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Government Measures for Economic Support in the Conditions of a Floating Exchange Rate of the National Currency

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ABSTRACT

This article is focused on the government measures for economic support in the conditions of a floating exchange rate of the national currency. The authors analyzed foreign experience of the other countries and propose measures that should be improved in the national field. The implementation of monetary policy causes an increase in the money supply by the recession, stimulate spending, but at the time of inflation, on the contrary, limits the money supply in order to reduce costs. Currently, the main goal of the National Bank of the Republic of Kazakhstan is to ensure price stability in the country, expected accomplishments and keeping inflation low. In order to achieve the targets and the implementation of monetary policy, the National Bank uses certain tools. This article discusses the purpose and monetary policy instruments that have been used by the National Bank in current period and their influence on the economic system.

KEYWORDS
Monetary policy; exchange rate; banks; government measures.

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Introduction

The currency rate is not limited to a passive intermediary function in the international exchange of goods, services, and capital. Its level and dynamic can actively affect the internal and external flows of goods and financial assets of the country. The exchange rate of the national currency, which is an element of the state monetary system, performs a significant function in the monetary transmission mechanism by interacting with interest rates and parameters of money supply and affecting the general economic environment of the country. Therefore, the practice and concepts of the exchange rate, despite their

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alternativeness, are regarded as an essential characteristic and means of maintaining economic balance in both domestic and foreign economies. The exchange rate is especially important for an open economy (Lobanov, 2008).

The role of the exchange rate in the system of macroeconomic regulation measures largely depends on the exchange rate regime in use. Nowadays, countries can choose between different exchange rate regimes, depending on the current goals set before the economy. During the last decades, various intermediate and hybrid types of exchange rate (exchange rate bands, sliding pegs, etc.) have become popular. When assessing the factors that affect the choice of an exchange rate regime, it is worth keeping in mind the discrepancy between the official regime of the country and the one that is actually being used. In practice, it is often difficult to clearly determine whether the exchange rated is fixed or floating. The problem is that on the one hand, certain countries that officially declared a fixed exchange-rate policy allow it to deviate significantly and frequently reconsider this rate. The term "soft peg" is used to characterize such exchange rate regimes. On the other hand, declared floating exchange rates are often regulated by the state through intervention into currency market. The term "hard float" was introduced to characterize such exchange rate regimes (Babula & Ötker-Robe, 2002).

The country's choice of currency, in respect to which the rate of the national currency is fixed, is affected by a number of factors. Before the collapse of the Bretton Woods system, it did not matter for many countries to which key currency they should fix the rate of their currency, since under fixed parity, the fixation to the pound sterling or French franc did not differ much from the fixation to the US dollar. However, in the mid-1970s, the choice of the fixation currency for the exchange rate became very important. It was found that exchange rate fluctuations could cause unwanted changes in the effective exchange rate and, consequently, aggravate the conditions of trade with other countries. Therefore, the fixation of the exchange rate to a specific currency was more beneficial if the country was a major trading partner. However, many countries had a considerable external debt that had to be settled in a different currency, which complicated the choice of the currency for the fixation of the exchange rate (Reinhart & Rogoff, 2002).

The growth of the number of countries that used various types of flexible exchange rates is explained by a number of factors, such as growth of inflation, uncertainty caused by fluctuations of the rates of major world currencies, and exchange reserve deficit. In recent years, this trend has been enhanced by the growing international mobility of capital, which limits the possibilities of sterilized intervention.

Most developing countries and countries with a transition economy are not ready to use a free-floating exchange rate regime, since the unstable currency market can become uncontrollable, when even a few deals can generate strong short-term exchange rate fluctuations. Therefore, such conditions necessitate governmental intervention, with a view to preventing extreme instability of exchange rates.

It seems that the fixed exchange rate can be used as an effective tool of the anti-inflation policy. However, executing an independent monetary policy becomes virtually impossible, because the efforts of the central bank are aimed exclusively at maintaining the declared exchange rate. American economist J.

