STATEMENT

of the Central Bank of the Republic of Azerbaijan on key directions of the monetary and financial stability policy for 2013

As a result of the socio-economic strategy successfully implemented under the leadership of the head of the state Mr Ilham Aliyev, the year of 2012 was one of the vital years in growth and diversification of the Azerbaijan economy, the non-oil sector posted high-speed growth, and the country consistently strengthened its position among medium-income countries. The process of rising welfare of the population accelerated, international ratings of the national economy were upgraded, strategic foreign exchange reserves having further accumulated prevailed over the volume of the non-oil gross domestic product. The flexible macroeconomic policy, as well as the monetary policy of the Central Bank yielded price stability and single-digit inflation in 2012. The banking sector sustained financially and further elevated financial intermediation in the economy.

The key directions of the monetary and financial stability policies for the year of 2013 have been shaped by socio-economic and macroeconomic outcomes of 2012, expectations and predictions on external and domestic economic environment, global risks and new growth challenges of the national economy. The paramount priority of the economic strategy is to make the non-oil sector drive economic growth, employment, budget and foreign exchange revenues. With this priority realized, the country will achieve balanced and sustainable economic growth that will catalyze inclusive growth and a high-income economy.

The triumphs of the recent decade certify that Azerbaijan is fit to face new challenges and possesses an adequate growth strategy. Being guided by these challenges, in 2013, the Central Bank will channel comprehensive support to implement new economic growth objectives ahead aimed at maintenance of macroeconomic and financial stability and increase of effectiveness of financial intermediation.

1. The Azerbaijani economy and performance of the Central Bank in 2012

1.1. Global economic environment

In 2012, the global economy slightly grew against the previous year amid rebalancing and financial risks. Efforts to recover global economic balancing continued. Developed economies accelerated fiscal consolidation, while developing economies (primarily surplus nations) accelerated revival of domestic demand.

Public spending cuts in advanced economies affected the global economic growth rate in a short-run. Economic stimulus packages as well as a loose monetary policy fight against considerable deterioration of the socio-economic stance. In 2012, over 50 countries eased monetary policy, which led to declined interest rates. The **International Monetary Fund** (IMF) Outlook[1] predicts a 0.4-0.7 percent LIBOR rate on various currencies in the current year.

However, the measures taken failed to recover consumer confidence and in 2012, **international credit ratings** of a number of developed economies were downgraded.

Developed countries find it tough to balance maintenance of fiscal discipline, financial stability and elimination of unemployment. **Eurozone** underwent **recession** in the environment of the dwelling sovereign debt crisis. Elevated **risks in the financial sector** constrained bank lendings, as a result of which aggregate demand, including the low level of investments hampered recovery of employment. The **unemployment level** in the EU countries is over 11 percent, while the unemployment level among the youth is above 23 percent.

The economic activity reached the pre-crisis level in **developing countries**, which are exposed to risks imported from developed countries via foreign trade and financial sources. Against a background of constrained export markets, a number of developing countries are pushing to revive domestic demand to fuel economic growth and employment.

Dwelling knots forced international financial – credit institutions to make adjustments to **global economic growth outlook.** According to the IMF, global economic growth of 3.8 percent in 2011 is expected to fall to 3.3 percent in 2012, that is 0.2 p.p decline from the previously issued outlook.

According to the United Nations Conference on Trade and Development (UNCTAD), whereas the volume of **global foreign direct investments** failed to reach the 2007 level, it will constitute USD 1.6 trillion having increased 7 percent. Over 50 percent of these investments have been channelled to developing and transforming nations. The global scale of foreign direct investments are expected to rise over 12 percent in 2013.

In 2012, prices in global commodity markets were unstable. In the circumstances of near double drop in the growth rate of the world trade turnover (a 3.2 percent expectation in 2012 against 5.8 percent in 2011), the year-over-year decline in the global commmodity prices index was 3 percent during 11 months of the current year. While the world price for Brent **oil** slipped to USD 112 in October from USD 126 in March, its overall year-over-year increase was 0.9 percent in 11 months (USD 112.2). Due to deteriorated natural conditions, the **food** prices index rose in July and started to decline in later months. In total, the world food prices index rose 8 percent in 11 months of the current year.

