Monetary Policy Guidelines for 2018

CONTENTS

INTRODUCTION

The year of 2017 has become the dramatic turning point in the social and economic development of the country; grand changes to streamline the processes in all economic networks and macroeconomic development paved the way to purse the monetary policy in consistency with new conditions, to improve it, and to implement specific measures in this area.

From this viewpoint, the Central Bank of Uzbekistan (CBU) took into consideration the option of strengthening the national currency in the new economic reality, mainly by anticipating the lowering of its internal purchasing capacity or the increase in domestic prices and decided to center its monetary policy on the stability of the prices in the economy starting with 2018. On this basis, activities are in progress to respectively amend and modify the Law *On the Central Bank of the Republic of Uzbekistan*.

The eventual goal in this regard was defined as the moderation of the Consumer Price Index (CPI) based inflation growth rate via monetary measures and maintaining it at stable low level.

It should be noted that the slowdown of price growth rates and maintenance of stable low inflation in the future are among the most needed conditions to ensure the medium and long term development. Specifically, the achievement of stable low inflation and relevant expectations would contribute to the increase in long-term investments and formation of underlying funds and resources.

The national economy is expected to grow faster in 2018 against 2017 due to expanding investment activities, improvement of business environment and external trading conditions on the basis of the growing transparency of macroeconomic policy.

At the same time, the plans for the next year include measures to minimize the impact of monetary factors on expected inflation pressure and price growth.

The analysis of international experience and current estimates evidence that certain time would be needed for the adaptation of the economy to new circumstances following the change in prices to be expected in times of dramatic structural changes and turns, related to the liberalization of forex and external activities, and that the inflation pressure stays relatively high during this period.

By taking this into consideration, the CBU would continue pursuing strict monetary policy aimed at retaining the impact of monetary factors on inflation level in 2018.

In the meantime, in cooperation and coordination with the Government and relevant ministries of the Republic of Uzbekistan, measures would be taken to ensure the stability of prices for the purpose of efficiently anticipating the inflation risks; these activities would be based on the approaches, the efficiency of which was proved by best international experience.

This engagement would have its major focus aimed at comprehensive implementation of *Series of Measures for Further Improvement of Monetary Policy and for Staged Transition to Inflation Targeting in 2017-2021* for 2018 and at the establishment of economic and legal basis to effectively ensure the medium and long term stability of prices in the country.

I. ANALYSIS OF MONETARY ACTIVITIES IN 2017 AND EXPECTED END-OF-YEAR RESULTS

1.1. Economic conditions underlying the monetary policy

The national macro-economic environment in 2017 was developing unevenly due to the constant nation-wide implementation of measures to liberalize the economy, liberalization of forex market, more proactive implementation of comprehensive and balanced regional development programs, including high inflation rate.

In particular, the last three years saw the devaluation of national currency in the major trading partners of Uzbekistan and respective strengthening of the real exchange rate; as a result, Uzbek authorities accelerated the devaluation of exchange rate for national currency in 2017 with the purpose of reducing the negative impact on domestic and international competitiveness of domestically produced goods.

The gradual liberalization of external trading activities and economic improvement in major countries-trading partners resulted in the considerable growth of goods and services export in the country to become one of the supporting factors for economic activities in the real sector.

Consequently, the accelerated devaluation of official exchange rate for the national currency in January-August 2017 along with the growing public and corporate expectations following the liberalization of domestic forex market had varying repercussions on economic activities.

Notably, the stepped-up implementation of national and regional social and economic programs, including the implementation of relevantly planned various projects and engagement of the public in business activities lead to more energetic lending activities of commercial banks. This in turn lead to growing supply of the money for the economy and the considerable growth of gross demand in January-June 2017 and respective acceleration of inflation rate.

The forex market liberalization measures in the second semester of the year lead to considerable changes in the macroeconomic conditions, defining the monetary policy.

Specifically, the liberalization of forex market has expedited the intra-bank circulation of the cash from extra-bank sector and fortified the economic foundations for growing efficiency of monetary policy.

1.2. External economic conditions and profile

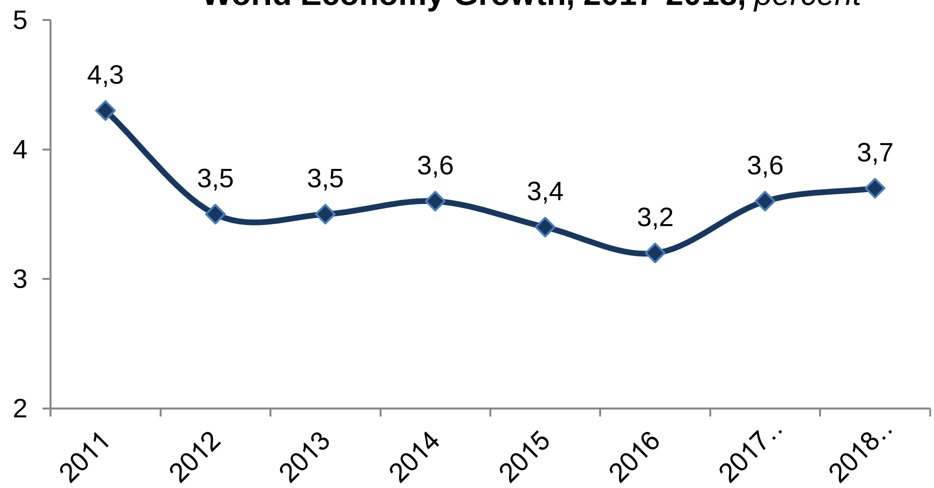
The economic growth recovery at global scale and in Uzbekistan's major trading partners in this year, formation of favorable environment at global markets and liberalization of forex market and external economic conditions, especially efforts to develop the economic ties with neighboring countries are contributing to tangible expansion of Uzbekistan's foreign trade turnover.

1.2.1. Economic profile of Uzbekistan's major trading partners and world as a whole

According to the revised projections of the IMF, the world economy would increase to 3.6 percent in 2017; this is higher by 0.4 percent than in 2016 (3.2 percent).

Diagram 1

World Economy Growth, 2017-2018, *percent*



Source: World Economic Outlook, October 2017 (IMF)

In particular, it is expected that, for the developing economies, the growth rate would go up from 4.3 percent in 2016 to 4.6 percent this year and that the overall growth in advanced economies would increase from 1.7 percent to 2.2 percent.

