

STATEMENT

ON THE MAIN DIRECTIONS OF THE MONETARY AND FINANCIAL STABILITY POLICY OF THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN FOR 2016

*Uncertainties in the global economy and volatility in the global financial markets increased, while global risks intensified and economic growth slackened in a number of emerging and advanced economies in 2015. Under these conditions, world commodity prices, including **oil prices** witnessed sharp declines, and depreciation of a number of currencies, including currencies of commodity exporting countries accelerated.*

*Complex global and regional economic processes also affected the Azerbaijani economy, which is closely integrated to the world economy. Sharp decline in oil prices brought about a considerable fall in **foreign currency** income and the surplus of balance of payments. In this regard, challenges to **boost sustainability** of the national economy have become more pronounced and in line with these challenges, budgetary-tax and monetary-exchange rate maneuvers have been used. Key components of domestic demand which are the main factor of non-oil growth changed considerably.*

*All these factors have fundamentally changed the balance shaped in the **foreign exchange markets** during high oil prices and have increased pressures on the exchange rate of Manat. At the same time, a series of devaluations in the trade partner countries have created risks on international competitiveness of the national economy. New conditions forced to reconsider the exchange rate regime. Taking into consideration the further deepening of the long-term external economic shocks, the Central Bank has decided to switch to the '**floating exchange rate regime**' in order to equilibrate the balance of payments, to maintain foreign exchange reserves at a critical level and maintain competitiveness of the national economy. Tactically, this transition was a macroeconomic maneuver, while strategically a support for the diversification of the national economy.*

***Maintaining financial stability** became more crucial amid increased risks for the banking sector in global and domestic environment. The Central Bank started the restructuring in the banking sector, and took further actions to enhance the banking sector's financial sustainability and risk management. In the meantime, the country's financial infrastructure kept growing, and the scope of payment systems widened.*

POLICIES CONDUCTED BY THE CENTRAL BANK

1.1. MACROECONOMIC ENVIRONMENT

GLOBAL ECONOMIC CONDITIONS. *2015 witnessed heightened uncertainties in the global economy, weak and fragile growth in interdependent country groups, sharp decline in commodity prices, exchange rate volatilities, and the bursting of financial and property bubbles in a number of emerging economies.*

Given the existing trends, the IMF revised its **global growth** forecasts down. Recent forecasts suggest that the global real economic growth is likely to be 3.1% in the current year, 0.2 p.p. lower than previous forecasts. The economic growth forecast was revised down to 2% for developed countries (DDCs), and to 4% for developing countries (DDCs). The estimates based on the IMF forecasts suggest that, 15 countries – main trade partners of Azerbaijan (non-oil exports weighted), including the CIS countries are expected to experience 0.64% and 2.7% recession respectively.

The IMF projects a decline in the global GDP (nominal GDP) for the first time since 2009. Estimates suggest that the global GDP is likely to drop 5% y.o.y. in nominal terms and amount to USD 73.5 trillion. This could be explained both by the fall in USD terms of the nominal GDP of majority of countries, driven by their currencies' devaluation against the USD and the drop in commodity prices.

Global trade growth, one of the significant components of global economic growth remained weak. Global goods and services trade is expected to grow only by 3.2% in 2015.

Slack in economic activity complicates the recovery of global employment. According to the International Labor Organization, currently, the unemployment is numbering 204 million all over the world, 34 million more compared to the pre-crisis level.

The geography of global **financial and investment flows** kept orienting towards DDCs in 2015. UNCTAD estimates suggest that FDI is likely to rise by 23.8% on DDCs and 3.3% on DDGs in 2015.

The exchange rate of **USD** has strengthened against majority of currencies – 11% against Euro, 4% against Chinese Yuan, 26% against Turkish Lira, 22% against Russian Ruble, 86% against Kazakh Tenge, and 17% against Norwegian Krone. The USD appreciation is related to gradual exit from the accommodative monetary policy in the USA, and declines in foreign exchange inflows in a number of countries.

A lot of countries witnessed a fall in their foreign exchange reserves in 2015. According to the IMF, foreign currency reserves of central banks decreased by USD 121 billion in the first half of 2015 mainly in DDGs due to the capital inflows and current account, central banks' sales in the FOREX market and appreciation of the USD against other currencies.

