CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REPORT

JANUARY-MARCH

2023
№1

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ACRONYMS

AE	Advanced economy
APPI	Agricultural Producer Price Index
BCI	Business Confidence Index
CBA	Central Bank of the Republic of Azerbaijan
CCI	Consumer Confidence Index
CPI	Consumer Price Index
EME	Emerging market economy
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign direct investment
FED	Federal Reserve System
FX	Foreign exchange
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
ILO	International Labor Organization
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
NDA	Net Domestic Assets
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Assets
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
REER	Real Effective Exchange Rate
RSM	Real Sector Monitoring
SCC	State Customs Committee
SSC	State Statistics Committee
WEO	World Economic Outlook
WTO	World Trade Organization
Yoy	Year over year

EXECUTIVE SUMMARY

In Q1 2023, the CBA implemented its monetary policy in accordance with the 'Statement of the Central Bank of the Republic of Azerbaijan on main directions of the monetary policy for 2023'. Central Bank conducted a policy aiming to protect macroeconomic stability in the country.

The operational environment of the CBA was marked with high uncertainties related to the world economic outlook, attributable to persistent geopolitical tension and lingering aftereffects of the pandemic. Still, favorable conjuncture in the world energy carriers market had a positive effect on the balance of payments, the FX market equilibrium and economic activity. Albeit relatively slowed down, persistent high inflation in partners weighed on inflation in Azerbaijan as well.

The CBA continued the anti-inflationary monetary policy in response to the risks in internal and external environments of inflation. The CBA strived to contain inflationary pressures through the monetary condition. Monetary policy decisions were taken in light of dynamics of inflation, the level of deviation of the forecast from the target and how persistent the risks are. The Bank kept improving the monetary policy operational framework taking into account both current and strategic challenges.

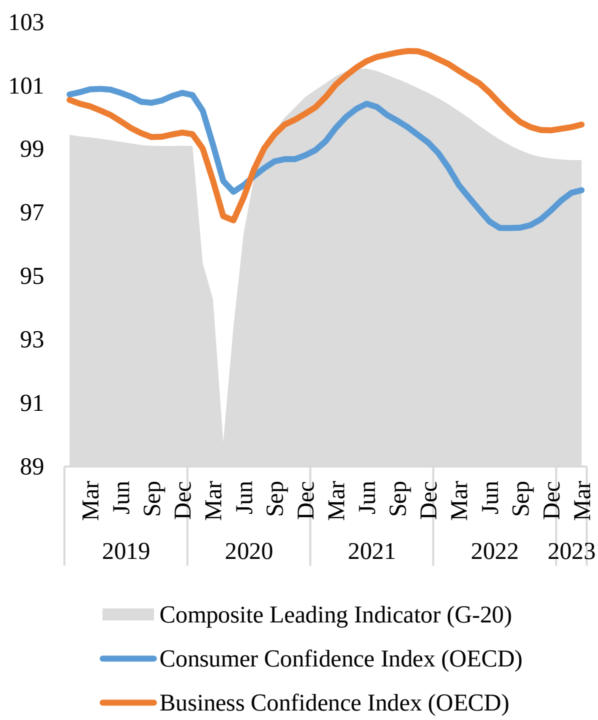
I. GLOBAL ECONOMIC ENVIRONMENT

1.1. Global economic trends

In 2023, the global economy was driven by geopolitical conflicts and recent turbulences in the financial sector. These developments impede the way back to pre-pandemic economic growth rate. The tightening of the global financial condition to subdue inflation decelerates economic recovery on the other hand. Consequently, income of most economies is increasing more slowly amid higher unemployment in 2023. Moreover, although major central banks increased interest rates to fight inflation, price stability may take a longer time.

Q1 2023 witnessed various trends that formulate the world economic outlook and affect businesses and consumers in the world. Gradual drop in negative impact of the pandemic, higher demand in China that reopens its economy, gradual removal of supply chain disruptions, slowdown in hikes in prices for goods and commodities contributed to global economic activity indicators. Hence, in Q3 2023 the CCI and the BCI, economic activity indicators of the OECD countries increased, while the G-20 Composite Leading Indicator remained stable.

Chart 1. Global economic activity indicators



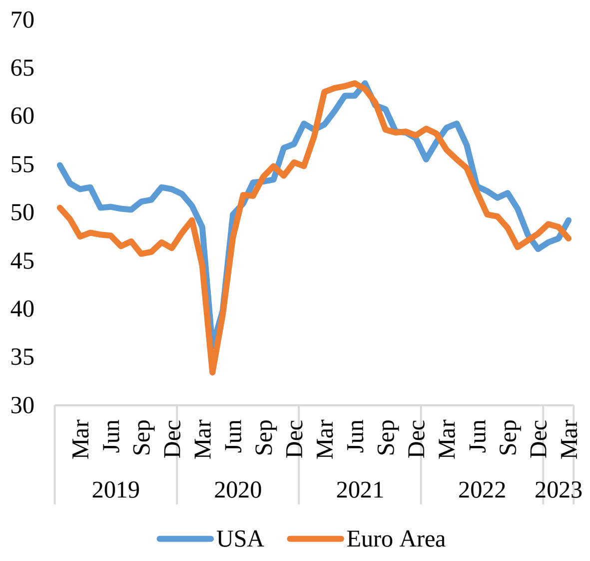
Source: OECD

Another indicator of economic activity, the Purchasing Manager's Index (PMI)[1] on production has been falling since 2021 in the USA and the euro area.

[1] The Purchasing Managers' Index measures trends in sectors – over 50 stands for expansion and below 50 – stands for contraction compared with the previous month.

However, rising demand and supply increased output and consequently the PMI in the USA in Q1 2023. The PMI that increased in the euro area in Q4 2022 decreased because of weak changes in production, new orders, and unemployment.

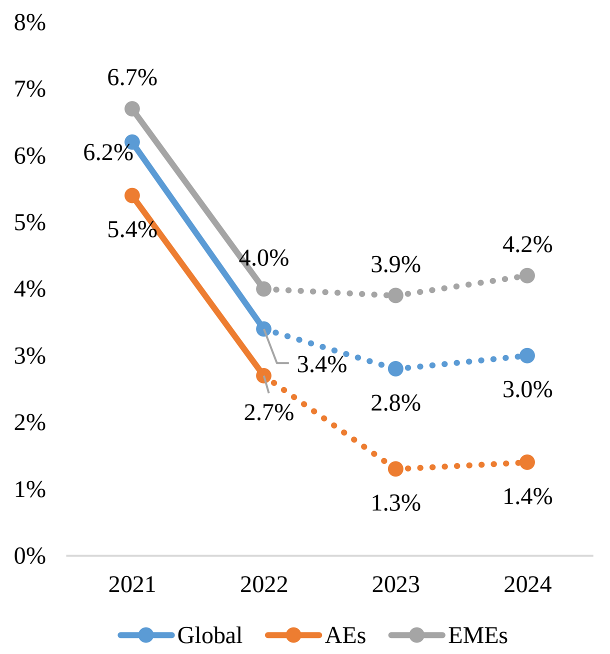
Chart 2. Purchasing Manager's Index (PMI)



Source: Markit Economics

Global economic trends had a considerable effect on economic growth projections of international organizations. The IMF WEO April 2023 releaseforecasts global growth to stand at 2.8% and 3% for 2023 and 2024 respectively, down by 0.1 pp compared with the January forecast. The probability that global growth will surpass pre-2022 forecasts (3.6%, October 2021) in upcoming years is low. The report also predicts that global output gap will increase by 2.7% (cumulatively) until 2026, twice higher than the initial level, due to economic fluctuations that have a negative effect on investments made to capital, training, research and development.

Chart 3. Economic growth projections, %



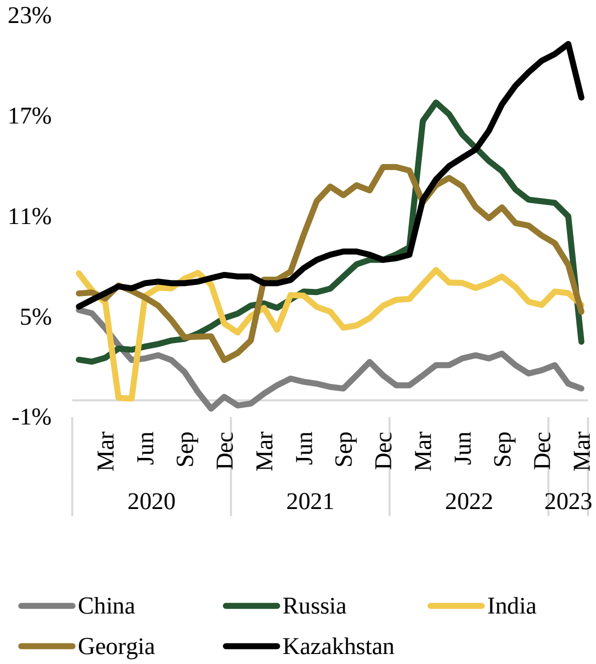
Source: IMF, WEO April 2023

The IMF WEO April 2023 release forecasts that economic growth on AEs will decrease from 2.7% (realized in 2022) to 1.3% in 2023. Moreover, the IMF projects more optimistic economic growth in 2024 – 1.4%. The WEO April 2023 release forecasts changes in economic growth rates in most AEs in 2023. For instance, economic growth forecasts were revised up for the USA (0.2 pp), the euro area (0.1 pp) and the UK (0.3 pp) and down for Germany (0.2 pp) and Japan (0.5 pp) compared with the January 2023 forecast. This anemic trend in economic growth in AEs is attributable to the tight monetary policy necessary to subdue inflation, the recent aggravated situation in the financial system, geopolitical problems under way since last year and rising geoeconomic fragmentation.

