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Conception of the Currency Regime Liberalization in the Republic Of Kazakhstan

Introduction

The achievement of stability in the money markets, balanced demand for foreign exchange, and a manageable inflation rate caused a necessity to develop new approaches to currency regime liberalization aimed at the removal of particular restrictions imposed on foreign exchange transactions and at the use of alternative foreign exchange transactions regulation methods according to the demands of the times and international practices.

This Conception has to be considered not as the initial stage of the exchange policy liberalization process, but as its continuation within the framework of the Development Strategy of Kazakhstan until 2030, since, in the process of gradual evolvement of the foreign exchange market and entering of new participants into it, a certain stage of liberalization has already been passed in this domain. The restrictions and barriers imposed earlier by the exchange legislation of the Republic of Kazakhstan and which are still in force at present, are a characteristic of the most of the countries where markets are developing. In the conditions of globalization in the world economy and financial operations growth capital movement liberalization is an inevitable and necessary condition for economic development of the countries who are willing to take the advantage of more active integration into the world economy.

Currency Regime in Kazakhstan

Exchange Rate Regime of the National Currency. During the introduction of the national currency, the tenge, there remained a substantial deficit in gold and foreign exchange reserves. Fixed exchange rate regime would not resolve the problem of supporting the tenge's internal stability nor curb the currency depreciation rate in the presence of fast-growing demand for foreign currency, induced to a certain degree by lack of confidence in the tenge by households.

In order to build a liquid foreign exchange market and sustain the convertibility of the tenge into foreign currencies, effective January 1994, 50-percent export proceeds surrender requirement was temporarily introduced for all businesses. The new regulation did not apply to newly formed enterprises with a stake of foreign capital. The above-mentioned rate was reduced to 30 percent on June 10, 1995, and abolished on August 4 of the same year. The reasons for that were a decrease in the depreciation rate of the tenge relative to the US dollar, higher confidence in the national currency, and the introduction of new financial instruments of higher returns. In this circumstances, a decision was made to introduce the regime of managed floating aimed at further reduction of inflation rate and dampening of expectations of depreciation.

The consequences of 1998 Russian financial crisis led to the acceleration of tenge depreciation and notably severe exchange rate fluctuations in the segment of foreign exchange market formed by the households. Considerable devaluation of Kazakhstan trade partners' currencies, first of all Russian ruble, resulted in real appreciation of the tenge and unfavorable competitive position of Kazakhstani exports. The introduction of freely floating exchange rate regime resulted in the necessity to sustain the balance in the financial market. Thus, the NBK reintroduced the 50-percent export proceeds

surrender requirement. At the same time measures were taken to preserve tenge assets of pension funds and tenge deposits by natural persons in commercial banks.

All these measures contributed to the increase in foreign currency supply in the foreign exchange market and helped to overcome the crisis, which, in combination with favorable conditions in the world commodity markets, allowed to nullify the surrender requirement in November of 1999.

At the same time, other measures of administrative control over foreign exchange transactions imposed by the currency regulation legislation are still in force. The act “On Currency Regulation” issued in 1993 determined the list of current exchange transactions which can be effected with no restrictions. All other transactions were classified as connected with capital movement; and the National Bank was given the right to impose limitations on them.

Licensing the transactions involving currency valuables. The new act of the Republic of Kazakhstan “On Currency Regulation” issued in 1996 states that the exchange transactions connected with capital movement (the list of which was determined by the Act) and transfer of currency valuables from residents to nonresidents are subject to NBK licensing. The currency legislation of the Republic of Kazakhstan had established a unified approach to the exchange transactions licensing for all participants of external economic activities regardless of their form and the economy sector they belong to.

In 2000, there were addenda to the Act of the Republic of Kazakhstan “On Licensing”. The addenda determined the following list of currency valuables transactions subject to licensing:

- 1) Retail sales and services activities for foreign currency cash;
- 2) Opening of accounts (including those in the tenge) by residents in foreign banks and other foreign financial institutions, having appropriate rights according to the legislation of the country where they are registered;
- 3) Outward investments by residents (excluding broker and dealer activities by banks);
- 4) Transfers from residents to nonresidents in payment for real estate property rights;
- 5) Transfers of money from residents to nonresidents in payment under import contracts stipulating for prepayment(s) for goods and/or services 120 or more days in advance; and if the collection period of export revenue exceeds 120 days since the date of exports of goods (services);
- 6) Lending by residents to nonresidents for a period over 120 days;
- 7) Entry to the accounts of third parties of a foreign currency received by a resident as a credit from nonresident.

