**Expert Comment**

Trends in a transition economy: Kazakhstan’s monetary policy after independence

David Celetti (2019)
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After the collapse of the Soviet Union, former socialist countries entered a phase of economic reforms, coupled with intensive social transformations. During this period, they faced the daunting challenges of creating a market economy and integrating into networks of global exchange. They were also confronted with sharp ‘transitional recessions’. These were the result of falling output, rising unemployment, hyperinflation, and vast resource reallocation, together with processes of widespread social disruption.

This paper explores aspects of the Kazakh transition economy experience between 1993 and 1998. During that period, the newly independent state obtained full economic independence and created the basis for the development of a liberal market economy. It also underwent a severe recession, the consequences of which have only partially been compensated for by subsequent growth. The causes of such dramatic trends have been widely debated, alternatively stressing the negative weight of the Soviet heritage and the costs of the radical reforms approach known as “shock therapy” (Olofsgard, 2018). This present paper moves away from this perspective to focus on the outcome of the ‘orthodox’ monetary policies adopted during this period. It examines economic development and wealth redistribution, aiming to verify if and to what extent those policies worsened the transitional recession.

The paper is structured in three parts. The first presents Kazakh monetary policy immediately after independence, highlighting its theoretical framework, rationale, and implementation processes. The second section of the paper discusses the actual results of
the policy in a medium-term framework, linking them with the overall ‘shock therapy’ approach. The third section questions the alternative ways of mastering hyperinflation.

Sources, along with available scientific literature, include official publications from the Asian Development Bank, the Committee for Statistical Analysis of the Republic of Kazakhstan, the European Bank for Reconstruction and Development, the International Bank for Reconstruction and Development, the International Monetary Fund (IMF), and the National Bank of Kazakhstan (NBK). The paper also derives information from collaborative work with Zhandos and Ospanbayev (Department of International Relations and World Economy of the Al-Farabi National Kazakh University, Alma-Ata; Celetti, 2018).

The Rouble-zone period

Kazakhstan began to adopt an independent monetary policy in November 1993 following the collapse of the ‘rouble zone’.

After the dismemberment of the Soviet Union, the Soviet rouble was automatically inherited by all its successor states. Monetary union, however, was not established according to any specific plan. It emerged as a consequence of a process of disintegration that lacked, among other things, any specific programmes aimed at the resettlement of monetary systems. Besides, the maintenance of a common currency was supported by most international economic institutions. The IMF viewed it as a factor easing commercial exchange among the Commonwealth of Independent States (CIS).

As a matter of fact, centrifugal tendencies soon emerged, jeopardising the new monetary settlement from the very beginning. Although theoretically subordinated to the Central Bank of the Russian Federation (CBRF), specific ‘national banks’ acted as ‘central banks’, without coordination, with the main objective of extending credits and subsidising economies in deep crisis. Structural trade deficits with Russia, formerly compensated through administrative prices, now had to be paid by obtaining loans from the CBRF. Credit
to intra-republic trade increased in 1992, by as much as 196 times the volume at the start of
the year. In addition, certain republics, such as Ukraine, Lithuania, and Azerbaijan, issued
‘coupons’ – a de facto parallel currency. The Central Bank of Ukraine also arbitrarily issued
around 500 billion roubles in 1992 to pay for imports of Russian oil (see charts 3 and 4).

A growing monetary base and rapid price deregulation generated hyperinflation
(Byung-Yeon, 2002). Hyperinflation in the rouble zone started in 1992. In Russia, after
deregulation in January 1992, there was 250% price inflation for the month of January. By
December, 1992 prices were 26 times the level of December 1991 (McKinnon, 1991;
Orlowski, 1993; IMF, 1995, 1998; see charts 5-8). Aside from different degrees of
dependence on imports of oil and manufactured products from Russia, dissimilar
approaches to economic reforms and structural heterogeneities among former Soviet states
increased divergent trends, opening the way to centrifugal forces that disintegrated the
monetary union from within (Orlowski, 1993).

The rouble zone reached its final stage in July 1993, when the CBRF required daily
bilateral clearings between Russia and the other post-Soviet states, and made the roubles
issued prior to 1993 no longer legal tender in Russia (Snoek, 1999; IMF, 1999; Kornai,
2001). At that point, remaining members of the rouble zone – among them Kazakhstan –
had no choice but to leave it and introduce their own currency (Dabrowski, 1995a, pp. 20-
31, 1995b; Chavin, 1995; Broome, 2010, pp. 77-111).

