The main goal of this publicly disclosed quarterly review is to present the analysis of current macroeconomic developments and information on the monetary policy implemented by the Central Bank of the Republic of Azerbaijan to broad public.

Baku – 2017
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## ACRONYMS

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**ACRONYMS**

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<td>CBA</td>
<td>The Central Bank of the Republic of Azerbaijan</td>
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<td>ADB</td>
<td>The Asian Development Bank</td>
</tr>
<tr>
<td>EBRD</td>
<td>The European Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>ILO</td>
<td>The International Labor Organization</td>
</tr>
<tr>
<td>IMF</td>
<td>The International Monetary Fund</td>
</tr>
<tr>
<td>NBCI</td>
<td>Non-bank credit institution</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign direct investment</td>
</tr>
<tr>
<td>SSC</td>
<td>The State Statistics Committee</td>
</tr>
<tr>
<td>DGCs</td>
<td>Developing countries</td>
</tr>
<tr>
<td>DDCs</td>
<td>Developed countries</td>
</tr>
<tr>
<td>OECD</td>
<td>The Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>CPI</td>
<td>The consumer price index</td>
</tr>
<tr>
<td>APPI</td>
<td>The agricultural producer price index</td>
</tr>
<tr>
<td>SME</td>
<td>Small and medium-sized enterprises</td>
</tr>
<tr>
<td>NEER</td>
<td>The nominal effective exchange rate</td>
</tr>
<tr>
<td>OPEC</td>
<td>The Organization of Petroleum Exporting Countries</td>
</tr>
<tr>
<td>REER</td>
<td>The real effective exchange rate</td>
</tr>
<tr>
<td>RSM</td>
<td>The Real Sector Monitoring</td>
</tr>
<tr>
<td>IPPI</td>
<td>The industrial producer price index</td>
</tr>
<tr>
<td>NFES</td>
<td>The National Fund for Entrepreneurial Support</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>The United Nations Conference of Trade and Development</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>WTO</td>
<td>The World Trade Organization</td>
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EXECUTIVE SUMMARY

The CBA underpinned macroeconomic stability in Half I, 2017. The Bank implemented anti-inflationary monetary policy – effectively managed currency emission sources jointly with relevant authorities and pursued an adequate interest rate policy over the period.

The CBA operated amid relatively improved balance of payments of the country in Half I, 2017. Constant measures to expand non-oil exports and support import substitution, comparatively higher oil prices, and increased economic activity in partner countries had a positive impact on the BoP.

The exchange rate has become more flexible since current January after critical preparatory efforts to improve the monetary policy’s strategic frame. The Bank introduced a new competitive FX auction mechanism, and removed the limit on exchange rate spreads in the cash and cashless FX market. The USD/AZN exchange rate, that was highly volatile at the initial stage of the more flexible FX policy implementation, was gradually replaced by stability in the FX market.

In total, accomplished policy measures and improved BoP yielded and strengthened positive patterns in macroeconomic stability in Half I, 2017. On the backdrop of the rebalancing in the FX market, high inflation expectations slowed down, the monthly inflation rate has been sliding since January. It became possible to increase money supply without detriment to macroeconomic stability.
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1 Global economic trends

Global economic growth continued to accelerate thanks to recovery in investments, manufacturing and trade in Half I, 2017. Economic growth, and recovery of commodity prices from their troughs as a result of agreed restrictions on oil supply helped reduce deflationary pressures.

Global economic growth. Revival of demand, investment demand in particular, from Half II, 2016 accelerated global growth. Following a slowdown in late 2015 and early 2016, manufacturing and trade displayed considerable growth. While the economic growth rate varied across DDCs, the overall trend was positive in Half I, 2017.

Business and consumer confidence indices increased in OECD countries. The indices (Graph 1) have been steadily increasing over the past 10 months. The business confidence index increased by 0.9%, while the consumer confidence index increased by 0.4% y/y.

