THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

January – September 2015

The main goal of the publishing this review is to present current macroeconomic state analyses and expectations of the Central Bank of the Republic of Azerbaijan (CBA). Another goal of the present publicly disclosed review is to regularly deliver to the public possible impacts of the policy pursued by the CBA on the economy. The review is disclosed to the public four times a year.

Baku – 2015

TABLE OF CONTENTS

ACRONYMS

Executive summary

I. Global economic environment and the external sector **5**

1.1. Global economic trends 5

1.2. International commodity markets 10

1.3. Global financial markets and investment flows 12

1.4. Azerbaijan's external sector developments 14

II. Macroeconomic processes in Azerbaijan **18**

2.1. Aggregate demand 18

2.2. Aggregate supply and employment 22

2.3. Inflation 26

III. The monetary and exchange rate policy **29**

3.1. The FX market and the exchange rate of Manat 29

3.2. Monetary policy tools 32

3.3. Money supply 35

IV. Economic outlook 37

4.1. Global economic outlook 37

4.2. Macroeconomic prospects on Azerbaijan 42

Graphs and tables

ACRONYMS

CBA	The Central Bank of Azerbaijan
ADB	The Asian Development Bank
APPI	Agricultural Producer Price Index
EBRD	The European Bank for Reconstruction and Development
ILO	The International Labor Organization
IMF	The International Monetary Fund
FDI	Foreign direct investments
SSC	The State Statistics Committee
DGCs	Developing countries
DDCs	Developed countries
OECD	The Organization for Economic Cooperation and Development
CPI	Consumer Price Index
CIS	Commonwealth of Independent States
FED	Federal Reserve System of the United States of America
SME	Small and medium entrepreneurs
LIBOR	London Interbank Offered Rate
NEER	The Nominal Effective Exchange Rate
OG	Output gap
OPEC	Organization of the Petroleum Exporting Countries
REER	The Real Effective Exchange Rate
RSM	Real Sector Monitoring
PPI	Producer Price Index
NFES	The National Fund for Entrepreneurial Support
UNCTAD	The United Nations Conference on Trade and Development
GDP	Gross Domestic Product
WTO	The World Trade Organization

EXECUTIVE SUMMARY

The CBA operated in the environment of continuing negative impact of the unfavorable international conjuncture on the Azerbaijani economy over 9 months of 2015. Uncertainties in the global economy elevated, global economic growth was weak and fragile in parallel with higher economic risks in the region. Global commodity prices, as well as oil prices kept declining accompanied by a new wave of depreciation of a number of currencies.

Complex economic processes across the globe and the region affected the Azerbaijani economy, which is deeply integrated to the world economy through different channels. Direct and indirect impact of the external environment manifested itself in lesser foreign currency supply and higher demand in the FX market.

The CBA's monetary and exchange rate policy targeted macroeconomic and financial stability and higher competitiveness of the non-oil economy amid emerging new risks and challenges.

Decisions on exchange rate policy directed to maintain parity in the country's balance of payments and sustainability of strategic foreign exchange reserves. The nominal effective exchange rate of Manat depreciated, which added momentum to growth in import substituting and export oriented sectors.

Strategic targets of monetary policy were favorably attained over the period. Inflation remained on single digits over 9 months of 2015. Domestic inflation was lower than in trade partners. Monetary policy tools were properly used given the environment the monetary policy.

Overall, the Azerbaijani economy was highly resilient to negative impact of developments in the global economy and remained committed to its stable growth path. No wonder that according to the recent Global Competitiveness Report, Azerbaijan maintained its leadership in the CIS and the top 10 position in terms of macroeconomic stability. In the meantime, leading rating agencies approved the country's international investment grade credit rating.

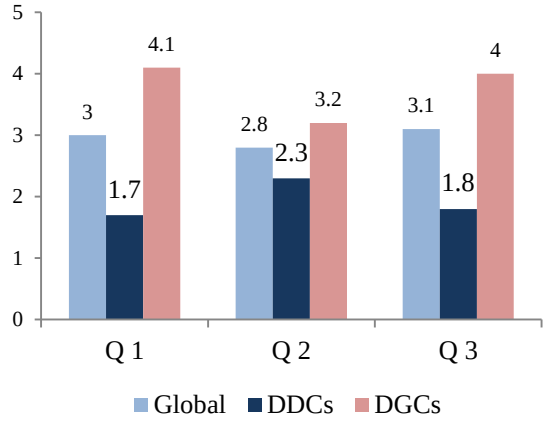
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1 Global economic trends

The past period of 2015 displayed again that the global economy has not yet reached to a sustainable growth path, having witnessed higher uncertainties, weak and fragile economic growth on mutually dependent peer countries, volatile exchange rates, sharp slides in commodity prices, and collapse of financial and property bubbles in a number of DGCs. The accommodative monetary policy weakly transformed to real sector investments due to lingering structural problems in DDCs.

The global economy rose 3.1% in Quarter 3 (annual seasonally adjusted) as per initial estimations. DDCs rose 1.8%, while DGCs grew 4%. Overall, growth rates varied across quarters and regions over the past period of 2015 (Graph 1).

Graph 1. Global economic growth in 2015, %, over previous year, seasonally adjusted



Source: Barclays

Results of the period show that dynamics of the economy in DDCs is not sustainable. The slack in the US economy in Quarter 1 was followed by higher than expected economic growth in the following quarters, primarily driven by internal demand components, mainly consumer spending, which account for 70% of GDP. The consumer demand is heading up at the expense of low oil prices, loose financing terms, high consumer confidence, and gradual recovery of employment. However, appreciated dollar, decreased commodity prices, weak economic activity in DGCs had a downward

effect on investments and foreign demand. The Federal Reserve System left the interest rate unchanged given lower than expected internal economic activity and higher uncertainties in external environment.

The euro zone economy followed the expected recovery path. Albeit the negative impact of external factors, internal demand, particularly consumer demand supported the economic activity. Retail sales and consumer confidence display high consumer spending. Low oil prices, the accommodative monetary policy and a cheap exchange rate factor in the process of recovery. The ECB continued the monetary easing given the recent trends.

A high economic activity in Japan in Quarter 1 was followed by economic slack in the following quarter. Initial estimations suggest that low net export and industrial production in Quarter III, as well as lower than expected growth in consumer spending is likely to end up with technical recession.

The economic growth rate remained weak in major DGCs, primarily due to tight financial conditions, lower commodity prices and spillover of the processes in the Chinese economy to other DGCs (except for India).

The Chinese growth was in line with forecasts. Consumer demand remained high, although the investment activity y.o.y dropped. Net export positively contributed to economic growth, since import fell more than export.

Box 1. Asian and European financial crises compared

The European and Asian financial crises are one of the major regional crises, which together covered 15 countries (10 European and 5 Asian). Although the causes of these crises were different, there existed some similarities.

Since 1970 economists classify 4 types of financial crises: currency crises, sudden stop (also known as balance of payment or current account crisis) crisis, debt (external debt of the country or the public sector's external or total debt) crises and systemic banking crises. It is difficult to argue that one type dominated, because most crises are a mix of at least two, if not all four, types.

During the crises European countries received more external financial support, compared with the Asian countries. The differences between Asian and European crises were exchange rate regimes, breadth of crises, persistence of crises, role of the private and public sectors, and preparedness. A principal difference between the Asian and the European financial crises is that the latter involved advanced countries.

Five differences stand out:

1. The first central difference between the two groups of countries was the nature of their exchange-rate arrangements.
2. Second, the European crises involved DDCs, while Asian crises involved DGCs and transitional countries. The implication of this difference is that advanced countries could not or should not have crises that require international rescues.
3. The third difference in the origins of the Asian and the European crises is that the former were rather transitory events measured by the number of years that passed before real GDP regained its pre-crisis level. The gap was just 2 years for Korea and the Philippines, 3 years for Malaysia, 4 years for Thailand, and 5 years for Indonesia. The IMF projects that Europe will not fill the gap until 2018, which is equal to 10 or 11 years.
4. The fourth difference is in the relative roles of the private and public sectors. The Asian crises generally involved excesses and imbalances associated with the private sector (current account deficits, external debts, over-reliance on financing via debt versus equity and weak financial systems threatened by credit booms) which was resolved without significant government intermediation. In Europe, private sector debt problems more virulently metastasized into public sector debt problems.
5. The final difference is that the Europeans were unprepared to deal with their crises, in particular, in the face of their substantially higher degree of economic and financial integration. The lack of European preparedness included an absence of institutions experienced at managing crises for a group of countries bound together in a monetary union.

The Asian crisis is a liquidity crisis, while the European crisis is the solvency crisis. The institutional and economic environment is the key during crises. The institutional environment was more favorable in Europe than in Asia. The global and regional economic environment was more conducive to recovery for Asia than for Europe. But the negative impacts of the European crises on the global economy have been substantially larger than those of the Asian crises.

Source: Edwin Truman. "Asian and European financial crises compared", Peterson Institute for International Economics, WP 13-9, 2013

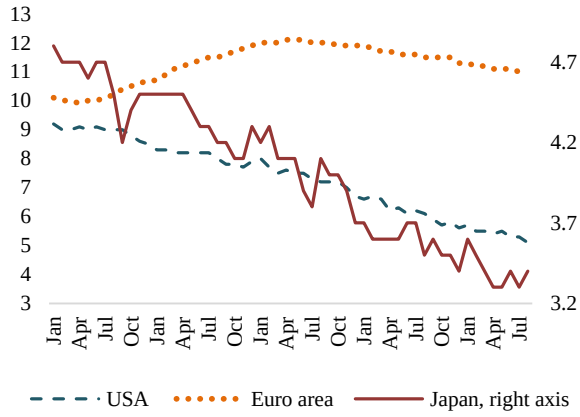
The National Bank of China took a number of decisions to underpin the economic activity and contain volatility lingering in financial markets since July, reduced interest rates and reserve requirements, devaluated the national currency and widened the intervention corridor.

