STATEMENT OF THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN ON MAIN DIRECTIONS OF THE MONETARY POLICY FOR 2023

With the purposeful policy implemented under the leadership of the Honorable President Mr. Aliyev macroeconomic stability in the economy was generally safeguarded, economic growth continued in 2022.

The operating environment of the Central Bank in 2022 is marked by multifaceted effects of global economic developments on the country economy. Global demand recovering faster than supply, sharp volatility of global commodity prices and inflation in trade partners, as well as higher transportation-logistic costs weighed on inflation. The external environment was mainly favorable for Azerbaijan in terms of the balance of payments and support of domestic economic activity. Supply expanded on the backdrop of the balance of payments (BoP) surplus and strategic foreign exchange reserves kept increasing.

The monetary policy was oriented towards easing inflationary pressures by means of monetary factors. Monetary factors limited excess increase of aggregate demand. Monetary policy decisions were taken in light of actual and forecasted inflationary factors and the balance of risks. The Bank took a number of decisions to improve the monetary policy operational framework and started to apply monetary policy tools in a new configuration. The mentioned measures served to strengthen the transmission of monetary policy decisions to inflation through interest channels. Current year interbank interest rates started to react to interest rate corridor parameters of the Central Bank for the first time.

In the upcoming year, the monetary policy will be oriented towards safeguarding price stability in the country too. In 2023, the monetary condition will be adjusted to the behavior of annual inflation indicators and deviation of updated forecasts from the target band. In the event of decrease in actual and forecast indicators of annual inflation, the Bank will consider a pause on monetary policy tightening to be followed by the possibility of its decrease.

The Central Bank will continue its efforts to improve monetary policy's strategic and operating framework under the guidance of 'Socio-economic development Strategy of the Republic of Azerbaijan for 2022-2026' approved by the decree of the President of the Republic of Azerbaijan dated 22 July 2022.

I. MONETARY POLICY IN 2022

1.1. Monetary policy environment

The year of 2022 is marked with higher geo-political tension, rise in global commodity prices and inflation in trade partners, lingering problems in the global *value chain and impact of these developments on the global economy at the time when the world is gradually leaving the pandemic behind. Whereas inflationary pressures elevate in increasingly complicated global environment, external sector indicators improved in Azerbaijan and economic growth rate increased.*

Global economic activity was prone to decreasing in 2022, attributable to higher than the target inflation in most countries, tighter monetary conditions and geo-political tension. Taking into consideration recent trends, international organizations revised global economic growth forecasts down over the year. The IMF in WEO October 2022 forecasts 3.2% global growth in 2022, down by 1.2 pp compared with the January forecast.

Faster recovery of global demand and geo-political tension, mutual sanctions led to a record surge in **global commodity prices,** in particular in energy and food prices in Q1. According to international organizations, in March energy prices yoy increased by 106% (the World Bank), food prices by 34% (the FAO). Whereas price hikes gradually slowed down towards the end of the year, they are still high.

Average Brent oil **price** was $100.9 over 11 months of 2022, yoy up by 42% ($71). The price for natural gas also peaked in 2022.

In the context of surge in commodity prices, inflation was higher than expected and persistent in most countries. High transportation-logistic costs and longer delivery period were the main reasons leading to the strengthening of global inflationary developments. In November, **average annual inflation** in country's trade partners was 20%.

Effects of emerging new global economic realities on the economy were not uniform. On the one hand, higher global commodity prices and transportation-logistic problems increased inflationary pressures in Azerbaijan too. On the other hand, price hike of main export products of Azerbaijan positively weighed on the BoP, equilibrium in the FX market and economic activity.

Over 9 months **current account** surplus amounted to 30.7% of GDP. Positive developments continued in the external sector in the following months. In general, over 11 months foreign trade surplus, the key component of the BoP, amounted to $23.5B (yoy up by 2.5 times). Amid BoP surplus, over 11 months **strategic foreign exchange reserves** increased by 12.3% ($6.5B) to $59.8B.

In 2022 **economic activity** remained **high,** expectations related to its outlook were optimistic.

Over 11 months of 2022, real GDP increased by 4.8% (9.2% on the non-oil and gas sector). The non-oil and gas sector grew by 5.3% and agriculture by 3.4%.

Real sector monitoring by the Central Bank also confirms that economic activity remains high; over 11 months of the current year an average indicator of the business confidence index improved year over year on the non-oil and gas industry, trade and services. Capacity utilization in non-oil entities increased year over year.

