



THE CENTRAL BANK OF
THE REPUBLIC OF AZERBAIJAN

№4(12)
2012

MONETARY POLICY REVIEW
Q4

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Acronyms

CBA	–	The Central Bank of Azerbaijan
ILO	–	International Labor Organization
IMF	–	International Monetary Fund
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
GDP	–	Gross Domestic Product
WTO	–	World Trade Organization

EXECUTIVE SUMMARY

The Central Bank of the Republic of Azerbaijan implemented its policy in 2012 in the environment of re-balancing in the global economy, and fragile growth amid financial risks, stronger macroeconomical sustainability and deeper diversification of the country's economy.

In 2012 the Azerbaijani economy continued to successfully grow on the unstable global economic background. The foreign economic position of the country was favorable, the process of diversification of the economy and launch of new jobs accelerated. Government's active support for socio-economic growth was the locomotive in economic growth. Strategic foreign exchange reserves – the macroeconomic buffer kept growing and international economic ratings of the country improved.

In 2012 the CBA targeted a single-digit level of inflation, a stable exchange rate of manat, robust financial sustainability, as well as promoted deeper financial intermediation.

I. GLOBAL ECONOMIC PROCESSES AND THE NATIONAL ECONOMY

1.1. Global economic trends

Large scale incentives in leading countries of the world yielded ongoing recovery trends in the global economy. Nevertheless, still dwelling global economic risks manifest themselves in economic growth expectations for 2013.

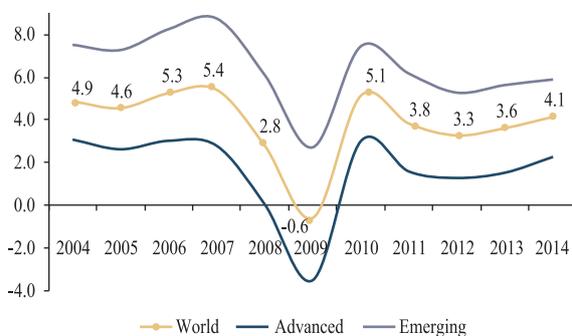
Although five years have passed since the onset of the global economic crisis, it is still affecting the world economy. Amplified fiscal problems, swollen central bank balance sheets, weakened lending channel, unstable processes in the real estate markets of leading countries are the signs of lingering effects of the global crisis. Over the past period albeit fragile recovery trends resulting from policy measures taken, they became complicated and slightly slowed down compared to the previous year. In 2012 the world economic growth is expected to be 3.3% which falls below the previous year by 0.5 p.p.

Although monetary easing in leading countries enabled to neutralize short-run

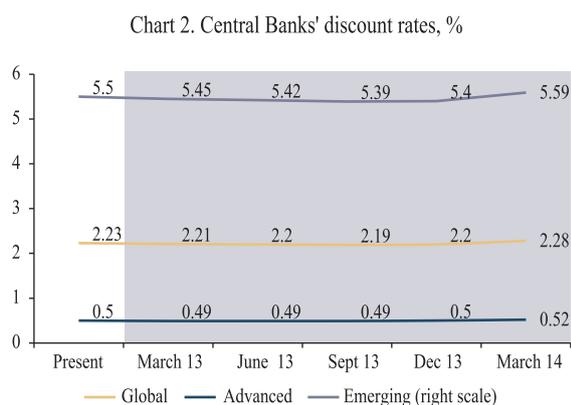
negative effects of fiscal consolidation, no strong growth was witnessed in 2012. Growth in the world economy was driven by DGCs in 2012. However, China (7.8%) and India (4.9%) posted the weakest growth of the recent decade. The highest decline was observed in the Euro zone countries – Greece, Portugal and Spain over the year. The US economy, that posted moderate growth over first 3 quarters of the year, plunged into recession in Quarter IV (-0.1%). The recession in the Euro zone remained on a -0.4% level during the year.

Relatively positive trends were observed in the world economy due to monetary easing. Central banks of DDCs continue large scale liquidity injections to the economy along with moving refinancing rates down, as a result of which real interest rates were negatively zoned in the recent two years: in DDCs – 1.4% and in DGCs – 1.1%. Unlike fiscal incentives, monetary support essentially serve for revival of private demand, which should allow to sustainably ensure economic growth. However, in major countries the monetary policy is concentrated on coverage of short run cash demand of the economy instead of expanding production capacity. The expansionary monetary policy further added up to swollen balance sheets of central banks. If the ECB assets to GDP ratio made 21% in 2011, this indicator is expected to exceed 30% in 2012.

Chart 1. Global economic growth, %



Source: IMF



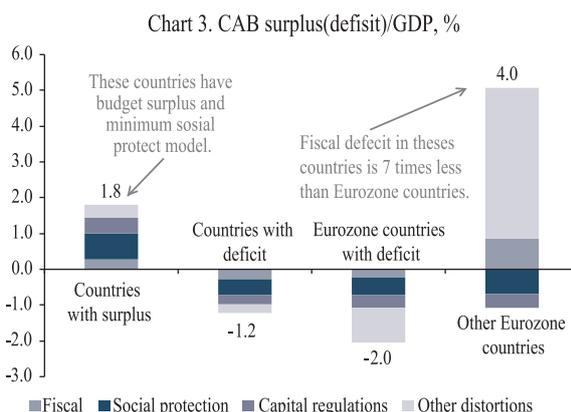
Source: J.P.Morgan

The processes display that the DDCs will continue the accommodative monetary policy in the coming one year. Currently, low level inflation creates favorable grounds for central banks to implement monetary easing.

As a result of fiscal consolidation measures a number of countries succeeded in slightly decreasing the budget deficit and the sovereign debt to GDP ratio. Budget expenditure cuts along with high tax rates threaten public demand, economic growth, employment and social parity. Assessment of short- and medium-

run economic prospects suggests that within the period particularly for the DDCs the capacity of the fiscal policy to stimulate aggregate demand exhausted.

Accelerated fiscal consolidation positively affects reduction of current accounts deficit. In such environment internal demand targeting in DGCs leads to decline in global imbalances.



*Classification includes 22 countries and the Euro zone

**Germany, Netherlands

*** Private sector activity, export performance etc.

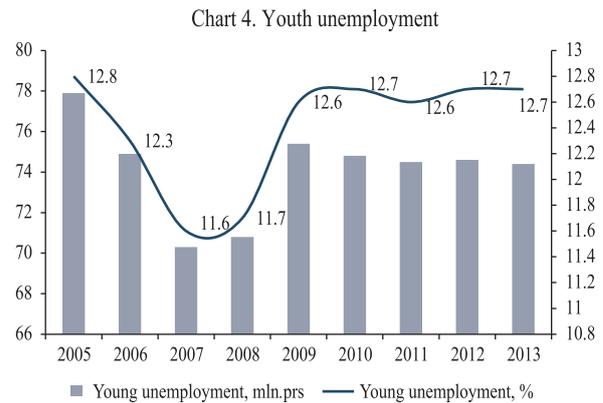
Source: IMF, World Bank

Table 1. Fiscal consolidation measures

	Expenditure Measures					
	Public wage freeze/reduction	Control of the size of civil service	Savings from pension-related spending	Savings from health care-related spending	Reduction in public investment	Other expenditure measures
Australia		✓	✓	✓	✓	✓
France		✓	✓	✓		✓
Germany						
Greece	✓	✓	✓	✓	✓	✓
Italy	✓	✓	✓	✓	✓	✓
Japan	✓	✓			✓	✓
Portugal	✓	✓	✓	✓	✓	✓
Spain	✓	✓	✓	✓	✓	✓
United Kingdom	✓	✓	✓	✓	✓	✓
United States	✓	✓		✓		✓
Hungary	✓	✓	✓	✓		✓
Lithuania	✓	✓	✓	✓	✓	✓
Romania	✓	✓	✓	✓	✓	✓
Russian Federation	✓	✓			✓	✓
Turkey	✓			✓		

Source: IMF

Unemployment still challenges the world economy. The number of the unemployed in the world increased again and reached the in-the-crisis level – 198 million persons. The epicenter of the unemployment crisis is the DDCs. Thus, since the onset of the crisis half of the growth in the number of unemployment (28 million persons) has fallen to the share of these countries. While unemployment makes 7.8% in the US, it equals to 11.8% in the Euro zone, 10.3% in France, 26% in Spain and Greece.



Source: ILO

Box 1. Relationship between economic growth and unemployment

Over the recent decade the DGCs have maintained a high economic growth rate and left the financial crisis behind with fewer losses unlike the DDCs. Variable economic growth trajectory across country groups was pronounced in unemployment as well. Thus, in 2011 the unemployment level in DGCs reached the pre-crisis level. On the contrary, the level of unemployment in the DDCs remains high.

Then what is the relationship between unemployment and growth across country groups?

To identify operability of the law in DGCs the IMF experts make estimations through 3 diverse techniques. Two of them analyses relationship between economic growth and unemployment, the last one between economic growth and employment based upon Okun's law. The gap between the first and the second is a negative effect of economic growth on unemployment and positive effect on employment. The results of estimations are shown in Table.

Short-run relationship between unemployment and economic growth across country groups

	Okun ratio (1)	Okun ratio (2)	Employment
DDCs	-0.39	-0.33	0.49
DGCs	-0.17	-0.29	0.20

To answer this question, IMF experts conducted a research using Okun's Law. To remind, Okun, who studied the relationship between unemployment and economic growth (1962), proposed short-term relationship between output and unemployment which later was called Okun's Law. Further studies showed that Okun's Law is of significant effect in major DDCs. Thus, 1 p.p. rise in total output decreases cyclic unemployment by about 0.5%. However, the effect of Okun's law varies across countries (min. -0.16% (Japan) and max. -0.85% (Spain)).