The IMF WEO April 2023 revised down economic growth on EMEs by 0.1 pp compared with the January 2023 forecast to 3.9% in 2023 and revised up to 4.2% in 2024. Although economic growth outlook for EMEs is relatively higher than in AEs on average, these forecasts vary across regions. While economic growth outlook was left unchanged for EMEs in Asia in 2023 (5.3%), it was revised down for EMEs in Europe (0.3 pp), Latin America (0.2 pp), Middle East and Central Asia (0.3 pp) and Sub-Saharan Africa (0.2 pp). In this context, GDP is expected to grow by 5.1% on average in low-income EMEs in 2023-2024. However, per capita income is expected to grow merely by 2.8% in 2023-24, lower than the average indicator for middle-income countries (3,2%). Thus, this level of growth is lower than the one needed to reduce the gap between living standards.

The IMF increased global inflation forecast by 0.4 pp to 7% in 2023 compared with the January forecast (8.7% in 2022) and forecasts it to stand 4.9% in 2024 in the WEO April 2023 release. Inflation decreases with lower than expected rates, and is still higher than targets. Inflation is forecasted to fall to 4.7% (7.3% in 2022) in AEs and to 8.6% (9.8% in 2022) in EMEs. These indicators are predicted against the background that disinflation processes will continue in 76% of country groups in 2023, non-fuel commodities will become cheaper, and monetary tightening will have a ‘cooling’ effect on economic activity. According to the recent release of IMF, inflation will only return to the target in 2025 if current risks persist. It was also noted that, in 2023, average annual inflation would surpass targets in 97% of 72 economies whose official inflation target is known (34 AEs and 38 main EMEs).

Chart 4. Inflation in some EMEs, %



Source: National statistic offices

To return inflation to the target central banks decided to either tighten or maintain the monetary policy in Q1.

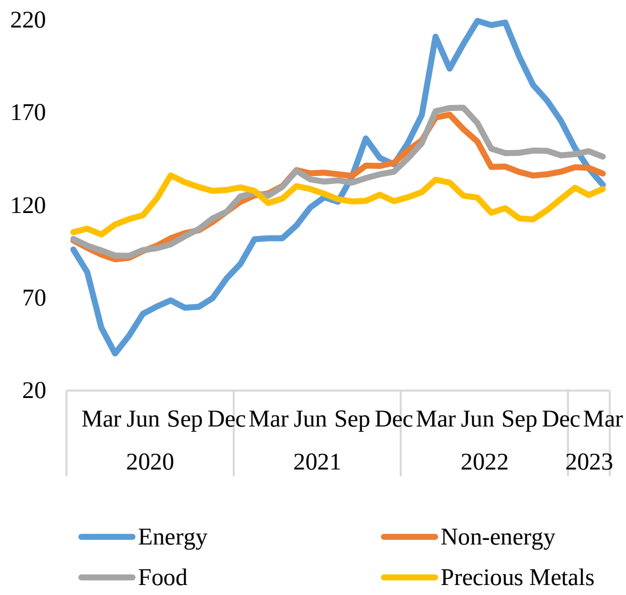
In March 2023, unemployment varied across countries – it increased in India (7.8%), the UK (3.8%) and Japan (2.6%) and decreased in the USA (3.5%), China (5.3 %) and Russia (3.5%, February), and remained stable in the euro area (6.6%, February) and Georgia (3.1%). According to the WEO April 2023, economic slowdown expectations in AEs allows forecasting higher unemployment from 2022 through 2024 increasing by 0.5 pp on average.

1.2. Global commodity markets

Over the past period of 2023, prices in global commodity markets were prone to stabilizing amid global economic slowdown and monetary tightening by central banks. However, with the geopolitical tension still under way uncertainties related to the future trajectory of commodity prices persist. The current uncertain geoeconomic environment makes it particularly hard to forecast energy prices that are directly affected by global developments.

Despite lingering geopolitical and geoeconomic tension, global prices for most commodities dropped over the past period of the year. According to the World Bank Commodity Markets Outlook April 2023, energy prices decreased by 20.9%, non-energy by 0.7%, raw materials by 1.9%, fertilizers by 15.3%, metals and minerals by 0.7% in Q1 2023. However, prices for beverages increased by 5.4% and precious metals by 4.3%.

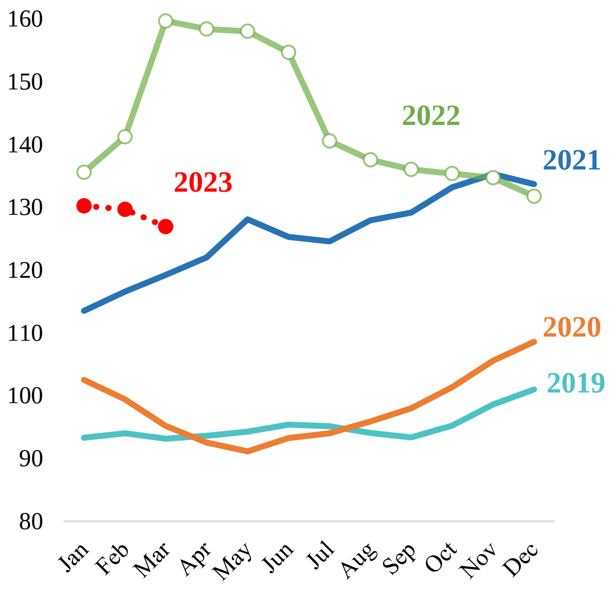
Chart 5. Global commodity indices (2019 December=100)



Source: World Bank

According to the UN FAO, in March 2023, the food price index decreased by 3.7% compared with the beginning of the year. This indicator has decreased on an annual basis for 12 consecutive months by 20.5% from the peak of March last year. Over the first quarter, the drop in the FAO food price index was driven by the fall in prices for grain, vegetable oils and dairy products.

Chart 6. The FAO Food Price Index



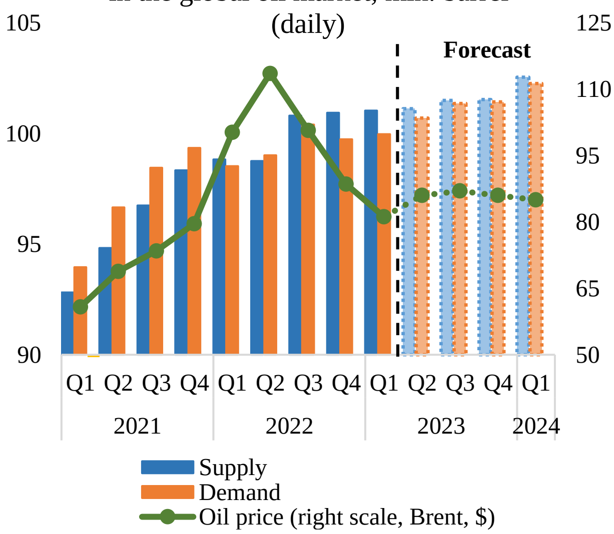
Source: FAO

The IMF WEO April 2023 forecasts decrease in commodity prices in 2023 due to weaker global demand. The IMF predicts global food prices to decline by 5.6% in 2023 and by 2.8% in 2024. According to the report, weakened economic activity will trigger low demand for import that will translate to the drop in commodity prices.

The highest price drop was in energy prices over the quarter. The average price for the Brent oil was about $82.2 per barrel, down by 17.1% compared with the average price of 2022 ($99.2). The IMF WEO April 2023 forecasts the average price fall to $73.1 in 2023 ($81.1 in January release) and to $68.9 in 2024.

The US EIA, in its April report predicts that with the reduction of oil production of OPEC++ countries by 1.16 mln. barrels per day the global oil production will decrease compared with the previous forecast, but consumption will remain stable, as a result the average Brent oil will increase to $85 per barrel in 2023 ($82.95 in March release). However, the report highlights that ongoing concerns related to the global economic condition, in particular recent turmoil in US banking sector may elevate the risk of low oil demand and trigger drop in oil prices.

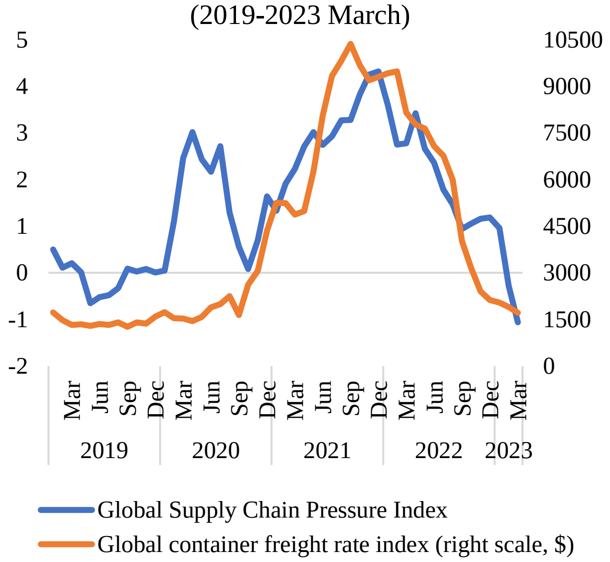
Chart 7. Dynamics of demand and supply in the global oil market, mln. barrel (daily)



Source: The US Energy Information Administration (EIA)

Gas prices, peaked to historical highs of recent 10 years in 2022, the year full of geopolitical and geoeconomic developments, considerably fell over the past period of 2023. The average gas price for 1000 cubic meters decreased by 60% to €562 compared with the average indicator for the last year (€1405) on the Dutch TTF gas index. Mild winter in Europe and the level of gas storage reaching the maximum of recent years drove sharp fall in gas prices.

Chart 8. Dynamics of global indices (2019-2023 March)



*water transport, 40 feet (12 meters) container

Source: The Federal Reserve Bank of New York, Statista

The gradual recovery of supply chain disruptions, which were initially impacted by the pandemic and subsequently by geopolitical tension, led to lower transportation-logistic expenses. This recovery was one of the main factors driving down inflationary pressures. The Global Supply Chain Pressure Index, released by the Federal Reserve Bank of New York successively decreasing in Q1 2023, reached the lowest level since 2011 (-1.15).

Despite stabilization trends in global commodity markets, prices are still higher than the pre-pandemic level. Uncertainties related to the expected dynamics of prices remain. Maintaining the flow of grain from Ukraine and Russia, the largest grain exporters, ensuring supply chain continuity and preventing protectionist tendencies between countries and groups of countries are critical for global food security.

