

THE CENTRAL BANK OF THE REPUBLIC OF
AZERBAIJAN

REPORT
ON ACCOMPLISHMENT OF MAIN GOALS AND
FUNCTIONS IN **2018**

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Introduction

Considerable efforts were made in the country to safeguard macroeconomic stability in 2018 under the leadership of Honorable President Ilham Aliyev. Inflation stabilized at a low single-digit rate, economic growth endured, the exchange rate of the national currency sustained and strategic foreign exchange reserves increased.

High non-oil export capacity and favorable global oil prices contributed to improved external sector indicators. Export of services and money remittances maintained positive behavior along with trade balance. Strategic foreign exchange reserves kept increasing on the backdrop of better external sector indicators.

Revival in economic activity kicked-off last year continued. Economic growth was mainly driven by high foreign demand and public investments and expansion of private consumption amid elevated real income of the population and consumer confidence.

The CBA maintained its mandate functions in 2018 contributing to safeguarding macroeconomic and financial stability. The monetary policy implemented by the Central Bank in 2018 was oriented towards price stability in the national economy and formation of socio-economic environment favorable for well-being and business activity of the population by maintaining low and stable inflation. The monetary policy eased over the reported year contributing to economic growth without prejudice to price stability.

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

In 2018 the final target of the monetary policy was to maintain inflation within 6-8% band. Amid the effective monetary and exchange rate policy inflation was much lower than average inflation in trade partners, contributing to competitiveness of the economy.

According to the State Statistics Committee (SSC), average annual inflation was 2.3% in 2018. The CPI components – food prices rose by 1.7% on annual average, non-food prices 2.6%, and services by 2.7%.

Prices for 23% of products (521 goods and services) in the consumer basket dropped, 8% remained unchanged, and price hike for 62% of products was below 5%, only for 7% of products increase was over 5%. As in previous periods, prices for agricultural products, fruits and vegetables in particular, were more fluctuating, due to seasonal and natural factors.

Average annual core inflation estimated excluding goods and services, whose prices are regulated by the government and seasonal agricultural products was 1.8% in 2018.

Consumer prices were mainly affected by swings in energy prices. The agricultural producer price index increased by only 2%. Transportation services price decreased by 1%, owing to cheapening of the transportation service.

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

Monitoring among households and real sector entities shows that inflation expectations are in historical lows of recent years. According to the regular real sector monitoring by the Central Bank price expectations decreased across all areas in trade, mainly in automobiles for upcoming 3 months of 2019. Overall price expectations dropped across all areas in services, mainly in transport, hotels and healthcare. Price expectations dropped in food and beverages, metallurgy and other non-metal mineral products in processing and increased on construction, chemical products, machinery, plastic mass and textile.

Further safeguarding of macroeconomic stability will be a priority direction for the Central Bank policy; the Bank will continue the policy oriented towards decreasing inflation and inflation expectations. The Central Bank will take adequate monetary policy decisions in light of inflation risks, economic growth prospects and developments in the monetary sector, and continue efforts to purify the monetary policy framework.

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 operations.

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 AZN274.4B (3.4 times of GDP) (39.9 mln. transactions). The size of payments y/y increased by 30.6% (AZN64B), while the number of transactions y/y increased 5.3% (2 mln. pcs).

In 2018 CBA continued conducting preventive measures in payment systems to avoid rising cyberthreats in global e-environment.

