Central Asia Economic Papers

No. 17

November 2015




# *The fall of the tenge.* A critical analysis of the official narrative on the Kazakhstani currency devaluation

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On August 20, 2015 the government of Kazakhstan and the National bank of Kazakhstan announced the introduction of a free floating exchange rate and abandoned the peg band that was revised on July 15, 2015 and was widely expected to last until the end of the year. The subsequent sharp depreciation of the tenge, which had been a stable currency for a long time, has surprised foreign investors and financial analysts worldwide.[1] However, the decision was not a big surprise for local experts and representatives of the Kazakhstani business community, as they strongly advocated for devaluation, claiming that it was necessary for the local manufacturing products to compete with their neighbors. Moreover, the macroeconomic data was indicating a sharp slowdown of economic activity (the GDP growth forecast for 2015 was revised down to a meager 1.5%).[2]

In this paper, the arguments of devaluation proponents are examined, critically analyzed and empirically verified. Supporting devaluation was justified with three main arguments: a need to increase the competitiveness of Kazakhstani manufactured goods' exporters, the importance of saving the foreign currency reserves, and the adoption of new monetary policy instruments such as inflation targeting. The

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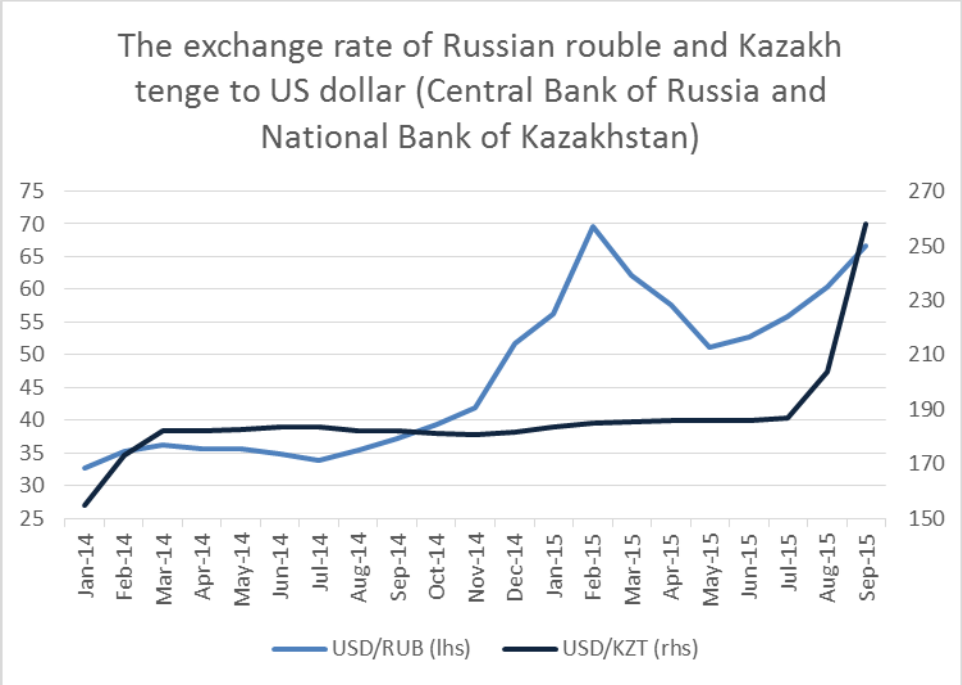
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arguments of devaluation advocates were strong and on the surface persuasive, but few months after the devaluation we can see that the tenge is still experiencing downward pressures and remains highly unstable. The narrative used by the Kazakhstani business community and the government concealed a real objective of devaluation: to improve the earnings of resource exporting companies. This essay argues that the overall devaluation of the tenge has not achieved its stated goals (i.e. the aforementioned three arguments), but, on the contrary, has weakened the long-term competitiveness of the local manufacturing industry and the financial sector.