Global commodity prices continued to drop in the first eleven months of 2015 by 25.5%, including **food prices** by 15.7%, and **metal prices** by 26.6%.

Global oil prices has an upward trend reaching USD 68 per barrel in the first 5 months of the current year which was followed by sharp drop reaching USD 37 per barrel, the lowest level in 11 years. The factors that led to sharp decline in oil prices include recent high supply in the global oil market, particularly higher oil supply by the OPEC, the US decision to lift the 40-year ban on oil exports, possible return of Iran to global oil markets as a result of the removal of sanctions, etc. The US Fed's decision to raise interest rates strengthened the US dollar, thereby having a downward effect on oil prices indirectly. Slack economic growth in a number of major oil consuming DDCs is also among the fundamental factors contributing to the fall in oil prices.

Overall, **the price of oil has dropped more than 3 times since June, 2014**, accompanied by reductions in government spending and devaluation of national currencies in some oil exporters.

THE EXTERNAL ECONOMIC POSITION. *The external economic position of Azerbaijan developed under the influence of the world commodity market conjuncture and the situation in the trade partners.*

The current account of the balance of payments had surplus of USD 241 million in 9 months of 2015. Considerable fall in the surplus relative to the previous year is explained primarily by decline in oil prices. The balance on non-oil goods and services was affected by the economic developments in partner countries.

Surplus of current account of the balance of payments, which accounted for USD 17 billion during the peak year (2011), is forecast to drop down to USD 0.5 billion by the end of 2015.

Export decreased by 48.7% y.o.y., while import remained almost unchanged in 11 months of the current year. The decline in export was mainly driven by the non-oil sector. Surplus of the **foreign trade balance** constituted USD 2.4 billion, having fallen more than 5 times.

The situation in main trade partners also affected remittances received, initial numbers suggest that remittances decreased by more than 30% relative to the previous year.

Strategic foreign exchange reserves of the country were maintained at the adequate level in 2015. Currently, strategic reserves make up USD 39 billion, equal to 26.5 month goods and services import and surpass the external debt over 5 times.

ECONOMIC GROWTH. *Economic growth continued in 2015 primarily driven by the non-oil sector.*

Over 11 months of the current year **real GDP** rose by 3.1 percent, including a 4 percent rise in the non-oil economy. The non-oil sector accounts for 69.3 percent of GDP. Domestic demand, including consumer demand and investments played a critical role in economic growth.

Over 11 months of 2015 investments in the country economy amounted to AZN 14.4 billion. As in previous years, public investments contributed to the investment activity of the country. Households' consumption expenditure was primarily affected by revenue growth over 11 months of the current year. Population's nominal money income rose by 5.7 percent and average monthly salary by 4.6 percent.

1.2. IMPLEMENTATION OF THE MONETARY POLICY

INFLATION. *Price stability and single-digit rate of inflation have been one of the main tasks of the Central Bank and the government over the reporting period.*

Average annual inflation constituted 3.7 percent over 11 months 2015. Food prices rose by 5.9 percent. The NEER, inflation expectations and high inflation in trade partners had an upward effect, while money supply and shifts in global prices had a downward effect on overall prices. Moreover, price regulation of some socially important products made a downward contribution to inflation.

Rise in population's nominal income exceeded the inflation rate, resulting in a 2 percent increase in real disposable income of the population over 11 months. Inflation in trade partners averaged 8.3 percent, 4.6 p.p. higher than inflation in Azerbaijan. The IPPI dropped by 32 percent y.o.y., while the APPI rose by 2.3 percent.

EXCHANGE RATE. *The Central Bank implemented its exchange rate policy within the objectives of ensuring macroeconomic sustainability and strengthening international competitiveness of the national economy on the backdrop of a sharp rise in foreign exchange demand in 2015.*

In 2015 both the cash and cashless segments of the foreign exchange market witnessed a considerable fall in **foreign exchange supply**, and a sharp rise in **foreign exchange demand**.

A fall in trade balance surplus resulted in a reduction of **transfers of oil revenues** to the budget in light of squeezing **budget spending** which in turn led to significant fall in foreign exchange supply. Amid reduction of transfers, foreign exchange sales of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) fell by 33 percent relative to the previous year. A sharp rise in foreign exchange demand is basically explained by high **dollarization**.