Frankel (1999) called this problem an "impossible triad" or "trilemma" (a country has to abandon one of the three following goals: open capital markets, independent monetary policy, and fixed exchange rate), since achieving all three is impossible.

Literature Review

The literatures, which studied the monetary policy in the inflation targeting countries, consider the exchange rate movement in the policy decision. L. Ball (1999) states that, under the open economy model, central banks who do not consider the exchange rate in the policy decision create a large variation in the exchange rate and the output, which is too dangerous for the economy. T. Cavoli (2008) finds that responding to the exchange rate in the policy function assists the policymakers in achieving the domestic objectives; inflation objective and the output objective.

T. Wollmershäuser (2006) examines the policy rule when the exchange rate uncertainty is high. The results show that the Taylor rule augmented with the exchange rate movement delivers a lower welfare loss than the simple Taylor rule. This finding is also supported by R. Pavasuthipaisit (2010).

Many empirical studies (Marston, 1990; Goldberg & Knetter, 1997; Campa & Goldberg, 2005) showed that the exchange rate pass-through is incomplete for developing and developed countries such as OECD, Eastern European, US and Asian countries.

The monetary independence hypothesis originated with J. M. Fleming (1962), R. A. Mundell (1964), and R. Dornbusch (1976) models, argues that flexible exchange rates allow countries to pursue independent monetary policies and the domestic interest rate should be less sensitive to changes in international interest rates other things equal. M. Obstfeld & K. Rogoff (1995) were among the first who employed open economy macroeconomic models.

Ability of the exchange rate to transfer external shocks to the national economy remains one of the most discussed areas relating to the current stage of the monetary integration process in the European single market (Anderton, 2003). The degree of exchange rate pass-through to the domestic prices emphasizes its role as the external price shocks absorber especially in the situation when the exchange rate development is less vulnerable to changes in the foreign nominal variables (Campa, Goldberg & Gonzalez-Minguez, 2005).

R. Hausmann et al. (1999), studying exchange rate regimes in Latin America, discovered that flexible exchange rate regimes did not permit more stabilizing monetary policy and that pro-cyclical monetary measures were actually supported by flexible exchange rate regimes. R. P. Flood & A. K. Rose (1995) found either no support or weak support for the trade-offs implied by the trilemma. J. Frankel (1998) concludes that countries having floating or intermediate regimes, exhibit much higher interest rate responses than countries with less flexible exchange rate regimes.

J. Bluedorn & C. Bowdler (2010) compare international interest rate responses under pegged and nonpegged regimes to identified, unanticipated, and exogenous U.S. interest rate changes and realized U.S. interest rate changes. They found important differences in estimated transmission from the two sets of measures - identified interest rate changes demonstrate a greater concordance with the impossible trinity than realized rate changes.

G. Calvo & C. Reinhart (2000, 2002) argue that under the modern float there could be limited monetary autonomy. M. Fratzscher (2002) analyzes the trade-off between exchange rate flexibility and monetary policy autonomy for a group consisting of open emerging market countries and countries under the Exchange Rate Mechanism, finding no systematic link between exchange rate flexibility and monetary independence.

As stated by A. Waiquamdee, P. Disyatat & R. Pongsaparn (2005) in the aftermath of the Asian crisis, there have been common changes from intermediate exchange rate regimes to "corner solutions" that, on the one hand, may have a clean float or a rigid peg or, on the other, may have a managed floating regime.

D. G. Rodionova, V. V. Pshenichnikov &. E. D. Zherebova (2015), who studied currency crisis in Russia on the spun of 2014 and 2015, proposed measures aimed at the improvement of Russia's monetary policy to ensure the stability of the Russian currency.

S. Mahfoudh (2013) proposed the determination "the policy mix" as the interaction between monetary policy and fiscal policy. The results of his studying showed that monetary and fiscal policies in Tunisia are crossed, indeed expansionary fiscal policy led to an intervention by the monetary authorities to increase the interest rates and consequently to implement a restrictive monetary policy.

