Research Paper Finance

Devaluation of the Tenge in the Republic of Kazakhstan, negative consequences under market shocks

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ABSTRACT

This article discusses the effects of devaluation on output growth and overall economic development of the Republic of Kazakhstan. The issue has played an important role in economic and political agendas of developing countries for several decades during which devaluation has been one of the most frequently used policy tools in most of the CIS states. Whether devaluation of the currency affects the national economy positively or negatively has also received considerable attention among researchers. In this paper, in order to analyze empirically whether or not devaluation has negative effects on further development we used the arguments of prominent scholars and brought some of the recommendations necessary to avoid devaluation of currency.

KEYWORDS Devaluation, depreciation, regulator, exchange rate, foreign reserves.

The devaluation of currency has always been a high concern among government officials, citizens and scientists of Kazakhstan. Devaluation means the process under certain circumstances currency loses its purchasing power. If the government usually establishes a floating exchange rate, market forces may generate changes in the value of the currency, known as currency depreciation. If a fixed exchange rate system is selected, as in terms of Kazakhstan, devaluation can be conducted by regulator, usually motivated by commodities market prices instabilities.

In Kazakhstan, fixed exchange rate system is used in order to alter official value of currency usually as a response to unusual market pressures and other internal reasons.

When the government devalues its currency, it is often because the interaction of market forces and policy decisions has made the currency's fixed exchange rate untenable. In order to sustain a fixed exchange rate, a country must dispose sufficient foreign exchange reserves, often dollars, gold and be willing to spend them, to purchase all offers of its currency at the established exchange rate. When a country is unable to do so, then it must devalue its currency to a level that it is able and willing to support with its foreign exchange reserves. "To recap the foreign reserves of Kazakhstan are 24715 bln. US dollars."

"A key effect of devaluation is that it makes domestic currency cheaper relative to other currencies. There are two implications of devaluation. First, devaluation makes the country's exports relatively less expensive for foreigners. Second, the devaluation makes foreign products relatively more expensive for domestic consumers, thus discouraging imports. This may help to increase the country's exports and decrease imports, and may therefore help to reduce current account deficit." But the real problem may arise if a country does not possess the capacity of production comparative to import, in which case the economy is affected by stagnation because of the overall price increase. Most of the times, the government may argue that devaluation was a necessary means to boost aggregate demand in the economy in an effort to fight unemployment rather than to spend too much money on currency back up.

"Furthermore, government may intend to fight foreign reserves stock decrease, and as a measure to devalue its currency, however, according to E. Floyd, devaluation under less-than-full-employment conditions thus leads to an increase in output and employment and a one-shot increase in the stock of foreign exchange reserves. This decrease in foreign exchange reserves would be avoided if the central bank were to increase stock of money base appropriately by purchasing bonds in the open market.

Devaluation may increase the stock of reserves but it does not necessarily mean that it increases the rate of growth or reduce the rate of decline in reserve stock. Thus, it will not necessarily cure a balance of payment deficit. A balance of payment deficit can be easily cured

without changing the exchange rate by simply reducing the rate of money base growth. Also, a one shot increase in the stock of reserves can be brought about by a one-shot reduction in money base without changing the official exchange rate. Since devaluation is not necessary to improve the balance of payments, what would be its real purpose?

"Sometimes the reason is a desire to expand output and employment in a recession. The problem is, however, that when all other countries maintain their fixed exchange rates this is a so called beggar-thy-neighbor policy- when any gain in domestic output which occurs through an increase in the current account balance comes at the expense of employment and output of neighbors."

Lots of reasons could be given, but the fluctuations of mineral resource prices are the basic reason for resource wealthy state. Most of resource wealthy states are in direct dependence on oil, gas, metals price volatilities. Another cause is the shrunken foreign currency market, which became a trend for the last 6-7 years, after the financial crisis took place. Low inflow of the dollar raised its value in the developing world, making those states to be more and more vulnerable to huge dollar supply in their economies, making their money to be more and more vulnerable in competition with the dollar.

Let us remind ourselves that the last official rate of the dollar to tenge, fell from 155 to 185 plus/minus 3 tenge in Kazakhstan, in February 2014, fixed exchange rate was set up. As expected, foreign goods boosted their prices, because the state is highly dependent on import, which is always prevailing over export. In other words, devaluation triggered a decline in the country's standard of living. Traditionally, the tool used by non-wise financial policy of regulator.