Overall, macroeconomic indicators formed during the period of high oil prices (USD 100) needed considerable corrections in the newly emerging situation. Given the emergence of significant pressures on the foreign exchange market and the exchange rate of Manat, the national currency – **Manat was devalued** and the foreign exchange market and the exchange rate of Manat were adapted to the oil price of 50-55 USD in February of the current year. The Central Bank even bought foreign exchange in May-July of this year.

However, the rapid decline in oil prices starting from the end-July significantly increased pressures on the FOREX market and the exchange rate of Manat again. At the same time, ongoing devaluations in partner countries had more negative impacts on international competitiveness of the national economy. Given increased volatility in recent months, the national currencies of some partner countries were devalued by more than 100 percent since early 2014.

All these factors created high pressure over the exchange rate of Manat, increasing demand for foreign currencies and raising expectations of Manat's further exchange rate change and led to sharp imbalances in the forex market. The Central Bank's forex sales exceeded USD 8 billion, **forex reserves** decreased to USD 5 billion. Thus, the Central Bank returned the foreign exchange to the economy which was purchased during high oil prices, as a result, the currency composition of balance sheets of economic entities changed. Foreign currency denominated deposits (in USD) of the population exceeded USD 5 billion, having increased by over 40 percent since early year.

The current conditions necessitated adaptation of the forex market and the exchange rate of Manat to new oil prices. Thus, the Management Board of the Central Bank took a decision on transition to the '**floating exchange rate**' regime on 21 December 2015, which conditioned formation of the exchange rate of Manat at a new level in line with the forex market conjuncture. Consequently, the nominal bilateral exchange rate of Manat was devalued significantly against the currencies of all partner countries, with more than 40 percent depreciation of the **NEER**. Depreciation of the NEER is among the factors that substitutes import and stimulates development of export.

MONETARY SITUATION. *Dynamics of money supply developed primarily under the influence of FOREX market processes.*

Broad money supply in Manat (**M2 monetary aggregate**) fell by 48 percent over 11 months of the current year, driven basically by economic entities' conversion of their cash and cashless deposits to foreign currency. The share of foreign currency denominated deposits in total deposits increased from 36.2 percent of the early year to 68.4 percent as of the end-period.

The Central Bank considered the inflation target when taking decisions on monetary policy tools. The Central Bank decreased reserve requirement from 2 to 0.5 percent, and the **refinancing rate** from 3.5 to 3 percent, taking into consideration the acceptable level of inflation and changes in money supply.

The Central Bank injected **liquidity** to the economy via various channels (refinancing of banks, financing of projects of socio-economic importance guaranteed by the government, reduction of reserve requirement, purchase of securities from banks and NBCIs, 'SWAP' operations, etc.) in order to support economic growth and maintain financial stability.

1.3. FINANCIAL STABILITY AND DEVELOPMENT OF THE BANKING SYSTEM

PRUDENTIAL SUPERVISION. *Prudential regulation was used to maintain the sustainability of the banking sector, and relevant preventive measures were taken through monitoring domestic and external factors affecting banks' activities.*

The Central Bank enhanced flexibility of **banking supervision and prudential regulation system**. The measures taken allowed manage banking sector risks in adequate levels. The requirement on **open currency position**, used to regulate the exchange rate risk was adjusted flexibly so that banks could adapt to the exchange rate corrections. The Central Bank eased its provisioning requirements on bank assets in order to minimize impact of exchange rate corrections on debt burden of borrowers and took additional actions to maintain financial sustainability of the banking sector. Quantitative regulatory requirements were eased, the capital adequacy ratio reduced to 10 percent, and the leverage ratio to 5 percent. Consequently, the banking sector was provided with additional capital and lending opportunities.

Significant decisions were taken within the framework of **banking system restructuring**. Remediation actions on preparation for privatization of state-owned shares of the "International Bank of Azerbaijan" was defined by the decree of the President of the Republic of Azerbaijan dated July 15, 2015. As part of the implementation of the decree, bank's bad assets were transferred to the "Aqrarkredit" CJSC Non-Bank Credit Institution ("Aqrarkredit" CSC). At the same time, 2 unhealthy banks were removed from the banking sector (the share of those banks' assets in total banking sector assets was 0.3 percent).