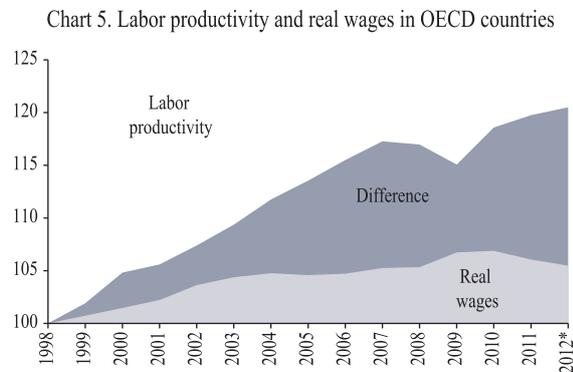
According to results of economic estimations, economic growths on both country groups have a significant effect on unemployment (employment) and the effect of impact is relatively weaker in DGCs than in DDCs, the reason for which is shown to be a variable volume of the shadow economy and the structure of the labor market across country groups. Thus, in the countries with a high volume shadow economy and a high level of employment, unemployment has a weaker response to changes in output.

Source:

"World Economic Outlook: Jobs and growth: can't have one without the other" October, 2012.

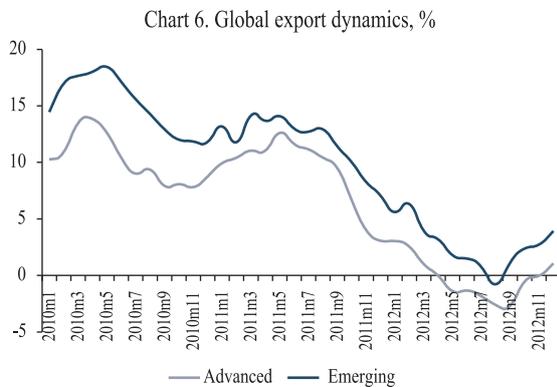
However the level of unemployment among the youth (15 – 24 ages) is double high. According to the ILO, there is potential for decline in the number of the unemployment among the youth in harmony with the recovery in DDCs.

The dynamics in growth trends of the world economy reflects itself in decline in productivity. According to initial estimations of 2012, the growth rate of global productivity decreased 1 p.p. compared to the previous year and made 1.9%. In recent 2 years low wages and salaries in the OECD resulted in bigger gap with productivity.



Source: OECD

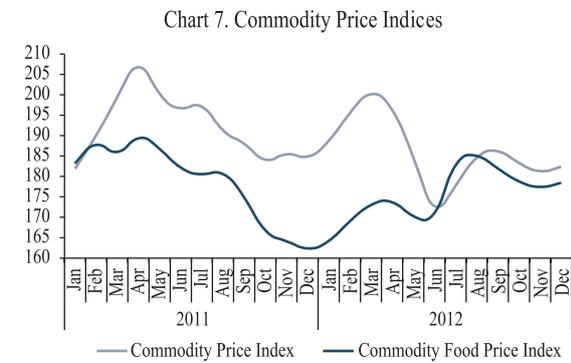
Shrinkage of external demand in DDCs negatively affected world commodity and services turnover. Compared to 2011, the growth rate of the world trade dropped 3.1 p.p. and made 2.8%. Import in DDCs went down 3.4%, while export – 3.5%.



Source: WTO, IMF

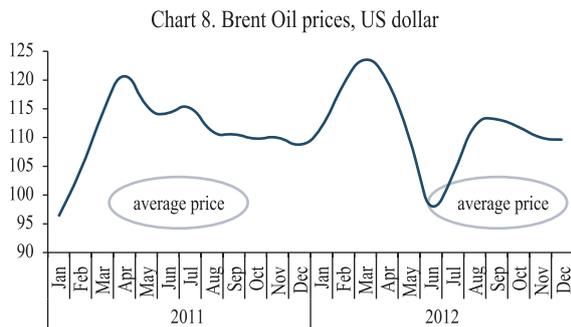
Over the year global FDIs underwent abrupt structural changes. Thus, the share of DGCs in FDI receipts rapidly goes up (50%→55%), while the share of FDI receipts in DDCs (45%) dropped below the 2009 level. The decline stemmed from the US and the Euro zone.

In 2012 the dynamics of commodity prices changed, commodity prices fell, while food prices rose against the previous year. Thus, compared to early year the commodity prices index decreased 1%, while the food prices index increased 10.4%.



Source: IMF

Although the price for Brent crude oil went down in the first half of 2012, prices went up from July onward. Over the year oil price averaged USD 112, y.o.y. increase being 1%.



Source: IMF

Box 2. Oil and world economy: Possible future trends

Over the past decade the world has experienced a persistent increase in oil prices. It is put down to continued rapid demand growth in DGCs amid stagnant supply. The IMF, using the Global Integrated Monetary and Fiscal Model (GIMF), regularly evaluates possible future effects of slowdown in the growth rate of oil production in the world economy on macroeconomic indicators (GDP, current accounts balance, and oil prices). This model also allows to evaluate the impact of possible future oil supply shocks on various economies. Evaluation is made via a number of scenarios.

The analysis begins with a baseline scenario. The economy is exposed to a negative supply shock and the effect of a 1 p.p reduction in the growth rate of oil production. Recent simulations show that downward shifts in world oil production leads to high oil prices, while they trigger reduction in GDP and large deficit in current account balance in oil importing countries. While in oil exporting countries it promotes short-run trade and capital flows, it leads to their hiked revenues, high consumption, domestic price rise, and sharp appreciation of the exchange rate. The surfaced Dutch disease syndrome effect results in weaker production in the trade sector in these countries, reduction of GDP by 7% in the first 5 years and by 10% in 10 years. Upward shifts in oil prices create surplus equaling 8% of GDP in current operations balance in long-run (20 years) in these groups of countries. On the contrary, GDP of oil importing countries decline on a more stable basis, i.e. per annum between 0.2% and 0.4%. Estimations show that oil scarcity does not hinder long-run global growth and current accounts balance deterioration. The following scenarios implying baseline scenario modification result in larger negative impacts:

The Technology Externality Scenario: This scenario indicates that the output contribution of oil is higher than indicated by its cost share. Other production factors – labor and capital, as well as oil and oil-driven technology are considered to be an external factor. It is emphasized that the share of oil in production (directly or via technology) makes 25% in the trade and 20% in the non-trade sector (in baseline scenario respectively 5% and 2%). Simulations reveal that oil prices make 400% upward shift instead of 200% in a long-run unlike the baseline scenario which ends up with even worse GDP in oil importing countries. The reason for a larger scale of this effect is that other production factors fail to compensate for low oil production or it is hard to replace oil-driven technology with another one.

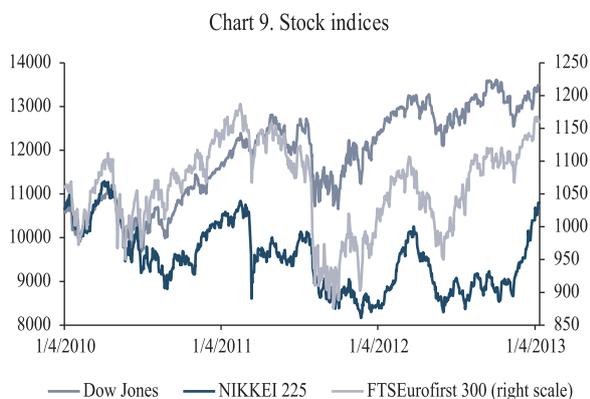
The Larger Shock Scenario: Unlike the baseline scenario, reduction in the growth rate of oil production is 4 p.p. In this scenario long-term production and the impact on the current accounts balance is over 4 times as much in harmony with the scale of shock. In the US and the Euro zone the GDP growth rate declines 1% unlike the baseline scenario (0.25%). The Current Accounts Balance deteriorates up to 5% of GDP in oil importing countries.

Summarizing these scenarios, we can conclude that medium shocks do not have a huge impact on the growth rate of oil production. However, large shocks, resulting in lower oil consumption and demand of oil for hi-tech will considerably decrease GDP. Also oil prices may make such upward shifts to make it hard to regulate.

Source:

IMF Working Paper: *Oil and World Economy: Some Possible Futures*

Over the year financial markets were relatively stable. The Dow Jones index rose 13.3%, and the Nikkei 225 index 23%.

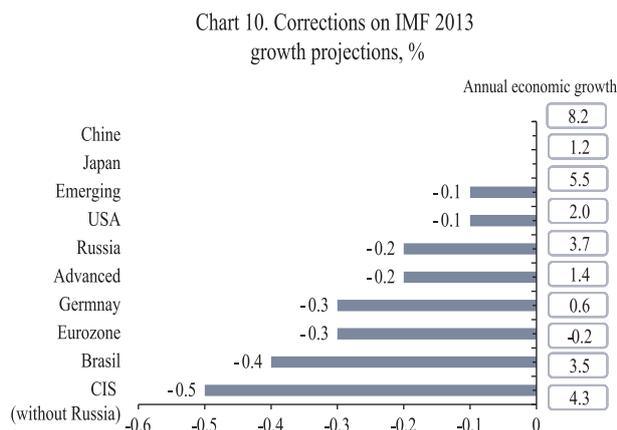


Source: Bloomberg

Currently, two groups of risks related to the global economy are on a special focus: i) replacement of currently observed deflation trends with sustainable inflation in the short- and medium-run, low purchasing power of

households, shrinkage of private demand, and finally critic development of processes in a real estate market; ii) positive output gap in leading DGCs and overheating of those economies.