Source: IMF

Expansion of private consumption and recovery of global trade triggered economic growth. The US economy grew by 1.4% in Quarter I, above the initial projection of 0.7%. The FED’s preliminary estimates suggest that economic growth was 1.9% in Quarter II.

Uncertainties after the Brexit referendum affect economic growth. According to initial forecasts, economic growth was 0.3% in the UK in Quarter
II, 2017 (the same with the previous quarter), with a 0.3% y/y decline.

Driven by net export expansion, Japan’s economic growth was higher than expected. Unemployment dropped down to 2.8%.

Economic growth in Germany, the Eurozone’s dominant economy, significantly increased as a result of strong domestic demand. Preliminary estimates suggest that the German economy grew by 0.6% in Quarter II, 2017.

DGCs displayed various growth rates over the period. The Chinese economy grew at a high rate with constant government support, while India’s economic activity slowed down due to the provisional negative consumption shock arising out of currency exchange initiatives. The Chinese economy grew by 2.21% in Half I, 2017. Economic activity in oil and non-oil commodity exporters remained weak. Economic growth slightly stagnated in the Middle East and Turkey due to geopolitical factors.

**Global employment.** According to recent data from the ILO, the number of unemployed is expected to be 201.1 million throughout the world, which means that global unemployment will equal 5.8% in 2017. Overall, the number of the unemployed is 37.9 million in DDCs, and 147 million in DGCs. The young account for 35% (71 million) of the total unemployed. The vulnerable employment accounts for

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1 The large denomination currency reform of the Prime Minister in 2016
42% of total employment, which includes households’ activity and self-employment. In DGCs, almost one out of every two employees belongs to the vulnerable employment group. Long-term unemployment remains high in both Europe and North America. Despite a decline in the overall unemployment rate, long-term unemployment is still rising, particularly in Europe.

Global commodity prices. Global commodity prices, that rose in Half II, 2016, relatively decreased over the reported period. As of the end-Half I, 2017, the commodity price index published by the IMF dropped by 6.8% compared to early year. The food price index rose by 4.2%, while the metal price index decreased by 6%. The fuel price index rose by 45% relative to January, 2016, but dropped by 12% from early 2017. The non-fuel commodity price index remained stable compared to early year.

As of the end of June, the price for Brent oil dropped by 14.5% compared to early year. However, the average daily price of oil for 6 months of 2017 increased by 30% y/y. Despite the price declines in recent weeks, strengthened economic activity and positive expectations for aggregate demand indicate that the oil prices will
1.1 Global economic trends

equal $52-53 per barrel in 2017 (EIA, IMF).

At its May 25 meeting, OPEC decided to extend the production cuts agreement till March, 2018, beyond its original expiry date of June, 2017. The Energy Information Administration (EIA) of the US forecasts that OPEC’s average daily crude oil production will be 32.3 million barrel in 2017, and 32.8 million barrel in 2018.

Natural gas prices are also on the rise. The average price for Europe, Japan, and the US in February, 2017 was 19% higher than it was August, 2016.

Increased economic activity coupled with higher commodity prices has led to a rise in the global inflation since the beginning of this year. In some parts of Japan and Eurozone that experienced the lowest base inflation before, the inflation slightly rose over the recent months. Pass-through effects of sharp devaluations of early 2015-2016 slackened in other countries, thereby resulting in lower inflation in many cases.

**Global financial markets and the monetary policy.** Monetary policies in DDCs remained almost unchanged, while fiscal expansion projections gave rise to revival in financial markets over the period. Positive macroeconomic indicators and higher consumer confidence led to huge profits in stock markets of these countries in recent months.

The US Fed raised its benchmark interest rate in June, 2017. Reforms in the financial system and increased investments after the presidential

*Source: EIA*
election also raised profitability in financial markets. Profitability of 10 year treasury bonds of the US rose. The UK faced a sharp increase in long-term interest rates. Although long-term income grew moderately in Eurozone under the impact of political and banking sector uncertainties, it varied across countries.

