THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW
January – September 2014

The key goal of the review is to address current macroeconomic situation analyses and expectations of the Central Bank of the Republic of Azerbaijan (CBA). Another goal of the present review, which is open to the public, is to regularly convey possible impacts of the policy pursued by the CBA on the economy to the public. The review is quarterly disclosed to the public.

Baku – 2014

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ACRONYMS

CBA	The Central Bank of Azerbaijan
ADB	The Asian Development Bank
EBRD	The European Bank for Reconstruction and Development
ILO	The International Labor Organization
IMF	The International Monetary Fund
FDIs	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
APPI	Agricultural Producer Price Index
SME	Small and medium entrepreneurship
NEER	Nominal Effective Exchange Rate
OG	Output gap
OPEC	Organization of the Petroleum Exporting Countries
REER	Real Effective Exchange Rate
RSM	Real Sector Monitoring
PPI	Producer Price Index
NFES	The National Fund for Entrepreneurship Support
UNCTAD	United Nations Conference on Trade and Development
GDP	Gross Domestic Product
WTO	World Trade Organization

Executive Summary

The Central Bank of Azerbaijan pursued its policy amid ongoing fragile global economic growth, accommodative monetary policies in advanced economies, changes in the geography of capital flows, remaining global financial stability risks, and strengthened domestic macroeconomic sustainability and diversification over the past period of 2014.

The country economy continued to develop dynamically on the backdrop of heightened vulnerability and uncertainty in global commodity markets. The non-oil economy was the main driver for economic growth. The balance of payments of the country was in surplus, and strategic foreign exchange reserves kept growing over the period.

In the 9 months of 2014 the CBA implemented an adequate policy, keeping an eye on factors affecting macro-economic and financial stability. The CBA directed its activity to aims as low-level inflation, the stable exchange rate of manat – a significant anchor for macro-financial stability, and maintenance of stability of the banking-financial system, and promoted the development of financial intermediation. As a result of the policy pursued, macroeconomic stability was maintained, with low levels of inflation.

I. GLOBAL ECONOMIC ENVIRONMENT AND EXTERNAL SECTOR

In 2014 global economic growth continued, though at a slower pace compared to the previous periods. Economic growth accelerated and the economic activity increased in advanced economies, while DGCs witnessed a slowdown in economic dynamics.

Geopolitical escalation, dynamics in commodity prices, the limited impact of stimulative macroeconomic policy in advanced economies, and the sovereign debt problem still remaining pressing significantly affected the global economic outlook. Despite existing risks, however, the world economy is likely to keep growing in the short term.

1.1 Global economic trends

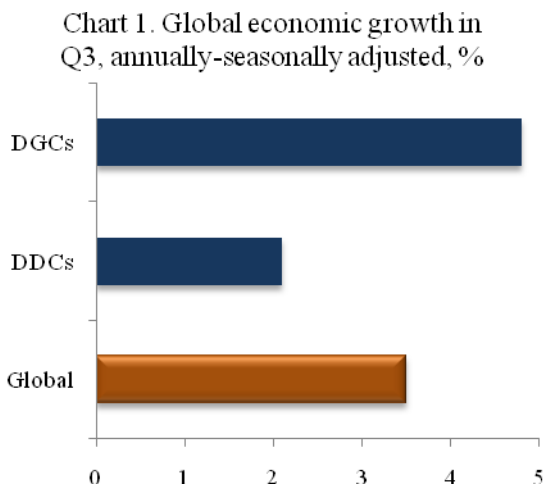
Post-crisis recovery and growth processes in the global economy continue at a fragile pace.

Accommodative monetary policy and slow-paced fiscal consolidation are among the main factors supporting global growth.

Initial estimates suggest that the global economy grew 3.5% over Q3. DDCs grew 2.1%, and DGCs 4.8%. Overall, economic growth from the beginning of H2, 2014 has been slower than expected, which is a ground for negative expectations for the year-end.

The U.S. and Great Britain economies have grown faster relative to other DDCs. The Japanese economy has been growing as well, however, high public debt of previous years and low growth potential cause serious macroeconomic challenges. Growth in the euro zone economy may fall to zero, particularly in

southern part of the euro zone periphery.



Source: Barclays Capital, economist.com

The U.S. economy grew 3.5% over Q3 of the current year. The increase in consumption and to some extent in investment was the main driver of growth. Ongoing economic growth also positively contributed to employment growth. Given the positive dynamics, the U.S. Federal Reserve continued its activities to tighten monetary policy. Thus, the Federal Reserve reduced monthly liquidity support to the economy down to USD 15 billion (*which was USD 85 billion in September, 2012*).

The euro zone economy is still facing serious macroeconomic problems. The euro zone economy grew 0.2% over Q3. Under these circumstances, the ECB further easied its monetary policy in order to enhance the economic activity. Thus, the refinancing rate was reduced from 0.25% in the early year down to 0.15% in June, and to 0.05% in September. Despite the refinancing rate cuts, the euro zone is still prone to deflation.

Japanese economy contracted with a 1.6% annulized decline over the reporting period. The 'Abenomics' policy, which gained popularity in a short period of time, accompanied by positive dynamics, continued over the reporting period.

Box 1. Comparison of economies by their GDP size

The World Bank announced the key results and findings of the 2011 International Comparison Program in August, 2014. Note that the International Comparison Program is a worldwide statistical initiative - the largest in geographical scope, established in 1960 by the UN.

Ranking by GDP	Economy	GDP size, USD billion (PPP-based)	Share in world GDP (world = 100%)
1	United States	15534	17.1
2	China	13496	14.9
3	India	57858	6.4
4	Japan	4380	4.8
5	Germany	3352	3.7
6	Russian Federation	3217	3.5
7	Brazil	2816	3.1
8	France	2370	2.6
9	United Kingdom	2201	2.4
10	Indonesia	2058	2.3
11	Italy	2057	2.3
12	Mexico	1895	2.1

According to the estimate of 2011, the PPP-based world GDP as represented by the 177 economies was $90,647 billion.

High-income economies* (56 economies), which are home to only 16.8 percent of the world's population, account for 50.3 percent of the world's GDP. Middle-income economies (84 economies), home to 72.1 percent of the world's population, produce 48.2 percent of the world's GDP. Low-income economies (32 economies) account for only 1.5 percent of the global economy with 11.1 percent of the world population.

Estimates suggest that average per capita world GDP accounts for $13,460. 28 percent of the world's population lives in economies with per capita GDP expenditures above the $13,460 world average. 72 percent lives in economies that are below that average. Per capita GDP averages $40,282 in high-income economies, $9,004 in middle-income economies, and $1,839 in low-income economies.

PPP-based GDP for Azerbaijan is estimated to be $144.5 billion (nominal exchange rate based GDP - $44.6 billion). The gap between PPP-based GDP and nominal exchange rate based GDP is related to considerably lower prices in Azerbaijan compared to world prices. Per capita GDP for Azerbaijan is estimated to be $15,963, 18.6 percent higher than the world average and 77 percent higher than the average of middle-income economies.

** The categorization of economies by income group is based on the classification depending on the per capita income level through the Atlas method. The income categories for 2011 are as follows: low income—per capita gross national income (GNI) less than $1,025; middle income—per capita GNI from $1,026 to $12,475; and high Income—per capita GNI greater than $12,475.*

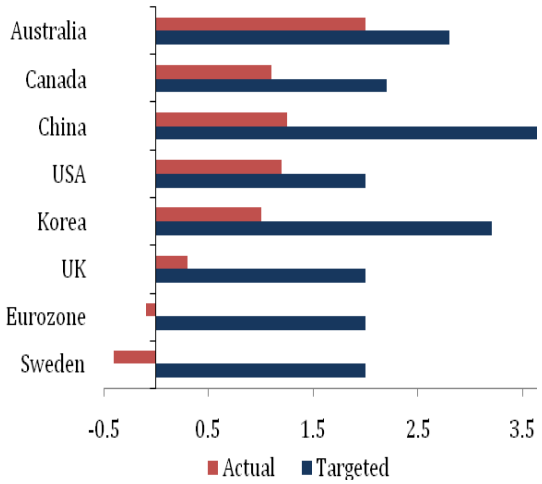
Source: "Purchasing Power Parities and Real Expenditures of World Economies, Summary of Results and Findings of the 2011 International Comparison Program", www.worldbank.org

Economic growth in DGCs is about 2 times higher than in DDCs, though below pre-crisis levels. China maintained high growth, which started to slow down, however. (0.2-0.3 p.p.) India put an end to the economic downturn, while the uncertain investment environment deteriorated growth prospects in Russia and Brazil. Estimates from international financial institutions suggest that Russia's poor economic growth could reduce money remittances sent to other CIS countries.