In the course of development of the financial market and entering of its new participants, the approaches to the regulation and record of operations connected with capital movement changed. Also, the list of the operations was extended according to the amendments to the currency legislation. As long as licensing is one of the administrative barriers to making financial and trade transactions, other methods of influence on the foreign exchange market came into use in the currency regulation practices.

Thus, the requirement of licensing does not apply to the following types of exchange transactions connected with capital movement: international transfers under the contracts related to pension assets accumulation and international transfers under the insurance and reinsurance contracts with

savings features. This is the result of improvement in the prudential regulation procedures in these venues.

Moreover, the number of state bodies with which the licensing is coordinated was reduced; and the following operations were excluded from the list of currency valuables transactions subject to licensing:

- Transactions connected with capital movement under export and import contracts that do not exceed the equivalent of US\$5,000;
- Investments by residents in the securities issued on the territory of the Republic of Kazakhstan by international financial organizations;
- Transactions stipulating for credit to the accounts of third parties of a foreign currency transfer(s) received by a resident as a loan from nonresident under: (1) public credits and publicly guaranteed credits; (2) publicly non-guaranteed credits by foreign banks stipulating for documentary forms of payments; (3) loans taken for the purpose of export and import contracts financing which are not guaranteed by the state and insured in foreign state export insurance agencies (according to a certain roster).

For the purpose of realization of the securities market development program, a simplified licensing procedure was introduced for the pension asset management companies. In particular, these juridical persons are given the right to obtain a general license for effecting such transactions.

Foreign Exchange Cash Imports and Exports. Until recent time, there was a limit of the equivalent of US\$3,000 for resident natural persons on foreign exchange cash exports from the Republic of Kazakhstan without documents certifying the legal origin of the funds. The amendments to the NBK regulations raised the amount to US\$10,000.

Introduced in 1999 customs duty on foreign exchange cash imports by juridical persons set at 1% of the face value of the imported foreign exchange was removed on May 23, 2001.

Grounds for foreign currency purchases in the domestic market. For resident juridical persons the grounds for foreign currency purchases on the domestic market were widened. For nonresident juridical persons the restriction to acquire foreign currency on the domestic market of the Republic of Kazakhstan only for revenue in tenge resulted from current exchange transactions was lifted.

Registration of operations connected with capital movement. According to the Rules of Registration of Capital Exchange Transactions Connected with Capital Movement, providing for the receipt of property (funds) by residents from nonresidents there was established a procedure for registration and organization of record of such operations as: (i) obtaining loan(s) from nonresidents with maturity longer than 120 days, including financial leasing; (ii) credit (loans) by nonresidents with maturity of more than 120 days to finance export and import contracts by residents; (iii) direct and portfolio investments by nonresidents into the Republic of Kazakhstan; (iv) transfers by nonresidents in payment for the full transfer of exclusive intellectual property rights belonging to residents; (v) transfers by nonresidents in payment for real estate property rights.

Registration is not a restriction and is of book-keeping character. It is done for reliable and timely statistical record and balance of payments and country's external debt analyses.

Questions of Further Currency Regime Liberalization in Kazakhstan.

Preconditions for Further Currency Regime Liberalization.

During the last seven years the volumes of oil and gas extraction in Kazakhstan grew almost twice and were around 40 mln. metric tons in 2001. And what is more, according to a modest prognosis, by 2010, the physical volumes of oil extraction will reach 100 mln. metric tons annually, which is a 2.5-fold increase. Despite current account deterioration in 2001, which was the result of an external price shock, the net FDI flow adjusted for the current account balance remained positive and was at 5 percent of GDP. Exploration and exploitation of new deposits will provide for the further inflow of FDI in Kazakhstan. Moreover, the growth rates of external financing as a whole and a continuing decrease in net outflow under the “Errors and Omissions” item allows to say, that, at present, investing capital in Kazakhstan pays more than exporting it abroad. In these circumstances maintaining the existing restrictions on resident capital outflows will create disparity in capital flows in the economy and may lead to a number of negative consequences:

- a. Under freely floating exchange rate regime, potential excess supply of foreign currency will put upward pressure on the exchange rate resulting in nominal, hence real appreciation of tenge. *Ceteris paribus*, this will have a negative effect on the competitiveness of manufacturing sector.
- b. Deteriorated competitiveness of the non-primary commodity sectors of economy will induce the aggravation of sector concentration in the economy; which finally will make the economy more vulnerable to external shocks and produce new difficulties for the achievement of long-term economic policy goals.
- c. If stable exchange rate is maintained, NBK’s purchases of the excess foreign currency on the domestic market will result in monetary expansion. Hence, there either will be difficulties in keeping low inflation rates, if the money supply growth is not matched by demand increase, or the NBK will incur losses from the servicing of debt securities, which will have been used for monetary sterilizations.

The achievement of relatively stable balance of payments in the medium-term perspective allows to shift the currency regulation policy accent from strict control over capital outflows to the task of raising the effectiveness of funds attraction and utilization through solving the following questions:

1. Creation of conditions for investment portfolio diversification for the purpose of attaining optimal return and investment risk diversification requires a wider range of both instruments and possibilities available for investments, including investments in foreign assets.
2. Increase in the country’s economic potential, powered by outward direct investments in foreign enterprises with long-term commercial interest, will contribute to the enlargement of the production base of domestic businesses, penetration into new promising markets, and transaction cost decline.
3. Domestic stock market development and the appearing of new more complex investment instruments are not possible without more active involvement of nonresidents.
4. Foreign funds attraction by non-financial sector should base not only on the financing needs, but also on the firm’s ability to timely service its liabilities, i.e. its solvency.
5. Creation of the mechanism for controlling and restraining the speculations by nonresidents and non-financial organizations, who are sizeable participants of the foreign exchange market. Later, the limitations on foreign currency purchases in the domestic market should be lifted.

6. Decrease in the number of administrative restrictions and requirements imposed on the residents foreign trade operations and simultaneous increase in the effectiveness of control over the conscientiousness of their effecting.

Gradual liberalization of the currency regime will considerably reduce the transaction cost of economically significant operations and create the environment for involvement of a wider range of residents into such transactions.

The long-term liberalization goal is to contribute to the achievement of sustainable economic growth through the removal of the existing currency regime restrictions.

Risks related to the currency regime liberalization

In the process of the currency regime liberalization it is necessary to take into account the following external and domestic risks, system risks:

1. World commodity markets prices, especially oil prices, are influenced to a large extent by various economic and political factors. And what is more, price fluctuations are of a large amplitude and long duration; that might cause problems with liquidity and country's creditworthiness. Immediate currency regime liberalization not coordinated with the situation in the balance of payments may lead to undesirable consequences for the external sector stability and for the economy as a whole.
2. Capital account liberalization cannot be the only means to reduce differentials between domestic and foreign interest rates, especially because the differences in the country and foreign exchange risks between Kazakhstan and the rest of the world will prevent full interest rate equalization. Immediate liberalization of the investments into foreign assets may lead to savings outflows abroad, which (i) will not contribute into the appearing of adequate investment instruments and stock market development in the country, (ii) will lead to the shortage of domestic financial resources in the existence of growing demand for them by the real sector.
3. As the experience suggests, speculative attack risk against a currency is not always determined by the existence of fundamental imbalances in the economy. A higher degree of capital mobility may lead to a growing number of short-term transactions of speculative nature, which highly depend on the investors' expectations, which are sensitive to external and domestic situation.
4. Due to high level of US dollar denominated liabilities in the non-financial sector, there is a risk of insolvency of those enterprises if there are considerable exchange rate fluctuations.
5. "Regulative arbitrage" risk, i.e. the currency regulation system might be built (unintentionally) in such a way, that the international economic transactions participants could circumvent the restrictions established on particular operations through channels and transactions for which the currency regulation requirements had already been softened.

Currency regime liberalization principles.

The liberalization of currency regulation regime in Kazakhstan will be based upon the following fundamental principles:

1. *Consistency Principle.* The liberalization of currency regulation regime will find its reflection in the simplification of the procedures of and softening of the requirements for

particular current and capital account transactions and their following abolishment. The abolishment must not be temporary in its nature.