Conflicting global economic processes led to uncertainties in forecasting economic growth prospects for 2013. The IMF, given the



Source: IMF

Box 3. Macroeconomic effects of uncertainty

In recent years the term “uncertainty” has been most frequently used in studies related to the economic stance. According to some economists, economic uncertainty deepens the financial crisis in the Euro zone and the problem of unemployment in the US, as well as weakens recovery in DGCs. Economic uncertainty is the environment in which little or nothing is known about the future stance of the economy. Shocks that lead to economic uncertainty stem from economic policy changes, dispersions in forecasts, wars, acts of terrorism and natural disasters. Uncertainty may be measured in a number of ways on a micro- and macrolevel (through estimating volatility in return on stock, total output, economic policy and forecasts).

Economic theory suggests that macroeconomic uncertainty adversely affects total output through diverse channels. On the demand side: households, when facing uncertainty, reduce consumer expenses, while companies make less investment, and postpone

implementation of projects. On the supply side: high uncertainty cause changes in companies’ hiring plans.

Economic analysis shows that, uncertainty, output, consumption and investments are negatively correlated. Thus, a 1 standard deviation increase in uncertainty is associated with a decline in output growth between 0.4 and 1.25 p.p (depending on the measure of uncertainty). Moreover, the analysis used an uncertainty measure estimated on the basis of volatility in return on shares and economic policy. High uncertainty is associated with much fewer investments compared to output and consumption. Estimations show that in 2006 – 2011 uncertainty rose by 5 standard deviations which hindered additional 2.5% rise in economic growth in DDCs. Empirical evidence suggests that output in crises accompanied with high uncertainty go down over two times as much compared to other crises.

Source:

“World Economic Outlook: How does uncertainty affect economic performance” October, 2012.

recent processes, made pessimistic revisions to economic growth expectations for 2013 in its Global Economic Outlook.

The key expectations for 2013 amid highly complicated global economic environment are:

- recovery will keep going in the key economic power centers:
 - *The US real estate market is stabilizing and consumer confidence improving. Cheaper internal energy resources will promote energy-intensive production;*
 - *Expected investments to infrastructure in China in 2013 (transportation, power supply) lessens the rough landing probability.*
- Global unemployment will keep elevating:
 - *Hiring plans of companies for the upcoming quarter are negative*
 - *According to the ILO, in 2013 global unemployment will rise 2.5% and reach 202.3 million persons.*
- Global FDIs will follow sluggish rates:
 - *According to the UNCTAD, in 2013 global FDI will rise 7% and reach USD 1.4 trillion.*

Leading financial institutions recommend to focus on further improvement of policy directions to reduce the impact of the global economic crisis for the upcoming year:

- go on with reforms to subside risks in the global financial system, further enhance supervision over systemically important financial institutions;
- accelerate stable and sustainable fiscal consolidation focusing on social parity;
- maintain a balanced level of capital and pay taxes.

A high level of prices for raw materials and no serious economic crisis trends in the key trade partners amid the processes in the world economy increases the export capacity of our country and paves the way for huge surplus in the balance of payments.

1.2. Macroeconomic processes in Azerbaijan

In the environment of a favorable foreign position and wider internal demand in 2012 the country economy continued to grow. The state support for the economic activity, ongoing structural and institutional reforms also had an upward impact on economic growth. Albeit certain risks coming from the global environment, macroeconomic and financial stability have been maintained over the year.

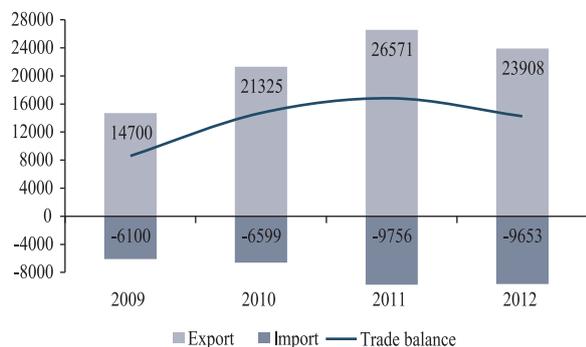
1.2.1. External sector

As in recent years, in 2012 Azerbaijan's foreign position was favorable. The average price for the Azerbaijani oil reached USD 113, which nearly compensated the negative impact of the downward shift in oil production.

According to the SSC, in 2012 foreign trade turnover made USD 33.6 billion, of which USD 23.9 billion falls to the share of export and USD 9.7 billion to import.

In 2012 y.o.y decrease in export was 10% and 1% in import. Surplus of foreign trade balance constituted USD 14.2 billion. Drop in export relates to 11% decrease in crude oil, oil products and natural gas export. In total, export exceeded import by 2.5 times as much.

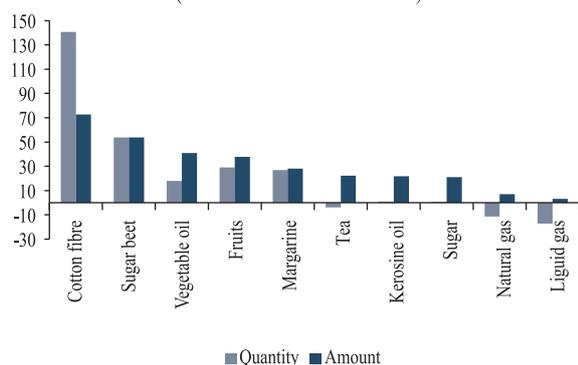
Chart 11. Foreign trade (January-December, USD million)



Source: SSC and CBA

Export of cotton, sugar beet, vegetable oils, fresh fruits and others followed an incremental path. While in certain sectors quantity of exported goods decreased in certain sectors, an inverse process was observed in others.

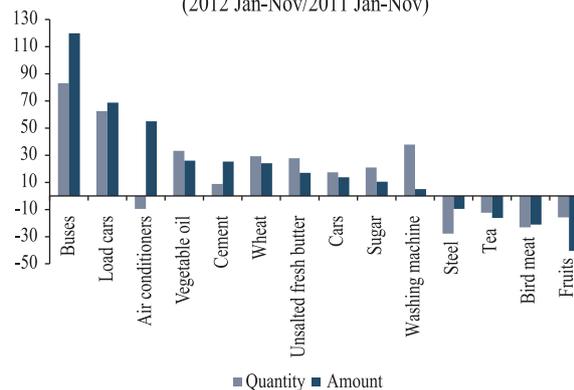
Chart 12. Quantity and amount changes of primary export goods, % (2012 Jan-Nov/2011 Jan-Nov)



Source: SSC

Import of durables, vegetable oils, tea, fruits etc. was high. Machines, mechanisms and vehicles made 45% of import, which declined about 12% during the period. Moreover, the decline in import of food products indicates high domestic production.

Chart 13. Quantity and amount changes of primary import goods, % (2012 Jan-Nov/2011 Jan-Nov)



Source: SSC

According to the SSC, export prices increase more rapidly than import prices, which display increase in opportunities to import more commodities and services through less export, which improve the terms of trade.

According to the IMF, as of the end of 2012 surplus of current account balance will make 15% of GDP. The country is the leader in the CIS in terms of the given indicator, and takes one of the most leading positions among the DGCs. The Fund predicts huge surplus to linger

Table 2. Price indices of import – export commodities, % (Jan – Nov, 2011 vs. Jan – Nov, 2012)

	Import commodities	Export commodities
Overall index	102.1	105.0
Processing phases		
Investment commodities	100.4	99.9
Intermediate commodities,	101.8	105.0
Energy commodities	104.5	105.1
Other intermediate commodities	101.8	100.3
Consumer goods	103.3	103.2
Non-durables	104.1	102.5

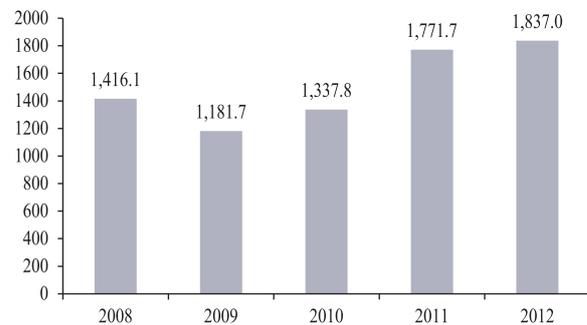
Source: SSC

in medium-run. Overall, currently out of 185 countries only 45 have surplus in the current account balance. Azerbaijan is on top 6 in this range.

Besides export, dynamics of remittances and capital flows from abroad also had an upward effect on FX flows into the country. According to the most preliminary data, y.o.y increase in the size of remittances was 4% over the period.

According to the SSC, the foreign investments to the country economy rose 23% and exceeded USD 4.2 billion.

Chart 14. Remittances inflow
(January-December, USD million)



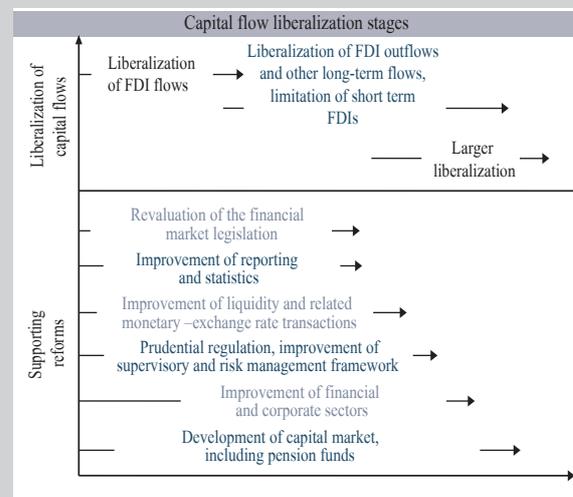
Source: CBA

Box 4. Liberalization of capital flows: an institutional approach

In recent years the size of global capital flows has been increasing, which in its turn gives rise to a number of policy challenges. Whereas the size of FDIs in 2011 was USD 1.5 trillion, this number is forecasted to reach USD 2.1 trillion in 2014. Therefore, one of the most robust macroeconomic policy challenges is to build an adequate frame on capital flows. Liberalization of capital flows has a solid positive impact potential on economic growth of a country, provided financial and institutional infrastructure is developed. According to the IMF experts, capital flows should be liberalized under the following scheme:

The growth level of the country economy, volatility and size of capital flows, their key directions factor in setting policy priorities. Larger capital flow channels have a number of positive effects – high economic activity, increase of competitiveness of the financial sector, stimulation of investments and consumption,

along with certain risks it causes. Macro-prudential instruments and capital flow regulatory tools (limits on flows) may be applied to manage risks.

