

THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

REPORT

on ACCOMPLISHMENT of MAIN GOALS and FUNCTIONS in
2017

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INTRODUCTION

The economic policy pursued under the leadership of Honorable President Ilham Aliyev, consistent reformative initiatives and systemic stabilization actions resulted in creation of grounds for sustainable macroeconomic stability, the prerequisite of sustainable economic growth in 2017. The balance of payments deficit of 2015-2016 was replaced by surplus in 2017; with huge amount of positive external trade balance. The foreign value of the national currency stabilized and the manat strengthened in 2017. Country's foreign exchange reserves started increasing again. Inflationary processes and expectations slowed down. Macroeconomic stability paved the way to economic growth, the non-oil sector recovered in 2017. All these positive consequences were made possible due to macroeconomic maneuver and a flexibly coordinated macroeconomic policy frame.

The CBA maintained its mandated functions in 2017 contributing to safeguarding macroeconomic and financial stability. The Bank implemented a macroeconomic stability oriented policy as part of the new monetary policy frame, the policy rate and money supply sources were regulated in line with the macroeconomic stability and maintenance of economic growth targets.

1. ACCOMPLISHMENT OF GOALS

The goal of the Central Bank is to maintain price stability, organize and ensure operation of interbank centralized and other non-licensed payment systems, and support banking system stability within the authorities established by the legislation.

1.1 Maintaining price stability within the authorities established by the 'Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan'

In 2017 the Central Bank implemented the monetary policy in light of the inflation target.

According to the State Statistics Committee (SSC), average annual inflation was 12.9% in 2017. The CPI components – food prices rose by 16.6% on annual average, non-food prices 11.7%, and services by 9.3%.

In 2017 overall price levels were mainly affected by swings in non-demand factors. The NEER, inflation expectations and inertia, swings in global commodity prices, supply-demand on a number of commodity groups, as well as government regulation of prices influenced prices. Over the year swings in external factors of inflation remained high.

Average annual core inflation estimated excluding goods and services, whose prices are regulated by the government and seasonal agricultural products was 12.1% in 2017.

According to the SSC, in 2017 the IPPI rose 39.2%. Price hikes are attributable to high prices in mining and electricity, gas and steam production. Prices in the mining industry were mainly affected by rising oil prices. The APPI increased 12% in 2017, mainly due to 13.5% hike in animal products. Plant products hiked 10.6%, owing to rising fruit growing costs.

As it was noted, expectations also contributed to swings in consumer prices. Stabilization of the exchange rate had a downward effect on inflation expectations. CBA's regular RSM revealed that price expectations were relatively high in home appliances on upcoming 3 months, however dropped across other segments. Overall price expectations lowered in services (except for postal services). In processing expectations dropped in food and beverages, construction materials and plastic segments. Price expectations were relatively high in construction.

1.2 Organization and ensuring operation of interbank centralized and other non-licensed payment systems and support for banking system stability

Stable and reliable operation of payment systems was one of the priorities for the CBA. Interbank centralized payment systems, the key components of the National Payment System (NPS), launched and managed by the CBA maintained uninterrupted operation in 2017.

Total size of payments made through the Real Time Gross Settlement System (AZIPS) and the Low Value Payments Clearing and Settlement System (LVPCSS) for small size and reiterating payments, the core components of the NPS, amounted to AZN210.2 B (38 mln. transactions). The size of payments y/y increased 44.6% (AZN64.8 B), while the number of transactions y/y increased 14.4% (4.79 mln. pcs).

Works on integration of the securities settlement system of the National Depository Center (NDC) were implemented. To ensure security of real-time information exchange among card processing centers they were integrated to AZIPS with Bank Certificate Services Center's (BCSC) e-certificates.

AZIPS now allows domestic settlements in foreign currencies (USD, EUR and GBP) along with the national currency.

Newly established regulation for AZIPS and LVPCSS allows to extend time for acceptance and handling of payment orders, while the LVPCSS uses a three-session operation.

To ensure effective use of systems' operation manual by participants, tariffs now are dependent on work hours of an operation day.

Preventive measures in payment systems kept going in 2017 to avoid rising cyber threats in global e-environment.

