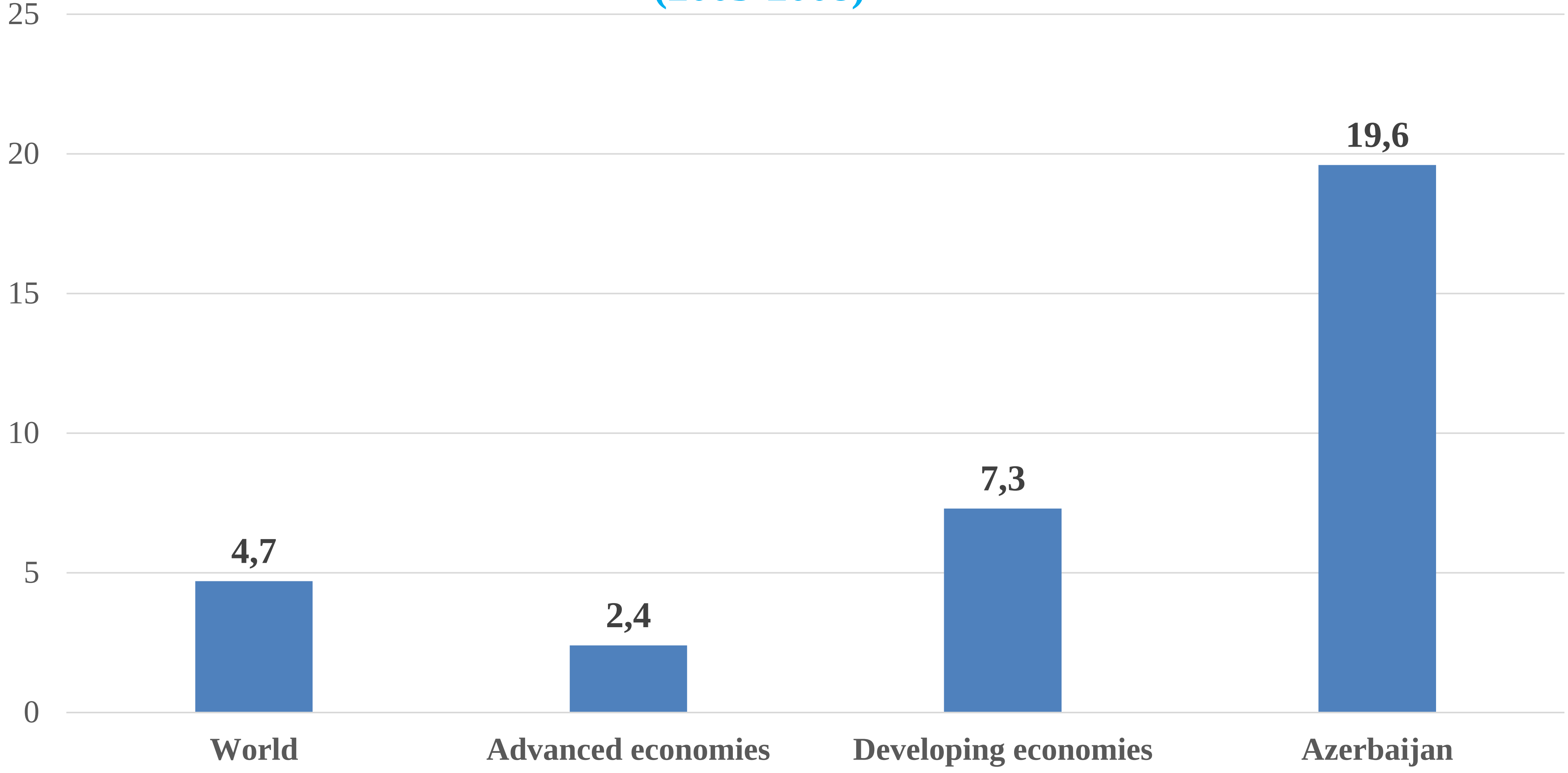
A Big Adjustment…

The Central Bank of Azerbaijan

Economic background

The period of huge growth rate

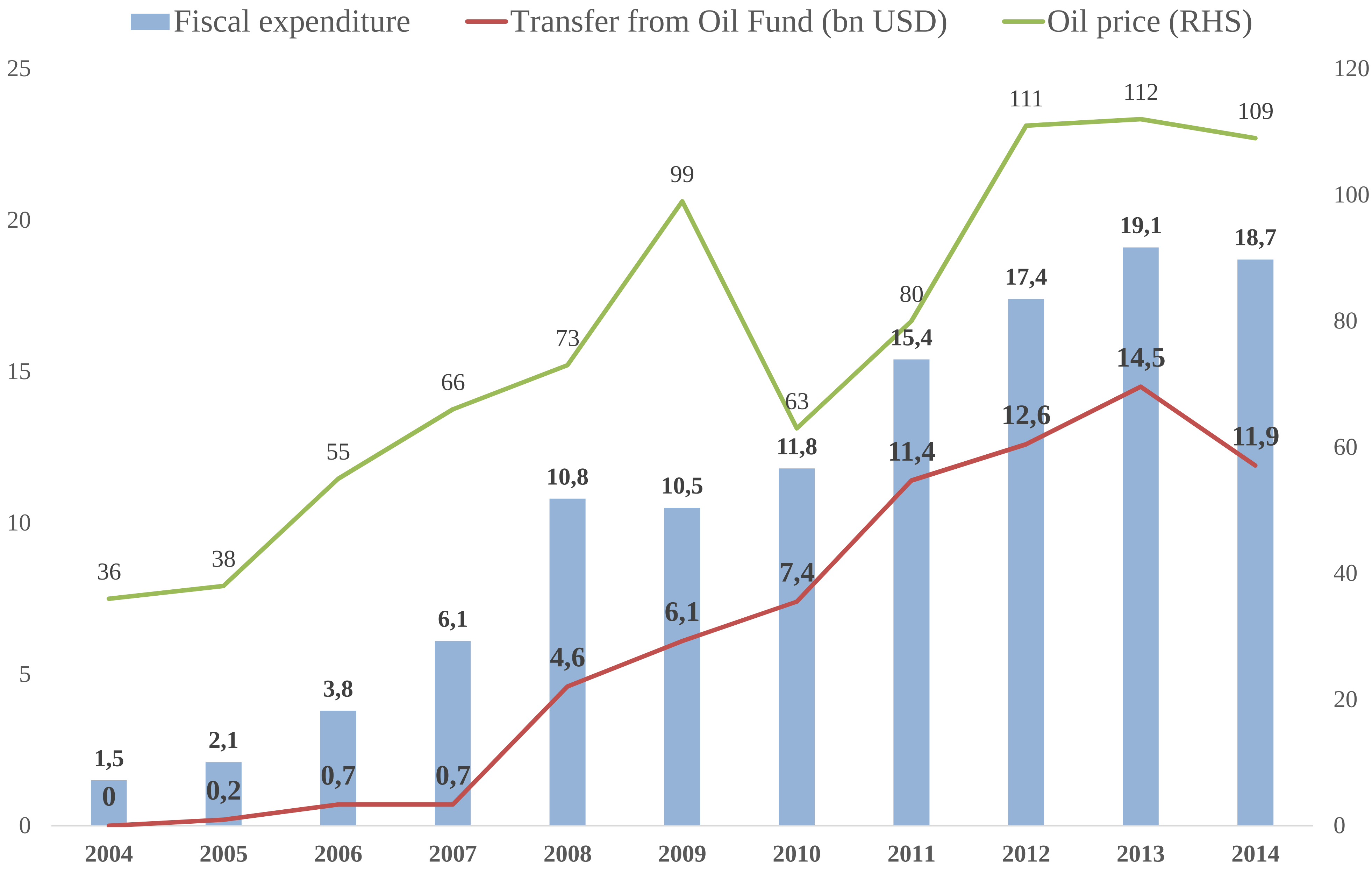
(2003-2008)