The Central Bank continued adapting the regulative framework to Basel recommendations and the European Directive in 2015. The "**counter-cyclical**" **management framework** was improved, and the early warning capacity strengthened. Measures on stage-by-stage adaptation of capitalization requirements to Basel standards continued in order to strengthen the capacity of the banking capital to absorb unexpected losses.

New initiatives on development of corporate governance in banks, particularly on regulation of compensation and remuneration policy were put forward. A methodological base was established for promoting 'responsible lending' in banks and NBCIs. Work toward the establishment of normative base for regulating banks' consolidation was completed.

The World Bank and the IMF implemented the second **Financial Sector Assessment Program (FSAP)** on assessment of the Azerbaijani financial sector, which covered the structure of the banking system and financial stability, access to financial services, and assessed the compliance of the supervision framework to Basel principles.

Relevant prudential supervision measures ensured maintenance of key **financial stability indicators** at an acceptable level.

As of the end of the reporting period, **capital adequacy** of the banking sector constituted 17.8 percent relative to a 12 percent norm. Share capital accounts for a large part of banks' capital, which is in compliance with global trends on increasing resistance against potential shocks.

Banking sector **liquidity** was at an acceptable level, liabilities and payments were settled uninterruptedly. The instant liquidity ratio of the banking sector 68.6 percent exceeded the Central Bank's threshold (30 percent) by over 2 times.

Bank assets' quality is at a satisfactory level. The share of overdue loans of the real sector and the population in the total portfolio constitutes only 7 percent.

The Financial Literacy Portal was launched in order to enhance financial literacy across the country.

FINANCIAL INTERMEDIATION. *Relevant measures continued to maintain growth dynamics of the banking system and optimize value of loans for economic entities.*

The Central Bank carried out complex actions to **reduce loan interest rates** through active dialog with the banking community. Commissions were reduced by 1 percent to strengthen social responsibility of banks with regard to lending to individuals. Service fees on interbank payments through the national payment system and cash withdrawal tariffs were reduced to cut down banks' operational expenses.

The average interest rate on loans constitutes 13.4 percent (given the rate of inflation, the real interest rate – 9.7 percent), including the rate on commercial loans - 9 percent (the real rate – 5.3 percent).

Bank assets equaled to AZN 27.8 billion, having risen by 10 percent, which accounts for 75 percent of the non-oil GDP. The size of loans to the economy amounted to AZN 18.7 billion, 77 percent of which is long-term loans. Business loans account for most of the portfolio (72 percent).

Given the risks on **household loans**, the Central Bank continued its preventive regulation in 2015. Loans to households fell by 2.3 percent and automobile loans by 42 percent.

Mortgage lending continued, AZN 96 million worth mortgage loans were granted to more than 2000 people. The lending portfolio of the Mortgage Fund reached AZN 789 million, mortgage borrowers outnumbered 18 thousand. Mortgage lending entered a new development stage by the Decree of 27 October 2015 of President of the Republic of Azerbaijan on establishment of the 'Azerbaijan Mortgage Fund' Open Joint Stock Company.

Deposits of the population, being the primary resource of banks over the reporting period, surpassed AZN 7 billion as of the end of the reporting period. An increase from 9 percent to 12 percent in the upper limit on interests of deposits insured by the Deposit Insurance Fund

played a significant role in the protection of the banking system deposits. Currently, protected depositors constitute 91 percent of the 7.3 million depositors served by DIF member banks.

PAYMENT SYSTEMS. *Maintenance and development of stable and secure operation of payment systems was of critical activity directions of the Central Bank.*

Payments made through **the National Payment System (NPS)** in 2015 increased by more than 13 percent and constituted 2.4 times the GDP.

The national payment systems' operation was re-established over the local telecommunication network to ensure its continuous and stable activity which allowed full protection of settlements in the national currency from outside effects and external risks. Complex measures were initiated to strengthen security of the payment card infrastructure and prevent transmission of data on conducted operations abroad.

'The Government Payment Portal' (GPP) kept expanding over the reporting year. 13 government entities and 12 public service organizations have already been integrated to the GPP. At the same time, the GPP infrastructure was fully integrated with 'E-Government' public information resource. Payments through the ASAN payment system, including payments for public services rendered in 'ASAN service' centers were made over the GPP.