Relatively higher interest rates in some advanced economies lead to changes in the geography of global investment flows. The changing geography of capital flows increases volatility in financial and foreign exchange markets of DGCs, poses grave risks to financial stability, and may possibly aggravate macroeconomic problems.

Advanced economies are becoming more prone to deflation. The U.S., Great Britain, and most of the Euro zone countries witnessed below target inflation rates over the period. Inflation is less than 2% in China, below the Chinese government's 4% target.

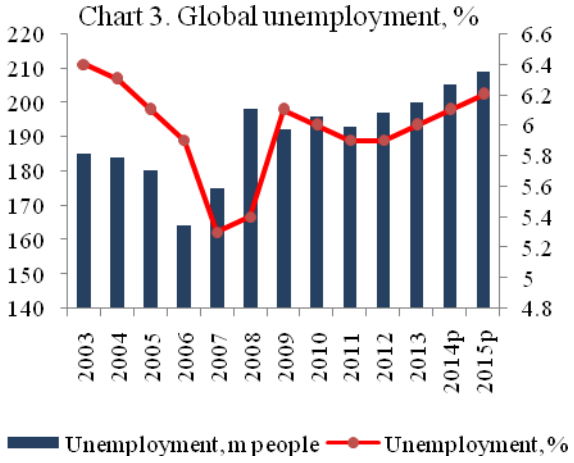
Chart 2. Targeted and actual inflation, September 2014, %



Source: based on data provided by Central Banks

Unemployment still remains problematic becasue of sluggish economic recovery. According to the ILO, there are over 200 million unemployed people worldwide, 73 million of whom are young people. Unemployment averages 7.6% in DDCs, and 6.7% in DGCs. The highest unemployment rates among European countries were registered in

Greece (27.1%), Spain (25.1%), Croatia (17.4%), and the lowest unemployment rates in Austria (4.9%), Germany (5.1%), and Luxemburg (6%).



Source: ILO

Among advanced economies, the U.S. proved most successful in reduction of unemployment. Currently, the unemployment rate in the U.S. is 5.9%, having decreased 4.1 p.p. relative to October, 2010 (the highest figure in the crisis period – 10%).

Box 2. Demand factors in global growth

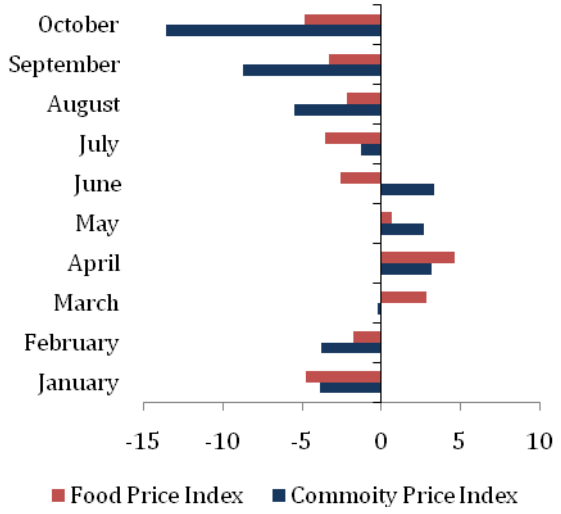
The most important challenge in the global economy is that private demand is not still the major driver of growth. Amid increased financial stability risks, banks in advanced economies are cautious about transforming accumulated large savings to investments. Under these circumstances, GDP grows primarily supported by public demand and accommodative monetary policy. Six years after the global crisis and global economic growth is still weak amid the monetary policy of zero interest rates. Fiscal stimulus channeled to economy, accommodative monetary policy, and partial solution to the problem of public debt were not sufficient to ensure the sustainable economic activity over the period. Under these conditions, discussions on stimulating investments by applying negative interest rates are underway. This, however, bears in itself the risk of reduced impact effectiveness of classical policy tools (fiscal-monetary).

Source: "Secular stagnation, facts, causes and cures" edited by Coen Teulings and Richard Baldwin. *www.voxeu.org/sites/default/files/Vox_secular_stagnation.pdf*

1.2. International commodity markets

A decline in global demand and economic activity reflected also in recent commodity market developments. Weak aggregate demand and fragile economic activity leads to drops in world commodity prices and a fall in inflation rates in different country groups.

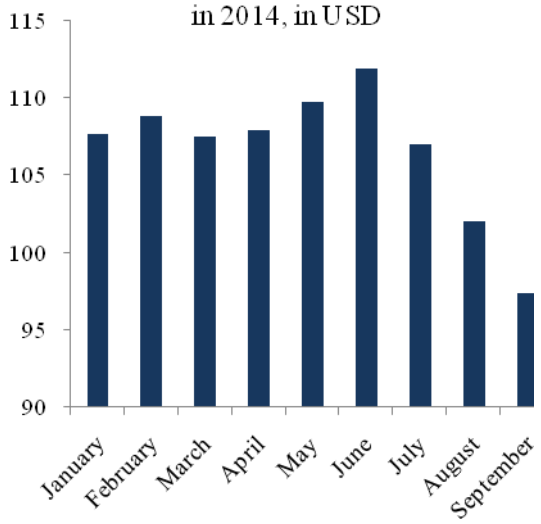
Chart 4. Dynamics of price indices, y.o.y., %



Source: IMF

In the 9 months of 2014, the commodity price index dropped 8.3%, and the food price index 5.8%. As of the end of the reporting period, the price for Brent oil fell 9.5% relative to the early year.

Chart 5. Average price for Brent oil in 2014, in USD



Source: IMF

Political escalation in some major oil exporters had an incremental effect on oil prices, while lower global demand and an increase in production and export of shale oil in the U.S. had a decremental effect.

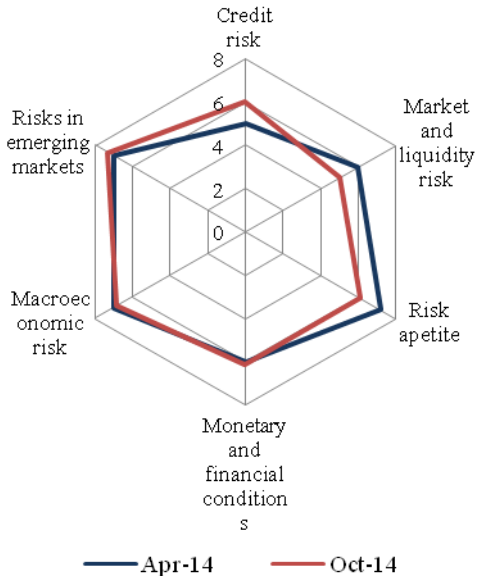
By the end of September the metal price index decreased 12.5% relative to the early year due to weak economic growth in China, and the appreciation of the U.S. dollar. However, the price of aluminum increased 11%, while the price of gold remained stable.

1.3. Global financial markets

Over the past period of 2014, a number of risks to global financial stability remained, with increased volatility in financial markets.

IMF estimates suggest that credit risks have been increased in global financial markets since April, while market and liquidity risks, as well as risk appetite decreased.

Chart 6. Global Financial Stability Chart*



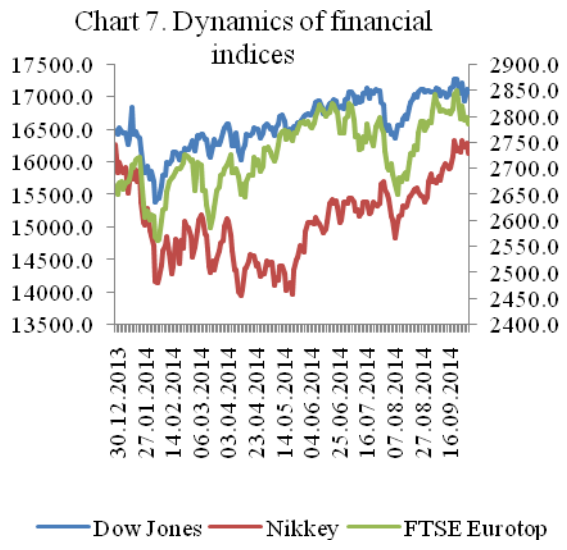
** Deviation from the center denotes high risk, accommodative monetary and financial conditions, and high risk appetite.*

Source: IMF

IMF estimates are fully consistent with the ECB stress tests. Thus, according to the results of the stress test conducted by the ECB in September, 2014 20 percent of systemically important banks in Southern European countries are facing bankruptcy risks. The banking system, facing serious financial stability risks, is still unable to stimulate private demand.

