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## **Monetary Policy Guidelines of the Republic of Kazakhstan for 2015**

### **Foreword**

The state of the global economy and current environment in which it is functioning are currently assessed as unstable and multidirectional. The Euro zone is at the verge of a new wave of economic recession. China, Russia and a number of other emerging market economies demonstrate the slowing rates of economic growth. The standing of oil-exporting countries is aggravated by the decline in the world prices of oil observed since the middle of 2014. In addition, persisting geopolitical uncertainty represents another factor contributing to deterioration of the situation in the global economy.

Thus, in 2015 the development of Kazakhstan's economy will be influenced by unfavorable external factors, including the volatility in global financial and commodity markets and unstable capital flows.

Under these conditions, monetary policy of the Republic of Kazakhstan will be aimed at ensuring price stability. The National Bank of the Republic of Kazakhstan (hereinafter – the National Bank) plans to expand the set of monetary policy instruments used for provision and withdrawal of short-term tenge liquidity, as well as to increase its participation in the domestic money market. Provision and withdrawal of liquidity will be conducted through open market operations (at the initiative of the National Bank) and standing facilities (at the initiative of banks). The main liquidity providing operations will be reverse repos. The National Bank will focus its efforts on increasing effectiveness of the interest rate policy by keeping market rates and their volatility within an acceptable range.

The exchange rate policy is designed to ensure a balance between the internal and external competitiveness of Kazakhstan's economy.

The National Bank depending on implementation of possible scenarios for the development of the economy will maintain the balance between the price stability as primary objective of monetary policy and to ensure the financial system stability.

The implementation of monetary policy measures is aimed to deliver the conditions for sustainable long-term economic growth and to retain the inflation within the target band.

## **Chapter I. Macroeconomic Development and Monetary Policy of the Republic of Kazakhstan in 2014**

### **Paragraph 1. Macroeconomic Development in 2014**

The economy of Kazakhstan was characterized by stable development amidst uncertain environment in the global financial and commodity markets.

According to the World Bank, growth rate of the global economy amounted to 2.6% in 2014. The United States economic growth rate amounted to 2.4%. The Euro zone has experienced a slight economic growth of 0.8% in 2014, in comparison to a decline of 0.4% in 2013.

A slowdown in economic activity also was observed in emerging markets, except for Chinese economy, where growth rate reached 7.4% in 2014. The economy of the Russian Federation, one of the key trading partners of Kazakhstan, shows the slowdown in the growth rates of gross domestic product (hereinafter – GDP) to 0.6%. The growth of inflation rate in Russian Federation amounted to 11.4%.

According to the IMF, the growth rate of global GDP in 2014 will remain at 3.3%, with the initial forecast of 3.7%, and will increase up to 3.5% in 2015.

In this context, the economic activity in Kazakhstan has slowed down. According to preliminary estimates of the Ministry of National Economy, in 2014 GDP growth in Kazakhstan amounted to 4.3%.

In addition, the growth rate of industrial production amounted to 0.3% in 2014 due to the increase in production of the manufacturing industry by 1.0%, including food manufacturing – by 2.9%, light industry – by 3.7% , oil refining – by 2.5%, mineral products – 3.5%, ferrous metallurgy – by 8.6%.

The growth of gross agricultural production amounted to 0.8%.

Growth of production of goods in 2014 amounted to 1.0%, services – to 6.0%. Growth of services was achieved due to a significant increase in the volume of trade – by 9.0%, information and communication – 8.5%, and transport and warehousing – 7.0%.

Fixed capital investments increased by 3.9% due to growth in enterprises own funds by 22%, which account for 58% of the total investment, and growth of state budget resources by 20.1%.

Positive trends in the economy have helped to maintain social stability in the country and to ensure the well-being of citizens.

In January-November 2014 the average nominal wage increased by 10.7% and amounted to 117.5 thousands tenge. Real income of households grew by 3.0%, real wages - by 3.8%. The unemployment rate in 2014 was 5.0%.

The steady growth of incomes and wages, as well as favorable unemployment rate has contributed to the increase in consumer activity. The growth of domestic consumption served as one of the main factors of economic growth in 2014.

During 2014, foreign trade turnover of Kazakhstan decreased by 10.5% and amounted to US\$ 119.4 bln. due to decline in imports by 15.6% as the result of tenge adjustment, and decrease in exports by 7.8%.

Based on the performance for 9 months of 2014, a current account surplus made up about US\$5.2 or 3.6% of GDP versus US\$1.0 bln. during 9 months of 2013.