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[1] www.imf.org

Albeit fragile global economic growth and international conjuncture, the improved trade condition and increased export and foreign investments positively affected the Azerbaijani economy in 2012.

1.2. Macroeconomic environment

In 2012, the Azerbaijani economy kept developing successfully amid unsteady qlobal economic environment and permanent risks. The foreign economic position of the country was favorable, the process of diversification of the economy and creation of new jobs accelerated, the state contributed to economic growth through active support for the socio-economic growth.

***FOREIGN ECONOMIC POSITION*.** In 2012, the current account witnessed large-scale surplus. Azerbaijan is the leader among the CIS countries in terms of ratio of this surplus to GDP (over 20 percent).

Prices for exported products prevailed over that of imported products. Over the past period of the current year, the scale of exports surpassed that of imports by 2.6 times, and the non-oil commodity exports grew 22 percent. Rise in the non-oil exports ensures a positive effect of the external demand on economic growth. Year-over-year increase in the scale of foreign investments to the economy was 29 percent. FDIs to the non-oil sector are expected to exceed USD 1 billion by the year-end.

Strategic foreign exchange reserves rose 14.7 percent in 11 months and surpassed USD 46.5 billion, sufficient to finance three-year imports, that exceeds the foreign public debt by 9 times. The strategic reserves are close to 70 percent of GDP. By this indicator, the country is in the top-15 in the world.

Foreign exchange reserves of the Central Bank approximate USD 12 billion having increased 14 percent since the beginning of the year. The Central Bank fashioned a new strategy to manage its foreign exchange reserves in 2013. This strategy implies diversification of financial tools and the geographic structure of reserves under the existing global economic environment.

***ECONOMIC GROWTH*.** Over 11 months of 2012, **Gross Domestic Product** (GDP) rose 1.2 percent, including 9.7 percent increase in the non-oil sector. State support for the economic activity had a positive influence on growth dynamics of the non-oil economy. In general, during the year economic activity expectations were optimistic, the number of entities with rising production and turnover increased.

Domestic demand, including final **consumption expenditures** and **investments** were the key contributors to economic growth. In 11 months of the current year, nominal per capita monetary incomes of population rose 12.2 percent, while final consumption expenditures grew

6.5 percent. The real sector monitoring conducted by the Central Bank among up to 350 enterprises demonstrates high consumer demand manifested by a decline in commodity stocks of the trade network.

High investment activity also was the key player in rising aggregate demand, over 11 months, **investments to the non-oil economy** increased 26 percent. Government spending was one of the key factors in the rise of domestic investments. A 16 percent increase in public investments boosted investment activity in the non-oil sector.

The high economic activity in the non-oil sector created conditions for higher **employment** in the country. Over just 9 months of the current year, newly-created jobs are numbering over 92 thousand.

International ratings of the economy improved further. Azerbaijan moved 9 steps up in the Global Competitiveness Report of the World Economic Forum. Azerbaijan is among the top 20 countries in terms of the macroeconomic sustainability. International rating agencies assess the credit rating of Azerbaijan as “stable”.

1.3. Implementation of the monetary policy

In 2012, the Central Bank targeted single-digit inflation, the exchange rate stability of manat and enhancement of financial stability, while promoting amplified financial intermediation.

***İNFLATION*.** Given the proximity of the economy to the natural rate of employment, decline in the growth rate of **consumer prices** that started from the second half of 2011 continued in 2012 as well. In the current year inflation remained on a **single-digit level,** average annual inflation was only 1.2 percent in 11 months, which is 8 p.p. below the previous year level. The growth rate of wages and salaries in the country surpassed that of inflation rate by 7.3 percent. The average inflation rate in trade partners exceeded the inflation in Azerbaijan by 5 p.p.. To compare, the IMF predicts 6.1 percent average inflation for developing countries.

In 11 months of the current year **agricultural producer prices index** declined 0.3 percent, which was primarily observed on plant-growing products. Also, major sectors of the non-oil industry witnessed the prices decline (food, metallurgy, chemical, wood processing etc). Prices in the **real estate market** remained dormant along with the consumption market.