Payments for more than 330 types of services of the institutions integrated to the GPP can now be made both cashless and in cash in up to 2000 payment points. Payment of tuition fees through this system was also made available. The size of operations processed in the system rose by 35 percent y.o.y.

63 postal branches and about 1104 post offices continued to render financial services to the economy in 2015. The number of payment cards reached 5.7 million, ATMs - 2695, POS-terminals - 76210. The number of ATMs increased by 4.2%, POS terminals by 11%. Cashless payments made with payment cards within the country rose by 29 percent, while e-trade payments made with payment cards rose by roughly 2 times. Public transport started mass use of cashless payments.

II. MONETARY AND FINANCIAL STABILITY POLICY FOR 2016

The strategic challenge of the economic policy is to 'rebalance' the national economy, accelerate transition to an economic growth model based on private investments and exports ('supply economy') and ensure more sustainable and diversified economic growth on this basis. In line with this challenge, the Central Bank will take a set of actions jointly with the government to transit the national economy to a new level of macroeconomic sustainability, and thereby ensure macroeconomic and financial stability by synchronizing all directions of the economic policy more effectively.

The Central Bank will pursue a policy that will enhance flexibility of the monetary policy and ensure financial sustainability and international competitiveness of the national economy in 2016. The Central Bank's exchange rate policy will aim at smoothing sharp exchange rate fluctuations as per the requirements of the 'floating exchange rate'. Besides, additional measures will be taken jointly with the government to balance the forex market.

*Furthermore, **maintenance of financial stability** is one of the critical targets. A set of actions will be taken to strengthen financial sustainability and **capital and liquidity position** of the banking sector, and **improve the deposit insurance system** in order to protect savings of the population and other deposits. Activities to develop the financial infrastructure, and expand cashless payments and e-payment systems will continue.*

2.1. THE GLOBAL ECONOMIC ENVIRONMENT AND FORECASTS

THE GLOBAL ECONOMY. *On the backdrop of high global risks, global economic growth is forecast to be weak and fragile and uncertainties in international commodity and financial markets to remain in 2016.*

The IMF predicts 3.8 percent **global economic growth** in 2016, higher relative to this year, but lower (4.2 percent) compared to ten years before the recent global economic crisis. 2.4 percent and 4.7 percent growth is projected for DDCs and DGCs respectively.

DDCs are expected to increase their share in global economic growth in 2016. Economic growth in the US is forecast to rise relative to the current year and constitute 3 percent next year. Under these conditions, the US Federal Reserve is expected to continue its policy to gradually abandon the accommodative monetary policy. The Euro area economy is expected to grow 1.7 percent in 2016 under the influence of the accommodative monetary policy.

DGCs are likely to witness fragile economic growth due to tighter financing conditions, sluggish implementation of structural reforms, and ongoing geopolitical tension in the coming year. The growth forecast for this country group in 2016 is 1.1 p.p. lower than the average of the past decade. Estimates based on IMF forecasts suggest that 15 trade partners of Azerbaijan (non-oil exports weighted) are expected to demonstrate only 1.2 percent growth in 2016.

Global trade is projected to grow 4.1 percent in the upcoming year, 1 p.p. lower than the average of 1990-2014. The existing global conjuncture gives ground to forecast that **capital inflows** are likely to grow more in DDCs in the upcoming year as well. According to UNCTAD, FDIs to DDCs are expected to increase by 13.9 percent and to DGCs by 3.9 percent in 2016. However, the share of DGCs in FDI inflows will remain high (over 50 percent).

Economic activity in advanced economies and central banks' monetary policies will also affect global financial markets. Currency flow uncertainties may increase the exchange rate

volatility of currencies of Azerbaijan's trade partners. Amid tighter monetary policy in the US and lower global commodity prices, new waves of devaluation might happen in DGCs.

Commodity market prices are projected to have volatile dynamics amid expected global economic environment. The IMF projects a 13.6 percent fall in commodity prices, and a 4.7 percent fall in food prices in 2016.

Forecasts for the **average price of oil** in world markets in 2016 vary. Most analytical centers forecast that oil prices will continue to drop down amid oversupply in the global oil market.