Generally, the effect of transmission of dramatic easing of monetary policy by central banks of advanced economies to the real sector and the strengthening financial sector remains anemic. Tougher prudential policies hinder growth of bank lending.

The dynamics of financial indices reflects effects of global economic processes. Relative to the early year, the Dow Jones index rose 3.6%, the FTSE Eurotop 4.5%, while the Nikkei dropped 0.8%.

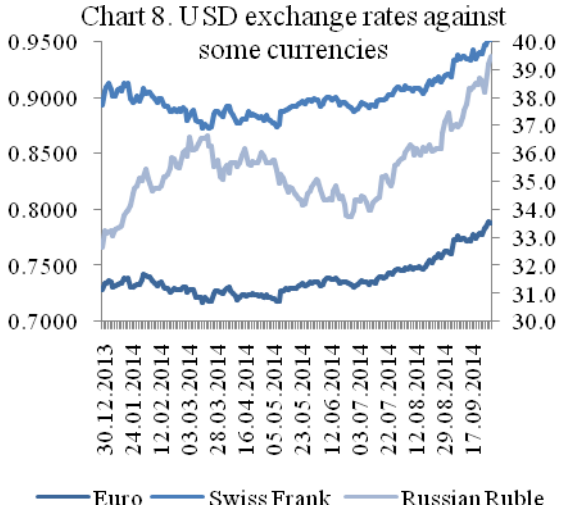


Source: Bloomberg

High probability of recession leads to a fall in global risk appetite of investors, and an increase in investments in safe heavens[1] and particularly in state securities of the U.S. and Germany.

The "tapering" (gradual exit from accommodative monetary policy) policy of the U.S. Federal Reserve is likely to affect financial markets significantly from next quarter.

Global economic processes, relatively strong economic position of the U.S. in particular, the decline of crude oil prices, and ongoing uncertainties in the euro zone are followed by the strengthening of the USD.



Source: Bloomberg

Thus, the USD has strengthened against the euro by 8.2% from the start of the current year.

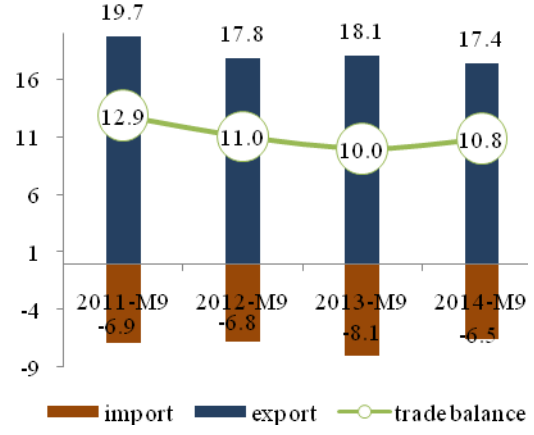
[1] *Investment instruments with high liquidity even in the crisis period. Gold and government securities of developed countries are the most typical examples of safe heavens.*

1.4. Azerbaijan's external sector developments

The country's foreign trade balance was in surplus and foreign exchange reserves kept growing over the reporting period.

According to the State Customs Committee (SCC), in the first 9 months of 2014 the foreign trade turnover constituted USD 23.9 billion, of which USD 17.4 billion falls to the share of export and USD 6.5 billion to import.

Chart 9. Trade balance, USD billion.



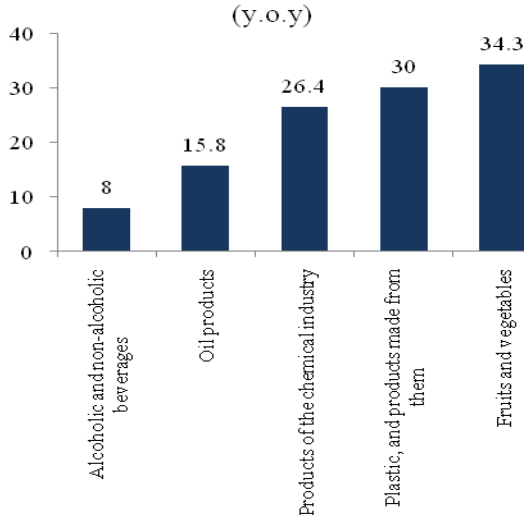
Source: SCC

Over the period the surplus of trade balance was USD 10.8 billion, while export exceeded import by 2.7 times. Y.o.y. increase in the surplus of trade balance was 8%.

53.3% of export was channeled to the EU countries, 3.6% to the CIS. 34.2% of import falls to the share of the EU, 22.4% to the CIS.

The main sectors of export with high growth rates include fruits and vegetables, beverages, oil products, chemicals, plastics and plastic products, etc.

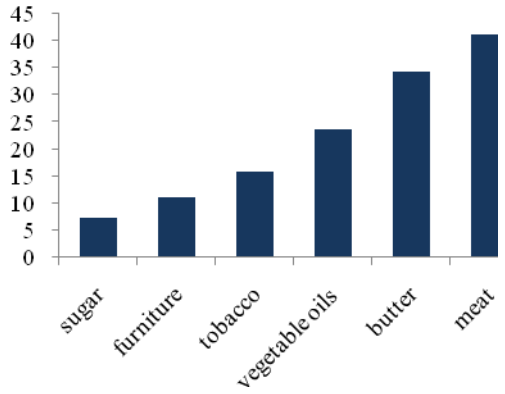
Chart 10. Changes in main export commodities, 9 months of 2014, % (y.o.y)



Source: SCC

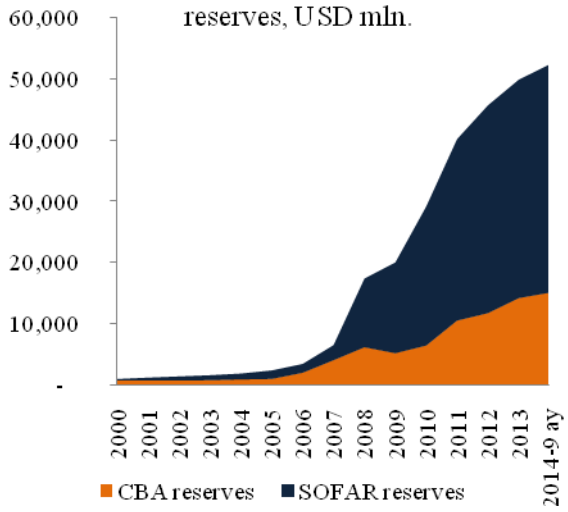
Imports with higher growth rates include meat, vegetable oils, butter, sugar, tobacco, furniture and others. A decline in imports of some product groups was due to the expansion of domestic production.

Chart11. Changes in main import commodities, 9 months of 2014, % (y.o.y)



Source: SSC

Chart 12. Strategic FX reserves, USD mln.



Source: CBA

High activity of foreign investors was maintained in the country. According to the SSC, the volume of foreign investments to the country economy exceeded USD 4.5 billion in January – September 2014, which takes 29.6% of total investments.

The dynamics of FX reserves reflects positive processes in the external sector. As seen from the below Chart, in the 9 months of 2014 country's FX reserves rose USD 3.5 billion or 7% and reached USD 53.7 billion. CBA's FX reserves grew by 6.1% to USD 15 billion.

Strategic FX reserves of the country are sufficient for about three-year import of goods and services.

II. MACROECONOMIC PROCESSES IN AZERBAIJAN

In the 9 months of 2014 the country economy continued to grow on the backdrop of a favorable foreign position. In January – September overall economic growth was driven by high growth of the non-oil economy.