Low consumer and investment demand in the Russian economy over the period resulted in higher than expected slack in economic growth.

Inflation lags behind the target in most countries amid low commodity and energy prices. Over the period the inflation rate in DDCs kept pace with oil prices and was close to zero albeit the quantitative easing. As of end- September annual inflation was 0% in the USA, -0.1% in the euro zone and 0.2% in Japan (as of end-August). Low commodity prices and a weak economic activity reduced inflation pressures in most DGCs. However, depreciated national currencies in Russia, Turkey, Brazil and Ukraine elevated inflation rates.

Low unemployment in certain DDCs over the past period of 2015 underpinned positive trends in the world economy, which decreased 0.6 p.p. to 11% in the euro zone, 1.1 p.p. to 5.1% in the USA, 0.2% p.p. to 3.4% in Japan as of end-August compared to the early year.

Graph 2. Unemployment rate, %



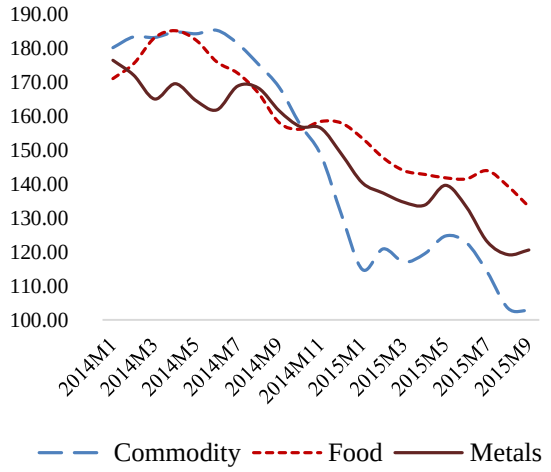
Source: OECD

Unemployment has dropped in the USA since 2011 (Graph 2) due to 4 million new jobs created after the global crisis. However, in current Quarter 3 growth in employment indicators was low compared to previous periods.

1.2. International commodity markets

Decrease in commodity prices is driven by the lower than expected global economic activity, global supply exceeding demand, and volatility in financial markets and economic slowdown in China.

Graph 3. Price indices, 2005=100



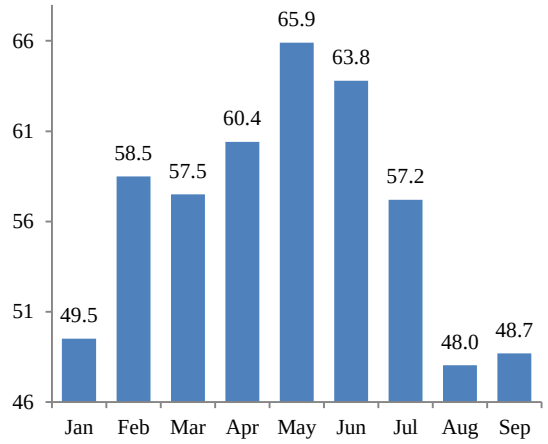
Source: IMF

Global commodity prices decreased 21.4% over 9 months of 2015.

Whereas metal prices rose 1.2% in September for the first time in recent 4 months, they are still 18.9% low relative to the early year. Low demand in China and high supply has a downward effect on metal prices. The aluminum price dropped 17%, while gold prices decreased 5.2% (1 ounce) over 9 months. Low demand for gold in China and India along with the stronger US dollar and expectations related to FED's raising interest rates move gold prices down.

The food price index dropped 15.6% over the period. Wheat prices declined 36%, and agricultural raw materials price index dropped 15%.

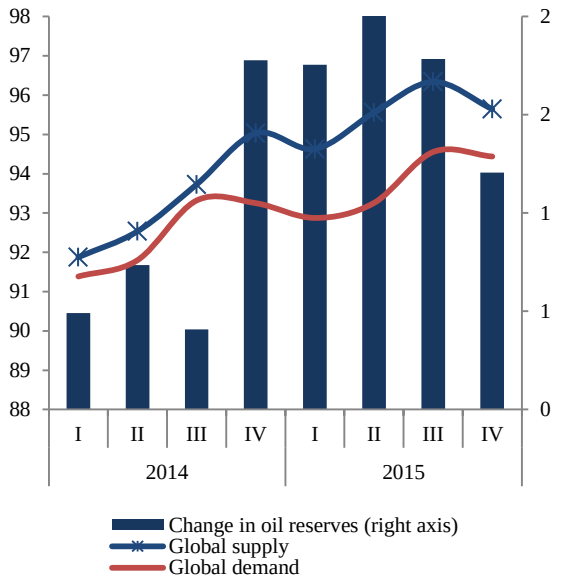
Graph 4. Average monthly Brent oil price, 2015, $/barrel



Source: IMF

While the Brent oil prices rose due to geopolitical tension, reduction in shale oil production in the USA and drops in oil investments in first 5 months, they dropped again as of the end-reporting period (Graph 4). Overall, y.o.y decrease in average prices for 9 months of 2015 was 47%.

Graph 5. Global oil supply-demand market in 2015, mln. barrel/day



Source: US. Energy Information Administration

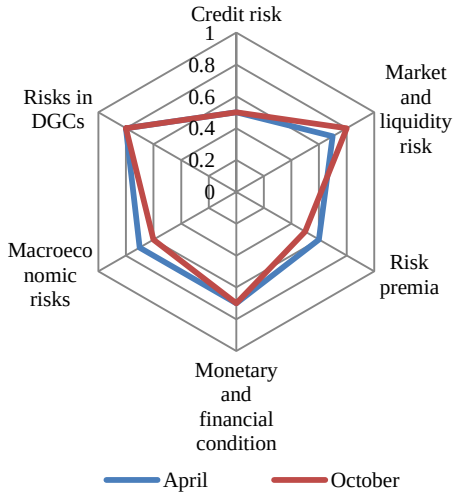
Oil prices slide over recent 5 months due to the following: OPEC supply is high, global demand lags behind global supply, probability of Iran's entering the market as a result of sanctions' removal and economic slowdown in China.

1.3. Global financial markets and investment flows

Although developed markets are financially stable, financial risks elevated in developing markets relative the early year.

According to the recent October IMF release, market and liquidity risks in global financial markets increased, and the risk appetite and macroeconomic risks decreased compared to April.

Graph 6. Global financial stability map: Risks and Conditions



***** *The farther from the center, the higher the risk, the more accommodative the monetary and financial condition is and the higher risk appetite is.*

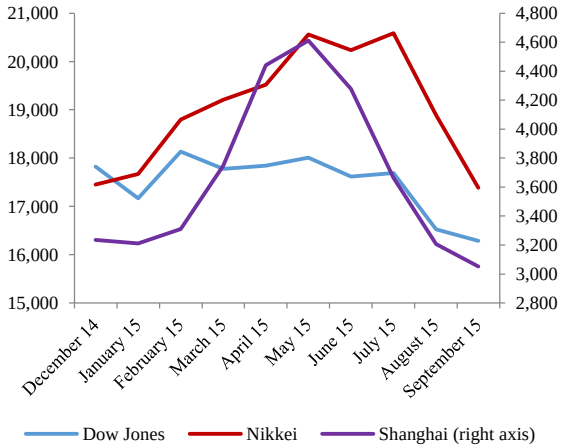
Source: "Global Financial Stability Report", Oct.15, IMF

The IMF considers fragility in DGCs markets, legacies of the financial crisis in DDCs and low liquidity as factors that negatively influence financial markets.

International investment flows to DDCs prevailed in 2015 as in recent years. Capital outflew from developing markets over the period. Total share of DGCs in international foreign investment flows decreased relative 2014. Capital investments were mainly directed to real estate, oil and gas, and telecommunication over recent one year.

Developments in the global economy also leave traces in the market indices. The Dow Jones Index dropped 8.6% and Nikkei 0.4% relative the early year.

Graph 7. Dynamics of financial indexes

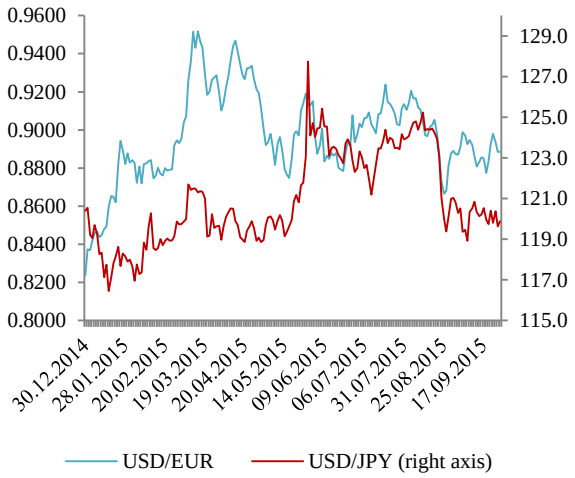


Source: Bloomberg

The economic slowdown in China triggered sharp drops in the Shanghai index, which is also affected by devaluation of the Yuan and FED's intentions to raise interest rates. The index dropped 5.6% relative the early year.

The US dollar keeps strengthening amid faint growth of the global economy, low oil prices and devaluations of the Yuan *(due to economic slowdown in China)* and number of Asian countries currencies.