NATIONAL ECONOMY. *The Central Bank will pursue its policy taking account of internal and external economic factors affecting the national economy, and middle-term projections.*

The non-oil sector will be the primary source of **economic growth** in 2016 as well. Additional measures aimed at diversifying the national economy and exports will have a positive impact on growth of the non-oil sector.

The oil price is the key factor affecting the **trade balance** surplus. The Government and the Central Bank have adequate policy reactions on different price scenarios. Given USD 30 oil price perspectives, the macroeconomic policy will be adapted to new conditions.

New favorable exchange rate of Manat should ensure considerable reduction and replacement of imports with domestic production even at lower oil prices, realization of non-oil exports potential, thereby equilibrating the balance of payments, and maintaining the **strategic foreign exchange reserves** at high levels (currently, over 100 percent of the GDP)

2.2. MONETARY POLICY FOR 2016

MONETARY POLICY OBJECTIVE AND FRAMEWORK. *Monetary policy decisions to be taken will balance between economic growth and inflation risks.*

Under its primary mandate, the Central Bank will endeavor to support price stability within its authorities and pursue a policy aimed at managing the **core inflation**.

Inflation in foreign trade partners and changes in the multilateral exchange rate of Manat will be crucial factors affecting inflation. Domestic demand and external factors will influence the inflation rate.

The Central Bank will adequately use liquidity tools in the money market in 2016, depending on the economic cycle. The Central Bank's interest rates on **liquidity tools** will be determined in line with the 'interest rate corridor concept'. Parameters of the interest rate corridor will be flexibly adapted to economic situation in 2016, taking into account peculiarities of the pass-through capacity of the monetary policy to the economy.

The Central Bank will continue efforts on adapting the monetary policy framework to **inflation targeting regime**. In addition to implementation of preconditions of the inflation targeting regime, changes to the monetary policy design, and recent trends on expansion of the target perimeter and tools arsenal of central banks will be taken into consideration.

Upon transition to the ‘floating exchange rate’ regime, the Central Bank will strive to influence monetary factors of inflation through alternative operational targets (‘anchors’). To strengthen the pass-through capacity of the monetary policy to interest rates and the economy, faster development of the **interbank money market** – a key mechanism to pursue this policy effectively – will be focused on with the consideration of the potential of integrating interest rates in the interbank money market to the interest rate corridor mechanism.

Further, the Bank will focus on **close coordination of the monetary and macroprudential policies**.

THE EXCHANGE RATE POLICY. *The exchange rate of Manat will primarily develop under the influence of fundamental factors determining the supply and demand in the forex market, within the ‘floating exchange rate regime’.*

The floating exchange rate should reliably safeguard the economy against negative external shocks, strengthen the economy’s mid- and long-term sustainability, accelerate diversification of the economy and exports, and further increase international competitiveness of domestic production. High flexibility of the exchange rate regime is the most critical factor that enables to preserve foreign exchange reserves at the adequate level.

Moreover, the floating exchange rate is one of the main preconditions of **the inflation targeting regime**. Economic entities are expected to be completely adapted to the floating exchange rate regime in the coming year.

External economic shocks, the oil price, and changes in the value of the domestic currencies of the main trade partners, including the countries strongly affected by oil prices will be key factors affecting the foreign exchange market and the exchange rate of Manat in 2016.

On the other hand, the foreign exchange balance will be affected by the fiscal policy, including the government investment policy, management of foreign debt, measures on improvement of the international settlement mechanism and solution of other institutional issues.

Taking all these factors into account, the Central Bank will strive to **balance the foreign exchange market**, and smooth sharp exchange rate fluctuations in 2016 jointly with the government, using the resources at its disposal.

2.3. FINANCIAL STABILITY AND FINANCIAL INTERMEDIATION

FINANCIAL STABILITY. *The Central Bank will strengthen its efforts to heighten the sustainability of banks against risks in a volatile economic environment in 2016. If needed, the*

Central Bank will focus on implementing relevant interventions in the banking sector in order to maintain and effectively manage financial stability by preventively simulating the state of the banking sector against various economic shocks.

First of all, the decree of President of the Republic of Azerbaijan on preparation for privatization of state-owned shares of the "International Bank of Azerbaijan" Open Joint Stock Company will be implemented within the **framework of banking system remediation**.