The current and projected development pace of world economy is driven by the following factors:

- Higher-than-previous year economic activity in large developing countries like Brazil and Russian and in developed countries like US, Japan, Germany, Italy, Canada, and France;

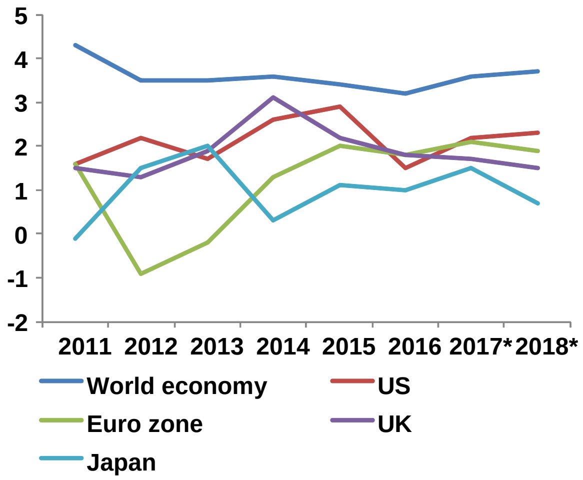
- Positive payback from last year research and technological investments in the world to anticipate negative impacts from lower primary produce prices and global financial crisis and growth of labor productivity in the economy;

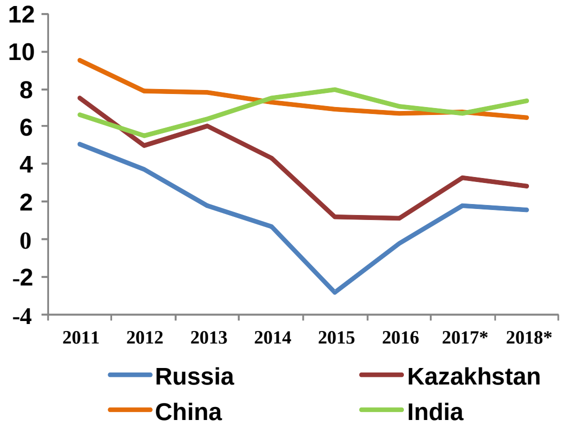
- Stable growth of gross demand in developed and developing economies, further expansion of continuing revitalization in global investment activity, and further growth of international trade; and

- Development of mutual economic ties within the framework of "One Belt – One Road" regional connectivity initiative for Asia and Europe.

Diagram 2

GDP growth in world economy and particular countries, *percent*





*forecast indicators

Source: World Economic Outlook, October 2017 (IMF)

In these conditions, positive changes are also expected in the countries, which are the major trading partners of Uzbekistan. In particular, as of end of 2017, the projects demonstrate the economy growth in Russia to be 1.8 percent after 0.2 percent decline in 2016; the considerable revival in Kazakhstan against the previous year (1.1 percent growth) with economic growth to be 3.3 percent higher by the end of this year.

It is anticipated that the economic growth would also revitalize in China and Turkey and make up 6.8 and 5.1 percent respectively as of the end of 2017.

1.2.2. Dynamics of global prices by major export and import goods

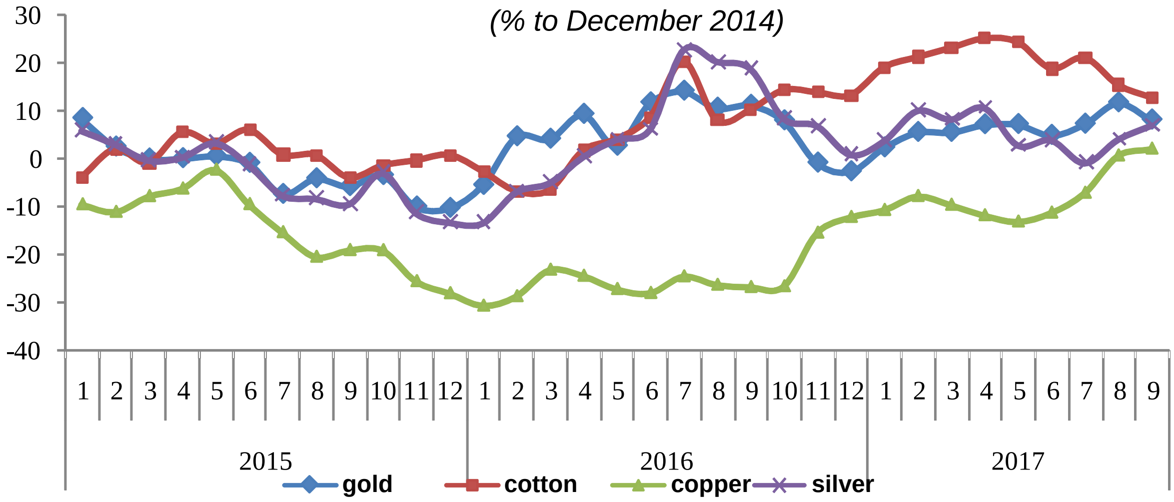
The stable growth in global economy and external demand in the countries, which are the major trading partners, in 2017 defined the positive dynamics of global prices for Uzbekistan.

The downward price trend for commodities on world markets in 2014 slowed down in 2017 and price recovery started. Fuel prices remained intact at world primary produce commodity exchanges whereas the prices for non-ferrous metals upped.

Diagram 3

Movement of price for individual commodities on world markets

(% to December 2014)



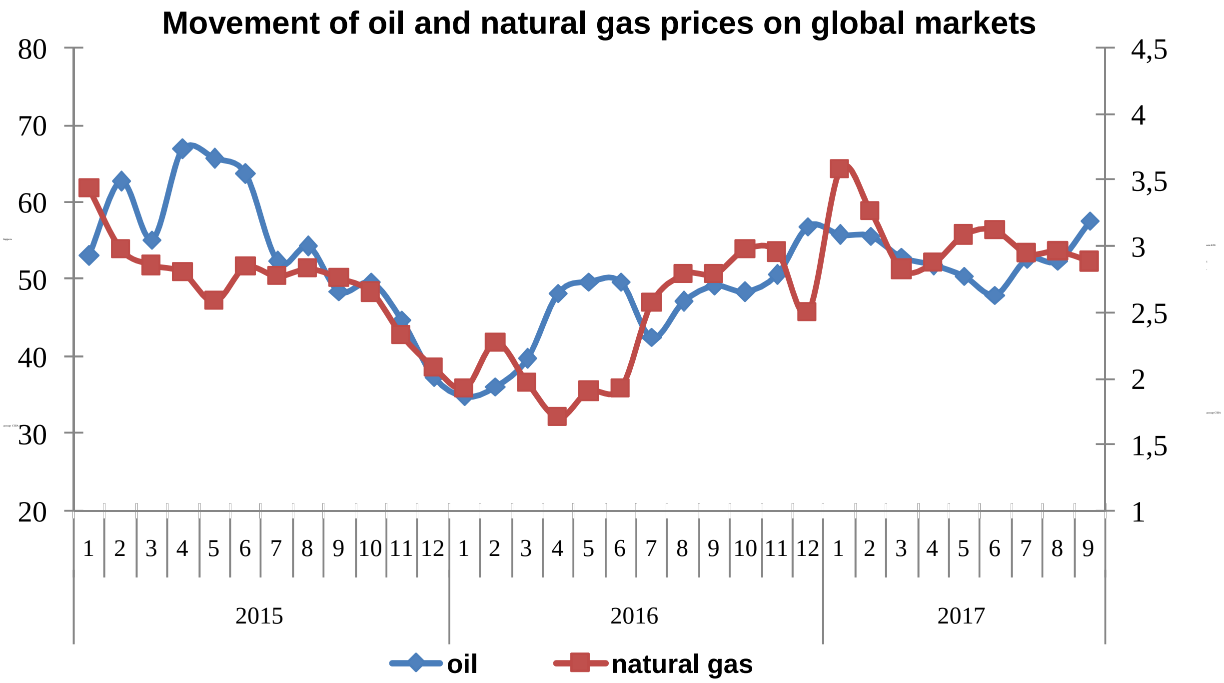
Source: World Bank data

In particular, the copper and gold prices, which are considered to be the major export items of Uzbekistan, increased by 16 and 11 percent respectively against the beginning of the year.