Some central banks of DGCs softened their monetary policies, while some pursued tightened monetary policy. The refinancing rate was decreased by 275 basis points to 10.25% in Brazil, while it was increased by 125 points in Mexico. The refinancing rate was reduced by 1 p.p. to 9% in Russia due to faster than expected economic growth and inflation nearing the 4% target in 2016. The refinancing rate cuts were implemented in three stages: in March, April and June. Further reduction in the interest rate in Half II, 2017 is not excluded. The Chinese government tightened financial conditions to prevent a credit boom.

**Source: Reuters**

Although the Fed’s decision to raise its benchmark rate slightly increased the US dollar's REER, euro, British pound, Swiss franc, and Korean won have appreciated against the US dollar since the beginning of the year. While Brazilian real, Turkish lira and...
1.1 Global economic trends

Malaysian ringgit devalued, currencies of DGCs – commodity exporters, Russian ruble in particular, appreciated. Japanese yen appreciated by 4.7%, South African rand by 5.5%, and Chinese yuan by 2.7%. Economic growth is projected to be 2% in DDCs, and 4.6% in DGCs.

*Forecasts and risks.* Overall, recovery of the global economy accelerated after 2016, leading to positive expectations for the future. According to IMF’s recent forecasts, world growth is expected to rise from 3.1% in 2016 to 3.5% in 2017, and 3.6% in 2018, slightly above the October 2016 forecast.

Inflation is expected to be higher (2%) than it was in 2016 in almost all DDCs. Inflation in DGCs, except for Argentina and Venezuela, is expected to rise to 4.7% in 2017.

Among DDCs, the US economy is forecast to grow by 2.1% in both 2017 and 2018. Eurozone is expected to grow by 1.9% in 2017, and 1.7% in 2018. As of the current year-end, economic growth is forecast to be 1.7% in the UK, and 1.3% in Japan. Continuous moderate economic growth is likely to be supported by the stimulative fiscal policy in the US, accommodative financial conditions and higher investor confidence in Eurozone.

DGCs of Asia are expected to demonstrate sustainable growth. India’s economic growth forecast for 2017 has been reduced by 0.4% to 7.2% due to temporary negative consumption shocks. China’s growth is projected to fall to 6.7% in 2017, and 6.4% in 2018. Overall, economic expectations for DGCs of Europe are mainly positive, with 3.5% for 2017, and 3.2% for 2018. Latin American and Caribbean economies demonstrate weaker than expected recovery. These economies are likely to grow by 1.1% as of the end of 2017.
Forecasts related to CIS countries which include several trade partners of Azerbaijan y/y improved. Economic growth in these countries is projected to equal 1.7% in 2017. Russia, which experienced recession over the past 2 years, is expected to emerge from recession, with 1.4% growth in 2017. Improved financial conditions, recovery of aggregate demand, and stable oil and gas prices are the key factors for economic revival. Economic recovery in Russia is likely to contribute to other countries of the region through investments, trade channels and remittances.

Source: IMF, Global Economic Outlook, July, 2017
1.2 Azerbaijani external sector developments

Steps taken for non-oil export expansion and import substitution, as well as developments in the global economy and major trade partners affected Azerbaijan’s foreign economic position in Half I, 2017.

According to the State Customs Committee (SCC), foreign trade turnover amounted to USD 8.7 billion in Half I, 2017: exports USD 5.3 billion and imports USD 3.4 billion. Foreign trade surplus made up USD 1.9 billion.

EU countries account for 37% of trade turnover. Shares of individual countries in Eurozone trade were as following: Italy 41%, Germany 11%, Portugal 8%, and Czech Republic 6%.

CIS countries account for 17% of total trade turnover, of which Russia 65%, Ukraine 20%.

Other countries account for 32% of trade ties, divided as Turkey 43%, China 24%, Georgia 10%, Israel 8% and India 8%.