In autumn 2014 National Bank set the band rate in the range of 170-188 tenge, which is said to be a better choice for unstable prices of major Kazahk export items. However the managed floating rate makes unstable market to be more volatile, as the real wages in the economy are rigid, the change in exchange rate for 3 tenge may affect income, and more essentially affects the real wage, which is quite unsafe for the stability of family income if it is 18 tenge.

Sometimes countries get involved in an endless cycle in which high inflation causes the country's export products to be uncompetitive, prompting a devaluation that only leads to more inflation and inability to raise the supply of goods. Moreover, it is quite simple that currency devaluation usually used as a tool to retain governmental expenses at their pre-level, as the budgetary plan had been formed at the end of previous year. Some may say it is very unfair to spend as much as government officials want to, but government is nor eager to do something else.

It is a known fact that currency devaluation is a policy applied by developing countries, highly dependent on raw materials production. If once upon a time prices of oil go down, it always means that currency is going to be devaluated, in order to maintain the level of income return for national companies and state budget. Most of the times the regulator gives a speech about new opportunity to support national exporters and end product manufacturers, so they be capable to export more goods, and buy less amount of foreign ones. But in reality the national producers will raise their output prices, as a consequence of imported equipment appreciation, and some of additional salary rise. These way overall inflation level outbursts much higher levels than it is usually predicted at the pitch of 6-8%.

"Therefore as long as budget deficits continue to spiral out of control, presumably, there's no end in sight to how much currency that central banks will print, or how much politicians will try to tax. A key problem may hurt investors doing business in the country. It will also result in

decline of volumes of foreign direct investment in our manufacturing industry, as the situation leaves to be unstable. This is psychological danger. To the extent that devaluation is viewed as a sign of economic weakness, the creditworthiness of the nation may be posed at risk."

Another point that should be emphasized is the banking sector, which suffers a lot, as its foreign borrowings becomes much expensive to borrow more, and serve this loans, as the national currency is fragile to international market shocks. It is essential to note, the high inflation rate again, because the overall price increase both for domestic and imported goods, makes people to spend less and save more, decreasing their purchases, consequently less loans involved, which itself may be a factor of declining production inside the country, deteriorating weak production potential.

Usually devaluation in Kazakhstan expands construction business, fostering real estate prices to go up, and as soon as people do not believe the currency any more, they prefer to invest in hard assets. And here is no direct relation with volumes of real estate supply and prices for it. In Kazakhstan we face a huge bubble in realty market, which is actually doesn't correspond to its real cost of production, but the artificial cost occurs out of fierce demand, leaving more and more people to be property disadvantaged.

Another possible consequence is a round of successive devaluations. For instance, trading partners may become concerned that devaluation might negatively affect their own export industries. Neighboring countries might devalue their own currencies to offset the effects of their trading partner's devaluation. Which is called "beggar thy neighbor" policies tend to exacerbate economic difficulties by creating instability in broader financial markets. The same situation happens with other regional economies, when Russian ruble goes down, Kyrgyz som, Belarus ruble and Ukrainian grivna are amongst devalued currency list. Here Kazakh tenge tends to be depreciated as the trade partners of Kazakhstan are Russia, Belarus, Ukraine, China and others. Some dependency on Russian ruble among CIS countries' is observed, as export of Russia usually prevails over import.

Here are some figures indicating the devaluation rate, and other economic categories among Kazakhstan trade partners. It could be stated that the inflation rate among observed states almost the same while, the speed of devaluation is different, as well as GDP growth and trade turnover are different. The negative aspect here is that devaluation is conducted in terms of one day, which is very depressing measure in Kazakhstan. (Table 1.2)

Table 1

Currency devaluation rate, inflation rate, GDP growth of Kazakhstan trade partners									
Country	Devaluation rate %		Inflation rate %		Foreign reserves,bln. USD	GDP (USD)		CIS states' trade turnover with Russian Federation (bln. USD)	
	2012/13	2013/14	2013	2014	2014	2013	2014	Export	Import
Kazakhstan	1.9	19	4.8	6.2	28.2	6.0	4.6	2.1	5.1
Russia	7.8	40	4.5	9.7	443.8	1.3	0.8		
Belarus	11	37	16	11	6.6	0.9	1.0	13.8	18.8
Ukraine	10	46	0	19	12.5			11.4	16.4
Kyrgyzstan	3.9	14	8	6.8	2.2	8.8	5.6	-	-

Source: National Bank of the Republic of Kazakhstan

Table 2
Source: National Bank of the Republic of Kazakhstan

Exchange rates of dollar to the national currencies of Customs union member states					
Country	2013	2014	October 2014	November 2014	December 2014
Kazakh tenge	155	185 (+/-3)	181.0	180,8	182
Russian ruble	32.88	48	43	46	52
Belarus ruble	8790	9710	10660	10815	10830

In addition the Republic of Kazakhstan has its external debt equal to 48 bln. of US dollars, which is 70% of GDP. This amount makes sense when the state has to return it after devaluated currency. It must be a problematic process for every state is default on external debt, which may take place any time as a result in the weakening of the national currency, the increase in unemployment and general deterioration of the economic situation in the country.

