

STATEMENT

of the Central Bank of the Republic of Azerbaijan on directions of monetary and financial stability policy for 2012

In 2011, the economy of Azerbaijan demonstrated high level of sustainability with persisting stability and continued growth in the complex global economic environment. Such sustainability rests upon the socio-economic course founded by the national leader Heydar Aliyev, and skillfully and consistently pursued by President Ilham Aliyev. The merits of this policy, proactively supported by the Central Bank were reaffirmed during the recent global crisis. Effective measures ensured an ongoing economic growth in the period of the crisis as well, playing an important role in the stable development of the national economy throughout 2009 – 2011.

The external economic outlook of the country remains favorable with strategic foreign exchange reserves at a level sufficient to entirely neutralize potential macroeconomic risks. Currently, the economic growth stems entirely from the non-oil sector. Inflation is controlled optimally at a single-digit level. The exchange rate of manat – the main anchor of the macro-financial stability – is stable. The banking sector enjoys high degree of financial robustness. Access to financial resources is expanding and promoted, as a result, leading to increasing credit to economy. The credit rating of Azerbaijan was upgraded, while major countries are downgraded.

The key directions of monetary and financial stability policies for the year of 2012 are aimed at maintaining macroeconomic stability, ensuring financial stability in the banking sector and deepening financial intermediation as the main prerequisites of economic growth and development. In order to achieve these targets, the Central Bank shall carry out continuous improvements in strategic framework of monetary policy and banking supervision, as well as provide necessary support to further coordination of macroeconomic policy.

1. The Central Bank's Activity in 2011

1.1. Processes in the global economy

Higher-than-expected growth rate early in 2011 slightly slowed down starting from the second quarter. Given the new trends, the International Monetary Fund (IMF) revised global economic growth forecasts for 2011 and 2012. The changes in the economic growth rate affected the level of unemployment and other social indicators. The global economic growth varied across regions. According to the IMF estimations, the economic growth in developing

economies exceeded that of developed economies by over 2.6 times in 2000-2007, the gap is forecasted to be 3.6 times in 2011- 2012.

The ongoing sovereign debt problem in leading countries is the main factor that hinders the global economic growth. Currently, in 15 developed and developing economies, forming $\frac{3}{4}$ of the world economy, the debt of the public and private sectors has reached an unsustainable level. The volume of the public debt in Eurozone is close to the level of the Gross Domestic Product, which contributed to the downgrade of credit ratings of a number of leading countries. According to the IMF estimations, to contract the public debt to GDP ratio in developed economies to 60% up to 2020, the budget surplus equal to 8% of the GDP is to be generated during the period. The implementation of a significant fiscal consolidation is needed to achieve these goals.

The processes in the global economy significantly affected commodity and financial markets. In developed markets the financial instruments became less attractive, exchange rate risks increased, fund indices dropped. Commodity prices and inflation, upon their peak in the first quarter of the current year decreased after the second quarter. Although no significant price increase is expected up to the yearend, inflation is forecast to be higher than the previous year.

1.2. Processes in the national economy

The Azerbaijani economy kept growing and developing in 2011. In 2009 – 2011, the years of the crisis, the average economic growth was 5%. Over the past 11 months of 2011 the non-oil sector grew by 9.5%, demonstrating 11.7% growth in the non-oil industry, 9.9% in trade and 22.2% in services. Employment expectations index for the industry, trade and services has improved against the previous year. Over 11 months of the current year 19.2% increase in nominal income of the population and 21.7% increase in bank loans to households positively contributed to to elevate the domestic demand that mostly resulted in the consumption of durable goods. During 11 months investments increased by 28.3%, including 39% increase in the non-oil sector.

Ongoing growth of the strategic foreign reserves – “the safety cushion” adds up to the economic sustainability of the country. In 2011 the foreign exchange position of the country improved. During the current year, high export prices and boost in foreign financial flows positively affected the balance of payments. Over 9 months of 2011 the commodity export increased by 34% and became USD 26.8 bln, while services export made USD 1.9 bln having increased by 26.4% against the relevant period of the previous year¹. As a result, the surplus of current account rose by 20.4% against the similar period of the previous year and made USD 14.4 bln. This made a USD 10.4 bln worth contribution to reserve assets covering the capital account deficit. As of 1 December 2011 the strategic foreign reserves reached USD

¹ Based upon the balance of payments developed by the Central Bank

42 bln,exceeding 65% of GDP. The strategic foreign reserves are sufficient to finance three year commodity and service import, exceeding the external public debt roughly by 10 times. The foreign reserves of the Central Bank increased more than 60% and reached USD10.5 bln.