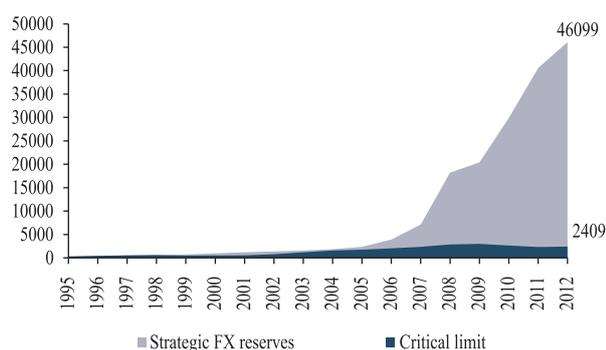


Source:

The liberalization and management of capital flows: an institutional view, IMF, November 2012;
World Investment Report 2012, UN Conference on Trade and Development.

In 2012 strategic FX reserves of the country rose USD 5.5 billion or 14% and surpassed USD 46 billion, sufficient for three-year import of goods and services. To compare, only in 20% of medium-income countries sufficiency is over 11 months. At the same time, strategic FX reserves exceed external debt about 8 times as much.

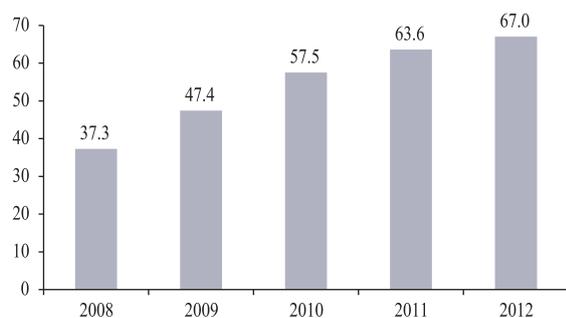
Chart 15. Sufficiency of strategic FX reserves, USD million



Source: CBA

CBA's FX reserves increased 12% and made USD 11.7 billion, sufficient for one-year import of goods and services.

Chart 16. Ratio of strategic FX reserves to GDP, %



Source: CBA

Currently, the strategic FX reserve to GDP ratio approximates 70%. Azerbaijan is among top 15 countries in terms of this indicator. Overall, a high growth rate of strategic forex reserves is the factor that reduces vulnerability of the country economy to possible foreign shocks or shapes a strong macroeconomic buffer, as a result of which, the country's Net International Investment Position is favorable.

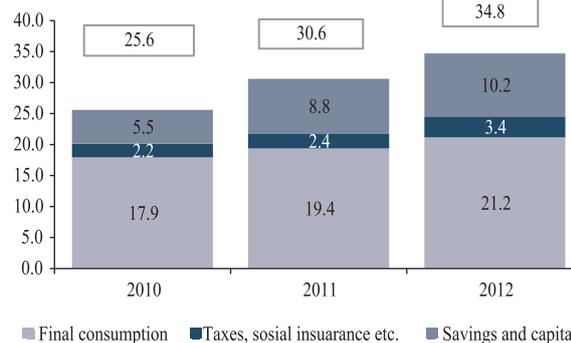
1.2.2. Aggregate demand

In 2012 all components of the aggregate demand, including final consumption expenditures, investments and external demand positively contributed to the economic growth. Over the year increase in income of the population and domestic investments to the economy has revived all components of the GDP.

1.2.2.1. Final consumption expenditures. In 2012 final consumption expenditures drove economic growth.

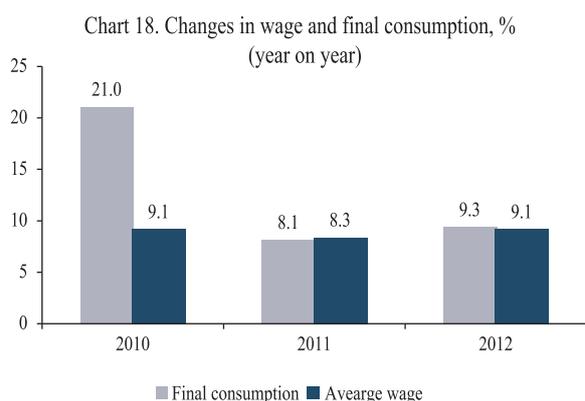
Households' consumption. During the reporting period per capita nominal money income of the population increased 12.2% and reached AZN 3784.3 or AZN 315.4 on monthly average. The population directed about 61% of their income to final consumption on purchase of goods and services. Final consumption expenditures of the population increased 9.3% in nominal terms and constituted AZN 21.2 billion or 39.3% of GDP.

Chart 17. Populations' income, AZN billion



Source: SSC

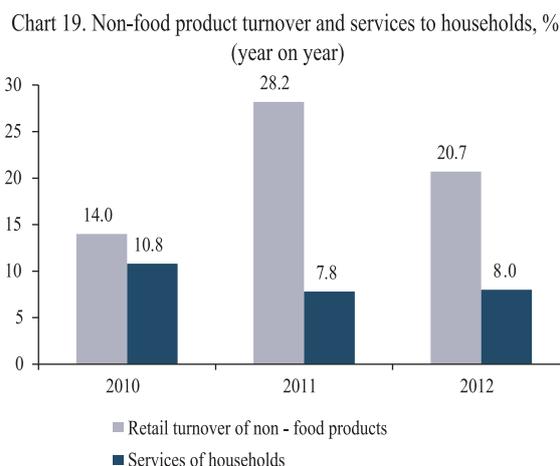
Average monthly salary rose 9.1% and equaled AZN 391.4, which contributed to a high share of the final consumption in the GDP. Annual increase in average monthly salary was 20.5% in the oil sector, 8.7% in the non-oil sector, 10.5% in the public sector and 7.5% in the private sector.



Source: SSC

Parallel step-up in loans to households also had an upward effect on demand. Thus, in 2012 loans to households (by commercial banks and NBCIs) rose 30.2%.

The retail trade turnover and off-free services to the population went up due to aggregate demand.



Source: SSC

Over the year retail trade turnover increased 9.6%, including 21% rise in retail trade turnover

Table 3. Retail trade turnover

	2012, AZN billion	Compared to 2011, %
Retail trade turnover	17.6	9.6
- trade entities	10.8	12.1
- markets and fairs	6.7	5.7

Source: SSC

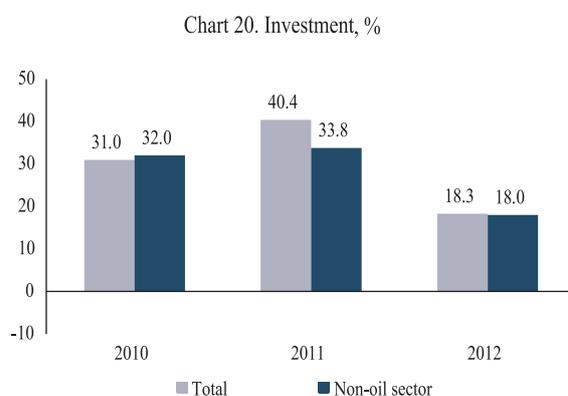
on non-food staff. Off-free services to the population grew 8%.

According to the RSM by the CBA, commodity stock diminished in trade in 2012 resulting from new orders.

73.8% of oil products was directed at coverage of domestic market demand, and 26,2% was exported.

Government and public organizations. During the reporting year the main share of Government consumption expenditure was spent on goods and services. Over the year social expenditures took AZN 4.7 billion (27.4% of expenses) of budget expenditures, which is 7.9% higher compared to 2011.

1.2.2.2. *Investment expenses.* In 2012 investments to the economy from all sources increased 18.3% and constituted AZN 15.3 billion, equal to 28.3% of GDP. It included 78.8% increase in domestic and 21.2% increase in foreign investments.



Source: SSC

Table 4. Production of oil processing products in domestic market

	2012, thousand ton	2011, thousand ton	2012 vs. 2011, %
Total	4 805.7	4 416.6	108.8
including:			
automobile gasoline	1 281.8	1 179.5	108.7
diesel fuel	1 289.0	1 064.8	121.1
aircraft fuel	490.6	532.2	92.2
reduced fuel oil	283.3	239.7	118.2
oil asphalt	275.9	251.5	109.7
liquid gas	125.1	135.2	92.5
lubricants	14.3	12.5	114.4
other oil products	1 045.7	1 001.2	104.4

Source: SSC

76.2% of investments were channeled to the non-oil sector. In total, investments to the non-oil sector exceeded the previous year level

Total volume of investments include funds of enterprises and organizations – 44,6 %, bank loans – 4,9%, budget funds – 43,8%,

Table 5. Size of investments by sectors of economy

Sector	In 2012, AZN million	Y.o.y, %	Share, %
TOTAL	15 338.5	118.0	100.0
Industry	5 615.4	103.0	36.6
Agriculture	583.5	131.4	3.8
Construction	456.3	198.9	3.0
Trade	540.8	173.0	3.5
Transport and warehouse	2 591.7	101.4	16.9
Tourism	133	43.1	0.9
Information and communication	325.3	103.1	2.1
Finance and insurance	76.9	195.4	0.5
Real estate	1408.2	146.8	9.2
Professional, scientific and technical activities	240.5	13.8 d.	1.6
Administrative and supplementary services	350.7	149.8	2.3
Public management and protection; social security	1 215.3	157.2	7.9
Education	787.6	2.6 t.	5.1

Source: SSC

by 18%. Of the non-oil sector, the growth rate of investments to agriculture, construction, finance and insurance, trade and education was particularly high.

off-budget funds 3,7%, personal funds of the population – 2,6 %, other funds – 0,4%.