I. V. Popescu (2014) analyzed the behavior of central banks setting interest rate and found that the stance of monetary policy was able to prevent asset price bubbles in stock markets.

Materials and Methods

The theoretic-methodological basis of this study are modern approaches of scientists in the theory of Central Bank policy under a floating exchange rate. The authors used methods of analysis, comparison, forecasting, scientific abstraction, analogy and survey.

Results

Kazakhstan is a resource-mining country; 70% of its export is energy. According to experts, including foreign ones, a switch to a free exchange rate will help to cope with the negative impact caused primarily by a drop in oil prices. The drop in oil prices has a direct effect on the gross domestic product, especially in countries that depend on oil extraction. For instance, in 2014, the GPD of Kazakhstan dropped by 4.3%; it continues to drop due to smaller demand and drop in oil prices. The domestic demand has reduced because of the erosion of purchasing power after the devaluation of the tenge in February of 2014, stiffening of conditions of consumer lending, and constant expectations of further devaluation. The foreign demand reduced due to the drop in oil prices and the geopolitical events in the region.

The financial sector of Kazakhstan remains unstable. The rate of overdue loans in the general credit portfolio was 26% as of the end of 2014; however, it dropped to 10% in June of 2015. The banking sector is the main source of funding for businesses that continuously call the accessibility of capital a serious obstacle for development. The domestic loans to the private sector in Kazakhstan amounted to about 40%, which was significantly lower than the

world levels. The underdeveloped financial sector limits the investment potential.

The financial sector operated in a relatively difficult environment, characterized by a high level of dollarization and, until recently, problems in exchange rate regulation (OECD, 2016).

The government reacted to devaluation and its effect on the reduction of economic growth by implementing the economic support program that allocated 1 trillion tenge, which was equal to 5.5 billion US dollars in 2014-2015. This support funds were aimed at solving the problems of bank loans, with a view to buying out non-performing loans and supporting small and medium-sized business. In addition, due to the further drop in oil prices and decelerating economic growth, the Government of Kazakhstan launched an additional 14 million US dollar program titled "Нурлы Жол" (The Part to the Future) for 2015-2017, with a view to building transport and social infrastructure and providing credit support to small and medium-sized business.

The National Bank of Kazakhstan approved the governmental monetary policy up to 2020 ("Monetary Policy of the Republic of Kazakhstan to 2020", 2015), the main tool whereof was inflation targeting. It was noted that orientation on reduction and stabilization of inflation at a low level could potentially enhance confidence of markets in the National Bank and facilitate the sustainable and balanced economic growth of Kazakhstan, which is why inflation targeting was the preferable monetary policy regime for Kazakhstan.

Nowadays, there are different opinions regarding the choice of the target indicator of national central banks. Most countries choose inflation as the target indication of the central bank. At that, central banks choose the refinance rate as an instrument of influence on the economy, with a view to controlling market interest rates. This forces banks to waiver control over the exchange rate and switch to floating rates of the national currency. The experience of other countries showed that the switch to inflation targeting starts when the economy has already suffered from inflation. Inflation targeting has proven itself as an effective means of tackling inflation. Inflation targeting is a set of measures taken by governmental authorities to control the level of inflation in the country under the monetary policy of the national bank. The main tool of the monetary policy for maintaining the planned level of inflation is the manipulation of the basic refinance rate. For instance, raising the refinance rate also raises deposit rates in second level banks and makes money saving more attractive, which is a source of bank funding. Furthermore, raising the basic rate increases the interest rates in banks, which lowers the demand for loans and deprives commercial banks of their main source of income.

Lowering the refinance rate reduces the deposit rates in second level banks and makes money saving less attractive, while lowering the basic rate allows credit organizations to lower the loan interest rate. Thus, lowering the refinance rate increases inflation, while raising the basic rate decreases inflation. The tax of the National Bank of Kazakhstan is to maintain a 6-8% inflation under inflation targeting.

