

STATEMENT OF THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN ON MAIN DIRECTIONS OF THE MONETARY POLICY FOR 2019 AND MEDIUM TERM

The monetary policy implemented by the Central Bank of the Republic of Azerbaijan was oriented towards price stability in the national economy and formation of socio-economic environment favorable for well-being and business activity of the population by maintaining low and stable inflation.

Significant work was done to safeguard macroeconomic stability in the country under the leadership of the Honorable President Ilham Aliyev. Inflation stabilized at a low one-digit rate, economic growth continued, the exchange rate of the national currency sustained, and strategic foreign exchange reserves kept increasing.

Based upon macroeconomic forecasts the monetary policy in 2019 and medium run will focus on shaping low and stable inflation-based resilient socio-economic environment meanwhile further accelerating economic growth. At the same time, main goals of the monetary policy to be pursued will include optimization of the monetary policy regime, improvement of its strategic and operational framework, reduction of inflation expectations, more confidence in the monetary policy and higher openness of information.

I. THE MONETARY POLICY IN 2018

1.1. Monetary policy environment

Effects of external conditions on development of the national economy were not unambiguous in 2018.

Relatively high global **oil prices** (35%) underpinned economic growth and maintained rebalancing of the balance of payments (BoP).

Despite still high global economic growth, the International Monetary Fund revised its **global economic growth** forecast down for the current and following years.

Rising geopolitical pressure, uncertainties in foreign trade policies, swings in oil prices of recent months and spillover of these developments to neighboring countries – key **trade partners** in the region, posed considerable risks to macroeconomic stability. In 2018, sharp devaluation of national currencies in a number of these countries (the Russian ruble, the Turkish lira, and the Iranian rial) against the USD triggered psychological expectations, yet actions taken allowed their neutralization. Albeit forecasts and expectations dynamics of higher import from them fell behind that of total imports.

Current account surplus amounted to \$5.1B (15% of GDP) over 9 months, fully covering deficit in capital and financial flow account. Capital account surplus mainly stemmed from trade surplus (up by 67%). However, 2 times drop in services balance and 9% rise in secondary income balance had an upward effect on current account surplus.

Positive trends in the external sector still continued in the last quarter of 2018. According to the State Customs Committee (SCC), over 11 months of 2018 **foreign trade surplus** amounted to \$7.6 B. Commodity export y/y increased by 43.3%, including 10.2% rise in non-oil export. Commodity import increased by 32.2%, including 32.7% rise in non-oil import. The share of non-oil imports from Turkey and Russia, whose national currencies underwent sharp devaluations, in total non-oil import y/y decreased by 1.3 and 3.8 p.p. respectively.

Surplus in the BoP contributed to increase in **strategic foreign exchange reserves**, which increased by 7% (\$2.9 B) relative early year to \$44.8 B, sufficient for 31-month import of goods and services and exceeds foreign debt by 3 times.

In 2018 **economic growth** continued to be positively zoned. Over 11 months GDP increased 1% in real terms, including 1.3% rise in non-oil GDP. Non-oil growth mainly stemmed from trade. The non-oil industry grew by 8.7%, agriculture 4.6%.

Findings of Central Bank's **real sector monitoring** also confirm lingering economic activity. According to the monitoring, major sectors of the non-oil industry, including the food industry, production of construction materials, and metallurgy posted growth. The business confidence index (BCI) across these sectors was positively zoned over the reported period. Economic activity indicators also improved across major service sectors covered by the survey (communication, postal services, transportation, hotel, touristic services) and trade (home appliances, automobiles).

Economic growth was driven by consumer and government demand components of foreign and domestic demand.

The level of **consumption** was formulated under the influence of money income of the population and credit investments. Real income of the population increased by 6.7%, household lending by 15%. On this backdrop, consumer confidence index also further improved.

The size of **investments**, another domestic demand component, made up AZN 12.9 B (48.2% private sector).

Budget expenditures were critical factors to influence domestic and foreign demand. State budget expenditures y/y increased by 27.2%, including 5.9% rise in current expenses, 65.6% in capital expenses, 44.3% in public debt servicing expenses.

In the environment of continually rising budget expenditures and capital expenses in particular, lower than potential economic growth, accompanied by higher import

necessitate making budget expenditures more effective and removal of structural restrictions in the economy.