Cotton prices upped in January-May and went down in the second semester, with the result that the prices remained almost intact as compared to the beginning of the year. The prices for foodstuffs, metals, and natural gas steadily remained at a high level.

In its turn, such factors as the growing operations at global financial market, US dollar rate depreciation, and geopolitical risks as well as growing demand for jewelry items in India and China in the first semester of the current year contributed to the growing prices for gold, as a result of which in early September of 2017 gold prices went up to USD1,350 per ounce. On the other hand, the increase in interest rates of the US Federal Reserve System in October resulted in the recovery of dollar value and in gold price to go down to USD1,280 per ounce.

Diagram 4



Source: World Bank data

The reporting period demonstrated two opposite trends in the oil **price movement**.

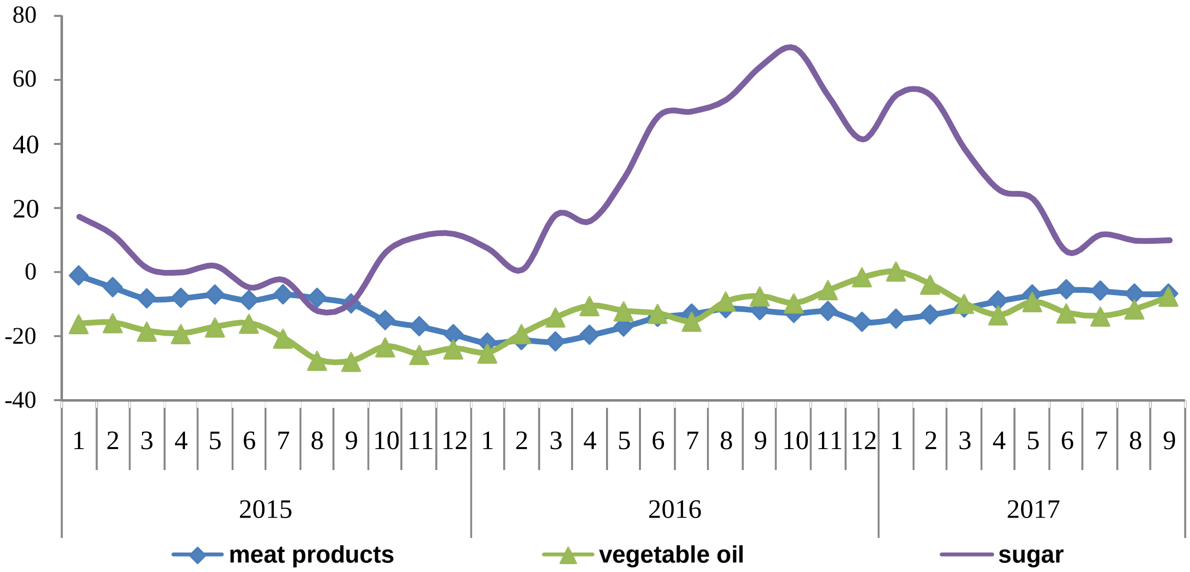
In particular, Brent prices decreased by 15.7 percent in the first semester of 2017. Oil production increase in non-OPEC countries, in particular in Canada, US, Europe, and Latin America, resulted in the higher supply of this commodity at the fuel market and, respectively, in lower prices for oil.

The decision in the third quarter of the current year to extend OPEC+ agreement to March of 2018 and lower oil production in Venezuela and Russia brought to 20.1 percent increase in prices for this product and, according to 9 months, oil prices went up by 1.3 percent as compared to the beginning of the year.

January-September saw the considerable decrease in prices for individual goods imported to Uzbekistan. In particular, world prices for sugar decreased by 22.2 percent and for vegetable oil, by 6.1 percent against the beginning of the year.

Diagram 5

Price movement for meat products, vegetable oil, and sugar at world markets
(*% to December 2014*)



Source: UN FAO data

1.2.3. Major indicators of foreign economic activities

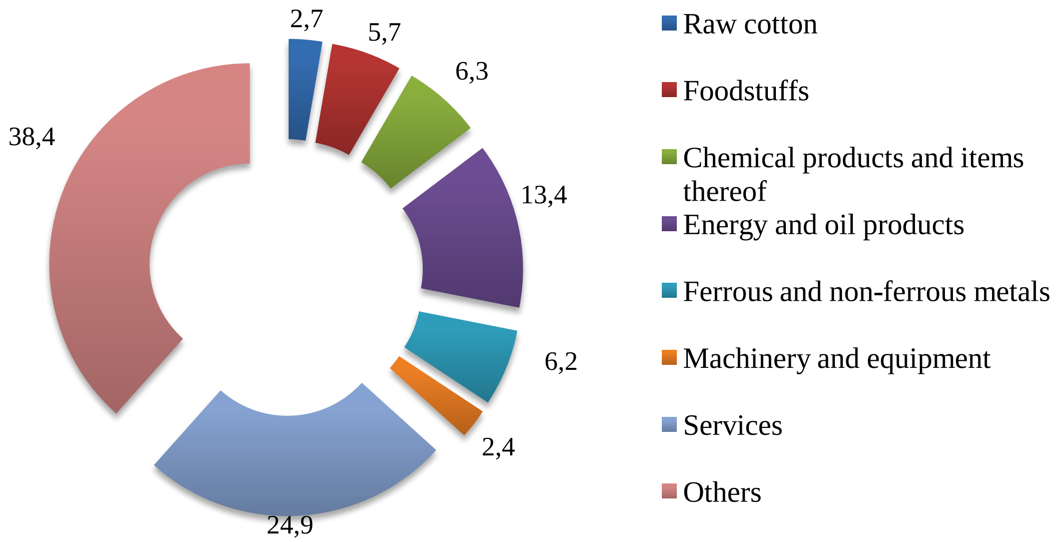
The foreign economic turnover went up by 16.7 percent according to the first 9 months of 2017 against previous year and made up around USD20 billion. That said, the goods and services export grew by 25.6 percent and made up USD10.4 bln whereas the import grew by 8.4 percent and made up USD9.6 bln.

The high export growth was driven by foodstuffs (23.5 percent growth rate and 5.7 percent share in total exports), energy and oil products (11.3 и 13.4 percent), ferrous and non-ferrous metals (24.8 and 6.2 percent), machinery and equipment (60.5 and 2.4 percent), services (10.8 and 24.9 percent). At the same time, the cotton export went down by 18.6 percent (with 2.7 share) with chemical product export to decrease by 2.2 percent (with 6.3 share).

The import growth was driven by growing import of chemical products (5.6 percent growth and 17,1 percent share in total exports), energy and oil products (13.5 and 5.2 percent), machinery and equipment (1.8 and 38.7 percent), and services (22.5 and 7.3 percent). At the same time, the import of foodstuffs decreased by 8.2 percent (10.2 percent share in total exports).

