

Tenge: Exchange Rate Stable, Interest Rates Volatile

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Since the sudden stop of 2007, Tenge has been heavily managed, with mixed success. In early 2009, a severe terms-of-trade shock made the balance of payments deficit unsustainable and led to a sharp devaluation of the Kazakh currency. Since then, the terms of trade have largely recovered, yet Tenge failed to appreciate. The onset of volatility in the commodity and stock markets and the worsening of the global economic outlook have raised the likelihood of another severe terms-of-trade shock. These risks have put the issue of sustainability of the managed Tenge regime back into the policy agenda. How will Tenge fare should the downside risks to global growth realise? Has the policy of keeping Tenge undervalued in good times made it immune to shocks in bad times? In this article we look at the factors that we believe will shape the policy response to external shocks in the months to come.

MANAGING TENGE IN GOOD TIMES

Since the devaluation of 2009 and up to now, the exchange rate has been very surprisingly stable despite improving terms of trade and inflows of speculative capital. The stability of the exchange rate was in large part due to the policies of the central bank which communicated the intentions clearly and acted on them consistently. The post-devaluation exchange rate policy had two quantifiable parts: a relatively narrow band of 150 ± 5 KZT/USD and a 'smoothing' rule that aimed at keeping daily fluctuations under 0.27% in either direction. The band was widened in February 2010, one year after the

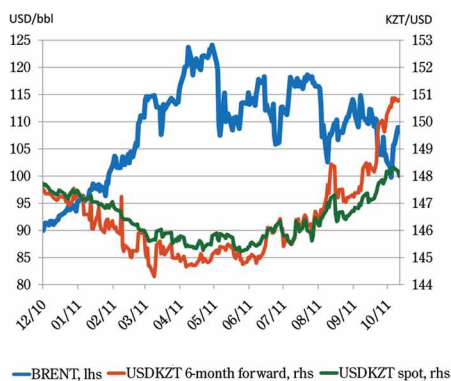
devaluation, to 150KZT/USD +10% and -15%, or 127.5-165 KZT/USD. The new corridor hinted at greater flexibility, but the National Bank of Kazakhstan (NBK) suggested that wider bounds did not imply much in terms of volatility.

The band was an explicit policy commitment made immediately after the devaluation. It acted as an anchor of the longer term expectations. The smoothing rule was disclosed a few months later as an internal operational target and was couched in non-binding terms. The smoothing rule seems to have been actually employed considering that 97% of daily changes during the two years were under 0.25%. As such, the smoothing rule helped

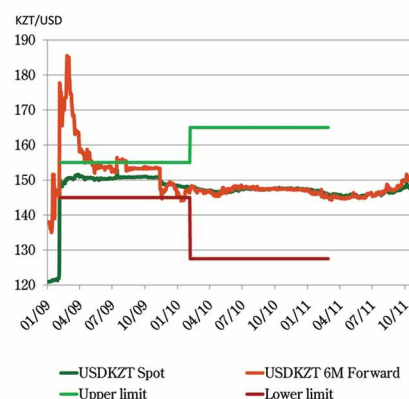
to lower the short-term volatility of the exchange rate. However, most of the time daily changes were kept well under 0.25%, illustrating the extent of discretion that the NBK exercised in interventions.

In contrast with the NBK, the intervention rule of Central Bank of Russia (CBR) is less discretionary yet more flexible. The CBR has two bands: the inner band, where the CBR does not intervene, and the outer band, where it does intervene. These bands drift in the direction of the market when the boundaries of the outer band are reached. As a result, USDRUB is lot more volatile and more elastic with respect to the price of oil.

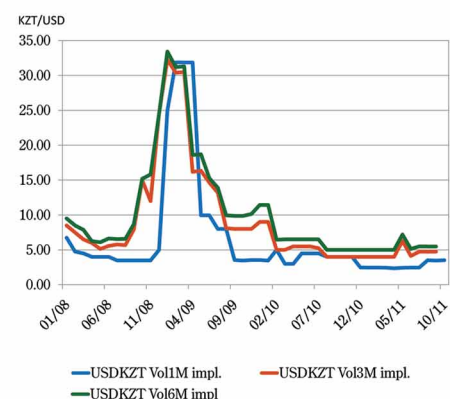
USDKZT is inelastic with respect to oil price



USDKZT was not even close to touching the exchange rate band



Time structure of implied volatilities suggest USDKZT is somewhat more flexible at longer horizons



The credibility of the USDKZT exchange rate regime certainly benefitted from the fact that the external shocks were largely supportive of the balance of payment and interventions did not strain the domestic financial markets. It also helped that Kazakhstan's balance of payments, unlike Russia's one, was not very sensitive to the price of oil. In Russia, an increase in the price of oil raised exports and the current account; imports increased too, but with a lag. In Kazakhstan, higher oil price raised exports almost proportionally, but the outflows increased too, almost in lock step, making the current account much less sensitive to changes in the oil price than in Russia. These outflows included imports of services and investment goods, payment of dividends on FDI and government savings in the National Fund. These three accounts offset the increases in exports by absorbing them into the National Fund, redirecting abroad as imports of services and investment goods or returning as dividends to the international shareholders of major oil projects. This feature of the external account helped the NBK to keep Tenge from appreciating in the face of improving terms of trade.