1.3. Monetary policy

The Central Bank controlled the factors affecting macroeconomic stability by implementing an adequate policy in 2011. Over the past period of the current year the Central Bank targeted a single-digit level of inflation, stability of the exchange rate of manat, enhanced financial stability.

The exchange rate of manat strengthened under a huge surplus of the balance of payments. In 2011 the Central Bank implemented exchange rate policy in the environment of expansion of supply channels in the foreign exchange market. To prevent substantial appreciation of the exchange rate and neutralize negative impacts on competitiveness of the non-oil sector, the Central Bank sterilized USD 4 bln leading to the appreciation of manat against the USD by 1.5%. Real effective exchange rate on the non-oil sector was nearly neutral, and ensured competitiveness of the country. Over the past 11 months average weighted inflation in trade partner countries was higher by 2.3 percentage points than the inflation in Azerbaijan.

Given trends in the domestic demand and external factors, in 2011 the Central Bank conducted anti-inflationary monetary policy under its mandate. The Central Bank has changed the refinancing rate twice since the beginning of the year and shifted it from 3% to 5.25%. At the same time, the required reserve norm on internal and external liabilities of banks was raised from 0.5% to 3%. Currently, in the countries with underdeveloped financial markets the role of required reserves in regulation of liquidity and foreign capital inflows is observably increasing. International institutions also recommend an active utilization of this instrument in necessary situations (in the case of financial bubble risk). Moreover, the Central Bank conducted open market operations to regulate money supply.

During 11 months of the current year, inflation remained on a single-digit level, under the monetary policy target, with average annual inflation constituting 8 percent. According to the estimations, over 11 months of the current year 2.3 basis point of inflation stemmed from external factors. Of non-monetary factors, “cost-push” inflation also contributed to the price increase. Average annual growth was 10.7% on agricultural producer price index and 5.9% on producer price index.

1.4. Financial stability policy and financial intermediation of the banking sector

In 2011 the banking sector maintained financial stability and the sector kept institutionally developing. Capital adequacy and liquidity indicators of the banking system remained on an acceptable level. Access to financial services expanded and lending to the economy continued. Potential risks of the banking sector were regulated on a timely manner. The sector was restructured on an ongoing basis.

In 2011 formation of the risk-based prudential supervision framework continued given potential risks and the Basel III standards on the banking supervision. A crucial supervisory regime and instruments were applied to ensure more reserved and sound performance of banks under new macroeconomic conditions. Capitalization programs endured, and a new norm was applied to the capital requirement. The main targets of this policy were stable and sustainable performance of banks, the protection of the population's and investor's confidence, the enhancement of governance potential in banks, assets remediation, increase of the financial provisioning and risks regulation.

The banking system sustained financially, quality indicators of bank assets preserved an acceptable threshold. The share of overdue loans of the real sector and the households in the banking system made 6.5%, half of which was provisioned for by banks. The banking sector maintained its optimal profitability and investment remained attractive. Currently, overall liquidity level is high. The share of liquid assets in total assets was 14.3% over the past 11 months.

The banking sector maintains the necessary level of capital to cover potential risks and support economic activity. The actual capital adequacy is estimated at 15.8% whereas the requirement is 12%. The growth of aggregate capital of banks has been 8% since the beginning of the year. The sector's foreign position is sustainable and has improved. The external debt of the private banking sector has decreased twice over the past 3 years. Stress-testing demonstrate that the banking sector is capable of absorbing risks and maintaining sustainability.

In 2011 financial intermediation of the banking system continued to amplify. Over the past 11 months, credit to economy increased by 7.5%, bank assets – 10.7% and deposits of the population – 26.4%. 22.1% increase in term deposits during the period indicates high confidence in the banking system. The dollarization level (the share of deposits in foreign currency in broad money supply) has gone down by 4 basis points over the past one year.