Economic background

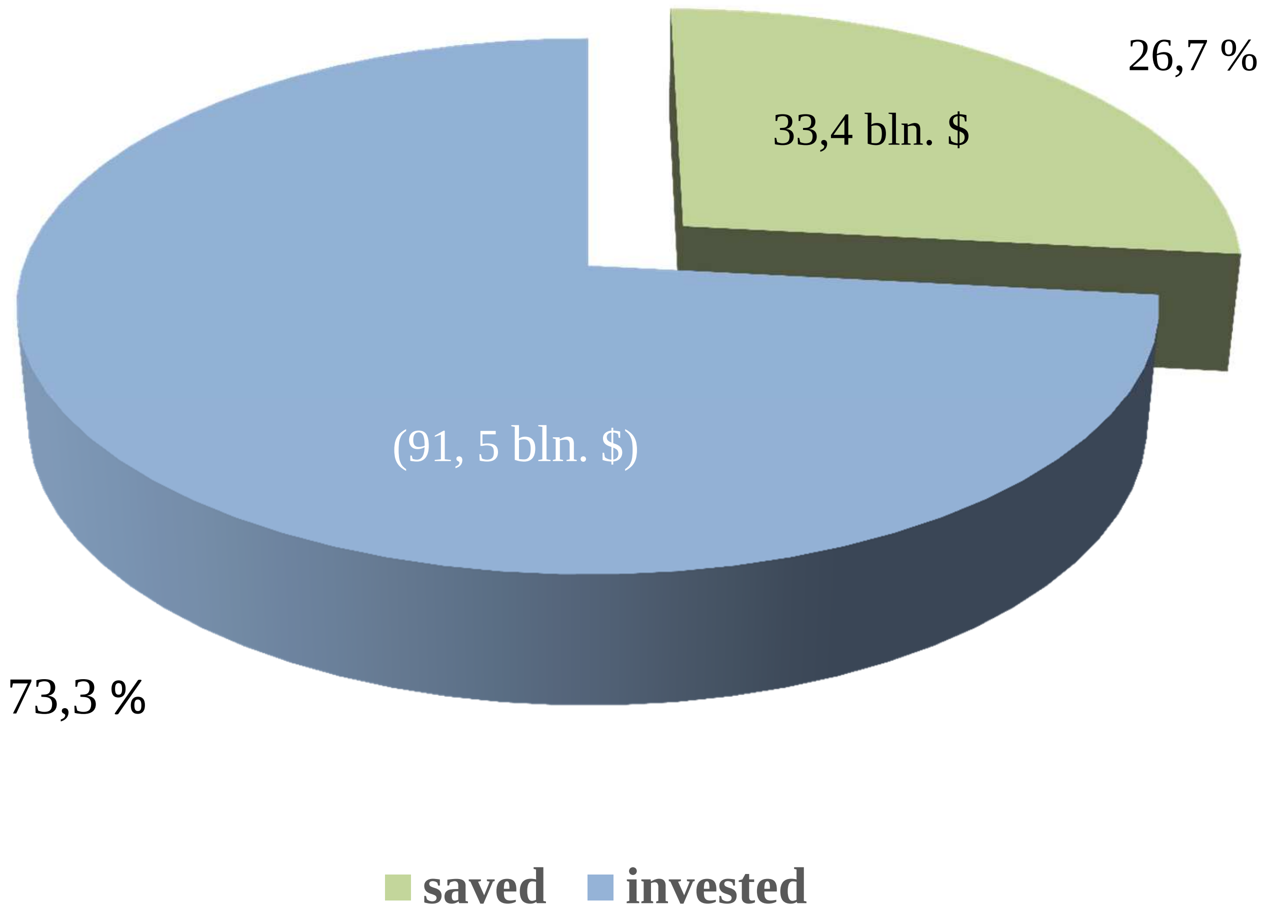
- The huge economic growth in ***2004-2014 years*** was stemmed by two key fundamentals:
  - The decade of high oil prices: ***4 times higher than it was in previous decade***.
  - Local oil extraction boom: Azerbaijan has extracted ***3 times more than ever before***.
- As a result, ***oil exports increased 10 times*** (20 bln $ in 2014), and a huge amount of CA surplus (15-17 bln $) emerged;
- Government got 125 bln. $ from the oil contracts in last 10 years, 75% of it has been spent for raising the living standards, through employment and social benefits;
- Government’s investments and social expenditures has increased 9 times and 8 times accordingly;
- ***Non-oil economy has tripled***, due to the boost in domestic demand;
- ***The demand boost pushed the growth in non-tradables***, but not in tradable sector, since the latter suffered by a lost in competitiveness.