2.1. Aggregate demand

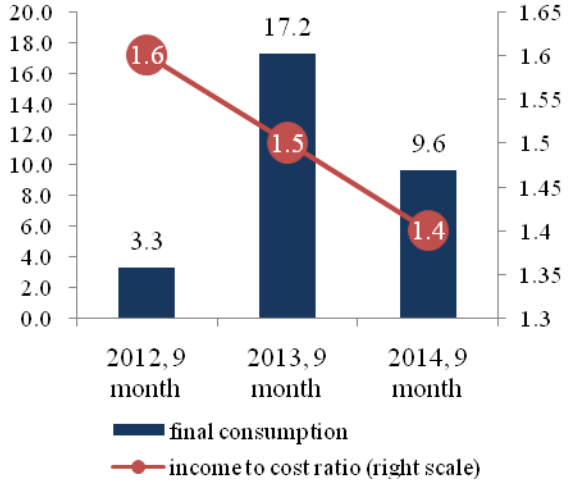
In the 9 months of 2014 growth of income of the population and investments in the economy reflected in demand components of GDP.

Final consumption expenditure in the 9 months of 2014 y.o.y. increase in money income of the population was 5.4% in nominal terms and 3.9% in real terms. Per capita nominal money income of the population increased 4% and real money income 2.5%. In January–August, 2014 average salary in the country rose 5.9% in nominal terms and made AZN 440.9.

Y.o.y increase in disposable income of the population was 5.9% and made up AZN 24.7 billion. The income to expenses coverage ratio of the population was 1.4.

In the 9 months of 2014 total consumer activity was high owing to an increase in real income of the population. Y.o.y increase in consumption expenditures made up 9.6% (17.2% - in 9 months of 2013).

Chart 13. Final consumption expenditure, y.o.y.,%

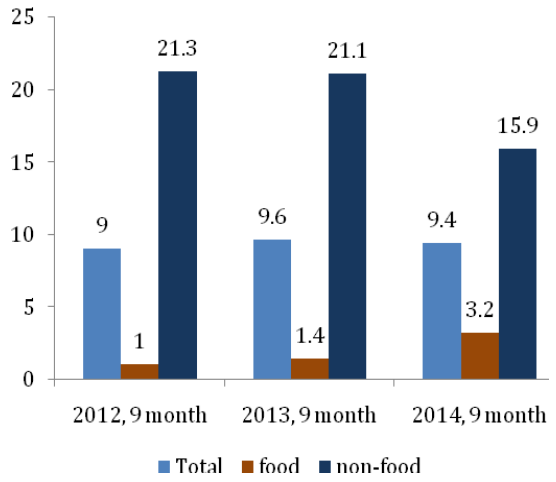


Source: SSC

Growth in consumer spending contributes to retail turnover growth. In January-September, 2014 the volume of goods and services sold in the consumer market to meet

consumer demands increased 8.9% y.o.y. Y.o.y. increase in retail trade turnover was 9.4%, including 9.4% in the private sector.

Chart 14. Trade turnover dynamics, %



Source: SSC

In the 9 months of 2014 y.o.y. rise in retail trade turnover on food was 3.2% and 15.9% on non-food products. Off-free services to the population grew by 6.4%, including 7.8% on non-state ownership. The share of the private sector in off-free services to the population was 76.8%.

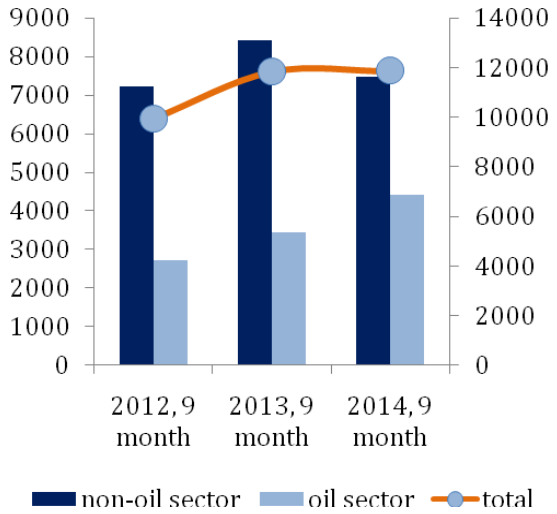
The next survey on "Financial behavior, intentions and inflation expectations of households" conducted among 4250 households (families) in September, 2014 suggests that the Consumer Confidence Index (CCI) is at a level (25), considered high enough in international practice and in a positive zone.

Government expenditures. Government's consumption expenditures mainly directed to expenses on goods and services from the state budget over the reporting period. 43.9% of budget expenditures was channeled to the development of the economy, 11.2% to social protection and social welfare of the population, 7.6% to education, and 3.5% to healthcare.

Investment expenditures. In the 9 months of 2014 total investments to the economy increased 0.2% and made AZN 11.9 billion, equal to 27% of GDP. Investments to the non-oil sector made AZN 7462.4 million.

The share of investments to the non-oil sector in total investments was 62.9%.

Chart 15. Investments, mln.manat



Source: SSC

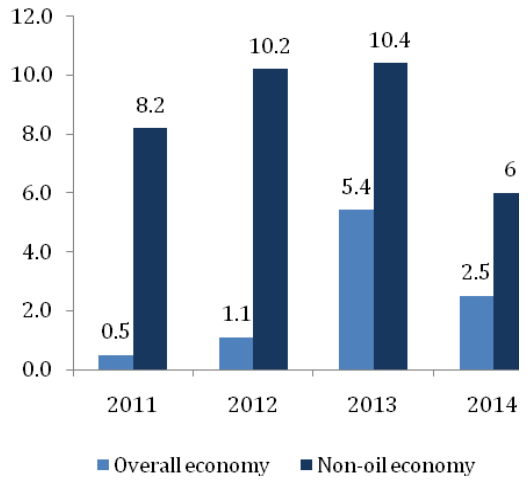
70.4% of funds channeled to capital stock stemmed from domestic sources, out of which 34.9% relates to the non-public sector. 29.6% of funds channeled to capital stock stemmed from foreign sources. 55.2% of investments sourced from businesses and organizations, 35.2% from budget.

2.2. Aggregate supply and employment

Economic growth kept pace adequately to aggregate demand over the reporting period.

Economic growth. In the 9 months of 2014 the economy grew at a rate of 2.5%. A 6% increase in the non-oil economy was the key contributor to the overall economic growth.

Chart 16. Economic growth in January-September, %

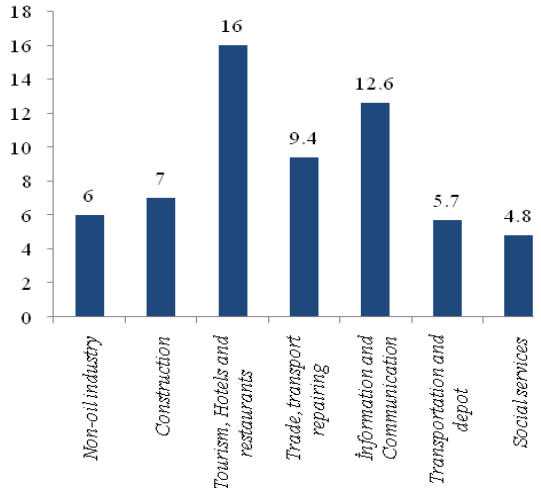


Source: SSC

Overall, the two third of the value added falls to the share of production and the one third to services. 57.9% of GDP falls to the share of the non-oil sector.

As seen from Chart 17, in January – September most segments of the non-oil sector posted growth. The highest growth rate among the segments was in tourism, hotels and restaurants, information and communication, as well as construction. Activities carried out within the 'Industry Year' were accompanied by the strengthening of positive trends in the non-oil industry. The non-oil industry increased 6% over the period.

Chart 17. Growth on segments of the economy, %



Source: SSC

Surveys conducted by the CBA demonstrate high economic activity in the country. The CBA's Real Sector Monitoring (RSM) results suggest that the Business Confidence Index[2] on both the non-oil manufacturing sector and the trade sector remained positive in the 9 months of 2014. Note that surveys are conducted among 400 businesses, covering 70 thousand employees.

Employment. As of the end of the reporting period, economically active population of the country was numbering 4820.7 thousand persons, of which 95.1% was engaged in various segments of the economy and the social sector. According to the SSC, as of the end of August the number of hired labor was 1511.4 thousand persons, y.o.y. increase being 1.3%. 95.5% of hired workers was engaged in the non-oil sector, while 4.5% in the oil sector.

