

STATEMENT

of the Central Bank of the Republic of Azerbaijan on key directions of monetary and financial stability policy for 2011

The global economy started to gradually leave recession behind yielding trends of economic revival in 2010. However, a newly emerging post-crisis global “balancing”, structural and macro economic challenges in leading economic centres as well as fiscal unsustainability led to uneven and unstable global growth. At the same time, significant risks still dwelling in the global financial system factored in to high volatility in financial markets.

Against such a complicated global background, the Azerbaijani continued to enjoy growth and development in the current year with a sustained macroeconomic stability dominating in the economy. Overall, the consequences of global crisis were mitigated. Financial viability of domestic economy enhanced, foreign exchange reserves witnessed significant growth.

In 2010, the Central Bank aimed at maintaining inflation at an acceptable level, protecting stability of exchange rate of the manat, provision of stable development and sustainability of the banking-financial sector in accordance with declared key directions of the monetary policy. Within the framework of realizing these targets, the Central Bank preserved macroeconomic and financial stability as well as delivered crucial support for economic growth through adjusting its policy within the year.

Key directions of the Central Bank for 2011 and strategic period are built on the latest global trends and new development challenges of the national economy. Primary target of the monetary policy shall include maintenance of macroeconomic stability. Another target of the Central Bank shall be provision of financial stability in the banking sector. In order to achieve these targets, the Central Bank shall improve strategic framework for monetary policy and banking supervision on an on-going basis. At the same time, a necessary support shall be provided to a more enhanced macroeconomic coordination and increased financial depth of the banking sector.

1. Economic standing in 2010 and the Central Bank policy

1.1. Situation in the global economy

In 2010, the world economy enjoyed growth trend, however, with high volatility observed in the global markets. According to latest projections of the International Monetary Fund, global economic growth is forecast to be 4.8% in 2010. While there was growth in the world economy, it is characterized with sectoral asymmetry and regional inequality. Revival

primarily driven by developing countries was more vivid in corporate sector compared with the financial sector. Uncertainties emerged against the background of worsening macroeconomic imbalances and structural problems triggered volatility in the markets. As such, significant increase in commodity prices, high volatility in exchange rates of leading currencies and fund indices in financial markets were observed. Oil prices enjoyed a particular price hike, while a rise in food prices were primarily due to decrease of productivity in wheat exporting countries.

During the global crisis, government debt of the USA and Eurozone went up markedly, thus limiting opportunities for fiscal support of the economy. Budget deficit in developed countries averaged 9% of the Gross Domestic Product, and the government debt neared the volume of the Gross Domestic Product. In such circumstances, a number of countries declared plans on fiscal consolidation as well as freeze of social expenditures. These reforms with an important part occupied by pension reforms are expected to be implemented primarily through cost savings. While consolidation measures would negatively impact activity in a short run, it is expected to trigger economic growth in a longer run.

As recession is coming to end, central banks are gradually starting to prioritize their key mandate – inflation. While the USA softened monetary policy within the year, China tightened it further, whereas Europe preferred neutrality. At the same time, in order to underpin economic growth, global coordination efforts against mutual depreciation of national currencies strengthened. It was found advisable to stimulate economic growth through other means, primarily structural reforms.

1.2. Processes in the Azerbaijan economy

With negative consequences of the global crisis being neutralized, sources of economic growth has started reviving. Within the past 11 months, economic growth comprised 4.5%, including 5.9% increase in the non-oil sector. Actual production index and the level of utilisation of production capacities were also observed to increase. As microeconomic monitoring reveals, a number of entities with increased production and turnover grew against the previous year. Growth in non-oil industry totaled 5.9%, Business Confidence Index on industry, trade and services improved against the previous year. In such conditions, a number of employed population increased, employment expectations in industry, trade and services improved against the previous year.

Domestic demand was positively affected by a 12 percent growth in nominal money income of the population and 14.7 percent growth of bank loans to households within 11 months of the current year. Accumulated stocks of durable goods decreased in retail trade during recent months. Index on actual sales in trade and demand in services increased. Within

the past 11 months, investments went up by 15.2 percent, including 7.7 percent in the non-oil sector.

With effects of the global crisis phasing out, external position of the country kept improving. A rise of export prices, gradual restoration of access of banks to foreign lending, growth of external financial flows positively affected the balance of payments in the current year. The surplus of current account having increased by 69 percent within 9 months of 2010 neared USD 12 bln., which fully covered capital account increasing foreign exchange reserves by more than USD 9.7 bln. As of December 1st, 2010, strategic foreign exchange reserves totaled USD 30 bln., which is sufficient for 3-year commodity and services imports.