Stable and reliable performance and improvement of payment systems were of the major activity directions of the Central Bank. The scale of payments through the National Payment System infrastructure in 11 months of 2011 surpassed the same period of the previous year by 23.3%. The number of payment points of banks and Azerpost LLC in Baku and over 50 regions are more than 1.700. To increase the utilization of non-cash payment tools, the network of POS-terminals in retailers, catering and other service entities is being expanded and the scale

of settlements via payment cards is being increased. Over 11 months of 2011 the number of payment cards in circulation increased by 7.2%, the number of installed ATMs – 11.2% and POS-terminals – 62.3%.

Regional coverage of the financial sector and access to banking services expanded.

Over the past 11 months 23 new bank branches were opened, 13 of which are located in regions. Currently, over 49% of bank branches are located in regions.

Mortgage lending was one of a key player in underpinning economic activity in the current year as well. AZN 16 mln worth social mortgage loans were issued for 500 persons in 2011 funded by state budget. Market resources continued to be attracted for mortgage lending. Over the past period of 2011 assigned credit institutions issued AZN 77 mln worth mortgage loans to total 2000 persons, social mortgage lending excluded. Thus, the number of the families that benefited from mortgage lending (total AZN 342 mln) is 8750. Portfolio on the mortgage loans was sound and no delays were observed in repayments on loans.

2. Key directions of the monetary and financial stability policy for the year of 2012

In 2012 the Central Bank's monetary and exchange rate policy shall be directed to maintain macroeconomic stability, with the vital priority being the formation of the counter-cyclic policy framework. The monetary policy will target a possible optimum of rebalancing inflation and economic growth, the value of money and rate of return in the economy. The main imperatives of the financial stability in 2012 are maintenance of sustainable and stable banking sector, optimization of bank activities, rebalanced and sound development of the sector.

2.1. Projections of the Azerbaijani economy

Given the latest global projections, commodity prices, that constitute Azerbaijani export, are expected to positively influence the balance of payments in 2012. According to the IMF projections, the oil price per barrel will be over USD 100, which is higher than budget level (USD 80). In this environment, the foreign reserves will increase due to current account balance. According to estimations of the Central Bank, current account balance is expected to have surplus accounting for 20-25% of the GDP in 2012.

The economic growth is projected to increase due to high domestic public demand in 2012. The socio-economic development forecasts indicate 5.7% GDP growth in the following year. Given the expected volume of oil production, the economic growth will source from the non-oil sector (primarily under the influence of domestic demand). Public expenditures will be a key factor contributing to non-oil sector growth.

Macroeconomic projections make it necessary to enhance a coordinated control over inflationary factors. The inflationary factors are expected to be affected both by domestic demand and external factors in the upcoming year. This environment makes macroeconomic stability targets more actual the next year.

2.2. Targets and strategic framework of the monetary policy

The anti-inflationary policy will remain important task the next year as well. The main target of the Central Bank's monetary policy for the year of 2012 shall be single-digit inflation. The low level of inflation factors in ensuring demand with payment capacity, preserving real value of financial accruals of the population and business, drop of interest rates and competitiveness of the real exchange rate of manat.

In order to achieve the inflation target, the Central Bank will use money supply and exchange rate as intermediate targets. The strategy of the Central Bank regarding monetary policy framework is to increase ability to manage aggregate demand and directly target of inflation. By this way monetary policy can ensure monetary control over aggregate demand and the value of money. Diversified economy, expanded scale of non-cash circulation, enhanced mechanisms of coordination of the macroeconomic policy, developed capital markets are the key prerequisites for transmission of monetary policy decisions to economic activity and the inflation level.

The exchange rate of manat will preserve its significance in maintenance of macroeconomic stability, management of financial stability, as well as preserving international competitiveness of the non-oil sector. The exchange rate of manat will be affected by increase in foreign currency inflows to the country in 2012. Given significant effect of oil revenues on the real effective exchange rate of manat the Central Bank will consider opportunities of gradual transition to more flexible exchange rate regime in the medium term.