[2] Business Activity Index in Industry = (production – product stock + production expectation)/3

Business Activity Index in Trade = (actual sales – product stock + sales expectation)/3

Box 3. Diversified development

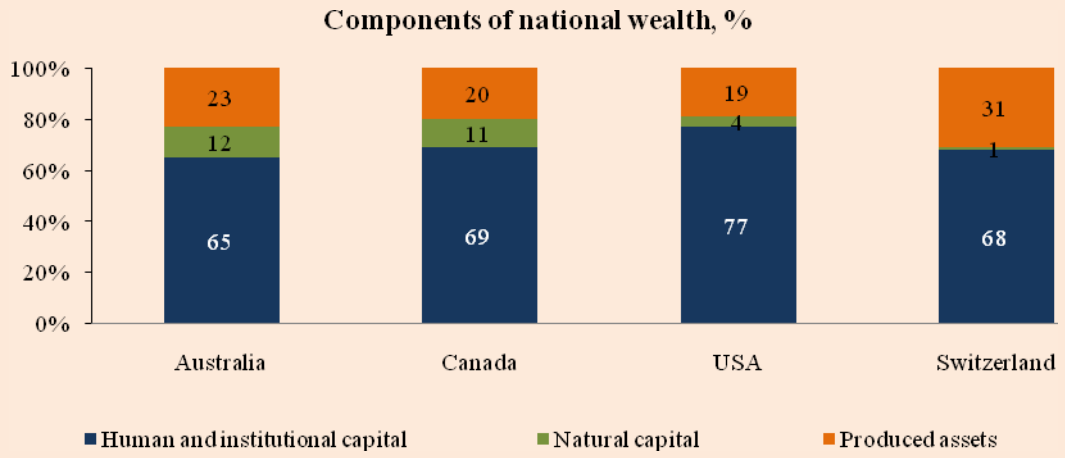
Diversification of economy and exports is among the trends of particular importance in most modern development paradigms. Diversification is the key way to get rid of a 'middle-income trap' – one of the major risks for DGCs.

In DGCs raw materials accounted for 80 percent of exports in 1990s, currently industrial products are 80 percent of exports. This change primarily stemmed from big industrial giants – China, S. Korea, India, Mexico, etc. These countries differ from other DGCs for both highly diversified economies and the level of economic development.

An interesting question arises when investigating the experiences of countries that achieved successful diversification of their economies and exports. Is commodity diversification necessarily important for economic growth?

The experiences of countries, like the U.S., Australia, Canada, and Brazil show that commodity diversification is in fact not necessarily important. In other words, the diversified range of commodities can be deemed sufficient for development.

As shown in the Chart, Canada and Australia have achieved high levels of well-being and economic development with lowly diversified exports. Exports of both countries, very narrowly specialized, are not diversified. This fact gives ground to look for key determinants of growth in another field.



The experiences of some countries stuck in a middle income trap suggest that economic growth can be achieved for a certain period of time at the expense of capital accumulation. However, after an economy comes to the level of sustainable growth, and the 'take-off' stage ends, the driver of sustainable growth can be achieved only through increasing efficiency.

When we take a look at the structure of national wealth of DDCs irrespective of the diversification level, we can see the largest share of 'Human and institutional development'.

The conclusion is that inclusive development results not only from diversification, but also from high-level human and institutional capital. Quality diversification of economy and exports becomes possible thanks to institutional development.

Sources:

1. Estimating National Wealth: Methodology and Results. World Bank, 1998

2. Diversified Development: Making the most of natural resources in Eurasia. World Bank 2014

2.3. Inflation

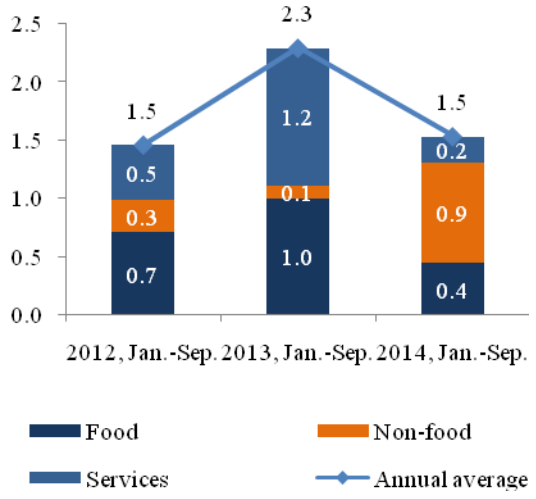
In the 9 months of 2014 prices remained stable and inflation was maintained at low levels. Lower than in trade partners growth rate of prices had a positive impact on the competitiveness of the economy.

Consumer Price Index (CPI). In the 9 months of 2014 average annual inflation decreased 0.8 p.p. against the relevant period of the previous year and amounted to 1.5%. Components of the CPI – food prices changed 1%, non-food prices 3.6%, while services changed 0.4% in January – September.

Estimates suggest that 0.4 p.p. of 1.5% average annual inflation stemmed from rise in food products, 0.9 p.p. in non-food products and 0.2 p.p. in services.

The average annual core price index, which is inflation adjusted from swings in prices for commodities regulated by the government and seasonal factors increased 1.8% in January – September.

Chart 18. Annual average inflation, %,



Source: CBA estimations based upon SSC data

In January-August 2014 import prices rose 0.5%. Prices of imported consumer goods increased 1.5%.

In the first 9 months of 2014 inflation in foreign trade partner DDCs was 1.1%, in DGCs 8.5%, in oil- exporting countries 8.2%. In total, average inflation in trade partners was 5.4%, which exceeds the average annual inflation in Azerbaijan 3.9 p.p.

Industrial Producer Price Index (IPPI). In the 9 months of 2014 the IPPI increased 1.2%, due to a

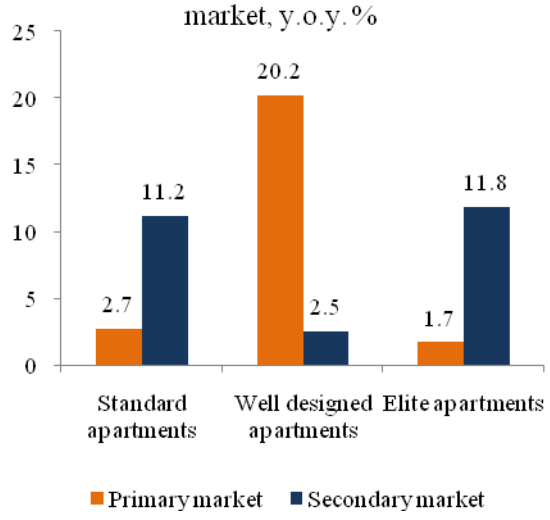
16.8% price upswing in the processing industry. Prices in the mining industry decreased 1.1%.

Agricultural Producer Price Index (APPI). Over the 9 months of the current year prices for agricultural products grew 0.8%. Prices for livestock products went up (3.4 %). Prices for plant products dropped 1.7%.

In the 9 months of 2014 slight price swings of agricultural products pooled to maintaining overall price stability.

Real Estate Prices. According to the SSC, in the 9 months of 2014 y.o.y. increase in real estate prices was 13.1%. Prices in secondary and primary markets respectively grew by 13.1% and 11.6%. The highest price hike in the secondary market was observed in low-quality apartments (15.4%), and in the primary market in well-designed apartments (20.2%).

Chart 19. Price index in housing market, y.o.y. %



Source: SSC

Other activity indicators on the real estate market also posted growth. According to the "MBA LTD Appraisal and Consulting Co", y.o.y. increase in rent fees for residential property was 11.9% and 8.9% for commercial property.

III. MONETARY AND EXCHANGE RATE POLICY

The CBA implemented its monetary and exchange rate policy in line with the "Statement of the Central Bank of the Republic of Azerbaijan on main directions of the monetary and financial stability policy for 2014" over the past period of 2014.