Graph 8. Exchange rate of USD



Source: Bloomberg

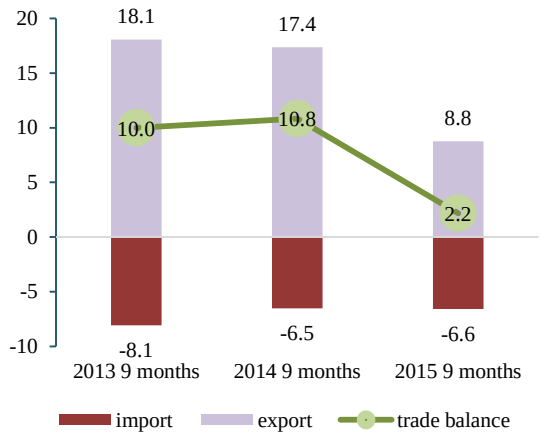
The US dollar strengthened 7.9% against the euro over the period partly due to QE in the euro zone. The US dollar depreciated 0.4% against the Japanese yen relative the early year. The Bank of Japan, which is targeting high export, devalues yen by boosting monetary easing. The USD strengthened 30.8% against the Turkish Lira, 48.8% against the Kazakhstani Tenge, 13.9% against the Russian ruble, 28.8% against the Georgian Lari, 60.8% against the Belarus ruble and 8.2% against the Norway krone over 9 months.

1.4. Azerbaijan's external sector developments

The Azerbaijan's external sector was affected by developments in the global economy, including processes in global energy markets and trade partner countries over 9 months of 2015.

According to the State Customs Committee (SCC), foreign trade turnover constituted USD 15.4 B. over 9 months of 2015, of which export accounts for USD 8.8 B. and import accounts for USD 6.6 B.

Graph 9. Trade balance, B.,USD

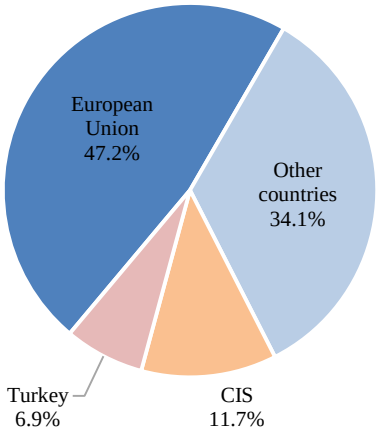


Source: SCC

Surplus of trade balance was USD 2.2 B., with export prevailing over import by 33.3%.

Azerbaijan traded with up to 148 countries over the period.

Graph 10. Share of main trade partners, 2015 9 months, %



Source: SCC

The EU countries account for 47.2% of the trade turnover. Breakdown of trade turnover with EU countries was about: 29.7% Italy, 21% Germany, 10.1% France and 6.2% Czech Republic.

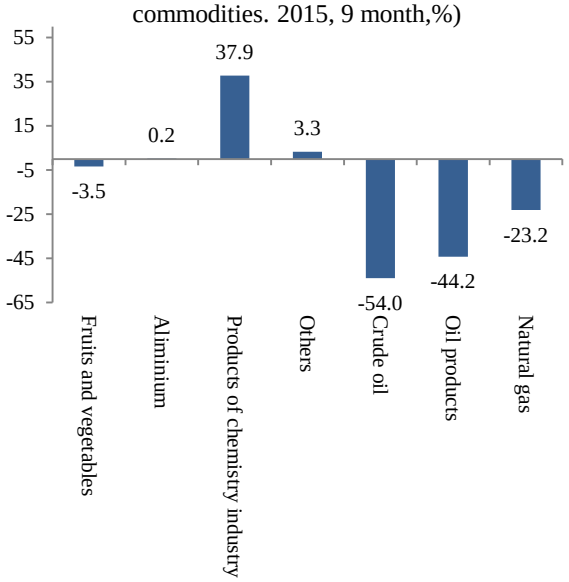
CIS countries account for 11.7% of the trade turnover. Breakdown of trade turnover with CIS countries was about: 74.7% Russia and 13.5% Ukraine, 11.8% others.

Other countries account for 34.1% of trade ties. Key partners in this peer group are the USA (14.8%), Israel (9.2%) and Georgia (5.7%).

Commodity export y.o.y dropped 49.5%, primarily on the oil-and-gas sector with a higher share in export. Export dropped 54% on crude oil, 44.2% on oil products and, 23.2% on natural gas.

Export of chemicals posted a high growth rate with 37.9% rise.

Graph 11. Change in export of commodities. 2015, 9 month,%)



Source: SCC

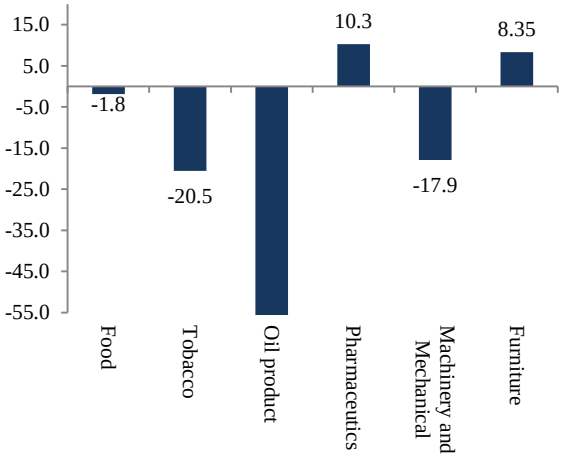
Key export partners included Italy (20.5%), Germany (11.5%), France (6.6%), Israel (6.4%) and the Czech Republic (4.6%).

Commodity import y.o.y increased 0.9% over current 9 months. Import by the public sector went down by 28.9%.

Russia accounts for 16.3% of import products, Turkey – 12.6%, the USA – 10.2%, Germany – 7.9%, Japan – 6.5% and China – 5.7%.

Import increased on vehicles and parts, fruits and vegetables, wood and products, black metals and products over the period. Import on a number of products declined due to expansion of domestic production.

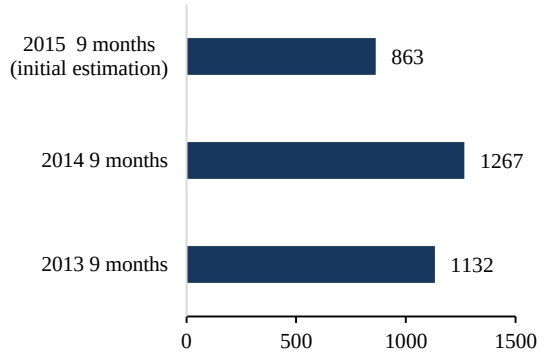
Graph 12. Change in import of products, 2015, 9 months , over previous year, %



Source: SCC

The situation in economic partner countries affected the dynamics of remittances, which constituted USD 863 M. in 9 months according to initial estimations.

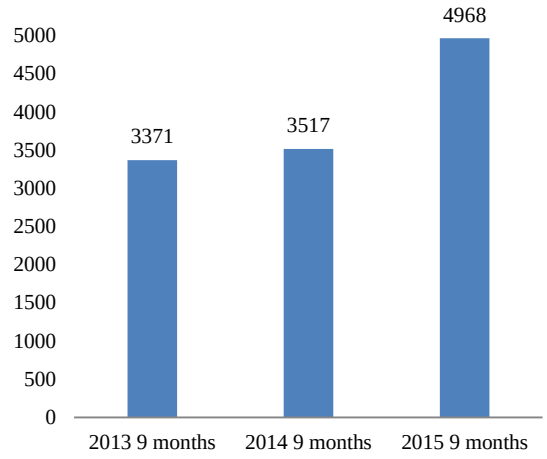
Graph 13. Inflow of remittances, mln.$



Source: CBA

Over the reporting period foreign investment to fixed capital continued. According to the SSC, foreign investments to fixed capital equaled to AZN 4968 M. over 9 months of 2015, which accounts for 42% of total investments. The y.o.y growth rate of foreign investments made 41.3%. Maintenance of the country's international rating positively factored in foreign investment inflows.

Graph 14. Foreign investments, M. manat



Source: SSC

Foreign investments to fixed capital from Great Britain, Norway, Turkey, Russia, Iran, the USA, Japan, Malaysia and Sweden accounted for most part of investments from foreign countries and organizations (89,6%).

Over the reporting period country's strategic foreign exchange reserves were maintained at adequate level. As of the end of 9 months strategic foreign exchange reserves sufficed for 27 month commodities and services import and surpassed the country's foreign debt by 6 times. At the same time, they exceeded broad money supply in Manat 4.5 times.

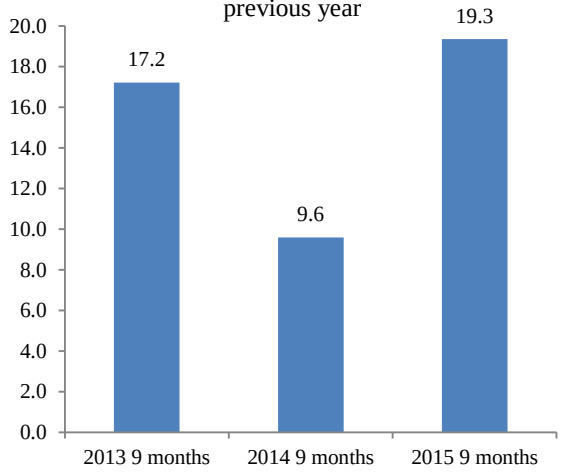
II. MACROECONOMIC PROCESSES IN AZERBAIJAN

2.1. Aggregate demand

Internal demand made critical contribution to economic growth over 9 months of 2015.

Final consumption expenditures. Over 9 months of 2015 households' consumption expenditurees y.o.y increased 19.3% and reached to AZN 22.8 B., which accounts for 75.6% of household income. Over the reporting period every consumer purchased on average AZN 279.6 worth of commodities and chargeable services with y.o.y AZN 33 increase.

Graph 15. Final consumption, %, over previous year

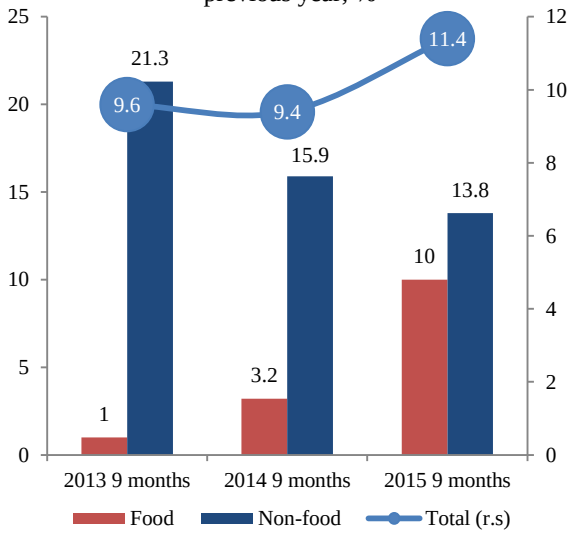


Source: SSC

Over the period the size of commodities and services sold in the consumer market to meet consumer demand rose 10.3% and reached to AZN 23.9 B.

