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Kazakh Inflation- Brief Observations and Recommendations

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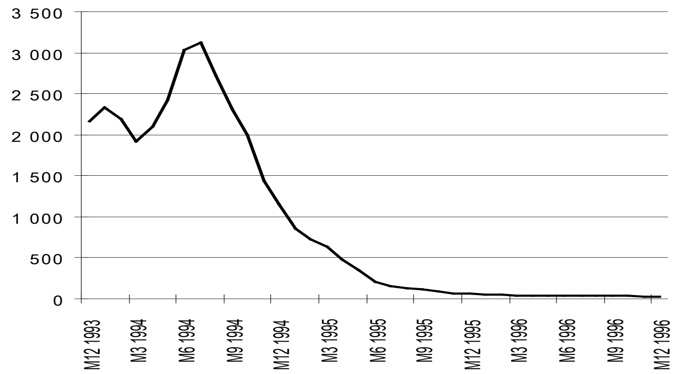
Much like in the rest of the world, inflation in Kazakhstan has been resurfacing recently. Global factors such as food and energy price surge are obviously one part of the story. However, autonomous Kazakh policies could do more to contain inflation pressures coming from demand pressures triggered by buoyant economic activity. This brief casts a critical eye on the Kazakhstan's disinflation experience and more recent inflationary developments.

Fig 1. Inflation in Kazachstan 1993-1996 (in %, year on year changes)



Source: National Bank of Kazakhstan and International Financial Statistics

On the verge of hyperinflation…

Following the break-up of the Soviet Union Kazakhstan had to develop its own instruments of controlling monetary policy and inflation. The first major step was the introduction of the national currency tenge in November 1993 which enabled building the ground for autonomous money and foreign exchange market. The tenge became fully convertible for current account transactions in July 1996, while full capital account convertibility was introduced no earlier than in 2007.

The early years of the tenge were marked by extreme macroeconomic instability which led Kazakhstan into a several-month long period of hyperinflation. The Kazakhstani authorities decided to start reforms with the liberalisation or semi-liberalisation of many administrative prices including staple foodstuffs and housing-related services such as rents, electricity, hot water supply and other municipal services. Resulting were monthly inflation rates reaching 50% for the general CPI and multiples of this figure for goods and services which were subject to upward adjustments. The annual inflation peaked at over 3000% in early 1994 but fell below 100% by the end of 1995.

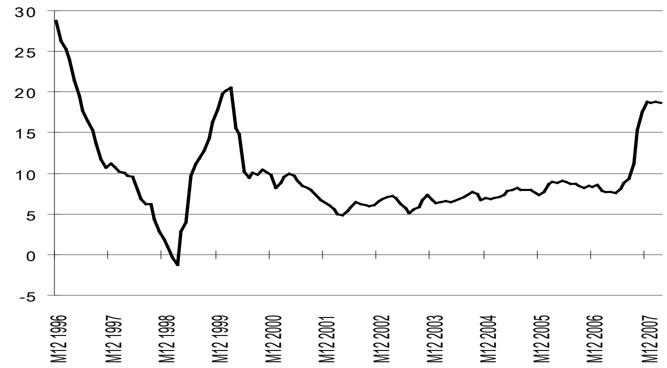
The unclear role of the tenge

The Kazakh tenge did not anchor inflationary expectations during the initial years of transition and depreciated markedly on a monthly level during 1993-1994. The average monthly depreciation rate in the first half of 1994 was 39% coupled with the average monthly CPI inflation of 32% resulting in a massive real depreciation of the currency which further exacerbated inflationary pressures in the domestic market. Beginning in mid-2004 the situation got calmer and the depreciation of the tenge, while still high at 4.2% and 2.9% on a monthly level in 2004H2 and 2005H1, respectively, fell short of the consumer prices which continued to surge at an average rate of 15% and 5% in analogous half-year periods. The ensuing real appreciation of the tenge continued until early 1998.

The real depreciation trend that set in around mid-1998 was exacerbated by the consequences of the Asian and Russian crises. The maxi-devaluation of the Russian rouble in August 1998 and lower oil prices put the tenge under mounting pressure that left the NBK unable to support the currency. In April 1999 the NBK decided to float the tenge resulting in the immediate 30% devaluation. Further weakening occurred in the course of the year leading the tenge to fall from 77 tenge/USD on average in the second quarter of 1998 to 120, 133 and 140 tenge/USD in the second, third and fourth quarter of 1999. This sharp nominal weakening naturally led to the significant real depreciation of tenge with ensuing inflationary consequences. Inflation jumped from the all-time low of -1.3% year on year in March 1999 up to 20.5% a year later.

Following the 1998-99 crisis the new Government was appointed in November 1999 and renewed credibility (IMF programme signed) coupled with the rise in oil prices brought the stabilisation of the real tenge exchange rate. This trend continued until early 2002 – both for USD real exchange rate and real effective exchange rate. Due to the gradual decline of the dollar, the tenge has continued its appreciation trend vis-à-vis this currency until present. The developments vis-à-vis the basket of 24 currencies included in the REER were slightly different: 2002 saw a mild depreciation, 2003 to mid-2006 witnessed gradual strengthening and relative stabilization in the REER prevailed in the most recent period since late 2006.