1.2. The monetary policy and its results

In 2018 the Central Bank implemented the monetary policy under its 'Statement on main directions of the monetary policy for 2018 and medium run'. The final target of the monetary policy was to maintain inflation at a 6-8% range. The Bank took decisions to ease the monetary policy in view of considerable drop in inflation and inflation expectations.

In 2018 **inflation** decreased at a higher than expected rate and stabilized at a single-digit level. Average inflation was 2.3%. Average annual inflation was below 3% in the second half of the year. Price swings were 1.9% on food products, 2.7% non-food staff, 2.6% on services on average. Over recent 12 months prices for 23% of products included to the consumer basket decreased, 7% remained unchanged, while for 62% of products price hike was below 5%. Only for 8% of products, price hike was over 5%. As in previous years prices for agricultural products, fruits and vegetables in particular, were more fluctuating, mainly due to seasonal and natural factors. Average annual **core inflation**, calculated by excluding goods and services, whose prices are regulated by the government and seasonal agricultural products, was 1.8% over 11 months.

Consumer prices were mainly affected by swings in energy prices. The agricultural producer price index increased by only 2.2% over 11 months. Transportation services price decreased by 1%, owing to cheapening of the transportation service.

Main **factors** that had a downward effect on inflation were the sustained exchange rate of the manat, optimal management of money supply and low inflation expectations. The effective monetary policy pursued by the Bank neutralized upward effect of inflation in trade partners, as well as rise in certain administrative prices.

Inflation is expected to stabilize around 2.3% **as of the end 2018** according to recent forecasts.

The **exchange rate** of the manat reacted to BoP trends and dependent supply and demand in the forex market. On the backdrop of improved external sector indicators and within the frame of the adopted macroeconomic policy the bilateral AZN/USD exchange rate remained stable. In general, the manat was under the pressure of strengthening in 2018; supply prevailed over demand in the forex market. Higher demand for foreign currency in April and August was attributable to sharp devaluation of national currencies in certain partner countries. Since higher demand for foreign currency in the above months did not arise from fundamental macroeconomic factors, its influence on the exchange rate was neutralized. Monetary policy decisions by central banks of those countries in the following months stabilized financial markets.

In 2018 the **official exchange rate** of the manat was set on the basis of the average exchange rate on interbank transactions (both auction and non-auction). Buy-sell exchange rates set by banks were close to the official one over the year.

In 2018 the actual dynamics of inflation and rebalancing in the FX market stabilized **inflation expectations**. Inflation expectations of the business sector have decreased across all sectors, particularly in trade and services. Households' inflation expectations dropped to historical lows since 2015.

The Central Bank made necessary corrections to the **interest rate corridor parameters** in light of recent macro-economic developments and updated forecasts. The Bank has discussed the parameters several times since early year taking decisions on reducing the policy rate to 9.75% from 15% in phases, the ceiling of the interest rate corridor to 11.75% from 18% and the floor to 7.75% from 10% on a stepwise basis.

In 2018 changes to **money supply** maintained an optimal balance between realization of macroeconomic stability targets and covering demand of the economy for liquidity. Over 11 months money base in manat increased by 5.2%, broad money supply in manat (M2) by 13.3%. **De-dollarization** of money supply continued. The share of foreign currency denominated savings and deposits in M3 money aggregate decreased by 5 pp., while de-dollarization on savings of individuals decreased by 3.9 pp.

To meet money demand of the economy and effectively manage liquidity, the Central Bank activated various term **open market operations** in 2018, held 55 deposit auctions on attraction of excess funds in the national currency, and 51 auctions on issue of notes. Maturity of deposit operations was 14 days, while notes were issued for 28 days. Over 11 months the size of funds attracted by deposit auctions and issue of notes decreased by 9.7% to AZN1.75 B as of the end-period. Despite lower return on sterilization operations due to reduction of the floor of the interest rate corridor, supply significantly prevailed over demand at auctions, attributable to excess **structural excess liquidity** in the liquidity position of the banking system.

In 2018 drop in inflationary pressure and positive behavior of economic growth paved the way to gradual recovery of **lending**. Over 11 months credit investments increased by 6.9%, yet banks' capacity to issue loans to the economy is much higher.