1.3. Monetary policy and macroeconomic stability

The Central Bank having kept factors affecting macroeconomic stability under control pursued adequate policy. Ultimate and interim goals targeted for the monetary policy were achieved, money supply was regulated at optimum, stability of exchange rate of manat was preserved. As a result, a key target of inflation was kept at a single-digit level..

The Central Bank implemented exchange rate policy in the environment of expansion of supply channels of the foreign exchange market. Within the past 11 months, the Central Bank purchased foreign currency amounting to USD 1 bln. in the foreign exchange market. Nominal exchange rate of the manat against the USD stably strengthened by 0.4percent. Real effective exchange rate on the non-oil sector was nearly neutral, while it depreciated vis-a-vis the near foreign countries, which imports a bulk of non-oil exports goes, hence positively affecting competitiveness.

Given trends in the economic cycle, the Central Bank continued soft monetary policy in 2010, however, given the latest specified forecasts, it decided to “neutralize” monetary policy in November. In order to underpin business activity, the Central Bank did not alter monetary policy to the end of October, refinancing rate was maintained at 2percent level, and required reserve norm was preserved at 0,5percent level with liquidity window remaining open. Through the operations of the Central Bank, within 11 months of the current year, broad money supply increased by 20.2percent. It had a downward effect on interest rates. However, at the end of second half of the year, a number of cycle indicators permanently analysed by the Central Bank in favor of correction of the monetary policy started to rise. Given revival of the aggregate supply, inflation trends and forecasts of the balance of payments, the Central Bank took a decision to raise the refinancing rate up to 3percent as of November 1st. At the same

time, in order to regulate external factors of the money supply a required reserve norm of 0.5percent was introduced on foreign liabilities of banks.

During the period, inflation remained at single-digit level with average annual inflation constituting 5.5percent, and 7.4percent on a year-on-year basis according to the results of 11 months of the current year. Acceleration of inflation in partner countries, particularly a decline in food production factored in the upward effect on inflation. Unfavorable natural environment led to decline of agricultural output, resulting in a 3.7percent rise of consumer price index in agriculture. Notwithstanding, the inflation is expected to remain at single-digit level. Prices in the real estate market, however, kept declining.

1.4. Development in the banking sector and financial stability policy

In 2010, indicators of the Azerbaijan's banking sector kept increasing. Total capital of banks increased by 7.9percent since the beginning of the year. Savings of population grew by 22.8percent, lending went up by 8.1percent, while bank assets rose by 8,8percent within the past 11 months. During the period, a rise of term deposits by 30.2percent points to increase of confidence in the banking sector. Revival in global financial markets restored access of the banking sector to external financial sources along with domestic sources.

Given an ongoing formation of Basel-III standards on banking supervision, the Central Bank improved its macroprudential framework. Prudential measures are targeted at risks minimization, provision of stable performance and preservation of the trust of banks. Based on the new Basel-III concept on capital, liquidity and macroprudential supervision tools, the financial sector is recommended to apply new sustainability norms. Overall, these norms should protect banks more reliably from negative impact of economic shocks constraining procyclic behavior among them. In light of the above, the Central Bank has taken the following measures:

- Governance capacity and risk management systems at banks strengthened;
- Level of financial provisioning increased further;
- Assets remediation measures endured;
- Capitalisation programs adopted and launched to be implemented;
- New framework of liquidity management adopted, preparatory work on application of new norms launched.

As a result of measures taken by the Central Bank, the Azerbaijan's banking sector preserved its financial sustainability. Quality indicators of bank assets stabilized having been maintained at sustainable levels, share of overdue loans to the real sector and the population did not exceed 5percent. Large part of potential risks were properly provisioned for by private

banks having been duly recognised. The banking sector maintained its optimal profitability and investment remained attractive. Currently overall liquidity level is high. The banking sector maintains the necessary level of capital to cover potential risks and to support economic activity. Capital adequacy indicator is 16.8percent while the norm is 12percent. Stress-tests demonstrate that the banking sector is capable of withstanding macroeconomic shocks and covering losses thereof.

Regional network of the banking sector and access of rural economic subjects to banking services expanded. Lending in regions increased by more than 12percent, a number of bank branches comprised 316. The “Azerpocht” project successfully finalized, post offices started to conduct limited banking operations. A start-up of postal banking system allowed to expand network of financial services in regions and to improve competitive environment in the regions.