Retail trade turnover increased 11.4% and constitude to AZN 18.1 B.

Graph 16 Retail trade turnover, over previous year, %



Source: SSC

Over the reporting period consumers spent 50% of their funds on food, beverage and tobacco in retail trade.

Over the period every consumer monthly purchased on average AZN 105.5 worth of food, beverage and tobacco and AZN 105.7

worth of non-food products for private consumption in retail trade.

Table 1. Share of spending items in trade facilities in 9 months of 2015, %

Spending item	Share, %	
	2014, 9 months	2015, 9 months
Food, beverage and tobacco	50.1	50
Knitwear, clothing and shoes	19.9	18.1
Electric appliances and furniture	4.4	6.1
Computers, telecommunication equipment and other devices	0.7	0.8
Pharmaceuticals and medicals	1.4	1.2
Fuel	8.3	6.5
Other non-food staff	15.2	17.3

Source: SSC

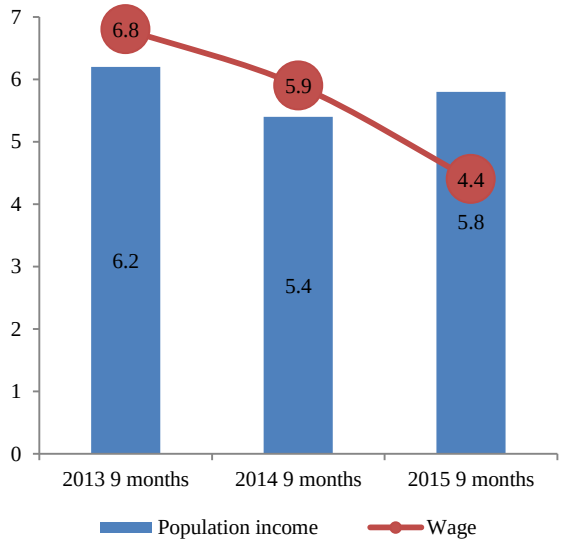
To note, a portion of non-food products was purchased via e-trade. Y.o.y increase in consumer purchases via e-trade network was 2 times in January – September, 2015.

In January - September, 2015 y.o.y increase in catering turnover was 15.1% and paid services to the population 6.2%.

High consumer demand mainly stemmed from rise in income of the population. Over the period income of households rose 5.8% in nominal and 2.1% in real terms. Per capita income rose 4.5% in nominal terms and prevailed over price rise in the consumer market by 0,8 p.p.. Disposable income of the households increased 5.7% and constituted AZN 27.3 B.

Average monthly salary nominally increased 4.4% and reached to AZN 460.1 in January – August. Salary increased 20.3% in the oil sector and 3% in the non-oil sector, including 0.3% rise in the public sector and 6.7% rise in the non-oil sector.

Graph 17. Population income and wage, %, over previous year



Source: SSC

Over the period consumer demand was also supported by bank loans to households, the volume of which as of the end-period approximated AZN 7.6 B.

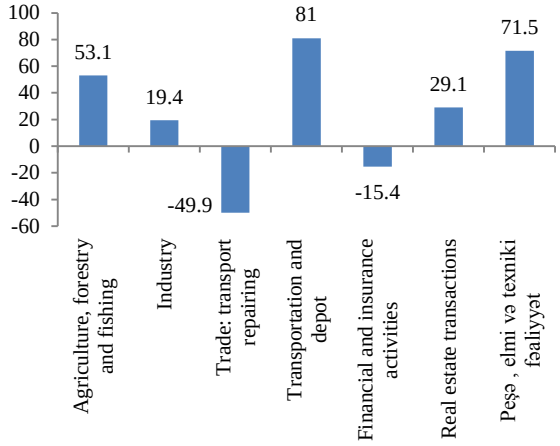
The population channeled AZN 3.6 B. (12.1%) worth of income to savings in January - September.

Government spending. Public expenditures were one of the key factors of internal demand in January – August, 2015. Government's consumption expenditures were primarily directed to expenses on goods and services from the state budget. According to the SSC, in January – August state budget expenditures made AZN 10.8 B.

11.7% of budget expenditures were channeled to social protection and welfare of the population, 8.5% - to education and 3.7% to healthcare (SSC).

Investment expenditures. In January – September 2015 investments y.o.y increased 0.5% to AZN 11.8 B. Over the period investments to the oil sector constituted AZN 5.3 B. while investments to the non-oil sector made up AZN 6.5 B.

Graph 18. Sectoral breakdown of investments, %, over previous year



Source: SSC

Y.o.y increase in the investments was 19.4% in segments of industry, 81% in transportation and depot, 2.2 times in information and communication, 29.1% in real estate related operations, 7.2 times in tourism and catering. 7.5% of total non-oil investments were used for the development of the non-oil industry.

58% (AZN 6.8 B.) of funds channeled to capital stock stemmed from domestic, while 42% (AZN 5 B.) from foreign sources.

As in previous years funds of entities and organizations prevailed in total investments over the reporting period.

Table 2. Sources of investments

	2014 9 months	**2015 9 months**
Funds of entities & organizations	6555	8209.8
Bank loans	434.4	660.5
Budget funds	4173.7	2211.8
Off-budget funds	252.9	210.7
Population's own funds	387.9	385.1
Other funds	64.6	153.5

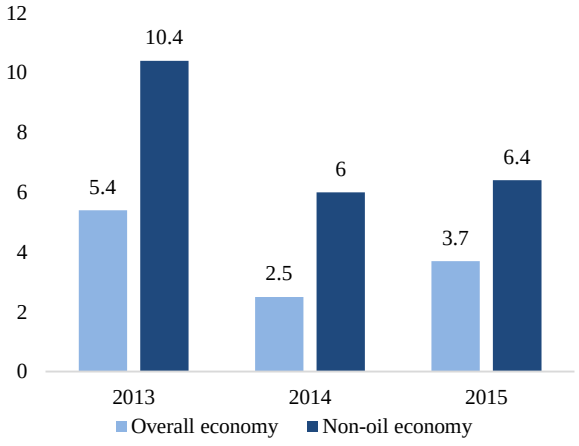
Source: SSC

2.2. Aggregate supply and employment

Economic growth in the country continued over 9 months of 2015 primarily driven by the non-oil sector.

Economic growth. In January – September 2015 real GDP increased 3.7% and nominally reached AZN 40.7 B.

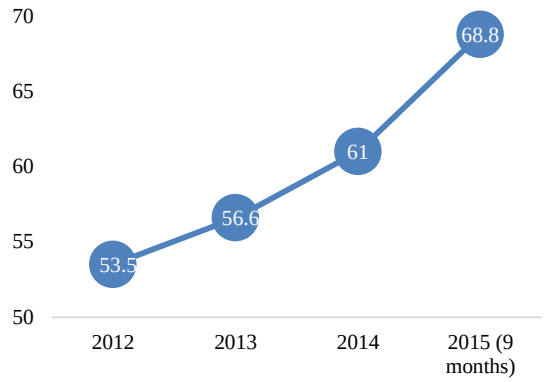
Graph 19.Economic growth in the 9 months of 2015, %, over previous year



Source: SSC

GDP growth was mainly driven by the non-oil economy. Over the reporting period the oil sector demonstrated 0.1%, and the non-oil sector 6.4% growth. The non-oil economy accounts for 68.8% of GDP, with its 3.4 p.p. contribution to total growth.

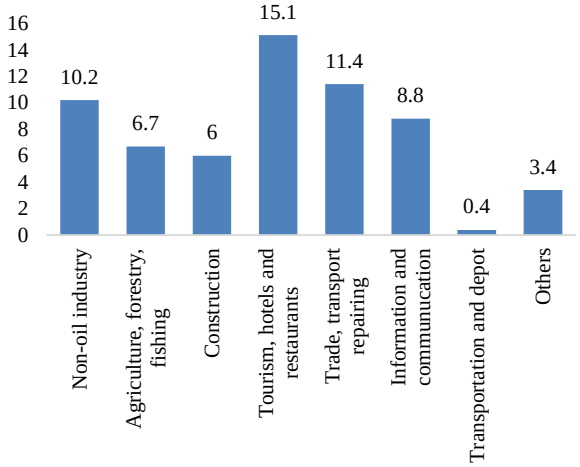
Graph 20. Contribution of non-oil sector to GDP



Source: SSC

As seen from the below Graph, over the period all sectors of the non-oil economy demonstrated growth.

Graph 21. Sectoral growth of non-oil economy in the 9 months of 2015, %, over previous year,



Source: SSC

The highest growth rate among sectors was in tourism, catering and trade.

Box 2. Experiences with economic diversification in oil-exporting countries

Low commodity prices have necessitated economic diversification in resource rich countries since mid-2014. IMF experts shared the experience of 4 resources rich countries – Malaysia, Indonesia, and Mexico perhaps offer the best examples of countries that have been able to diversify away from oil, while Chile has had some success in diversification away from copper.

Malaysia's diversification experience involved active intervention on the part of the state to spur growth in targeted sectors. This was predicated on an international competitive drive underpinned by technological transfers, with a focus on developing national companies into global firms. Malaysia also targeted SME development, while the economy had an import-substitution strategy in heavy industry, there was an export promotion focus for manufactures. Diversification was achieved by means of attracting FDIs in the export sector and a focus on human capital development.