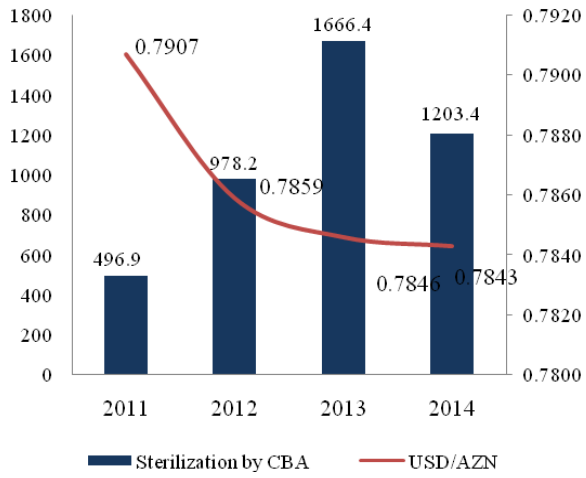
3.1. The FX market and the exchange rate of manat

In the 9 months of 2014 parameters of the exchange rate policy was determined taking into account the necessity of maintaining macroeconomic stability, the position of balance of payments, and objectives of safeguarding financial stability in the banking sector and competitiveness of the non-oil sector.

Over the reporting period the CBA pursued its exchange rate policy within targeting the bilateral USD/AZN exchange rate.

Amid balance of payments surplus in the country supply prevailed over demand in the FX market during the reporting period. The CBA sterilized USD 1.2 billion worth currency to prevent strengthening of the exchange rate over the 9 months of the current year.

Chart 20. CBA's sterilized intervention (USD million) and the exchange rate of manat, 9 months



Source: CBA

Consequently, the exchange rate of manat against the US dollar strengthened as little as 0.03%.

Box 4. The Bank of Russia's system of monetary policy instruments

The basis of the Bank of Russia's system of instruments is one-week auction-based operations which are conducted as repo auctions or deposit auctions, depending on the banking sector liquidity position. The uniform rate on these auctions is the Bank of Russia key rate which reflects the monetary policy stance. Auctions are held weekly, as a rule, on Tuesdays. The volume of funds provided (absorbed) at the auction is determined on the basis of a liquidity forecast for the coming week so that it can fully satisfy the average weekly need of credit institutions to attract or deposit funds. As there is currently structural liquidity deficit in the banking sector, the main operations used by the Bank of Russia are repo auctions.

Overnight standing facilities, which are available to banks on their own initiative, are used by the Bank of Russia to limit fluctuations in money market rates. Deposit operations are a standing facility used to absorb liquidity. Refinancing standing facilities are diverse in terms of the form of operations (secured loans, repos, swaps) and the types of collateral used (bonds, shares, foreign currency, claims on nonfinancial organizations, guarantees, gold) and offer banks a wide range of opportunities to obtain funds. However, the provision or absorption of liquidity is not the priority of such transactions, per se, and so their volumes are small compared with Bank of Russia main operations.

The Bank of Russia's system of instruments also includes refinancing operations with terms of more than one month, the use of which is conditioned by the specific circumstances of the Russian banking system. Non-marketable assets, guarantees and gold can be used as collateral for these operations. Amid rising structural liquidity deficit some credit institutions lack securities eligible as collateral for the Bank of Russia repo operations. In this environment the provision of funds using alternative forms of assets helps to reduce the burden on the main refinancing operations and thus to steer money market rates.

The main longer-term refinancing operations are monthly auctions to provide loans secured by nonmarketable assets for a three-month term at a floating interest rate linked to the Bank of Russia key rate. Thus, the interest rate on outstanding loans is adjusted for changes in the key rate. Additional longer term refinancing is provided through fixed-rate loans for terms of up to 12 months, secured by nonmarketable assets, guarantees or gold.

In order to manage banking sector liquidity, the Bank of Russia can also conduct other types of operations, in particular issuing Bank of Russia bonds (OBRs), and purchasing or selling securities in the open market. These operations are not used at the present time.

On 13 September 2013 the Bank of Russia Board of Directors decided to implement a set of measures aimed at developing the system of monetary policy instruments as part of transition to inflation targeting. These measures include:

1) introduction of Bank of Russia key rate by the unification of interest rates on one-week liquidity provision and absorption open market operations;
2) formation of Bank of Russia interest rate corridor and optimization of instruments for managing banking sector liquidity;
3) change (reduction) of refinancing rate role in the system of Bank of Russia instruments.

These measures contribute to strengthening the interest rate channel of the monetary policy transmission mechanism.

Source: "Доклад о денежно-кредитной политике", February 2014, N1(5), www.cbr.ru

Table 1. Bilateral nominal and real exchange rate indices of manat in 9 months of 2014

	Compared to December 2013	
	Nominal bilateral exchange rate index*	Real bilateral exchange rate index*
US	*100*	*97.6*
Euro area	*106.1*	*104.7*
Great Britain	*100.3*	*97.9*
Turkey	*107.1*	*99.6*
Russia	*115.3*	*107.3*
Ukraine	*156.7*	*133.5*
Georgia	*101.8*	*99.6*
Iran	*106.7*	*95.2*
Kazakhstan	*118.1*	*110.3*
Japan	*103.6*	*99.6*
Israel	*103.6*	*102.9*
China	*101*	*98.5*
Belarus	*111.3*	*97*
S. Korea	*98*	*95.6*
Switzerland	*104.6*	*97*

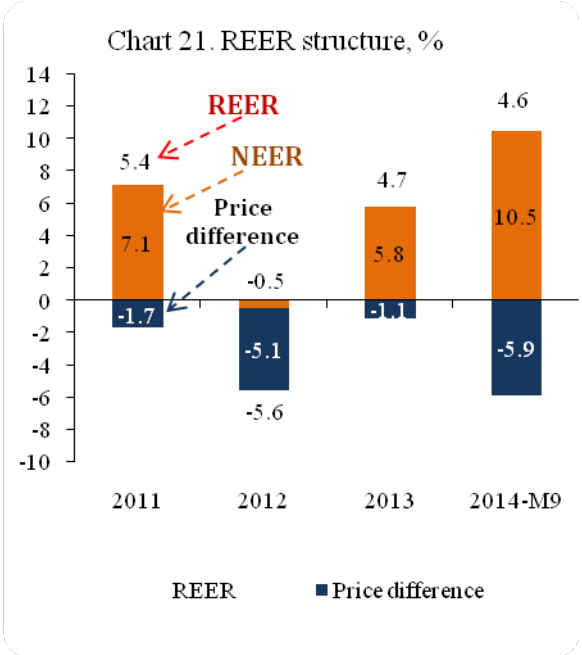
**Average monthly exchange rates of AZN against currencies of partner countries*

Source: CBA

Dynamics of the nominal bilateral exchange rate of Manat influenced real bilateral exchange rates. Manat strengthened both in nominal and real terms against the national currencies of the Euro zone, Russia, Ukraine, Kazakhstan, and Israel, and depreciated against the currencies of the USA, Great Britain, Turkey, Georgia, Iran, Japan, China,

Belarus, S. Korea and Switzerland in real terms.

In the 9 months of 2014 the NEER on the non-oil sector (on gross trade turnover) appreciated 10.5%. According to model estimations[3] 1% strengthening of the NEER decreases consumer prices by 0.28 p.p.



Source: CBA

Inflation differences had a downward impact on the REER. As a result, the REER on the non-oil sector strengthened as little as 4.6% over the period.

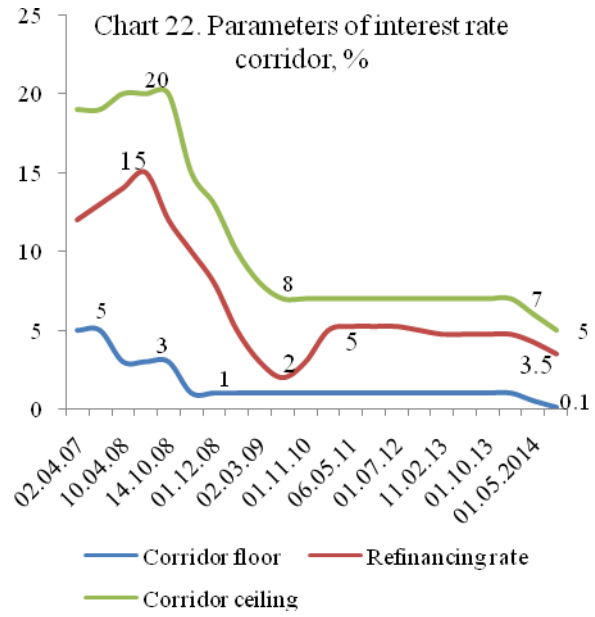
[3]Calculations are based on the result of the VAR (Vector Autoregressive) model.