Mortgage lending was a key player in underpinning economic activity in the current year as well. During the period, market resources continued to be attracted to mortgage lending. Within the past 11 months, assigned credit institutions issued mortgage loans amounting to AZN87.3 mln. to total of 2213 persons, including social mortgage loans amounting to AZN15 mln. to 453 persons through the Mortgage Fund. At the same time, given the last financial crisis, the mortgage mechanism underwent adequate adjustments. Portfolio on mortgage loans was highly sound and no delays were observed in repayments on loans.

2. Key directions of monetary and financial stability policy for the year of 2011

2.1. Global economic expectations and macroeconomic policy challenges

While the world economy is forecast to grow in 2011, this growth is expected to occur in the environment with instability and significant risks not eliminated completely. Thus, under the latest International Monetary Fund projections, the global growth in 2011 is expected to fall 0.8 basis points (4.2percent) behind 2010. Globally, there are expectations of inflationary threats due to decline in food production.

The imbalance of the world economy and uncertainties emerged thereof increase instability of the global demand, commodity markets and financial flows. The problem of unemployment is expected to still endure in a short run with fiscal consolidation plans underway and risks in financial sector remaining. Under these circumstances, international institutions conclude that equilibrium in foreign trade between countries with deficit and those with surplus will be a crucial factor for global stability. The former should enhance fiscal discipline and increase external demand through new structural reforms, and the latter should stimulate domestic demand through flexible exchange rate regimes, as well as focus on opportunities to tighten monetary policy in the environment of increasing inflation. *The*

countries exporting natural resources should adhere to fiscal sustainability criteria in utilizing financial assets accumulated from export of raw materials to stimulate domestic demand. At the same time, they should pursue a policy of diversification to decrease cyclical vulnerability of national economy, and provide for more sustainable long term sources of economic growth.

International financial institutions recommend to apply individual macroeconomic means to separately affect inflation, economic growth and financial bubbles. Price stability should be the primary target of the monetary policy, while supplemented by “countercyclical” macroprudential policy. Prudential tools, since “targeted”, increase opportunities to effectively manage bubbles avoiding economic volatility. Key means for the global economic equilibrium to occur within a short time is to implement a structural policy. Broad deregulation measures may be crucial to mitigate gaps in market mechanisms particularly in developing countries.

2.2. Projections of the Azerbaijan economy and strategic challenges

Macroeconomic projections indicate significant strengthening of external economic position of Azerbaijan in 2011. In the environment of the global growth, prices for key export products and oil revenues are expected to rise, external financial-investment flows to the country would increase too in 2011. The balance of payments is projected to have a significant current account surplus, and strategic foreign exchange reserves are expected to increase further. Upgrading of country’s credit rating also creates favorable conditions for increase in external capital flows to the economy. All these are fundamental factors to affect exchange rate of the manat and money supply.

Economic growth is expected to endure with “restrained” growth of domestic demand, and gradual increase of external supply. According to socio-economic development projections of the country, the economic growth is expected to primarily benefit from non-oil sector in the environment of stabilization of the oil sector. It is assumed to mainly source from domestic demand. A single-digit increase of state expenditures and private demand, a gradual expansion of non-raw materials exports are key factors forming non-oil growth. Under these circumstances, the gap between potential and actual level of the Gross Domestic Product is expected to decline in 2011.

Conservative growth of public expenditures in 2011 is a key step towards fiscal sustainability. Given high results achieved in modernization of physical and social infrastructure, the objective of strengthening domestic fiscal consolidation, directing public expenditures to new development priorities – diversifying the economy, increasing exports potential, developing human capital takes on a higher relevance.

In total, volume of oil revenues necessitates strengthening of coordinated control over monetary indicators of inflation. In 2011, the level of inflation may be affected by price hike in

partnering countries, as well as in the world food markets along with domestic demand. All of this stipulates setting macroeconomic stability targets as key priorities in the following year.

2.3. Targets and strategic framework of monetary policy

As negative impacts of the global crisis have been neutralized, the Central Bank shall direct monetary policy at providing macroeconomic stability under its mandate in the following year.

Given macroeconomic projections, including external economic factors and increase in oil revenues, the Central Bank finds the following targets expedient for the monetary policy in 2011:

- *Preserve annual (12-month) inflation at a single-digit level and prevent high volatility of inflation.*

Coordination of activities of other economic structures shall be key to realization of this target.

To attain these targets, a flexibility of exchange rate of the manat based on a supply and demand of foreign exchange is of key conditions, however, given financial stability priorities no sharp volatility of exchange rate shall be allowed. In the long run, the Central Bank, in order to more effectively to inflation targeting, shall continue transition to flexible exchange rate regimes. As such, flexible exchange rate regimes are considered to be a primary pre-requisite to enhance control over money supply in international experience. Gradual transition to any regime shall be feasible depending on the level of diversification of foreign exchange income, development of financial tools to insure against foreign exchange risks, decline of dollarization, financial market depth, as well as the level of real impact of the manat on competitiveness of exports sector.