Export of commodities increased by 36.5% mainly due to both the oil and non-oil sectors. Thus, exports increased
by 28.8% on crude oil and by more than 6 times on natural gas.

Import of commodities decreased by 15.7%, and import on the public sector by 23.4% over the period.

Russia accounts for 19.4%, Turkey 16.8%, China 9.8%, Germany 5%, Ukraine 4.8%, the USA 4.4%, and Italy 4% of imported products.

Imports increased on meat, milk, tea, sugar, wood and wood products, butter and other milk oils, while it decreased on fruits and vegetables, wheat, cement, vehicles and spare parts and furniture.

Key export partners were Italy (23.1%), Turkey (11.7%), China (6.5%), Russia (5.5%) Portugal (5%), and Georgia (4.5%).

In Half I, 2017, the economic situation in trade partners affected dynamics of remittances to the country.
along with non-oil exports. According to initial data, remittances constituted USD 459 million over six months of 2017.

\[\text{Graph 13. Inflow of remittances, mln.$} \]

- 2017 6 months (initial): 459
- 2016 6 months: 290
- 2015 6 months: 546

Source: CBA

During the given period FDI inflows by foreign enterprises and organizations continued too. According to the SSC, direct investments from foreign sources amounted to AZN 4.3 billion equivalent (60% of total investments). The growth rate of FDIs was 0.6%.

\[\text{Graph 14. Foreign investments, mln. manat} \]

Investors from Great Britain, Turkey, Russia, Iran, the USA, Japan, Malaysia and Switzerland account for major part of investments to fixed capital stock among foreign countries and international organizations.

Strategic foreign exchange reserves were maintained at a critical level. As of end-Half I, 2017 strategic foreign exchange reserves made up USD 40.5 billion, sufficient to cover 33 month import of goods and services, and exceeded the sovereign debt by 3.6 times.

Source: SSC
II. MACROECONOMIC PROCESSES IN AZERBAIJAN

2.1. Aggregate domestic demand

In Half I, 2017, economic growth was mainly driven by domestic demand as in previous years.

**Final consumption expenditures.** According to the SSC, final consumption expenditures y/y increased by 20.8% in nominal terms, while the real growth rate of consumption expenditures was 6.1%.

The nominal size of final consumption expenditures amounted to AZN 20.3 billion, 86.3% of household income. Average consumer purchased on average AZN 352 worth of commodities and services monthly (y/y rise AZN 44.7).

The size of goods and services sold in the consumer market to meet consumer demand increased by 1.5% to AZN 20.5 billion.

Retail trade turnover increased by 1.8% to AZN 16.2 billion. Retail trade turnover on non-food products amounted to AZN 8.1 billion.

**Table 1. Share of spending items in trade outlets over 6 months of 2017, in %**

<table>
<thead>
<tr>
<th>Spending item</th>
<th>Share, %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Food products, beverage and tobacco</strong></td>
<td>49.2</td>
</tr>
<tr>
<td><strong>Knitwear, clothing and shoes</strong></td>
<td>17.4</td>
</tr>
<tr>
<td><strong>Electric appliances and furniture</strong></td>
<td>6.1</td>
</tr>
<tr>
<td><strong>Computers, telecommunication equipment and others</strong></td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Pharmaceuticals and medicals</strong></td>
<td>1.4</td>
</tr>
<tr>
<td><strong>Fuel</strong></td>
<td>5.7</td>
</tr>
<tr>
<td><strong>Other non-food stuff</strong></td>
<td>19.4</td>
</tr>
</tbody>
</table>

Source: SSC
Consumers spent 50% of their funds on food, beverage and tobacco at trade outlets.

Average consumer monthly purchased on average AZN 139 worth of food, beverage and tobacco and AZN 138.8 worth of nonfood items for private consumption in retail trade.

Catering turnover rose by 2.1%, and paid services to the population by 0.4%.