Notwithstanding such a troubled environment, Kazakh authorities were quite
surprised by Russia’s move, and their first reaction was to explore ways to create a new
union. Tight historical links between the two countries, the deep integration of their
economies, and the political attitude of the Kazakh leadership – worried by the possible
social consequences of a sharp division from Russia in terms of interethnic relations – made
it difficult to opt abruptly for separation. On 7 September 1993, Russia, Kazakhstan,
Uzbekistan, Tajikistan, Belarus, and Armenia signed a treaty to coordinate monetary policies
and stabilise exchange rates. Bilateral-framework agreements intended to maintain a unified monetary system were ratified in the following weeks (Dabrowski, 1995, pp. 20-25; Khabarov, 1995, pp. 1298-3010; Gleason, 2001; Broome, 2010, pp. 77-111; Granville, 2016, pp. 19-26).

Meanwhile, old and new Russian notes kept circulating in parallel; the former, however, suffered rapid devaluation. If in July 1993, currency conversion was set at a parity level, by early autumn the respective value had soared to 5:1. The trend highlighted widespread flight from the common currency. The exchange rate of old roubles with the dollar also deteriorated consistently, passing from 2,700 in late October up to 7,000 to 10,000 in early November. As monetary reform was made by the NBK, introducing a Kazakh currency became ever more likely. People and enterprises abandoned roubles altogether, resorting to barter and the use of foreign currency. A trend of progressive “dollarization” – which was to last up to the early 2000s – emerged in parallel to hyperinflation (Dabrowski, 1995, pp. 20-31; Kazbekov, 2002, pp. 85158; Yilmaz, 2009, pp. 1-12). On 15 November 1993, the Kazakh government introduced the Tenge (KZT), the new currency. The circulation of rouble notes was suspended by 18 November. Individuals and legal entities could exchange their roubles by following specific procedures, whereas authorities set up controls to avoid artificial price increases (IMF, 1995, p. 24).²

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¹ The Central Bank of Kazakhstan was the heir to the previous Republican Bank of Kazakhstan, which acted as a branch of the State Bank of the USSR (Gosbank). However, the newly independent Central Bank of Kazakhstan continued to obtain funding from the CBRF, and, therefore, nothing changed substantially in relations between the two institutions, nor did political independence actually enhance the possibility of independent monetary policy in Kazakhstan.

² Individuals could exchange up to 100,000 roubles in cash per person at the rate of 500 roubles per KZT, exceeding sums having been deposited in special bank accounts that had been frozen for six months. Legal entities followed different rules in relation to their sector of activity and level of involvement in retail trade (IMF, 1995, p. 24).
Monetary independence

The introduction of the new currency opened the way to independent monetary policy, the implementation of which was committed to the NBK. The Bank was the heir of the State Bank of the Socialist Kazakh Republic, transformed after independence into the National Bank of the Republic of Kazakhstan. Laws of 13 April 1993 and 30 March 1995 defined the Bank’s tasks, rules, and objectives. Both acts granted the central bank consistent degrees of independence (Loungani, 1995), with monetary stability as the principal objective (Law No. 2155, 30.03.1995, 2,7).

In their theoretical architecture, these acts mirrored the neoliberal monetarist approaches that were being promoted at both scholarly and institutional levels at the time under the umbrella of the so-called “Washington Consensus” (Aslund, 2001). It is therefore not surprising that policies focused from the very beginning on rapid price stabilisation through the control of monetary aggregates (IMF, 1995, 1998). As soon as the KZT was issued, the NBK increased commercial bank reserve requirements from 20% to 30%. Refinance rates passed from 170% in November to 240% in December 1993, reaching 270% on 10 January 1994 (IMF, 1995, p. 25). The currency freely floated on the international market, with minor intervention to smooth – and not control – such trends. The rate was initially set at 5 KZT/USD in November 1993 and had increased to 70 KZT/USD by the end of 1996. Credit from the NBK to commercial banks fell from 25% to less than 10%; broad money increases slowed down from 64% to 25% a year between 1993 and 1994. Inflation gradually diminished, and, by 1994, currency depreciation trends offered signs of stabilisation (see charts 1, 2, 6, and 9).

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3 This orthodoxy was not surprising for attentive analysts. During the final months of the rouble zone, the central bank had already started implementing credit policies in order to lower inflation, implementing currency controls to limit the inflow of rouble notes, enhancing foreign reserves, accumulating domestically produced gold, and suspending foreign currency auctions (IMF, 2000, p. 23).

4 The results were even more remarkable if we take into account that quite a relevant portion of them was due to the increasing of foreign assets by the central bank (IMF, 1995, p. 25).
The trend was abruptly interrupted by the bursting of the so-called ‘arrears crisis’. The credit bubble threatened to jeopardise financial construction in the initial years of independence, while highlighting the side effects of monetary policies focused only on ‘inflation targeting’.