MORE FLEXIBILITY IN 2011

Nevertheless, by late 2010 Tenge came to be seen as undervalued as the price of oil rose to over \$90 per barrel from \$65 per barrel in early 2009. In late 2010 - early 2011, as oil price continued to rise, Tenge began to appreciate, partly in response to a statement by

the NBK that seemed to have let it appreciate in a way that at the time appeared predictable. In October 2010 the NBK announced that the corridor would be removed in March 2011 and 'Tenge would return to the regime of managed float that was operational for ten years before the devaluation of 2009'. The lifting of the bands hinted at greater flexibility, but the exchange rate remained more managed than floating and the implied volatility changed little.

However, as price of oil continued to climb while the bands were still in place, the expectations of a more flexible Tenge began to attract foreign investors in search for yield. In 2006-2007, when Tenge was appreciating, such hot money obtained exposure to Tenge by buying government paper, tenge-denominated bonds of commercial banks and through bank deposits. In early 2011, less than a year after a painful restructuring of three large banks, the preference was understandingly in favour of the government paper despite the low yield.

To this, the NBK responded by a combination of policies that has not been used by the NBK before. Interventions formed the backbone of this policy: they slowed the pace of appreciation to 0.33% per month in January and to 0.75% per month in February, making Tenge less attractive for speculations. In addition, the NBK increased the issue of the NBK notes, domestic liabilities of the Bank, which sterilised the effect of interventions on the money base. Finally, the NBK raised

the minimum reserve requirements on deposits held by non-residents, following a similar action by the Central Bank of Russia in response to a similar problem. The increase in minimum reserves was marginal, but the signal to the speculators was unmistakable: the monetary authority has the instruments and is not afraid to use them to minimise the effect of speculative inflows on the economy.

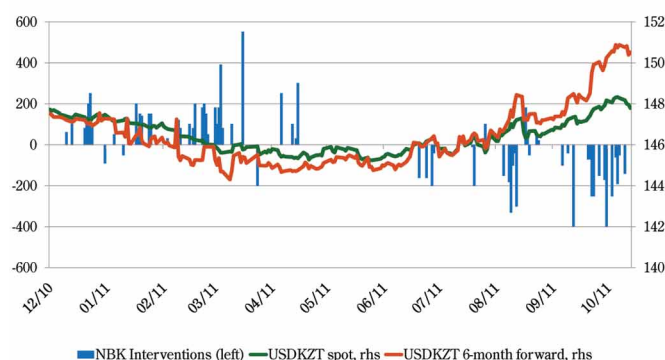
OIL PRICE VOLATILITY

The worsening of the global economic outlook during the summer has put the sustainability of the regime of managed Tenge back onto the macroeconomic agenda. With the oil price volatility near 40%, the probability that a barrel of Brent would fall below \$76 within 6 months rose from 0.5% to 3%. This probability became a very good predictor of the implied 6 month NDF.

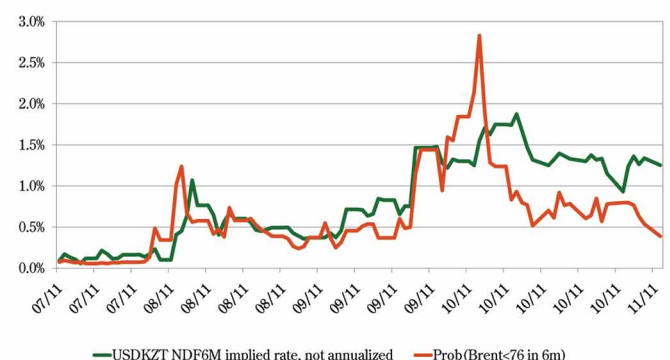
During August and September, non-residents closed the bulk of Tenge positions acquired in the beginning of the year¹, mainly by reducing the holdings of the NBK notes. Tenge weakened in the spot market by 1.17%, its depreciation was slowed down by the central bank's interventions. Tenge weakened more in the NDF market, from 146.1 in July to 150.6 in early October for 6-month contracts.