Diagram 6

Export structure according to 9 months of 2017, *percent*



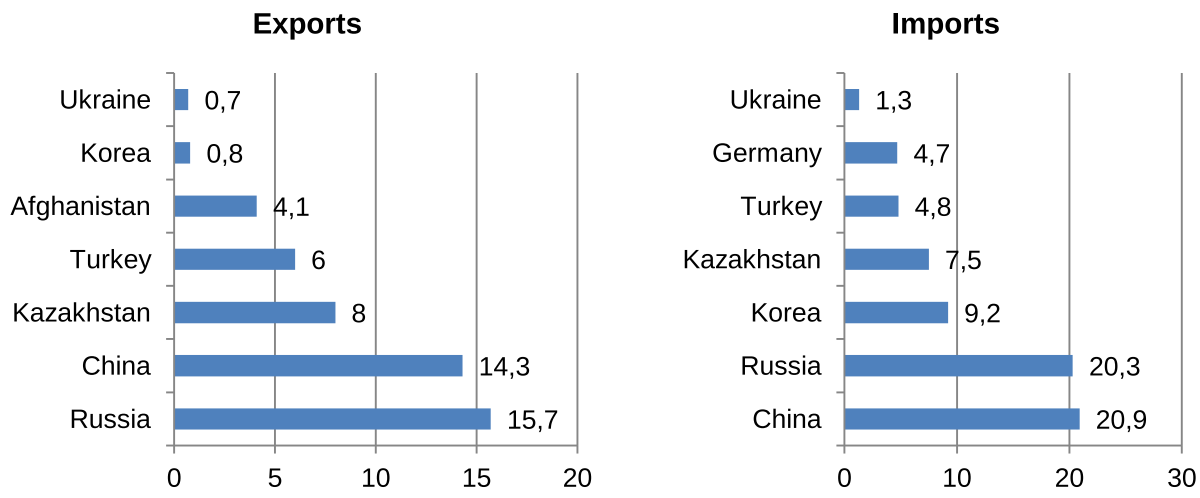
Source: State Statistics Committee of the Republic of Uzbekistan

The breakdown of total exports is as follows: Russia - 15.7 percent; China – 14.3 percent; Kazakhstan – 8.0 percent; Turkey – 6.0 percent; and Afghanistan – 4.1 percent.

The breakdown of total imports is as follows: Russia – 20.3 percent, China - 20.9 percent; Republic of Korea – 9.2 percent; Kazakhstan - 7,5 percent; Turkey - 4,8 percent; Germany - 4,7 percent; and Ukraine - 1,3 percent.

Diagram 7

Structure of export and import operations with foreign trade partners of Uzbekistan in January-September 2017, *%*



Source: State Statistics Committee of the Republic of Uzbekistan

Following the results of 2017, the dynamics of growth in export volumes and the positive balance of foreign trade turnover are expected to continue.

1.3. Inflation

According to the State Statistics Committee of the Republic of Uzbekistan, the inflation rate based on the consumer price index was 9.3 percent in January-September 2017.

The main reasons for the inflationary pressures observed in the first semester of this year were the high rates of lending to the economy, money supply and devaluation of the exchange rate.

At the same time, in the reporting period, along with monetary factors, the level of inflation was significantly influenced by traditional seasonal and supply factors.

The structure of inflation by commodity groups has the prices for food and non-food products growing higher than the prices for services.

In particular, prices for food products rose by 9.4 percent (in 2016 decreased by 2.5 percent), and their impact on the inflation rate was 4.1 percent.

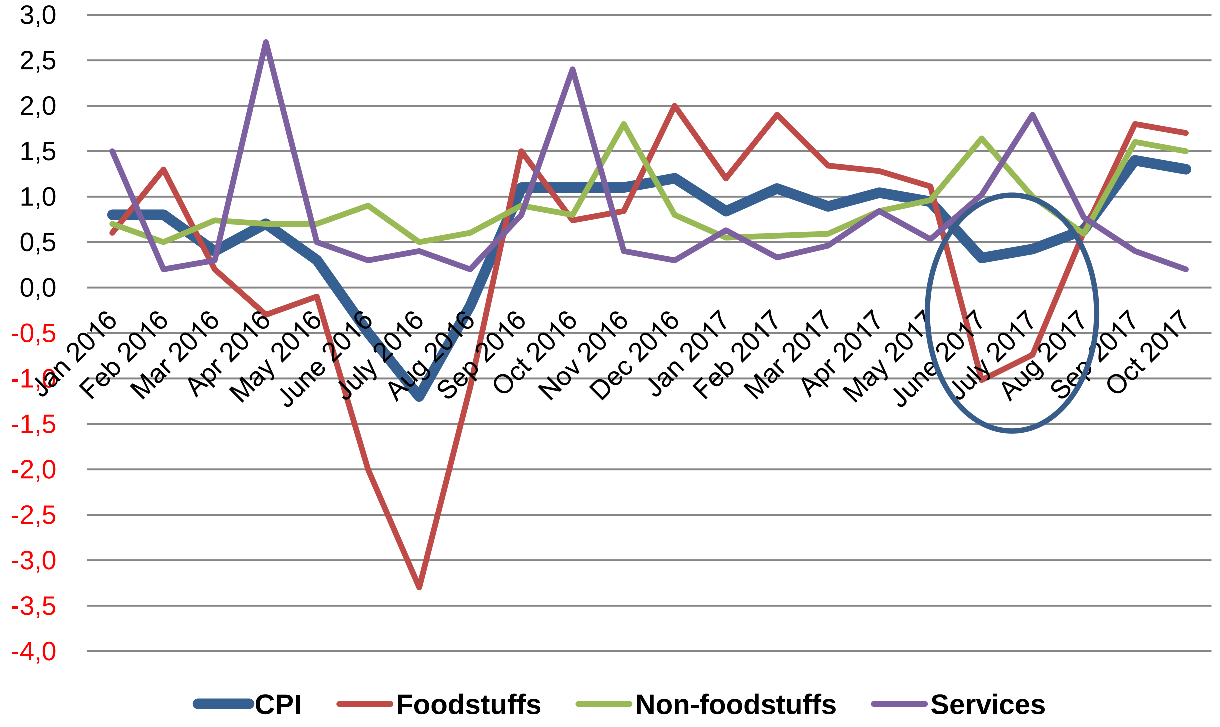
As part of this commodity group, there was a significant increase in prices for beef, lamb, and poultry as well as the certain types of fruits and vegetables influenced by seasonal factors.

At the same time, the rapid increase in the prices of individual food products is associated with the reduction in the production of these goods for various reasons (lower harvest in 2016/2017, crop diseases and pests, instable supply of these goods for the domestic market in winter-spring).

The growing exports of certain food products lead to the decline in their supply for the domestic market. In particular, in January-August, the exports of carrots increased 3 times, apples, 2.3 times, tomatoes, 1.4 times. In addition, the beginning of eggs export in the current year contributed to 10 percent increase in prices for this product in the domestic market.

Diagram 8

Inflation movement, *percent*



Source: State Statistics Committee of the Republic of Uzbekistan

Prices in the group of non-food products increased by 10.3 percent (increase was 7.2 percent in 2016), and their impact on the inflation rate was 3.7 percent. In particular, clothes went up by 10.9 percent, footwear, by 10.2 percent, construction materials by, 10.7 percent, basic household goods, by 11.5 percent, washing and cleaning products, by 11.2 percent, stationary, by 9.5 percent, means of communications, by 10.7 percent. This price increase was mainly influenced by the growth of import prices due to the accelerated exchange rate devaluation.