## The story of tenge devaluation

The August 2015 decision to devalue the tenge, i.e. instituting a free floating exchange rate, was highly controversial and quite distinct from previous rounds of devaluations because it was highly anticipated by market players who placed additional pressure on policy-makers, who then delayed the decision to devalue the currency after the ruble plunge in December. The Kazakhstani authorities used all of their gears to neatly introduce the devaluation of the currency. The right to announce key changes in the monetary policy of the country was given to the Prime Minister – Karim Massimov. The second voice in support of the free floating exchange rate was President Nursultan Nazarbayev, who rarely commented on exchange rate policy and needless to say delivered the unpleasant news to the people of Kazakhstan.[3] And last, by the end of the long month of August there was a statement from Kairat Kelimbetov, the Chairman of the National Bank of Kazakhstan, who usually delivered such news in the past and was considered to be the main spokesperson on monetary policy of the country.[4]

**Figure 1**

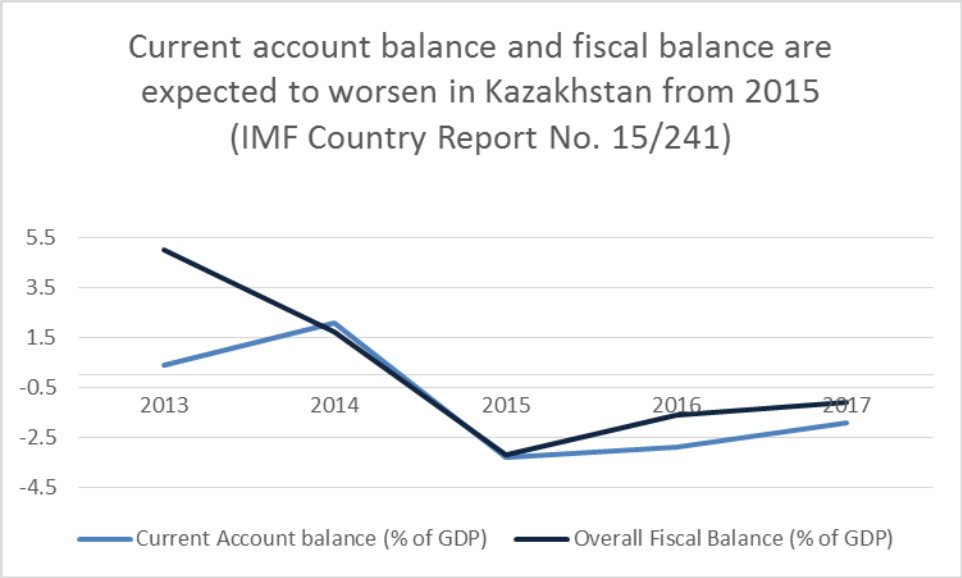



The sequence of speakers was carefully planned and aimed at sparing the National Bank of Kazakhstan from criticism and rendering greater credibility to the decision to introduce a free floating exchange rate. The government, together with leading figures from the national business community, put enormous efforts toward supporting the argument for devaluation. The analysis of the three aforementioned criteria provides a wealth of data on reasons to devalue the currency and neatly summarizes the main arguments of advocates for devaluation.

**Argument 1: Kazakhstani producers cannot compete with Russian and Chinese producers due to the depreciation of the ruble and renminbi**

The sharp devaluation of the Russian ruble at the end of 2014, while the Kazakhstani tenge maintained its peg to the US dollar, opened up significant current accounts and an overall fiscal deficit emanating from trade (see figure 2). Historically, goods and services in Kazakhstan were considered to be more expensive than Russian ones, largely because of transportation costs and limited information on prices of goods and services, i.e. information asymmetry. Importing goods to Kazakhstan was profitable, but was not a lucrative business. However, in December of 2014, when overnight the ruble collapsed 40% in its value, ordinary people realized that cars, equipment and other consumer goods appeared considerably cheaper (at least 40% in lieu of devaluation) in neighboring Russia in comparison with Kazakhstan.[5]