Consumer demand was driven by the rise in population’s nominal income. In January – June, 2017 population’s money income increased by 7.3% in nominal terms. Per capita income increased by 6.2%, while population’s disposable income increased by 10.4% to AZN 21.5 billion.

Nominal average monthly salary y/y increased by 6.3% to AZN 520.1 in January – February.

Bank loans to households, one of the components of consumer demand, dropped by 13.1%. The retail consumer lending portfolio constituted AZN 5.1 billion.

The population channeled AZN 776.4 million (3.3%) of income to savings.

**Government expenditures.**

Government expenditures were one of the critical factors of domestic demand. According to the Ministry of Finance of the Republic of Azerbaijan, state budget expenditures amounted to AZN 8.2 billion.2

Following the economic classification 42.7% (AZN 3.5 billion) of state budget expenditures were channeled to social spending (the salary fund, pension and social allowances, drugs and food), y/y rose 18.3% or AZN 541.4 million.

**Investment expenditures.**

Investments to the economy made up AZN 7.1 billion. AZN 4.3 billion worth

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of investments were channeled to the oil, while AZN 2.8 billion were channeled to the non-oil sector. Public sector accounts for 30.2%, and private sector accounts for 69.8% of total investments.

40% of funds channeled to fixed capital stemmed from domestic, while 60% from foreign sources.

**Table 2. Investment sources, %**

<table>
<thead>
<tr>
<th></th>
<th>2016 H1</th>
<th>2017 H1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Funds of enterprises and organizations</strong></td>
<td>75.9</td>
<td>70.3</td>
</tr>
<tr>
<td><strong>Bank loans</strong></td>
<td>9.1</td>
<td>11.9</td>
</tr>
<tr>
<td><strong>Budget funds</strong></td>
<td>10.8</td>
<td>11.4</td>
</tr>
<tr>
<td><strong>Off-budget funds</strong></td>
<td>0.9</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Population’s own funds</strong></td>
<td>3.2</td>
<td>4.6</td>
</tr>
<tr>
<td><strong>Other foods</strong></td>
<td>0.1</td>
<td>0.5</td>
</tr>
</tbody>
</table>

*Source: SSC*

Funds of entities and organizations prevailed in total investments (70.3%).
2.2. Aggregate supply and employment

The economic growth changed proportionate with aggregate demand changes.

Economic growth. According to the SSC, GDP made up AZN 31.3 billion in nominal terms. Per capita GDP made up AZN 3224.6.

The mining industry extracted 19.1 million tons of crude oil, and 9.3 million m³ of natural gas. Oil extraction dropped by 9%, and gas extraction by 0.2%.

Source: SSC

The value added in the non-oil sector y/y increased by 1.7% to AZN 19 billion (60.6% of GDP).

Source: SSC

Most areas of the non-oil sector posted growth.

The non-oil sector grew by 4.4%.

Employment. As of the end-period the labour force was numbering 5044.2 thousand persons.

Source: SSC
According to the SSC, the number of wage-paid workers y/y increased by 1.6% to 1525.2 thousand persons as of June 1, 2017.

Of the total wage-paid work employed by enterprises and organizations, 22.8% were involved in production, including construction (7.1%), processing (6.6%), mining (2.2%) and agriculture (3.1%).
2.3. Inflation

The average monthly inflation rate declined, while inflation expectations slowed down.

**Consumer Price Index (CPI).** According to the SSC, the average annual inflation rate was 13.9%. The CPI components - food prices shifted by 18.1%, non-food prices by 12.4%, and services by 9.4% on an annual basis.

<table>
<thead>
<tr>
<th>Component</th>
<th>Average Annual Inflation, %</th>
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<tbody>
<tr>
<td>CPI</td>
<td>10.5</td>
</tr>
<tr>
<td>Food</td>
<td>13.9</td>
</tr>
<tr>
<td>Non-food</td>
<td>12.0</td>
</tr>
<tr>
<td>Service</td>
<td>15.4</td>
</tr>
</tbody>
</table>

Source: SSC

7.6 p.p. of average annual inflation goes to the share of food, 3.3 p.p. to non-food and 3 p.p. to services.