The credit crunch succeeded, in fact, in curbing inflation. It also substantially contributed to lowering companies’ liquidity and gradually increasing their financial burden. In conditions of a chronic shortage of working capital, credit became the essential source for funding ordinary activity – including the import, mainly from Russia, of large sets of vital items. By November 1993, Kazakh enterprises were already suffering a net debtor position of around 260 billion roubles (IMF, 1994). After the introduction of the KZT, the situation worsened. Anticipating an oncoming crunch, firms delayed payments and subscribed new credits, trying to avoid, or simply postpone, bankruptcy. Arrears soared. By the first trimester of 1994, the number of entities in arrears reached such a level that a major financial crisis became ever more likely.

The government reacted with a bailout plan for over 38 billion KZT to cover the worst-distressed debts. Another share of assets, worth 18 billion KZT and owed by still-viable net debtor enterprises, was covered by credit at an interest rate of 200% to be paid back by 1994.

The operation substantially reduced the risk of major breakdowns. It also increased bank credit, broad money – the latter expanding by 72% in the second quarter of the year – and base money, which registered an increase in the same period of 60% (see charts 5-8). Inflation soared again, and exchange rates depreciated (see charts 1, 2, and 10). Negative expectations of price controls, and speculative operations in the domestic and international financial markets contributed to a worsening of these trends (EBRD, 1994, pp. 26-27; IMF, 1995, p. 25, 1997, pp. 5-7, 29-37).
The NBK renewed restrictive monetary policy, sterilising the expansionary effect of the ‘assets crisis’. The refinance rate was increased to 300% in March 1994, not to be lowered to 270% until September, when inflation started a new decline. Credits to the bank sector were limited to a period of nine, then six, months; their renewal was prohibited; and their granting was limited to ‘perspective enterprises’. This last step, justified as a means to eliminate – or at least reduce substantially – the forming of new ‘arrears waves’, acted as a selection mechanism, sustaining firms that could present credentials of future growth, most of them concentrated in the export-oriented sectors (see chart 9).

By 1996, inflation had finally come under control. Consumer price increases fell from an annual average of 1,892% in 1994 to 176% in 1995, 39.1% in 1996, and 17.4% in 1997 (EBRD, 1994, 2001; Kazbekov, 2002, p. 63). Results were substantial, especially because they had been reached within a framework of capital inflows determined by improvements of the trade balance and net foreign direct investments (EBRD, 2001; see charts 15.1 and 16.1). Capital outflows lessened as a reaction to a perceived successful stabilisation and positive economic perspectives. Monetary policy, as predicted by most experts, had worked out: Inflation lowered, the trade balance improved, and the national currency stabilised its rating in the international market.

These results, in turn, should have paved the way for a new era of economic development. Net capital inflow and renewed trust in the country’s future were considered early signals of the beginning of a new era (Waikar, 2011).

**Monetary policy in the transition economy**

Kazakh monetary policy presents a high degree of coherence throughout the period of this study. The central bank clearly stated that curbing inflation through monetary base targeting was its first priority, and this goal was actually achieved. Deflections from such a strategy, as in 1994, were short-term adjustments to external shocks and didn’t significantly influence
the overall consistency of the NBK’s action. Results, according to most analysts, had met expectations (IMF, 1995b; Broome, 2010, pp. 152-184).

Shifting perspective from monetary to broad economic aggregates reveals, however, a more complex and contrasting picture. Following reforms, Kazakhstan experienced not only hyperinflation, but also a significant decline in production in all economic sectors. This was accompanied by widespread unemployment, a drop of state receipts, a decrease in the standard of living among the vast majority of the population, and skyrocketing revenue inequalities (see charts 12-14). Poverty and unemployment nourished criminality, and institutional weakness opened the way to widespread corruption. Recession, instability, and a lack of prospects led to drug and alcohol abuse. Life expectancy significantly diminished and the whole social framework showed dangerous signals of implosion (Kazbekov, 2002, pp. 7-8). Yet, in 1999, as economic recovery was consolidated, Kazakh GDP was just 40% of its 1990 level. The country’s ranking in the Human Development Index had fallen from 30th in 1990 to 107th in 1998. Kazakh economic structure had undergone radical transformations, losing a portion of its industrial and agricultural potential in order to concentrate on export-oriented production such as that of oil, gas, and precious metals (Kazbekov, 2002).