Fiscal expansion



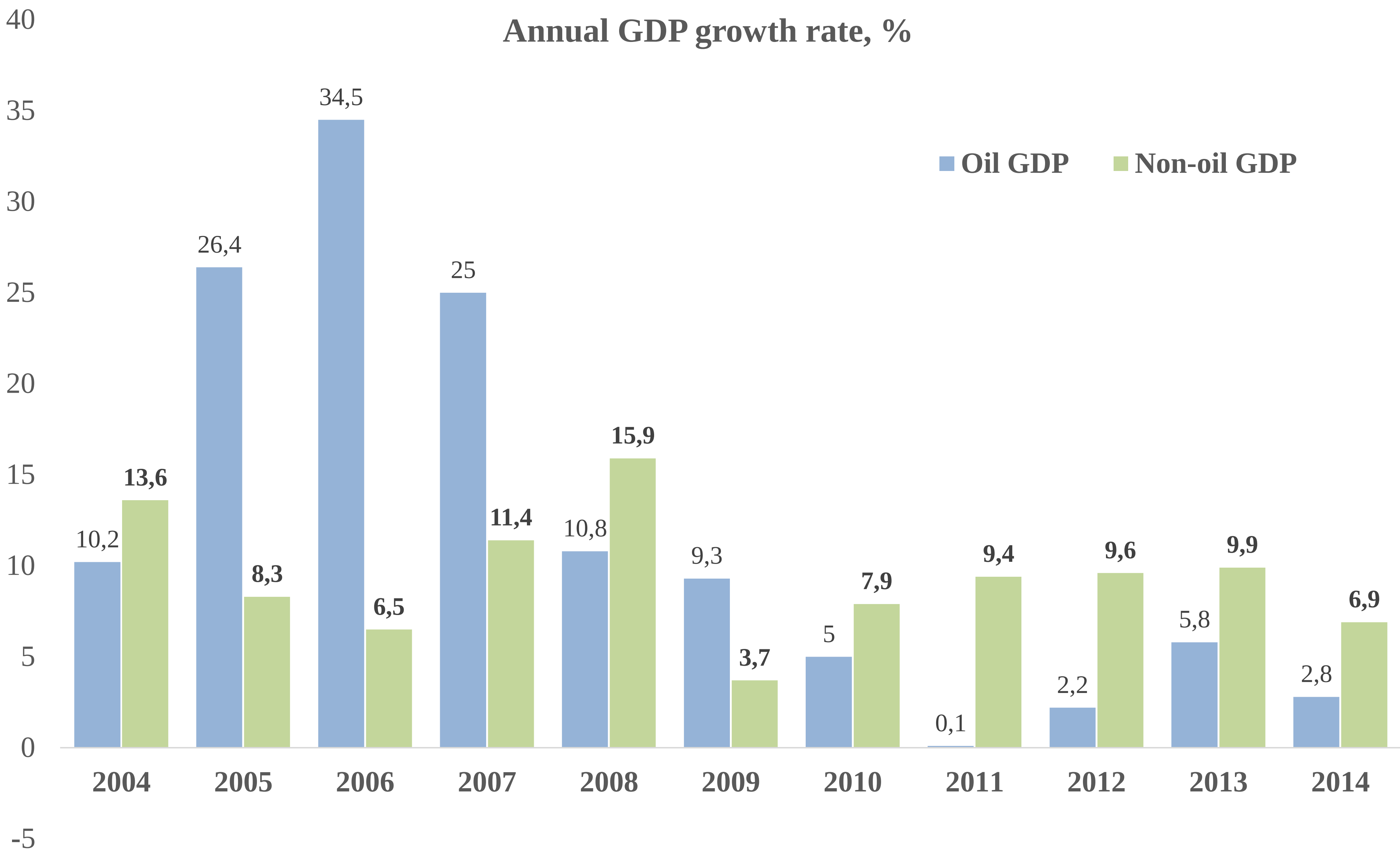
Invested and saved oil money

Overall oil revenues (2001-2015): 125 bln. $

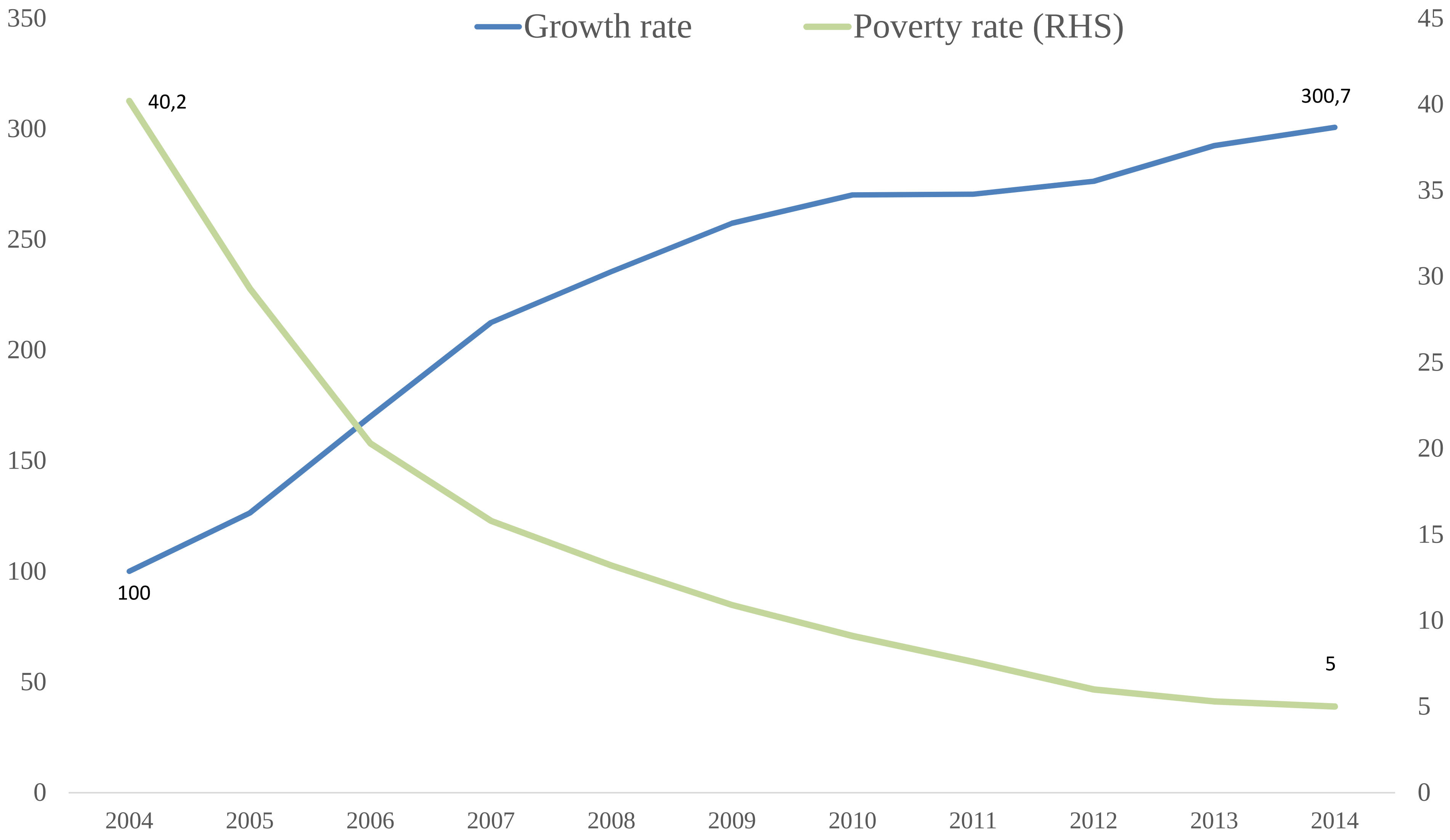


Year	Oil prices
2004	36
2005	38
2006	55
2007	66
2008	73
2009	99
2010	63
2011	80
2012	111
2013	112
2014	109
2015	54