Relative improvement of the current account during three quarters of 2014 versus the same period of 2013 occurred due to the increased balance of trade surplus of US\$3.7 bln. to US\$30.0 bln. During three quarters of 2014, exports of goods amounted to US\$61.8 bln. (the decrease of 2.6% versus the same period of 2013), and imports of goods amounted to US\$31.8 bln. (reduction by 14.4%).

The financial account (excluding operations with reserve assets of the National Bank) during 9 months of 2014 had a negative balance of US\$6.4 bln. The increase in the net capital inflow or “a net borrowing from the rest of the world” of more than US\$4 bln. versus the same period of 2013 was secured by operations of the 3<sup>rd</sup> quarter when a negative balance of the financial account reached US\$ 5.2 bln. as a result of a notable reduction in short-term foreign assets against the continuing growth in liabilities on direct investments.

In 2014 the international reserves of the Kazakhstan have increased by 7.3% and amounted to US\$102.4 bln., including US\$73.5 bln. of assets of the National Fund of the Republic of Kazakhstan and US\$28.9 bln. of foreign exchange reserves of the National Bank.

The 50% decline in the world prices of oil (Brent) from US\$112/barrel (June 2014) to US\$56/barrel (December 2014), as well as process of metals which represent major items of Kazakhstan’s exports will have a negative impact on the status of the country’ balance of payments in the near term.

The change of business environment in foreign markets also affected the lending and savings in the economy. Alongside with that, a slowing business activity is caused both by internal and external reasons. Completion of the quantitative easing program in the US, overflow of capital from developing markets to developed countries, first of all to the US, have effect on the regional and domestic economy. Given these circumstances, elevated expectations of devaluation persist in Kazakhstan, this having impact on the business activity.

In these circumstances, in 2014 the overall volume of bank credits to the economy reached 12.1 trln. tenge, having increased by 7.2%. Credits in the domestic currency increased by 7.9% to 8.6 trln. tenge, and foreign currency credits – by 5.5% to 3.5 trln. tenge.

In 2014 it was decided to allocate the funds from the assets of the National Fund of the Republic of Kazakhstan for the support of the economy. Meantime, 100 bln. tenge designated for SME lending via commercial banks were used in full. In addition, 250 bln. tenge were channeled to replenish the shareholders’ equity of the Distressed Loans Fund JSC to deal with non-performing loans of the second-tier banks. As of January 1st, 2015, the level of loans which are overdue for more than 90 days has decreased from 33% to 23.5% in 2014.

In 2014, the National Bank undertook measures in order to limit an excessive growth of consumer lending. As the result, the consumer lending growth rates decreased from 46.4% in 2013 to 17.3% in 2014.

During 2014 deposits of residents increased by 15.9% and amounted to 11.7 trln. tenge. Deposits of non-bank legal entities increased by 18.1% to 7.3 trln. tenge, and deposits of individuals increased by 12.6% to 4.4 trln. tenge.

Deposits in domestic currency decreased by 17.7% to 5.2 trln. tenge, and foreign currency deposits increased by 72.2% to 6,5 trln. tenge. Accordingly, the share of foreign currency deposits reached 55.6%.

## **Paragraph 2. Monetary Policy and inflation processes in 2014**

The main objective of the National Bank in 2014 was to ensure the stability of prices and to keep the inflation within 6-8%. Based on performance in 2014, at the year-end inflation accounted for 7.4% (in 2013 – 4.8%), thus corresponding to the established target band.

Acceleration of inflation in the first half of 2014 was associated with the adjustment of exchange rate of local currency in February 2014 and associated increase in prices for imported goods as well as with seasonal factors. However, the effect of the Tenge adjustment on pricing was of a short-term nature and was limited. In February 2014, the level of inflation was 1.7%, in March 2014 – 1.0%. Starting from April 2014, the monthly inflation rate decreased and corresponded to the trends of the past years. The measures taken by the Government of the Republic of Kazakhstan to curb the unjustified price and tariff growth were also conducive to the decrease in the inflation rate.

The increase in prices for gasoline and diesel fuel in the domestic market in August 2014 resulted in some increase in the inflation rate in the second half of 2014.