Expansion of the infrastructure of the Government Payment Portal (GPP) continued in 2018. The Electronic Licensing Portal, the Central Bank's Bank Certification Services Center, the Deposit Insurance Fund and the Baku Transport Agency were integrated to the GPP. 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, option to collect payments related to this coordinating body via the official Internet resource of the GPP was introduced. Currently, 11 central state executive bodies (Ministry of Justice, Ministry of Finance, Ministry of Taxes, Ministry of Economy, Ministry of Emergency Situations, Ministry of Education, Ministry of Internal Affairs, State Social Protection Fund under the Ministry of Labor and Social Protection of the Population, State Customs Committee, State Migration Service, State Committee on Property), 4 state utility enterprises ("Azərsu" OJSC, "Azərişiq" OJSC, "Azəristiliktəchizat" OJSC, "Azəriqaz" PA), 5 landline and mobile communication operators ("Aztelekom" LLC, "Bakı Telefon Rabitəsi" LLC, "Azercell Telecom" LLC, "Azerfon" LLC, "Bakcell" LLC), Electronic Licensing Portal, 97 judicial bodies over the 'E-court' portal, 14 insurance companies via the Compulsory Insurance Bureau, the Baku Transport Agency, the Deposit Insurance Fund, Mortgage and Credit Guarantee Fund, State Examination Center, higher education institutions (Azerbaijan State Economic University, Baku Slavic University, Azerbaijan State Academy of Art, Azerbaijan Technical University, Sumgayit State University) and the National Certification Services Center have been integrated to the portal. Today, payments for over 550 services, including over 400 public services (taxes, duties, administrative fines etc.) are paid at about 2500 payment points of the Azerpost LLC, the Nakhchivanpost LLC and 30 banks, over 1000 payment terminals in cash and in a cashless form over Internet resources of the portal, banks' e-banking services by payment cards and bank accounts. In 2018 the system processed total AZN2421M worth of 37.4 million payment transactions, the size of processed transactions y/y increased by 15.79% (AZN330.15 M), and the number of transactions by 2.23% (815.31 thousand 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. Tariffs (interchange) among banks using the ICC were reviewed and optimized in order to increase cashless payments and expand the use of card infrastructure and tariffs on operations over the GPP at ASAN Service Centers are set to zero. Air tickets for the Azerbaijan Air Ways (AZAL) are currently sold in 14 various currencies with the payment cards issued domestically. 10.4 mln card operations were conducted over the ICC (▲990 M, \$5.4 M, €2 M). Compared to 2017, the size of operations in manat rose by 38.26%, in USD by 55.55%, and by 65% in EUR.

The number of payment cards issued in the country reached 6.5 mln. pcs, ATMs 2502 pcs, POS-terminals 66110 pcs. The size of payment card transactions y/y increased by 65%.

According to the 'Strategic Roadmap on Development of Telecommunication and Information Technologies' the Central Bank was assigned to implementation of the State Program on Expansion of Digital Payments in 2018-2020 aimed at digitalization of economy and expansion of digital payments which was approved by Decree#508 of the President of the Republic of Azerbaijan dated 26 September 2018. The goal of the program is to considerably expand cashless operations in the economy, minimizing the scope of cash payments, eventually strengthen the financial resource base of the banking sector, and decrease cost of cash circulation.

A dedicated work group has been established with the involvement of main executing public institutions on the State Program. To monitor and assess the progress of the actions specified in the Program, the Center for Analysis of Economic Reforms and Communication developed a relevant methodological framework and a detailed Actions Plan and submitted to implementing agencies. Works on launch of the Instant Payment Systems allowing 24/7/365 payments between individuals and legal entities have started in light of best practices. The Bank held an international tender and signed a contract with the selected winner. A work group of the representatives of involved organizations has been established and works are being implemented under the draft plan. Within the infrastructure capacity under way users will be able to make payments to one another any time and by any facilities. At the same time, modern payment solutions, like the QR codes and other mobile solutions will be possible to be introduced in vendors across the country. The result will be an environment allowing to expand digital payments among economic agents, decrease cash economy in the country and boost cashless payments.

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 2018. Monetary policy tools were applied in light of safeguarding macroeconomic stability and stabilization of inflation at a low single-digit rate, developments in financial markets, and the transmission capacity of the monetary policy. Stronger macroeconomic stability trends allowed to gradually ease monetary condition.