Monthly inflation was prone to decline. Inflation made up 1.6% in February and March, and only 0.2% in April and May, while it was 2.3% in January. Monthly inflation in March across regions was close to monthly inflation throughout the country. Seasonal deflation has been observed since June (1% deflation in June).

Regional monthly price change indices demonstrate deflation in all regions in June.

Graph 20. Regional inflation in June, m/m, %

Source: SSC

The diffusion index - a measure of change dynamics pertaining to the number of goods and services with rising and falling prices in the basket of consumer goods - had a downward...
2.3. Inflation

Monetary policy review

January - June 2017

Figure 21. Scale of inflation, %

Graph 22. Annual average core inflation, %

Source: SSC, CBA estimations on the basis of SSC data

Overall, prices of 186 out of 521 items of goods and services declined and remained unchanged for 125 items.

The NEER, inflation expectations and inertia, inflationary processes in partner countries, administered prices, and seasonal and other factors influenced inflation over the period.

The annual core inflation averaged at 13.2 %, if to skip the items of goods and services, as well as seasonal agricultural products the prices/values of which are regulated by the government.

As it was noted, expectations also contributed to swings in consumer prices. While inflation expectations heightened under certain cost factors in some segments, overall, expectations were mainly prone to decline. Regular RSM by CBA revealed that price expectations fell on home appliances and vehicles and remained relatively stable on furniture for upcoming 3 months. Price expectations dropped on all segments in services, which manifested itself mainly in transportation, hotel, healthcare and
communication. They dropped on food and beverage, chemistry, textile, machine building and plastics segments in processing. Price expectations slightly increased in construction.

**Producer Price Index.** According to the SSC, the Producer Price Index shifted more on industrial products. The IPPI y/y increased by 49.7% mostly due to high prices in mining and electricity, gas and steam production (52% and 59.6% relatively). Prices increased by 52% in oil and gas extraction and 23.8% in metal extraction.

The PPI rose by 32.8% in processing industry. The highest price hike in processing was in tobacco products and knitting industry (45%), oil processing (41%), the chemical industry (43%) and metallurgy (50%).

![Graph 23. Annual average change in PPI, %](image)

Source: SSC

Agricultural output rose by 10.4% in PPI driven by price hikes for animal products (12.5%). Prices rose by 7.1% on forestry and 1.8% on fish and fishery products. Prices for plant growing products hiked 8.6% due primarily to price rise in fruit-growing.

Tariffs for transportation services increased by 10.6%, attributable to 12.3% rise in prices for cargo services. Although prices for passenger transportation rose by 5.3%, prices for communication and postal services remained unchanged.
III. MONETARY AND EXCHANGE RATE POLICY

3.1. The FX market and the exchange rate of manat

The exchange rate of manat conformed to BoP dynamics on the backdrop of higher exchange rate flexibility.

The FX market diminished in size y/y; USD denominated transactions decreased by 23.3%, while EUR transactions increased by 4.8%.

Transactions in USD accounted for 85.9%, while other currencies 14.1% of transactions in the FX market.

The Interbank FX market accounts for 24.4%, while the intrabank FX market accounts for 75.6% of currency transactions. 57.6% of USD transactions on the interbank FX market was carried out to control banks’ currency positions. 95.7% of transactions on the intrabank FX market comprise currency sales to legal entities.

The foreign exchange cash segment also downsized. While banks sold USD 151 million net cash in Half 1 of the previous year, they bought USD 91 million net cash over the past period of the current year, which is attributable to the stability of manat.
Complex measures to maintain macroeconomic and financial stability, policy decisions to ensure macroeconomic resilience made the exchange rate more flexible. The CBA changed the currency auction mechanism to make the exchange rate more flexible from 12 January 2017 onward. In harmony with these changes auctioned currency is sold at prices quoted by market participants on a new competitive basis. In other words, sale of the currency is conducted starting from the highest bidder and is completed until the lowest bidder.