The Bank attached great importance to improvement of monetary management and effective **communication** of the monetary policy in the current year. 6 meetings of the Management Board of the Central Bank were dedicated to the monetary policy. Each monetary policy decision related press-release of the Central Bank was accompanied with relevant analytic comments aided by regular press-conferences. The Bank released quarterly Monetary Policy Reviews. Speeches and interviews by Central Bank officials also were critical in monetary policy communication. At the same time, activities of the Central Bank are in details highlighted on its website.

II. MAIN DIRECTIONS OF THE MONETARY POLICY FOR 2019 AND MEDIUM TERM

The key strategic objective for 2019 and medium run is to make macroeconomic stability more sustainable and boost its role in acceleration of economic growth.

With this objective in view, the Central Bank will continue its monetary policy oriented towards price stability, as required by its mandate. The monetary policy's strategic and operational framework will be further improved to formulate macroeconomic environment with low inflation.

2.1. Macroeconomic forecasts and risks for 2019 and medium run

Main directions of the monetary policy for 2019 and medium term base upon official forecasts for socio-economic growth and budget, covering the above period.

In the forecasted period, the external condition is expected to influence the monetary policy across several directions.

Still high **global economic growth** in 2019 paves the way to high non-oil export, reflected in official forecasts.

High exchange rate volatility in main **trade partners** and the risk of effect of their rising inflation to price stability through import is still significant in the year to come.

Due to **normalization of monetary policies in leading economies**, the effect of forecasted developments on price stability, the FX market and the exchange rate of the national currency in the first instance is minimal and will be neutralized with the help of available macroeconomic tools.

The crucial channel of the external environment affecting macroeconomic stability remains to be the **conjuncture of global energy markets**. Over the forecast period global oil prices will react to global economic growth and demand for oil on the one hand, and global supply management, demand and supply and geopolitical factors on the other hand. Aggregate and multifaceted impact of these factors causes uncertainties in the global oil market and price swings.

In view of all these, the Central Bank is planning to neutralize both the official base forecast and negative factors to influence them in shaping the main directions of the monetary policy for the upcoming year and medium term.

There are a number of critical **domestic structural conditions** for effective monetary policy in the country, which, in the first instance, includes the existing structure of the national economy, the recent phase of the business cycle, the level of diversification, monetary and fiscal control and the dynamics of available resources.

Structural factors have significant influence on formulation of an effective macro-fiscal frame and returning to a sustainable economic growth trajectory fully utilizing these resources.

On this backdrop, formulation of the effective monetary policy and sustaining macroeconomic stability will depend on the synthesis of the monetary and fiscal policies within an optimal **macroeconomic frame**, as well as on coordination of reforms planned and already kicked-off in both directions.

2.2. The monetary policy for 2019

The main goal of the monetary policy for the year to come and medium term will be to maintain a stable low inflation rate. In view of this, the Central Bank will indirectly underpin social welfare, economic growth and employment by continuing its stabilizing monetary and exchange rate policy.

The **upmost monetary policy target** for the following year will be safeguarding price stability, within the authorities of the Bank, by maintaining inflation at 4% ($\pm 2\%$).

Dynamics of the bilateral exchange rate of the manat will remain one of the critical conditions for low inflation. According to estimations, the upward effect of cheaper manat on inflation is higher compared to downward effect of stronger manat on prices. From this standpoint, the sustained exchange rate of the national currency is the prerequisite for price stability 'anchoring'. The main factor that maintain rebalancing in the FX market will be the balance between money supply of the State and main components of the economy's demand for currency. Currency demand will be affected by dynamics of import reacting to public expenditures, foreign debt flows and capital account surplus, as well as indirect influence of the international conjuncture. Long-term trend of the exchange rate of the manat is determined by these macroeconomic fundamentals.

Money supply will be regulated in response to economic growth and inflation forecasts, as well as developments in financial markets and the banking system's liquidity position. The Bank will also focus on uninterrupted payments and coverage of the economy with necessary liquidity.

To hit the inflation target, the Central Bank will use **monetary policy tools** at its disposal commensurate to the macroeconomic stance, and their quantitative parameters will be flexibly corrected depending on the gap between forecast and actual inflation.