The Central Bank will employ monetary policy tools to ensure a possible effect of money supply on economic growth. Parameters of interest rate corridor, including refinancing rate will be adequately regulated depending on the level of inflation, economic cycle and situation in the financial markets. Liquidity of the banking sector will be managed both through injection, and sterilization. In order to increase macroeconomic effectiveness of the monetary policy tools, it is crucial to promote financial deepening. This being on the focus, the Central Bank will support the activity in interbank money market during the following year.

Development of intellectual framework of the monetary policy will remain in the focus, while the capacity for economic diagnostics, research and forecasting will be enhanced. The Central Bank will focus on expansion of the empiric research base, amplification of diagnostics and forecasting, launch of a modern and standardized statistics system. A conceptual activity shall be continued to model the country economy in medium and

long run. Applied models for export driven economies will be used in forecasting. The Central Bank will provide measures of economic and financial education for the population.

2.4. Development and stability policy of the banking sector

In 2012 the Central Bank's financial stability policy will be directed at ongoing remediation measures in banks and preventive regulation of risks. To that end, the prudential supervision shall be adjusted to the post-crisis requirements and the latest global challenges. To further resist risks, banks will be promoted to adequately respond to the existing macroeconomic stance and increase financial provisioning through supervisory mechanisms. In this context, the measures on risk positions, liquidity and remediation with respect to assets quality in banks, particularly in systemically important banks shall be on focus. Capital adequacy shall be "soundly" zoned and leverage ratio (Tier I Capital of a bank to bank assets and off-balance sheet liabilities ratio) maintained. Works on early warning systems and improvement of stress-testing potential will continue.

The prudential supervisory framework will be improved to achieve the main targets on financial stability and be in harmony with the Basel III standards. Conservative capital buffer will be applied to boost the quality and quantity of bank capital and to amplify the role of stable capital sources. A new liquidity norm suggested by the Basel III standards may be used to manage the short-term liquidity position. The Central Bank shall focus on the approximation to the International Financial Reporting Standards on the recognition of financial losses (the global consensus to be reached).

Restructuring and denationalization of banks, promotion of competition in the sector will be one of the key priorities in 2012. To advance competitiveness in the sector, investments of branded foreign banks will be promoted. To enable the banking system readily withstand possible risks to be imported from the foreign environment, internal institutional capacity will be improved and developed. Banks' governance framework and internal resources will be optimized along with adjustment to corporate governance standards and to improve the risk management system.

The Central Bank will continue deepening of the financial sector in 2012. To increase access of regions to financial resources, the regional network of financial institutions, including activities of non-bank credit institutions and financial services by the Azerpost LLC will be promoted. However, banks' lending activity should be in harmony with the economic stance and business profile.

Card settlements and promotion of e-payments will be promoted within the e-government project to trigger non-cash payments. Development of banking infrastructure and internal capacity of banks should positively affect the drop of cost of financial services and

access of economic subjects to financial resources. Launch of longer term and cheap resources for banks depends on the development of capital markets, insurance sector, investment and private pension funds in the country. Parallel development of securitization and property rights institutions and transparency of financial reporting in the real sector are main factors, which increase access of financial subjects to financial services.

Measures to further develop mortgage lending in the country on the basis of a new program will continue in 2012. Development and increase of the social mortgage will continue to support economic growth, employment, and effective realization of the youth policy. Mortgage lending will be further commercialized to increase access to mortgage lending.

The Central Bank will take crucial steps to further heighten its regulatory capacity and transparency indicators. Central Bank joined FSAP² program. The results of assessments of FSAP for 2012 will contribute a lot to identify growth priorities of the Central Bank and the banking system

The Central Bank is starting to implement its fourth in the row strategic activity plan. The measures, of this plan, are oriented at more effectively implementing Bank's mission on the back of global economic transformations and a new qualitative growth phase of the country economy. In the period of the new strategic planning, the Bank prioritizes further acceleration of its institutional development being guided by a 21st century central bank concept. This way shall lead the Central Bank to substantial modernization and standardization of activity frames that ensure management of macroeconomic and financial stability, as well as realization of the major functions specified in the legislation.

² *Financial Sector Assessment Program is a joint IMF and World Bank effort that provides for identification of strengths and vulnerabilities of financial systems in member countries, assessment of growth needs of the financial system, promotion of remediation of financial systems, and assistance for member countries in decrease of probabilities of crises.*