1.3. Global financial markets

The monetary policy implemented by central banks to lessen inflationary pressures weighed on global financial markets in the first quarter of the year as well. Financial stability risks in certain advanced economies have become of current concern.

The monetary policy of central banks. Monetary policy tightening by most central banks in 2022 is likely to continue in the first quarter of 2023. Over the reporting period 42 central banks increased, 34 banks left unchanged, while 7 banks decreased policy rates. The US Fed shifted the policy rate from 4.25 to 4.75%, the Bank of England from 3.5% to 4.25% and the ECB from 2.5% to 3%. However, some central banks paused monetary tightening and decided to leave policy rates stable.

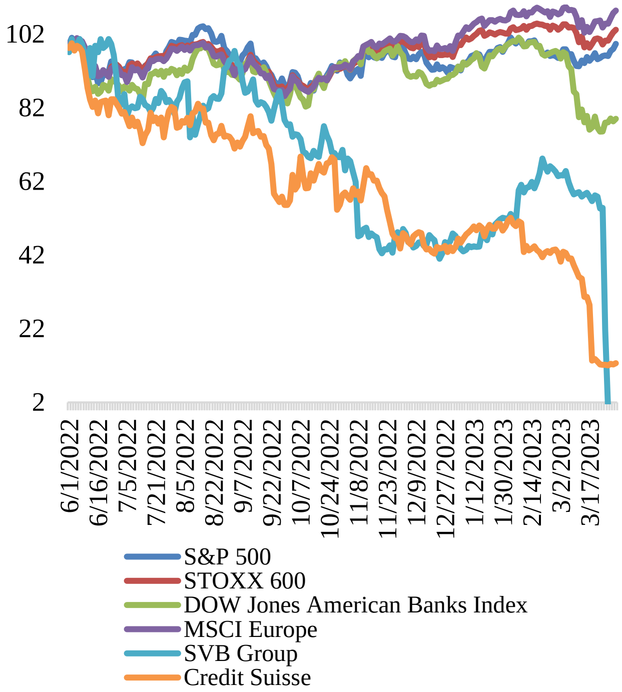
Stock exchanges. Stock exchanges in different countries reacted diversely to interest rate changes. Despite the fall in shares of banks and other financial institutions, key stock indices have appreciated since early year. The NASDAQ gained 14.7%, the FTSE Eurotop 6.2%, the DAX 10.3%, the Shanghai Composite 5.7% and the Nikkey 7.3% in Q1 2023.

The global financial system. Over the reporting period, liquidity issues intensified in certain regional US and European banks. Several global systemically important banks failed in Q1 2023. Only in March three regional banks collapsed and regulators took them over in the United States. The US Silvergate Bank announced liquidation in March due to the fall in crypto prices. Tech-lender Silicon Valley Bank with $212B worth of assets was declared bankrupt on March 10, mainly due to the fall in bond prices in parallel with the rise in policy rates and huge losses at bond sales to maintain liquidity. The collapse of Silicon Valley Bank went down to history as the second largest bank failure in the USA along with the failure to raise capital and withdrawal of deposits by depositors. Deposit withdrawals and liquidity problems led to insolvency of another bank – the Signature Bank on March 12. To avoid the similar case in the First Republic Bank 11 large US Banks injected $30B in March.

Financial system instability began to manifest itself in a number of European banks. The STOXX Europe 600 Banks index, which tracks 42 big EU and UK banks, fell by 5.6% over recent one year. Stocks of the Deutsche Bank fell significantly amid a rise in insurance cost against the bank defaulting. The UBS acquired the Credit Suisse, one of the largest banks of Europe and the world on March 19.

The IMF GFSR April 2023 specified several threats to the global financial system. Although the US and European governments take decisive actions to fight financial crises, uncertainties among global financial market participants persist. Tightened monetary conditions, financial leverage, liquidity gaps on assets and liabilities and

Chart 9. Dynamics of the stock markets



Манба: BVF

Close interdependence between non-bank financial institutions and traditional banks may further exacerbate fragilities in the global financial system. Sovereign debt sustainability keeps deteriorating, especially in middle and low-income countries. Rising borrowing cost reduces savings of households during the pandemic and increases default risks. Remaining geopolitical tensions may increase economic and financial fragmentation among major economies and impede free movement of capital.

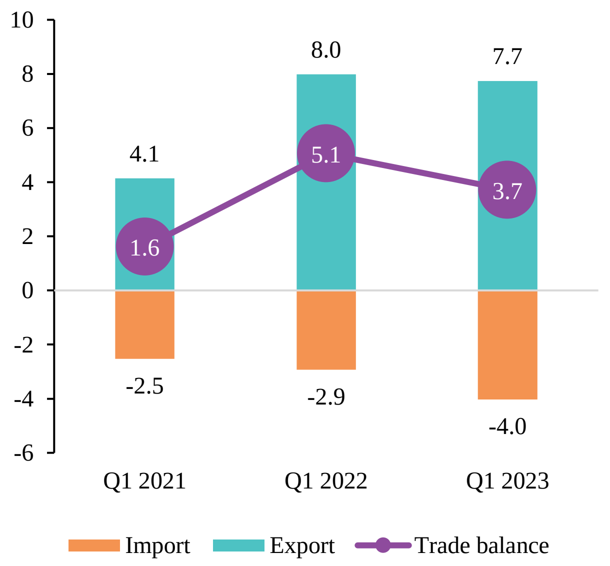
The report provides several proposals to safeguard global financial stability. Ensuring financial stability relies on several key conditions, including open and transparent communication by central banks, strengthened internal risk management within banks, effective application of capital and liquidity ratios, resolution of systemic liquidity problems, and intervention in foreign exchange markets when necessary, enhanced management of risks associated with high debts, and direct provision of liquidity to non-bank financial institutions.

II. INTERNAL MACROECONOMIC CONDITION

2.1. External sector

In Q1 2023, the international conjuncture had a positive effect on external sector indicators of Azerbaijan. Foreign trade balance, the key balance of payments component, was still in surplus.

Chart 10. Trade balance, $ billion

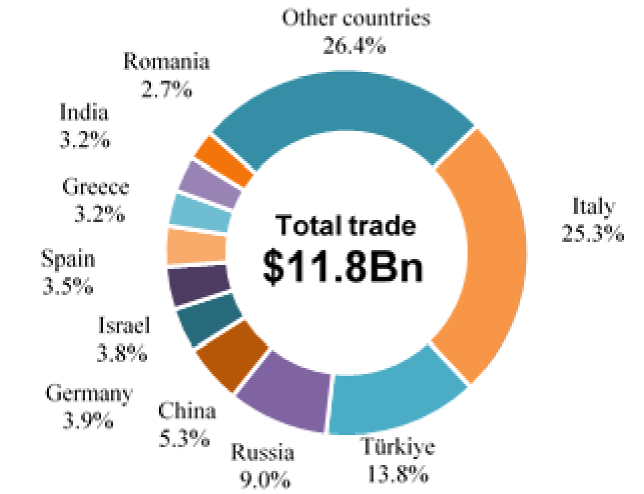


Source: SCC

According to the SCC, foreign trade turnover amounted to $11.8 B – export $7.7 B (65.8%), import $4B (34.2%) in Q1 2023. Foreign trade surplus stood at $3.7B, yoy down by 26.7%.

Azerbaijan traded with 171 countries over the period (yoy 152).

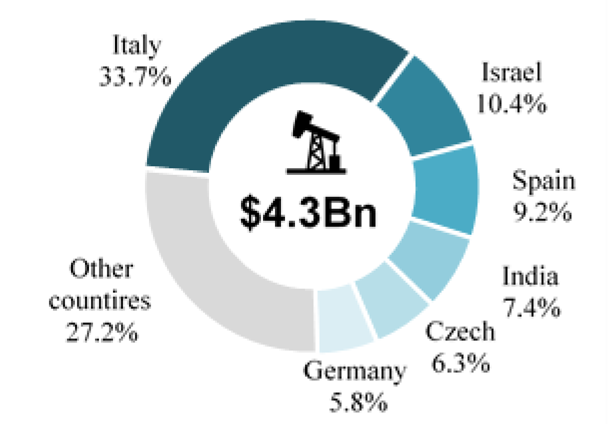
Chart 11. The main countries in trade in Q1 2023, (%)



Source: SCC

Italy, Türkiye, Russia, China, Germany, Israel, Spain, Greece, India and Romania accounted for over half of trade turnover. Export decreased by 3.2%, oil and gas export decreased by 5.9%, due to the change in export prices. The value of export decreased by 16.1% on crude oil and by 32.2% on natural gas. 33.7% of crude oil and oil products was exported to Italy, 10.4% to Israel, 9.2% Spain, 7.4% to India and 6.3% to Czechia.

Chart 12. Countries to which crude oil and oil products are exported in Q1 2023, (%)

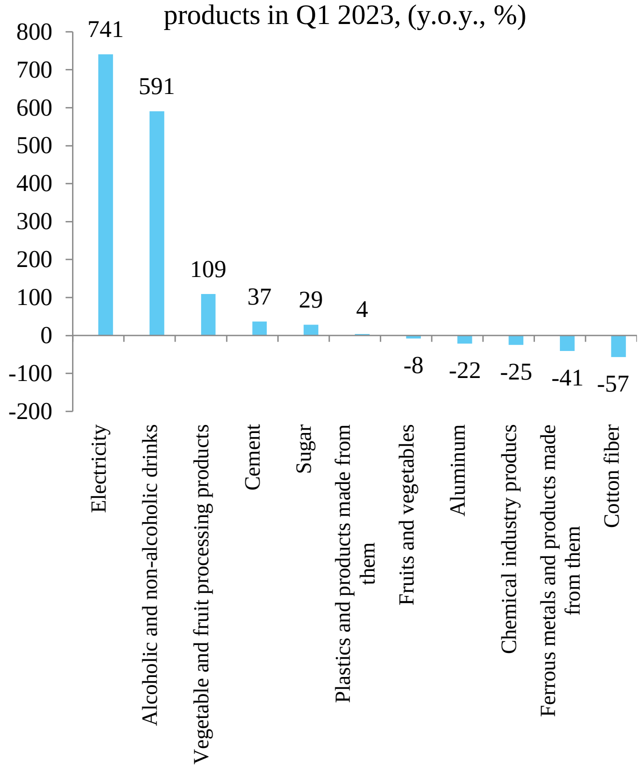


Source: SCC

Non-oil export increased by 25.4%. Exports of electricity, alcoholic and non-alcoholic beverages, processed fruit and vegetable products, pomegranates, apples, cement, sugar, plastics and products increased.