Expansion of the infrastructure of the Government Payment Portal (GPP) continued in 2017. Works on integration of the internal information system of the "Naxtel" LLC to the GPP completed, efforts on sending traffic related administrative fines to the GPP by the State Road Police are completed. Payments are received in bank branches operating in ASAN centers of the State Agency for Public Services and Social Innovations under the President of the Republic of Azerbaijan and mobile ASAN buses in cash and with payment cards using POS-terminals in the GPP. At the same time, payments related to this coordinating body are collected over the official Internet resource of the GPP. Currently, 13 central executive power bodies, 96 courts of justice, 10 pilot municipalities, 9 legal entities whose qualifying holding belong to the state, 6 state higher educational institutions, 13 insurance companies via the Compulsory Insurance Bureau and 3 mobile communication operators have been integrated to the GPP. Payments for total 440 services across these organizations, including over 400 public services (tax, duties, rent fees, administrative fines and penalties etc.) are made in cash in about 2000 payment points of the Azerpost LLC, the Nakhchivanpost LLC and 30 banks and over 1000 payment terminals, and in cashless order with payment cards and bank accounts over portal's Internet resource and e-banking services. The system handled total AZN2.1 B worth of 36.6 mln. payment transactions. The size of transactions handled in the system y/y increased 1.66% (AZN 34,1 M), while their number increased 20.56% (6,2 mln. pcs).

The card infrastructure kept developing. Business continuity of the Interbank Card Center (ICC) launched to domestically handle data on operations among service centers using payment cards issued in the country was maintained. Efforts to obtain the PCI-DSS v3.2 certificate continued to boost security in transactions via the ICC and align to international standards. Tariffs (interchange) among banks using the ICC were reviewed and optimized in order to increase cashless payments and expand the use of card infrastructure. In 2017 AZN716 M, USD3 M, EUR1.3 M worth of total 24.6 mln pcs of financial transactions were conducted via the ICC.

The number of payment cards issued in the country reached 5.8 mln. pcs, ATMs 2431 pcs, POS-terminals 65471 pcs. The size of payment card transactions y/y increased 42%.

To hit the formation of digital economy and expansion of digital payments target assigned to the CBA in the 'Strategic Roadmap on Development of Telecommunication and Information Technologies' works on development of a three-year new strategy with the MasterCard Worldwide continued. As part of the project the Bank maintained comprehensive analytics and diagnosis on identification of factors hindering development of digital payments, identified the scale of the shadow economy, and estimated the size of the cash economy in overall economy and particular sectors. Experience of over 30 countries was investigated, relevant recommendations were elaborated for their application, with their effect analyzed. Proposals based upon international practice were discussed with related public authorities included to the task force, service providers and banks. As a result of the works done, the 'State Program on Expansion of Digital Payments in the Republic of Azerbaijan for 2018-2020' was drafted with the involvement of the Institute of Economy of the National Academy of Sciences of Azerbaijan, which included 18 priorities with main actions per priority on elimination of institutional challenges hindering development of digital payments, improvement of business environment, banking sector rehabilitation, formation of digital eco-system and raising financial awareness and literacy. The draft State program was submitted to President Administration for approval.

2. DISCHARGE OF FUNCTIONS

To attain the main goals the CBA took necessary efforts to determine and pursue the state's monetary and exchange rate policy, organize cash circulation, regularly set and announce the exchange rate of manat against foreign currencies, regulate and control currency, develop reporting balance of payments (BoP) and participate in development of the forecast BoP, maintain and manage international gold – foreign exchange reserves at its disposal, compile consolidated (both public and non-public) foreign debt statistics and international investment balance and discharge other functions under the legislation.

2.1 Setting and implementation of the state's monetary and exchange rate policy

The CBA's monetary and exchange rate policy was oriented towards price stability in 2017.

In 2017 rise in country's foreign exchange reserves on the backdrop of improved BoP paved the way to stabilization of the situation in the FX market. Amid higher supply in the market, manat has appreciated 4% since the early year with a downward effect on inflation expectations and dollarization.

In the environment of a flexible exchange rate the CBA pursued a conservative anti-inflationary monetary policy focused on price stability, its key mandate. The Bank managed

money base sources, the monetary policy's key operational anchor within the monetary program frame upon coordination with related authorities.

In general, the implemented policy maintained liquidity management in the economy and stable operation of payment systems. Money base in manat increased 8.7% in 2017. Amid higher supply in the FX market and challenges on currency transfers to the budget, demand of the fiscal sector for liquidity factored in high money base and the monetary condition.

The CBA discussed interest rate corridor parameters several times over the year and decided to leave the refinancing rate unchanged. In light of the macroeconomic stance and the conjuncture in the money market the CBA Management Board decided to lower the floor of the interest rate corridor by 2 p.p. at its meeting of 21 June 2017. As of the yearend the ceiling of the interest rate corridor is 18%, the refinancing rate 15%, the floor 10%.

To cover demand of the economy for money and effectively manage liquidity the CBA kept active various maturity standing facilities (1, 7, 14, 28 days) and open market operations.

In the environment of weak lending activity major part of rising money supply was channeled to the liquid financial tools market, including state securities and CBA financial instrument. At CBA's sterilization tools – short-term notes placement and deposit auctions demand was much higher than supply, reflective on the yield on tools. Outstanding amount of funds attracted at deposit auctions and notes placement jumped 10 times. The CBA conducted 61 deposit auctions and 49 auctions for placement of notes. Funds were attracted for 14 days at deposit auctions, while notes were placed for 28 days. As of yearend total outstanding amount of funds attracted via deposit auctions and notes placement amounted AZN1938 M – AZN1012 M funds attracted at deposit auctions and AZN926 M funds attracted via notes placement.