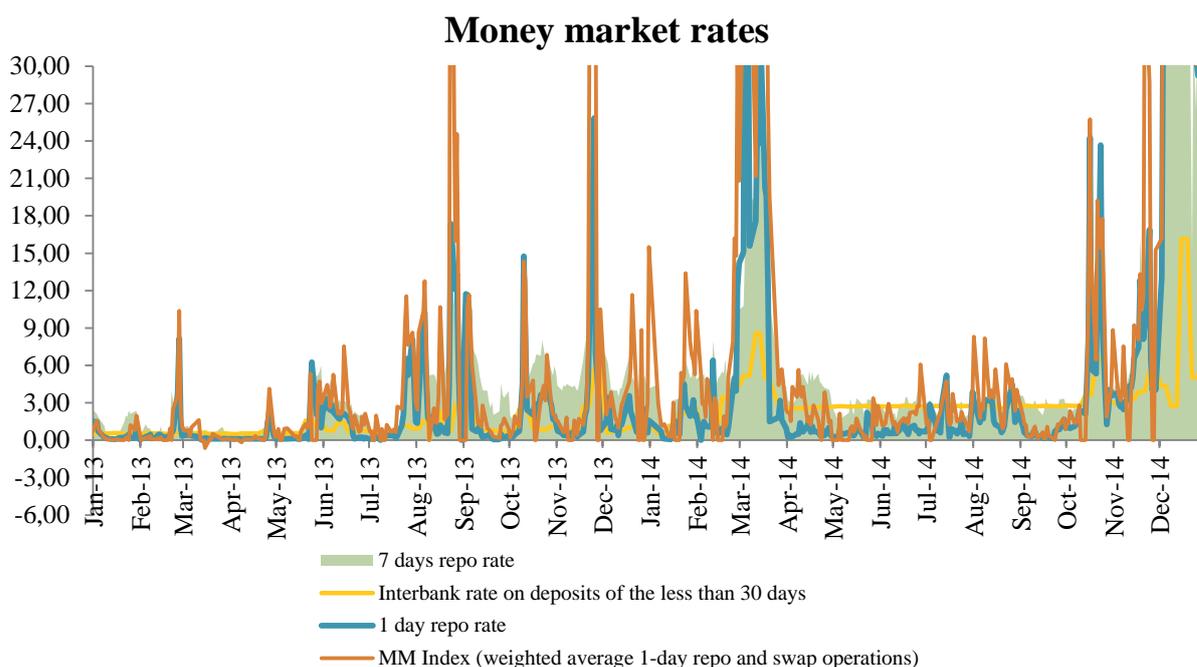
By the end of 2014, the inflation rate was decreasing due to the decline in the marginal prices for gasoline and diesel fuel in December 2014 because of falling world prices of oil, the decreasing rates of growth in prices for industrial production of Kazakhstani producers as well as cheapened goods imported from the Russian Federation due to depreciation of the Russian ruble exchange rate.

In 2014, the National Bank conducted operations to provide Tenge liquidity. In February 2014, the National Bank performed the adjustment of the Tenge exchange rate and set the exchange rate band at KZT 185/US\$ plus/minus 3 tenge. With a view to make the instruments in the Tenge more attractive, in February 2014 the National Bank increased rates on 7-day deposits from 0.5% to 2.75%, and from December 15, 2014 – to 3.05%. In addition, the National Bank suspended deposit-taking operations with one month maturity. The level of the official refinancing rate in 2014 remained unchanged at 5.5% in annual terms.

The situation in the money market during certain periods in 2014 was differing significantly. In January-February, the National Bank was providing the short-term

Tenge liquidity to banks through reverse repos. At the beginning of 2014, the money market rates were characterized by high volatility associated with devaluation expectations and the adjustment of the exchange rate of Tenge. Starting from April 2014, the situation in the money market had stabilized and the market rates were at low levels except for certain tax payments periods.

Since July 2014, the National Bank has begun providing the long-term Tenge liquidity to banks through cross-currency interest rate swaps that influenced the situation in the money market and helped reducing the volatility of market rates. Money market rates are shown in the figure below.



Source: National Bank of the Republic of Kazakhstan

The situation in the foreign exchange market remained stable and there was a trend for appreciation of the Tenge exchange rate versus the US Dollar. In September 2014, the National Bank expanded the exchange rate band of the Tenge versus the US Dollar and established an asymmetric band of KZT 185 +3/-15.

The increased volatility of market rates and their dramatic growth in the interbank market in October-December 2014 were caused by devaluation expectations associated with declining prices of oil and dramatic depreciation of the exchange rate of the Russian ruble. In these circumstances the National Bank provided the short-term Tenge liquidity through reverse repos and currency swaps.

During certain periods in 2014 short-term excessive liquidity was observed that was regulated by the National Bank of the Republic of Kazakhstan through deposit-taking operations and issuance of short-term notes. During 2014, the volume of attracted deposits amounted to 4608.7 bln. tenge (in 2013 –2916.6 bln. tenge). During 2014, the volume of issued short-term notes of the National Bank amounted to 81.4 bln. tenge

In 2014, minimum reserve requirement ratios remained unchanged: 2.5% on domestic short-term liabilities, 0% on domestic long-term liabilities, 6.0% on foreign short-term liabilities, and 2.5% on foreign long-term liabilities. In 2014, minimum reserve requirement ratios were aimed at restricting foreign borrowings by banks.