The CBA holds currency auctions several times a week upfront informing market participants on auction parameters via Bloomberg terminal.

The CBA scrapped the requirement for banks to buy or sell cash and cashless foreign currency at a range of no more than 4% from the officially set exchange rate on 12 January 2017.

The Bank held $1687.6 million worth of total 47 currency auctions to organize currency sales of the SOFAZ (30.8% down y/y).

Source: CBA

On non-auction days the interbank FX market operated on the Bloomberg platform. The size of out-of-auction interbank FX market transactions amounted to $417 million.

Source: CBA
The official exchange rate of manat was set on the basis of the exchange rate on interbank transactions (both auction and off-auction) over the period.

Improved balance of payments and regulation of some foreign currency liabilities of the public sector out of the foreign exchange market had a balancing effect on the foreign exchange market, thereby stabilizing the exchange rate of manat.

The USD appreciated in January and the first half of February and started to depreciate slightly from the second half of February. The USD/AZN exchange rate stabilized over the second quarter. Whereas as of end-2016 the USD/AZN exchange rate stood at AZN 1.7707, it peaked to AZN 1.9200 on 01.02.17 and plunged to AZN 1.7020 on 26.05.17-01.06.17.

As of end-Half I, 2017, AZN appreciated 3.9% against the USD. The average daily USD/AZN exchange rate was AZN 1.74.

Bilateral exchange rates affected multilateral exchange rates. Total trade weighted REER of manat on the non-oil sector appreciated by 1.4%.

0.8% depreciation of the NEER has a downward effect, while inflation differences in partner countries has an upward effect on the REER.

The new exchange rate regime allows the CBA to maintain a required

Source: CBA

Graph 28. Exchange rate USD/AZN

Graph 29. Dynamics of REER, (2000=100)

Source: CBA
level of reserves. As of 30 June 2017 CBA’s foreign exchange reserves stood at USD 4964.1 million, exceeding internationally set sufficiency standards (coverage of three-month import of goods and services, ratio of national currency to money supply).
3.2. Monetary policy tools

Monetary policy tools were applied in light of inflation and money supply targets.

The Central Bank has discussed parameters of the interest rate corridor several times since the beginning of the year and made a decision on keeping the refinancing rate unchanged. Given the macroeconomic situation and conjuncture in the money market, the CBA Management Board decided to cut the corridor floor by 2% at its 21 June 2017 meeting. Currently, the corridor ceiling is 18%, the refinancing rate 15%, and the corridor floor 10%.

The Bank kept various term (1-day, 7-day, 14-day, 28-day) standing facilities and open market operations active to meet the economy’s money demand and efficiently manage liquidity.

Source: CBA

The Bank regularly used sterilizations and held 34 deposit auctions to attract available funds in the national currency and 23 auctions to place notes. Maturity of deposit operations is 14 days, while notes are placed for the period of 28 days. As of end-Half I, 2017 total outstanding amount of funds attracted through deposit auctions and placement of notes made up AZN 750 million – AZN 400 worth of funds attracted via deposit operations and AZN 300 million attracted via placement of notes.
3.2. Monetary policy tools

Note that deposit operations and placement of notes – as open market operations – are conducted at interest rates fluctuating between the interest rate floor and the refinancing rate (currently 10%-15%). Deposits were attracted at 10%-14.8%, and notes were placed at 12.01%-14.99%.

The reserve requirement was left unchanged.

Table 3. The reserve requirement, %

<table>
<thead>
<tr>
<th>Date</th>
<th>Foreign currency denominated liabilities</th>
<th>Liabilities in manat and precious metals</th>
<th>Funds attracted from nonresident financial sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.05.2011</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>01.07.2011</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>01.08.2014</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>01.03.2015</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>30.12.2015</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>03.03.2016</td>
<td>1</td>
<td>0.5</td>
<td>0</td>
</tr>
</tbody>
</table>

The reserve requirement on liabilities in the national currency and precious metals stood at 0.5%, 1% on foreign currency liabilities, and 0% on liabilities to the non-resident financial sector and settlements with international financial institutions.

