JUSAN ANALYTICS

# Monetary conditions

October 2022

Periodic research

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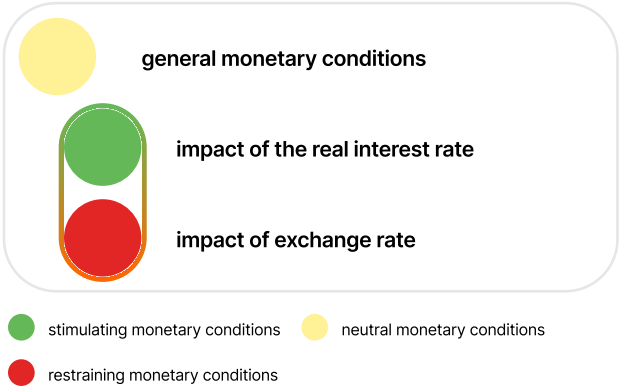
## Interpretation of results

The dynamics of Monetary Conditions Index1 (RMCI) signal a change in the parameters of monetary conditions in the domestic economy. In October, monetary conditions became tougher compared to the previous 3 months and the Index value **corresponds to the transition from stimulating to neutral monetary conditions.**




The components of the Monetary Conditions Index **have a multidirectional effect on inflationary processes and economic prospects**. Thus, the interest rate component has a stimulating effect on business activity growth, and on the contrary, the exchange rate component causes harsh conditions that restrain aggregate demand and slow economic growth and inflation.

According to October data, interest rates were not high enough to limit consumer and investment plans of economic units. And as a result, **the stimulating pressure on economic growth and inflation has increased relative to the previous period in terms of the real interest rate**.

## Dynamics of Monetary Conditions Index


[1]From an analytical point of view, not the absolute value of RMCI itself is important, but its dynamics. When the Index is in a negative zone, we can talk about a period stimulating monetary conditions, in a positive one – about a restraining one. If the RMCI value ranges from -1 to 1, we regard this as neutral monetary conditions.

## Interpretation of results

The exchange rate component of the Monetary Conditions Index in the form of the real effective exchange rate in October shows a significant positive gap since the **level of REER has developed above its potential. This corresponds to the overvaluation of tenge.**

The overvaluation of the national currency contributes to the growth of the investment attractiveness of tenge on the one hand, and it restrains domestic consumption, reduces aggregate demand, and leads to a decrease in output on the other hand. **The downward pressure from these indicators contributes to the weakening of the intensity of inflationary processes in the economy.**

## Calculation methodology

**Real Monetary Condition Index (RMCI)** is used to assess and analyze the monetary policy conditions and subsequent monetary decision-making. The real interest rate (the difference between TONIA and the actual level of price growth) and the real effective exchange rate of tenge (REER) are used in the calculation to assess monetary conditions.

Two types of rates can reinforce or compensate each other, the simultaneous increase in the interest rate and the exchange rate tightens monetary conditions. On the other hand, if an increase in the interest rate is accompanied by a depreciation of the tenge, then the monetary conditions will either remain unchanged or go into stimulating ones.

In the case of Kazakhstan, which is characterized as a small open economy with low diversification and a weak interest rate channel, the ratio (1:3) most often used in calculating RMCI is not suitable, so we considered that the ratio of 1:1 would be optimal.

The equilibrium values of the real interest rate and the real effective exchange rate were determined using the Hodrick-Prescott filter.

### RMCI is calculated by the following formula:

$$RMCI=\theta_R(R_t-R_*)+\theta_e(e_t-e_*)$$

where, $R_t - R_*$ - is real interest rate gap
$e_t - e_*$ - is real effective exchange rate gap
$\Theta_r$ – "is weight reflecting the effect of the interest rate on aggregate demand"
$\Theta_e$ – "is weight reflecting the effect of the exchange rate on aggregate demand"
$\Theta_R + \Theta_e = 1$

- The weighting coefficients reflect the effect of changes in the interest rate and the exchange rate on aggregate demand. According to international practice, their ratio is selected depending on the specifics and development of the economy. In developed countries, a 1:3 $(\Theta_e=0.25, \Theta_R=0.75)$ ratio of weights is usually used, this reflects the high development of financial markets, a strong interest rate channel of the monetary policy transmission mechanism and the ability to absorb external shocks through the exchange rate easily.

- And in developing countries, the ratio can vary from 1:1 to 1:4 $(\Theta_e=0.2., \Theta_R=0.8)$ and is selected by each country separately.

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