In general, main export partners were Italy (37%), Türkiye (13.7%), Israel (5.8%), Spain (5.1%), Greece (4.8%) and India (4.1%).

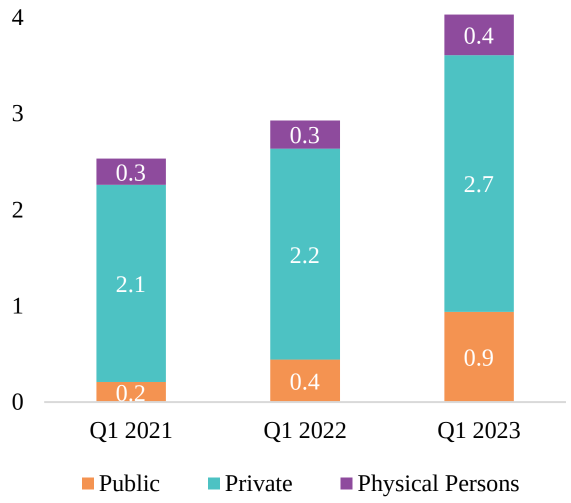
Chart 13. Changes in export of some products in Q1 2023, (y.o.y., %)



Source: SCC

Commodity import yoy increased by 37.6% - by 2.1 times to $0.9B on the public sector, by 21.6% to $2.7B on the private sector and by 45.5% to $0.4B on individuals.

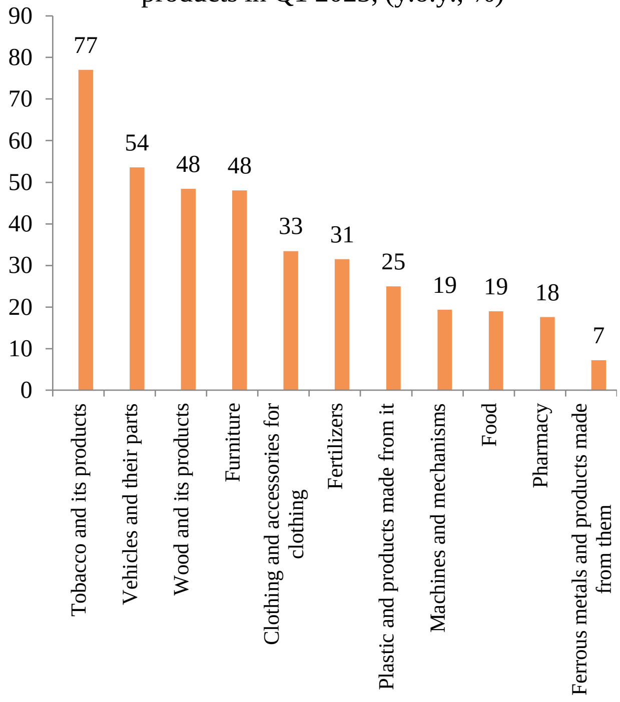
Chart 14. Dynamics of imports by sectors, billion $



Source: SCC

Import increased by 77% on tobacco and tobacco products, by 53.5% on vehicles and parts, by 48.4% on wood and wood products, by 48.1% on furniture and parts, by 33.4% on clothes and clothing accessories, by 31.5% on fertilizers, by 25% on plastics and products, by 19.3% on machinery and mechanisms, by 18.9% on food products, by 17.6% on pharmaceuticals and by 7.2% on ferrous metals and products.

Chart 15. Changes in imports of some products in Q1 2023, (y.o.y., %)

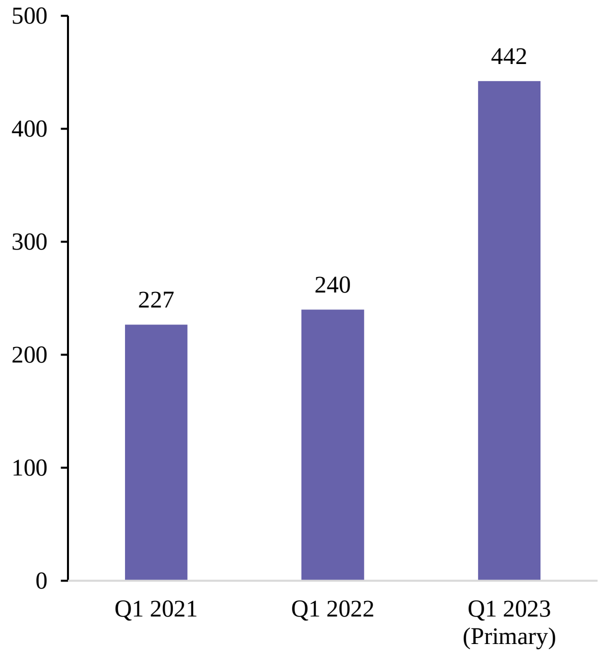


Source: SCC

Russia accounts for 19.8%, China for 14.6%, Türkiye for 14%, France for 5.5%, Germany for 5.0%, Turkmenistan for 4.7%, Iran for 3.2%, Italy for 2.7%, the USA for 2.6% and Kazakhstan for 2.5% of imported products.

According to preliminary data, remittances to the country yoy increased by 84.2% to $442.1M in Q1 2023.

Chart 16. Remittance inflows, $ million



Source: CBA

Capital inflows from foreign enterprises and organizations continued over the period. According to the SSC, FDIs amounted to AZN3.5B. Domestic investments amounted to 73.2% of total investments.

Investor funds from the UK, France, the USA, Türkiye, Japan, Switzerland, Russia, Norway, and Iran accounted for 96.7% of total FDIs (AZN914.4M).

Strategic FX reserves still exceed internationally accepted adequacy norms. As of 31 March 2023, strategic FX reserves sufficed for 36-month worth of import of goods and services (considering the import of goods and services for 2022). Strategic reserves exceeded broad money supply in manat (M2) by 3.7 times (M2 as of 31.03.2023).

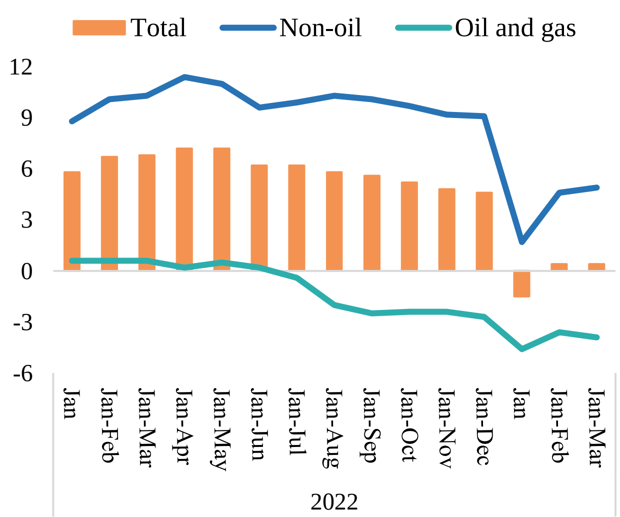
2.2. Economic activity

In Q1 2023, economic activity continued in the country. Expanded aggregate demand underpinned economic growth.

Economic growth. According to the SSC, GDP yoy increased by 0.4% in real terms to nominal AZN30.3B in Q1 2023.

Oil and gas value added decreased by 3.9% to nominal AZN13.3B (43.9% of GDP). 7.7 million/ton crude oil (yoy down by 7.4%), 9.2 billion cubic meters natural gas (yoy up by 1.1%) was extracted in Q1 2023. Total production in oil and gas sector yoy decreased by 4% in real terms.

Chart 17. Economic growth, yoy, %



Source: SSC

Non-oil value added yoy increased by 4.9% in real terms to nominal AZN17B. Production in the non-oil and gas industry increased by 4.7%.

Agriculture grew by 3.4%. Livestock products increased by 3.5%, and plant products increased by 1.3%.

Services also posted growth. Freight and passenger transport yoy increased by 6.4% and 22.8% respectively, information and communication increased by 17.8%. Tourism and public catering kept growing, related value added yoy grew by 24.3%.

Table 1. GDP stucture, weight, %

Sectors	Q1 2022	Q1 2023
Industry	54.1	47.5
Construction	3.7	5
Agriculture, forestry and fishery	2.2	2.6
Trade, repair of vehicles	7.9	9
Transport and warehousing	5.8	5.4
Tourism and public catering	1.3	1.9
Information and communication	1.3	1.5
Other	15.7	17.6
Net taxes on products and import	8	9.5

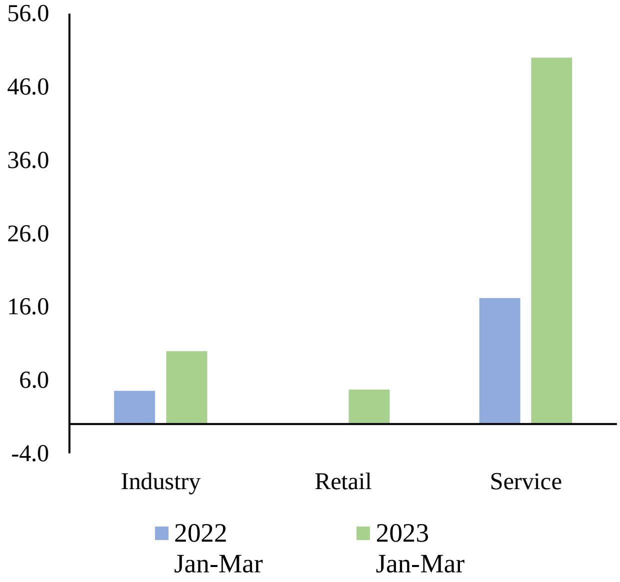
Source:SSC

CBA's real sector survey results confirm that economic activity elevated. The BCI was mainly positive across sectors.