The improved balance of payments allowed to maintain stability in the domestic FX market in 2018 as well, the sustained exchange rate of manat on the backdrop of higher

supply than demand in the FX market across most months of the reported year had a downward effect on inflation expectations and dollarization.

The monetary condition eased maintaining an optimal balance between implementation of macroeconomic stability targets and support for economy.

The Central Bank made necessary corrections to interest rate corridor parameters of its liquidity operations in light of recent macroeconomic developments and inflation forecasts. The Bank discussed interest rate corridor parameters several times over the year, and shifted the refinancing rate to 9.75% from 15% on a step-by-step basis. The floor of the interest rate corridor was shifted to 7.75% from 10%, while the ceiling to 11.75% from 18%.

To effectively manage liquidity in the economy the CBA kept active various maturity standing facilities and open market operations. Despite weak lending activity, the banking sector still has excess liquidity pushing high demand for Central Bank's sterilizations.

In 2018 the Central Bank conducted 54 deposit auctions on attraction of available funds and 51 auctions on issue of notes. Maturity of deposit operations was 14 days, while notes were issued for 28 days. Total outstanding amount of funds attracted by deposit auctions and issue of notes made up AZN 1.71B, down by 8.2% vs early year.

Despite lower return on sterilization operations due to reduction of the floor of the interest rate corridor, demand prevailed over supply by 2.7 times at deposit auctions and by 2.6 times at note auctions, attributable to still high banking system liquidity.

Deposit and short-term note operations both sterilize excess money supply and promote money market development contributing to improvement of monetary policy's operational framework and development of the interbank market. Return on CBA's sterilization tools is translated into other interest rates becoming an important representative of the money market.

Money supply was enough to cover demand of the economy for money and ensure uninterrupted payments. Money base in manat increased by 11.7% to AZN9.5 B as of the end-period. Demand for money is still driven by liquidity needs of the fiscal sector and the banking system. Bank's market operations partly compensated a downward effect of fiscal operations on money base. Broad money supply in manat increased by 17.5%.

The Central Bank attached great importance to improving monetary management and effective communication of the monetary policy. 6 meetings of the CBA Management Board were dedicated to the monetary policy in 2018. Related press-release on policy decision was published accompanied with comments, in parallel with regular press-conferences. Quarterly Monetary Policy Review went public. Speeches and interviews by Central Bank officials were important in monetary policy communication. At the same time, Central Bank's activities were highlighted in details on its website.

2.2 Organization of cash circulation, issue of monetary units to and withdrawal from circulation

The Central Bank covered demand of the economy for cash in full, under the required structure and in time 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'.

The CBA withdrew AZN10.1B or 486 mln. pcs of monetary units from and issued AZN9.8B or 431 mln. pcs of monetary units into circulation. In general, money in circulation increased by AZN 224M (55 mln pcs) (2.8%) to AZN8.4B as of the end-year

Taking into account dynamic growth of the country economy, and changes in the structure of cash in circulation, as well as to make cash effectiveness higher and maintain adequacy in payments, the Bank issued a new AZN 200 banknote into circulation in 2018.

The AZN200 banknote, dedicated to the 'Modern architecture' theme, is designed by the Crane Currency (USA) and produced by the Giesecke+Devrient (Germany). The front of the note depicts the image of the Heydar Aliyev Center, built to the memory of the National leader and considered to be one of the pearls of world architecture, and several exterior and interior design elements, a series of national carpet patterns and other national ornaments. The AZN200 banknote is equipped with the most state-of-art security elements.

The 'Clean money in circulation' policy adopted to make the quality of money in circulation higher kept going, 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 banknotes per 196 000 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, 1 fake currency per 5000 USD, 1 fake currency per 132000 Russian rubles).