Fig 2. Inflation in Kazachstan 1997-2008 (in %, year on year changes)



Source: National Bank of Kazakhstan and International Financial Statistics

The relative stability of the REER and the gradual appreciation in the real USD exchange rate since 2000 created a good disinflation environment. Indeed, the period between mid-2002 and mid-2007 has been the longest period of stable single-digit inflation averaging 6.7% on an annual level.

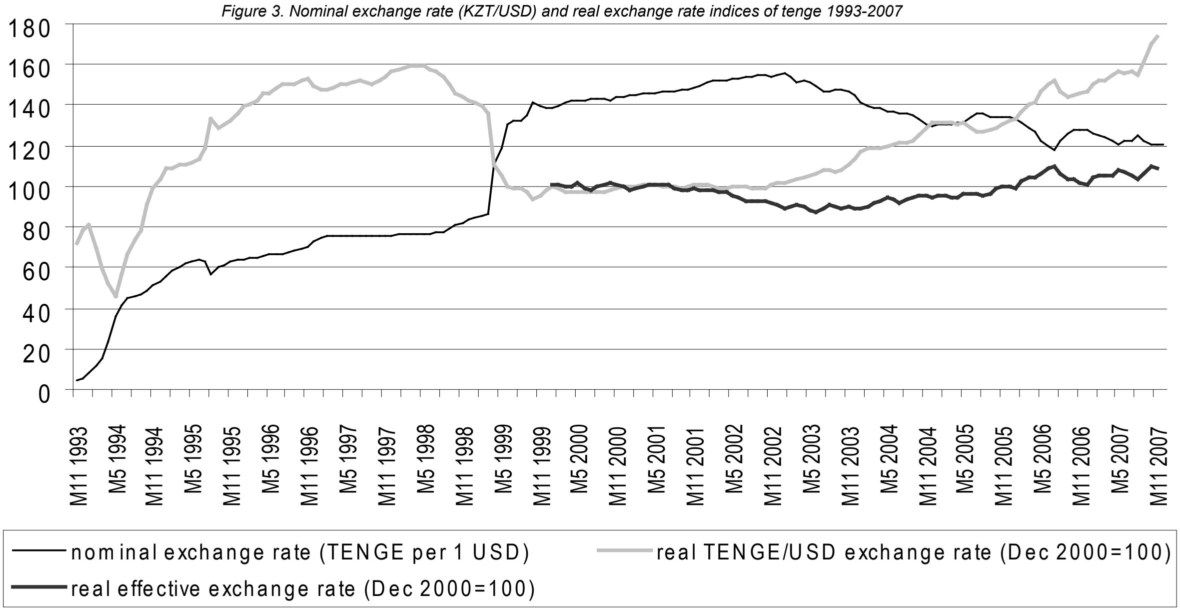
Was monetary policy anti-inflationary ?

The annual monetary policy guidelines of the National Bank of Kazakhstan suggest that the targeted inflation was to be achieved by controlling money supply (monetary base) through setting the interest rates (mainly refinancing rate), mandatory required reserves and – increasingly since late 1990s– open market operations. The NBK has been trying to achieve this while keeping a close eye on the level of reserves and on the movements in the real exchange rate. However, as mentioned earlier, the NBK gave up tighter controls of the exchange rate in April 1999 and interventions in the forex market became less frequent since then.

Figure 4 presents the main policy interest rate and developments in credit to households over the past decade. The figure suggests that the NBK refinancing rate was used very actively in the course of the period. Up to early 2004 the annual rate of the refinancing credit was set at a level exceeding the annual inflation, thus ensuring positive real rates (with few brief exceptions in mid-1996 and early 2000). The rate reached its peak of 26% in real terms in early 1999 when the nominal rate of 25% was kept constant in spite of the rapidly falling inflation (which fell below zero for 2 months). However, since 2004 the real refinancing rate has been very close to zero and turned negative in several months. The second half of 2007 saw an even larger disparity: inflation rising gradually to 18.8% in December, coupled with a constant (until late December) refinancing rate of 9%, widened the negative real refinancing rate to -8.5% in November and -7.8% in December (following the rate hike).