Kazakhstan’s market-oriented reforms followed the so-called ‘shock therapy’ model experimented with in Russia and were backed at the time by most experts, as well as by the IMF and the World Bank. The approach consisted of a set of standard neoliberal measures of institutional transformation, economic restructuring, and financial stabilisation that, acting within a comprehensive framework, should have led to transition from a planned to a market economy. An initial crisis should have been rapidly followed by recovery and development. As hyperinflation burst out in 1992-1993, monetary policy became, however, the primary instrument in the transition process, and the central bank became a pivotal actor. Curbing inflation emerged, in fact, as a prerequisite for any subsequent action.
Within this framework, the NBK fought price instability (Amato, 2002). The reasons that led the NBK to embrace extremely orthodox approaches, sticking to them even when they evidently contributed to a deepening recession (Kazbekov, 2002, pp. 85-99), are complex and not unequivocally identifiable. Objective stabilisation needs, neoliberal theoretical approaches, and the inexperience of NBK directors with market mechanisms might all have played a role. Another major cause, however, may be spotted in the complexity of economic conditions in the early 1990s, coupled with the unexpected results produced by other measures of the reform package. Rapid privatisation, and liberalisation of prices and trade in particular, should have led to the simultaneous formation of market mechanisms. This, in turn, should have paved the way for rapid growth, compensating for the deflationary, recessive, monetary policy. Such a perspective was, however, itself the result of a theoretical oversimplification of the economic environment of the early 1990s.

The falling apart of the Soviet Union as a federal but unified state created new frontiers in which uncertainties arose, contributing to a deepening and already serious ‘transition crisis’. Enterprises faced the breakdown of traditional markets in a context of structurally insufficient working capital. A lack of confidence choked expectations and investments. Crisis diminished tax revenues and weakened government capabilities, severely limiting institutional action. The lack of experience of most actors – public and private alike – led to mismanagement, whereas an absence of clear rules and controls opened the way to widespread illegal practices.

The ‘package’ supported by the IMF widely ignored such aspects. It was based, in fact, on a purely macroeconomic theoretical framework very distantly suited to the actual conditions of post-Soviet economies. The model forecasted that strict monetary policy necessary to reduce inflation would have been balanced by structural reforms – rapid privatisation, price and trade liberalisation, a downgrading of the state’s presence, and budgetary equilibrium – thereby sustaining and stimulating growth. Of the two pillars of the
reform package, however, only the monetary one worked out effectively; structural reforms widely disrupted the old system without creating effective market mechanisms. If up to 1993 the main cause of crisis was the disruption of inter-republic trade, from 1994 onward the strongest vehicle of recession became ‘orthodox monetary policy’ undertaken in the absence of balancing factors in the real sector.

Privatisation was implemented in an environment lacking an efficient financial market, strong institutions, experienced actors, or a competent entrepreneurial class. Under such conditions, resources could hardly be effectively allocated. Far from enhancing efficiency and boosting supply within a transparent market, privatisation swept away entire sectors, enlarging the crisis to include still-competitive firms. Supply diminished, which, in turn, alimented inflation within a stagnant economy.

Price liberalisation also proved problematic. It was anticipated that after an initial increase of consumer prices up to three-to-five times initial independence-era levels, stabilisation would have followed. This then would rapidly lead to a new equilibrium between supply and demand within a coherent price system, and effective market mechanisms. Production would have rapidly soared, pushed by new price levels, pulled by solvent demand, and sustained by the higher competitiveness of privatised firms. In reality, price liberalisation led to rapid resource reallocation, shifting investment abruptly toward export-oriented and highly rentable economic branches, the first being raw materials, energy, and trade services. This followed a long-term downscaling of domestic firms operating in consumer-oriented sectors. Consequently, imports rapidly increased for a wide range of products, with negative effects on the balance of trade, the state budget, the value of the currency, and the position of the country in the world economy as a whole.

To counterbalance the increasingly evident import dependency of the Kazakh economy, there was a controlled devaluation of the Tenge. This measure should have helped newly privatised firms, giving them an additional competitive advantage in the
international market. The Kazakh Tenge was introduced with an exchange rate to the USD of 4.64 per dollar. At the end of the first quarter after introduction, it had fallen to 33.63, reaching 51.05 Tenge per dollar by December 1993. The trade deficit actually diminished, passing from 1,546.6 USD in 1993 to 1,398.3 USD the following year. The trend was, however, too small to positively impact the overall economic situation. Besides, it went hand in hand with the structural transformation of the Kazakh economy. In 1994, exports fell 19.1%, but imports fell only 8.3%, which mirrored the emergence of economic dependency paths. Therefore, price liberalisation, far from compensating recessionary monetary policy, acted as another multiplier of inflationary trends within a stagnating economy.

