBK will put banknotes of a new design in circulation, something made necessary by the development of copying and computer technologies. Banknotes will contain new protective and machine-readable elements.

In the context of promoting stability of the financial system, the NBK will coordinate its activities closely with the Republic of Kazakhstan Agency for Regulation and Supervision of the Financial Market and Financial Organizations.

Monetary policy will help to maintain the financial market's stability. Further development of the financial market in keeping with the Conceptual Framework for Development of the Financial Sector of the Republic of Kazakhstan in 2003-2006 will proceed along the lines of bringing all of its segments closer to international standards.

Jointly with the Republic of Kazakhstan Agency for Regulation and Supervision of the Financial Market and Financial Organizations and other interested government authorities, the NBK will prepare a financial stability report explaining the factors that contribute to the economy's vulnerability.

Active cooperation with international financial organizations will be continued (International Monetary Fund, World Bank, European Bank for Reconstruction and Development, Asian Development Bank, Islamic Development Bank, and others).

Within the context of integrative associations, the NBK will continue efforts to organize a common payment system, to create an integrated exchange market of EurAsEC member nations, and to participate in the work of intergovernmental and interagency groups to form the Single Economic Space and the Shanghai Cooperation Organization.

Table 1.

**Projection of the Main Indicators of Monetary Policy for 2006-2008
(Moderate Oil Price Scenario)**

as of period's end

	2005	2006	2007	2008
Inflation (average for the period), %	7.6	5.7-7.3	5.0-7.0	5.0-7.0
Refinancing rate, %	8.0	8.0	7.5	7.5
Gross gold and foreign exchange reserves of the NBK, US\$ billion	7.1	9.7	11.2	12.5
<i>change, %</i>	<i>-23.8</i>	<i>37.7</i>	<i>15.4</i>	<i>11.7</i>
Base money, T billion	663	939	1184	1416
<i>change, %</i>	<i>14.7</i>	<i>41.7</i>	<i>26.1</i>	<i>19.6</i>
Money supply, T billion	2065	2789	3561	4413
<i>change, %</i>	<i>25.2</i>	<i>35.0</i>	<i>27.7</i>	<i>23.9</i>
Deposits of residents, T billion	1654	2228	2830	3525
<i>change, %</i>	<i>30.1</i>	<i>34.7</i>	<i>27.0</i>	<i>24.6</i>
Bank credits to the economy, T billion	2592	3676	4782	6028
<i>change, %</i>	<i>74.7</i>	<i>41.8</i>	<i>30.1</i>	<i>26.1</i>