Table 6. Investments on financial sources

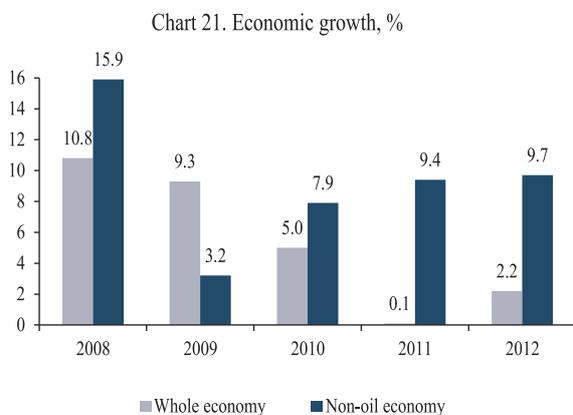
	In 2012, AZN million	Y.o.y, % (comparative prices)	Share, %
TOTAL	15 338.5	118.0	100.0
including:			
Funds of enterprises and organizations	6 836.0	116.8	44.6
Bank loans	756.1	92.0	4.9
Budget funds	6 716.5	121.0	43.8
Off-budget	563.9	142.1	3.7
Personal funds of the population	396.6	113.1	2.6
Other funds	69.4	2.6 t.	0.4

Source: SSC

1.2.3. Aggregate demand

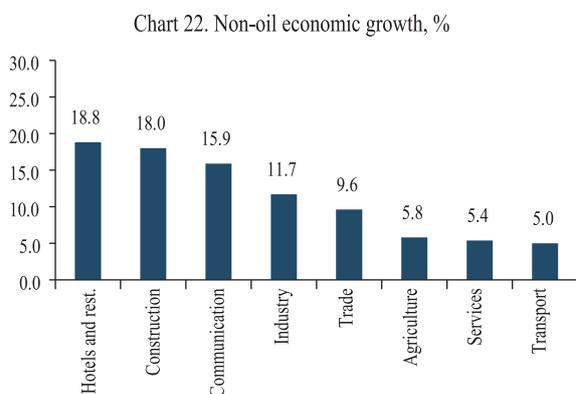
In 2012 GDP rose 2.2% in real terms and nominally reached AZN 54 billion. Over the reporting period the oil-and-gas sector declined by 5%, while the non-oil sector grew by 9.7%. Two third of the value added falls to the share of production, and one third – to services.

Economic growth. GDP growth stemmed from the activity in the non-oil sector. Thus, half of GDP fell to the share of the non-oil sector that made 4 p.p. upward contribution to total growth.



Source: SSC

In 2012 all segments of the non-oil sector posted growth. The highest growth rate among the segments was in hotels and restaurants and catering, construction, communication and processing. Growth in the industry mainly sourced from food industry, metallurgy, machinery and chemistry. The high growth



Source: SSC

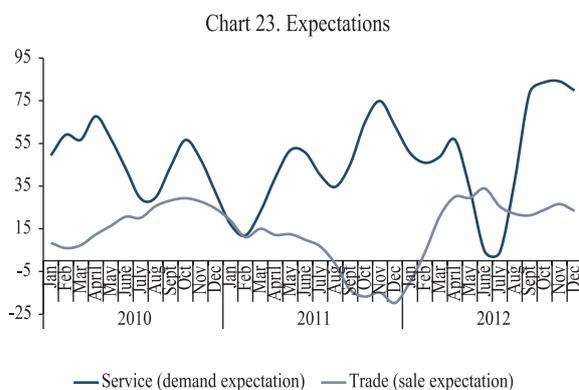
rate in agriculture owes to both crop sector and livestock.

Of services the highest growth was observed in construction and communication. As a result of high growth in 9 months of 2012 year over year increase in services export was 52% and made USD 2.9 billion. Over half of total trade export falls to the share of touristic services, 18% to transportation and 5% to construction.

During the reporting year crude oil production dropped 5.3%, while natural gas extraction rose 5.4%. Over 1563 kg gold and 626 kg silver was extracted during the period.

Economic growth expectations. According to expectations of the Government, the CBA, as well as financial institutions, economic growth in the country is expected to linger in the short-run. The World Bank, in its recent economic outlook, forecasts 4.2% economic growth in Azerbaijan in 2013 Overall, the WB, the IMF, the EBRD and the UN forecasts show average 3.5% growth in the country in 2013.

The Real Sector Monitoring (RSM) conducted by the CBA also display optimistic economic activity expectations. Thus, according to the RSM findings, since early year the demand expectation index on services and the sale expectation index on trade have been prone to growing. Positive expectations were also observed in food, construction materials production and weaving sub-sections of the industry, and furniture and electric appliances



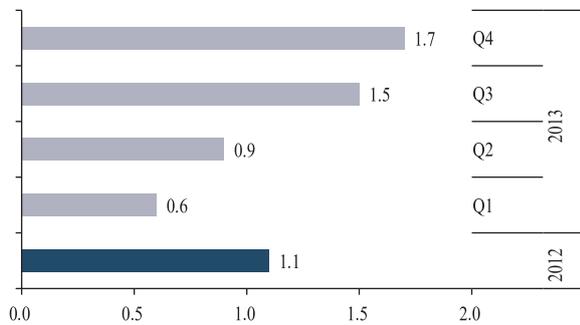
Source: CBA

Note: Three-month moving average was used to smooth out fluctuations, as monitoring findings are likely to be exposed to seasonal adjustments.

segment of trade. Such positive expectations resulted in decrease of stocks. In total results of the RSM conducted by the CBA in recent months demonstrate increase in the number of enterprises with incremental production and risen growth and sustainability of this growth.

According to estimations by the CBA, output gap (the gap between potential and actual levels of GDP) was -0.5% in 2011 and +1.1% in 2012 and due to high public demand was forecasted to be in 2013.

Chart 24. Output gap, to previous quarter, %



Source: CBA

Note: Light blue color stands for forecast

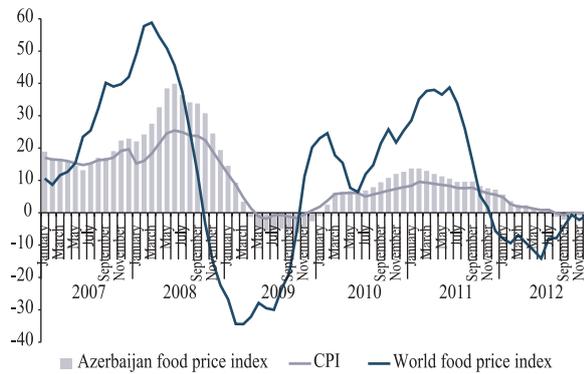
1.2.4. Macroeconomic equilibrium

In 2012 the country economy remained macroeconomically stable and inflation was on a single-digit level.

1.2.4.1. Consumer Price Index (CPI). In 2012 average annual inflation was 1.1%, the lowest in recent three years. In 2011 food prices increased by 7.1%, while in 2012 decrease in food prices was 1%, which, ultimately, resulted in deflation in total prices (-0.3%).

Average annual inflation on non-food products was 1%, while it was 0.4% year on year terms. Service prices rose 0.4% comparing to the beginning of the year and average annual was 1.2%.

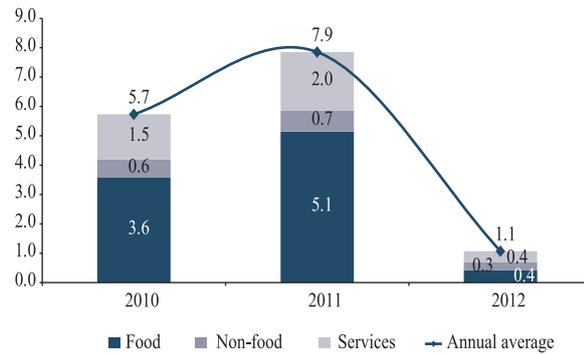
Chart 25. Azerbaijan and world food CPI (year on year, %)



Source: CBA estimations based upon data from SSC and FAO

Decompositional analysis of average annual inflation in 2012 displays that 0.4 p.p. of total average annual inflation relates to rise in food staff, 0.3 p.p. in non-food products and 0.4 p.p. in services.