**Figure 2**

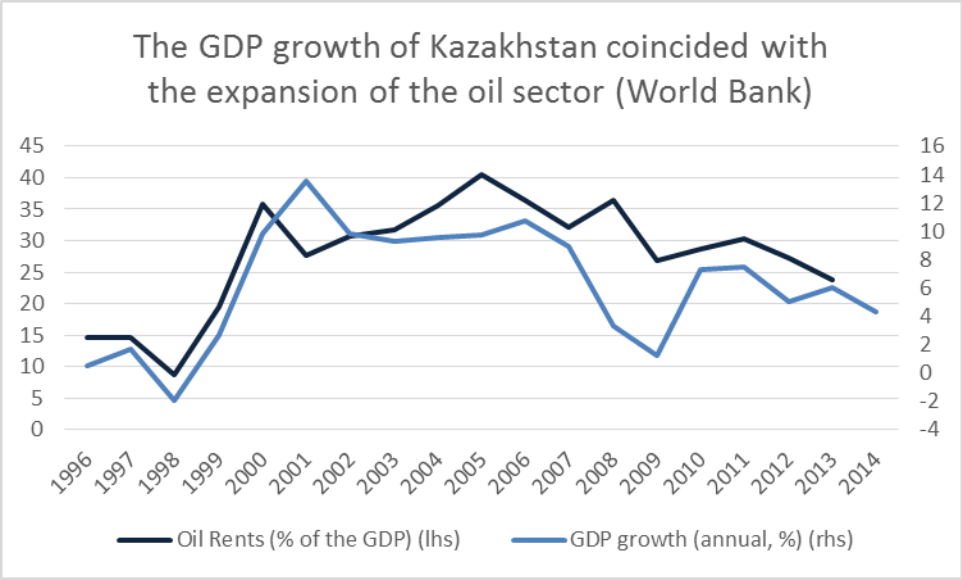



Uncomfortably for the government of Kazakhstan, it lacked administrative tools to restrict the movement of capital across the border. The integration agenda and establishment of the Eurasian Economic Union on January 1, 2015 made it difficult to establish any trade barriers or tariffs on Russian products. At the border with Russia, some roadblocks were constructed temporarily; however, they did not stop trade, with the only inconvenience being waiting lines to cross the border between countries.[6] The first to see the impact were the Kazakhstani car manufacturers, who noticed a 40% collapse in car sales in January.[7] Slowly, complaints were raised by agricultural products producers, consumer goods manufacturers and other businesses. The message was loud and clear that devaluation of the ruble gave an unfair competitive advantage to Russian goods and services.

The summer of 2015 also appeared turbulent, with the unexpected collapse of the Chinese stock market, investors pulling out from developing countries, further slowdown of the global economy and low commodity prices. Those events further eroded the terms of trade for Kazakhstani goods and services as the president pointed out that, in monetary terms, exports in the first half of 2015 collapsed by a whopping 73%.[8] Also notable is that the hope of oil prices rebounding in the near future evaporated by August 2015, and it became obvious for the government that in the medium-term perspective, maintaining huge trade deficits was not sustainable. Thus, the solution was to join the race to the bottom by devaluing the tenge.

To respond to the proponents of competitive devaluation, we should first critically analyze the underlying factors of the competitiveness of the Kazakhstani economy. Competitive devaluation is defined as the process of external adjustment for a country's export products when lowering the exchange rate improves competitiveness in the global market. However, one has to look at Kazakhstan's export structure. In 2014, commodities constituted 77.8% of exports, while manufactured products only constituted 22.2% (conversely, manufactured products accounted for 94% of imports to Kazakhstan).[9] Hence the currency devaluation disproportionately affects imports rather than helping to boost exports, as the price for commodities are set by global markets. The overall positive effect on the Kazakhstani economy due to improvement of the local manufacturers' competitiveness will be limited if one considers that the impressive GDP growth during 2000s was driven mainly by the expansion of the oil sector.