The structure of reserve assets in 2014 gradually changed: the share of bank correspondent accounts in the Tenge decreased (from 55.4% at December 30, 2013 to 44.5% at December 29, 2014). Despite decreased volume of reserve assets (the 2.1% decrease on a year-to-date basis as of December 29, 2014), in 2014 reserve assets exceeded the required reserving volume by 2.2 times in the system as a whole.

## Chapter II. Scenarios for the Development of the Economy and the Monetary Policy of the Republic of Kazakhstan in 2015

### Paragraph 1. Scenarios for the Development of the Economy in 2015

The National Bank, as part of drafting of the Monetary Policy Guidelines of the Republic of Kazakhstan, designed two scenarios for the development of the economy in 2015 as presented in the Table below.

#### Forecast of the key Monetary Policy Indicators for 2015

(at end-period)

Key Indicators	2014	2015	
	Estimate	Forecast	
		first scenario (price of oil US\$50/barrel)	second scenario (price of oil US\$60/barrel)
<b>GDP, KZT bln.</b> (forecast by the MNE RK)	40 258*	41 308	41 855
<b>Real GDP growth, % annualized</b>	4.3*	1.5	2.0
<b>Inflation, % annualized</b>	7.4	6-8	6-8
<b>Official refinancing rate, % annualized</b>	5.5	6-8	6-8
<b>Money supply, KZT bln.</b>	12 816	13 150	13 337
<b>Deposits of residents, KZT bln.</b>	11 694	12 003	12 174
<b>Credits to the economy, KZT bln.</b>	12 106	12 423	12 588
<b>Monetization of the economy, %</b>	31.8	31.8	31.9

\*According to estimates of the Ministry of National Economy of the Republic of Kazakhstan

Annual average level of the world oil prices was defined as a key criterion for distinguishing between scenarios. Two scenarios for development of macroeconomic situation were considered; they assume the average level of the world oil prices at US\$50 and US\$60 barrel based on the GDP forecasts made by the Ministry of National Economy of the Republic of Kazakhstan.

To perform scenario-based forecasts of the balance of payments, the information about physical volumes of goods production taking into account

implementation of investment and infrastructure projects with participation of international financial organizations prepared by the Ministry of National Economy as well as the outcomes of the monitoring foreign exchange transactions registered with the National Bank was used.

According to estimates of the National Bank, quite a steady growth in lending volumes is anticipated during the reviewed period. Resources to be allocated from the National Fund of the Republic of Kazakhstan in 2015-2017 to support the country's economy will serve as one of the lending sources. Furthermore, the volumes of medium and long-term lending will also be influenced by the measures of the National Bank designed to improve the quality of second-tier banks' assets.

As part of the program on improvement of second-tier banks' asset quality and reduction of non-performing loans volumes, the National Bank is drafting of the Law of the Republic of Kazakhstan on non-performing loans and assets of banks, aimed at reduction of administrative barriers when conducting operations to improve the quality of distressed assets, the strengthening of secured creditors' rights, development of a neutral tax environment when conducting transactions for the transfer of non-performing assets.

The National Bank will continue working on development of favorable environment to increase the efficiency of cooperation between "Distressed Loans Fund" JSC and second-tier banks. The main purpose of the National Bank in this context is to achieve the target level of non-performing loans (loans overdue for payment of principal and / or interest) of 10% of the loan portfolio of second-tier banks.

According to estimates of the National Bank, based on performance in 2014 the balance of trade surplus will remain at the level of 2013, parallel with the decreasing exports and imports of goods. On other current account items, a negative balance caused by the decreased imports of goods and distributions to foreign investors is expected to decrease. Thus, despite significant deterioration in fundamental factors at the end of the year, based on performance in 2014 the current account surplus is anticipated along with continuing net inflow on direct and other long-term investments.

Realization of all scenarios of the Kazakh economy development in 2015, the main objective of the National Bank is to ensure the price stability, which implies that the annual inflation will be kept within the band of 6.0-8.0%.

In case of realization of the first scenario, where the average level of the world oil price will remain at US\$50/barrel, the growth rate of real GDP is estimated at 1.5%.

The implementation of this scenario in 2015 implies reduction in net exports, given the reduction of imported goods and volumes of distributions of income to non-residents. As a result, the current account deficit will not exceed 4.0% of GDP.