Source: CBA
Monitoring findings display that banks’ cumulative balances on correspondent accounts with the CBA considerably exceeded amounts to be maintained as required reserves every month of the period.

Reserve requirements were applied on the averaging basis, which, in its turn, contribute to the development of the interbank market and allow banks to more flexibly manage liquidity.

By the decision of the Central Bank of the Republic of Azerbaijan dated 30 May 2017, required reserves on liabilities in manat and precious metals should be held in manat correspondent accounts and required reserves on liabilities in foreign currency correspondent accounts in order to effectively regulate money supply and thereby support price stability. Changes to ‘Regulations on the rate, calculation and maintenance of required reserves’ will take effect from 1 August 2017 and banks should maintain their liabilities in line with the changes specified in the regulations from 15 August.
3.3. Money supply

The CBA controlled money supply channels in light of inflationary factors making the money base the key operational anchor of the monetary policy.

CBA’s liquidity operations rested upon the money base target to regulate money supply channels and prevent rise in inflation.

While relatively softened in Quarter II, overall, the monetary conditions were neutral over the period. The money base – the key operational target of the monetary policy increased by 5.3% in response to money demand of the economy, including the fiscal sector, and made up AZN 8274.5 million as of end-Half I, 2017. This factor ensures stability of payment systems, thereby expanding lending to the economy.

Cash money supply in circulation (cash outside the banking system and in bank vaults) increased by 5.6%, while correspondent accounts in manat rose by 1.6%.

As of the end-period the money multiplier in manat was 1.38.

Graph 33. Change in money supply, %

Source: CBA

Broad money supply in manat (M2) decreased by 1% to AZN 11435.9 million.

Cash stock, savings of individuals and deposits of legal entities in the structure of money supply in manat (M2) performed differently; cash stock increased by 6.2%, and national currency denominated savings of individuals by 21.2%, while national currency denominated deposits of legal entities decreased by 21.9%.
3.3. Money supply

Table 4: Money aggregates, m. manat

<table>
<thead>
<tr>
<th></th>
<th>01.01.16</th>
<th>01.01.17</th>
<th>01.04.17</th>
<th>01.07.2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>M0</td>
<td>4 776</td>
<td>6 377</td>
<td>6 145</td>
<td>6 774.5</td>
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<tr>
<td>M1</td>
<td>6 897</td>
<td>8 960</td>
<td>8 411</td>
<td>9 263.4</td>
</tr>
<tr>
<td>M2</td>
<td>8 678</td>
<td>11 546</td>
<td>10 982</td>
<td>11 435.9</td>
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<tr>
<td>M3</td>
<td>21 287</td>
<td>20 890</td>
<td>19 903</td>
<td>20 973</td>
</tr>
</tbody>
</table>

Source: CBA

Term deposits in manat decreased by 16%, while demand deposits decreased by 3.7%.

Broad money supply (M3) increased by 0.4% to AZN 20973 million as of the end-period.

Dollarization of bank deposits underwent minor changes; the share of savings and deposits in foreign currency in M3 increased by 0.9 p.p. relative to the early year, and equaled 45.6% as of the end-period.

Source: CBA

Whereas foreign currency denominated savings and deposits accounted for 64.4% of total savings and deposits early year, they made up 67.2% as of the end of Half I, 2017.

Savings of individuals in manat increased by 21.2%, while their savings in a foreign currency decreased by 19.5%. Accordingly, dollarization of deposits of individuals decreased to 73.4% (79.6% early year).

Source: CBA

Dollarization of bank deposits underwent minor changes; the share of savings and deposits in foreign currency in M3 increased by 0.9 p.p.
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