EXCHANGE RATE POLICY. In 2012, the Central Bank implemented the exchange rate policy within the **managed exchange rate regime** (corridor mechanism).

Owing to huge surplus in the balance of payments of the country, supply prevailed over demand in the forex market. Against this background, the Central Bank **sterilized** USD 1.5 billion worth **currency** in the current year to prevent considerable appreciation of the exchange rate and thus neutralize negative impacts on the competitiveness of the non-oil sector. As a result, in general, over the period, the exchange rate of manat remained stable against the USD and strengthened only 0.2 percent.

In general, in the last 15 years, average annual variation of the exchange rate of manat against the USD was below 1 percent. The exchange rate **stability** had a positive influence on macroeconomic and financial stability in the country, enhancement of confidence in the national currency and decline in dollarization.

The real effective exchange rate for non-oil sector of manat depreciated 4.3 percent in 11 months.This resulted from maintainence of the exchange rate of manat at a favorable level, and a low level of domestic inflation compared to trade partners. The depreciated REER eventually improves competitiveness of the non-oil sector (price prevailance in foreign markets).

MONETARY CONDITIONS. The monetary policy tools were implemented given specifics of the policy passthrough to aggregate demand and prices, economic dynamics and inflation expectations.

Taking into account the downward trend in inflation and interest rates, **the refinancing rate** was lowered once over the year to 5 percent. While taking this decision, the Central Bank, from the tactical standpoint, considered increased economic cycle indicators favoring loosening monetry policy stance, while from the strategic standpoint, it took into account the priorities of the diversification strategy and the profitability of the non-oil sector.

To regulate growth rates of money supply and banking system liquidity, the Bank used open market operations and reserve requirements. The application mechanism of reserve requirements was significantly improved, and new regulations enabling effective management of liquidity by banks took effect.

Money supply kept pace with demand of the economy for money. In 11 months of 2012, money supply in manat (M2) rose 15 percent. Increase in money supply sourced from domestic assets along with external assets. **Non-cash money** supply in manat increased 11 percent, as a result of measures to stimulate cashless payments. The share of savings and deposits in foreign currency (M3) – one of the indicators of **dollarization –** has dropped 1.2 p.p. since early year.

Thus, the monetary policy considerably contributed to the diversification of the economy through single-digit inflation, the stable and favorable exchange rate and adequate coverage of demand for money.

İNSTİTUTİONAL DEVELOPMENT. Under the 2011 – 2014 **Strategic Plan,** in 2012, the Central Bank continued its institutional development.

Results of **empirical research and econometric models** were applied in the monetary and financial stability policy. *The Dynamic Stochastic General Equilibrium Model,* broadly applied in central banks and tailored by the CBA to local specifics, was improved; economic growth and inflation scenarios were developed having been built on diverse factors via the model in question.

To boost the **financial stability assessment** potential, the Bank prioritized identification of systemic risks in the banking sector. Resilience and sensitivity of the banking sector was regularly assessed via stress tests and financial stability indicators.

The Central Bank is finalizing works on launch of an **electronic statistics** and **analytic reporting** system. Reporting and statistics have been transformed to the data warehouse. This system is the key element of the e-government concept, being successfully promoted accross the country, and enables effective and prompt collection, flexible processing and distribution of economic data in line with international standards. Monitoring of market trends, enabling qualitative diagnostics of an economic cycle was widened and conjuncture indices built upon.

The Bank provided broad measures to **boost economic and financial literacy of the population and economic subjects.** Over the year, interactive financial literacy projects, that triggered public interest, were implemented jointly with international and local bodies through media involvement. For the first time ever the country celebrated the World Savings Day.

1.4. Financial stability and financial intermediation of the banking sector

The past period of 2012 was marked with stability of the banking sector, acceleration of institutional development and deepening of financial intermediation. The Central Bank took comprehensive measures to align regulatory and supervisory framework to international standards.

PRUDENTIAL POLICY. The Central Bank continued to take measures to maintain confidence in the banking system, minimize systemic risks, strengthen management potential in banks and increase financial sustainability. The Bank accelerated formation of a risk-based prudential supervision framework given the **Basel III** standards on banking supervision; a supervisory regime to preserve financial stability was applied.

