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NATIONAL BANK OF KAZAKHSTAN

MONETARY POLICY GUIDELINES OF THE REPUBLIC OF KAZAKHSTAN FOR 2017

Almaty
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FOREWORD

The main objective of the National Bank of the Republic of Kazakhstan (“the National Bank” hereinafter) is to ensure price stability. Achieving this goal is one of the primary conditions for a sustainable long-term economic development. In addition, the National Bank, along with ensuring price stability, creates conditions for maintaining financial stability, mitigating the impact of external shocks on the economy and preventing the buildup of imbalances in the financial system. Actions taken by the National Bank represent a part of general state macroeconomic policy and can secure a sustainable economic growth and the financial system stability only if coupled with coordinated and consistent fiscal policy measures.

In 2016, the monetary policy was designed and implemented in the circumstances of distribution of internal and external shocks as well as of adaptation of population and businesses to a new monetary and exchange rate policy regime. Oil prices were at a lower level as compared to prior years, exchange rates in countries - trading partners demonstrated volatility, a high level of dollarization was persisting despite a significant overflow of assets from foreign currency-denominated assets to tenge denominated assets, budget expenditures were growing and there was a structural surplus in the money market. These factors were having primarily a constraining effect on the efficiency of measures taken. Nonetheless, as a result of improving conditions in external markets and measures taken by the National Bank, the situation had stabilized and inflation approached its targets quite closely.

In 2017, the National Bank expects the prices of main commodities to remain at their average values of 2016, and slow but sustained recovery of the domestic economy as a result of supporting programs by Government. Herewith, a neutral fiscal policy will most likely have a limited influence on the inflation as part of measures to be taken by the Government next year to consolidate the state budget.

The National Bank will continue to follow the principles of the inflation targeting. In order to achieve its targets, the monetary policy will be implemented based on the course of development announced earlier, including by enhancing interest rate policy and the monetary policy instruments, optimizing the decision-making process as well as managing inflationary expectations of economic agents.

I. MONETARY POLICY OF THE REPUBLIC OF KAZAKHSTAN IN 2016

Since August 2015, the National Bank has been implementing its monetary policy in accordance with the inflation targeting principles where the focus is made on the interest rate policy in the environment of a floating exchange rate regime of the domestic currency. During 2016, the National Bank implemented and improved the basic components of inflation targeting so as to have an impact on monetary conditions in the economy and, ultimately, to achieve the main goal of inflation. At the same time, the monetary policy implementation was complicated by a number of internal and external shocks.

At the end of 2015 – beginning of 2016, unfavorable environment in the global commodity and financial markets had a negative effect on the economy and the financial sector of the country. As a result of impact of external factors, the money market and the foreign exchange market demonstrated a high volatility and the deficit of the tenge liquidity. In order to stabilize the situation in the financial market and to mitigate the negative impact of external factors, the National Bank conducted operations to fill the deficit of the tenge liquidity. In January 2016, minimum reserve requirements were eased in order to reduce the burden on banks. In addition, in February 2016 measures were taken to increase attractiveness of assets in the tenge; recommended interest rates on deposits in the tenge were raised from 10% to 14% and interest rates on foreign currency deposits were lowered from 3% to 2%.

The exchange rate of the tenge was fluctuating under the impact of fundamental factors enabling to ensure price competitiveness of domestic goods and to maintain gold and foreign currency reserves. The National Bank's participation in the foreign exchange market was aimed to smooth short-term and speculative fluctuations, unrelated to fundamental factors which may cause risks to the financial stability.

As the situation in the money market and foreign exchange market was recovering, conditions were created to restore the monetary policy's interest rate channel. Therefore, in February 2016 the National Bank resumed the practice of using the base rate as the main tool of the monetary policy which had been suspended before. In order to meet the balance of risks, the base rate was set at 17%. In this context, the interest rate could not be too high in order to prevent the risks for the financial stability; at the same time, the interest rate could not be too low with purpose to prevent increase of devaluation expectations. As a result of measures taken in February-March 2016, the balance in the financial market had been restored.

In order to increase the effectiveness of monetary policy, the National Bank was building the appropriate system of instruments. A basic set of tools that allowed the National Bank to keep the target rate (short-term interbank money market rate TONIA) within the established band of the base rate was designed. In this context, an indicator of the effectiveness of monetary policy is the retention of the target rate as close as possible to the base rate.