The BCI on the industry was positive driven by the chemical industry, plastic, food products and beverages sub-sectors. The BCI was negative in machine-building, knitted goods and production of other non-metal mineral products sub-sectors.

The trade BCI was positively zoned. The BCI was mainly positive in electric appliances and furniture. The BCI was positively zoned in the service sector, except for postal services.

Chart 18. Business confidence index, (quarterly average)



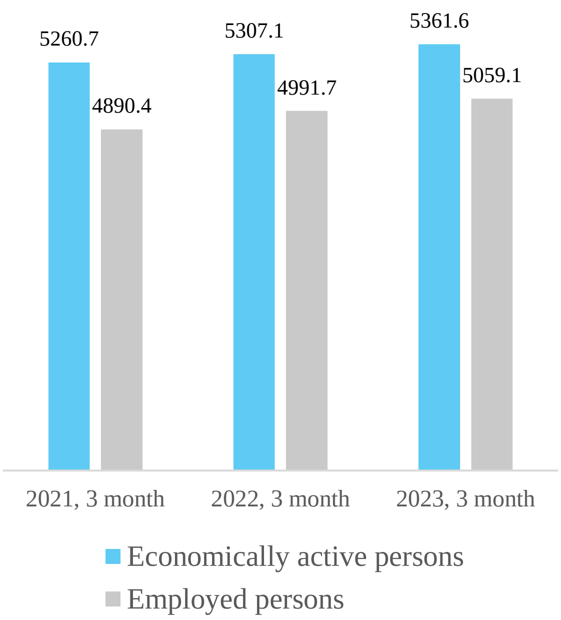
Source: CBA calculations based on RSM results[2]

Employment. As of April 1 2023, total labor force was 5361.6 thousand persons, yoy up by 54.5 thousand. Employed population numbered 5059.1 thousand persons, yoy up by 67.4 thousand persons.

As of 1 March 2023, hired labor was 1715.8 thousand persons, yoy up by 2% – 901 thousand persons were engaged in the public and 814.8 thousand persons in the non-public sectors.

[2] *Industrial BCI = (output – final goods inventory + production expectations)/3*
Services BCI = (business condition + actual demand + demand expectation)/3
Trade BCI = (actual sale – changes in goods inventory+ sale expectations)/3

Chart19. Dynamics of economically active and employed persons (in thousands)



Source: SSC

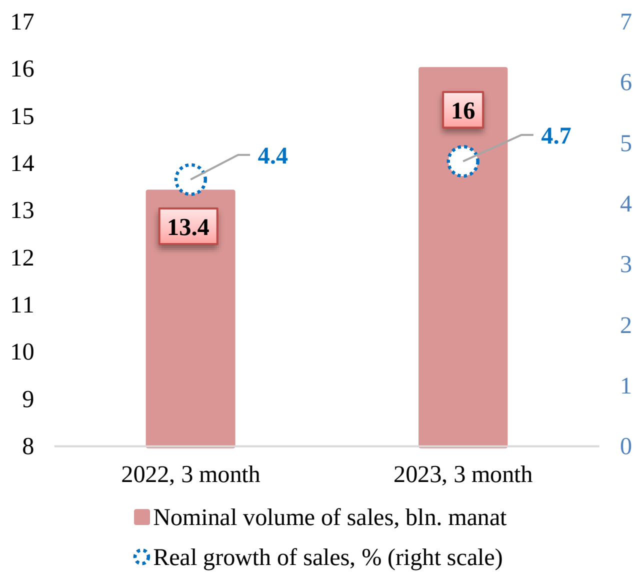
23.1% of hired labor in enterprises and organizations was involved in production, 6.7% in construction, 7.3% in processing, 3.6% in agriculture, forestry and fishery, 2% in mining, 1.9% in water supply and waste management, 1.6% in electricity, gas and steam production, distribution and supply.

Results of RSM by the CBA indicate that, employment expectations of economic agents were positive in the industry, trade and services.

Aggregate demand. Aggregate demand supported economic growth in Q1 2023.

Aggregate demand expanded due to consumer demand. Goods and services sold in the market to meet consumer demand yoy increased by 4.7% in real terms to AZN16B. Every consumer spent on average AZN527.4 in the consumer market (yoy up by AZN83.8).

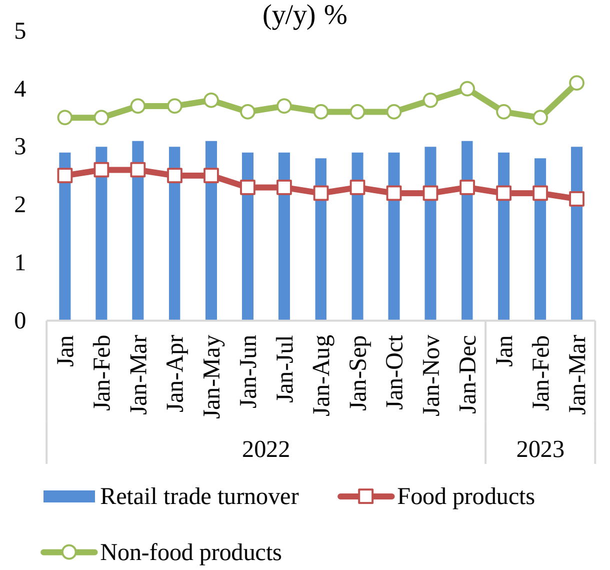
Chart 20. Change in volume of sales in consumer market



Source: SSC

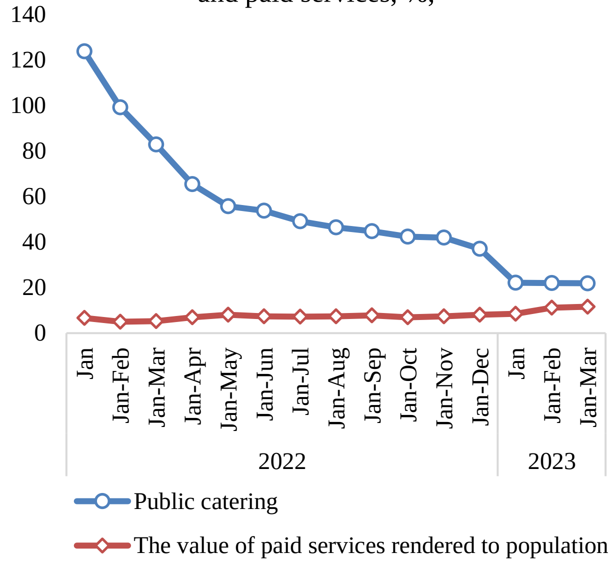
Retail trade turnover yoy increased by 3% in real terms to AZN13B. Retail commodity turnover on food products, beverages and tobacco products increased by 2.1%, and non-food trade turnover increased by 4.1%.

Chart 21. Growth in retail trade turnover, (y/y) %



Source: SSC

Chart 22 . Dynamics of public catering and paid services, %,



Source: SSC

Consumers spent over half of their funds (57.1%) on food, beverages and tobacco products in retail trade outlets.

Every consumer purchased, on average, AZN427.9 worth of goods (yoy up by AZN63.8) in nominal terms in retail trade – AZN244.4 on food, beverages and tobacco products, and AZN183.5 on non-food stuff.

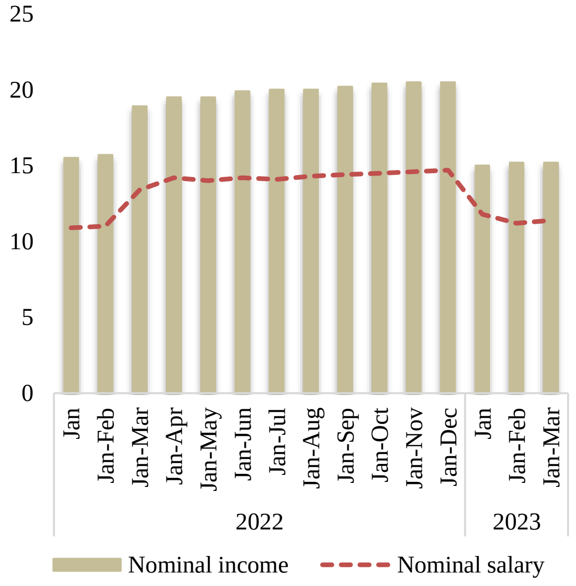
Public catering turnover yoy increased by 21.9% in real terms. Paid services to the population increased by 11.6% in real terms to AZN2.6B. Per capita paid services consumption yoy increased by AZN47 to AZN257.4 on average in nominal terms in Q1 2023.

Growth dynamics of nominal income of the population was the main factor in the rise of consumer demand in Q1 2023. The nominal growth rate of personal income continues to outpace the average annual inflation rate, which means that incomes are rising in real terms.

According to the SSC, money income of the population increased by 15.2% to AZN18.5B in nominal terms. Per capita money income was AZN1823.7. Population’s disposable income increased by 15.3% to AZN16.3B. Average monthly nominal salary of hired labor yoy increased by

11.2% to AZN854.5 over 2 months of 2023.

Chart 23. Growth dynamics of incomes and salaries, (y/y) %



Source: SSC

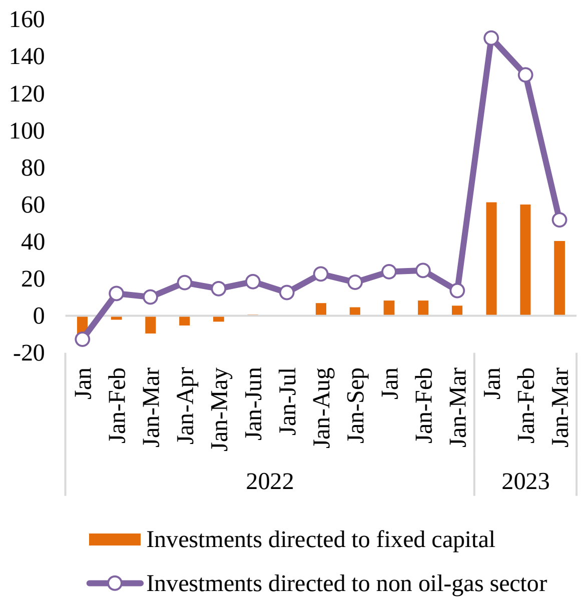
Lending activity also weighed on the consumer demand. Loans to households yoy increased by 27.2% to AZN11.8B.