Indonesia also had an import-substitution policy in place, as well as policies to attract foreign capital in the manufacturing exports field. The country enacted a number of incentives to promote exports, such as setting up free zones, providing tax incentives to firms and industries, and reducing barriers to trade. A fundamental element of its diversification strategy, hovvever, was large exchange rate devaluation.

Mexico is another example where export diversification efforts hinged on creating a business environment conducive to export promotion. To strengthen the business environment, a number of incentives to ease firm entry were extended, strong state investment in infrastructure, incentivizing firms to send workers abroad for training, and providing tax incentives to lure foreign firms to local industries. Mexico embarked on the establishment of free trade zones, and worked to ensure that wages were attractive in the labor market. What sets Mexico's export diversification apart from other commodity-exporting countries is its accession to the NAFTA— that opened up new markets for its exports and served as a means to attract foreign investment, particularly into the car manufacturing industry.

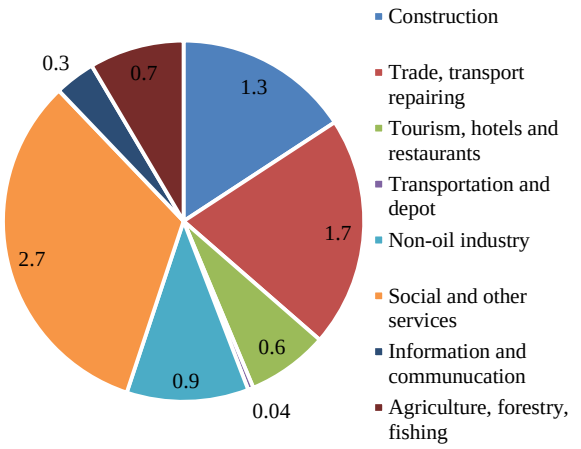
Chile's approach to export diversification was different in terms of the tools it used, particularly the use of export subsidies and its reliance on public-private partnerships to help establish and develop new firms. Chile also identified and worked on important sectors having comparative advantage, strengthening technical skills and encouraging innovation. The country's diversification strategy took advantage of the focus on SME development.

While each country followed its own path, a number of common elements are evident, including institutional reforms, strengthening of nontraditional sectors, attraction of foreign direct investments, export promotion, better integration, and human capital development and increasing the role of SMEs in the economy.

Source: Al-Darwish et al. "Saudi Arabia: Tackling Emerging Economic Challenges to Sustain Growth" IMF, 2015

Social and other services made 2.7 p.p. contributions to 6.4% growth of the non-oil economy.

Graph 22. Sectoral contributions to non-oil economic growth in 9 months, %, 2015



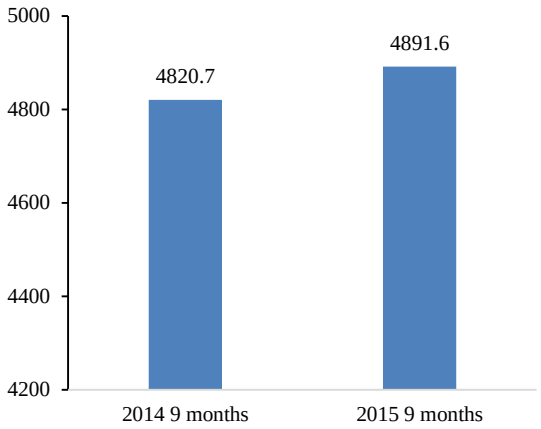
Source: CBA calculations based on SSC data

Efforts of previous years yielded ongoing positive trends in the non-oil industry, which overall posted 10.2% growth in January – September 2015.

Over the reporting period the mining industry yielded 31.4 M. ton crude oil, and 14.4 M/m^3 natural gas.

Employment. The dynamics of employment is another sign of economic activity in the country. As of the end-period economically active population was numbering 4891.6 thousand people, of which 95.2% was engaged in various segments of the economy.

Graph 23. Number of employed people, end of period, in thousands



Source: SSC

According to the SSC, the number of hired labor was 1509.8 thousand people as of September 1. Of them 1474.9 thousand people (97.7%) are engaged in the non-oil sector, while 34.9 thousand people (2.3%) in the oil sector.

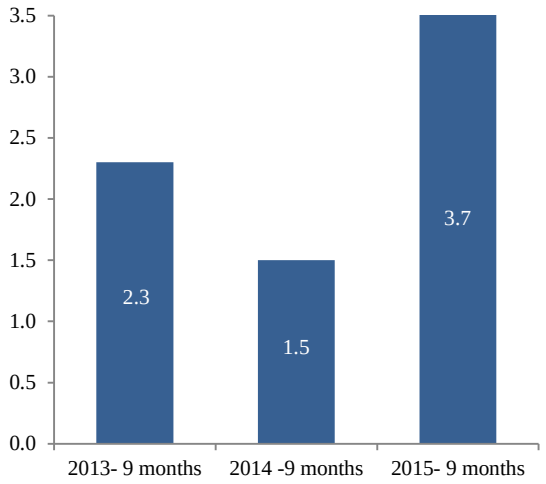
21.9% of the hired labor in enterprises and organizations are engaged in production, 6.7% in construction, 6.5% in processing and 3% in agriculture. 78.1% of hired labor is concentrated in services.

2.3. Inflation

Inflation was on an acceptable level over 9 months of 2015.

Consumer Price Index. According to the SSC, over 9 months of 2015 average annual inflation was 3.7%, which 3.8 p.p. lags behind the average annual CPI of recent 10 years.

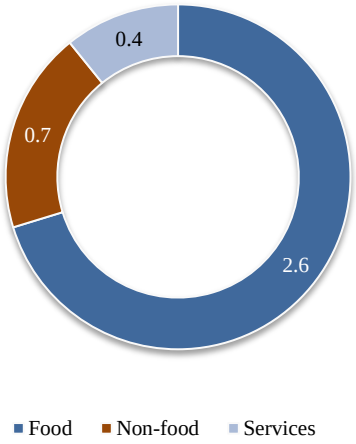
Graph 24. Annual average inflation, %



Source: SSC

The CPI components - food prices changed on average annual 6%, non-food prices 3%, and services 1.1%.

Graph 25. Components of annual average inflation, %

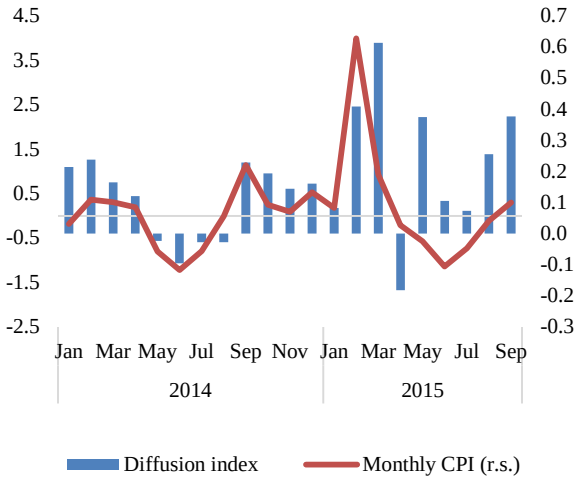


Source: CBA calculations based upon SSC data

Over the period prices for breadstuffs and cereals gained 10%, oils and fats 12.8%, fruits 9.6%, coffee, tea and cacao 10.4%, while prices for vegetables declined.

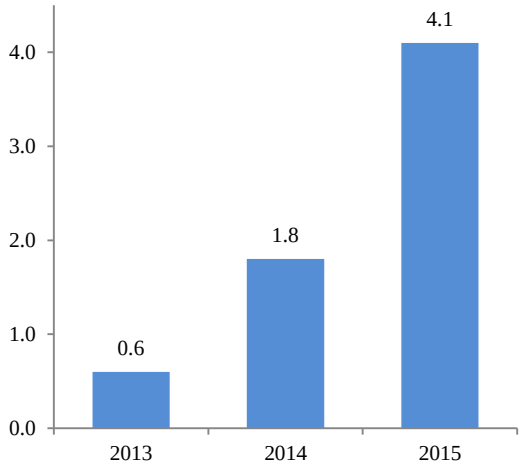
The diffusion index, that measures changes in the number of products and services in the consumer basket, whose prices increase and decrease, was volatile over the period (Graph 26).

Graph 26. Scale of inflation, %



Source: SSC, CBA estimations based upon SSC data

Graph 27. Annual average core inflation in 9 months, %



Source: SSC

Overall, average annual prices for 119 goods and services included to the basket, as well as 30 foods, 66 non-food staff and 23 services reduced over 9 months. Average annual prices for 45 goods and services, including 3 non-food and 42 services, remained unchanged.

Average annual core inflation, which is inflation adjusted from fluctuations in prices for commodities regulated by the Government and seasonal factors made 4.1%.

The Government regulated prices for medicinal products in the current year, which resulted in drops in prices for pharmaceuticals. The Tariff (price) Council adjusted prices for total 2183 drugs, which reduced prices for 98% of medicinal products in the market. Prices for 53% of drugs in the market decreased over twofold compared to existing prices, while 28% of them dropped over threefold. *(Source: http://www.tariffcouncil.gov.az/)*

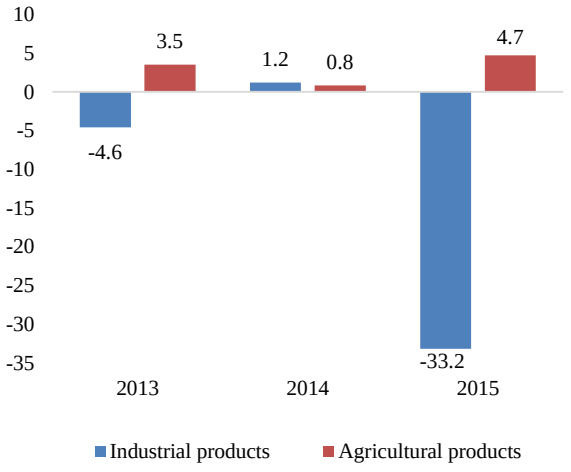
Over 9 months of 2015 the NEER, inflation expectations and high inflation in trade partners had an upward effect on prices, with a downward effect by seasonal factors

and shifts in the money base and global food prices.