As the situation in the financial market was stabilizing and forecasts of macroeconomic indicators were improving, the National Bank started to ease monetary conditions by gradually lowering the base rate. Inflationary processes were decelerating, inflationary and devaluations expectations reduced, and the environment in key external markets improved. Foreign currency preferences of the population started to shift towards the domestic currency. In the foreign exchange market, volumes of foreign exchange sales were exceeding volumes of its purchases; also, an overflow of deposits denominated in the tenge into foreign currency deposits was observed.

At the same time, as a result of conversion of deposits from a foreign currency into the tenge as well as large expenditures of public and quasi-government sectors, banks had accumulated excessive tenge liquidity. Thus, from the second quarter of 2016 the money market started to operate in the conditions of a structural surplus of the tenge liquidity. In order to limit inflationary processes, the National Bank conducted liquidity withdrawal operations.

Open market operations to absorb liquidity such as short-term notes issuance and direct repos as well as deposit operations with banks were conducted by the National Bank and helped to maintain the target rate TONIA within the interest rate band of the base rate. In the conditions of a significant surplus of short-term bank liquidity, the target rate was close to the lower boundary of the established band.

At the same time, the National Bank started to take measures to create conditions for building an yield curve which was intended to serve as a benchmark for the cost of money in the domestic market. In this regard, since May 2016, the National Bank started to issue notes with a longer maturity (91 days, 182 days, 364 days), along with short-term notes with maturity of 7 and 28 days which are being used for monetary policy purposes. In order to build an yield curve for a medium-term horizon, auctions for operations with government securities with maturity longer than one year were also launched.

In general, in 2016 the National Bank conducted a cautious and balanced monetary policy aimed at maintaining the balance of risks between the price stability and financial stability. While making decisions on monetary policy the National Bank was basing not only on the current situation but also on the forecast about the behavior of macroeconomic variables in the medium-term horizon, including inflation and expectations of the population and the market participants.

In this regard, in 2016 the National Bank began conducting surveys to assess population's expectations. The results of survey allow to tracking the financial position of households, their consumption and saving behavior, their perception of the price growth, expectations about inflation and the exchange rate as well as the general public sentiments regarding the country's economic situation as a whole.

An important element in the decision-making process regarding the monetary policy is to design forecasts for the development of the economy and the inflation. Therefore, as part of the inflation targeting regime, the National Bank uses the Forecasting and Policy Analysis System FPAS (Annex 1). As part of the system,

quarterly forecasting rounds are conducted where the forecasts of key macroeconomic indicators, including inflation, for the medium-term horizon are designed.

An active and good quality communication policy of the central bank is an important component of the inflation targeting regime. Therefore, alongside with the monetary policy measures, in 2016 the National Bank was taking measures to increase transparency and to improve the communication policy. A list of the published statistical and analytical information on the monetary policy issues was significantly extended; the practice of press-conferences and meetings of the National Bank's top officials with experts and the mass media was introduced. These measures are aimed at proper understanding of processes in the financial market by economic agents, at the formation of rational expectations about inflation, exchange rate and other macroeconomic indicators.

During 2016, inflationary processes were building up under conditions of weak consumer demand, slow recovery of the business activity as well as a low lending activity of banks. Price surges were observed due to the inflationary pressure as a consequence of factors which are beyond the National Bank's influence area and which are related to deregulation of prices for certain goods, monopolization of some sectors of the economy and imperfect competitive environment.

The inflation rate for 11 months of 2016 accounted for 7.5%. It is expected, that at the year-end the annual inflation will be close to the upper boundary of the target band of 6-8%.

Thus, the National Bank made efforts in all areas in line with stated goals and objectives of the monetary policy.

However, a number of challenges still exist. So, the objectives of increasing the effectiveness of the interest rate channel are still relevant. Constraints associated with a high dollarization of the economy and insufficient development of the financial market do not allow the transmission mechanism to fully pass-through impulses from the monetary policy via interest rates onto macroeconomic indicators, mainly inflation.

Some of the monetary policy instruments, minimum reserve requirements in particular, do not meet the purposes of their use under the inflation targeting regime and remain inefficient in terms of their impact on liquidity and the money market rates.

In addition, the objectives of improving the set of tools, communications and restoring confidence in the monetary policy remain relevant.

II. MONETARY POLICY OF THE REPUBLIC OF KAZAKHSTAN FOR 2017

The Target for 2017

The National Bank sets the target band for inflation in 2017 at 6-8%. This target band reflects the continuing process of adaptation of the economy to the existing prices of commodities and to the free floating exchange rate regime as well as instability of inflation expectations among the population and their persistence at a fairly high level.

Achieving and maintenance of the target, *ceteris paribus*, will be ensured by the National Bank throughout 2017. At the same time, short-term deviations from the target, including those which do not require the National Bank's response, are possible in case of a significant change in external and internal economic conditions. In order to achieve its inflation target, the National Bank will use all of its monetary policy instruments.