Tariffs for services grew by 7.2 percent (increase was 9.6 percent tin January-October 2016), and their impact on the general price level was 1.5 percent. In particular, the prices for housing services and utilities increased by 6.8 percent, passenger transport, by 6.9 percent, railway transport, by 17.7 percent, air transport, by 48.2 percent, communications services, by 23.8 percent, services of preschool establishments, by 8.3 percent.

By taking into account the current dynamics of prices in the current year, the year end inflation is projected at the level of 12-14 percent.

1.4. Analysis of monetary policy

1.4.1. Formation and change of money supply in the economy

The actively expanding integrated and proportionate social and economic development programs of the regions in Uzbekistan as well as the growing lending to the economy, including entrepreneurial activities, in the first semester of this year led to the accelerated growth of money supply.

In particular, in the first half of 2017, the balance of aggregate loan portfolio in commercial banks increased by 32 percent, wheras the amount of money supply, by 15 percent.

At the same time, there was an increase in the share of cash in the structure of money supply. The growth of cash in circulation was mainly due to the increase in demand for cash in connection with the timely provision of social and priority payments, as well as disproportionate increase in cash receipts to banks' cash desks due to current problems at the domestic foreign exchange market.

Accelerated growth in lending and cash in circulation resulted in a 2.5 time decrease in liquidity in many banks and in the banking system as a whole in comparison with the beginning of the year.

In this situation, since June 28 of this year, the refinancing rate of the Central Bank has been raised from 9 to 14 percent in order to curb inflationary processes and limit the growth of the money supply as well as optimize the volume of economic lending, the CBU increased its refinancing rate from 9 to 14 percent.

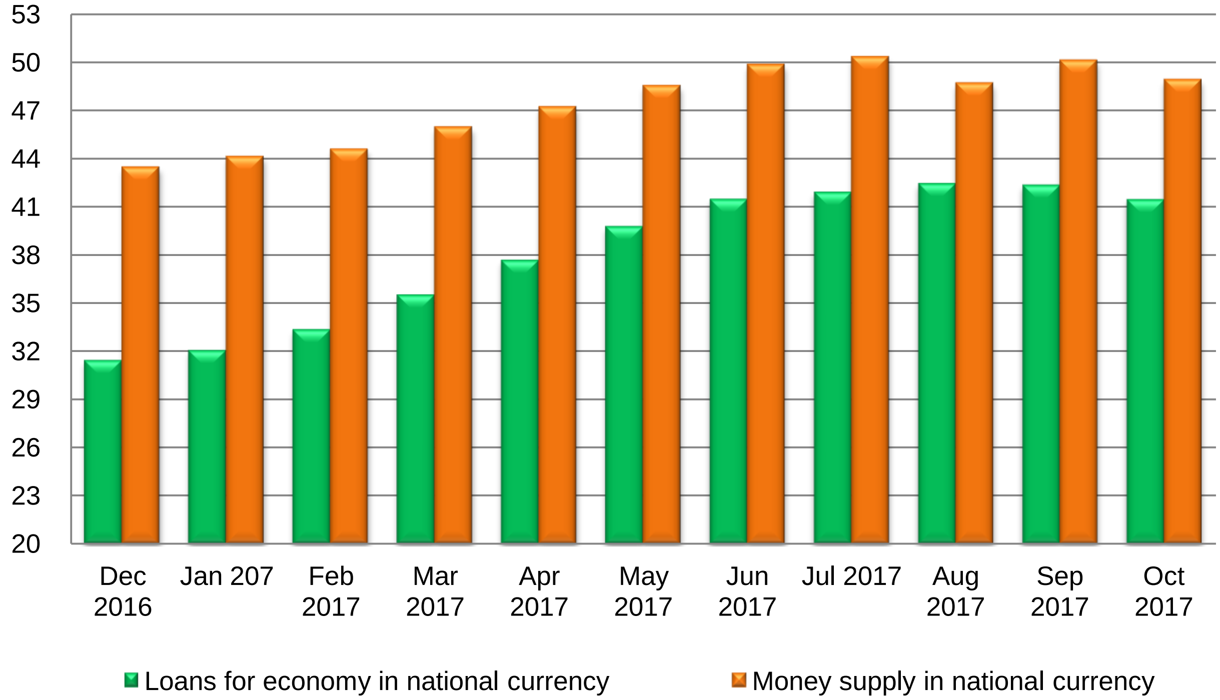
At the same time, in order to prevent the negative impact of quickly growing loan portfolio on the financial profile of commercial banks and banking system in general, banking supervision measures were strengthened in a timely manner.

Toughening monetary and credit policy since July of this year has made it possible to lower the growth rates of lending and money supply as well as to limit the emerging inflationary pressure.

In general, the decline in the growth rates of loans and money supply since July 2017 is indicative of the restraining nature of monetary factors in the second semester of the year.

Diagram 9

Movement in balance of credit exposure and money supply in 2017
(at period end, UZS trln)



In particular, the average monthly growth rate of loan balances and money supply in national currency decreased from 4.7 and 2.3 percent in the first semester of this year to 0.1 and 0.2 percent respectively in July-October. At the same time, in July-October this year there was an increase in lending in foreign currency.

The implementation of the state budget with a surplus as well as increase in cash balances on the accounts of the state budget and extra-budgetary funds for 10 months of 2017 was a factor in restraining the growth of the money supply.

In January-October of this year, the balance of funds in the government accounts grew significantly. This increase was mainly due to the growth in export earnings in national currency and proceeds from the production of precious metals as a result of transition to market mechanisms in the formation of national currency rate.

In general, the anti-inflationary dynamics of the money supply is expected to continue until the end of this year, as a result of which the growth rates of money supply in the national currency would be 17-20 percent by the end of the year.

1.4.2. Analysis of the application of monetary policy instruments

The intensification of CBU operations to provide short-term loans to commercial banks against foreign exchange and the conduct of swap operations have increased the opportunities for effective use of monetary instruments in regulating the liquidity in the banking system.

In particular, the Central Bank issued loans commercial banks in the amount of UZS1.4 trln, including July, UZS689 bln; August, UZS466 bln; and September, UZS262 bln. By taking into account repaid loans in August (UZS131.7 bln), in September (UZS848.9 bln) and in October (UZS313.2 bln), the balance of outstanding loans to commercial banks as of November 1 of this year amounted to UZS84.4 bln.

Repayment of Central Bank loans in September and October of this year is explained by the satisfaction of banks' demand for liquidity through the sale of forex by commercial banks via forex exchange previously used as collateral in the conditions of transition to market mechanisms for the formation of the exchange rate.

The process of lending by the Central Bank for the past period covered 11 commercial banks. At the same time, 62 percent of these operations accounted for the share of systemically important banks, including Xalkqank, Asakabank, Agrobank, Qishloq Qurilish Bank.

In general, the provision of CBU refinancing loans contributed to the increased efficiency of interest channel within the transmission mechanism of monetary policy. This created the conditions for effective influence, primarily on the change in interest rates on the interbank money market; on loans and deposits of commercial banks; and on monetary aggregates; as a result, it helped to gradually reduce the influence of monetary factors on inflation in the economy.