During a global crisis and drop in oil prices and the cost of other items of export of the Kazakhstan's mining industry, the National Bank should cooperate with the Government to find a way out of this situation. A general state strategy is required, the main goal whereof should be to maintain stable prices. The new

monetary policy should provide for an effective budgetary and tax system and a flexible exchange rate. When the prices of petroleum commodities, primarily oil, dropped, the tax budget revenue dropped by 20%. This situations requires measures for expanding the income base of the budget not by raising taxes, but by enhancing control over the expediency and fullness of tax payments and collections, by eliminating various tax concessions, especially in special economic areas, especially if the country decided to use market economy mechanisms that provide for equal economic conditions and requirements to all economic entities. The market economy implies competition of powerful players, while the weaker players are forced to either unite or leave the market. "Dragging" uncompetitive players at the expense of the state, i.e. taxpayers, is unfair.

This requires proper use various tools of the monetary policy, which will normalize and strengthen the banking system. Unfortunately, nowadays in Kazakhstan, short-term tools are used to bridge the cash gap in banks, while the problem of deficit of tenge liquidity for crediting the economy remains. In this situation, banks rely on the Unified Accumulated Pension Fund (UAPF), which in turn poses a risk to and causes concern about the future of the UAPF clients. All private pension funds in Kazakhstan have been abolished and reorganized into a unified pension fund. The main reason behind the unification of all private accumulated pension funds was the argument that they invested accumulated pensions in parental structures, mostly second level banks. The managing authority of the Unified Accumulated Pension Fund is the National Bank. The National Bank allocated 1 trillion tenge of UAPF funds to the support of the economy in 2015; 400 billion tenge were allocated to funding the budget deficit; 600 million tenge were allocated to long-term project loans (Table 1).

Table 1. Leading banks in terms of loans from the UAPF in 2015.

Banks of Kazakhstan	*Amount, billion tenge*
1. Kazkommertsbank	312.0
2. Halyk Bank	303.6
3. Kaspi Bank	266.5
4. Eurasian Bank	190.0
5. ATF Bank	160.0

Source: the National Bank of the Republic of Kazakhstan.

The situation with loans from the UAPF by banks is related to the concept of the investment activity of the UAPF, where bank deposits are one of the fund's main sources of investment. This is beneficial for the banks as support of tenge liquidity, especially given the deficit of tenge liquidity with a free-floating rate, one of the causes whereof is the conversion of the people's deposits into a foreign currency. The money of the Unified Accumulated Pension Fund should not be used to credit business, since this is a very risky investment for UAPF investors under ineffective management of the banks' credit activity, which is shown by a large percentage of non-performing loans in the loan portfolio of second level banks.

After the free float of the tenge in August of 2015, the Government took measures to compensate for deposits of up to 1 million tenge by converting them with regard to the tenge devaluation for one year. The same should be done with UAPF deposits, especially since the depositor cannot use the funds before retirement. The deposits of the UAPF have devaluated by at least 35%.

With a floating tenge rate, the tax policy is aimed at improving the attractiveness of the economy and attracting foreign investments. To that end, foreign investors in the manufacturing industry have a number of tax concessions, for instance, 10-year exemption from the corporate tax and 8-year exemption from the land tax. Various programs for supporting business and not increasing the tax burden are provided for domestic companies, with a view to stimulating the development of manufacturing.

Kazakhstan developing a mechanism of state-private partnership, one of the main goals whereof is to reduce the load on the state budget, with a view to funding state programs of economic development. Naturally, corruption aspects can emerge during the implementation of state-private partnership mechanisms, which is why an effective and transparent procedure is required to implement state-private partnership in the real sector of the economy.

Table 2 and charts show that during the February 2015 and August 2015 devaluation of the tenge, banks mostly issued short-term loans to legal entities, mostly in the national currency – tenge.

At the same time, the deposit portfolio of the banking system of Kazakhstan during the same period shows the prevalence of deposits in foreign currency (Table 3 and charts).