With respect to financial account, the decrease in the net inflow on direct investments is anticipated, due to the fact that the peak of financing on projects

implemented in the prior years was covered and with a potential deferral of implementation of new projects with participation of foreign direct investors.

The dynamics of money supply will correspond to the dynamics of nominal GDP, which will preserve the monetization during the forecasted period at the same level as in 2014.

Implementation of the second scenario assumes that in 2015 the world price of oil would be somewhat higher than under the previous scenario, however, it would be below the actual level of 2014 about US\$60/barrel. As a result, the rate of real GDP growth in 2015 will account for 2.0%.

In 2015, the balance of trade surplus and distributions of income to non-residents are expected to decrease. As a result, the current account deficit is expected not to exceed 3.0% of GDP.

With respect to financial account, there might be a reduction in the net borrowing by private sector that may be offset by new government borrowings from international financial organizations and transfers from the National Fund of the Republic of Kazakhstan.

In 2015, demand for money under this scenario will be higher as compared to the previous scenario. The dynamic of money supply would be in line with the rates of the GDP nominal growth thus ensuring the growth in monetization in the forecast period compared with the 2014.

The National Bank believes that the first scenario of the Kazakh economy development is most likely to be realized. Based on these assumptions, monetary policy measures for 2015 have been elaborated.

## **Paragraph 2. Monetary Policy Instruments in 2015**

In order to achieve the inflation target, in 2015 the National Bank will regulate short-term liquidity through open market operations, standing facilities, as well as through the mechanism of minimum reserve requirements.

Given the limited volume of liquid securities in the banks' portfolio, there is an intention to extend the list of collateral thus expanding the access of banks to the short-term Tenge liquidity. Inter alia, examine the possibility of drafting the framework of liquidity provision to banks against the pledge of non-market assets (high-quality loan portfolio) and the possibility of conducting deposit auctions.

Open market operations and standing facility of the National Bank are presented in the table below.

## Monetary Policy Instruments of the Republic of Kazakhstan

Purpose	Type of instrument	Instrument	Collateral	Duration	Frequency
Liquidity provision	Standing facilities (at fixed rates)	Reverse REPO (purchase of securities with agreement to sell them)	government bonds, other securities in Tenge	1 day	daily
	Open market operations (auctions)	FX swap	foreign currency	1/7 days	if needed
		Reverse REPO (purchase of securities with agreement to sell them)	government bonds, other liquid securities in Tenge	7 days	2 times a week
Liquidity withdrawal	Open market operations (auctions)	Direct REPO (sale of securities with agreement to buy them back)	government bonds	7 days	2 times a week
		Treasury Bills of NB RK		28/91/182 days	weekly
	Standing facilities (at fixed rates)	Deposits		1/7 days	daily

Within the framework of open market operations the National Bank will conduct 7-day reverse repo auctions. These transactions will be conducted twice a week.

In case of shortage of instruments of pledge, the National Bank will be providing liquidity through currency swaps.

In case of excess liquidity direct repos auctions will serve as the key instruments and in perspective – 7-day deposit auctions conducted 2 times a week. Short-term notes will continue to be issued on a weekly basis with maturities 28, 91 and 182 days.

Within the framework of standing facilities, the National Bank will be providing liquidity on a daily basis through 1-day reverse repos. Deposits of the National Bank on an ongoing basis will be available with maturities 1 and 7 days.

In 2015, the National Bank will continue to implement the interest rate policy aimed to increase attractiveness of the Tenge instruments. In the interest rates system of the National Bank the official refinancing rate will perform a more indicative role, and will reflect the rate of inflation and inflation expectations.

As part of fine-tuning its minimum reserve requirement mechanism as an instrument for managing the banking sector's liquidity with a view to further discourage the growth of banks' foreign currency liabilities, the National Bank will introduce a more detailed structure of reserve liabilities by distinguishing liabilities in the Tenge and foreign currency liabilities while preserving the principle of residency

and maturity. Additionally, with a view to improve the banks' ability to manage their liquidity, there is an intention to change the procedure for calculation of minimum reserve requirements while retaining the principle of averaging.

The exchange rate policy is designed to ensure a balance between the internal and external competitiveness of Kazakhstan's economy.

Participation of the National Bank in trading in the domestic foreign exchange market will be dictated by the need to smoothen dramatic and significant fluctuations of the exchange rate that could destabilize the situation in the foreign exchange market and could have a negative impact on the stability of the financial system.

The National Bank in 2015 will continue its work to increase transparency of its actions and to increase the public awareness of measures and instruments of the monetary policy being implemented.

In general, implementation of the above measures of monetary policy is aimed to provide conditions for a sustainable long-term economic growth and for keeping the inflation within the target band.

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