At the same time, the revitalization of these operations has enabled to timely meet the demand for short-term liquidity on the part of the banking system and support the stable operation of the payment system..

Interest rates of the Central Bank on operations with commercial banks

CBU loan type	Term	Interest rates
Loans provided against foreign currency at fixed interest rates	Up to 1 month	At the refinancing rate (14%)
	Up to 2 months	Refinancing rate + 0.25 percentage points
	Up to 3 months	Refinancing rate + 0.25 percentage points

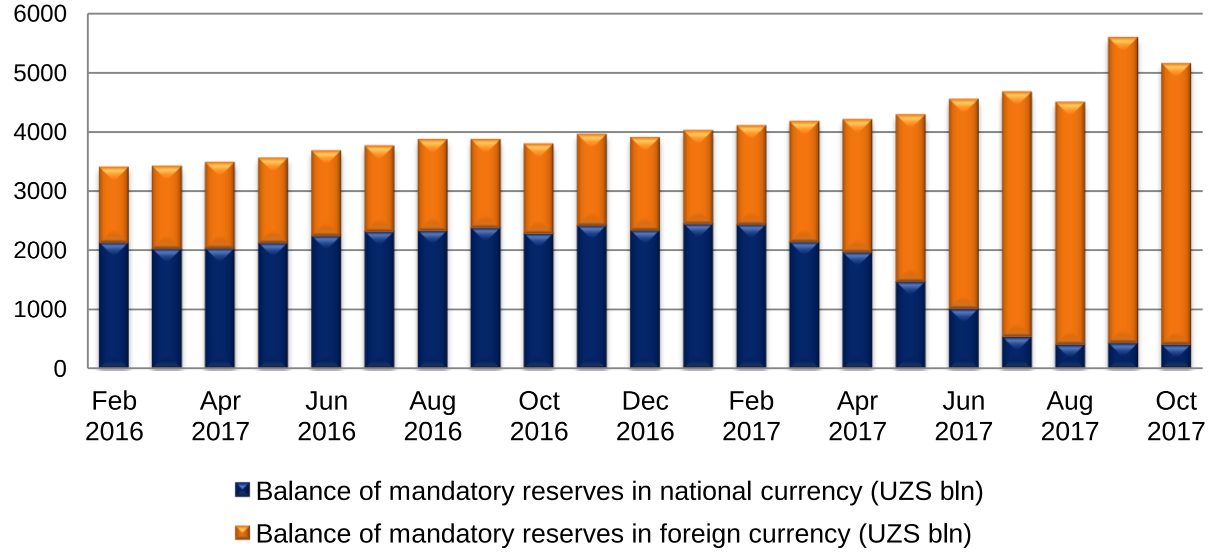
At the same time, based on the current situation in the economy and the monetary sphere, while regulating the liquidity of commercial banks, the instrument of mandatory reserves was also used flexibly.

As of November 1, 2017, the mandatory reserves balance of commercial banks in the Central Bank has increased by 32 percent since the beginning of the year (from UZS3.9 trln to UZS5.2 trln). This growth is explained by the real growth in the deposit base of commercial banks and by the increase in the UZS equivalent of deposits in foreign currency.

The specific weight of all funds in national currency in the structure of mandatory reserves decreased from 60 percent at the beginning of the year to 8 percent as of November 1 of the current year. This, in turn, reflects the continued high demand from commercial banks for liquidity in national currency and shows that this instrument served as one of the main sources to cover the liquidity deficit in UZS.

Diagram 10

Balance movement of mandatory reserves



1.4.3. Analysis of interest rates and interbank money market

The decrease in the volume of liquidity in commercial banks, in turn, led to an increase in the volume of operations to raise funds in the interbank money market.

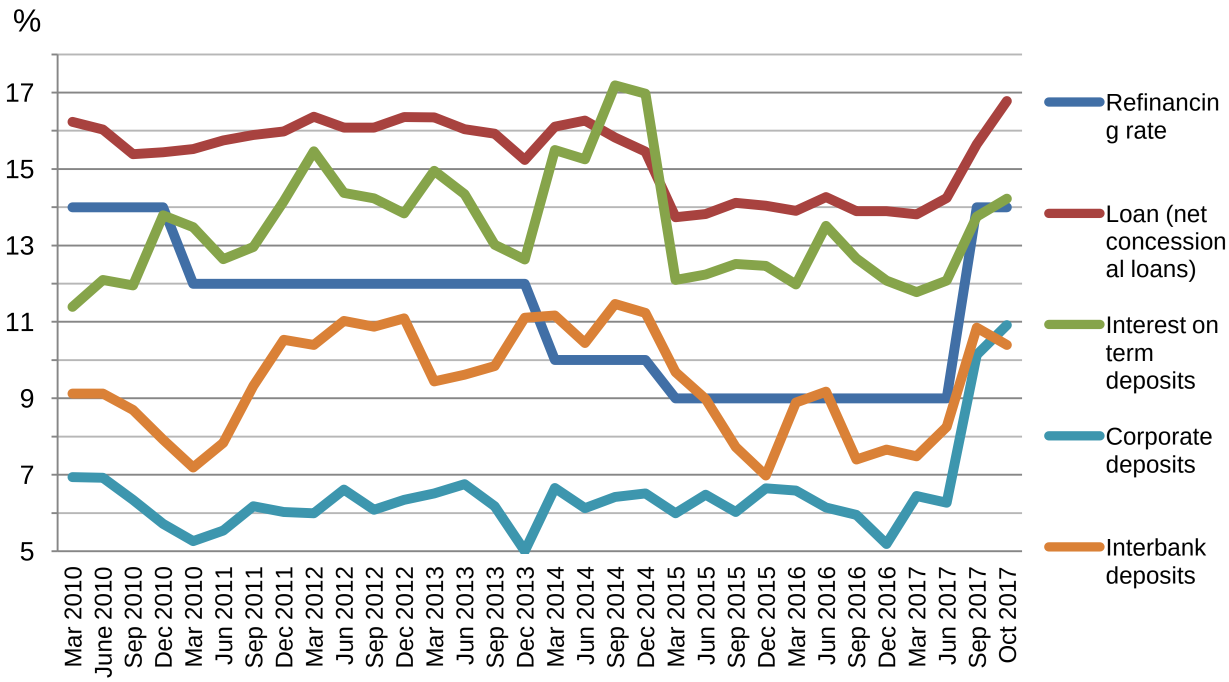
In particular, the volume of operations in the interbank money market in January-September of this year increased 1.9 times compared with the corresponding period of the previous year and amounted to UZS7.1 trln. At the same time, in May alone the volume of transactions increased 4.5 times compared to the corresponding month of the previous year and amounted to UZS1.2 trln.

Due to the increased refinancing rate, the average interest rate on the interbank money market grew in January-June from 7.9-9.2 percent to 12 percent in July and 12.2 percent in August. At the same time, due to the improvement of liquidity in commercial banks, the weighted average interest rate fell to 12.1 percent in September and 11.75 percent in October. That said, the interest rates on operations on the interbank money market amounted to 11-14.5 percent in October.