To **protect the banking sector's asset quality**, special focus will be on bad loans. Initiatives on improving the mechanism of protection of creditors' rights, and realization of collateral will continue. Implementation of banks' lending policy within the 'responsible lending' philosophy will be broadly promoted in the upcoming year as well.

The Bank will strive to maintain the banking system **liquidity** at an acceptable level, and create its effective management mechanisms. The Central Bank's short-term liquidity window, and, if necessary, mid- and long-term liquidity tools arsenal will significantly contribute to maintaining banking system's liquidity. Furthermore, expansion of the government securities, and development of the interbank lending market will be among the factors affecting flexible regulation of the liquidity position by banks.

Taking into account Basel principles and European Directives, the work on **improvement of the banking supervision framework**, and on application of risk-based, and counter-cyclical prudential regulation will continue in 2016. The Central Bank will start to cover operational risks of banks by prudential requirements.

Increasing banks' **internal risk management capacity** will be supported in 2016 as well aided by new efforts to boost the capacity of banks to apply corporate governance standards, stress-tests and modeling.

The scope of insured deposits and transition to a differential insurance system as part of **increasing confidence in the banking system** will be focused on. If necessary, insurance of full amount of deposits in line with international practice may be considered. Efforts to strengthen the protection of the rights of consumers of financial services and raise population's financial literacy will contribute to building more confidence in the banking system. A wide range of educational measures to improve financial literacy of various target groups of the population will continue in 2016.

DEVELOPMENT OF FINANCIAL INTERMEDIATION. *The Bank will continue efforts to strengthen the role of the banking-financial sector in supporting economic growth, and broaden economic entities' access to loans in 2016.*

The Central Bank's efforts to deepen financial intermediation will target development of an effective financial system ensuring effective funding for economic growth, and covering all economic entities with wide range of financial products.

New programs will be initiated jointly with the government to enhance **access** of real sector enterprises, particularly small and medium businesses to cheap and long-term **financial resources**. Broad application of corporate governance in the non-financial sector, and strengthening of the mechanism for creditors' protection will crucially condition expansion of business lending in the year to come as well.

The Central Bank will continue an active dialog with the banking community on the reduction of the interest rates in 2016. Increasing lending resources via expansion of cashless payments, ongoing development of all segments of financial markets, and optimization of operational expenses in banks will have a downward impact on **interest rates** in the upcoming year.

Expansion of the regional network of credit institutions will be promoted in 2016 as well. Efforts to enhance access to banking services via the regional service network of banks, and NBCIs, including the postal system will continue. Additionally, wider application of innovative financial tools in regions will be focused on.

Implementation of the IMF and WB recommendations within the FSAP will play a significant role in improving the prudential supervision framework and widening financial intermediation in the upcoming years.

DEVELOPMENT OF PAYMENT INFRASTRUCTURE. *Development of cashless payments, wider application of e-payment services and innovative payment technologies will be one of the priorities of the Central Bank.*

The e-payment infrastructure will be developed through **application of new services**. Integration of internal information systems of public authorities that receive mass payments to the Government Payment Portal, as well as integration of the system of tuition fee and municipal taxes collection, notary services, state registration of civil status acts, and 'E-Court' to the GPP will continue. A new payment tool that will automatically charge monthly recurring payments (utility, internet, telephone bills, etc.) from clients' accounts will be made available.

The e-signature infrastructure established to ensure **information security** in payment systems in line with international standards will be more widely used in the financial sector. As a continuation of the work started this year, a new system coordinating infrastructures of all card entities rendering processing services in the country, and processing transactions made between those infrastructures, will be created.

The Central Bank will continue to work with banks to **enhance the efficiency of services** and reduce fees.

The legal and institutional base of e-payment services will be strengthened by creating a normative-legal base defining rights and responsibilities on payment services, basics of establishment and activity of non-bank payment service providers and e-money organizations.

The Bank will **develop e-banking** via wider application of innovative technologies in cashless payments and continue work with banks on developing Internet and mobile banking services, expanding the range of distant services, widening use of payment tools based on contactless payment technologies. Recent changes to the Tax Code that require settlements be made cashless during the purchase and sale of goods with excise labels will contribute to reduction of cash turnover.

Efforts to increase the level of **awareness** on the use of electronic payment services will be intensified with parallel training of students on the use of e-payment services in coordination with relevant government entities.