**Figure 3**

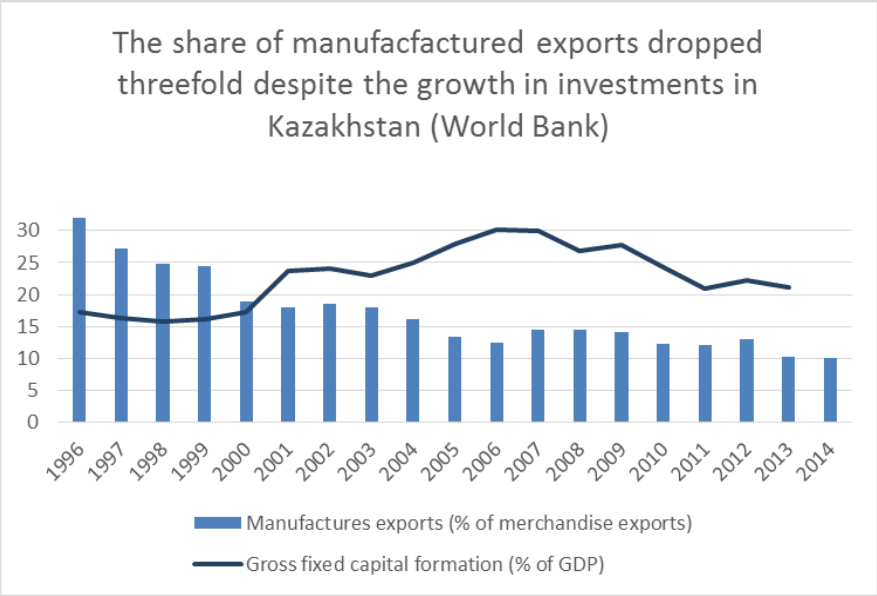



In the case of Kazakhstani tenge devaluation against foreign currencies, it is important to consider the quality variance between local and foreign products along with their position in value chains. The basic tenet of those who compare the price of two products is that the quality of those products has to be roughly the same. For instance, a study conducted by OECD looking at agricultural production in Kazakhstan singled out inadequate quality of produce as the main challenge for development of the sector (58% of respondents).[10] From this point of view, Kazakhstani consumers are pushed to buy locally-produced, lower quality products, while foreign products are comparatively of better quality and often cheaper. Thus, in the case of currency devaluation, economics suggests that Kazakhstani consumers might prefer to decrease their consumption of Russian or Chinese goods of higher quality rather than switch to Kazakhstani manufacturing or food produce. This clearly shows that despite the official narrative, the devaluation of the tenge would not necessarily lead to increased exports of Kazakhstani goods abroad or to increased consumption of local products.

Another dimension to the story is that the Kazakhstani business community bears a large portion of responsibility for the economic stagnation of the country. Over the last decade, the government has launched an impressive scale of programs for entrepreneurship development, industrialization, and business opportunities promotion. It provided enormous support for businesses and industry during the crisis of 2009 and the implementation of the first industrial policy in 2009-2014. It upgraded infrastructure and subsidized business loans. While critics can argue that a chunk of the investments were ineffective or wasteful, overall the government was going in the right direction. Despite attracting high levels of investments, manufacturing exports dropped (as seen in the figure

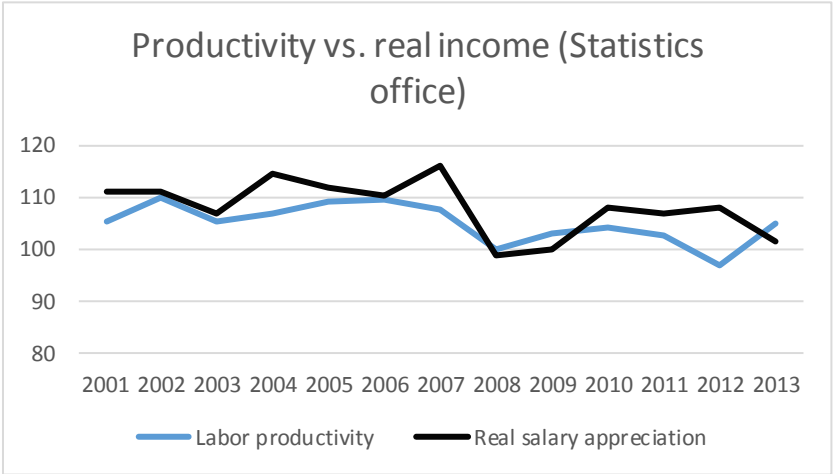
4). This clearly reveals that Kazakhstani businesses failed to develop competitive products on global markets.

**Figure 4**




In the meantime, Kazakhstani businesses learned to live off of generous government subsidies while not investing in R&D (the rate of innovative activity was 8.1% in 2014) or producing high quality goods. The Return on Investment (ROI) of the government is thus significantly negative, with businesses primarily exploiting resource extracting industries, which provide windfall profits for little effort. [11] The Whiteshield Partners recent report, *Diversification of Kazakhstan's Economy: A Capability-based Approach*, registers decreases in the Economic Complexity Index and Opportunity Value in the period from 2009 to 2014, which means that the country was moving towards the periphery of the Product Space, reducing the complexity and sophistication of its products.[12] The lowest Regional Capability was registered in resource-extracting regions of Kazakhstan. Kazakhstani businesses adjusted to make profits and capture rents in the lucrative oil and gas sectors, along with the booming real estate and services sectors, but did not invest in innovation or quality.

**Figure 5**




Moreover, over the past 15 years, income appreciation exceeded productivity gains. While having on average lower productivity than in Russia or Eastern Europe, incomes in

Kazakhstan were rapidly converging. This situation was not sustainable in the long run, with the solution either to cut salaries or raise productivity (for instance, automation of production), with most likely a combination of both.