To increase financial sustainability of the banking sector, the Central Bank toughened **capital requirements** to banks. The Bank decided to raise aggregate capital of functioning banks, as well as the minimum amount for paid-in capital of newly-launched banks up to AZN 50 million. The banks owning 89 percent of banking sector assets comply with this requirement. The new regulation on the minimum amount of aggregated capital of the banks will take effect from 1 January, 2014 onward. Application of the new capital requirement will enable to boost effectiveness and depth of financial intermediation of banks along with strengthening of their capital position.

FINANCIAL SUSTAINABILITY. In 2012, the quality of banks' assets, liquidity and profitability indicators improved, the banking sector maintained high capital adequacy.

The share of **overdue loans** of the real sector and the population to the banking sector in the lending portfolio made only 6.4 percent, half of which are covered by banks' reserves. The **capital position** of the sector is on a satisfactory level. The capital adequacy ratio is 15.7 percent, above the 12 percent norm. In 11 months, the scale of aggregate capital increased 30 percent. Over 11 months of the current year, ROE was above 9 percent and ROA 1 percent.

The sector maintains stable and favorable **liquidity.** Liquid assets approximate 12.8 percent of total assets, sufficient to cover half of the deposits of the population. The banking sector kept integrating to the global financial system and attracting resources from external sources. The share of **external debt** liabilities in banks resources is on an acceptable level (15.5 percent). Maturity of over 60 percent of external liabilities of banks is over one year.

FINANCIAL INTERMEDIATION. In 11 months of the current year, assets of the banking system increased 20.6 percent, while loans rose 20.9 percent. Loans to industry and production rose 50 percent, and to agriculture and processing 16 percent. Long-term loans grew 23 percent. Loans rose 19.6 percent in regions and 28 percent on Non-Bank Credit Institutions (NBCIs).

Mortgage lending continued through the inflow of market funds. In the current year, credit institutions allocated AZN 66.4 million worth mortgage lending to over 1.800 persons through funding of the Azerbaijan Mortgage Fund.

The population trusts more the banking system, **savings** grew 15.6 percent and reached AZN 4.8 billion. The size of savings over 1-year maturity rose 17.4 percent. The growth rate of savings in manat (23 percent) considerably prevailed over that of foreign currency. The volume of savings in regions rose 16 percent. Under Decree of President of the Republic of Azerbaijan dated 14 March 2012, individual one-off payments are being made to depositors of the former Savings Bank of the USSR, citizens of the Republic of Azerbaijan.

In 2012, **interest rates** tended to decline. Average interest rates on loans and deposits were decreased by 2 p.p..

The **regional network** of the financial sector further expanded. Banks launched 26 new branches and 14 new divisions in 11 months of 2012. Currently, bank branches are numbering 654, while the number of bank divisions is 162, half of which are operating in regions. Moreover, 132 NBCIs are operating across the country with 114 branches.

The Central Bank continued to develop the banking infrastructure. Year-over-year increase in the size of payments through the **National Payments System** over 11 months of 2012 was 16.8 percent and constituted AZN 104.8 billion.

The scope of the Mass Payments System expanded to regions, and the Bank continued to further increase the scale of POS-terminals and settlements via payment cards. Over 11 months of 2012, the number of payment cards in circulation rose 9.7 percent, the number of installed

ATMs increased 5.1 percent, while the number of POS-terminals grew over 3 times as much. To increase cashless circulation in the country the Central Bank launched the National Payments Council comprised of relevant bodies.

2. Key directions of the monetary and financial stability policy for 2013

2.1. Global processes and national economy in 2013

WORLD ECONOMY. International financial institutions and the leading global think-tanks predict ongoing global economic growth in 2013. According to the recent October release of the IMF, the global economic growth is expected to be 3.6 percent in 2013, that 0.3 p.p. falls behind the July outlook.

The debt crisis in the euro zone, that was kept only within the borders of few small states, gives special importance to the realization of optimistic expectatiopns regarding **global economic growth**. The IMF predicts 1.5 percent economic growth in developed and 5.6 percent in developing countries in 2013. The unemployment level in developed countries with the severe sovereign debt problem is expected to be high, and the financial sector will remain sensitive.