In turn, there was an increase in the interest rates of commercial banks. In particular, the weighted average interest rate on bank loans allocated in 2017 (excluding concessional loans) increased in the first half of the year from an average of 14.1 percent to 16.8 percent in October of this year.

Diagram 11

Movement of bank interest rates in 2010-2017



The increase was also observed in the dynamics of interest rates on deposits. If in January-June 2017 the average weighted interest rate on time deposits of legal entities and individuals was 11.9 percent, this indicator to 12.9, 13.5, 15.2 and 14.2 percent, respectively, in July-October amounted. At the same time, the increase was mainly due to interest rates on term deposits of legal entities. In particular, interest rates on these deposits increased from 6.4 percent in July to 9.8 percent in August and 11.4 percent in September, with going down to 10.9 percent in October.

This dynamics is also due to the impact of relations between changes in the liquidity of the banking system and interest rates.

The above increase in interest rates on loans and deposits was mainly due to an increase in interest rates on short-term resources.

Interest rate changes were also affected by such factors as decrease in liquidity in banks and reduction in the volume of transactions between commercial banks in the interbank money market.

1.4.4. Analysis of forex market

The introduction of market mechanisms for the formation of the exchange rate and liberalization of the domestic foreign exchange market after September of this year have created an important basis for implementing cardinal positive changes not only in the monetary sphere, but also in the economy as a whole.

In particular, these reforms help resolving the accumulated problems in the sphere of monetary circulation, attracting money from the banking system into the banking system, and, most importantly, increasing the efficiency of monetary policy.

In its turn, the formation of the exchange rate based on market mechanisms, i.e. current supply and demand, serves to build an effective mechanism for the allocation of foreign exchange resources in the economy.

In September-November 2017, commercial banks bought foreign currency funds from households in the amount of about USD730 mln. Given that these funds were previously in circulation on the informal market, they serve as an additional source of supply on the forex exchange.

In general, in September-November 2017, the average volume of transactions on the forex exchange increased almost 1.5 times, and the volume of sales of forex earnings on the part of exporters grew more than 2 times compared with the average index of the first semester of 2017.

Given that the bulk of foreign trade transactions is carried out in US dollars, it was UZS to USD exchange rate that was used as operational target when determining the exchange rate of UZS against other currencies.

The movement in the exchange rate against the US dollar reflected the dynamics of total supply and demand in the foreign exchange market at this stage.

In particular, as a result of excessive supply against demand at the domestic forex market, the rate of fixing sessions increased from UZS8,110/USD1 to UZS8,054/USD1.

In October and November of this year, the dynamics of supply and demand was volatile. In particular, in November of this year, due to the relatively large volume of demand for foreign currency, the UZS exchange rate went down to UZS8099 per 1 USD.

Relatively small fluctuations in the dynamics of UZS exchange rate (in the region of 1 percent) in the last three months have a positive effect on the formation of stable expectations regarding the exchange rate in the economy and increased volume of deposits and investments in the national currency.

In this case, the higher return on deposits in the national currency compared to deposits in foreign currency is reflected in the stable growth of household term deposits in the national currency. In particular, in September-November of 2017, the increase in the volume of these deposits was 13 percent.

2. MONETARY POLICY FOR 2018

The monetary policy for 2018 is aimed at comprehensive implementation of action program following from the *Series of Measures for Further Improvement of Monetary Policy and for Staged Transition to Inflation Targeting in 2017-2021* for the next year, at the anticipation of gradually growing inflation pressure and risks during economic reforms, and at the establishment of economic and legal basis to effectively ensure the stability of prices in the country.

2.1. Prospects of national economic development in 2018

The major drivers for national economic development in 2018 would include the liberalization of FX market and foreign trade along with the improvement of national investment and business climate by further deepening subsequently.

In particular, the expected economic growth rates in the world and in countries considered as major trading partners should revitalize and contribute to the improvement of economic growth conditions of Uzbekistan.

International experts are positively assessing the economic prospects of Uzbekistan's major trading partners in 2018.

Particularly, the projections show the growth in Russia and Turkey and its contribution to higher domestic and international demand thereof. The major element to define the faster economic growth includes the commissioning of new oil fields and respective oil production increase in Kazakhstan.

The 2018 growth in China is likely to be 6.5 percent with some slowdown in 2018.

At the same time, some uncertainties remain in the global economy, i.e. those related to political changes in the USA and UK and other geopolitical and financial risks.

In general, available projections show the economic growth rate in 2018 being equal to 5.5 – 6.0 percent, the surplus of the State budget, and surplus in national BoP, in particular regarding the current account.

The BoP and current account surplus, in turn, would be contributing to the further strengthening of Uzbek Soum exchange rate.

Inflation risks and expectations in economy in 2018

The next year projections demonstrate the persistence of some inflation pressure and price growth, especially driven by non-monetary factors.

In particular, these are the following:

a) Adaptation of domestic prices to international ones following the liberalization of foreign economic activities;

b) Growing prices for energy products, in particular, for gasoline, diesel fuel, and electricity, following the growing production costs in market conditions, including on required imported resources;

c) Growth of such factors as salaries, wages, pensions, and other social payments could also result in the growth of 2018 inflation rate at a relatively higher rate.

Specifically, the potential driver for inflation pressure could be the relatively faster expansion of investment needs resulting from the implementation of the other programs, aimed at the regional development and national socio-economic development, and stepping up of construction activities in 2018.

It is expected that inflation risks would grow in the economy in 2018 under the influence of external factors. *Inter alia*, the higher pressure on domestic price sustainability could come from positive prospects emanating from the growth of external demand on the side of major national trading partners of Uzbekistan, export growth backstopped by invigorating competition of domestic manufacturers following the liberalization of forex regime, growth of foreign remittances, and increasing external capital inflow.

It should be noted that, the application of internationally established fixed weight method would contribute to relative variation in inflation rates as compared to previous years, when defining the 2018 inflation rate.

With consideration of the aforesaid, the present-day conditions and forecasts show that 2018 inflation growth rate would be higher against current year and that the annualized inflation would make up 11.5-13.5 percent.

In this context, the Central Bank would undertake all necessary steps to reduce the inflation rate as much as possible to one-digit figure with short timelines.

In this respect, the Central Bank plans to preserve the refinancing rate in 2018 with due consideration of inflation expectations and risks.

2.2. Objective and tasks of monetary policy in 2018

The monetary policy of 2018, as mentioned before, would be pursued in the context of relatively high inflation expectations in the economy.

In this light, the implementation of monetary policy in the next year would focus on minimizing the impact of monetary factors on inflation and hence promoting the required conditions for ensuring the stability of prices.

By taking into account the degree of interconnection of inflation rate with the broad money and exchange rate in present-day development of country's economy and banking and financial system, the "broad money variation" would be used as intermediary target for the monetary policy.

At the same time, for the purposes of reducing the inflation pressure, the liquidity and broad money would be subject to proactive and adaptive implementation of monetary instruments.

In particular, the strict monetary policy would provide for maintaining the positive real interest rate in the economy and reducing the volatility of exchange rate as following from internal factors.

The achievement of these objectives would rely on relevant actions aimed at improving the efficiency of monetary policy and relevant instruments.