Nor was monetary policy itself, although technically successful, free from unexpected side effects. High interest rates, for example, along with immediate ‘recessive effects’, should have supported savings and therefore investments. They should also have contributed to pushing managers to optimise available resources, diminishing ineffective expenses and increasing productivity. In reality, savings grew at a relatively slow rate, far from sufficient to respond to the needs of the real sector. Managers, then, didn’t react to increasing efficiency, but asked for new credit in the expectation of ever higher interest rates. As available money diminished, they slowed down production, postponed wage payments, increased prices, resorted to speculation, and eventually to barter practices.

Recession trends were, as a matter of fact, interrupted by exogenous factors more than by domestic reforms. The sharp rise in the price of many export goods in the early 2000s, such as oil and gold, interrupted the transformational recession by pouring substantial resources into the country. This allowed for investment, which increased the state’s revenues, the standard of living, and consumption, opening a new era of economic growth for Kazakhstan.
Conclusions

Kazakhstan’s experience in transitional economic reforms highlights the shortcomings of the traditional neoliberal model, which oversimplifies reality and fails to take historic, social, and economic specificities into account. It reveals the potential and the limits of orthodox monetary approaches in helping to achieve macroeconomic stabilisation at the price of costly recessionary trends.

Whether alternative monetary policies would have been possible in the given context, remains, however, an open question. Softer monetary approaches might have eased the real sector’s growth, but at the risk of losing control of monetary aggregates. However, hyperinflation and stagnation were the real consequence of the inner character of the transition process followed by most post-Soviet republics. The chaotic context of the late Gorbachev’s perestroika; the abrupt collapse of Soviet economic, politic, and social order; and, even more, the shock therapy approach converged to create a ‘transitional recession’, the economic, social, and human costs of which have had no peacetime historical equal (Popov, 2017).

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Chart 01 - Consumer Price Index (1994-1998 - Nov. 1993 =100)

Source: NBK 2018; and Author's Elaborations.

Chart 02 - Inflation rate (1991-2006)

Source: FMI 2000, 7-8, and Author's Elaboration..
Chart 03 - Monetary Transfers from Central Bank of Russia to Other FSU States (1992- billions of rubles)

Source: Dabrowski 1995, p. 36; and Author's Elaboration

Chart 04 - Russian Financial Assistance to Other FSU States (% GDP of particular states)

Source: Dabrowski 1995, p. 36; and Authors' Elaborations.
Chart 05 - Monetary Base and Aggregates of Broad Money (1994-98 in Mln of KZT)

Source: NBK 2018; and Author’s Elaborations

Chart 06 - M1, M1 composition (Mln of KZT)

Source: NBK 2018; and Author’s Elaborations
Chart 07 - M2, M2 composition (Mln of KZT)

- M2 - Total
- M2 - Other deposits in tenge and transferable deposits of individuals in foreign currency
- M2 - Other deposits in tenge and transferable deposits of non-banking legal entities in foreign currency

Source: NBK 2018; and Author’s Elaborations

Chart 08 - M2, M2 % changes

- M2 % changes to the previous month
- M2 % changes to December of the previous year

Source: NBK 2018; and Author's Elaborations
Chart 09 - Interest Rates

- refinance rate
- Treasury Bill rate (3 months)
- Lending Rate

Source: NBK 2018; and Author’s Elaborations

Chart 10 - Foreign Exchange Rate (vs USD)

- exchange rate (end year)
- exchange rate (annual average)

Source: NBK 2018; and Author's Elaborations
Chart 11 - Share of Administered Prices in Consumer Price Index (per cent)

Source: NBK 2018; and Author's Elaborations

Chart 12 - Real GDP Growth per Sectors (per cent change)

Source: NBK 2018; and Author's Elaborations
Chart 13 - Productive Sectors (percentage of GDP) 1993-97

Source: IMF 1998; and Author's Elaboration

Chart 14 - Labour Market (1990-98)

Source: NBK 2018; and Author's Elaborations

- Dotted line: Share of total trade with non-transition countries (in per cent GDP)
- Solid line: Share of trade in GDP (in per cent)
- Dashed line: Tariff revenues (in per cent of imports)

Source: EBRD 2000, 175-77; and Author's Elaboration

Chart 16 - Trade Balance (Mln USD - 1992-2000)

- Black bar: Current account
- Green bar: Trade balance
- Yellow bar: Merchandize exports

Source: EBRD 2000, 176-77; and Author's Elaborations.
Chart 17 - Share of Privatised Firms

Share of small firms privatised (in per cent)  Private sector share in GDP (in per cent)

Source: EBRD 2000, 176-77: and Author’s Elaborations