To allow banks to manage liquidity flexibly, the Central Bank will shape a **new configuration of its various term standing facilities and open market operations**. Access to standing facilities and monthly averaging of required reserves will also enable banks to optimize liquidity management in the upcoming year. One portion of the Bank's open market operations will serve to short-, while the other one to long-term liquidity

regulation. The Bank will consider expansion of maturity range of securities it issues. Changes to the configuration of tools will strengthen the role of the interest rate channel in monetary policy transmission, activation of the money market and formulation of the yield curve. The Bank will continue efforts on improvement of the liquidity monitoring and forecasting system.

The interest rate policy will depend on attaining the inflation target. Decisions on **the interest rate corridor parameters** will be taken in light of macroeconomic developments in the country, dynamics of cyclic indicators, and changes to recent forecasts and the balance of risks. Normalization of the monetary condition may be continued, depending on how effectively inflation is managed. However, the Bank will take into consideration the factors, like making national currency denominated savings more attractive and avoiding contribution of credit investments to rise in inflation, when regulating the parameters of the interest rate corridor. The monetary policy may be toughened in case of more active inflation risks.

The Central Bank will continue actions oriented towards stabilization of inflation expectations of economic agents, focusing on **effective communication** and boosting transparency **of the monetary policy**, as well as making monetary policy decisions public under the previously disclosed schedule (Annex 1). Activities aimed at financial and economic literacy improvement will continue due to its role in making the effect of communication stronger.

2.3. Monetary policy directions for medium run

The Central Bank will take necessary actions to improve the monetary policy to effectively manage inflation according to Decree of the President of the Republic of Azerbaijan dated 22 December 2018 on a number of issues related to introduction of the Law of the Republic of Azerbaijan on the State Budget of the Republic of Azerbaijan for 2019.

Maintaining and supporting **low, stable and forecastable inflation** for medium run is critical for sustainable economic growth. Price stability underpins more effective allocation of funds in the economy and more sustainable economic growth rates.

Experience of major developed and developing countries display that, **inflation targeting** is the most optimal regime in safeguarding price stability and maintaining a low and stable inflation rate. In view of this, the Central Bank considers inflation targeting as an optimal monetary policy regime for Azerbaijan in the long run and will continue efforts to realize the conditions for transition to the regime.

In inflation targeting inflation and inflation expectations are managed **through interest rates** – central bank's policy rate influences short-term interest rates in the interbank market during the first round of the monetary policy transmission to the

economy, while during the second round short-term interest rates change aggregate demand and inflation by affecting long-term cost of money.

The current situation with critical conditions for effective introduction of inflation targeting necessitates a stepwise transition to inflation targeting in Azerbaijan.

The Bank will strengthen efforts to **shape the monetary policy's alternate anchor** as part of the gradual transition to the new regime. According to best practices, short-term interest rates in the interbank market may be the best alternative anchor. Accordingly, the Bank, jointly with relevant authorities, will continue its efforts to activate the money market, deepen the securities market and elaborate infrastructure elements that contribute to interbank money market development. The new configuration of the Bank's monetary policy tools will also support activation of the money market.

Implementation of the 'State Program on **expansion of digital payments** in the Republic of Azerbaijan for 2018-2020' approved by Decree of the President of the Republic of Azerbaijan on 26 September 2018, is expected to result in significant decrease of cash turnover in upcoming 3 years, which will have a positive effect on stronger monetary control, boosting the level of monetization of the economy and effective management of inflation.

Over medium term, avoiding the dominance of any direction of the macroeconomic policy, development of the capacity of counter-cyclic application of fiscal rules, rehabilitation of the banking system and strengthening of financial intermediation, as well as structural institutional **reforms** under way will also accelerate transition to the new monetary policy regime.

To shape economic agents' adequate expectations, the Central Bank will continue making the monetary policy **communication** more effective, and improve its **analytical and forecasting** system.

Consequently, in 2019 and medium term safeguarding macroeconomic stability, and price stability in particular will be the base condition for sustainable economic growth. The Central Bank will further contribute to safeguarding macroeconomic and financial stability it has achieved by its monetary policy. Success of the monetary policy, to be implemented, will, to a considerable extent, depend on effective coordination across all directions of the economic policy.

Schedule of disclosure of monetary policy decisions to public

In 2019 decisions related to the parameters of the interest rate corridor will be publically disclosed 8 times according to the below schedule:

1 February

15 March

26 April

7 June

26 July

13 September

25 October

13 December

Out of the above dates disclosure of decisions will be accompanied by press-conferences on 1 February, 26 April, 26 July and 25 October.