Global capital flows, exchange rates of leading currencies and world commodity prices will be highly variable in the upcoming year. According to the recent IMF outlook, in 2013, **price per barrel of oil** is expected to stay at a USD 105 .

AZERBAIJANI ECONOMY. In 2013, external demand and world prices for key export commodities are expected to have a positive effect on the balance of payments of the country. At the same time, non-raw goods and services exports expectations are high as well. These factors qualify for expectations of achieving the current account **surplus in the amountof 15 – 18 percent of the GDP** in 2013. The country's upgraded credit rating creates favorable conditions for more foreign investments to flow to the non-oil economy. Eventually, all this will also ensure growth in strategic foreign exchange reserves of the country in the next year. The predictions regarding the balance of payments will serve as a fundamental macroeconomic factor to affect the exchange rate of manat.

According to official forecasts, in 2013, **economic growth** in the country is expected to be 5.3 percent, including 11.7 percent growth in the **non-oil sector.** International financial institutions also predict ongoing economic growth in the country in the upcoming year. The non-oil sector growth will be primarily affected by domestic demand in 2013.

The strategic priority is to provide sustainability of economic growth, employment, state budget and the balance of payments based on: (i) optimal rebalancing between internal and external sources of economic growth in a long- and medium-run and (ii) development of a competitive export sector with a diversified structure. The “Azerbaijan – 2020: A Glance into the Future” Concept developed in concert with the Decree of President of the Republic of Azerbaijan dated 29 November 2011 covers all these priorities.

Macroeconomic stability is one of the fundamental conditions for the implementation of these strategic priorities. Thus, domestic inflation rate, lower than the average weighted inflation rate in trade partners, ensures price competitivness of non-oil products in export markets. From this standpoint, given the surplus of the balance of payments, regulation of growth rates of money supply to impact inflation becomes vital. In parallel, the exchange rate of manat also influences international competitiveness of export.

Overall, in 2013, Azerbaijan has sufficient manoeuvring capacity and an adeqate strategy to confront risks coming from the global economic environment and domestic development challenges.

2.2. Macroeconomic stability and targets of the monetary policy

In 2013, the Central Bank will keep the heredity of implmentation of the monetary policy principles, continue improving the strategic and operational framework of the monetary policy and enhance the macroeconomic stability management potential.

INFLATION TARGET. In 2013, the monetary policy will be aimed at hitting a **5 – 6 percent inflation** target. To that end, the Central Bank will make efforts to affect the growth rate of money supply through conventional policy tools.

At the same time, the Bank will focus on macroeconomic, institutional and structural preconditions to apply a new, more effective policy regime to influence inflation and economic cycle in a long-run.

Of these conditions, **the flexible exchange rate regime** is of particular importance. The flexible exchange rate regime ensures a more effective monetary control over money supply and interest rates. Diversification of the economy and exports, further enhancement of fiscal sustainability, development of the financial markets and transformation of the interest rate to influence inflation are of particular significance for transition to this policy regime.

EXCHANGE RATE POLICY. The exchange rate policy in 2013 will be aimed **at balancing supply and demand in the forex market** and through it, aversion of significant fluctuations of the exchange rate of manat against USD. Expected surplus of the balance of payments in current accounts balance will be the key factor to affect the exchange rate of manat against USD in the upcoming year as well.

Variation of the exchange rate of manat against other currencies will depend on the global forex market. In such circumstances, exchange rate risks are to be more effectively managed by economic agents.

Parameters of the exchange rate policy will be determined given the stance of the balance of payments, financial stability targets in the banking sector and maintenance of competitiveness of the non-oil export. In general, fundamental stability of the exchange rate stability of manat is one of the factors behind macroeconomic and financial stability.

MONETARY MANAGEMENT. The monetary program of the Central Bank implies regulation of the growth rate of money supply in harmony with the inflation target through direct and indirect monetary tools.

Parameters of the monetary policy tools, including **the interest rate corridor and reserve requirements** will be determined depending on an economic cycle and the situation in financial markets. To provide conditions to boost efficiency of the monetary policy tools application, the Central Bank will continue to support development of financial markets in the upcoming year as well.