2.2.1. Forecast parameters of monetary policy in 2018

The growing demand for cash driven by the inflation rate, projected for 2018, and anticipated economic growth projects the growth of broad money by 12-15 percent in the next year. Meanwhile, the balance of loans to the economy is also expected to grow at the same pace.

In its turn, the projected fiscal surplus would help to anticipate the gradual increase in the broad money.

The growth of broad money could accelerate due to the lasting surplus of BoP current account (2.5-3 percent against GDP) and growing international credit lines and foreign investments.

In this context, the CBU would be constantly analyzing the alterations in the broad money with breakdown by structure and factors and concentrating on understanding the particularities of every factor paving way for the growth of broad money.

2.2.2. Measures to raise the efficiency of monetary policy in 2018

The efficient containment of the inflation requires the actions, aimed at raising the efficiency of monetary policy and instruments; these actions include the activities to solidify the required economic and legal foundation, assisting in medium-term staged transition to inflation targeting regime.

The underlying element for these actions in the first quarter of 2018 is the detailed *Medium-Term Framework of Monetary Policy Improvement and Implementation* Roadmap, defining the transition to inflation targeting regime in 2018-2021.

The Framework accounts for changes in internal macroeconomic factors and external conditions with the aim of pursuing the efficient monetary policy and highlights the practical approaches of the CBU providing for enabling conditions to improve monetary instruments and improving the efficiency of transmission mechanism thereof.

In particular, the activities for improving the monetary instruments in 2018 would be aimed at the refinement of reserve mandatory requirements in consistency with the new economic realities and requirements, raising the significance and impact of monetary operations, and ensuring the equilibrium of monetary and fiscal policies.

At the same time, the efficient prudential banking supervision for ensuring the financial sustainability and resilience of the banking system would be considered as one of the required conditions to increase the efficacy of monetary policy.

From this viewpoint, the betterment of banking supervision practices on the basis of international experience and standards, including the streamlined competitive environment and the further wide scale introduction of market mechanisms in lending activities of the banking system would assist in raising the trust to the system and efficiency of monetary policy.

Improving interest rate instruments of monetary policy

The Central Bank would energetically use the market instruments of monetary policy in regulating and managing the liquidity of commercial banks.

In this light, by considering international experience and specific features of the national banking system, more ambitious actions would be taken to introduce new liquidity instruments and improve the existing instruments for commercial banks.

In particular, for reducing the inflation pressure as following from possible excess liquidity in the banking system, the CBU plans to improve and expand of operations to deposit the idle cash of commercial banks.

The implementation of these actions would enable to increase the efficiency of CBU interest bearing instrument and form the “interest gap” on monetary operations according to future plans.

Domestic market operations

The Central Bank would closely coordinate with the Ministry of finance in 2018 to issue government securities with the view of stepping up the open market operations.

The CBU would further draft and adopt a number of regulations in 2018 for improving its operations. In particular, the plans include the improvement of legal framework for swaps and other operations.

Improvement of cash market activities

It is planned to launch a single electronic platform for the interbank resource market, supplying the short-term liquidity, in 2018.

These activities would enable the interest rates to be formed on the basis of market mechanisms by relying on consolidating information on idle cash in commercial banks at single platform and clear cut monitoring of interest rates for market players.

At the same time, the single electronic platform would help in expanding the capacity of instant impact on short-term interest rates via CBU market operations and reinforcing the effect of interest channel transmission mechanism.

Requirements to mandatory reserves

It is planned to improve ratios and requirements to mandatory reserves with the view of further reinforcement of efficient liquidity management in the banking system in 2018.

From this viewpoint, the CBU plans to revisit the formation of mandatory reserves for commercial banks on the basis of best international practices next year.

FX policy

The implementation of FX policy would center on the formation of exchange rate on the basis of market mechanism and the minimization of CBU involvement in the forex exchange activities.

In this light, the interventions of CBU would be based on the maintaining the “neutrality of gold reserves” and would aim at “sterilizing” the broad money and additional liquidity resulting from purchase of monetary gold.

When pursuing the exchange rate policy, the above approach would comply with the requirements of truly volatile exchange rate and would enable the exchange rate to function as “internal automatic stabilizer” for the economy.

Increasing the transparency and improvement of communication system

The new reality makes the results of monetary policy closely interweaved with the efficiency of communication channels and the extent of influence on public and corporate expectations of inflations in numerous ways.

By considering this, the CBU would be increasing the transparency of its activities and would pay special heed to communicating the underlying drivers and main points of adopted regulations to the general public and businesses via mass media and electronic media; and to pursuing appropriate awareness campaigns on the analysis of inflation drivers and on the activities, aimed at the anticipation of inflation risks

Reinforcing analytical and forecasting capacity

The introduction of medium-term inflation targeting in 2018 drives the need to reinforce the analytical and forecasting capacity of the CBU and its constant improvement on the basis of up-to-date standards.

In particular, the stepping up of the following activities would take place in the next year: analysis of banking system liquidity and inflation with breakdown by relevant factors; implementation of current BoP statistics methodology; and improvement of forecasting instruments to be used for modeling monetary indicators.

In this context, the CBU would be assessing and analyzing the inflation expectations in the economy with the view of comprehensively surveying the inflations risks, developing the monetary policy, and ensuring the efficient implementation progress, starting from the upcoming year

The CBU plans to further improve the interaction with the Government in what concerns the deep examination of pricing processes in the economy, including the preemptive identification of inflation risks driven by non-monetary factors and the reduction of their impact on the stability of prices.

Cooperation with international financial institutions (IFI)

The CBU would closely cooperate with IFIs and other Central Banks with the view of taking its monetary policy to a new qualitative level.

The particular plans for 2018 include the attraction of the special TA mission from IMF and expansion of exchange and best lesson learning contacts with foreign Central Banks with the view of improving monetary policy and strengthening the role of monetary instruments, analyzing and forecasting the liquidity of the banking system, and adding value to open market operations.

2.2.3. Potential risks for the performance of monetary policy

The higher-than-expected fiscal expenditures, in particular, the harm potentially arising from overspending under social welfare programs at national and local level, could result in higher-than-expected variations of liquidity in the banking system and broad money in the economy.

At the same time, the achievement of projected growth targets, infrastructure development and growing size of construction activities could result in higher import requirement and hence in devaluation of national currency along with some increase in inflation pressure.

At the same time, even if these circumstances materialize, it is planned to prohibit the fundamental factors and drivers underlying considerable devaluation of projected current account surplus

The improvement of external environment could result in the faster growth of soft external assets in the banking system and additional growth of money supply.

Meanwhile, this development could support the further inflow of extra-bank cash, available in the economy, in the banking system and growth of money supply.

As mentioned before, the liberalization of foreign trade and the growing salaries/wages and energy prices are assessed as potential contributors to continuing inflation pressure and lower efficiency of monetary policy.

As a whole, the improvement of CBU analytical framework and monetary instruments coupled with the progress in creation of conducive environment would expand the capacity to conduct reviews of all processes in the economy including comprehensive understanding of price formation; forecast the prospects of economic developments; and take relevant efficient reaction measures

In the meantime, the harmonized implementation of activities falling under the domain of monetary policy would help to minimize the impact of the above risks on economic growth and monetary targets in 2018 and would assist in sustaining the macro-economic stability in the country.