Deposit and short-term notes placement operations both sterilize excess money supply, contribute to the money market, and have an upward effect on improvement of the monetary policy's operational framework and development of the interbank market. To note, deposit operations and notes placement are maintained at interest rates fluctuating between the floor of the interest rate corridor and the refinancing rate (currently 10%-15%). At deposit auctions funds were attracted at 10.01%-14.8%, while notes were placed at 10.01%-14.99%.

Reserve requirement was left unchanged – on liabilities in the national currency and precious metals at 0.5%, on foreign currency liabilities at 1%, and on liabilities to the non-resident financial sector and settlements with international financial institutions 0%. Monitoring findings display that banks' cumulative balances on correspondent accounts with the CBA considerably exceeded amounts to be maintained as required reserves. Reserve requirements

were still applied on an averaging basis, factoring in more flexible management of liquidity by banks.

2.2. Organization of cash circulation, issue of monetary units to and withdrawal from circulation under Part II, Article 19 of the Constitution of the Republic of Azerbaijan and the ‘Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan’

In 2017 demand of the economy for cash was covered in full, under the required structure and in time.

The CBA withdrew AZN9 B or 452 mln. pcs of monetary units from and issued AZN7.8 B or 376 mln. pcs of monetary units into circulation. In general, money in circulation increased AZN 1.2 B (17%) to AZN8 B as of the end-year.

The share of large denomination banknotes (AZN 50 and 100) has been increasing on an ongoing basis over 12 years of issue into circulation and exceeded 90% at the yearend. In international practice where the share of large denomination banknotes exceeds 75%, central banks consider issuing a new large denomination currency into circulation. The CBA assessed the process and started efforts to issue a new AZN 200 banknote into circulation in 2018.

The ‘Clean money in circulation’ policy adopted to make the quality of money in circulation higher kept going. Currency returned to cash centers of the CBA from circulation was handled, currency unfit for circulation was taken out of circulation. AZN7.7 M worth of currency unfit for circulation was replaced by the ‘Public service offices’ created at the CBA.

The CBA attached great importance to effective anti-counterfeiting, counterfeit currency detected in circulation was delivered to law-enforcement bodies for relevant investigations. As of the end-period the number of counterfeit banknote per 163 000 pcs of banknotes was 1, considerably low compared to relevant indicators of other countries (the rate in the euro zone 1 fake currency per 30000 pcs of banknotes).

A ‘Counterfeit Currency Monitoring System’ was developed to make anti-counterfeiting more effective; the system ensures exchange of information with related public authorities, analytic database for the banking system and e-access to cash services.

Cash management reached a new qualitative level at the CBA, the Cash Management System (CMS) that covers the entire banking system and integrated to other information systems of the CBA is operating in full swing. The system allows to maintain all cash related operations between the CBA (with the coverage of regions) and commercial banks and the national operator of postal communication in a real time automated mode.

The CBA represented the country at international conferences and organized such conferences in the country. Baku hosted an international conference titled 'High Security Printing' for the first time in 2017, attended by about 300 representatives from about 80 central banks, banknote printing companies and specialized international companies.

In general, the CBA focused on progressive practice based cash management, maintaining security in business processes, minimization of risks and improvement of related internal control procedures.

2.3 Regular setting and announcement of the official exchange rate of manat against foreign currencies

In 2017 the exchange rate of manat was in line with BoP trends amid higher exchange rate flexibility. Improved BoP paved the way to the exchange rate stability.

Stabilizing measures on adjustment of the economy to new oil prices and a series of decisions taken to support non-oil growth yielded improved BoP indicators in 2017. Total export increased 51.1%, including non-oil export increased 24%, positive external trade balance amounted to \$5 B, resulting in current account surplus (\$1062 B over 9 months).

Overwhelming measures oriented at macroeconomic and financial stability, macroeconomic sustainability related decisions created a favorable condition for higher exchange rate flexibility. As part of making the exchange rate more flexible the CBA made corrections to the auction mechanism from 12 January 2017, under which auctioned currency is sold at prices quoted by market participants. In other words, the auction completes with the sale of currency from the bank offering the highest to the one offering the lowest price.

Auctions are conducted twice a week; market participants are informed on parameters via Bloomberg terminal. Total 99 auctions were conducted in 2017.

The CBA scrapped the requirement for banks to buy or sell cash and cashless foreign currency at $\pm 4\%$ from the officially set exchange rate on 12 January 2017.

On non-auction days the Interbank FX market operated on the Bloomberg platform. Out-of-auction Interbank FX market transactions amounted to \$1065 M.

