

Monetary conditions

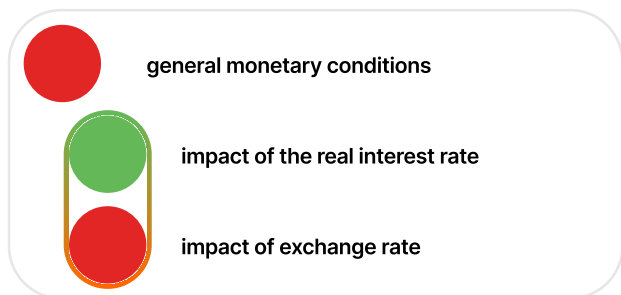
November 2022

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**.

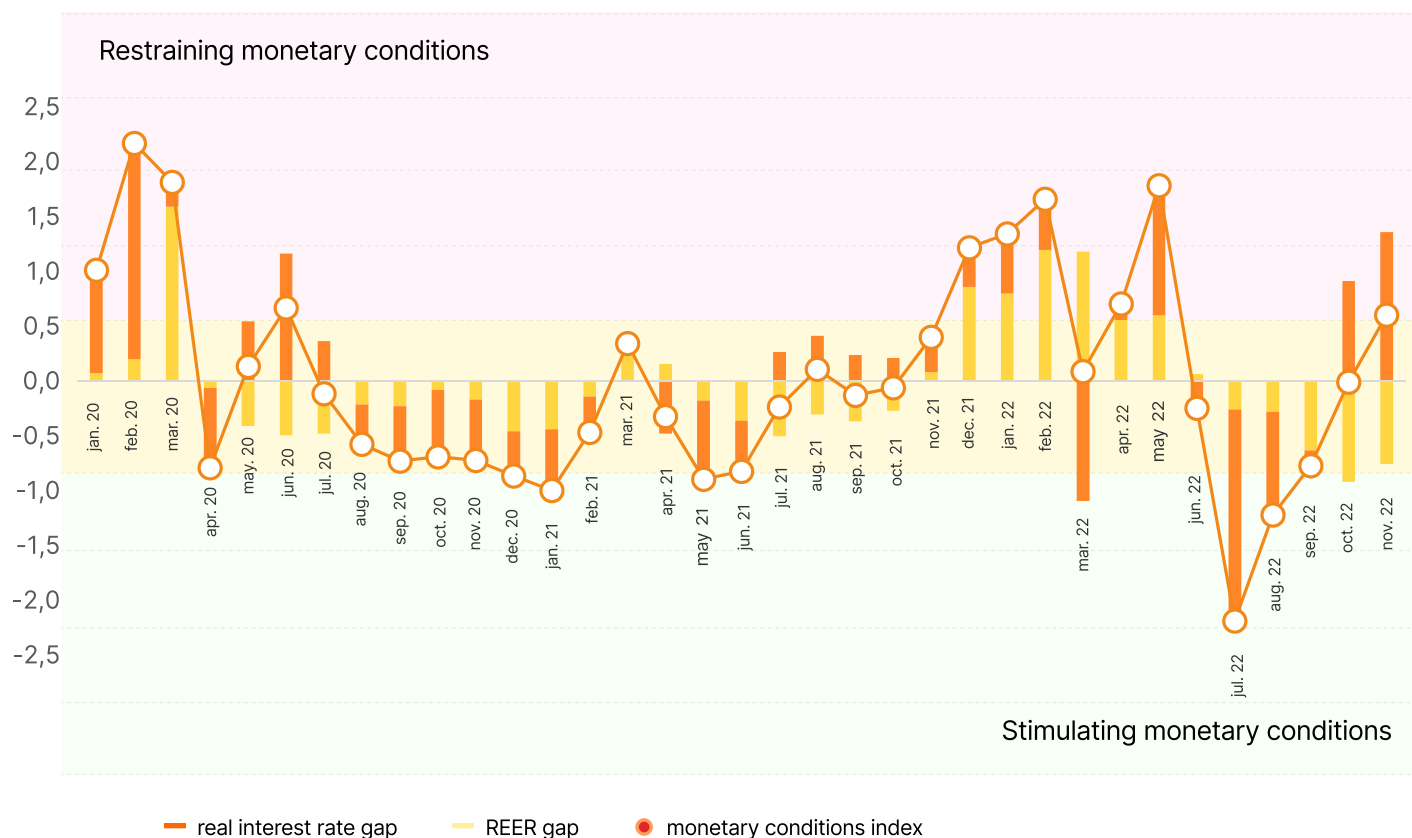
The components of the Monetary Conditions Index **have a multidirectional effect on inflationary processes and economic prospects**. Thus, the interest rate component has a stimulating effect on business activity growth, and on the contrary, the exchange rate component causes harsh conditions that restrain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



- 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 continued high double-digit inflation and deterioration of inflation expectations contribute to an increase in interest rates and, as a result, a decrease in the negative spread in the RMCI interest component. The exchange rate component of the Monetary Conditions Index in the form of a real effective exchange rate shows the expansion of the positive gap. **The REER level has developed significantly above its potential (probably overestimated in the short term).**

The main advantage of the increasing deviation from equilibrium, which leads to the national currency overvaluation in the current conditions, is the relatively low cost of imported goods, which acts as a deterrent to the import component of increased consumer inflation. On the other hand, the simultaneous price increase and reduction of exports deprive the country of a certain share of foreign exchange earnings, which leads to a decrease in the current account surplus. The long-term overvalued national currency exchange rate with the continuing unfavourable pressure from the external environment contributes to doubts on the marketability of the current exchange rate. And this is reflected in the devaluation expectations and the increasing risks of dollarisation.

Thus, the current restraining monetary conditions are formed due to the limiting effect of the Index exchange rate component and a negative gap reduction in the real interest rate caused by the base rate increase to 16.00% per annum adopted in November 2022 and a significant deviation of the actual price growth from the forecast trajectory. Restraining monetary conditions contribute to the consumer and investment demand reduction of economic agents and incentives for the household and business representatives' inflow of deposits. This contributes to the change of their behaviour from consumer to savings, and as a result, introduces disinflationary effects 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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