In 2022, all components of **aggregate demand** supported economic growth. Expansion of aggregate demand varied across sectors. Over 11 months of 2022 retail trade turnover (the main total consumption indicator) yoy increased by 3% in real terms and non-oil investments increased by 24.5%. The Consumer Confidence Index improved over recent quarters. Non-oil exports yoy increased by 13.9%.

Government demand remained one of the key sources of aggregate demand. Over 11 months state budget expenditures yoy increased by 16.4%, current expenditures increased by 11.6%, and capital spending increased by 39%. Increase in government's investment expenditures with changes to the state budget of 2022 provided additional support for economic activity over 11 months.

1.2. The monetary policy in 2022 and its consequences

In 2022 the monetary policy was oriented towards easing inflationary pressures by means of an adequate monetary condition, excess demand was contained via the monetary policy. Introduction of the new monetary policy operating framework enabled the interest rate corridor to impact the interbank market for the first time.

According to official statistics, annual **inflation** in November (November 2022 compared to November 2021) was 15.1%, average annual inflation was 13.8%. Core inflation[1] stood at annual 14.7% in November. Average annual core inflation was 11.4% over 11 months.

In 2022, **price hike for food products** made more contribution to inflation. In November, annual inflation stood at 20.1% on food products, 12.1% on non-food products and 10.7% on services.

Analyses suggest that, a significant portion of the price hike directly and indirectly relates to **cost factors of foreign origin.** Rise on annual import price index was 22.1% over 10 months, attributable to rising global commodity prices and transportation-logistic costs and high inflation rates in partners. In particular, global food prices seriously influenced domestic food inflation through imports. The monetary condition formed under the influence of the FX market equilibrium, the appreciated nominal effective exchange rate and monetary policy decisions considerably contained inflationary pressures.

Dynamics of actual inflation affected **inflation expectations** as well. According to December surveys, 81.9% of households expect inflation, 22.4% of respondents believe that the inflation rate will be higher. According to findings of real sector

[1] Core inflation is defined as the inflation that excludes swings in regulated prices of goods and services and seasonal factors

monitoring, inflation expectations year over year decreased in the non-oil and gas industry and construction on average, increased in trade and services over 11 months.

Over the reporting period, high BoP surplus had an upward effect on the **FX market equilibrium,** supporting the vital price stability anchor – exchange rate stability. Over 11 months of 2022 total non-oil trade weighted NEER of the manat appreciated by 7.9%, which had a containing effect on inflation. Analyses suggest that, 10% appreciation of the NEER drives inflation down by 3 pp.

In 2022, the Central Bank took **interest rate corridor** related decisions in light of global economic developments, the realization rate of external and domestic risks and updated forecasts. Over the past period of 2022 interest rate corridor parameters have been discussed nine times (last in December). During the year the Bank decided to shift the refinancing rate from 7.25% to 8.25%, the ceiling of the corridor from 8.25% to 9.25%. Due to the application of monetary policy tools in a new configuration, the floor of the interest rate corridor was shifted from 6.25% to 4% on 1 September 2022. Reduction of the floor of the corridor was found expedient in terms of sterilization of excess liquidity in the banking sector under favorable conditions and creation of opportunities for the formation of balanced interest rates in the interbank money market. However, the Bank reviewed the width of the interest rate corridor according to a prior announcement and shifted the floor of the corridor to 5% at the end of October and to 6.25% in December.

The Central Bank continued to contract excess money supply growth with its operations over the period. Over 11 months of 2022 base money in manat increased by 7.3%, broad money supply (M2) increased by 20%.

The Bank took a number of measures to improve the monetary policy operational framework.

The Central Bank began to apply **new** monetary policy **tools,** launched standing facilities and increased the range of open market operations. The institution started to use one-day deposit for liquidity absorbtion and one-day reverse Repo operations for liquidity provision as standing facility. Along with 1, 3, 6 and 9-month notes, if necessary, the Bank found seven-day Repo auctions expedient, to improve open market operations for sterilization purposes. It is planned to hold seven-day reverse Repo auctions for liquidity providing purposes.

Demand for **liquidity absorbing** tools was highest among new tools offered by the Central Bank. In September-November, average daily volume of one-day deposit operations was AZN456.6M. In October-November 2022, the Central Bank held 34 various term note auctions to manage liquidity effectively. In general, as of end-November total outstanding amount of sterilization via notes was AZN1170M.

The new operating framework had a positive effect on the **formation of the yield curve.** In November, return on 28-day notes was 3.62%, on 84-day notes 4.12%, on 168-day notes 4.39%, and on 252-day notes 4.78% on average.