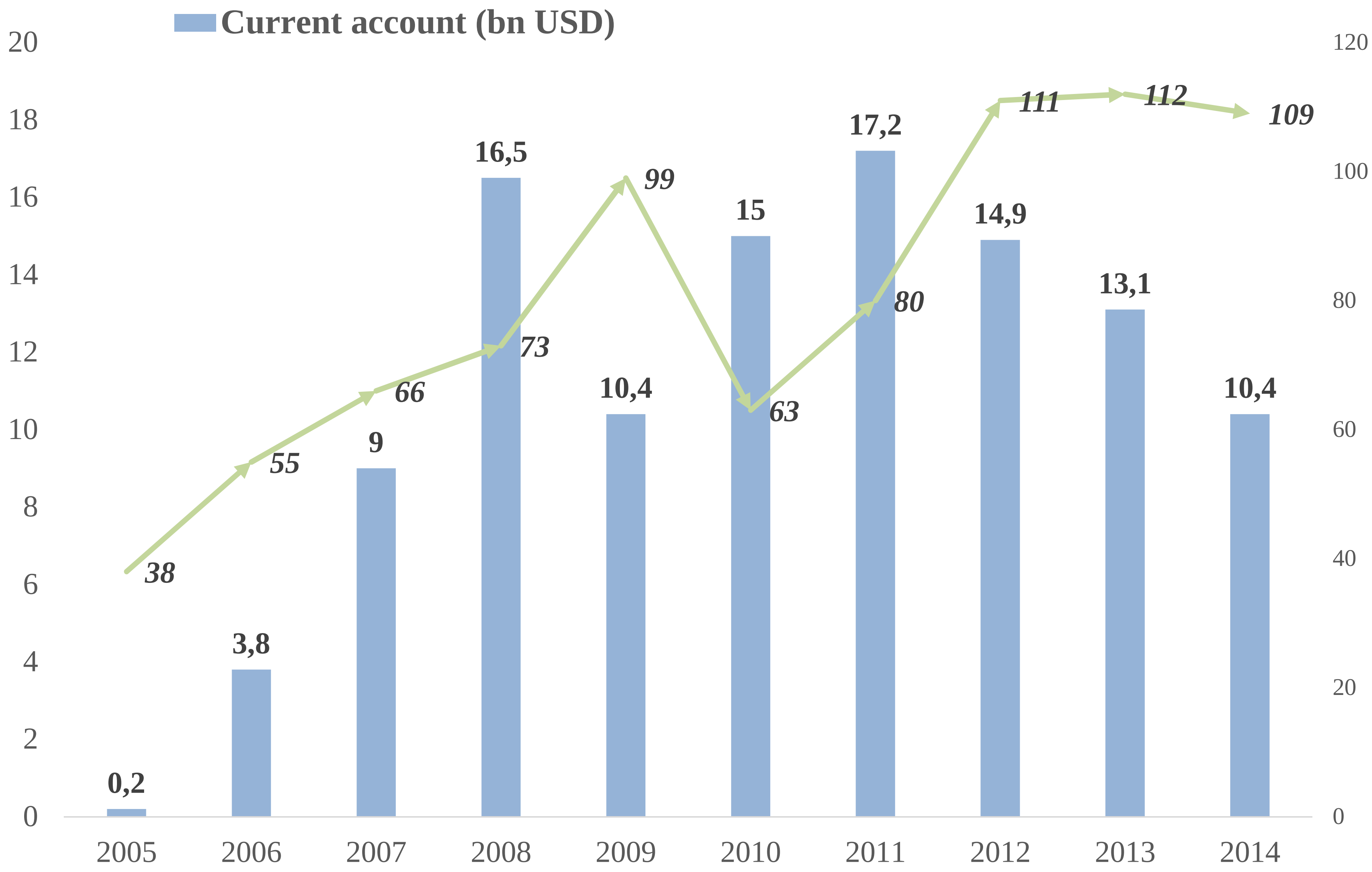
Economic growth



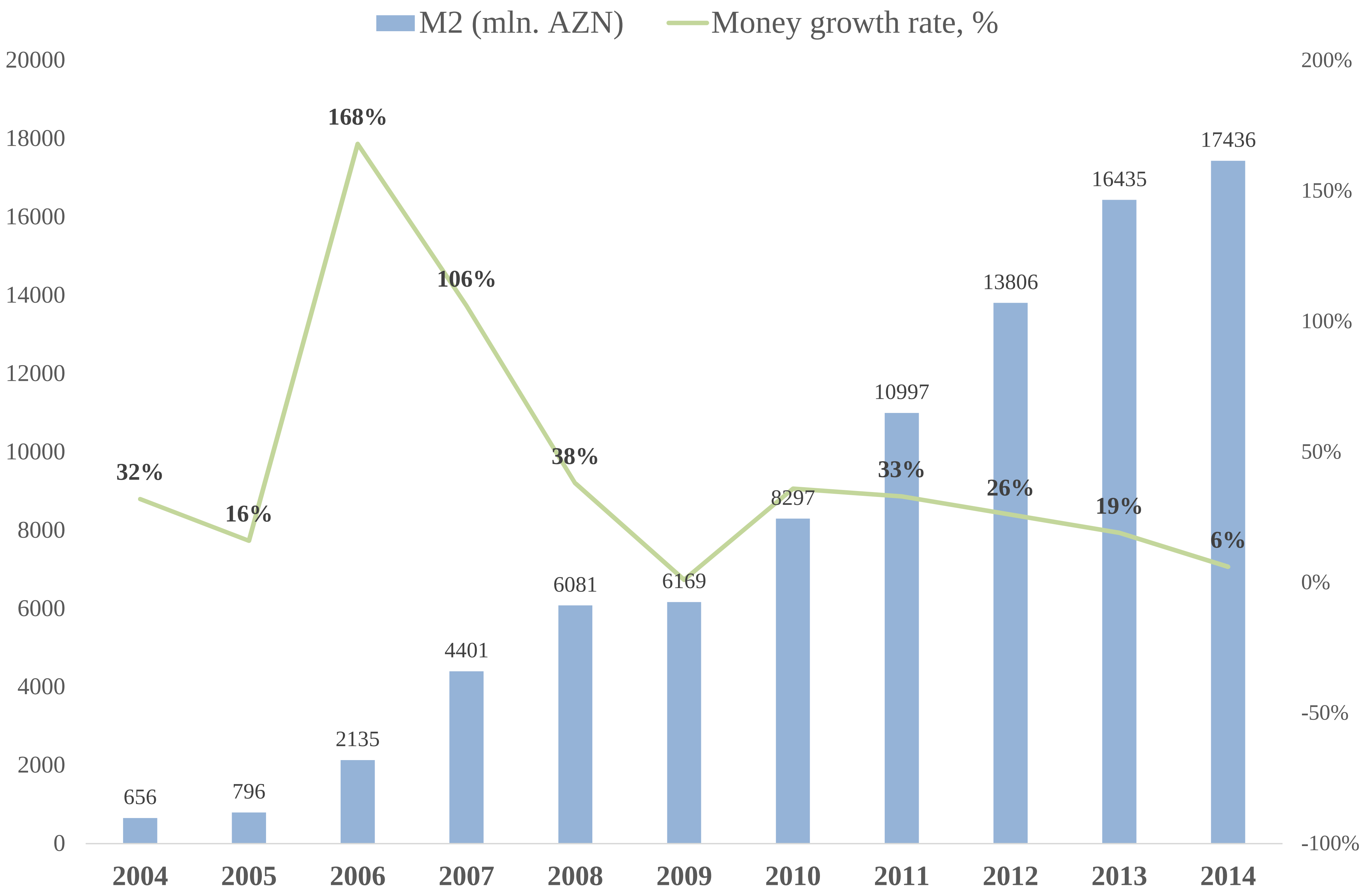
Accumulated growth and Poverty



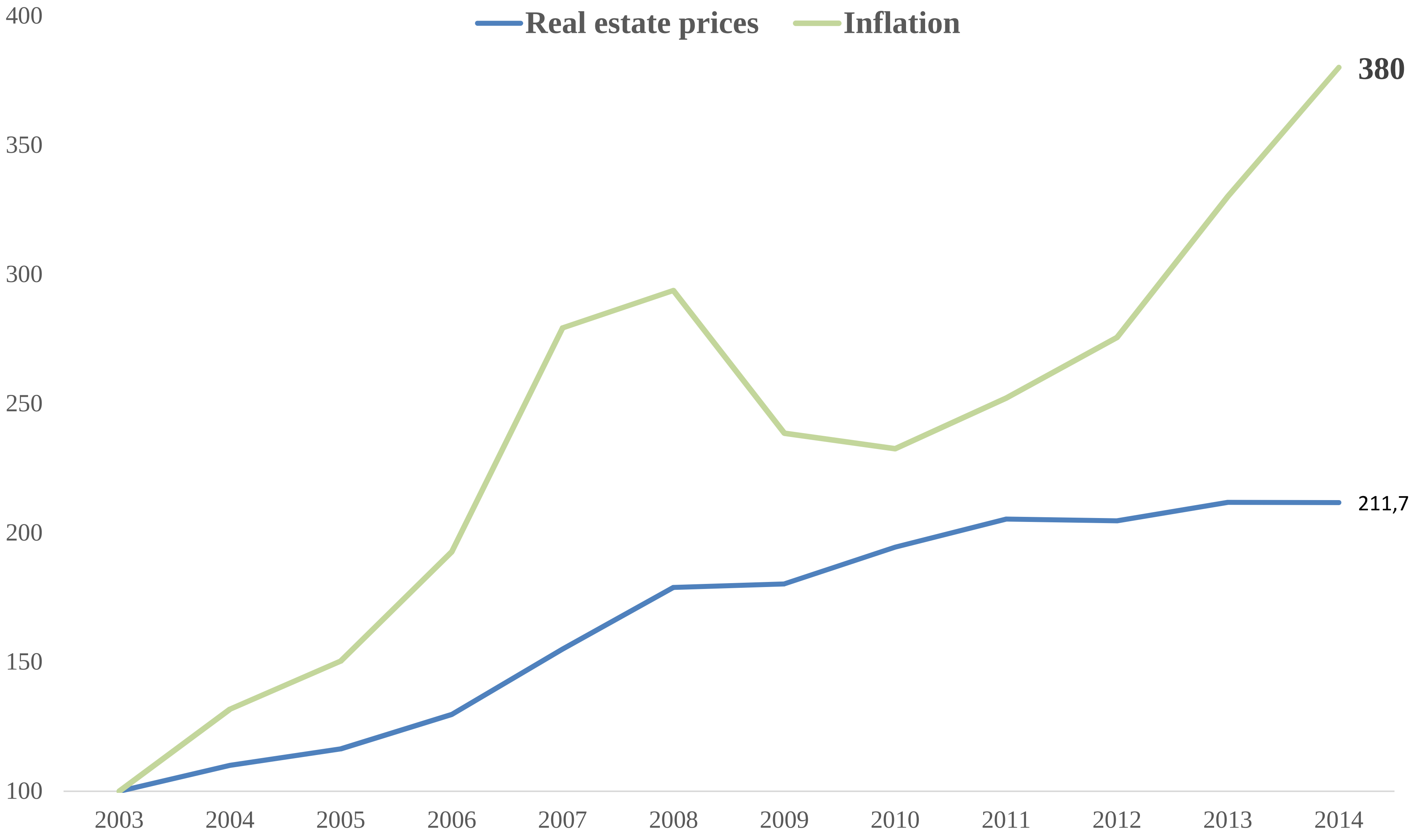
CA Surplus and oil prices



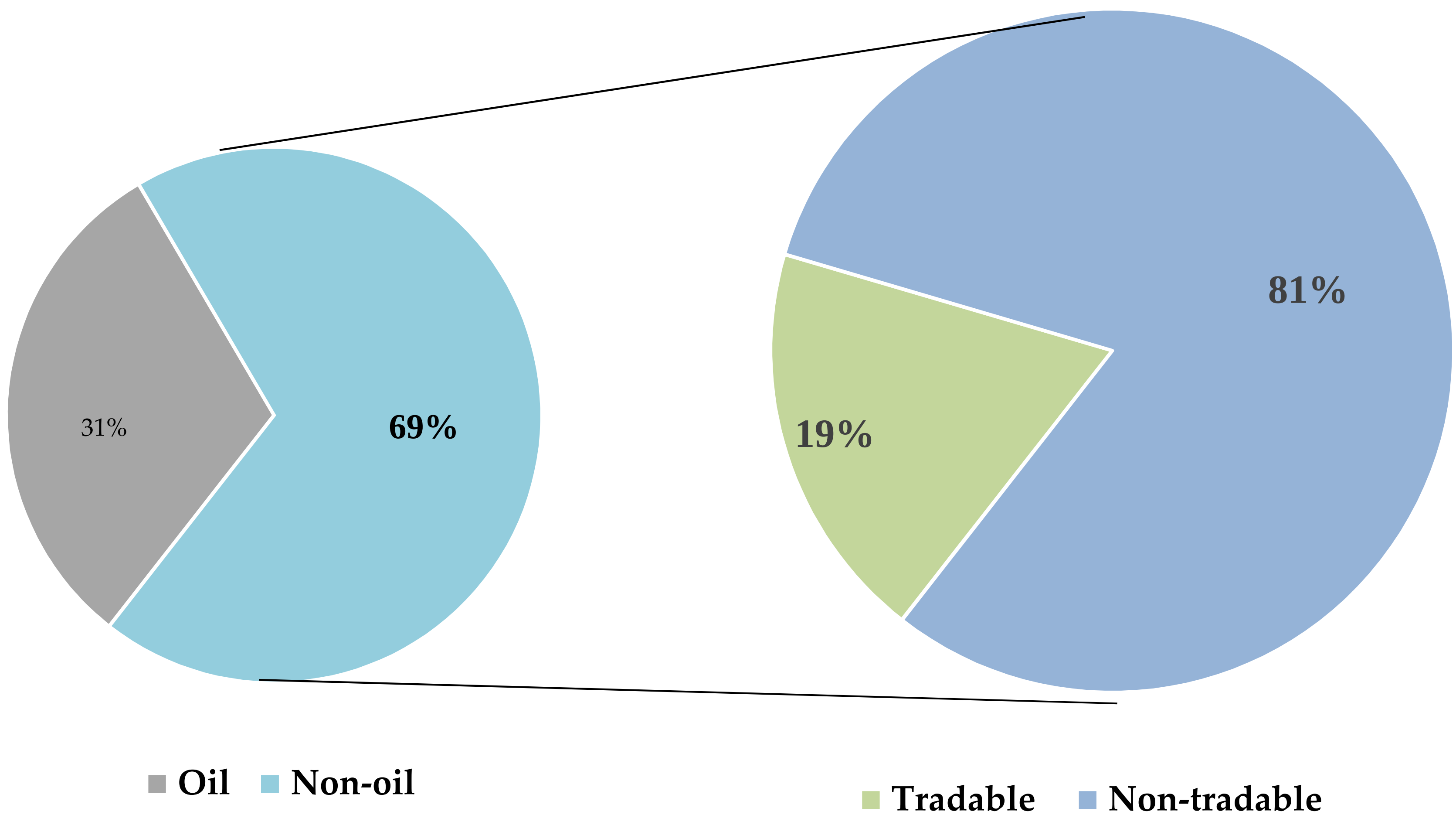
Monetary expansion



Real estate market



Structure of non-oil GDP



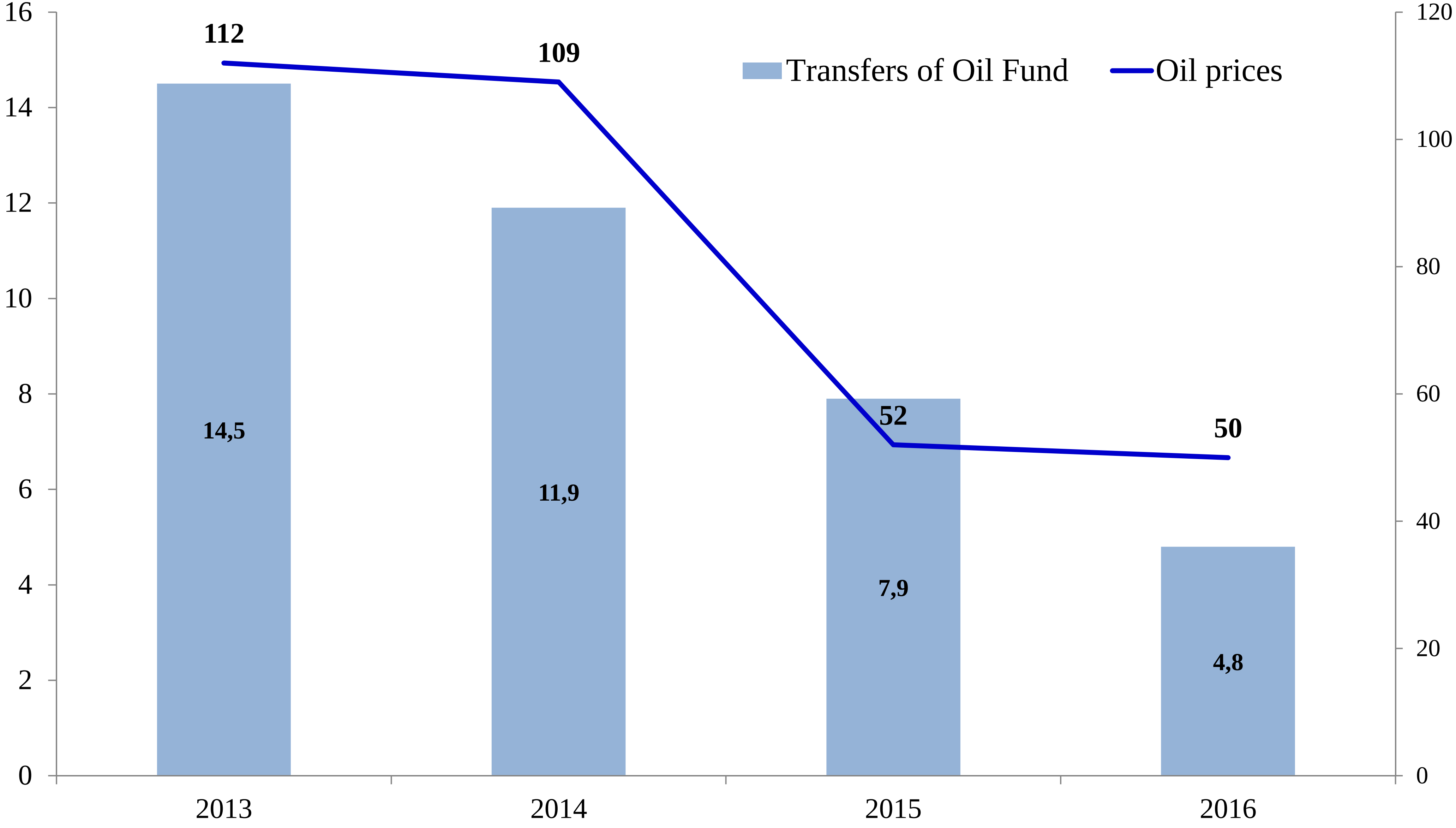
A big economic change

- Since 2015, the Azery economy, adapted to high oil prices, was ***hit by two external shocks***:
  - Sharp decline in oil prices;
  - Currency devaluation in trade partners, against the US dollar.
- Annual ***oil revenues decreased by 4 times***;
- Nominal exchange rate appreciated 60% due to depreciated of Ruble, Tenqe, Euro, Lira and Lari against the USD;