At the end of 2018, the National Bank sets inflation targets within the band of 5-7%. By 2020 the goal is to bring the inflation to the level below 4%.

Monetary Policy Guidelines in 2017

In 2017, the National Bank will continue taking measures aimed to increase its monetary policy effectiveness as part of the inflation targeting regime. In this connection, the following efforts will be made:

- *Improving the System of Monetary Policy Instruments and Increasing Efficiency of the Interest Rate Channel*

A further development of the monetary policy instruments will be mainly aimed to increase efficiency of the interest rate channel. Measures of the National Bank will help enhance the role of the base rate. In 2017, decisions regarding the base rate will be made 8 times according to the following schedule:

January 9

February 20

April 10

June 5

July 17

August 21

October 9

November 27

The National Bank will pay special attention to the open market instruments which play the main role in regulating short-term liquidity in the money market. In addition to short-term notes and the auction for the purchase of securities with reverse sale (credit auction), the National Bank plans to introduce deposit auctions.

System of Monetary Policy Instruments of the National Bank			
Purpose	Instrument Type	Instrument	Collateral
liquidity provision	standing facilities	reverse repo	government bonds
	open market operations	NBK auction for the purchase of securities with the reverse sale	Lombard list
NBK notes auction		-	
deposit auction		-	
liquidity absorption	standing facilities	direct repo	government bonds
		deposits	-

Standing facilities will be used to adjust short-term liquidity volumes resulting from open market operations. To absorb excess liquidity, the National Bank will use direct repos and deposits; and to provide liquidity it will use reverse repos. If needed, the list of instruments may be extended.

Efforts to improve the minimum reserve requirements are in progress (Annex 2). The role of this instrument will be shifted from regulation of the money multiplier towards regulation of the demand for liquidity; this will allow to regulate liquidity volumes in the money market in a more efficient way and to set the market interest rates within the interest rate band established by the National Bank.

Ratios of minimum reserve requirements will depend on the situation in the money market and will be set at the levels which would not allow negative consequences for the financial market to arise.

- *Specifying the Target for the Money Market in Implementing the Monetary Policy*

At present, the TONIA rate as an indicator of the money market is calculated on the basis of all transactions of overnight repos conducted in the sector of automatic repo with government securities on KASE, including the National Bank's operations. A similar methodology is also appropriate for other money market indicators of the KASE – MM Index, TWINA, SWAP-1D (USD), SWAP-2D (USD).

In the international practice, rates for lending operations in the interbank market excluding operations by the central bank are being taken into account in order to get target interest rates for money market. Given that the domestic interbank market is not significant and the volumes of conducted transactions are limited, the National Bank considers introducing a new indicator (by revision of existing indicators' calculations) which would more precisely reflect the current situation as well as expectations among participants in the money market.

- *Adhering to the Floating Exchange Rate Regime*

The National Bank will be insistently adhering to the floating exchange rate regime of the tenge in the future. This will allow not to accumulate imbalances in the

financial sector as well as to increase resilience of the economy to external shocks. Significant and destabilizing short-term fluctuations of the exchange rate can be smoothed by the National Bank's interventions. A long-term trend will be determined by the fundamental factors.

- *Converging the Official Refinancing Rate and the Base Rate*

Currently, the cost of money in the money market is determined by the base rate. Herewith, the official refinancing rate which is used in the civil, administrative and legal relations for the calculation of fines or penalties for compensation of damage, assessment of lost profits, i.e. performing the fiscal function reflects the cost of money in the non-financial sector of the economy.

In this regard, starting April 1, 2017 the official refinancing rate will be equated with the base rate in order to align the value of money in different sectors of the economy, and hereafter a change of the base rate will result in an automatic and simultaneous change of the official refinancing rate.

- *Building an Yield Curve*

The efforts on building a risk-free yield curve which is an indicator of market expectations about interest rates are continuing. The yield curve is intended to identify and reflect opinions and actions of the market participants over time regarding the cost of borrowing and rates at which assets are invested. In the short-term segment of the yield curve, the National Bank will be issuing notes with different maturities. If necessary, purchases and sales of government securities in the secondary market will be continued.

- *Measuring Inflationary Expectations*

The National Bank will continue to analyze and evaluate inflationary expectations as one of the key components of inflation targeting regime. They will be quantified¹, thus enabling to get a quantitative assessment of existing expectations of the population and to make more precise forecasts.