2. *Economic Expediency Principle.* The liberalization of currency regulation regime shifts the accompanying risks from the monetary policy authorities onto international economic transactions agents, financial institutions. That is why the range of transactions enjoying preferential regime and the time limits of the liberalization stages will be flexibly determined based on the economic expediency principle, governed by the balance of payments conditions, domestic financial and capital markets development level, and the national currency exchange rate stability.
3. *Priority Principle.* For safety considerations, it is important to impose restrictions preventing unexpected short-term capital outflows and in so doing reduce the possibility of excess pressure on the exchange rate and financial crisis break-out.
4. *Symmetry Principle.* Taking into account a possibility of capital inflow surpassing the outflow, it is necessary to gradually move from asymmetric regulation (stricter requirements to outflow transactions) to more adequate currency regime treatment of economically important international economic transactions.
5. *Uniform Treatment Principle.* The currency regime should not be more favorable for nonresidents than it is for residents.
6. *Coordination Principle.* Liberalization of operations by financial institutions should be accompanied by tightening of both prudential regulation and supervision procedures, especially regarding the requirements to the organizations' internal risk management systems (not only borrower's risk, but the foreign exchange risk, interest rate risk, etc.)
7. *Financial Stability Principle.* In relation to the non-financial sector, enterprises overburden with foreign currency denominated liabilities should not be allowed. That is why tightening financial-stability and solvency requirements for them should be a necessary condition for further currency regime liberalization.
8. *Statistical Monitoring Principle.* Currency regime liberalization will be associated with an increase in the number of international transactions participants, a wider range of and more complex executing structure of the transactions. In this context gradual liberalization should be accompanied by growing record and monitoring abilities especially in relation to the operations enjoying preferential regime, i.e. by amplification of the NBK authority in the sphere of (1) information collection for the purpose of balance of payments compilation and (2) establishment of the requirements to the information. Along with it, measures should be taken to improve and simplify the statistical monitoring system that should not put limits on the economic freedom of the economic agents.
9. *Transparency Principle.* Currency regulation system should be unambiguous and understandable for exchange control agents as well as for the parties of transactions.
10. *Exclusiveness Principle.* The NBK reserves the right to introduce predetermined individual restrictions only in case of a serious enough threat to the country's creditworthiness and domestic exchange market stability.

Criteria for determining transactions enjoying more-liberal regime.

- 1 *The type of the contract, long-term/short-term.* In the presence of vulnerability of the economy to external shocks the national currency stability depends directly on the ability to curb short-

term capital flows, which are sensitive to interest rate country risk changes both on the part of inflows and on the part of outflows. Transactions of long-term nature contribute to greater efficiency of foreign currency funds utilization and do not pose a serious threat to the balance of payments stability.

2 *Object of contract.* The capital transactions, which, firstly, are more attractive from the perspective of return-and-risk combination, and, secondly, increase economic potential of the country, are more preferable.

3 *Contracting parties.*

(a) Activities of such institutions as authorized banks, pension asset management companies, pension funds and insurance companies are considered to be more transparent and more-regulated by state agencies, therefore these participants will have more economic freedom in making exchange transactions to the extent allowed by the improvements in prudential regulation on consolidated basis and by the introduction of risk management systems.

(b) Taking into account the risk of non-financial sector enterprises insolvency, the expediency of effected transactions should be based on the contract party's financial stability criteria.

(c) Preferable transactions, involving nonresidents possessing investment-grade rating and registered in the countries, where there exist effective control and anti money-laundering systems, and international transactions, which are expedient and preferable because of the international economic relations of Kazakhstan with particular countries, may enjoy a more liberal currency regulation regime.

Sequence of Actions to Implement Currency Regime Liberalization

Based on the said above, the intention is to divide the process of further currency regime liberalization into three stages according to the set goals and priorities (see the appendix).

In setting the time limits for the stages and in determining the range of priority transactions the achievement of the earlier-fixed goals, the balance of payments situation, and the situation in the world commodity and financial markets will be the factors, on which further currency regime liberalization will depend.