The Central Bank shall flexibly utilize market tools to achieve the monetary policy targets. Parameters of interest rate including refinancing rate shall be adjusted depending on the level of inflation, economic cycle and situation in the financial markets. Liquidity of the banking sector shall be managed mainly through short-term operations. Relatively longer-term refinancing operations shall be used only in cases of necessity. The mechanism to apply required reserve norms shall be improved further, while the level of the norm shall be set depending on the scales of “hot capital” flows to the banking sector. In order to increase macroeconomic effectiveness of the monetary policy tools, promotion of activity in interbank money market shall be continued.

Development of institutional framework of the monetary policy shall remain in the focus, while the capacity for economic diagnostics, research and forecasting shall be

enhanced. Works to apply new models to fully launch a system of tracking economic cycles and for this purpose, to ensure analytical depth of macro- and microeconomic statistics (jointly with related structures), to estimate “equilibrium exchange rate”, to measure “bubbles” in the real estate market, and to forecast inflation will continue.

To conduct a dynamic research of various economic shocks, it is envisaged to develop a new macroeconomic model on theoretical foundations of a general equilibrium model given local specifics, as well as methodological challenges of a post-crisis era. This model shall enable the Central Bank to conduct simulations in diverse regimes of the monetary policy and deliver a more qualitative type of forecasts.

2.4. Financial stability policy in the banking sector

Given the post-crisis challenges, in 2011, the Central Bank shall direct its activity to further enhancing financial stability in the banking sector. Strategic target for the long run is to provide for an active role of the financial system in the diversification of the economy.

In 2011, the financial stability policy of the Central Bank shall be directed at realization of the following targets:

- *Preservation of capital adequacy;*
- *Maintenance of optimal liquidity level;*
- *Restructuring.*

In 2011, the regulatory and supervisory measures shall be targeted at reaching an optimal balance between the goals of growth and sustainability. It is crucial for the banking sector to rely on more stable and sustainable sources of growth in the post-crisis period. This is what primarily stipulates a direction of financial intermediation towards sound and long-term economic growth. For this purpose, it is crucial to increase a role of long-term savings sources, including the capital market.

In order to provide for a stable and safe development of the banking sector, an adjustment of regulatory and prudential supervisory framework to new global challenges shall be provided for on an ongoing basis. To that extent, in order to more effectively regulate risks covered by micro-prudential supervision (individual control over institutions), opportunities for utilization of new tools recommended on the platform of the Basel Committee on Banking Supervision shall be assessed. To improve banking regulation and supervision, enhancement of macroprudential approach has been set as a primary objective.

Formation of a policy on provisioning for bank assets based on a new countercyclicality concept has become particularly relevant after the last global crisis. Traditionally, banks tend to demonstrate a “procyclical” behavior (trend to follow economic

growth dynamics) in their activities that results in lack of necessary provisioning portfolio. Development of countercyclical approach shall stipulate a cautious behavior of banks during economic growth, while ensuring more sustainability during the downturns. Taking this into account, “countercyclical-dynamic provisioning” mechanisms shall be applied.

The Central Bank shall be focused on realization of the following measures to manage capital, liquidity and credit risks in the banks at a safe level:

- Apply a “leverage” ratio (the tool binding assets growth to capital growth) from the following year, while providing for an additional push of this ratio to capitalisation;
- Apply a more conservative approach to qualitative parameters of capital recommended by banking supervision within the framework of Basel III, maintain capital through more stable sources;
- Launch a preparatory work to apply short-term liquidity management tools recommended on the platform of Basel III;
- Enhance internal institutional capacity by increasing resistance of banks to financial risks.

Restructuring and denationalization of banks, promotion of competition in the sector shall be one of the key priorities. Full implementation of conditions for competition is of core factors of deepening financial intermediation function of the sector and increasing quality of banking-financial services. The restructuring of the banking sector and a higher quality demand for corporate governance shall enable enhanced competitive environment in the market.

The Central Bank envisions its core objective in preserving macroeconomic and financial stability and to that end, in improving the monetary and financial stability policy strategies in the following year as well as in the strategic period ahead. In the long run, this is one of the primary conditions of sustainable and dynamic economic growth. Full realization of export potential of the country and diversification shall be a locomotive in achieving sustainable economic growth. Core conditions to that end are to increase volume of direct foreign investments, to deepen the capital market, and to develop institutions and human capital.