Viewing the story from that angle, one can conclude that the government had to discipline the business community by cutting excessive wasteful subsidies, encouraging it to produce high quality/value-added and novel products, fostering investments in R&D, and undertaking other related measures. This was arguably done in South Korea, Taiwan and other tiger economies during their economic development.[13]

The expected result of currency devaluation was a net positive impact on the cash flow of Kazakhstani commodities' exporters. Commodity exporters generate revenue in foreign currency, while expenses are incurred in local tenge. So a 30% devaluation of tenge increases revenue of exporters by 30%, while salaries at least for a while remain the same. This logic was confirmed by the national oil extracting company KazMunayGas, which revealed that devaluation enabled it to achieve profitability of approximately 500 billion tenge in 2015.[14] However, it sends the wrong message to the business community: that there is no need to invest in productivity, R&D or innovation, as if profitability would magically return to comfortable high levels after currency depreciation. This in turn instills devaluation expectations, reluctance to conduct long term/over distance business due to currency risks, and heightened volatility caused by speculations.

Meanwhile, a rather unexpected outcome was witnessed by manufacturers and agriculture producers. The devaluation wiped out a significant amount of wealth and made consumers poorer, which limited their purchasing power and willingness to spend in uncertain economic times. By some estimates, the middle income class was reduced by 10-15% over September 2015.[15] Diminishing wealth and incomes in dollar terms circumvented the spending power of consumers and many had to tighten their belts, which reduced aggregate demand in the economy. Rapid fluctuation of the exchange rate brought panic and negatively impacted investment sentiment in the country. Some banks restricted availability of the credit while businesses and people who borrowed in foreign currencies and generated income in tenge suffered from currency risk. Overall, the promised benefits did not materialize, except for commodities exporters, while the action generated a number of negative externalities impacting Kazakhstan in the long run.

**Argument 2: Saving the National Wealth Fund and not wasting the foreign currency reserves of the National Bank of Kazakhstan**

Another important argument for free floating exchange rate devaluation is that it is prohibitively expensive to maintain the peg to dollar. Everyone knew that the National Bank of Kazakhstan was intervening in the exchange market by selling US dollars, but few knew the price tag of the currency stability. On August 20, 2015, it was revealed that over the period of 2014-2015, it cost the government $28 billion to maintain the peg.[16] This is a rather large amount of money for a country which only has reserves of approximately $100 billion. Assuming that there are no windfall proceeds to the reserves due to low commodity prices, such excessive spending may not last even a decade.

It is critical to note that data on the National Wealth Fund of Kazakhstan or the foreign exchange reserves has not been fully transparent. The National Bank of Kazakhstan has been criticized by numerous experts for not fully revealing its currency intervention records and for not providing the full picture on the assets of the National Wealth Fund. Apart from an obscure presidential decree, there is no official legislation on the functions and monitoring procedures for the Fund; almost no parliamentary or public scrutiny is produced on the operations of the National Bank that involves the foreign currency reserves.

Moreover, lately the government has had to tap into the National Wealth Fund not only to maintain the peg, but also to finance its current and investment spending. The Nurly Zhol program of infrastructure investment that was announced in November 2014 was entirely funded by transfers from the National Wealth Fund. Over a period of three years, the program is expected to cost $12 billion (5.8% of GDP), with a large chunk coming from the Fund and $7 billion from loans contracted from Multinational Development Banks (MDBs).[17]

The analysis of the state budget for 2015 paints a rather alarming picture. Income from taxation constitutes slightly more than half (52%) of the revenue stream in 2015, while a big chunk of the money (more than 42%) comes from the National Wealth Fund.[18] As demonstrated in the graph above, most of the investments have not supported the rise of manufactured exports. To top it off, the budget actually assumes a deficit of 3% of GDP. The simple conclusion is that the government spends beyond its means, which is not sustainable in the long run.

Introduction of the free floating exchange rate was supposed to alleviate the government from "wasteful" spending for maintaining the peg by concentrating on infrastructure and other priorities. However, the events of September 2015 proved this idea to be unviable. The exchange rate fluctuations went wild, with movements of up to 20% in a single trading day. This introduced distrust and uncertainty as many exchange kiosks shut their doors. By the middle of September, the tenge appeared in a free fall, depreciating 50% to early August levels.