- *Improving the Communication Policy*

The National Bank will continue its effort to increase transparency and improve the National Bank's communication policy. Ensuring an adequate degree of transparency will help to increase confidence of population in the National Bank, reduce inflationary and devaluation expectations and implement the monetary policy more efficiently. The National Bank will continue disclosing information about monetary policy guidelines and publishing information regarding its decisions about the base rate and other instruments of the National Bank, explaining the motivation behind the decisions made. If the announced targets are not achieved, the factors of their deviation will be identified including those which are beyond the National Bank's influence.

In the communication sphere, an increasingly larger role will be played by the Inflation Report – a quarterly publication of the National Bank where trends and

¹ Quantification means measuring the qualitative characteristics in quantitative terms, i.e. giving the numerical value to the results through corresponding indices

factors affecting the inflation as well as forecasts of macroeconomic indicators are reflected. In its way, the Inflation Report is a formalized visual outcome of a forecasting round. It will be preceded by a press release regarding the base rate with a rationale behind a relevant decision as well as by a public information notice with technical details, a detailed analysis and forecasts for the medium-term horizon.

- *Restoring Lending to the Economy*

Once the prices stabilize and the business activity restores, the cost of funding will decrease and lending to the real sector of the economy will recover. In this context, the National Bank will be setting interest rates at the level promoting stabilization of long-term expectations about inflation and supporting the demand for assets in tenge. Thus, macroeconomic conditions favorable for the growth in credits to the economy will be promoted.

Risks for the Monetary Policy in the Short-Term Horizon

The National Bank points out that there is a possibility of internal and external risks realization:

- *A Significant Change in Oil Prices*

Availability of alternative sources, a high level of stocks and the growing oil supply bear the risk of falling oil prices and increase in their volatility. The decrease in oil prices below the prime costs of exports will create additional risks for sustainability of the balance of payments. As a result, devaluation expectations are growing, exchange rates of oil exporters' currencies are depreciating and, as a result, inflationary processes are accelerating; in aggregate, this may prevent an effective monetary policy implementation.

One should not exclude the risk of change in oil prices as a result of political rather than economic factors. Additional efforts will be required on the part of the National Bank to keep the inflation within the established band.

- *Slowdown of the Global Economy*

A high degree of Kazakhstan's integration in the global economy determines both a direct and indirect impact of world economic trends on the domestic economy. The slow recovery of developed economies and deceleration of growth in China runs the risk of declining demand for raw materials from Kazakhstan by main trading partners of Kazakhstan.

- *Dynamics of Fed's Interest Rates*

The expected increase in the Fed's interest rates in 2017 will lead to appreciation of the US Dollar and may contribute to the capital outflow from emerging markets to developed countries and, as a result, to depreciation of national currencies. In addition, a change in the Fed's interest rates has a potential effect on quotations in the stock and commodity markets.

The increase in the Fed's interest rates also bears the risks that the cost of the external debt service and the cost of new borrowings will increase, including those used to refinance the existing debt by enterprises of Kazakhstan.

- *Depreciation of the Russian Ruble*

The similarity of the Russian and Kazakh economies in terms of their structure, a significant trade turnover between the countries increases the risk of the pass-through of economic shocks in Russia onto Kazakhstan; this is especially important in the current context of budget imbalances in Russia and Kazakhstan.

The correlation of the Russian ruble and the Kazakh tenge is primarily reflected in the volumes of imports from the Russian Federation (34% of the value of imports in 2015). Depreciation of the ruble may result in a significant strengthening of positions of Russian goods in Kazakhstan, so there is a potential risk of substitution of domestic goods by their Russian equivalents, including those in the consumer basket.

- *Persistently High Level of Dollarization*

At the end of October 2016, the level of dollarization in the Kazakh economy accounted for 55.7%. This fact represents a significant risk to the implementation of monetary policy since it facilitates instability of key macroeconomic processes. If the US Dollar amount remains as before, this will keep weakening efficiency of monetary policy measures while enhancing the impact of the US Dollar on the Kazakh economy.

- *State Budget Deficit*

Despite a thorough planning of the state budget and measures for its consolidation the growth in the non-oil deficit had been observed over the most recent years. Parameters included into the budget, deficit reduction and the structure of its financing will be influencing the conditions of the monetary policy implementation.

- *Structural Liquidity Surplus*

A significant structural liquidity surplus complicates the task of the National Bank of maintaining the target rate within the band of the base rate.

- *Deregulation of Prices*

Liberalization of the price regulation which is currently being considered bears additional risks for inflationary processes associated with price fluctuations in the process of their adaptation to the market conditions.