Inflation in Azerbaijan lagged behind average annual inflation in trade partners (average non-oil import weighted - 8.3%) by 4.6 p.p..

Producer Price Index. Over 9 months of 2015 the PPI dropped 33.2%. Prices declined 37.1% in mining and 8.9% in processing. Prices in the mining industry were mostly affected by slump in oil prices.

Graph 28. Annual average change in Producer Price Index, %, in 9 months



Source: SSC

Over 9 months of 2015 agricultural producer prices rose 4.7%. Price hike was 1.1% on animal products, 7.8% on plant products and 3% on fish and fishery products.

III. THE MONETARY AND EXCHANGE RATE POLICY

3.1. The FX market and the exchange rate of Manat

Over 9 months of 2015 CBA's exchange rate policy targeted enhancing country's international competitiveness and maintenance of macroeconomıc stability in the environment of increasing demand and decreasing supply for foreign exchange.

Slump in oil prices in global commodity markets from the end of 2014, and the waves of devaluation in our main trade partners triggered high demand for foreign currencies, particularly USD in the domestic FX market.

Over 9 months of 2015 total size of the FX market y.o.y increased 1.8 times. 91% of transactions were conducted in the US dollar, while 9% in other currencies. The size of USD denominated transactions y.o.y rose 1.8 times, while EUR denominated transactions rose 2.1 times.

Table 3. Turnover in the FX market over 9 months 2015, *M. currency units*

	QI	QII	QIII	9 months
USD	*21719*	*16275*	*16091*	*54085*
EUR	*1635*	*1844*	*1561*	*5040*

Source: CBA

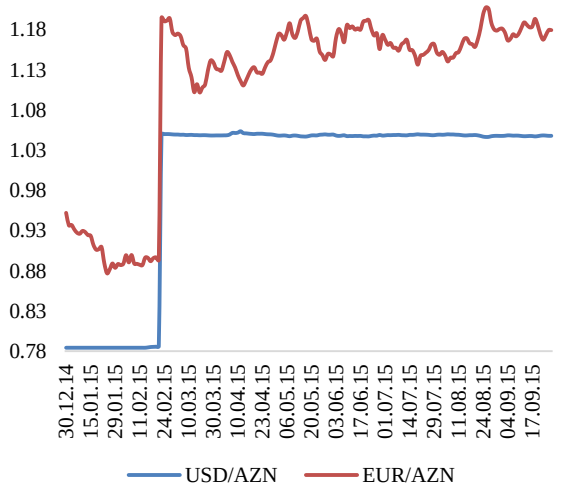
Over current 9 months y.o.y increase in net cash foreign currency sold to the population by banks was 61.7%.

High demand for cash foreign currency occurred in Quarter 1, which accounts for 63% of net USD and 38% of net EUR sold over 9 months.

The Management Board of the CBA decided to set the exchange rate of US dollar against AZN at AZN 1.05 as of 21 February 2015 in light of the situation in the FX market. The decision was taken to create additional momentum for the

diversification of the national economy, further enhance its international competitiveness and export capacity, and ensure strategic sustainability of the balance of payments and countries international solvency.

Graph 29. Exchange rate of USD&EUR against manat



Source: CBA

Also the CBA made decisions on the improvement of the operational framework of the exchange rate policy. Exchange rate policy has been conducted by pegging Manat to the basket of currencies comprising USD and EUR *(for additional information please see Monetary Policy Review, Quarter I, 2015)* Quantitative parameters of the new operational framework, introduced in Quarter I (the structure and value of the basket etc.) was optimized in Quarter II.

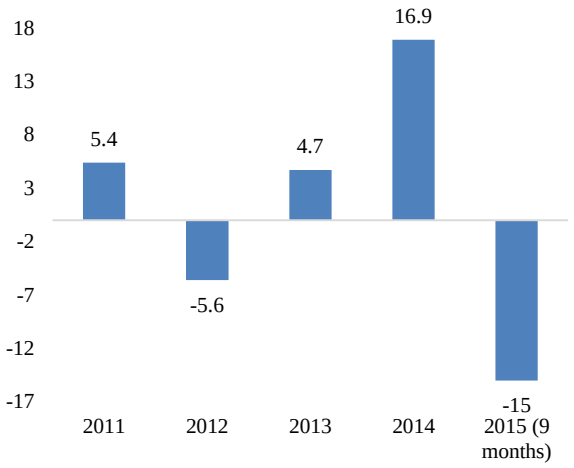
The CBA intervened to the FX market within the corridor (range between 'buy' or 'sell' rates). In the 9 months the CBA conducted FX market interventions by net selling in 6 months and by net buying in 3 months.

The nominal bilateral exchange rate of Manat depreciated against currencies of main trade partner countries over the period. Manat depreciated against currencies of all trade partner countries on 15 reviewed countries, except for the Kazakh Tenge, the Belarus Ruble and the Ukraine Hryvnia.

The dynamics of the nominal bilateral exchange rate of Manat caused shifts in real bilateral exchange rates, which in turn affected shifts in the REER.

Over the reporting period the REER (non-oil trade weighted) depreciated 15% stemming from 12.1% depreciation of the NEER.

Graph 30. Dynamics of REER, %



Source: CBA

As seen from the Graph, real appreciation of the Manat in 2013 - 2014 was neutralized over current 9 months.

The depreciated REER positively affects the competitiveness of the non-oil sector, stimulates the development of export oriented sectors and import substitution.

3.2. Monetary policy tools

Over 9 months of 2015 the CBA considered the environment in which monetary policy was implemented and the potential of achievement of inflation targets when taking monetary policy related decisions.

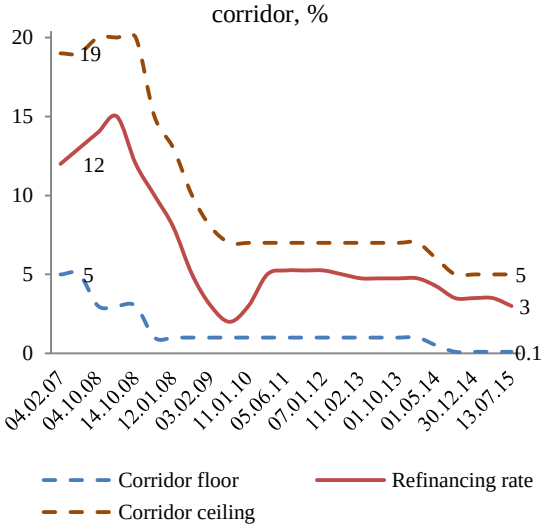
Over the period the CBA pursued the monetary policy in light of the trends in the economic cycle, the dynamics of money supply, as well as price and financial stability targets.

The CBA shifted the refinancing rate to 3% from 3.5% from 13 July 2015 to ensure higher financial contribution to economic growth in the non-oil industry, stimulate investments by accelerating drops in loan interest rates, and pave the monetary way to the optimization of SME financing and mortgage lending of the population.

Other parameters of interest rates corridor were left unchanged - the corridor ceiling remained 5% and the floor 0.1%.

Liquidity injection and absorption operations through the banking system were conducted within the interest rate corridor parameters.

Graph 31. Parameters of interest rate corridor, %



Source: CBA

To adjust growth rates of money supply and the liquidity level in the banking system over the period the CBA deployed reserve requirements.

Box 3. Monetary Policy Transmission in Emerging Asia: The Role of Banks and the Effects of Financial Globalization

Banks could potentially play a pivotal role in monetary policy transmission. Using bank-level data for nine Asian economies the IMF experts studied nine Asian countries *(Hong Kong, India, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand and Taiwan)* and various bank groups to check how sensitive heavy bank lending to monetary policy shocks is.

Loan growth responds negatively to a change in domestic monetary policy: a one p.p. increase in a policy rate leads to about a 1.3 p.p. decrease in the real loan growth rate on average. Monetary policy response varies across factors.

The response of credit growth to domestic monetary policy varies with the ownership type of individual banks including state, domestic private, and foreign banks. Following a tightening of monetary policy, state-owned banks shrink their loan supply more sharply than domestic private banks, while foreign banks react in a perverse direction. A 1% increase in the policy rate results in a reduction of loan supply by 2.6% for state-owned banks, and 1.8% for domestic private banks, while foreign banks' loans increase by 0.3%. Studies show that the larger share of foreign owned banks in the banking system reduces the credit response to monetary policy. A 10 p.p. increase in foreign presence in domestic banking system reduces the effect of monetary policy tightening on domestic private banks, shifting it from a 2.4% contraction of loan growth to a net contraction of 0.4%. Lower impact of domestic monetary policy on foreign owned banks is related to their financial linkage with banks in foreign countries.

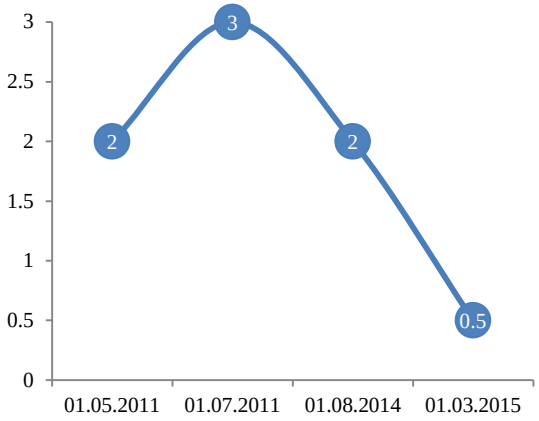
We then divide our sample into "traditional banking" and "non-deposit (non-traditional) funding. State and private domestic banks mainly prefer “traditional banking”, while foreign banks “non-traditional banking” It is the foreign and domestic banks with traditional funding that respond signifıcantly higher. However, banks with “non-traditional funding” (mainly foreign) respond significantly lower.