İNSTİTUTİONAL DEVELOPMENT. The Central Bank will implement targeted programs and projects to improve, modernize and fully adjust all functional directions of its activity to international standards and enhance **internal institutional potential** in harmony with the 2011 – 2014 Strategic Plan.

The potential for macroeconomic and financial stability management will be further increased, to that end **empirical research, modelling and forecasting as well as risk simulation** capacity in the financial system will be tailored to the latest global challenges. The Bank will continue systematic measures to raise financial literacy of the population (projects on launch of a financial literacy portal, knowledge sharing, realization of a virtual central bank laboratory etc).

The Bank, in parallel, will continue targeted performance to develop **human capital** and **competencies,** coordinate implementation of **corporate governance,** all business processes and and key functions to high quality and efficiency results, apply latest achievements in electronization (**e-management),** automation and İCT.

Eelectronic statistics will be applied, **microeconomic monitoring** expanded to more comprehensively assess market trends. The Central Bank will enhance social **communication** of its activity.

2.3. Financial sector stability and development policy

To continue to assist diversification of the economy in upcoming years, the Central Bank will strengthen measures to ensure sustainability of the financial sector performance, and promote diversification and inclusiveness of financial intermediation. Maintenance of depth, effectiveness and stability of, and wide access to resourcess will be top priorities.

FINANCIAL STABILITY. In 2013, the Central Bank will continue the policy aimed at enhancement of stability and sustainability capacity of the banking sector, increase of the capitalization level, development of corporate governance standards, and protection of depositors' and investors' interests aligned to international best practices.

The Bank will continue activities to shape a new framework of risk-based prudential supervision in harmony with the **Basel III standards.** This framework will enable to pursue a more flexible and effective supervisory policy and improve analytical tools of supervision.

Banks will be tailored to a new requirement established by the Central Bank on the minimum amount of aggregate capital. This process will create conditions to **strengthen the capital position** of banks and improve the quality of capital. The new capital requirement will serve for injection of cheaper and wider range of banking products to the economy, and more effective protection of depositors' and investors' interests along with enabling consolidation and restructuring of the sector. Therefore, a specific communication strategy is to be implemented.

To boost sustainability of the banking system and efficiency of the work with **problem loans,** the potential to launch a specialized structure based upon best practices will be explored. The Bank will raise requirements for **risk management systems in banks,** management competencies, technology and staff potential. Strentghening of the **consumer finance protection** will be a particular focus. To protect savings of the population, **the deposits insurance system** will be **improved**.

FINANCIAL INTERMEDIATION. The Central Bank will continue activities to amplify the depth of the banking – financial sector, as well as expand access of regions to financial resources. **Regional network** of financial institutions, as well as expansion of NBCIs' performance will be promoted.

The **mortgage lending** system will be developed on an ongoing basis. These measures will target wider access to mortgage lending, particularly higher possibilities for obtaining social mortgages. The Bank will research chances to apply alternative mortgage mechanisms.

The Central Bank will also prioritize **expansion of the scale of cashless payments.** Components of the National Payments System will permanently operate and develop. The Bank will take crucial measures to integrate related structures to Government Payment Portal established to ensure e-payment of taxes, duties, rent fees and other payments to public structures.

The service network of the Azerpost LLC will further increase access of regions to e-banking services. The Bank will further promote mass utilization of innovative payment tools and services and active use of e-payment services.

EXECUTIVE SUMMARY. *In 2012, the Central Bank widely contributed to maintenance of macroeconomic stability and promotion of growth in the non-oil sector of the economy. Inflation was maintained at a single-digit level, the exchange rate of manat remained stable, demand of the economy for money was met. The banking sector sustained financially and the sector kept expanding on a sound basis. Payment systems were developed and cashless payments upscaled.*

The paramount priorities of the Central Bank in 2013 will be to maintain macroeconomic and financial stability, to support economic growth and diversification on this basis. The Central Bank will also continue to support maintenance of a single-digit level of inflation, preserve financial sustainability in the banking sector, and further deepen financial intermediation of the sector in the upcoming year.