Government spending was critical in supporting domestic demand. Over the quarter state budget expenditures amounted to AZN6.6B (19.7% of state budget expenditures of 2023) (yoy up by 2.1%).[3]

In January-March 2023, AZN4.7B (72.3%) of state budget expenditures were channeled to current expenses, AZN1.6B (24.7%) to capital expenses and AZN198.0M (3%) to state debt and liabilities.

Investment demand expanded over the reporting period as well. According to the SSC, funds invested to the economy yoy increased by 40.3% (AZN3.5B). The change in investments in both the oil and gas and non-oil and gas sectors was positive. Investment in the oil and gas sector yoy increased by 23.8% and investment in the non-oil and gas sector increased by 51.7% in real terms.

Chart 24 . Dynamics of investment , (y/y) %



Source: SSC

[3] *http://www.maliyye.gov.az*

AZN175.4M (5% of total investments) out of AZN2.2B worth funds channeled to the non-oil and gas sector was used in non-oil and gas industry. The public sector accounts for 52.8% and the non-public sector for 47.2% of total investments.

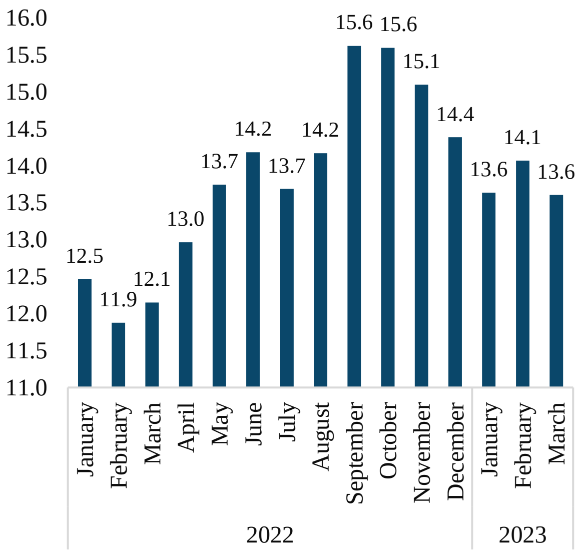
73.2% of investments stemmed from internal and 26.8% from foreign sources. Growth of funding sources of investments was positive across all directions. Funds of enterprises and organizations prevailed in total investments (45.8%).

2.3. Inflation

In Q1 2023, annual inflation was prone to falling. Certain developments in the global and internal environments paved the way to the drop in inflation. However, annual inflation is still higher than the target band.

Consumer Price Index (CPI). According to the SSC, annual inflation stood at 13.6% in March 2023 (March 2023 vs March 2022). Average annual inflation stood at 13.8% in January-March.

Chart 25. 12-month inflation in 2022, in %

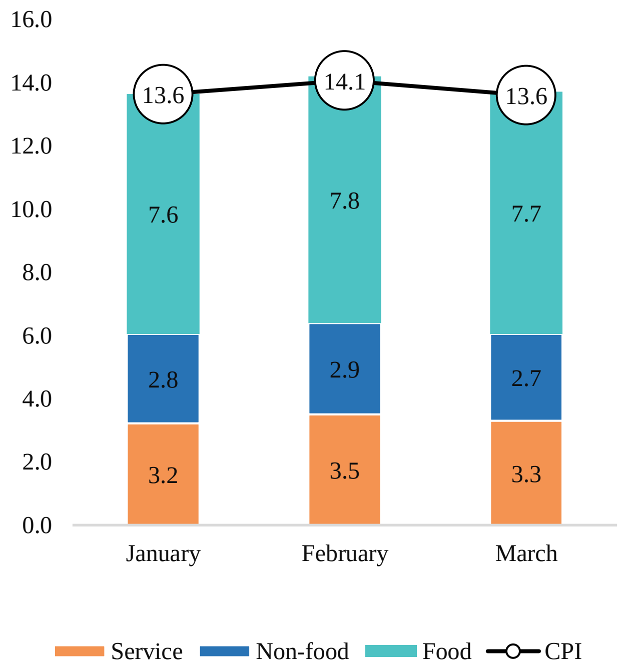


Source: SSC

Total inflation was mainly driven by food price hike. In March, annual food inflation was 16.8%, average annual food inflation was 17.1%. Non-food prices increased by 11.6% on annual and by 12% on average annual. Service prices hiked by 10.8% yoy. Average annual service inflation was 10.6%.

In general, food prices made 7.7 pp, non-food prices 2.7 pp and changes in prices and tariffs of services 3.3 pp contribution to annual inflation in March.

Chart 26. Contributions to CPI , in percentage points

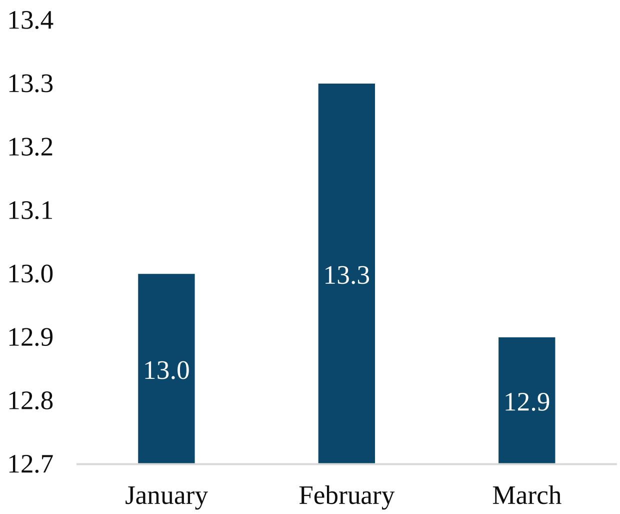


Source: SSC, CBA

Average annual core inflation calculated by excluding changes in regulated prices and prices for seasonal agricultural products was 13% in

January-March 2023. Annual core inflation was 12.9% March.

Chart 27. Change of average annual core inflation, in %



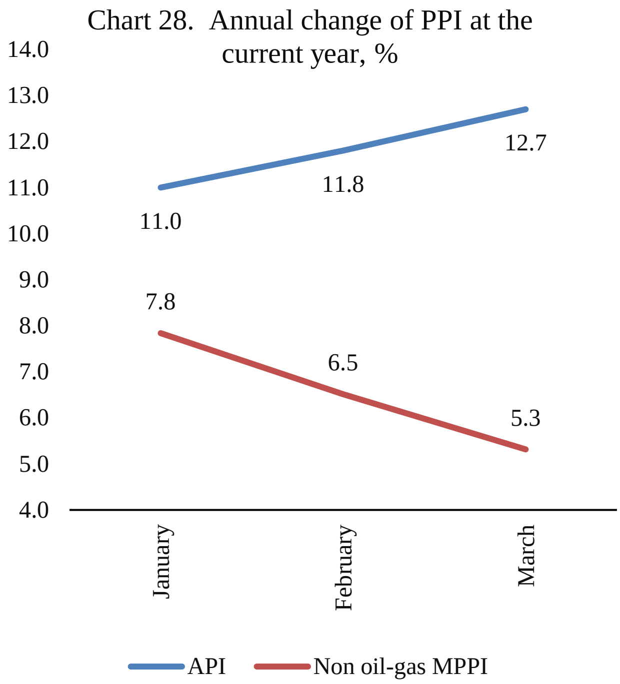
Source: SSC

Developments in the global economy weigh on foreign cost factors of inflation with certain time lag. Actual inflation in trade partners slightly slowed down under the influence of the drop in global economic activity, monetary tightening in most countries and continuing fall in world commodity prices. High uncertainties related to the global and national economies remain along with the above mentioned. The IMF in its April release revised up global inflation forecast. Rise in aggregate demand in the national economy has a push effect on inflation expectations. The above factors allow forecasted inflation to still exceed the target.

Note that, under baseline scenario assumptions the forecast that the annual inflation will be around 8% in 2023 remains unchanged.

Producer Price Index. According to the SSC, the APPI yoy increased by 12.7% in March. The IPPI yoy decreased by 20.4%. The IPPI decreased by 28.7% on oil-gas products and increased by 5.3% on non-oil-gas products. The non-oil-gas PPI decreased by 14.9 pp compared with March 2022.

The PPI in processing yoy increased by 6.6%. The food production price index increased by 6.4%, which had a push effect on food prices.



Source: SSC

In March 2023, prices for transport and warehousing yoy increased by 7.5%. Cost of freight transportation increased by 7.9% and passenger transportation by 4.2%. The warehousing and supplementary transportation price index decreased by 1.8%. Postal and courier service prices yoy increased by 1.2% in March.

According to the SSC, in Q1 2023 the price index in the housing market yoy increased by 9.9%. The price index increased by 8% in the primary housing market and by 9.9% in the secondary housing market.

III. Monetary condition

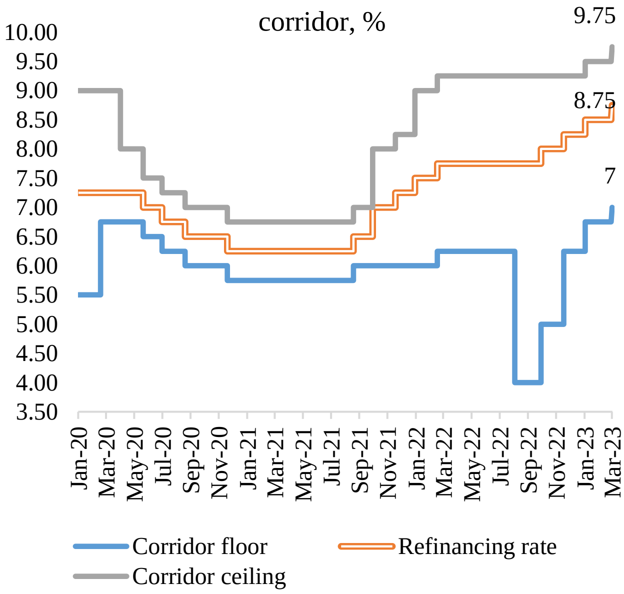
3.1. Monetary poilicy decisions and tools

In Q1 2023, the CBA's monetary policy was oriented towards easing inflationary pressures through the monetary condition; monetary policy tools were applied in light of the liquidity position of the banking system and the balance of risks. The Bank continued efforts to improve the monetary policy operational framework. These efforts served to strengthen the pass-through of monetary policy decisions to inflation through the interest rate channel.