Changes in international financial conditions are the third factor that may also influence the transmission of monetary policy. Banks do not only respond to monetary policy but also respond to changes in foreign financial conditions. Tight (loose) international financial conditions reduces (increases) credit portfolio. Banks with “non-traditional funding” respond significantly more than the banks with “traditional funding” to international processes.

Structures of domestic banks, their financing sources and reliance on the international financial condition need to be analyzed to properly understand monetary transmission mechanism. In the era of high financial globalization central banks need to in-depth analyze international processes and take informed macro prudential decisions.

Source: Nasha Ananchotikul and Dulani Seneviratne "Monetary Policy Transmission in Emerging Asia: The Role of Banks and the Effects of Financial Globalization" IMF Working Paper, 2015

Graph 32. Reserve requirements, %



Source: CBA

The CBA changed the reserve requirement to 0.5% from 2% in view of recent trends in movements in money supply in an effort to support economic growth by allowing drops in interest rates.

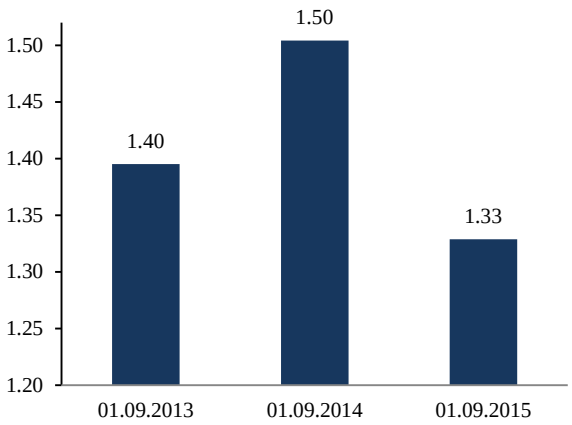
3.3 Money supply

Money supply in Manat was affected by the processes in the FX market over 9 months of 2015.

Over current 9 months money base in Manat decreased 38.9% to AZN 7050.4 M. as of the end-period. Dollarization had a decreasing, while other factors (CBA's market operations etc.) had an increasing effect on shifts in the money base.

The money multiplier of the banking system underwent no considerable changes.

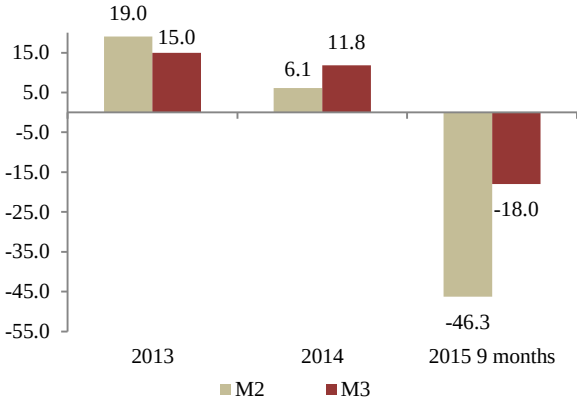
Graph 33. Money multiplier in AZN



Source: CBA

Broad money supply in Manat (M2) decreased 46.3% to AZN 9369 M. over the period at the expense of cash money supply.

Graph 34. Change in money supply, %



Source: CBA

Over the period broad money supply (M3) decreased by 18% to AZN 17684 M. as of 01.10.2015. The M3 money aggregate y.o.y decreased 16.3%.

Table 4. Monetary aggregates, M. AZN

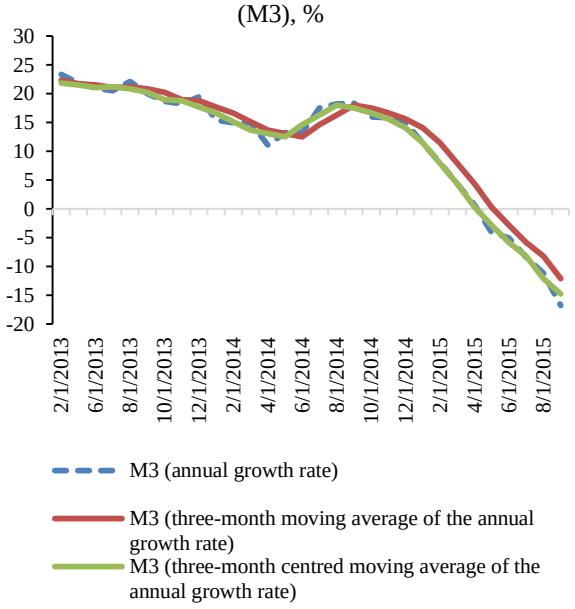
	01.01.2014	01.01.2015	01.10.2015
M0	*10459*	*10153*	*5457*
M1	*12737*	*12830*	*7189*
M2	*16435*	*17436*	*9369*
M3[1]	*19289*	*21566*	*17684*

Source: CBA

[1] Cash, demand and time deposits and savings in manat and foreign currency.

The decline in the M3 money aggregate over 9 months of 2015 is mainly associated with the drop in net foreign assets, which accounted for 59.5% in decrease of the broad money supply.

Graph 35. Dynamics of money supply (M3), %



Source: CBA

The share of foreign currency denominated deposits and savings in total deposits and savings was 68% as of the end-period. Deposits and savings in foreign currency accounted for 47% of M3 money supply.

IV. ECONOMIC OUTLOOK

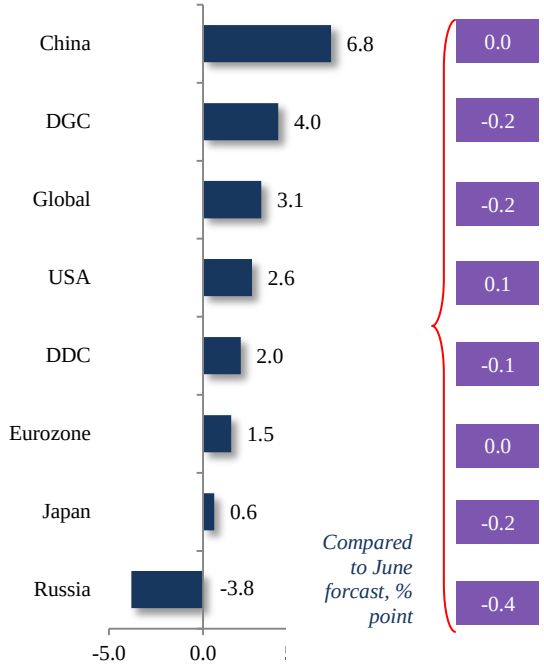
4.1. Global economic outlook

The IMF revised the global economic outlook for 2015 down given unexpected economic slack in the USA in the first quarter, the technical recession probability in Japan and weak economic growth in DGCs.

Global economic growth is recently predicted to be 3.1%, 2% in DDCs and 4% in DGCs. Recession in 15 main trade partners is predicted to be 0.6% (average non-oil export weighted).

Global economic growth is expected to be y.o.y 0.3 p.p. lower, due to mainly a low economic growth rate in DGCs, which has been declining since 2010, the forecast for the end of current year 1.6 p.p. lags behind the average indicator for 1995-2007. Lower contribution by DGCs to global growth will be partly neutralized at the expense of DDCs.

Graph 36. Global growth expectations for 2015, %



Source: IMF

IMF's economic growth outlook rests upon certain assumptions, which include: low geopolitical tensions, economic growth friendly fiscal and monetary policy by countries, favorable financing conditions across the globe (except for DGCs) and USD 51.62 average oil price (WTI, Brent, Dubai).

Trends in the global economy leave their traces in commodity markets. IMF forecasts 34.5% drop in global commodity prices, 16.8% drop in food prices, 46.4% drop in oil

prices, and 22.3% drop in metal prices in 2015. Appreciated USD, high supply and weak global demand generate ongoing slides in commodity prices.

Table 5. Dynamics of commodity prices, relative early year, %

	2014	2015
Energy	**-7.4**	**-43.9**
Oil prices	*-7.5*	*-46.4*
Non-energy	**-4.0**	**-16.9**
A/c products	*1.9*	*-11.8*
Food	*-4.1*	*-16.8*
Metal	*-10.3*	*-22.3*

Source: IMF

Inflation is expected to decline in many countries in the current year. Annual inflation in DDCs y.o.y will decrease 1.1 p.p. to 0.3%, due to low oil prices and output gap. In contrast, inflation in DGCs is expected to increase 0.5 p.p. to 5.6%. Except for high inflation in Venezuela (over 100%) and Ukraine (about 50%), annual inflation in DGCs will y.o.y decrease 0.3 p.p. to 4.2%.

Global trade, one of the critical factors of global economic growth, grows weakly. As of end-2015 global trade is expected to rise as much as 2.8%, which 2.3 p.p. lags behind the average indicator for 1990-2014. Import is expected to rise 3.1% on DDCs, 2.5% on DGCs, while export is expected to rise 3% and 2.4% respectively.

Central banks of advanced countries are expected to take critical monetary policy decisions in the last quarter of the current year given recent economic processes. The monetary easing is expected to be reviewed in terms of volume, composure and term amid deflationary trends and fragile economic activity in Japan and the euro zone. Global economic processes, particularly slack economic activity in China and internal economic situation in the USA decrease the expectations on FED's raising interest rates. As per bond markets, the probability that interest rates will be raised in 2015 is equal to 30%.

Box 4. What lies behind the global trade slowdown?

Global trade performance has been disappointing in recent years. Except for a solid post-recession rebound in 2010, when global trade rose 13 percent, it has been relatively subdued in recent years, averaging 3.4 percent annual growth rate between 2012 and 2014. Global trade is 20% below its potential level.