On September 16, 2015, after the dollar reached an unprecedented high value of 300 tenge per $1, the National Bank of Kazakhstan intervened by selling $144 million. Hence, in the period from September 16 to October 9, the National Bank spent $1,366 billion to stabilize the value of the tenge.[19] The interventions are likely to continue in the foreseeable future, at least until the oil price returns to a comfortably high level. The stated goal was not achieved, and the National Bank of Kazakhstan further diminished its credibility by first claiming that it would not intervene (i.e. free floating exchange rate), but then altering the rules of the game by intervening.

**Argument 3: Introduction of free floating exchange rate adds inflation targeting to the toolkit of the National Bank of Kazakhstan**

A rather unexpected argument, but the most often reiterated on August 20, 2015 was that free floating exchange is needed to pursue inflation targeting. However, all speakers failed to explicitly state the target, which was later revealed to be 6-8% in 2015.[20] However, this is a rather unexpected justification, as the inflation in the period of the first six months of 2015 barely reached 1.5%, which was the lowest level in the modern history of Kazakhstan. Such low inflation was caused by imports of cheap goods from Russia and China, while local producers had to adjust their prices in order to regain competitiveness. Curiously, the government was not happy with the low level of inflation in 2015 and tried to increase it by choosing the most radical instrument of currency devaluation. The issue of a low or negative inflation rate is common for many developed countries and lately the preferred tool has been quantitative easing and infrastructure investment.

Because of devaluation, Kazakhstani consumers saw an overnight appreciation of foreign goods and services. Prices for foreign products started to increase, while manufactured products accounted for 94% of imports to Kazakhstan in 2014. Sharp devaluation, approaching 50% by mid-September 2015, threatened the achievement of the set 6-8% inflation band by overshooting it.[21] Therefore, the National Bank of Kazakhstan, in accordance with the playbook of economics, decided to increase the base interest rate by setting the one day (overnight) repo rate to 12% and further raising it to 16% on October 2,

2015. Officially, it was aimed at pursuing financial and price stability. However, economic commentators pointed out that credit would become prohibitively expensive, which would annihilate investments at the time when they are most needed. Many draw parallels between actions pursued by the Central Bank of Russia in the fall of 2014 and the National Bank of Kazakhstan.[22] The result was that credit and funds were available and affordable only to established and reputable businesses. Meanwhile, entrepreneurs and start-up businesses faced high interest rates, which demotivated investors from taking risks. Effectively, in order to achieve the inflation target, the National Bank has shown willingness to drive the economy into a recession, which could prove to be counterproductive in the long-term.

## Conclusion

The competitive devaluation of Kazakhstani tenge has not achieved the stated goals that were declared in the official narrative of authorities. Moreover, it has made a bad situation even worse by failing to provide a foundation for sustainable growth. This essay shows that the only parties to benefit from the tenge devaluation were commodities' exporters. This makes them attractive for investors, but does not help to achieve the declared goal of economic diversification. On the contrary, it further reduces incentives to invest in R&D, innovation and quality improvement as Kazakhstani businesses lose motivation due to competitive currency depreciation expectations.

Moreover, the government has been setting a dangerous precedent by changing its strategy casually and without consulting all stakeholders. In the hypothetical not-so-distant future case of facing tough competition from foreign producers, the business community of Kazakhstan could spend more effort to pressure the government to once again devalue the tenge instead of looking for niches, innovating new goods/services or otherwise outcompeting others in terms of quality and/or price.

There are two major lessons to be inferred from the experience of Kazakh tenge devaluation to oil-dependent and other resource-dependent countries. Firstly, the official narrative, which has received all-encompassing support from the government and the Central Bank, can masquerade the true reasons for the devaluation, but it still destroys trust and improperly motivates consumers and businesses. Despite the announced goal of inflation targeting and support for locally produced goods, the financial system remains fragile and Kazakhstani consumers are yet to be persuaded to switch to local goods.

Secondly, resource exporting countries with small and undeveloped financial markets switching to a free floating exchange rate increases volatility in the short and medium-term. Conventional wisdom dictates that resource-rich countries need to switch to a free floating rate that would provide stabilizers in times of boom and bust.[23] This classic theory argues that devaluations of the exchange rate are often seen as an appropriate response to macroeconomic shocks that impair a country's competitiveness when nominal prices and wages are rigid, providing a case for floating exchange rates. However, as observed in the case of the Kazakh tenge, a sharp devaluation and pre-mature switch to a floating exchange rate can significantly increase risks for the financial system, and the National Bank will still need to spend its foreign exchange reserves to prop up the local currency.

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