The official exchange rate of manat was set on the basis of the average exchange rate on interbank transactions (both auction and non-auction). Manat reacted to supply and demand in the FX market with several appreciation and depreciation waves. Having appreciated in January and the first half of February, the USD started to lose value from the second half of February. Whereas the USD/AZN exchange rate stood at AZN1.7707 in end-2016, it peaked to

AZN 1.9200 on 01.02.17, and slumped to AZN 1.7000 later. In the USD depreciated against AZN by 3.9%. An average daily official USD/AZN exchange rate was AZN 1.72 over the year.

Multilateral exchange rates underwent no considerable changes. Compared to the end of 2016 non-oil weighted NEER strengthened 1%, and the REER 4%. The REER has depreciated 35.7% since the end of 2014, which factors in higher non-oil export and import substitution.

2.4 Maintaining currency regulation and control under the ‘Law of the Republic of Azerbaijan on Currency Regulation’

The CBA maintained currency regulation according to the Law of the Republic of Azerbaijan on Currency Regulation.

The legal regime of currency operations is determined by the Law of the Republic of Azerbaijan on Currency Regulation and the ‘Regulations on currency operations of residents and non-residents in the Republic of Azerbaijan’ approved at the CBA decision of 28 November 2016. Bringing of and taking out of the country of cash foreign currency is governed by the ‘Regulations on bringing foreign currency into and taking out of the Republic of Azerbaijan by residents and non-residents’ approved at the decision of the CBA dated 3 March 2016.

Regulatory norms of currency operations in place contribute to rebalancing of the BoP and exercising stronger control over taking foreign exchange funds out of the country. To make currency operations of individuals and legal entities functioning in the country more transparent, in exchange for import related advance payments goods should be imported or services be supplied within 180 days and accompanying documents be submitted to the bank. Moreover, limits have been imposed on currency transfers from the country through individuals’ bank accounts and without opening accounts (to close relatives up to \$10 000, in other cases \$1000 over operation day, total \$10 000 a month). Operation limits are also set on transfers to close relatives. Analyses suggest that these regulations played a certain role in optimization of the ratio between inflow and outflow of currency in 2017.

At the same time, it was necessary to adopt a dedicated legal act regulating no limits on inflow and outflow of national currency to and from the country as part of the currency regulation function. Whereas the valid legislation allows for no norms that prohibit these operations, during customs control citizens encounter certain hardships. To ease the situation and stimulate regional circulation of the national currency when it has stabilized, a draft legal act that regulates limitless pass of the national currency from the border under customs procedures has been

developed, coordinated with related public institutions and submitted to the Cabinet of Ministers of Azerbaijan for approval under the Law of the Republic of Azerbaijan on Currency Regulation.

The Financial Stability Board discussed proposals on Financial Markets Supervisory Authority's exercising control over currency regulation in a unified manner due to establishment of the latter and its assignment to supervise assigned banks and took relevant decisions. Under the decision in question, legislative proposals have been submitted as required.

2.5 Storage and management of international gold-foreign exchange reserves at its disposal

Amid low yield and high volatility arising from normalization of monetary policies of central banks of developed countries the key policy of the CBA's foreign exchange reserve management policy was maintenance of reserves in 2017.

High lending quality and liquidity of assets as the key components of foreign exchange reserves management was maintained. As of the end-period official foreign exchange reserves were held with reliable financial institutions – 90% in the USD, 5% in the euro, 2% in the pound, and 3% in SDR.

CBA's foreign exchange reserves increased by \$1,36 B to \$5,33 B as of the end-period. The Bank earned \$58,2 M worth of income from currency asset management.

2.6 Development of the reporting and participation in development of the forecast balance of payments under the legislation

Compiling of the international standards based BoP continued in 2017, actual and forecast indicators of the BoP were one of the critical information sources for adequate decisions in the macroeconomic policy.

To improve BoP compiling at the CBA, under the IMF Balance of Payments Manual (6th edition), new closed International Transactions Reporting System (ITRS) was introduced in an automated mode, which allows to generate detailed information on foreign currency operations, which, in its turn, is critical in further improvement of the BoP reporting and accounting, deepening of analytics in terms of foreign exchange balance, reconciling indicators and improvement of forecasting.

2.7 Develop country's consolidated (both public and non-public) foreign debt statistics and international investment balance, summary and dissemination of data

According to the Resolution of the Cabinet of Ministers 'on improvement of mechanisms for organization, consolidation and dissemination of international standards based foreign debt and international investment statistics', the Ministry of Finance submitted data on government and government guaranteed public debts; oil and gas companies functioning in the country data on oil-and-gas related foreign debt; the State Statistics Committee data on the non-public sector to the CBA, debt statistics on the financial sector was assessed on the basis of digital balance received from banks and an experimental version of aggregate debt statistics was developed in 2017.