- The ***current account surplus evaporated*** in 2015 due mainly to lower oil prices;
- The huge foreign exchange reserved enabled Government to sustain the fiscal expenditures and preserve the exchange rate fixed to the USD;
- However, since the oil price collapse perceived as a permanent, the Authorities viewed the new external environment as ***an opportunity to shift to a new economic paradigm*** that is based on a thriving and diversified non-oil private sector.

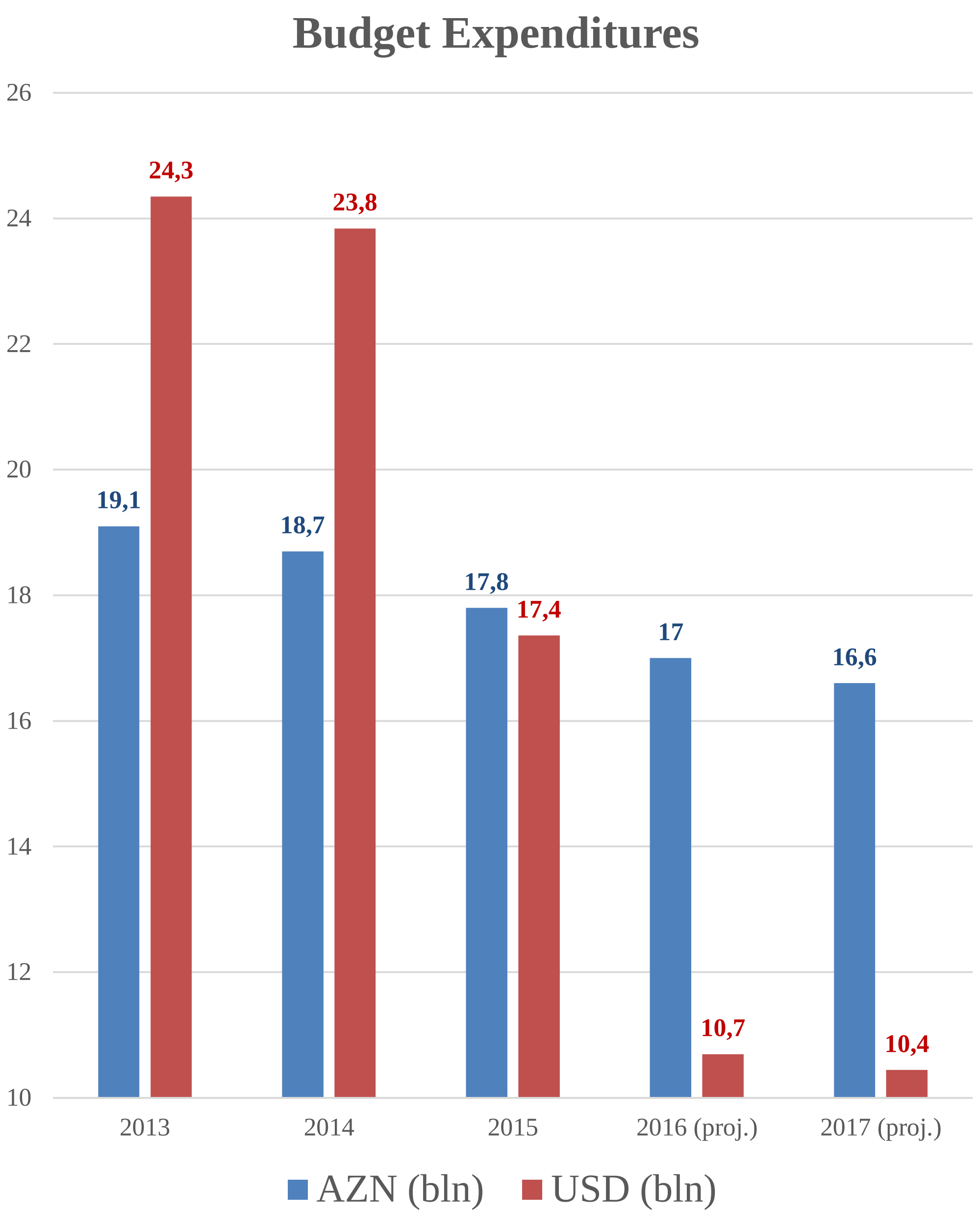
Policy measures taken out by the Authorities in 2016

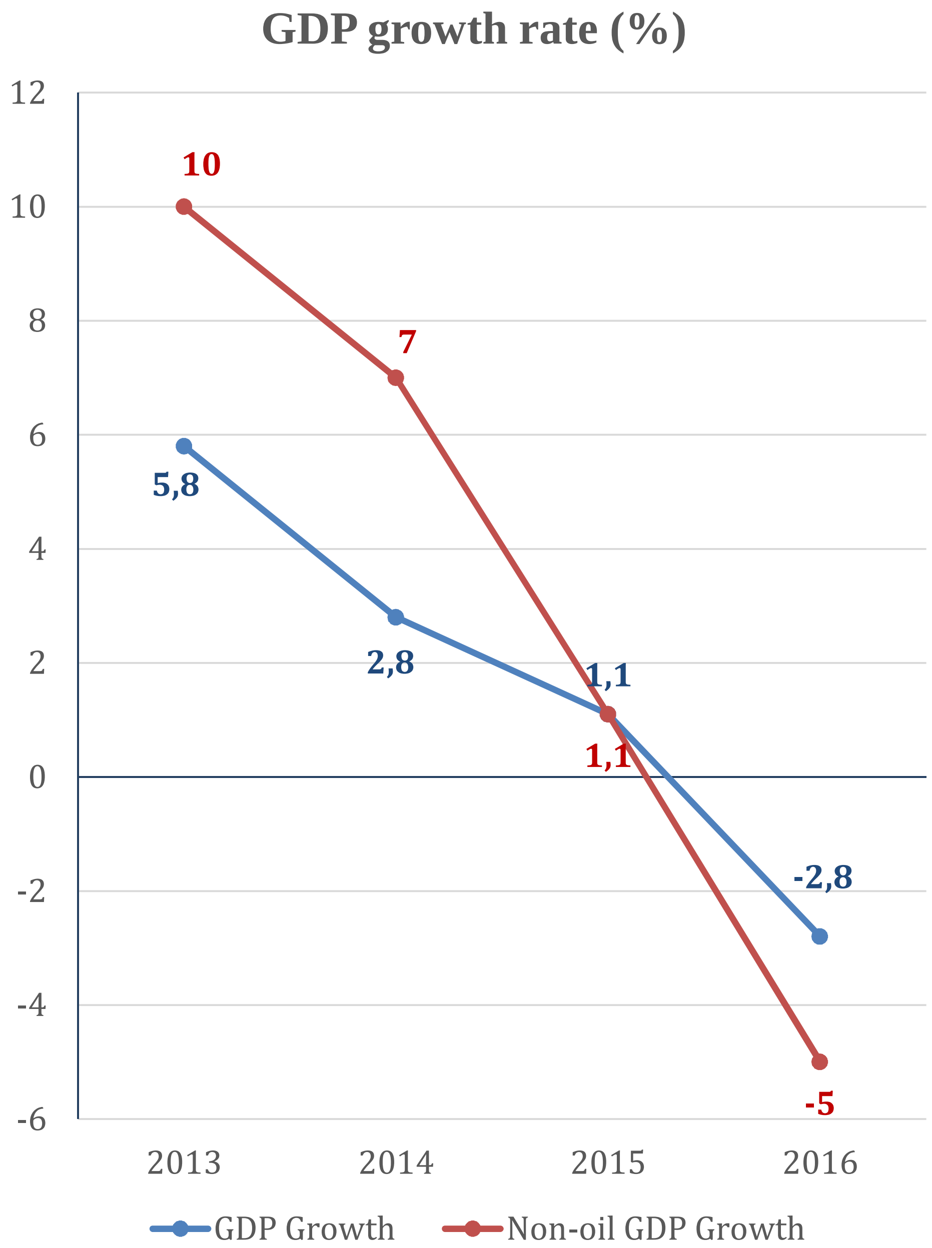
- Macroeconomic adjustment to shift the economy to a new external environment with a low oil price.
  - the transfers from the SOF to the ***Budget reduced by 3 times***. Investments decreased 5 times.
  - the CBA undertook ***two step devaluations*** and shifted to a managed float exchange rate regime in December, which were necessary to improve competitiveness.
  - The government plans to keep the fiscal consolidation in medium term to sustain the deficit at the 2 % level of GDP.
- However, the adjustment led to ***decline in GDP*** which was perceived as inevitable;
- Devaluation caused a rise in ***deposit dollarization***, and further weakened bank and private sector balance sheets, heightened financial stability concerns.
- Given cuts in public investment and stagnant credit activity, non-oil GDP ***declined by 7%*** in 2016;
- Reflecting the devaluation, 12 month ***inflation reached 17%,*** currently.