In general the real interest rates policy of the NBK, since 1996, can be described as relatively neutral-to-lax. With the exception of several

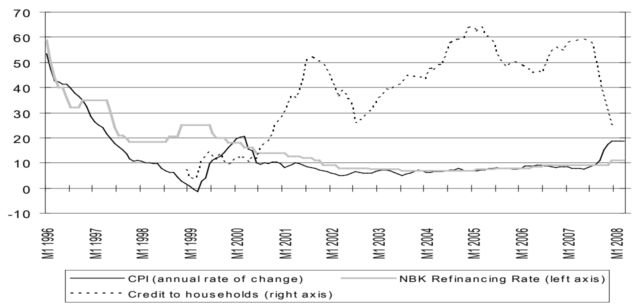
Figure 3. Nominal exchange rate (KZT/USD) and real exchange rate indices of tenge 1993-2007



Source: National Bank of Kazakstan and International Financial Statistics

periods of enhanced restrictiveness (1997-1999, 2001) the ex-post real refinancing rates have been rather low or zero. The resulting dynamics of the broad money supply have been high, exceeding 20% year on year and reaching as much as 100% in 2000 and exceeding 60% in 2004/5 and 2007 – the latter mostly on the back of oil-related foreign exchange inflows. Credit to non-government and in particular credit to households grew at much higher rates, on average exceeding 100% since mid-2003. No wonder that the stock of household credit increased in GDP from a mere 0.27% in 1997 to over 20% in 2007.

Figure 4. Inflation, NBK Refinancing Rate and Credit to households (in % year on year changes)



On the other hand, recent months saw an abrupt decline in both M1 and M3 annual growth rates as well as credit to the economy and especially, credit to households which fell from nearly 140% in the first half of 2007 to 68% in December.

Domestic effects of the global credit crunch

Inflation rose to 18.8% in December 2007 and again to 19.1% in April 2008 (the highest since early 2000) mainly on the back of rising prices of food (45% of the Kazakh consumption basket). This acceleration coincided with the global liquidity crunch, which has had considerable repercussions in Kazakhstan in view of the soaring credit action over the past several years and in particular since 2005. Kazakh banks have become increasingly exposed to the globally rising cost of credit due to financing large parts of their loan portfolios by external borrowing. The global liquidity problems that mounted in the autumn of 2007 exacerbated the refinancing of those credits and coincided with the Standard and Poor's cut in the country's credit rating.

These problems provoked the NBK to step in and intervene by injecting additional liquidity into the market and postponing the planned hike of the minimum reserve requirements until January 2008. They were also most likely the underlying reason for the central bank keeping its principal rates unchanged at 9% (until late December 2007) in spite of rapidly rising inflation. Notwithstanding constant NBK rates credit, market lending rates rose substantially. Interest rates on tenge-denominated credits to non-banking entities rose from 12.8% in June to 14.8% in December ,while those to households rose from 16.7% to 19.3%, respectively.

The developments in the credit market have exerted much pressure on the tenge, which exhibited increased volatility in August and September. The NBK has supported the currency by increased interventions (drawing extensively on foreign exchange reserves) which were efficient in stabilizing the currency around 120 KZT/USD.

The liquidity squeeze has translated into a sharp deceleration of annual growth rates of all major monetary aggregates including the M3 and credit to households which fell from 66% and 138%, respectively, in June down to 34% and 91% in December. Presumably taking the view that the worst of the liquidity problem is behind, the NBK tightened the monetary conditions considerably in November by issuing short-term notes in the massive amount of half-a-trillion of tenge and additionally in December - by raising the refinance rate by 200 basis points to 11%.

Why has inflation risen so much?

This has had so far little effect on annual inflation which has been rising until end-2007 and stabilized at around 19% since then. The factors behind this rise are not limited to the objective global food-price effect as demand-side pressures are playing a non-negligible role as well. With the economy growing at close to 10%, the unemployment rate dropped to an all-time low of 7%. Domestic demand has been expanding on the back of soaring wages (close to 30% year on year in 2007Q4) and a high (albeit decelerating) credit dynamics. This has led to a massive increase in imports (up by 38% in 2007) and contributed to a marked, almost four-fold deterioration of the current account balance from the deficit of US$1.9bn in 2006 to US$7.2bn in 2007.

All these symptoms call for a gradual tightening of the monetary policy through a combination of rises in the policy interest rates and minimum reserve requirements. If necessary these measures can be accompanied by controlled issuance of bank notes to fine-tune the money market. Naturally these steps have to be preceded by a careful consideration of the current and projected liquidity situation in the domestic banking system as well as prospects for future borrowing in the international money markets.

Additional disinflationary effects can be gained from further strengthening of the tenge. With prices of oil reaching new peaks the appreciation of the currency should not have profound effects on the competitiveness of the country. Stronger tenge will push prices of goods (in particular non-food goods) down and curb overall inflationary pressures.

On the other hand, administrative measures taken recently to control prices of foodstuffs are inevitably less effective in view of the structural character of the global food price rise. Minimizing its negative effects on the Kazakh food market could be done more efficiently by fully liberalizing and promoting more competition in the agricultural, processing and retail market in the country.

Przemysław Woźniak specialises in issues related to macroeconomics, monetary policy and inflation as well as economic transition of Central European and Balkan countries. He has led and worked in numerous international research projects as well as technical assistance projects in Montenegro, Serbia and Bosnia and Herzegovina. He obtained an MA (1997) and a PhD (2002) in economics from Warsaw University. Dr. Woźniak has worked as an economist for CASE since 1996 and is a member of the CASE Supervisory Council.

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