

Monetary conditions

December 2022

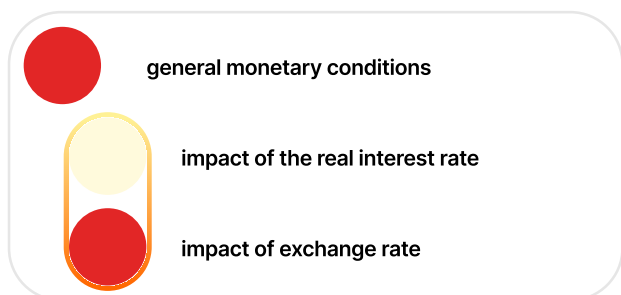
Interpretation of results

Monetary conditions tightened somewhat and became more disinflationary in December 2022. **This happened while simultaneously REER forming at a level above its potential and reducing the negative gap in the real interest rate.** The value of the RMC Index is in the zone of restraining monetary conditions and close to the neutral zone border.

The REER value for the period under review remained at the level of November 2022, which was facilitated by the continued favourable terms of trade. The trend of the REER strengthening observed in the last 5 months of 2022 should limit the price competitiveness of Kazakhstan producers in foreign markets. However, the periodic shortage in certain commodity markets due to geopolitical tensions reduces the possible negative effect on Kazakhstan's export revenue.

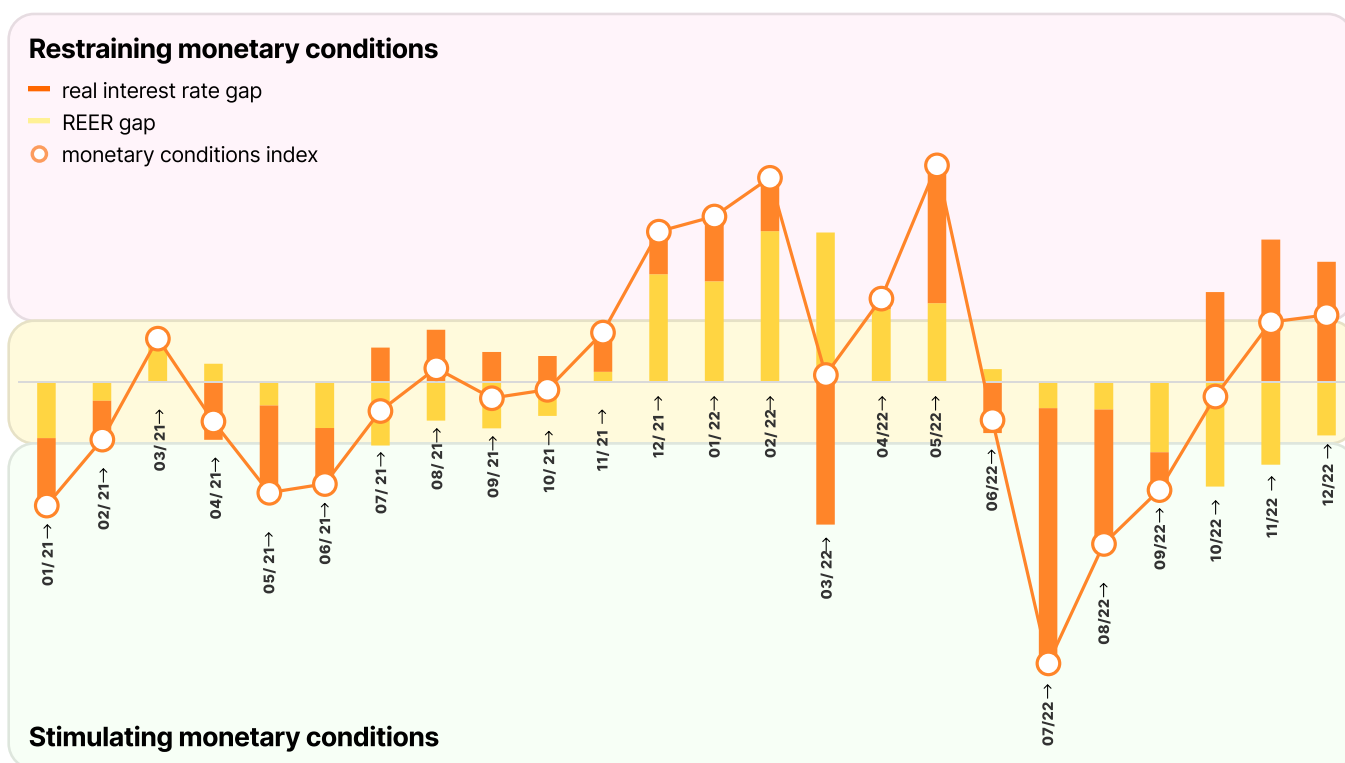
A slight reduction of the positive gap in the exchange rate component is a positive trend since this fact corresponds to a gradual correction of the REER value from its significant overestimation to a more fundamentally determined equilibrium value.

At the same time, **the interest component gap** was closer to 0, and the real interest rate was less negative. This is due to the base rate increase of 75 bps in early December and, contrary to the shock measures taken by the regulator in November 2022, a deterioration in inflation expectations, as well as an increasing excess of tenge liquidity by fiscal measures to support economic activity.



- stimulating monetary conditions
- neutral monetary conditions
- restraining monetary conditions

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 NBK's final decision in 2022 to raise the base rate to 16.75% and determine an inflexion point in monetary policy decisions (the announcement of the current value of the base rate as a peak and the intention to keep it at this level for a long time), with the observed slowdown in price growth rates, suggest that the influence of the Index interest component will be a more neutral effect. Monetary conditions will also be close to neutral as inflationary pressure weakens, and the REER value is close to the equilibrium value. **This will create favourable conditions for a smooth adjustment of the price growth trajectory to be targeted by the regulator inflation.** At the same time, it will take time to completely feel the impact of monetary restrictions, especially on the dynamics of price growth and inflation expectations.

Moreover, relatively tighter monetary conditions contribute to the tenge position growth relative to foreign currencies and a corresponding increase in demand for tenge assets. Thus, the tenge exchange rate against the US dollar for December 2022 strengthened by 1.2% due to the favourable external environment of fundamental factors and the real interest rate growth. And the level of dollarization of bank deposits decreased to a record 31.6%. Restraining monetary conditions contribute to the reduction of consumer and investment demand of economic agents as well as creates incentives for the household and business representatives' deposit inflows. This comprehensively contributes to their behaviour change from consumer to savings and has a disinflationary effect on 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

θ_R - "is weight reflecting the effect of the interest rate on aggregate demand"

θ_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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