3.2. Monetary policy tools

In the 9 months of 2014 the CBA applied its monetary policy tools considering growth dynamics of the economy, inflation expectations and characteristics of transmission of the monetary policy to aggregate demand and prices.

Amid low inflation the Central Bank used encouraging possibilities of the monetary policy in response to the economic cycle in the 9 months of 2014.

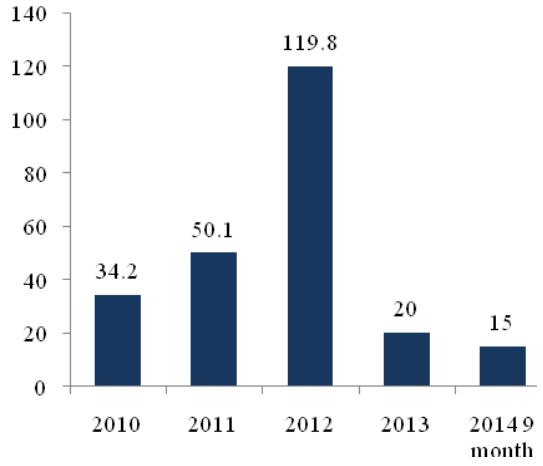
Given the low level of inflation, aggregate demand factors affecting economic growth, and growth rates of money supply, the CBA made changes to the parameters of the interest rate corridor twice to pave the way for further investment activities in the non-oil sector and the real sector, and for diversification of the economy, and thereby to provide necessary support to economic growth. Consequently, the refinancing rate shifted from 4.75% to 3.5%, the corridor ceiling from 7% to 5%, and the corridor floor from 1% to 0.1% in stages. At the same time, reserve requirements for banks' domestic and foreign liabilities were reduced from 3% to 2% from August, 2014.



Source: CBA

Open market operations were regularly used to adjust growth rates of money supply and the liquidity level in the banking system.

Chart 23. Short-term notes in circulation, AZN million



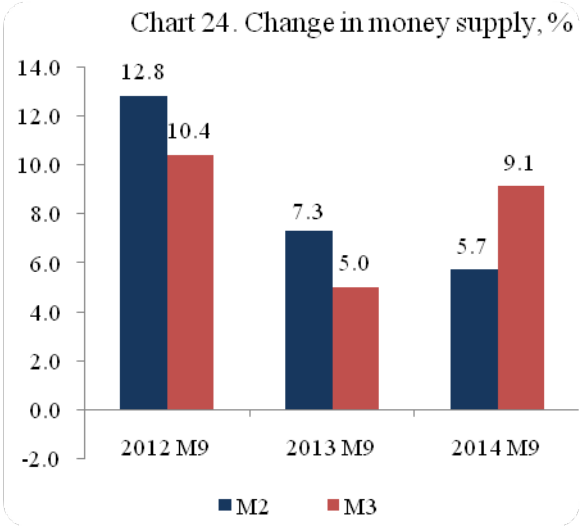
Source: CBA

In the 9 months of 2014 transactions through short-term notes were conducted within sterilization operations and the size of notes in circulation was AZN 15 million as of the end of the reporting period. Average return on notes at the latest auction was 1.05%, and at the early year 1.07%.

3.3. Money supply

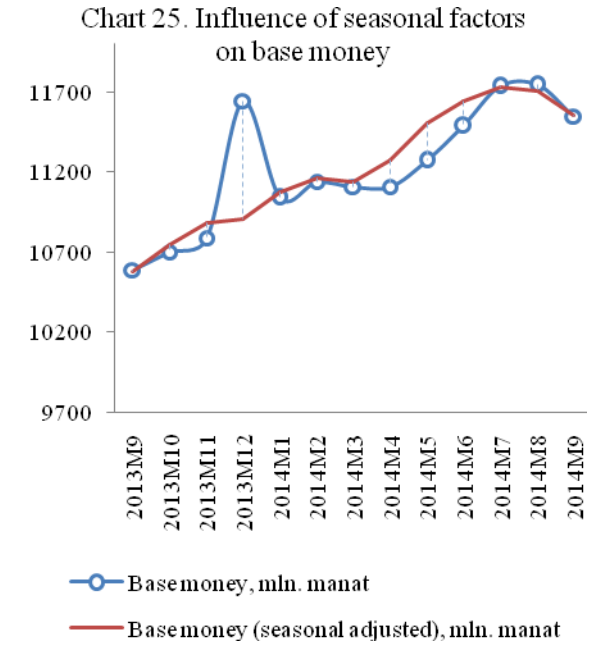
Over the past period of 2014 broad money supply kept pace with the demand of the economy and inflation, the structure of which continued to improve.

Broad money supply in manat (M2) rose 5.7% and reached AZN 17367.8 million over the period. The money multiplier of the banking system had increasing trend (0.1% increase compared to the beginning of the year), which paved the way for cashless money extension.



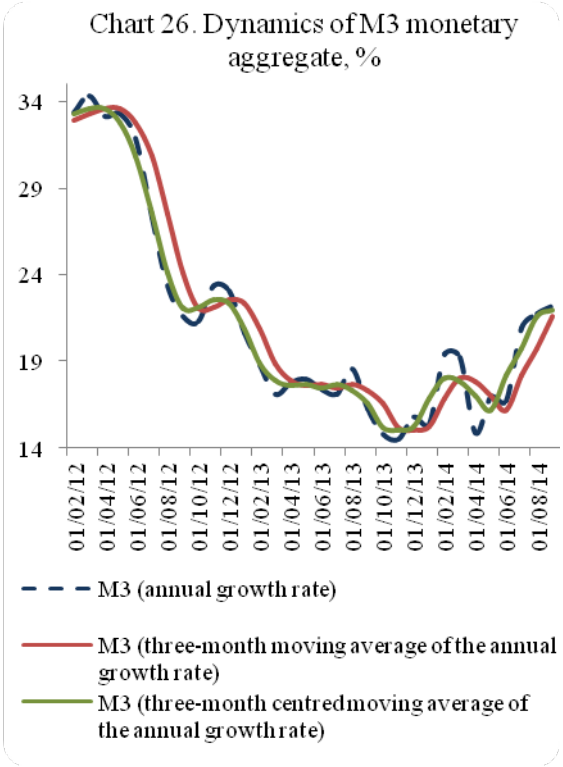
Source: CBA

Over the period the money base in manat declined 0.8% due to seasonal factors. The dynamics of the seasonally adjusted money base rose 6% relative to the beginning of the year.



Source: CBA

In the 9 months of 2014 broad money supply (M3) increased 9.1% and reached AZN 21113.1 million as of 01.10.2014. The share of foreign currency denominated deposits in total deposits constituted 34.8% as of the end-period. The share of foreign currency denominated deposits in M3 money supply made 17.7%.



Source: CBA

Cashless money supply grew 16.7% from the early year, which displays broader use of the cashless payments infrastructure.

Table 2. Monetary aggregates, AZN million

	01.10.13	01.01.14	01.04.14	01.10.14
M0 *(Cash)*	9560	10458.7	9953.6	10389.9
M1 *(Cash, demand savings and deposits)*	11736.8	12736.9	12300.5	12834.7
M2 *(Cash, demand and term savings and deposits, in AZN)*	14809.6	16434.8	16132.3	17367.8
M3 *(Cash, demand and term savings and deposits, in AZN and FX deposits)*	17613.6	19359.8	19377.0	21113.1

Source: CBA

IV. ECONOMIC PROSPECTS

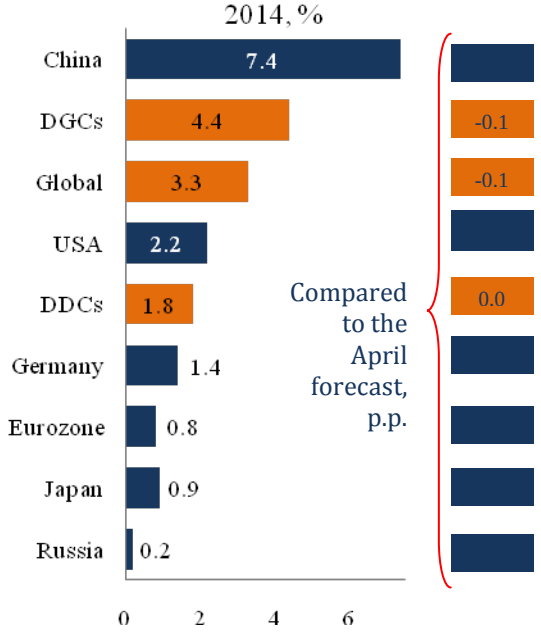
Notwithstanding complicated global economic environment, developments over the past period of 2014 suggest positive expectations for the future of the national economy.