Realization of the above risks as well as other events which are exceptional and difficult to forecast and which have unpredictable consequences for the economy may lead to deviation of inflation from the announced target for 2017.

Nonetheless, even if the above risks realize, the National Bank's main goal of ensuring the achievement by the inflation rate the targeted band will not change.

If the forecasted inflation rate goes above or below the target band, the monetary policy will be of tighten or easing nature, with the base rate changing accordingly. In making decision about the monetary policy, including regarding the base rate, the National Bank will be taking into account the situation in the financial sector in order to ensure financial stability. At the same time, the National Bank will

not respond to shocks which have a short-term effect on inflation as well as to factors which are beyond the National Bank's control.

The National Bank will be advising the financial market participants and the population of the decisions made in case of realization of internal and external risks as well as of the monetary policy guidelines.

Forecasting and Policy Analysis System of the National Bank (FPAS)

As part of transition to the inflation targeting regime, in 2014-2016 the National Bank designed and implemented the Forecasting and Policy Analysis System (FPAS) which is used for the purposes of information and analytical support in the decision-making regarding the monetary policy. This system was designed based on the best practices of leading central banks which apply the inflation targeting regime.

The system implies that forecasting rounds will be conducted 4 times a year, in order to forecast key macroeconomic variables, mainly the inflation rate, in the medium term (the next 7 quarters). Key assumptions used to make such forecasts include external indicators (GDP, inflation and the REER of Kazakhstan's main trading partners) as well as the world oil price, based on which the economic development scenarios are determined.

The forecasting rounds consist of three phases, in which the short-term (1st phase) and medium-term projections (2nd phase) are developed, as well as the reaction of monetary policy in the medium term (3rd phase).

A short-term forecast is prepared based on the use of econometric techniques and includes projections of GDP, inflation and its components as well as the analysis of external assumptions (situation in the countries of Kazakhstan's main trading partners, including Russia, China, and the EU).

Outcomes of the short-term forecast are used as part of the 2nd phase of the forecasting round. A medium-term forecast is built on the basis of a quarterly projection model where the modeling is performed by analyzing the gaps (i.e. deviations of actual values of macroeconomic indicators from their potential levels), thus enabling to estimate the economic cycle in Kazakhstan.

At the end of the 3rd phase, the resulting forecasts are taken into account in the decision-making about the level of the base rate in the medium-term. In 2017, four out of the planned eight decisions about the base rate will draw upon outcomes of the forecasting round:

- February 20;
- June 5;
- August 21;
- November 27.

Based on the National Bank's forecasts prepared as part of the "October-November 2016" forecasting round², the annual inflation is expected to be within the target band of 6-8% throughout 2017 under the baseline scenario (oil price of USD 40 per barrel).

² The forecast of macroeconomic variables is based on statistical information as of October 27, 2016.

The external situation, in terms of inflation, will be favorable. Low growth rates of the global economy, a stable situation in global commodity markets, moderate inflation in countries – Kazakhstan's trading partners will help slow down the import of inflation. The stabilization of world oil prices will become the ground for low devaluation expectations and a gradual adaptation of economic agents to new macroeconomic conditions.

In 2017, the growth rates of the Kazakh economy are expected to be at 1.7-2%. Meantime, throughout the year the economy will be functioning below its potential level. The economy will be still heavily exposed to exogenous shocks.

Refining Minimum Reserve Requirements

Minimum reserve requirements (MRRs) have been historically used in the international practice mainly for the purposes of prudential regulation, money supply management and liquidity management. Currently, MRRs are not used for prudential regulation due to the appearance of more efficient supervisory and regulatory tools. The use of MRRs for control over the money supply was relevant in the conditions of the money targeting; however, because of decreasing correlations between the change in the money supply and inflation, this role of reserve requirements has substantially weakened.

Nonetheless, minimum reserve requirements are actively used in many countries, including those which had moved to the inflation targeting regime. The focus in their application has been successfully shifted towards liquidity management with a view to regulate interest rates in the money market and keep them within the required band. By changing their minimum reserve requirements, central banks regulate the demand for their reserves on the part of commercial banks and by using their instruments they maintain the money market liquidity at the level which allows keeping short-term interbank interest rates within the target band.

In its current form, MRRs in Kazakhstan are not sufficiently effective in terms of liquidity regulation and impact on the interbank money market rates. In order to improve efficiency of MRRs, such elements of the mandatory reserving system as the structure of reserve liabilities, structure of reserve assets and other elements will be revised.

In such case, the National Bank will be building up the system of monetary policy instruments which will provide access for banks to resources of the interbank market or of the National Bank to compensate for any shortage or excess.