Decisions on interest rate corridor parameters of the CBA on liquidity operations were taken in light of the dynamics of annual inflation, deviation of updated forecasts from the target band, as well as developments in the global and national economies. When monetary policy decisions were taken, the Bank considered the time lag necessary for their translation to the real economy too.

The CBA Management Board has discussed the interest rate corridor parameters twice over the reporting period and decided to shift the refinancing rate from 8.25% to 8.75%, the ceiling of the interest rate corridor from 9.25% to 9.75% and the corridor floor from 6.25% to 7%. The CBA published interest rates related decisions under the pre-announced schedule with appropriate analytical comments.

Chart 29. Parameters of interest rate corridor, %



Source: CBA

Over the period, monetary policy decisions were based upon the analytics provided as part of the Forecasting and Policy Analysis System (FPAS) approved at the end of last year. Business processes provided as part of the FPAS mainly cover identifying assumptions and scenarios, conducting analyses on their basis and developing forecasts.

The Bank continued to apply monetary policy tools under new configuration. Demand for CBA's sterilization tools, in particular liquidity absorbing standing facilities was higher. Average volume of one-day deposit operations amounted to AZN560M.

In general, demand exceeded supply at notes placement auctions. The CBA held total of 12 various term note auctions over the period. As of end-March, total outstanding amount of sterilization via notes was AZN885M. Return on notes was prone to increasing. Return at recent auctions was 6.71% on 28-day, 7.95% on 84-day, 8.57% on 168-day, 9.29% on 252-day notes. Yield on CBA notes is critical in terms of formation of a yield curve affecting interest rates of other financial tools.

The Bank conducted AZN240M worth two 7-day Repo auctions for liquidity absorbing purposes in Q1 2023. Average return at the last Repo auction was 7.38%.

Amid persistent inflationary pressures the challenges like containing excess growth of money supply, paving the way to the effective application of the new operational framework, as well as stimulating de-dollarization trends stipulated revision of reserve requirement rates and their differentiation. Taking into account the above, as well as concentration of liquidity across banks and the fact that it stems from high concentration on liabilities attracted from legal entities at large banks, the Management Board decided to increase reserve requirements with the new differentiation. Reserve requirements were set as follows: i) 5% on national currency denominated deposits of individuals and private entrepreneurs; ii) 6% on foreign currency denominated deposits of individuals and private entrepreneurs; iii) 5% on the part of national currency denominated deposits of legal entities with total amount up to AZN1B, 10% on the part of national currency denominated deposits of legal entities with total amount over AZN1B; iv) 6% on the part of deposits of legal entities in foreign currency with total amount up to AZN750M, 12% on the part of deposits of legal entities in foreign currency with total amount over AZN750M equivalent; v) 5% on deposits attracted in precious metals. Banks have been maintaining reserve requirements under new norms since February 2023. Constant application of reserve requirements on an average basis allowed banks to manage liquidity flexibly.

Application of monetary policy tools under a new configuration and their consistent improvement is accompanied with the activity in the money market. In January-March 2023, banks concluded AZN6.8B worth of 671 transactions in the platform launched for unsecured operations in the Bloomberg system. 94% of them were 1-3-day operations. Interest rates on money market operations are responding to interest rate decisions of the CBA. Under the influence of monetary policy decisions an average interest rate on one-day transactions at the Bloomberg trade system in March was 1.07% higher than end of the previous year.

Over the reporting period the secured money market was active too. AZN729M worth of 111 transactions were concluded at the interbank Repo market. Notes issued by the CBA are used as securitization in the Repo market and have a positive effect on activation of the interbank market. 39% of operations in terms of number and 17% of operations in terms of volume were based upon CBA notes.

Table 2: Change in reserve requirements

Until September 2022

- 0.5% on deposits in national currency and precious metals, 1% on deposits attracted in foreign currency

September 2022- February 2023

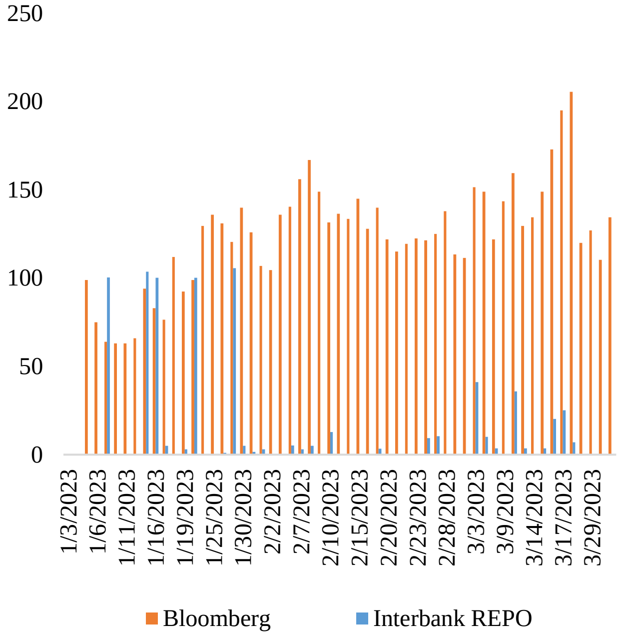
- 4% on deposits in national currency and precious metals, 5% on deposits attracted in foreign currency

From February 2023

- 5% on deposits of individuals and private entrepreneurs attracted in the national currency;
- 6% on deposits of individuals and private entrepreneurs attracted in foreign currency;
- 5% on the part of deposits of legal entities in the national currency with total amount up to AZN1B, 10% on the part of deposits of legal entities in the national currency with total amount over AZN1B;
- 6% on the part of deposits of legal entities in foreign currency with total amount up to AZN750M equivalent, 12% on the part of deposits of legal entities in foreign currency with total amount over AZN750M equivalent;
- 5% on deposits attracted in precious metals

Source: CBA

Chart 30. The volume of interbank operations in first quarter of 2023, mln.azn



Source: CBA

The Bank will adequately use its monetary policy tools depending on the domestic and global situation in upcoming quarters of the year. The CBA will further use all tools and mechanisms in its arsenal to contain excess expansion of aggregate demand. In parallel, the Bank will keep improving the monetary policy operational framework.

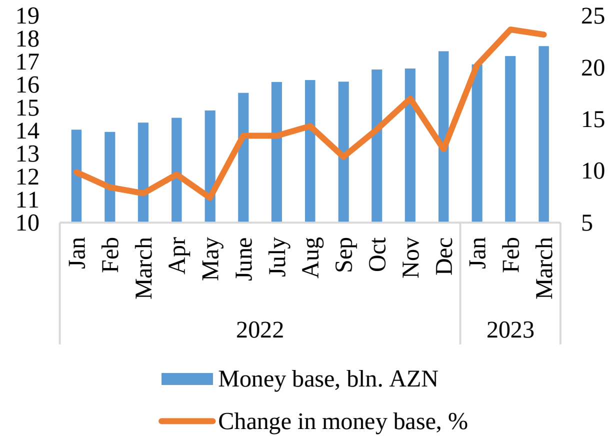
3.2. Money supply

In Q1 2023, money supply in manat responded to demand of the economy. The CBA regulated the change in money supply with its operations in accordance with policy targets.

Money base in manat increased by 1.3% to AZN17.7B as of the end-period. NFAs had a pull, while NDAs had a push effect on the change in money supply.

Cash in circulation, a structural element of base money in manat [4] increased by 3.1%, stock of correspondent accounts in manat decreased by 7.7%.

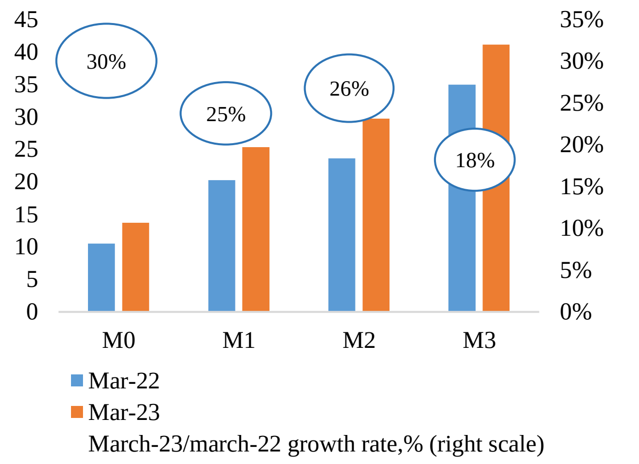
Chart 31. Monetary base and its annual change



Source: CBA

Money multiplier in manat (broad money supply in manat/base money in manat) was 1.68 as of end Q1. Broad money supply in manat (M2) increased by 0.4% to AZN29.7B.

Chart 32. Money aggregates (bln. azn)

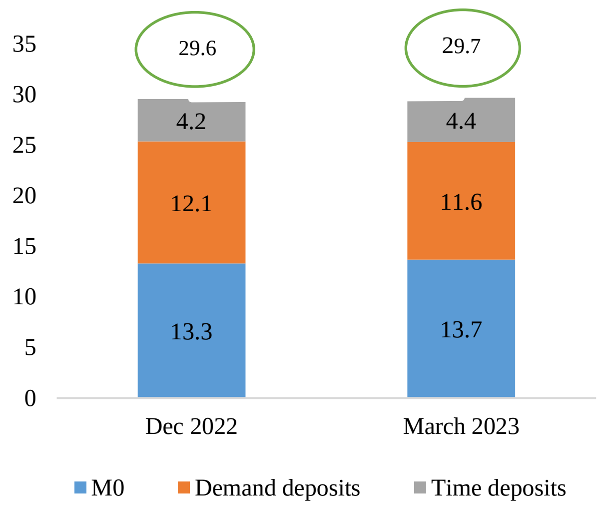


Source: CBA

Structural elements of M2 money aggregate shifted differently. M0 cash money supply and term savings and deposits increased by 2.9% and 4.5% respectively. Demand savings and deposits in manat decreased by 3.7%.