4.1. Global economic forecasts

In the light of the recent global trends, the IMF revised global growth projections for 2014. According to projections, global economic growth will be 3.3% (0.1 p.p. lower relative to the previous year) this year.

Recent projections suggest 1.8% GDP growth for DDCs, and 4.4% growth for DGCs. The economy of Russia, a foreign trade partner of Azerbaijan, is predicted to grow 0.2%.

Chart 27. Global growth forecasts for 2014, %



Source: IMF

Decline in global economic activity is reflected in projections on global commodity markets. IMF projections suggest that the oil price (WTI, Brent, Dubai) is likely to average USD 102.8 in 2014.

Thanks to favorable harvesting, prices of agricultural products are expected to continuously drop until the year end. Grain prices are predicted to decline roughly 20% before the end of the year (World Bank).

Box 5. Why growth in emerging economies is likely to fall?

The years 1981-1999 witnessed no significant difference in annual growth rates between DGCs (3.6 percent) and the U.S. (3.4 percent). The DGCs could not reach the U.S. levels in terms of per capita GDP, despite slightly higher growth.

From 2000 to 2012, leading DGCs (Brazil, Russia, India, China, and South Africa) grew on average 6.2 percent a year, while US growth was 1.9 percent a year on average. DGCs are likely to catch-up DDCs in terms of per capita GDP in the future, if this trend continues.

The research carried out by the experts of the Peterson Institute for International Economics shows that the growth rate in DGCs is likely to drop roughly 2 percent on the backdrop of the accelerated recovery in DDCs recently. This might pose difficulties for DGCs to catch-up DDCs as in 1981-1999.

The probability of decrease in growth rates in DGCs is based on various factors:

- Credit boom. One of the biggest credit booms of all time occurred in 2000-2008. As a result of non-conventional monetary policy pursued in DDCs the boom has continued for 5 years more. However, low interest rates cannot continue for a long period. Thus, gradually tightened monetary policy (a decrease in securities purchases) in the U.S. from 2013 has had an incremental impact on interest rates. Additionally, Claudio Borio (2012) proved theoretically that a credit cycle does not continue more than 15-20 years.
- Commodity price boom. A commodity boom has peaked out. Thus, current commodity prices depress demand, while stimulating supply. Additionally, technological development leads to a drop in commodity prices, increasing supply in commodity markets (shale gas, oil extracted from the deep soil, alternative energy, etc.).
- Investment activity. The optimal level of the investment to GDP ratio in DGCs accounts for 30-35 percent. While the ratio is at an acceptable level in India and Indonesia, it accounts for 47 percent in China, and 18-21 percent in other leading DGCs. The inevitability of a decrease in investment activity up to an optimal level in China, and factors of effectiveness of investments in other economies stipulates a reduction in economic growth
- Middle-income trap. Because of many years of high economic growth, the catch-up potential of DGCs has been reduced and the application of new governance strategy has stagnated, as a result of which economies may fall to a ‘middle-income trap’.
- Reforms. Most DGCs carried out material structural changes in 1980-1990. The USSR collapsed, some Latin American countries undertook economic reforms, the East Asian tigers boomed, and China carried out its gradual transition to a market economy. From 2000, however, structural reforms stagnated. Brazil even saw a significant deterioration. The leading DGCs are still facing a number of institutional problems.
- State capitalism. Some DGCs have drawn the wrong conclusion from the global crisis and think that state capitalism and industrial policy have proven superior to free markets. Therefore, they feel no need to improve their economic policies.
- Regional integration. DGCs have benefited from the ever more open markets of the DDCs in recent years. The reverse process, however, has not been satisfactory, thereby strengthening selective regional integration trends. Thus, the U.S is now negotiating free trade agreements with the EU and friendly nations within the WTO.

Source: Anders Aslund, “Why Growth in Emerging Economies is Likely to Fall”, Peterson Institute for International Economics, 2013

Table 3. **Dynamics of commodity price indices, (2010=100)**

	2011	2012	2013	2014 e.
Energy	**129**	**128**	**127**	**124**
Non-energy	**120**	**110**	**102**	**98**
Metal	*113*	*96*	*91*	*86*
Agricultural products	*122*	*114*	*106*	*103*
Food	***123***	***124***	***116***	***107***
Grain	*138*	*141*	*128*	*103*
Other foods	*11*	*107*	*104*	*109*

Source: World Bank

Inflation is likely to remain at low levels in most countries this year due to the large output gap, and poor financing conditions. Prices are likely to increase 1.6% in DDCs, and 5.5% in DGCs.

Global trade of goods and services is expected to grow as little as 3.8%. Imports are expected to increase 3.7% in DDCs, and 4.4% in DGCs, while exports growth is expected at 3.6% in DDCs, and 3.9% in DGCs.

Global interest rates are not expected to change significantly. The LIBOR for USD-denominated deposits is forecast to be 0.4%, and 0.2% (3 months) for euro-denominated deposits.

FDI is expected to rise 35% in DDCs, and 1.8% in DGCs before the end of the year. The share of DDCs in FDI flows is forecast to reach 52%.

Currently, the global economy is facing 2 strategic challenges. First, to eliminate grave consequences of the latest global crisis, second, to be prepared to handle risks, and avoid a new recession.

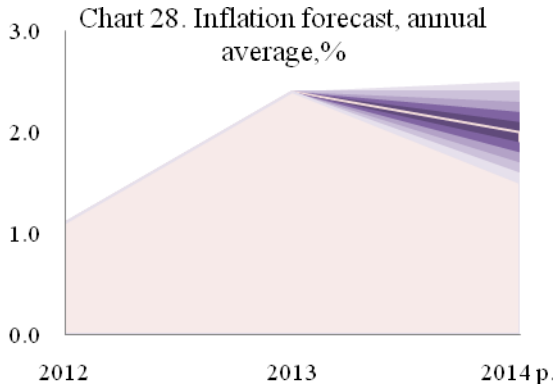
4.2. Macroeconomic prospects for Azerbaijan

The country is expected to sustain its growth in the near future, maintaining macroeconomic stability.

Growth expectations. Recent government forecasts suggest that country's economic growth is expected to equal 3.6%, including 8.1% in the non-oil sector.[4] All segments of the non-oil sector are likely to grow by the end of the current year.

The RSM conducted by the CBA also demonstrates positive growth expectations. Thus, RSM results suggest that the production expectation index for the non-oil industry has been growth-prone from the early year. Positive expectations manifest themselves in a decline in non-distributed stocks. Positive and high production expectations pave the way for real production growth. There are optimistic expectations for trade segments like furniture, electrical equipment, and for demand for services.

Inflation expectations. According to official government forecasts, inflation is expected to remain at low single digit levels. The IMF forecasts Azerbaijan's average annual inflation to be 5.1 p.p. lower than the CIS countries in 2014.



Source: CBA

The NEER dynamics, the growth rate of money supply, and a decline in world commodity prices are among the factors that condition for low inflation forecast.

Surveys conducted by the CBA also confirm the decline of inflation in

[4] Presentation of projects on state budget and consolidated budget of the Republic of Azerbaijan for 2015. page 9. http://www.maliyye.gov.az/

the country. The CBA's RSM results suggest that there is no significant increase in price expectations in the economy. According to surveys, year-end industrial sector price expectations are prone to decline. The declining trend of price expectations was affected by low price expectations on textile and chemical enterprises. The price expectations index on the service and trade sector remained negatively zoned over the year.

Results of the survey on 'Financial behavior, intentions, and inflation expectations of households' conducted by the CBA show that price expectations of households have not changed significantly over the past period of 2014.

Charts and Tables used

Charts

Tables

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