Transfers of Oil Fund (bln. USD)

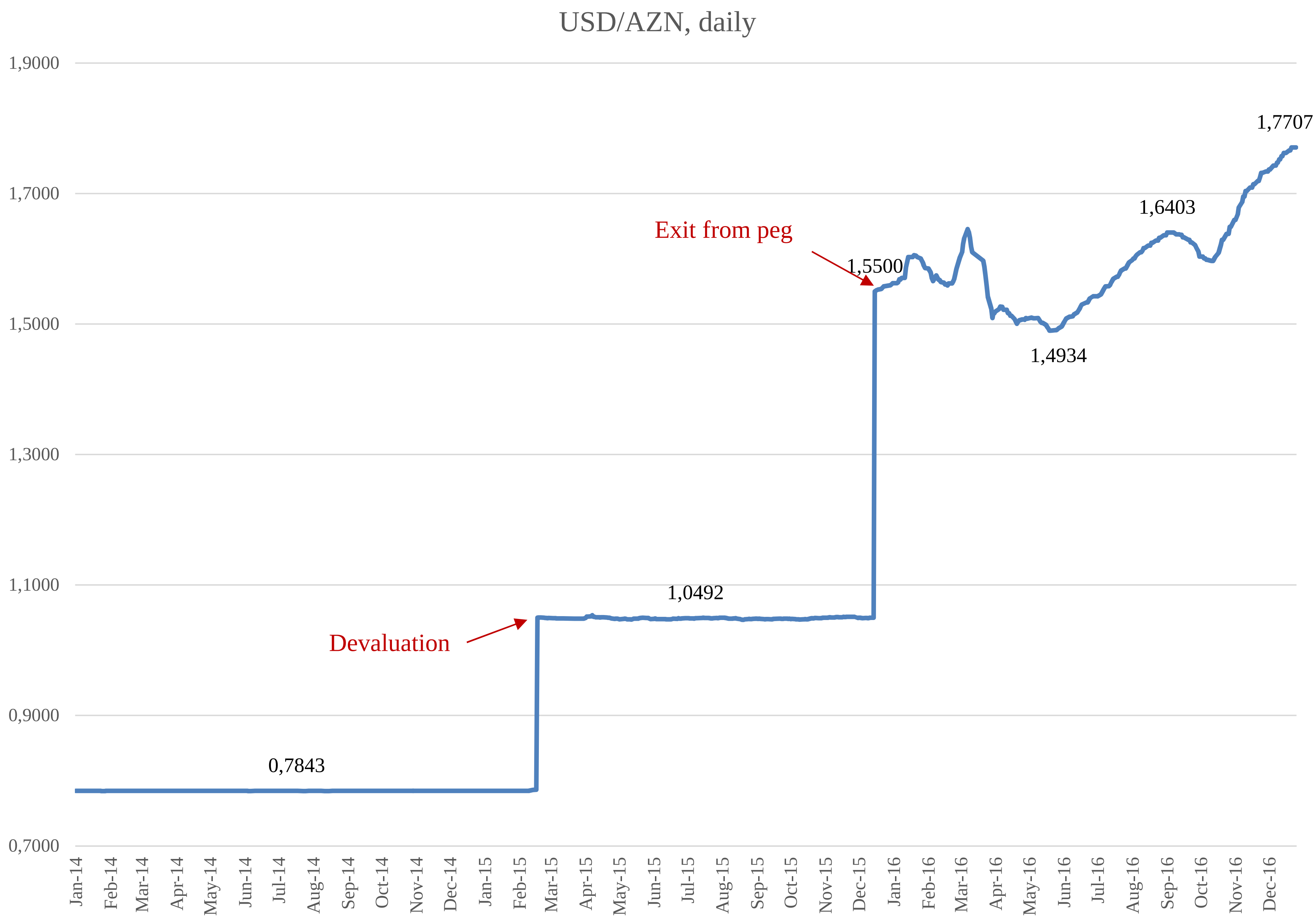


Reaction to oil price decline: *Fiscal consolidation*

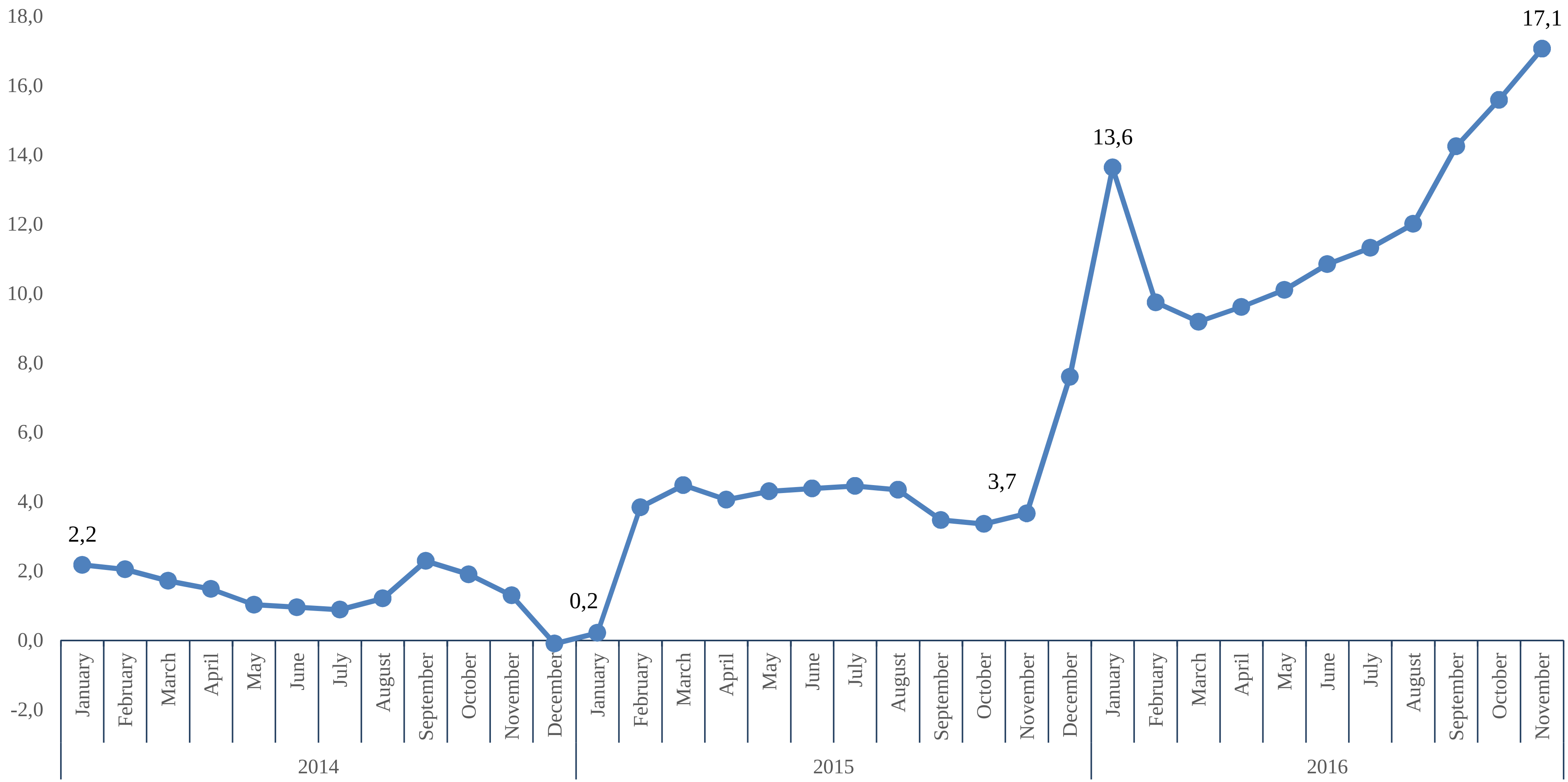




Reaction to oil price decline: *Devaluation and exit from peg*

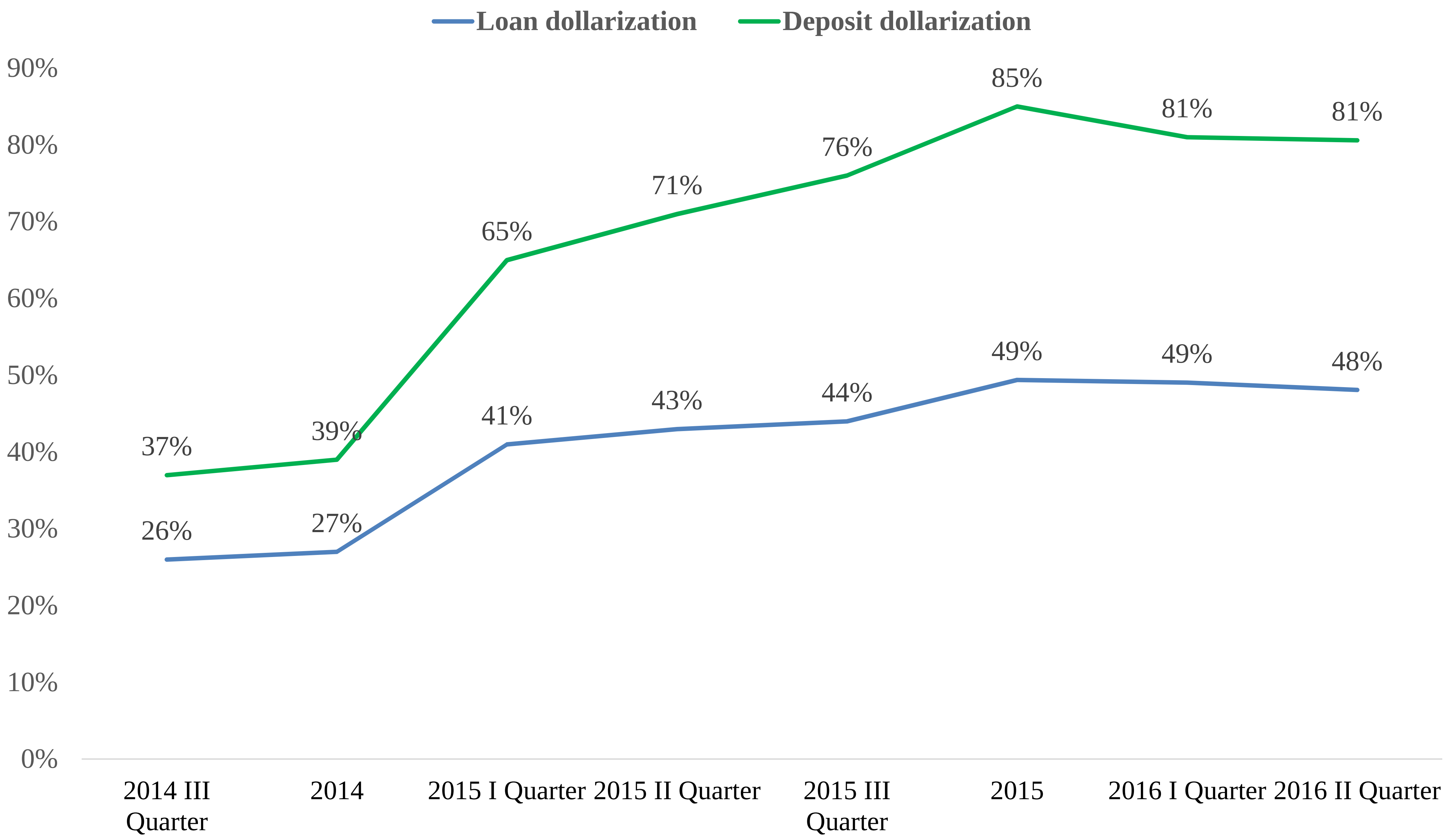


Inflation: *12 month headline inflation*

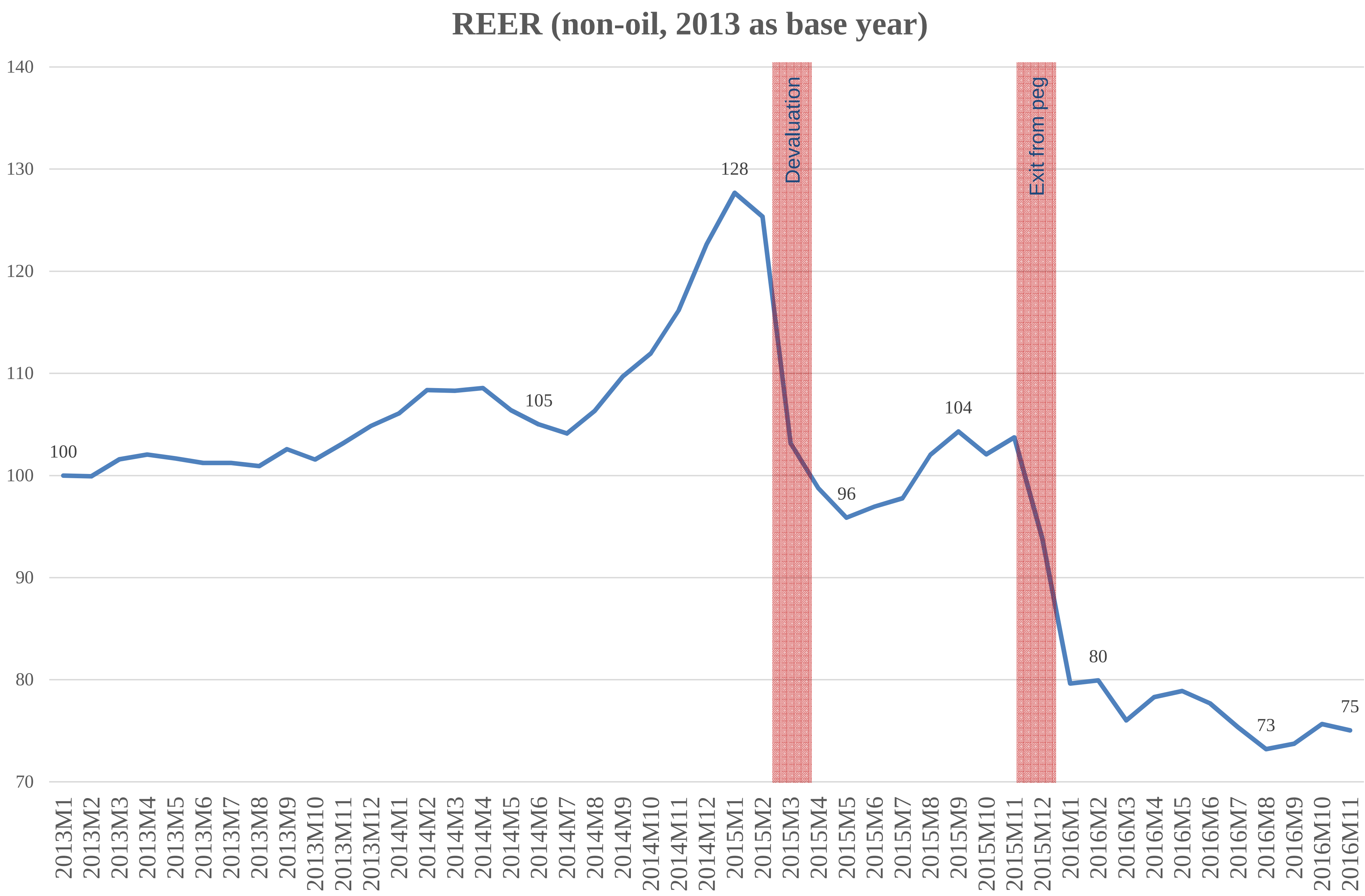


- **Factors affecting the inflation include:**
  - Exchange rate – nominal effective exchange rate depreciated by 55% during the last 2 years;
  - Global prices – global commodity price index and global food price index increased by 17,6% and 8,1% respectively this year;
  - Changes in administrative prices – there have been increases in fees for a number of state services (water, electricity and natural gas rates).