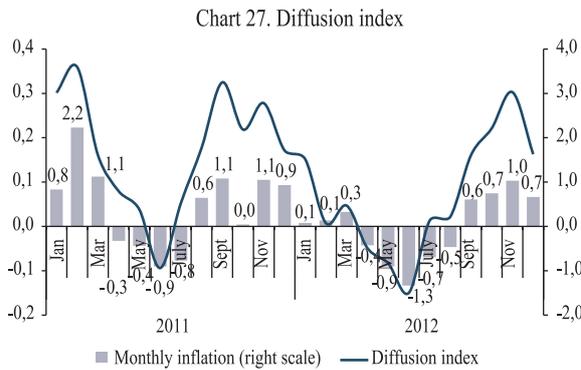
Chart 26. Annual average CPI, %



Source: CBA estimations based upon SSC data

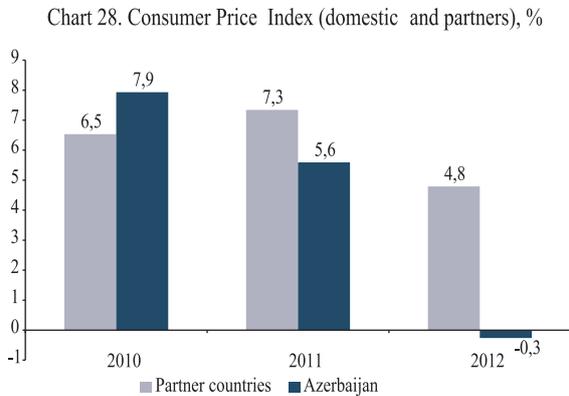
Average annual core inflation (inflation excluded prices for fruits and vegetables and regulated by the government) was 1.6%, while it was 0.3% comparing to the beginning of the year. In 2012 tariffs for loads transported via pipelines, and water transport respectively decreased 0.5% and 0.3%, while it increased 21.3% in rail transport. Tariffs for passenger transport decreased 3.1% in rail, 14.8% in air, and 1% in water transport. Overall, in 2012 transportation and postal tariff indices grew 0.1%.

The diffusion index¹ that address comprehensivity of price swings demonstrate that the number of products with downswing in prices in the consumption basket prevailed and comprehensivity of downswing in prices deepened.



Source: CBA estimations based upon SSC data

In 2012 inflation in trade partner DDCs was 1.6%, DGCs 6.6%, and in oil-exporting countries 8.8%. In total inflation in trade partners was 4.8%, which exceeds the inflation in Azerbaijan by 5.1 p.p..

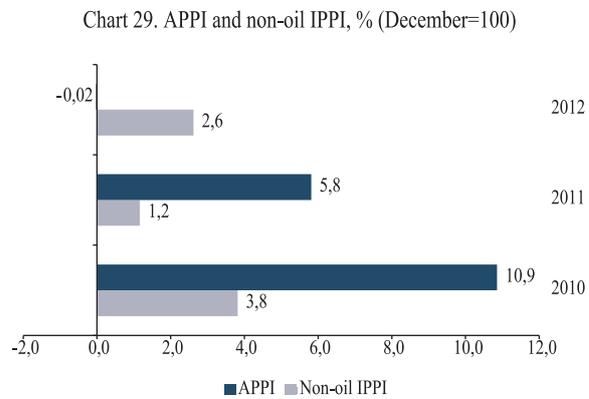


Source: SSC

1.2.4.2. Industrial Producer Price Index (IPPI). In 2012 average annual IPPI rose 4.5%, while prices for non-oil industrial products grew 0.1%. On average annual producer prices increased 4.9% on mining industry, 5.5% on machinery and equipment, 7.1% on metallurgy, and 1.1%

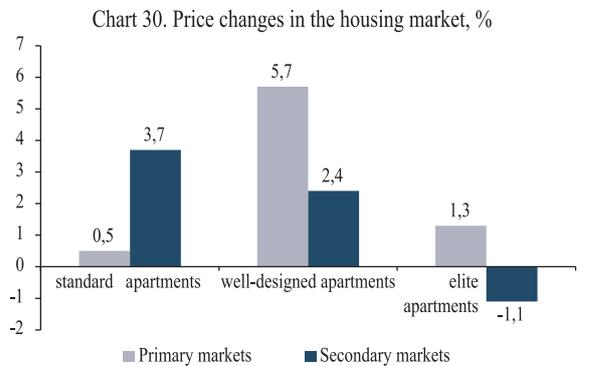
on chemical industry. However, some industrial sectors witnessed price downswings like 3% price downswing in food production, 8% on tobacco, 10.3% on production of rubber and plastic mass.

1.2.4.3. Agricultural Producer Price Index (APPI). In 2012 APPI declined on average annual 0.5%. Decrease on price dynamics was due to drop on annual plants (1.8%) and perennials (5%). Price upswing was 1.5% on livestock and livestock products.



Source: SSC

1.2.4.4. Real Estate Prices. According to the SSC, in 2012 prices in the housing market increased by 2.7%. Secondary and primary markets respectively grew by 2.7 % and 3.2%. Whereas prices for elite apartments in the secondary market dropped 1.1%, prices were up on other types of apartments. According



Source: SSC

¹ Diffusion index – difference in the number of products in the consumption basket with price upswings and those with downswings to the total number of products ratio.

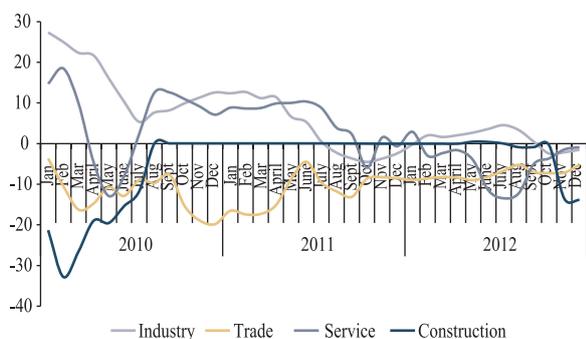
to the “MBA LTD” Appraisal and Consulting Company, the rent fee in residential and commercial real estate respectively rose by 19.7% and 8.2%.

Ongoing mortgage lending influenced activity in the real estate market, particularly the secondary market. In 2012 banks issued AZN 75 million worth mortgage loans.

1.2.4.5. Inflation expectations. According to the recent release by the IMF, in 2013 average annual inflation in Azerbaijan is expected to be 6%, 1.7 p.p. lower than in the CIS countries. The Asian Development Bank also forecasts single-digit 6% inflation in 2013.

Regular RSM by CBA suggests no considerable shifts in price expectations in the economy. In 6 months of 2012 price expectations were positively zoned in industry and construction, in recent 3 months price expectations shifted downward due to the seasonal factor. The price expectations index was negatively zoned in trade and services over the year.

Chart 31. Price expectation indices (3 months moving average)

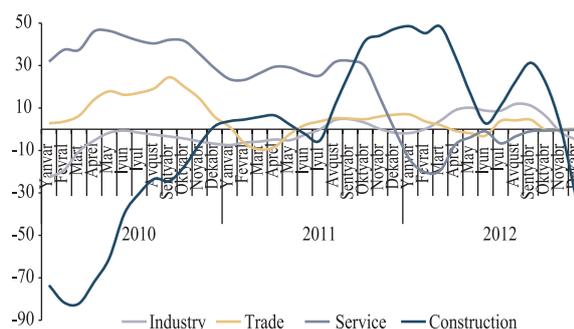


Source: CBA

1.2.4.6. Employment. In 2012 the economically active population was numbering 4688.4 thousand persons, out of which 4445.3 thousand persons were engaged in various segments of the industry and social sector. According to the SSC, in January – November the number of hired labor was 1470.2 thousand persons, out of which 1432.3 thousand persons were engaged in the non-oil, while 37.9 thousand persons in the oil sector.

The CBA monitoring in up to 300 enterprises within the RSM framework exhibit overall rise in employment. Of monitored enterprises, construction and industry underwent a considerable increase in the number of employees.

Chart 32. Employment expectation index (3 months moving average)



Source: CBA

Box 5. Survey based quantitative and qualitative measurement of inflation expectations

Inflation expectations are considered to be one of the key factors in implementation of the monetary policy and formation of the transmission mechanism. Therefore, various economic agents (consumers, producers, financial institutions etc) are surveyed and inflation expectation is identified through both quantitative, and qualitative measurement of survey results.

Central banks apply three approaches to measure inflation expectations:

Balance method – allows to ensure qualitative measurement of inflation expectations. In accordance with responses to survey questions (*will rise* (A_r), *remain constant* (S), *decline* (A_z)) direction of inflation is identified over a certain period.

$$BS = A_r + S - A_z$$

where A_r , S , A_z , shows the share of respondents in percentage respectively will rise, remain constant, decline

BS – direction of change of inflation expectation.

This method is applied by major central banks. The disadvantage of the method is that inflation expectations are not broadly applicable in quantitative measurement.

Regression method – survey results are taken as determinants of current inflation and inflation expectation is determined through regression.

$$\hat{\pi}_t^e = \hat{\alpha} \sum (A_r^e + S_t) - \hat{\beta} \cdot A_{zt}^e$$

where $\hat{\pi}_t^e$ - inflation expectation, A_r^e , S_t , A_{zt}^e - respectively time changes of percentage weight of those responding will rise, remain stable, decline; $\hat{\alpha}$, $\hat{\beta}$ - ratios derived from regression.

Probability method – is used to quantify inflation expectations. Firstly, assumptions are made about the probability distribution of survey responses. Secondly, inflation expectation is measured quantitatively based upon derived probability. The disadvantage of the method is that the probability distribution is not known, which might result in deviation of the obtained result from actual inflation.

Source:

Measurement of perceived and expected inflation on the basis of consumer survey data Tomasz Łyziak. National Bank of Poland. BIS.

II. MONETARY AND EXCHANGE RATE POLICY

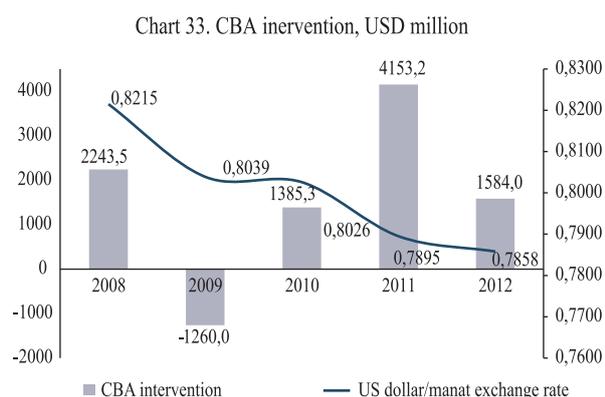
2.1. FX market and the exchange rate of manat

In 2012 the exchange rate policy targeted balancing between demand and supply in the FX market and a stable exchange rate of manat against USD. Parameters of the exchange rate have been established through considering the stance of the balance of payments, and targets of maintaining financial stability in the banking sector and competitiveness of the non-oil sector.