It in turn leads to further devaluation from one side and depreciation by inflation rise from another.

Meanwhile, the Eurasian Development Bank of Kazakhstan states that following the May 2014 inflation remained at an acceptable level for NBRK 6.5% in annual terms. However, until the end of the year inflation may still be accelerated by the effect of a more complete transfer of growth of import prices on domestic prices and may exceed the upper limit of the target band at NBK 2014 (6-8%) (eg. the price index of manufacturers of industrial grew by 17.8% in May 2014 in annual terms, while inflation in wholesale prices for food and consumer goods exceeded 10%).

And above all it must be stated that what may be more difficult to deal with is the production output which usually goes down, as well as the employment level. For example, Cooper (1971), Caves, Frankel and Jones (1996), Krugman and Taylor (1978) and Edwards (1986) mention the following channels through which devaluation may create negative effects on aggregate demand that leads to a reduction in output and employment. (p 6)

The above scholars explain that devaluation usually takes place when countries have a foreign trade deficit and related external balance difficulties. This is the typical case for the vast majority of developing countries. It is said that if a country initially suffers from trade deficit, the effect of devaluation on aggregate demand will be negative.

Following the devaluation, given that imports exceed exports, price increases of traded goods reduce the home country's real income and raise the real income of the outside world, since foreign exchange payments (import costs) exceed foreign exchange receipts (export revenues). "Within the home country the value of 'foreign savings' goes up ex ante, aggregate demand goes down ex post, and imports fall along with it. The larger the initial deficit, the greater the contractionary outcome." (p.446)

The question may arise – How government can cope with devaluation?

It would be better to get more international loans, to increase countries international foreign reserves, and be able to reinvest them further into high interest US securities, and European financial institutions, as well as to issue more of own debenture stocks, and bonds.

The next is the possibility to increase production level of primary mineral resources, as the state disposes new oil fields. This way foreign currency reserves will be replenished and government may easily buy out more of national currency, and stabilize money supply, giving it greater power.

The next we should foster common currency in frames of Customs union, so we may trade by our currency, not to be depended on foreign currency, not to feel its pressure. We should elaborate foreign trade policy of empowering our currency through new trade possibilities of final products manufacture and use of our common currency in international trade, whether it called tenge or any other.

In response to depreciating currency, the first line of defense for central bank should be rising short term interest rate, in order that by making domestic assets more attractive, higher interest rates will strengthen the currency. This was for example IMF prescription for monetary policy in East Asia. (A. Lahiri, 2000). But National Bank of Kazakhstan sets the level at 5.5% rate, backing it as a support for domestic producers, who could get more loans from banks. As more loans taken, more money stock appears in economy, inflicting faster inflation rates. These tolls must help the officials to be credited more by a public and increase overall confidence in our currency.

Consequently one of the best measures would be to diminish government expenses. Tightening of macroeconomic situation have to be taken into account and must be a reason to refuse from existing increase in 2014 budget expenses and decrease budget for 1/5 of current one. Such rapid decrease can be explained with 2 main reasons; worsening of general economic situation conjuncture (decrease of revenues of oil companies, increase in number of non-oil sector companies working with loss in terms of Customs Union, increase of the rate of closure of work places) and calculation of oil price as USD 70-75 for next year budget. Rapid decrease in next year's budget incomes will necessitate formation of new macroeconomic situation and accordingly government's review of financial, investment and fiscal-credit policy and their adoption to decreasing budget parameters.

Thus, we may conclude that currency depreciation as a deliberate measure is not wise tool to force economic growth, as firms, public suffer, inflation would be more difficult to get under control, and banks will not be able to lower their interest rates, because of lost profits after official devaluation, so the production output will not grow. Import appreciation and export increase would just mean for citizens of the devaluing country are getting less for what they are selling abroad and

paying more for what they are buying abroad; concomitantly they restricting the consumption, which is known as a process of national impoverishment.

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