For currency regulation and control purposes capital flow transactions and the transactions in the domestic market will be classified using following categories:

- a. transaction is subject to permission – NBK license
- b. transaction is subject to registration – transaction party has to inform the NBK of the transaction (within a specified period of time since signing the contract or since the transition of the transaction into a corresponding category of capital flow transactions subject to registration); based on that a confirmation in the form of registration certificate is given
- c. transaction is subject to notification – professional stock market participants, authorized banks, customs bodies or the transaction party itself notifies NBK of the nature of the undertaken transaction after its has been affected (within a specified period of time since it has been carried out).
- d. transaction is subject neither to licensing, nor certification, nor notification.

Economic expedience and the applicant's situation will be the central criteria for permission issuing. Thus the licensing system is to be of a discrete nature and be based on the established criteria of economic expedience and requirements to a transaction party.

Along with abolishment of administrative currency regulation restrictions it is necessary to improve the monitoring system of transactions involving foreign currency-denominated instruments, including term contracts, for the purpose of prevention of and control over speculative operations on the domestic foreign exchange market.

Currency regime softening finds its reflection in gradual moving of the preferred capital account transactions, for which there exist alternative regulation methods, from the category of those subject to licensing to the category of those subject to registration or advice or neither. In the process of improvement of the collection of statistical information for balance of payments compilation and determining of the NBK new authorities, it is possible to gradually switch from prior (before the transaction is undertaken or the payment is made) registration of a transaction to the requirement of advice, within a specific period of time since the transaction has been effected. The notification is aimed at augmenting to the roster of businesses engaged in external economic activities,

Concluding Provisions

The Conception is a document, laying down fundamental approaches to, principles, and directions of the currency regime liberalization, based on which a Program will be built.

Chairman of
the National Bank of Kazakhstan

G.A. Marchenko

Appendix

Stages of realization of the Currency Regime Liberalization Concept in the Republic of Kazakhstan			
	1 st stage	2 nd stage	3 rd stage
Preconditions	<ol style="list-style-type: none"> 1. Relative medium-term stability of the balance of payments 2. Achievement of relative stability in the foreign exchange market 	<ol style="list-style-type: none"> 1. Increase in the efficiency of the risk management system in the financial sphere. 2. Financial instruments development and growth in the securities market capitalization 3. Strengthening of the collection system of statistical information on international economic transactions. 	<ol style="list-style-type: none"> 1. Achievement of sustainable current account surplus 2. Achievement of a relative interest rate parity between the domestic and world financial markets
Factors determining the balance of payments situation	<ol style="list-style-type: none"> 1. Further inflow of FDI as a result of exploitation of North Caspian fields 2. Growth in investment goods imports, international services imports, and in the direct investors' income and remaining current account deficit financed by the FDI inflow 3. Growth in oil extraction volumes in the presence of considerable uncertainty about the world prices level. 	<ol style="list-style-type: none"> 1. Beginning of the North Caspian new oil fields commercial exploitation. 2. Decline in the FDI inflow 3. Domestic savings growth and as a result increase in outward direct and portfolio investments by residents 	<ol style="list-style-type: none"> 1. Arriving at peak oil extraction volumes 2. Domestic savings surpass domestic investment
Aims and tasks of currency regime liberalization	<ol style="list-style-type: none"> 1 Creation of conditions for investment portfolio diversification through currency regime liberalization for investments by residents in the securities issued by nonresidents possessing investment-grade ratings. 2 Residents production potential broadening due to stimulation of direct outward investment. 3 Removal of excessive administrative barriers for foreign trade transactions and increase in the effectiveness of export and import exchange controls. 4 Alleviation of risks related to capital flows. Due to: <ul style="list-style-type: none"> – Improvement of prudential supervision on the consolidated basis – Internal risk management systems introduction in banks, pension funds, and insurance companies – Developing the mechanism for controlling and restraining the speculations by non-financial organizations, who are sizeable participants of the foreign exchange market. 5 Improvement in transactions statistical record 	<ol style="list-style-type: none"> 1. Making the currency regime treatment more adequate in relation to long-term capital account transactions based on the “Type of Contract” criterion 2. Improvement in the exchange regulations related to the market risk hedging transactions with derivatives 	<ol style="list-style-type: none"> 1. Achievement of full national currency convertibility (internal and external) 2. Currency regulation regime liberalization for short-term transactions between residents and nonresidents 3. Lifting all restrictions imposed on opening accounts in foreign banks abroad and making transactions with the accounts. 4. Removal of all the limitations on foreign currency transactions in the domestic foreign exchange market.