The newly commissioned 'Counterfeit Currency Monitoring System' ensures exchange of information with related public authorities, analytic database for the banking system and e-access to cash services. The system allows to maintain analytic and statistical analyses on counterfeit money throughout the country in a real time mode, generate information on the degree their security elements are counterfeited, necessary investigations by law-enforcement agencies and more effective maintenance of other actions. The 'Counterfeit Currency Monitoring System' has been integrated to the Electronic Service Portal, newly launched at the Central Bank.

The Bank continued efforts on issue of commemorative coins to circulation within the frames of its related policy. The Central Bank issued to circulation commemorative coins made of precious metals dedicated to the 95 anniversary of the National Leader Heydar Aliyev and the 100 year anniversary of the People's Republic of Azerbaijan. Both commemorative coins were presented to public on 23 May 2018.

The CBA represented the country at international conferences and organized such conferences in the country. The AZN200 banknote was presented to the world community at the conference held in Dallas, USA in 2018. The banknote was assessed as one of the five best banknotes out of 30 delivered to the conference by experts in terms of its design and security concept.

Moreover, the Bank held a conference titled 'Cash circulation and organization of cash operations in banks' with the participation of central banks and other specialized institutions on the following topics: increasing effectiveness of cash management in the country, automation of business processes, printing of banknotes and ant counterfeiting etc.

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 2018 the exchange rate of manat was in line with positive BoP trends depending on supply and demand in the FX market.

As in previous years, the status of the BoP was a key macroeconomic factor to shape the value of the national currency over the reported year as well. Current account surplus amounted to 13% of GDP, fully covering deficit in capital and financial account. Current account surplus stemmed from trade surplus.

High non-oil export potential and favorable oil prices translated to improved external sector indicators. Commodity export y/y increased by 41%, including 10% rise in non-oil export. Commodity import increased by 30.8%, including 32.3% rise in non-oil import. Despite depreciated exchange rate in Turkey and Russia, the share of non-oil import from the said countries decreased in total non-oil import. Services balance continued improving along with trade balance. Deficit in services balance y/y considerably dropped, tourism surplus was maintained. Dynamics of remittances from abroad had an upward effect on foreign currency receipts. Strategic foreign exchange reserves increased by \$3B (7.1%) to \$44.9B amid improved external sector indicators.

The FX market operated in a self-regulatory mode on the backdrop of balance of payments surplus. The size of transactions increased in FX market's both segments – cash and cashless currency markets due to rising foreign trade turnover.

The CBA continued currency auctions to arrange sale of currency provided by the SOFAZ twice a week; market participants were informed on auction parameters by the Bloomberg terminal prior to auctions. The CBA held total 101 auctions in 2018.

In the environment of better external sector indicators and within the adopted macroeconomic policy framework, the AZN/USD exchange rate remained stable. In general, manat was under the pressure of strengthening in 2018, having a downward effect on inflation expectations and dollarization. High demand for foreign currency in April and August was attributable to translation of sharp depreciation of national currencies in certain partners (Turkey, Russia, Iran) into exchange rate expectations. Since high demand for currency did not arise from fundamental macroeconomic factors, its effect on the exchange rate was neutralized. Monetary policy decisions in the said countries over the following months and high interest rates stabilized financial markets.

The official exchange rate of manat was set on the basis of the average exchange rate on interbank transactions (both auction and non-auction). The average daily exchange rate of manat was 1.7000 AZN/\$. Buy-sell exchange rates set by banks were close to the official one. Commercial banks' daily average buy rate was 1.6965 AZN/\$, while sell rate – 1.7023 AZN/\$. Difference between official buy exchange rates and those of commercial banks was 0.2% (0.0035 AZN/\$), and sell rates – 0.1% (0.0023 AZN/\$).

Dynamics of bilateral exchange rates influenced that of multilateral exchange rates. Amid low inflation in Azerbaijan total trade weighted non-oil REER appreciated by 6.1%, despite sharp depreciation of national currencies in certain partners. The REER of manat has depreciated 32.3% since end-2014, contributing to non-oil sector competitiveness.