According to the data of the National Bank as of October 2015, more than 59% of the deposit portfolio of the banking system of Kazakhstan belong to five banks (Kazkommertsbank, Halyk Bank, Subsidiary Bank of Sberbank of Russia JSC, Tsensabank, ATF Bank) out of 35 banks. The question is: how do other banks operate on the lending market as the main source of income for banks with a low deposit portfolio as a source of bank funding? Therefore, it is necessary to tighten requirements to banks and funding sources not from governmental support, but from the banks' work. Small banks should either unite or leave the market.

All three directions of crediting (corporate business, small and medium-sized business, and retail business) continued their development in 2015. At that, the main direction was retail lending as the most profitable and dynamic segment of the lending market, which was why banks prioritized short-term loans with prevailing development of consumer lending and auto lending.

Table 2. Credits of second level banks as of the end of the period, billion tenge

	Total	*Currency*		*Term*		*Lending entity*	
		National currency	Foreign currency	Short-term	Long-term	Non-banking entity	Individual
12.14	12,106	8,565	3,541	2,497	9,609	8,091	4,015
01.15	12,166	8,524	3,642	2,500	9,666	8,178	3,988
08.15	11,379	8,325	3,054	2,117	9,262	7,258	4,121
09.15	11,834	8,427	3,407	2,251	9,583	7,660	4,174
10.15	11,964	8,508	3,456	2,174	9,791	7,779	4,185

Source: the National Bank of the Republic of Kazakhstan.

Table 3. The deposit portfolio of the banking system of Kazakhstan

	Dec. 2014	*Aug. 2015*	*Sep. 2015*	*Oct. 2015*
Total deposits	11,694,235	13,205,479	14,295,026	14,573,731
including:				
in national currency:	5,199,319	5,389,221	5,177,337	4,967,644
non-banking entities	3,760,612	4,006,551	3,825,244	3,608,961
individuals	1,438,707	1,382,670	1,352,093	1,358,682
in foreign currency:	6,494,917	7,816,258	9,117,689	9,606,088
non-banking entities	3,536,147	4,030,636	4,802,852	5,133,268
individuals	2,958,769	3,785,622	4,314,838	4,472,819
Of the total deposit amount:				
non-banking entities	7,296,759	8,037,187	8,628,096	8,742,230
individuals	4,397,476	5,168,292	5,666,931	5,831,502
Transferable deposits				
in national currency:	1,858,655	2,154,464	2,084,926	1,937,715
non-banking entities	1,499,088	1,813,028	1,759,767	1,605,992
individuals	359,567	341,437	325,160	331,723
Other deposits				
in national currency:	3,340,664	3,234,756	3,092,411	3,029,929
non-banking entities	2,261,524	2,193,523	2,065,477	2,002,970
individuals	1,079,140	1,041,233	1,026,933	1,026,959
Transferable deposits				
in foreign currency:	1,646,078	1,659,600	2,053,395	2,327,231
non-banking entities	1,561,604	1,544,360	1,929,948	2,205,038
individuals	84,474	115,240	123,446	122,193
Other deposits				
in foreign currency:	4,848,839	6,156,658	7,064,295	7,278,857
non-banking entities	1,974,543	2,486,276	2,872,903	2,928,231
individuals	2,874,296	3,670,382	4,191,391	4,350,626

Source: the National Bank of the Republic of Kazakhstan.

The deficit of bank funding and quality loaners on the market forces banks to include their risks into the cost of loans; more than 80% of banks prefer not changing their price (loan rate and additional fees) or non-price (maximum amount and term of loans, requirements to the financial status of the loaner, security requirements) lending terms. However, these lending conditions have been worsening lately. The national banking system does not take measures to temper the credit policy. Therefore, it is necessary to improve the system of credit application evaluation, especially under the support programs for small and medium-sized business and expansion of banking services.