The Central Bank decided to use the **reserve requirement** more actively to regulate effectively money supply amid rising inflationary pressures. Banks started to maintain 4% required reserves on deposits in the national currency and in precious metals; and 5% for deposits in a foreign currency at the decision of the Management Board of the Central Bank. All banks started to maintain required reserves under new norms from September 2022 onward.

To create conditions for the effective application of the new operating framework, the Bank undertook measures to activate the interbank money market. An **alternative operating platform** was rolled out for the said purpose. A new collective agreement on conclusion of interbank unsecured lending operations in the manat through the Bloomberg trade system took effect.

Efforts are accompanied with higher **activity in the interbank money market.** Whereas banks concluded 69 transactions in September and 146 transactions in October in the Bloomberg trade platform, the number increased to 168 in November. 93.6% of transactions concluded in November was short term (1-3 day). In November transactions concluded in the interbank repo market numbered 76, up by 3.6 times compared with the previous month. In general, in September-November total interbank transactions amounted to AZN3974M on the Bloomberg trade platform, and AZN305M on Repo.

Because of measures taken, for the first time **parameters of the interest rate corridor affected the interest rates in the interbank market.** In November, the average interest rate of one-day operations in the interbank unsecured money market was 0.6 pp higher than in October, attributable to better transmission of monetary policy decisions through the interest rate channel.

In general, the new operating framework serves to the formation of an alternate monetary policy anchor, **strengthening of the interest rate channel in the monetary policy transmission.** Activation of sterilization operations with the introduction of new tools is critical in terms of balanced growth of lending and supporting equilibrium in the FX market in the medium run. At the same time, introduction of new tools and activated operations in the interbank money market will allow banks to attract short-term funds, if necessary, and support uninterrupted and sustainable settlements.

The bank focused on **effective communication of the monetary policy** in the reporting period too. In 2022 under the pre-announced schedule, the Central Bank published press releases on each policy decision with relevant analytical comments and press conferences were held. A monetary policy review was released to the public on a quarterly basis. Activities of the Central Bank were regularly covered through its official website, as well as social networks like YouTube, Twitter, Instagram, LinkedIn and Facebook. A dedicated explanatory document on transition to the new monetary policy operating framework and a press release were published, meetings were held with market participants and press representatives. A number of Q&A videos related to monetary policy topics were broadcast. A meeting was held with independent economists.

II. MONETARY POLICY FOR 2023

2.1. Macroeconomic forecasts and expectations

Main directions of the monetary policy for 2023 were developed in light of forecasts related to the global economic and financial markets, as well as forecasts related to external, fiscal and real sectors of the country for the upcoming year.

Global economic growth forecasts for 2023 get formulated amid high uncertainties. A still fragile epidemiologic situation and a risk of reinstatement of restrictions, high volatility in food and energy prices, a tightening policy by central banks to prevent inflation, high lending by countries, supply chain disruptions and lingering geo-political tension have a downside effect on economic growth expectations. The IMF WEO October 2022 predicts 2.7% global economic growth in 2023, 0.2 pp down compared to the previous forecast. The report predicts 1.1% economic growth for advanced and 3.7% for emerging market economies. According to certain think tanks, a probability of recession even in the USA and the euro area is significant.

Amid geopolitical tension, **global commodity prices** will be one of the key factors to shape inflation in world countries. According to recent releases by international organizations, weaker global economic growth allows to expect gradual slowdown in global commodity prices by the end of 2023. This, in turn, may impact gradual drop in inflation in particular countries. According to recent releases by the IMF, in 2023 global inflation will stand at 6.5%, 2.3 pp down compared to the one in 2022. However, in the event the said factors persist, inflation is predicted to return to target bands of central banks only in 2024. The global geo-political situation both creates elevated uncertainty and leads to a lingering risk of deviation of inflation from forecast.

Weaker economic growth will also weigh on **global trade.** According to recent forecasts, global trade is expected to grow by 2.5% in 2023, 0.7 pp down compared to the previous forecast. Excessive global debt burden, rising interests in advanced economies, appreciation of the USD, the world’s dominant currency, will considerably weigh on global trade.

World oil prices will respond to global economic activity, geopolitical factors and decisions made within OPEC ++ next year too. The consensus price for 2023 by major think tanks (the IMF, the World Bank, the US Energy Agency, Standard Chartered, Fitch, Barclays, etc.) is $92 per barrel, including $85.5 per barrel by the IMF. In general, global oil demand is projected to stabilize in 2023 amid economic growth slowdown.

Taking into account high volatility of the operational environment of the Azerbaijani economy, the Central Bank will regularly update macroeconomic forecasts under various scenarios in 2023 too.