In 2012 the CBA implemented the exchange rate policy within a corridor targeting the bilateral exchange rate of USD/AZN.

Amid huge surplus in the balance of payments supply prevailed over demand in the forex market. However, to prevent considerable strengthening of the exchange rate and neutralize negative impacts on competitiveness of the non-

oil sector the CBA sterilized USD 1584 million worth currency over the year.



Source: CBA

As a result, manat strengthened against USD at a moderate rate, only 0.19%. The exchange rate stability of the national currency positively affected the macroeconomic environment and financial sector stability in the country.

Table 7. Bilateral nominal and real exchange rate indices of manat in 2012, %

	Compared to December 2011	
	Nominal bilateral exchange rate index*	Real bilateral exchange rate index
US	100.2	98.4
Euro zone	100.7	98.2
Great Britain	96.9	94
Turkey	95.9	90.1
Russia	97.9	91.6
Ukraine	101.4	101.4
Georgia	100.2	101.4
Iran	112.3	84.9
Kazakhstan	101.9	95.8
Japan	107.8	108.3
Israel	100.3	98.6
China	98.3	96.8
Belorussia	101.3	83
S. Korea	93.9	92.7

*Average annual change of exchange rates of manat against currencies of trade partners..

Source: CBA

Box 6. Exchange rate flexibility and real strengthening of exchange rate in various exchange rate regimes

Over the past years various countries have made corrections to exchange rate regimes due to global or regional economic processes. Those failed to shape an alternative anchor preferred a fixed regime, those targeting inflation passed to a floating exchange rate, others chose an intermediate regime. However, this question is still of interest: which exchange rate is acceptable – fixed or floating exchange rate, or an intermediate regime? It goes without saying that the answer to this question depends on macroeconomic specifics of a country, inflation history, institutional environment etc. For instance, 8 out of 30 oil exporting countries apply floating, 9 floating regulated and 13 fixed regimes.

for transition should be ensured as much as possible before, while a physical transition should be completed in a short run.

An exchange rate is a crucial macroeconomic variable from competitiveness standpoint of a country. To that end, one of the interesting issues is that in which exchange rate strengthening of real exchange rate is less rapid. Is it less in a fixed or floating regime? Country practices show that the fixed exchange rate regime is effective in curbing and lowering inflation. In parallel, the practice also proves that a floating regime is capable to form a price rise absorbent of the economy. Given all positive and negative aspects of both regimes we may say that in a long-run both of them witness price

Exchange rate regimes in oil exporting countries

Countries	Exchange rate regime
Saudi Arabia	Fixed (dollar)
Russia	Fixed (dollar and euro basket)
Norway	Floating
UAE	Fixed (dollar)
Venezuela	Fixed (dollar)
Iran	Managed float
Kuwait	Fixed (basket)
Nigeria	Floating
Kazakhstan	Managed float
Qatar	Fixed (dollar)
Oman	Fixed (dollar)
Mexico	Floating

Source: Brad Setser: “The Case for Exchange Rate Flexibility in Oil-Exporting Economies”, Peterson Institute for International Economics

However, overall country practices show that the most threatening and riskiest exchange rate is the intermediate exchange rate regime. Thus, the exchange rate fails to implement the nominal anchor function. If the alternative anchor is not found, the economy becomes less resilient to economic shocks. This idea has a number of policy implications. If a country is willing to pass to a floating regime from a fixed one, this transition should be quick. In other words, it is not purposeful to linger in a long-run intermediate regime. The acceptable approach is that terms and conditions

rise. Since we cannot ignore that the real exchange rate is formed both based upon changes in the nominal exchange rate and price gap. In a number of cases in a floating regime if revaluation of the nominal exchange rate is accompanied with a price rise at the expense of crowding out of domestic production and as a result a supply factor, the fixed regime witnesses the adverse case. Indirectly in a long run real strengthening of the exchange rate in response to cyclic movement of the economy is high.

Source:

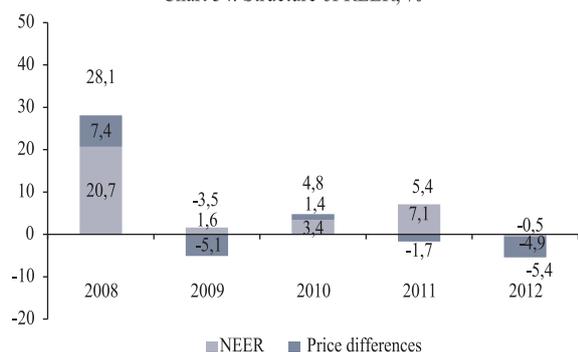
“Exchange Rate Regimes: Is the Bipolar View Correct?”, Stanley Fischer, January 2001.

Dynamics of the nominal bilateral exchange rate of manat contributed to swings in real bilateral exchange rates. Over the year manat strengthened both in nominal, and real terms against the national currencies of Ukraine, Georgia and Japan, depreciated against national currencies of other trade partners in real terms and appreciated against the currencies of the US, the euro zone, Iran, Kazakhstan, Israel and Belorussia in nominal terms.

In the current year the NEER (trade turnover weighted) on the non-oil sector depreciated 0.5%. The gap between inflation in partner countries and in Azerbaijan had 4.9 p.p. downward effects on the REER.

As a result, the REER of manat on the non-oil sector depreciated 5.4% over the year.

Chart 34. Structure of REER, %



Source: CBA

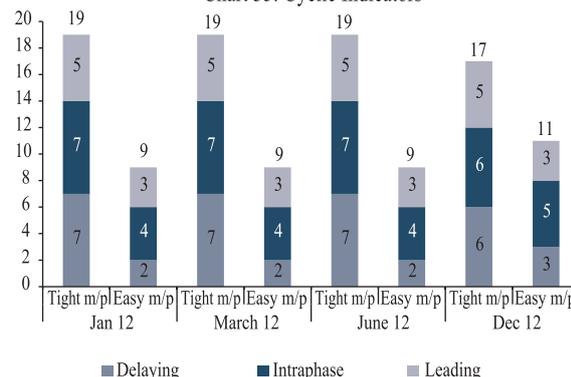
Thus, during the reporting year the CBA maintained bilateral exchange rate stability of manat. Real effective exchange rate of manat depreciated, which is positive from the perspective of improved competitiveness of the non-oil sector.

2.2. Monetary policy tools

In 2012 the Bank applied monetary policy tools allowing for economic dynamics, inflation expectations and the pass-through capacity of the monetary policy to aggregate demand and prices – transmission specifics.

In 2012 the key goal of the monetary policy was to ensure control over inflationary factors and their regulation in a preventive mode within the established target. The ratio of economic cycle indices in favor of tightening the monetary policy was down, while those in favor of easing were up.

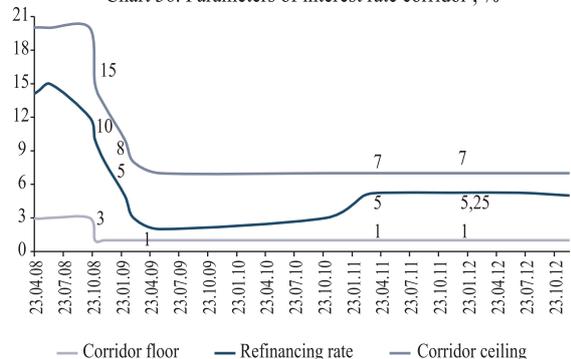
Chart 35. Cyclic Indicators



Source: CBA

To allow further drop in interest rates given the optimum level of inflation and thus support economic growth in the non-oil sector the CBA Management Board decided to shift the refinancing rate from 5.25% to 5% from 10 December 2012, and leave other parameters of the interest rate corridor unaltered. The CBA, while taking the decision, considered the profitability level in the non-oil sector.

Chart 36. Parameters of interest rate corridor, %



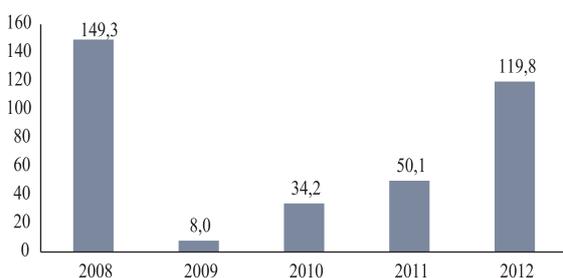
Source: CBA

The CBA's monetary policy decisions factored in changes to interest rates in the banking sector. Over the year interest rates on loans to legal entities having decreased 0.7 p.p. made 14.2%, while those on loans to individuals having decreased 1.5 p.p. made 21%.

To regulate growth rates of money supply and the liquidity level in the banking system the CBA actively employed open market operations and reserve requirements. The mechanism of reserve requirements application has been dramatically improved, and banks enacted new regulations allowing more efficient liquidity management.

In 2012 AZN 1675,6 million worth notes were issued within sterilization operations. Out of which AZN 1058,8 million worth notes were auctioned and placed.

Graph 37. Amount of CBA notes, end of period, AZN million



Source: CBA

Average return on notes was 1.87 % at the last auction, which was 2.84% at the beginning of the year. As of 01.01.2013 the volume of notes in circulation constituted AZN 119.8 million.

2.3. Money supply

In 2012 money supply kept pace with the demand of the economy, the structure of which continued to improve.

Broad money supply in manat grew by 25.5% in 2012.