We estimated the volume of the NBK interventions in this episode at \$3.44bn, including \$0.85bn in August, \$1.9bn in September and \$0.69bn in the first decade of October. However, in a press-

NBK interventions impede the convergence of spot to forward rates



Forward USDKZT is sensitive to the probability oil price dipping below \$76/bbl



¹ The process has actually started in 2Q. In 1Q the claims of non-residents' to the NBK increased by \$1.5bn as foreign holdings of the NBK notes increased by \$2.3bn. In 2Q non-residents' claims against the NBK declined by \$0.9bn, while their holdings of the NBK notes declined by \$0.7bn.

conference on Oct 12, the governor of the NBK criticised our estimates of September and October interventions as 'incorrect' and 'substantially overstating the actual amount', but refused to disclose their actual size. Since we were unable to revise the methodology within such a short time, we instead opted for revealing the methodology and for hedging our estimates by calling the interventions what they actually were -- 'the volume of large transactions against the market trend'.

By retarding the pace of depreciation, the interventions widened the gap between the forward and the spot exchange rates, although the difference remained small compared to the previous devaluation episodes. If measured in annualised interest rates, the difference between the NDF and the spot rates rose from negative in July to about 5% for 12M contracts and 4% for 6M contracts in early October.

Unsterilised interventions have a side effect, which compromises the credibility of the exchange rate defence, especially if the required interventions are too big. By selling foreign exchange, the central bank shrinks the supply of primary liquidity and thus raises its cost for commercial banks. The bigger unsterilised intervention is, the higher is the spike in short-term rates. In August the money base shrank by more than 10%, while short-term interest rates rose sharply. August interventions, in our opinion, were largely unsterilised, which explains the decline in aggregate liquidity and a spike in short term rates. The rise in interest rate was mostly visible in Tonia and Twina rates that tracked the rates in the automatic repo market overnight and fortnight.

In late September, when the gap between the NDF and the spot exchange rates has widened further, liquidity rates have spiked again. September interventions appear to have been largely sterilised, given that the monetary base did not shrink together with the reserves.

Had the NDF rate risen more than it actually had, how would the interest rates respond? How far would the NBK be willing to go to maintain the stability of the exchange rate at the expense of the stability of the monetary conditions?

TOWARDS GREATER FLEXIBILITY

The pair USDKZT will retain strong ties with oil price. NDF rates are very sensitive to the price of oil. By contrast, the spot rate appears almost insensitive to it, but this is only because the price of oil has been on the ascending trend in the last two and a half years. If the price falls below \$80-90 per barrel and will be expected to stay there for an extended period of time, the associated worsening of the current account could hardly be reconciled with the managed exchange rate regime. If the adverse terms-of-trade shock is large and persistent, devaluation will become inevitable. In our discussions with market participants and analysts we detected little disagreement on this point. Opinions, however, diverged about the price of oil that would trigger an attack on Tenge.

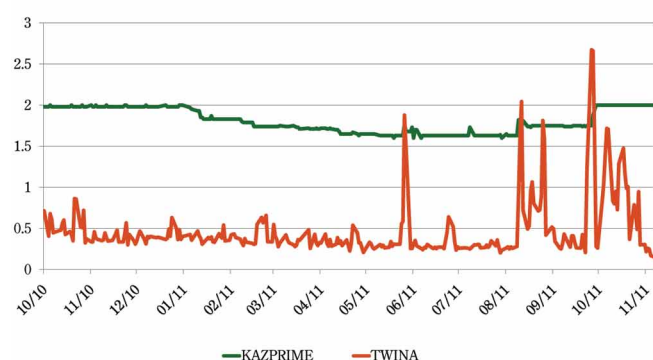
We believe that the price of oil is only part of the equation. What matters is how persistent and swift is the decline, and how the NBK will chose to deal with the risk of devaluation.

According to our model, in order for the decline in the oil price to trigger sharp devaluation, the shock should be (1) large (2) swift and (3) permanent. It has to be swift enough because the current exchange rate regime has some flexibility, which allows it to respond to slow changes in the oil price.

If all three conditions are met, the pressure on the NBK to devalue would be exerted through two possible channels. It will be either the loss of the foreign exchange reserves due to sterilised interventions or the deterioration in the liquidity market due to sterilised interventions. As of October 11, the probability that the price of oil falls below \$76 within six months is approximately 2%, down from 5% on October 5.

Sharp devaluation could be avoided if the NBK adopts a more flexible regime – a possibility that is becoming increasingly likely. Last month the Chairman of the NBK suggested that Tenge will weaken if Ruble depreciates by 25%. The reference to Ruble here is central. The ability of the authorities to isolate Tenge from external shocks is compromised by close integration with Russia, whose central bank has become much more flexible than it used to be. Recently, the CBR has become a lot more of an inflation targeter than it used to be and a lot less concerned about the volatility of the exchange rate. In that case, the pressure on the NBK to liberalise the exchange rate will be coming from the industrialisation imperative that would become compromised by the uncompetitive exchange rate.

Unsterilised sales of FX raise short-term interest rates



Unsterilised sales of FX result in the loss of reserves