World prices on main export products, macroeconomic stance in trade partners and realization of export capacity of non-oil products and services will be key factors to weigh on the **balance of payments** of Azerbaijan in 2023. Current account is estimated to be in surplus in 2023. Diversification of the export structure entails reduction of the role of oil that balances the current account.

In 2023 **government demand** will be critical in supporting economic growth as well. The state budget spending to GDP ratio is expected to exceed 30%. Implementation of the strategy on reduction of non-oil fiscal deficit and indebtedness is critical in terms of maintaining long-term fiscal sustainability with the continuation of application of the budget rule next year.

2.2. Main directions of the monetary policy for 2023

In 2023, the monetary policy of the Central Bank will be oriented towards safeguarding price stability. Monetary policy related decisions will depend on behavior of annual inflation indicators and deviation of updated forecasts from the target band. The Bank will continue reforms on improvement of strategic and operating framework of the monetary policy next year as well.

The objective of the monetary policy will be price stability next year too. Quantitative parameters on the inflation target are left unchanged. Maintaining the current monetary condition will depend on the behavior of annual inflation indicators and deviation of updated forecasts from the target band. If annual inflation indicators and forecasts converge to the target band, the Bank will first consider options for leaving the monetary condition unchanged to be followed by its easing.

High uncertainties related to the external environment make it difficult to **forecast inflation** for next year. Commodity prices in the world market, inflation in partners and transportation costs will influence inflation in the country next year as well. Inflation is forecasted to move gradually to the target band due to slowdown of external factors of inflation in medium term and concerted anti-inflationary measures with the government. Inflation will go down gradually given the inertia of growing inflationary pressures; the process may last longer than expected.

When pursuing the monetary policy the Central Bank will consider **pass-through of the exchange rate** to inflation in 2023 as well.

Decisions related to **interest rate corridor parameters** will be taken in light of updated macroeconomic forecasts, effects of external and domestic factors on inflation, inflation expectations and changes in the balance of risks next year too. As in previous years, the interest rate corridor is planned to be discussed at the Management Board of the Central Bank under the pre-announced schedule (attached) in 2023 too. The interest rate corridor will be used as an alternative value of placement and attraction of funds in/to the interbank short-term market.

Taking into account pass-through of the monetary policy to inflation with a time lag, the Central Bank will take monetary policy decisions in response to medium-term deviation of forecast inflation from the target band. At that, the Bank will take into account influence of transmission channels, such as interest, loans and expectations.

As an operating target of the monetary policy, the Central Bank will exploit all tools in its arsenal adequately in 2023 for convergence of short-term interests in the money market to the interest rate corridor of the Central Bank. The Bank will use reserve requirements, standing facilities and open market operations in liquidity management. Decisions on quantitative parameters and duration of tools will be taken in a prompt manner depending on the liquidity position of the banking system.

The Central Bank will improve the monetary policy as part of the 'Formation of base conditions for transition to **inflation targeting**' in accordance with the Actions Plan of the 'Socio-economic development Strategy of the Republic of Azerbaijan for 2022-2026'. Diversification of supply channels in the FX market, deepening of the financial sector, containing the cash-shadow economy and making macroeconomic coordination more effective will pave the way to transition to inflation targeting.

To formulate base conditions for transition to a new regime, the Central Bank will keep improving monetary policy tools and the money market infrastructure. The Bank will consider options for making the interest rate corridor more effective and managing short-term interests in the interbank money market close to the floor of the corridor. The Bank will focus on modernization of models for developing analyses and forecasts and expanding the range of forecast indicators. Efforts will continue to expand the scope of and maintain clarity of monetary policy communication. **To improve the monetary policy operational framework,** the Central Bank will continue an active dialogue with the banking society, professional participants of financial markets and independent experts. Adoption of a new banking legislation will provide a crucial support for the Bank to implement its mandate effectively.

Works done on transition to inflation targeting will gradually allow managing inflation with interest rates.

Management of inflation within its target band will depend largely on how effective the **coordination** among macroeconomic policy institutions is. Initiatives will continue to strengthen coordination across all directions of the economic policy, in particular between the fiscal and monetary policies in light of the potential for impact of non-monetary factors on inflation. In accordance with the adopted strategy, structural-institutional reforms under way in the country are supposed to improve the competitive environment and ease inflationary pressures.

Schedule of disclosure of monetary policy decision to public

In 2023, decisions related to the parameters of the interest rate corridor will be announced 8 times under the schedule below:

February 1
March 29
May 3
June 21
July 26
September 20
November 1
December 20

Disclosure of decisions will be accompanied by press conferences on February 1, May 3, July 26 and November 1.