Over the year monetary base rose by 27.1%, the change of which was due to CBA's currency sterilization and open market operations.

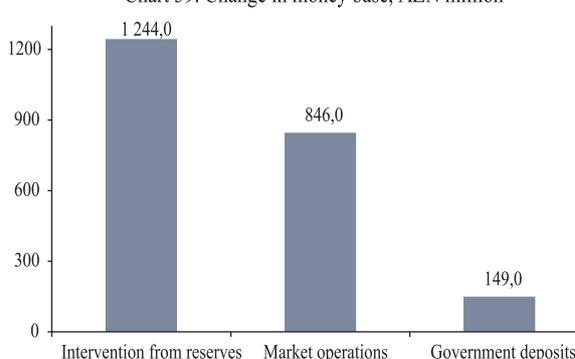
Chart 38. Change in money supply, %



Source: CBA

Diminished government deposits also had an upward effect on the monetary base.

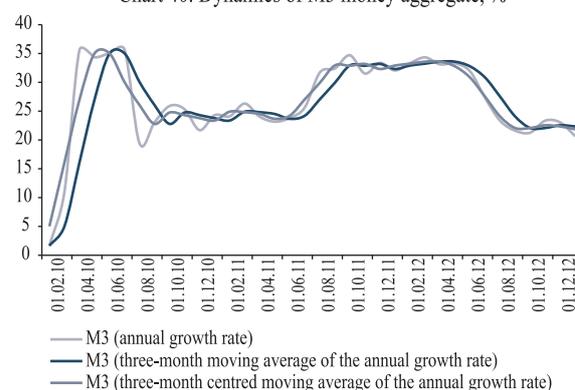
Chart 39. Change in money base, AZN million



Source: CBA

As of 01.01.2013 broad money supply (M3) rose by 20.7% and reached AZN 16775 million.

Chart 40. Dynamics of M3 money aggregate, %



Source: CBA

Growth of broad money supply stemmed from rise both in cash, and non-cash money.

Table 8. Money aggregates, AZN million

	01.01.10	01.01.11	01.01.12	01.01.13
M0 (Cash)	4147.8	5455.8	7158.2	9256.6
M1 (Cash, demand savings and deposits)	5239.8	6718.9	8824.8	11107.9
M2 (Cash, demand and term savings and deposits, in AZN)	6169.2	8297.5	10997.2	13806.4
M3 (Cash, demand and term savings and deposits, in AZN and hard currency)	8469.2	10527.5	13903.2	16775.3

Source: CBA

Box 7. Demography, property prices and money demand

The study that covers 22 DDCs from 1950 to 2010 concluded that demographic growth drives money demand and rising property prices. The findings display that when baby boomers born during the 1946 – 1964 demographic golden age – baby boom period joined the workforce and started saving, money supply and property prices entered a rising trajectory, the reason for which is that working-age populations save for their old age by investing in property or deposits. When they retire, this dynamics goes into reverse and banks are forced to look for additional fund sources.

The study suggests that growth of the population increases the share of money supply in GDP (Marshallian K), while income and savings cause rise in property prices, they do not increase inflation dramatically. With weakened demographic processes, i.e. less workforce in the market, ageing generation tend to withdraw savings or sell their properties. This is the reverse process – the share of money supply in GDP decreases (Marshallian K).

The most vital factor is that when the rising population enter the labor market money demand prevails over the economic growth rate. In this case money (deposit) is considered to be a better investment facility compared to property. Since the price for

a house is likely to fall with ageing of the people, however money usually keeps its value. Naturally, the created model includes inflation indicators and the effect of inflationary shocks on money supply growth in various periods was considered. The results show that high inflation or inflation expectations dissuade people from saving and lower the share of money supply in GDP (Marshallian K). Model results exhibit that 1% rise in workforce increases the share of money supply in GDP about 1% in the long-run (Marshallian K).

The theoretical model concludes that property and assets prices change in direct proportion to the number of population, workforce size and productivity. Whereas results slightly vary across periods and countries, in general 1% rise in workforce increases property prices over 1%. This model also confirms that monetary stability contributes to long-run property price stability.

Ageing workforce reduces demand of households for deposits, which, in the first instance, decreases the size of money supply, and results in a high loan-to-deposit ratio in banks and weakens the economic activity.

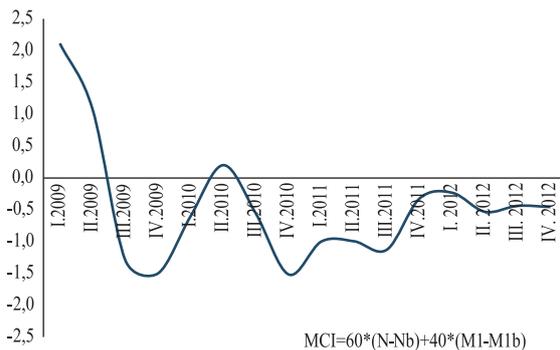
Source:

Ageing, property prices and money demand, Kiyohiko G Nishimura and Elod Takats, BIS Working Paper No 385.

Over the year non-cash money supply rose by 11.5%, resulting from incentives favoring non-cash payments.

During the year slight depreciation of the NEER of manat and high money supply had an overall easing effect on the Monetary Condition Index (MCI).

Chart 41. Monetary Condition Index



Source: CBA

2.4. Research base of the monetary policy

In 2012 the CBA continued a targeted activity on development of macroeconomic management and the institutional base of the monetary policy.

The Bank followed international debates to raise effectiveness of the monetary policy in Azerbaijan and shape macroprudential management, and researched application of best practices in light of local specifics.

The CBA Monetary Policy and Financial Stability Committee continued to function over the year. The Committee promptly traced the macroeconomic situation, analyzed internal and external factors, considered the monetary policy framework and macroeconomic forecast for the coming period and took crucial monetary and financial stability policy decisions.

The CBA conducted works on boost of macroeconomic diagnosis and research capacity in harmony with the 2011-2014 Strategic Plan.

To boost the financial stability assessment capacity, the Bank prioritized identification of systemic risks in the banking sector. Sustainability and vulnerability of the banking sector were assessed on a regular basis through stress tests and financial stability indicators. Modeling of structural optimization of bank capital (Tier I and II) was explored and a research based policy proposals were elaborated. Contribution of development of payment systems to economic growth was explored within the draft law on payment systems.

The Bank conducted a number of studies related to inflation, growth and macroeconomic equilibrium within the framework of improvement of econometric researches and forecasting. Symmetric and asymmetric pass-through capacity of monetary policy decisions on the economy was estimated, initial results of which were presented at the Swiss National Bank.

Overall, the CBA applied models on 5 directions, including 1 experimental model.

Within raising financial awareness framework the Bank attracted technical assistance from the World Bank, the German Savings Banks Foundation for International Cooperation and Pricewaterhouse Coopers. Specific financial literacy related e-educational materials were elaborated with total 25 events (ecobiography, a kid with money etc) held. A Banks to Schools, Schools to Banks week was held jointly with commercial banks, various trainings were delivered for employees of commercial banks and teachers.

The Economic Football played in over 20 countries in various languages was tailored for Azerbaijan, additional modules and questions developed and existing games translated. A series of financial literacy trainings were delivered for loan specialists of commercial banks.

Table 9. Models explored in the CBA

	Name of model and research	Description
1.	Estimation of the wealth effect in Azerbaijan	Consumer behavior of households in-the-boom and post-boom period was explored, impact of wealth effect on consumer behavior was empirically estimated.
2.	Estimation of the monetary transmission effect	This estimation allows econometric assessment of the monetary transmission. High power of CBA influence on interest rates of the banking sector was identified empirically.
3.	Estimation of currency replacement	Currency replacement across the country was estimated using a small-scale general equilibrium model, high redollarization and high confidence in the national currency was empirically demonstrated.
4.	Estimation of output gap	Output gap was ex-post estimated and a various filters based econometric model was built in order to issue quarterly forecasts.
5.	Estimation of optimum capital adequacy on the banking sector	Capital adequacy on the banking sector was estimated and an optimum threshold determined based upon empiric methods.
6.	Estimation of J-curve on the country economy	Export J-curve was estimated on the total economy, non-oil and sectoral level, existence of the J-curve was empirically demonstrated.
7.	Creation of Dynamic Stochastic General Equilibrium (DSGE) model	The DSGE is based upon the microeconomic agents' optimization problem in order to conduct various policy studies across the country, estimate policy scenarios, as well as issue short- and medium-run forecasts and includes intersectoral relationship.
8.	Estimation of factors affecting interest rates	The study empirically estimated factors that impact interest rates in the banking sector and analyzed interest rate spread.
9.	Estimation of price bubble on the property market	Price bubble on property market was empirically estimated, and the balanced level of property prices identified.

Source: CBA

To provide methodological support for the banking financial system through adequate statistics in line with best practices, guidelines on banking – financial statistics are being updated, the content and design of reporting formats, as well as monetary-financial statistics are being aligned to the IMF standards. Within implementation of the Electronic Statistical database and Analytical Reporting System (ESAS) project statistic reporting and data receiving on the entire banking – financial system, automated processing and e-distribution

to internal and external users have been ensured. Database collected from economic entities is being sent to the ESAS system in e-format. The balance of payments is being developed in harmony with the IMF's new methodology (6th edition) within application of development of the balance of payments under full e-format practice and at the technical assistance of the SEKO expert due to improvement of the external sector statistics.

The number of enterprises and organizations covered by the RSM has been expanded. 98

enterprises in the non-oil processing industry, 38 enterprises in services sector and 25 enterprises in the construction sector were added to the monitoring. Average annual response weight

made 60%. At the same time, a household financial health methodology is planned to be elaborated and applied.

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