WB analyses associate changes in global trade to 2 factors:

- Cyclical factor – weak demand:
  - Global GDP, GDP levels in the USA and the euro are about 4.5%, 8% and 13% respectively below average pre-crisis growth rates;
  - With high-income economies accounting for some 65% of global imports, their lingering weakness inevitably impacts the recovery in global trade.
- A structural factor – changing relationship between trade and income:
  - In recent years, world trade has become less sensitive to changes in global income. Estimates from an error correction model suggest that for the period 1986-2000, a 1% increase in world real GDP is associated with a 2.2% and 1.3% increase in 2001 – 2013 in the volume of world trade.

What explains the lower elasticity of trade:

- *Evolution of global value chains.* Much of the contribution to the decline in global trade elasticity has come from China and the United States. The decline in China's trade elasticity can be explained by the rising amount of domestic value added in its exports. For instance, the share of Chinese imports of parts and components in China's total exports has declined from a peak of 60% in the mid-1990s to the current share of approximately 35%.
- *Changes in the composition of demand.* Different components of aggregate demand have different import elasticity. Investment spending is the most import-intensive component of domestic demand, followed by consumption, with government spending being the least import intensive. Hence, the weak recovery in the post-crisis period in the components of aggregate demand that have a higher import intensity could help explain the relatively weak post-crisis elasticity;
- *Weak trade finance.* Post-crisis impaired credit channels and new regulatory rules have contained the development of global trade;
- *Increased trade protection.* Trade barriers have risen since 2009. In the year leading to May 2014, Group of Twenty (G-20) members put in place 228 new trade restrictive measures (WTO, 2014).

The WB analysis suggests that the recent slowdown in global trade relates to weak demand, shifts in the structure of value chains, weak recovery of import-sensitive components of aggregate demand, weak trade finance and trade barriers. According to forecasts, over the long term even if the recovery accelerates and global growth returns to its trend global trade growth may not return to pre-crisis trend levels unless global trade relationships change.

Source: "What lies behind the global trade slowdown?" Global Economic Prospects, World Bank, January 2015

Gradual tightening of the US monetary policy and the monetary easing in the euro zone are affecting global interest rates. LIBOR on 6 month deposits in USD is expected to be 0.4% (y.o.y 0.1 p.p. high), and on 3 month deposits in EUR is expected to be 0% (y.o.y 0.2 p.p. low), which in its turn may make EUR financing more attractive for DGCs.

Global finance and investments are expected to continue to flow to DDCs. The UNCTAD forecast 23.8% rise in FDIs on DDCs and as much as 3.3% on DGCs in 2015. However, DGCs will continue to account for major part of FDIs (over 50%).

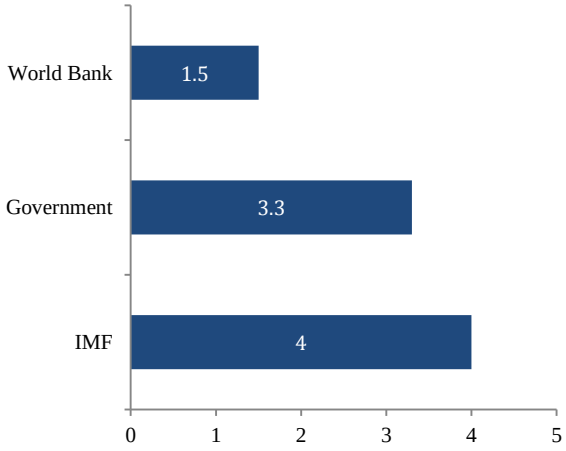
Different risks are on the air on peer group countries in the global economy. Key risks for DDCs include: the appreciation of the USD, low growth potential and non-full removal of global crisis triggered challenges, while key risks for DGCs are: geopolitical tension, low commodity prices, volatile asset prices, the tight monetary policy in the USA, and harder than expected landing in China.

4.2. Macroeconomic prospects on Azerbaijan

Economic growth is expected to continue in the country in the near term.

Economic growth expectations. The Government forecasts 3.3% economic growth in the country for 2015, as well as 5.9% growth in the non-oil industry. [2] The IMF predicts 7.1% growth in the non-oil sector.

Graph 37. Growth expectations for 2015, %



Source: Azerbaijan Government, IMF, WB

As per official forecasts, the share of the key driver of economic growth – the non-oil sector in GDP will y.o.y increase 7.8 p.p. and constitute 68.8% as of the yearend. Economic growth will be driven by investment and consumer spending.

As of end-2015 the real growth rate of capital investments will constitute 9.2%. Economic growth will be positively affected by domestic and foreign investments alike. Large-scale oil and gas projects, as well as high credit rating of the country in the light of complex global environment ensure higher foreign investment inflows, which are expected to increase by 49% by the yearend.

Households' consumer spending, another critical factor of economic growth, is expected to rise 1.4% in real terms. Consumer spending is mainly affected by high income of the population, which is expected to rise 1.9% in real terms.

Despite sharp slump in global oil prices, which is of key export products, the net export contributes to

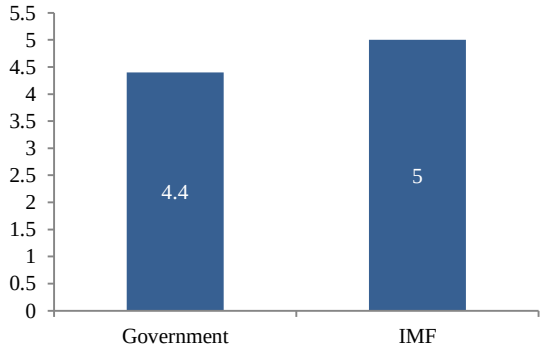
[2] *2016 state budget package of the Republic of Azerbaijan*

nominal GDP. Foreign trade balance is expected to have surplus as of the yearend.

Inflation expectations. Inflation is expected to remain on single digits as of the yearend. It reacts to price slides in global commodity markets, lingering devaluations in trade partners, as well as the dynamics of money supply.

Average annual inflation is officially forecast to be 4.4% in 2015.

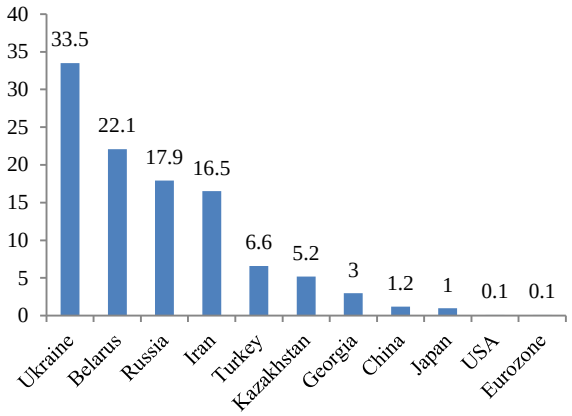
Graph 38. Annual average inflation expectations for 2015, %



Source: Azerbaijan Government, IMF

Estimations which are based on the forecasts of the IMF suggest that average annual inflation in Azerbaijan will lag behind the one in CIS countries by 10.9 p.p. and 3.4 p.p. the one in trade partners.

Graph 39. Inflation expectations in main trade-partner countries, 2015, %



Source: IMF

Findings of the Real Sector Monitoring by the CBA coincide with single-digit inflation forecast. According to monitoring findings, the price expectation index rose in industry and services, was neutral in construction, and dropped in trade. Sectorial price slide expectations are on postal services, healthcare, tourism, vehicles, and real estate and construction materials.

Single-digit inflation forecasts show how adequate the CBA implemented monetary and exchange rate policy was in the current year.

Graph and tables

Graphs

Graph 1	Global economic growth in 2015 ----------	5
Graph 2	Unemployment rate----------	8
Graph 3	Price indices ----------	10
Graph 4	Average monthly Brent oil prices ----------	10
Graph 5	Global supply-demand market in 2015----------	11
Graph 6	Global financial stability map: Risks and conditions----------	13
Graph 7	Dynamics of financial indexes----------	13
Graph 8	The exchange rate of the USD ----------	13
Graph 9	Trade balance ----------	14
Graph 10	Share of main trade partners----------	14
Graph 11	Change in export of main commodities----------	15
Graph 12	Changes in import of commodities----------	16
Graph 13	Inflow of remittances ----------	16
Graph 14	Foreign investments ----------	16
Graph 15	Final consumption ----------	18
Graph 16	Retail trade turnover ----------	18
Graph 17	Population income and wages----------	20
Graph 18	Sectorial breakdown of investments----------	20
Graph 19	Economic growth in 9 month--- ----------	22
Graph 20	Contribution of non-oil sector to GDP ----------	22
Graph 21	Sectorial growth of non-oil economy, 9 months of 2015----------	23
Graph 22	Sectorial contributions to non-oil economic growth in 9 months ----------	24
Graph 23	Number of employed people----------	24
Graph 24	Average annual inflation----------	26
Graph 25	Components of annual average inflation ----------	26

Graph 26 Scale of inflation ---------- 27
Graph 27 Annual average core inflation in 9 months---------- 27
Graph 28 Annual average change in Producer Price Index---------- 28
Graph 29 Exchange rate of USD&EUR against Manat ---------- 30
Graph 30 Dynamics of REER ---------- 31
Graph 31 Parameters of the interest rate corridor ---------- 32
Graph 32 Reserve requirements ---------- 34
Graph 33 Money multiplier in AZN---------- 35
Graph 34 Change in money supply---------- 35
Graph 35 Dynamics of money supply (M3)---------- 36
Graph 36 Global growth expectations for 2015---------- 37
Graph 37 Economic growth expectations for 2015---------- 42
Graph 38 Annual average inflation expectations for 2015 ---------- 43
Graph 39 Inflation expectations in main trade-partner countries, 2015---------- 43

Tables

Table 1 Share of spending items in trade facilities in 9 month of 2015---------- 17
Table 2 Sources of investments ---------- 19
Table 3 Turnover in FX market over 9 months 2015---------- 29
Table 4 Monetary aggregates ---------- 32
Table 5 Dynamics of commodity prices ---------- 35

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