2.4 Maintaining currency regulation and control

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

As part of complex measures to maintain financial stability the Management Board of the CBA approved the 'Regulations on currency operations of residents and non-residents in the Republic of Azerbaijan' on 28 November 2016 to stabilize the FX market.

Regulatory norms of currency operations in place contribute to rebalancing of the BoP and stronger control over taking foreign exchange funds out of the country. To make currency operations of individuals and legal entities 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.

Business entities have made numerous appeals to various public authorities and institutions, saying that this regime challenges commercial activities and entrepreneurs were involved to many legal proceedings.

Taking into account the effect of the raised problems on businesses, the Financial Stability Board discussed the issue, held meetings with business entities, related public institutions and judicial authorities involved, and maintained topic related analyses. Relevant changes were made to the above Regulations at Resolution#4/1 of the CBA Management Board dated 26 February 2018 on increase of the period of import up to 270 days allowing transfers with respect to intermediation and projects won by resident companies in international bids within the frame of the regime, in light of proposals from public institutions.

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 2018.

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.

At the same time, according to Part 3, Article 2 of the Law of the Republic of Azerbaijan on Currency Regulation, the Resolution of the Cabinet of Ministers on approval of the 'Regulations on taking out and bringing in the national currency and national currency denominated securities from/to the Republic of Azerbaijan by residents and non-residents' developed by the Central Bank and draft Regulations to be approved by the Resolution in question have been submitted to the Cabinet of Ministers considering feedbacks and proposals issued by related institutions. Currently, the draft document is on the final phase of coordination.

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

On the backdrop of high global activity, ongoing monetary policy tightening in the USA, high volatility in global financial markets, and BoP surplus, the principle for management of Central Bank's foreign exchange reserves is to conservatively maximize yield.

Diversification of tools and maintenance of high lending quality of reserves are selected as key components of the investment policy on foreign exchange reserve management. As of the end-period official foreign exchange reserves were held with reliable financial institutions – 89% in the USD, 5% in the euro, 2% in the pound, and 4% in SDR.

CBA's foreign exchange reserves increased by \$291.1M to \$5.6B as of the end-period. The Bank earned \$115.4M worth of income from currency asset management.

2.6 Development of the BoP report and participation in development of the country's forecast balance of payments

Compiling of the international standards based BoP continued in 2018, actual and forecast indicators of the BoP were one of the critical information sources for adequate decisions in the macroeconomic policy.

To improve external sector statistics the Bank maintained clarifications on relevant BoP components within the frames of the IMF mission, analyzed a technical and methodological base on the closed International Transactions Reporting System (ITRS) issuing recommendations to further improve the business process in February 2018.

The ITRS allowed to further purify the reporting and accounting system of the BoP, deepen analytics in terms of currency balance, reconcile indicators and improve forecasting.

In light of recent macroeconomic trends, the Central Bank regularly updated forecast BoP for 2018, consulted with related authorities on BoP forecasting, and sent necessary inquiries to some large state owned enterprises. At the same time the Bank assessed BoP forecast indicators and their effects to the FX market.

2.7 Develop country's consolidated foreign debt statistics and international investment balance, summary and dissemination of data

Efforts to collect and summarize data for country's consolidated foreign debt statistics and international investment balance continued.

To improve external sector and monetary statistics, the Central Bank reviewed the reporting system launched to compile external debt statistics and international investment balance, and discussed attraction of the data of banks under liquidation and making additions to the Charter of Accounts provided for the banking system within the frame of related technical mission of the IMF in February-March 2018.

Relevant authorities regularly deliver to the Central Bank government and government backed foreign debt statistics, and data on foreign debt by the oil-and-gas and non-public sectors, and assessed financial sector debt statistics on the basis of digital balance received from banks. Consequently, as a result of the actions taken the Bank developed initial version of the consolidated debt statistics and international investment balance in Quarter IV, 2018. The data have been submitted to relevant public institutions.