[4] Cash money outside the banking system, cash in bank ATMs and cash offices

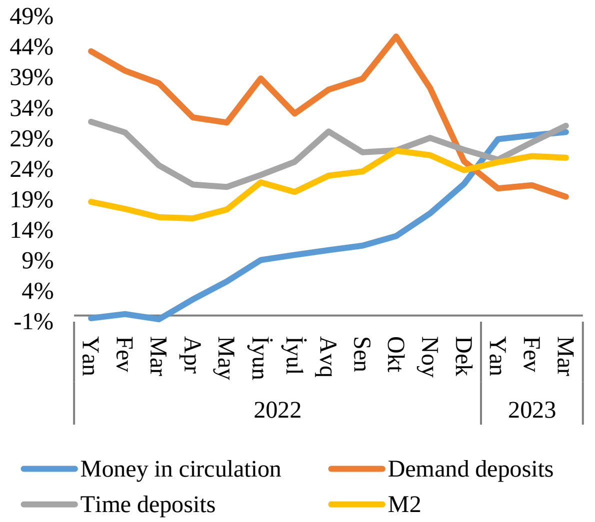
Chart 33. Dynamics of broad money supply in Q1 (bln. azn)



Source: CBA

Term savings and deposits increased at a higher pace year over year.

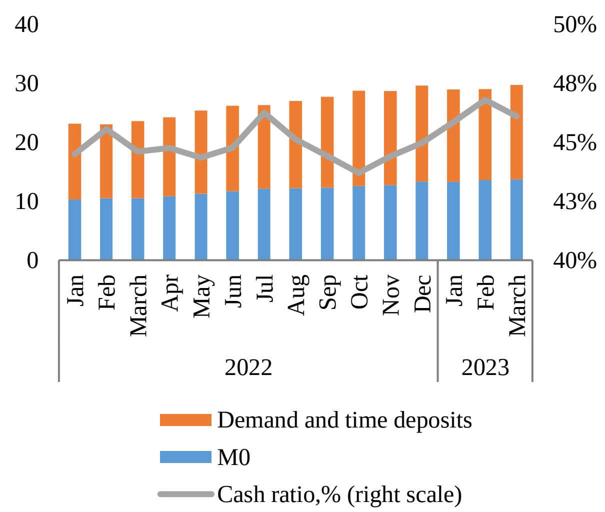
Chart 34. Dynamics of M2 and its components yoy(%)



Source: CBA

The weight of cash (M0) in broad money supply in manat (M2) was 46.1% as of end of Q1.

Chart 35. Cash ratio (M0/M2), (bln. AZN)

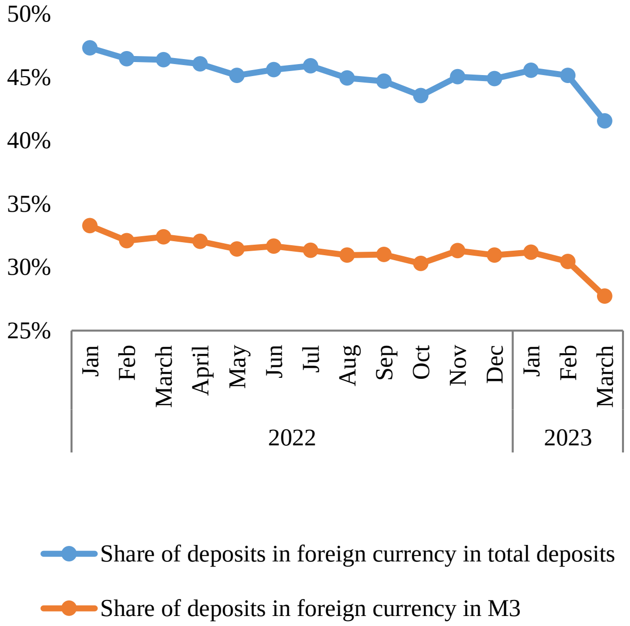


Source: CBA

Broad money supply (M3) decreased by 4.1% to AZN41.1B as of end-period.

Dollarization kept decreasing. Foreign currency denominated savings and deposits decreased by 14.1%, while their weight in total savings and deposits decreased by 3.3 pp to 41.6%. Posting the same trend, the weight of foreign currency denominated savings and deposits in M3 money aggregate has decreased by 3.3 pp since the beginning of the year to 27.7% as of the end-period.

Chart 36. Dollarization (%)



Source: CBA

The share of foreign currency in deposits of legal entities was 50% as of the end-period, down by 2.7 pp compared with the early year. Dollarization of savings of individuals has decreased by 1 pp since the beginning of the year to 38.2%. Dollarization of deposits of households (less savings of non-resident individuals) decreased by 1.1 pp to 34.5% as of end-period.

The CBA will use tools at its disposal over the remaining period of 2023 as well to allow adequate change of money supply in response to monetary policy targets.

3.3. The FX market and the exchange rate of manat

In Q1 2023, the exchange rate of manat against foreign currencies was formed according to supply and demand in the FX market. The current account surplus of the balance of payments supported the exchange rate stability, the key price stability anchor.

The volume of cash and cashless FX market operations decreased across all segments of the market.

Cashless transactions in the FX market yoy decreased by 8% to $6.8B equivalent[5]: 80.6% in the USD and 19.4% in other currencies. The Interbank FX market accounted for 21.3%, the Intrabank FX market for 78.7% of operations.

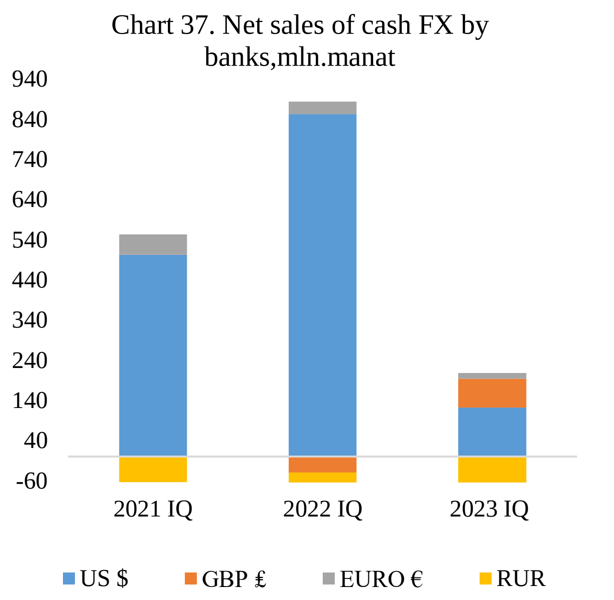
Interbank FX market operations yoy decreased by 35% to $1.4B equivalent. 98% of transactions were conducted in the USD. Currency operations in the Interbank FX market were mainly conducted over the Bloomberg platform.

To formulate a new behavior model in the Interbank FX market the Bloomberg's BMatch platform was activated, maintaining the existing auction mechanism. The platform allows the CBA to respond flexibly to the FX market, banks to track supply and demand for foreign currency in a real time mode and conclude deals with the most optimal exchange rate.

Intrabank FX market operations amounted to $5.3B equivalent, yoy up by 3.4% (76% in USD). Legal entities accounted for 93.2% of Intrabank FX market operations.

Cash currency traded by banks yoy decreased by 19.7% to $971M (83.1% in USD). Net cash currency sale fell six-fold yoy.

[5] *Including transactions with the USD, the euro, the pound, the Russian ruble*



Source: CBA

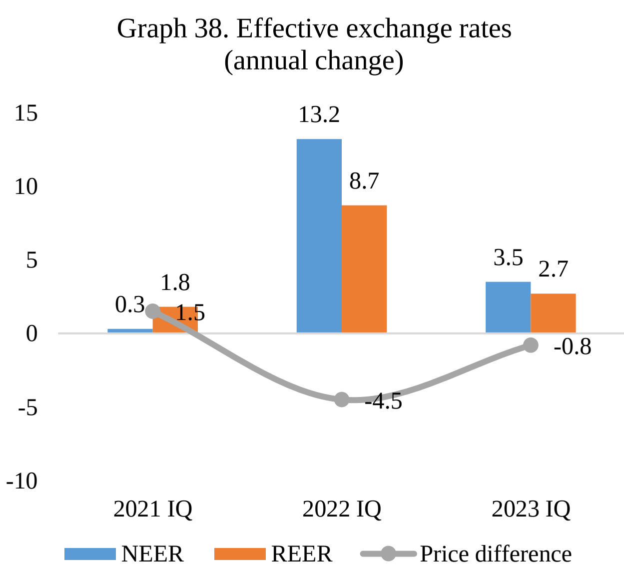
Note: Positive zone indicates sell, negative zone indicates buy transactions.

The CBA continued currency auctions to arrange the sale of foreign currency provided by the SOFAZ. The Bank held total of 23 currency auctions over the reporting period.

The official exchange rate of the manat against the USD was formed based upon the average exchange rate on interbank transactions over the period (both auction and over-the counter on the Bloomberg platform). The average official USD/AZN exchange rate was AZN1.7 over the period. Buy-sell exchange rates set by banks were close to the official exchange rate. Commercial banks' average buy/sell rate was 1.6966/1.7030.

The exchange rate of manat against currencies of trade partners varied over the period. Manat appreciated against the Turkish lira, the Russian ruble and the British pound, while it depreciated against the euro, the Kazakh tenge, the Swiss franc, the Japanese yen and the Georgian lari.

The dynamics of bilateral exchange rates influenced that of effective exchange rates. In general, total trade-weighted non-oil NEER of the manat appreciated 3.5% and the REER by 2.7%. Since inflation in Azerbaijan was lower than the average inflation in partner countries, it had a reducing effect on the REER.



Source: CBA

A stronger NEER of the manat acted as one of the factors to contain the inflation import.

Charts and tables

Charts

Tables

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