Dollarization level



Real Effective Exchange Rate



Latest policy measures taken out by the Authorities

- As response to the challenges, **The Financial Stability Board** has been established. It has been mandated to create **an action plan to ensure macroeconomic and financial stability**.
- The Borad's action plan was approved by the President at the beginning of the year. It includes:

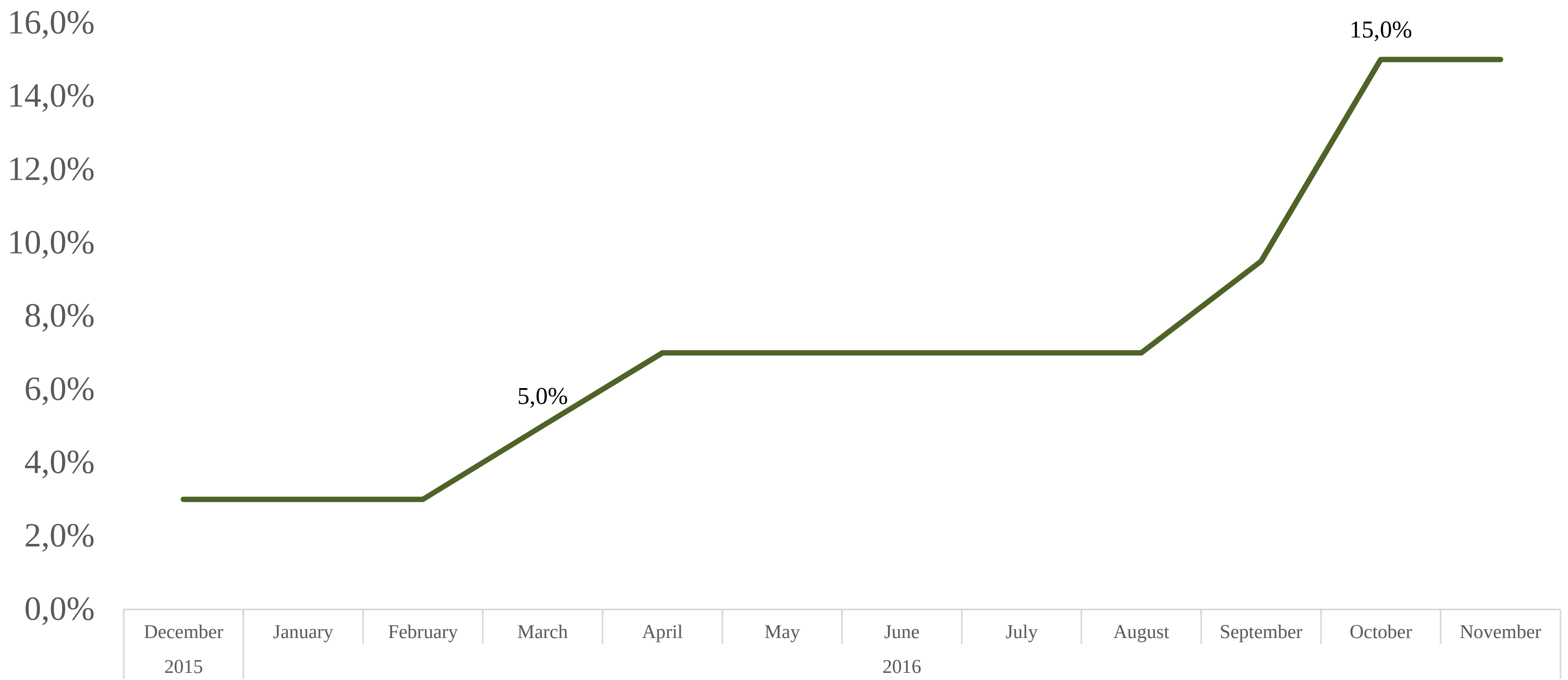
  1) pursuing tight monetary policy by the CBA;

  2) continuation of fiscal consolidation;

  3) pursuing clean up of the banking system;

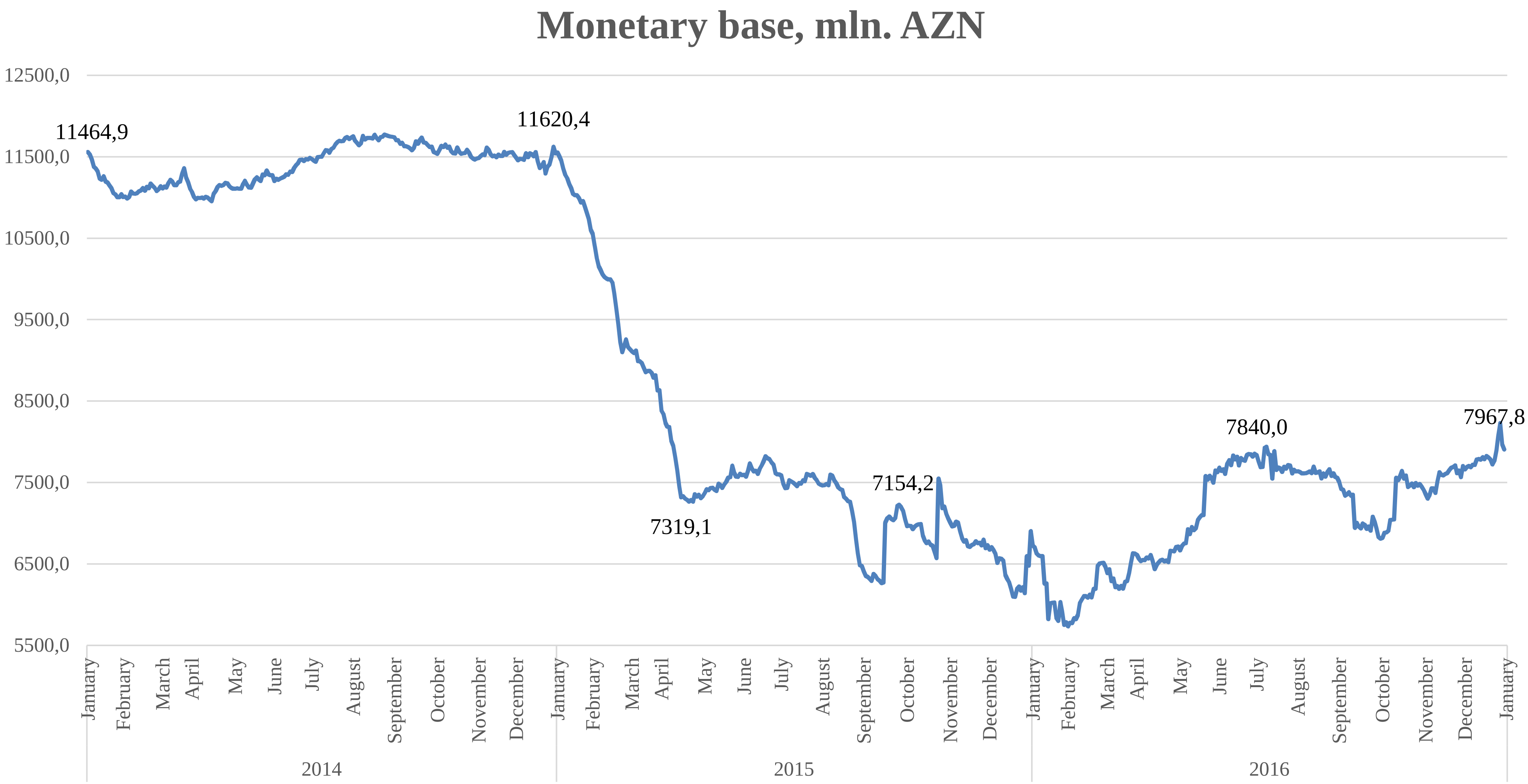
- The CBA moved to **free floating exchange rate regime** and abandoned intervention to foreign exchange market;
- The CBA adopted **monetary targeting regime** as a policy stance, since the correlation between monetary aggregates and inflation was found strong;
- CBA aimed to reduce money supply through its available monetary operations to bring inflation down

Monetary policy instruments



- **CBAR**
  - *rasied the policy interest rate by 3 times within year, to signal economy on tight policy stance;*
  - *introduced deposit auctions;*
  - *and restored note auctions to sterilize excess money in the economy.*

Operational target of Monetary Policy



- Main regulatory government agencies with the FSB (Ministry of Finance, Central Bank, FMSA, Oil Fund) have come to an agreement regarding monetary base target for 2016.

Current debate on Policy stance

Policy making challenges

- Can Monetary aggregates be an appropriate **nominal anchor** to ensure **certainty** in the economy?
- How to find an equilibrium in money market since the **demand for money is not stable**?
- How to predict the **structural break** that usually happen in the linkage between monetary aggregate and inflation?
- Can interest rate be an alternative anchor if **money market is underdeveloped**?
- Some experts believe that alternative monetary policy stance with free exchange rate regime is not able to restore the CBA’s credibility

Policy priorities in the medium term

- **Macro policies will be aligned with the new external environment;**
  - Given increasing risks and persistent ER pressures, the authorities targets an additional 4 pps of adjustment in the ***non-oil primary deficit*** over 2017-18, and another 4 pps in 2019-21;
  - The CBA will continue tight monetary policy stance in 2017 to limit exchange rate and inflationary pressures;
- **The priorities also include:**
  - accelerating structural reforms to foster private sector-led growth;
  - modernizing monetary and fiscal frameworks;
  - quickly restoring confidence in the banking system by closing insolvent banks,
  - restructuring the system, and strengthening the macro prudential framework and the financial safety net.

Smaller economy, but better start for development

Oil price	2014 110 $	2015 54$	2016 40$
CAB (bln. $)	11.4	0.5	-0.25
Oil money transfers (bln. $)	11.9	7.8	4.7
Budget (bln. AzN)	18.7	17.8	18.5
GDP (bln. AzN)	59	54.3	50

Thank you