Current governmental programs of easy-term loans for small and medium-sized business, the support of the automotive industry of Kazakhstan, and other programs include only several banks, usually the same ones. For instance, the Development Bank of Kazakhstan allocated 20 billion tenge to the support of Kazakhstan's automotive industry. Auto loans will be available at a nominal rate of 4% per annum for five years for individuals and 4% per annum for three-five years for legal entities and individual entrepreneurs in the national currency (International Agency "Kazinform"). Six banks were chosen to implement this program (Halyk Bank, Eurasian Bank, Subsidiary Bank of Sberbank of Russia, Forte Bank, CenterCredit Bank, and ATF Bank). If Kazakhstan declared the transition of the entire economy to market mechanisms, distinguishing specific banks through various programs of

financial support of the economy is unfair. Everyone should be on equal economic terms and find their own way out of the crisis. This will show the strong players, while the weak ones will have to either unite or leave the market.

Discussions

Kazakhstan's switch to a floating exchange rate inevitably caused debates in the society. Inflation targeting – the unpopular but necessary measure that the Government took regarding the exchange rate – was expedient and correct. It was required to improve the economy and preventing serious budget losses for maintaining the tenge rate.

Inflation targeting is a subject of debate in many countries. Several years have passed since the Central Bank of Russia officially declared a gradual transition to inflation targeting, but it is still unclear how effective this project has been implemented. On the one hand, this transition was as effective for developing economies as it was for developed ones. Furthermore, the goal of the Central Bank regarding inflation (4%) is achievable. On the other hand, the transition of the ruble to free floating is possible only when the ruble is strongly affected by dropping oil prices. Thus, it is unclear to what extent the authorities acknowledged the need for this transition and accepted the expenses associated with it. A recent prediction of the government, which implies that the target 4% inflation will be achieved only in 2019, further stresses this uncertainty (Orlova, 2016).

Many countries have tried different monetary policy regimes – a regime with a fixed exchange rate and one without any specific goals. At this point, the central banks of various countries declare inflation rate as their target and discuss how and when it should be achieved in order to find proper balance between financial stability and inflation. However, nobody doubts the fact that inflation should be the main target indicator for central banks. It is important that the main operational level that the banks use to affect the economy be the refinancing of the banking sector in a way that would allow controlling the market interest rate so that short-term market interest rates do not differ too much from the key and target interest rates set by central banks. However, this forces central banks to abandon the control of the exchange rate, which makes the currency rates more flexible and floating.

Conclusion

The practical implementation of the monetary policy is a result of a multistage and coordinated functioning of the monetary regulation system within the framework of general economic regulation. Effective functioning of the monetary regulation system is crucial for the Republic of Kazakhstan. The goals of assuring long-term socioeconomic growth and the evolution of domestic and foreign economic relations require continuous improvement of the currency system. The comparison of benefits and expenses associated with various regimes of floating or fixed currency rates implies a qualitative and quantitative analysis of the interaction of the exchange rate system and virtually all monetary and general economic parameters, with an obligatory highlight of short-term and long-term aspects.

Greater consideration of foreign economic factors based on the analysis and forecast of world markets and a regular analysis will improve the effectiveness of the exchange rate and monetary policy. The development of economic predictions and programs should include the assessment of the country's status by international criteria and enhancement of economic predictions and programs for both the financial block, which implies the consolidation of domestic and foreign sources of funds used in world practice, and the structural transformation block, which provides institutional, legal, and organizational conditions for the achievement of goals set in the economic policy of the Republic of Kazakhstan.

The National Bank analyzed the choice of the adequate monetary policy regime with regard to the peculiarities of the financial sector and Kazakhstan's level of economic development. The most acceptable regime is inflation targeting, which implies expanding the tools of the monetary policy and mortgage security, organizing an analysis and forecast system for short and long terms, and organizing a decision-making system. Inflation targeting will facilitate sustainable economic growth and help to achieve the strategic goals of the country that looks to become part of the thirty most developed countries of the world.

Disclosure statement

No potential conflict of interest was reported by the authors.

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