THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

January – December 2015

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

Baku – 2016

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ACRONYMS

CBA	The Central Bank of Azerbaijan
ADB	The Asian Development Bank
EBRD	The European Bank for Reconstruction and Development
ILO	The International Labor Organization
IMF	The International Monetary Fund
NBCI	Non-bank Credit Institution
FDI	Foreign direct investment
SSC	The State Statistics Committee
DGCs	Developing countries
DDCs	Developed countries
OECD	The Organization for Economic Cooperation and Development
CPI	The Consumer Price Index
APPI	The Agricultural Producer Price Index
SME	Small and medium entrepreneurs
NEER	The nominal effective exchange rate
OG	Output gap
OPEC	The Organization of the Petroleum Exporting Countries
REER	The Real Effective Exchange Rate
RSM	Real Sector Monitoring
PPI	The Producer Price Index
NFES	The National Fund for Entrepreneurial Support
UNCTAD	The United Nations Conference of Trade and Development
GDP	Gross Domestic Product
WTO	The World Trade Organization

EXECUTIVE SUMMARY

The CBA operated in the environment of increased negative impacts from the processes in the global economy, as well as in global energy markets and partner countries to the Azerbaijani economy in 2015.

2015 was the year of slack global economic growth, sharp drops in global commodity prices, decreased foreign exchange reserves and uncertain exchange rates dynamics in a number of countries. Oil prices plunged to historical lows of the past decade.

Increased long-term negative external shocks actualized the challenges related to the strengthening the sustainability of the national economy.

Changes in the balance formulated in the foreign exchange market during the period of high oil prices and series of devaluations in partner countries necessitated the review of the exchange rate policy and regime. The Bank took decisions on the exchange rate policy and regime which serve to maintain parity in the balance of payments, preserve foreign exchange reserves of the country and boost the competitiveness of the national economy.

Monetary policy decisions of 2015 were taken in light of the expected dynamics of inflation, which remained on single-digits under various factors and was below the average inflation of trade partner countries.

Overall, country's robust economic potential allowed minimizing the negative impact of the unfavorable international economic conjuncture in parallel with a maintained stable growth course.

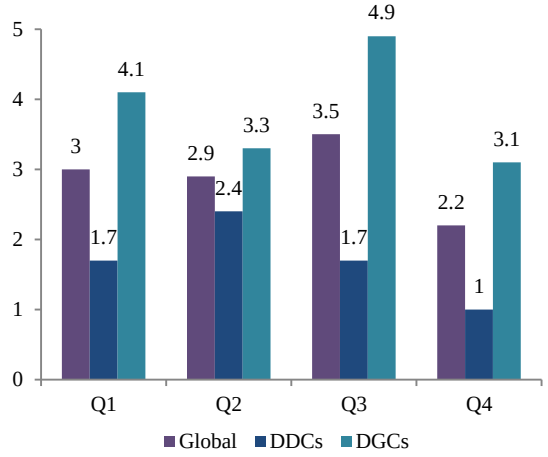
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1 Global economic trends

Uncertainties in the global economy topped in 2015. World economic growth was lower than expected in 2015 in the wake of a weak economic activity in leading DGCs. Slowdown in the economic growth rate in China, sharp drops in global commodity, particularly energy prices, the tightening of the US monetary policy and geopolitical tensions were the most critical factors to affect the global economy over the year.

Global growth. In 2015, according to initial estimations by the IMF, global economic growth was 3.1%, y.o.y. drop being 0.3 p.p. Growth in DDCs was 1.9% (y.o.y. increase 0.1 p.p.), while DGCs grew 4% (y.o.y. decrease 0.6 p.p.). Of the DDCs the USA (2.5%), Spain (3.2%) and Japan (0.6%) maintained a high y.o.y. growth dynamics.

Graph 1. Global economic growth in 2015, %, annual, seasonally adjusted



Source: Barclays

Accelerated economic growth in the USA in 2015 forced the Fed to increase the federal funds rate by 0.25 p.p. to 0.5%. High consumer expenses positively influenced economic growth. At the same time, high investments contributed to employment meanwhile increasing real income of the population over the year. However, stronger US dollar had a negative effect on exports.

Three main critical factors, that underpinned economic growth in the Euro Zone in 2015 included low oil prices, ongoing fiscal stimuli and the QE by the ECB. Continuing growth in production and services in the last quarter of the year was accompanied

by high employment. The revived labor market contributed to consumer demand. The ongoing QE in the Euro Zone led to credit expansion and improved financing conditions.

In Q4 growth expectations in Japan dropped, albeit positive economic dynamics over 2015. Although output gap shrank over Q4, economic growth remained slack, the reason for which is said to be low consumer expenses.

Continuing drops in commodity prices, tighter conditions in global financial markets and higher geopolitical tension weighed on lingering weak economic growth in DGCs in the last quarter of the year. Deep economic integration among DGCs promoted spillover of economic distress.

Economic growth in China was estimated to be 6.8% in Q4 of 2015, in line with forecasts. Overall, slack economic growth over the year is considered to be the historical low level of recent 25 years. Slowdown in the economy over the year had a negative effect on economic growth. However, the rebalancing in the Chinese economy led to rise in trade and services. The countercyclical economic policy by the Chinese Government contributed to the rebalancing.

Recent appreciation of the REER of the Chinese currency originated additional pressures on exports. China continued an accommodative monetary policy to avert the weakening of the economic growth rate.

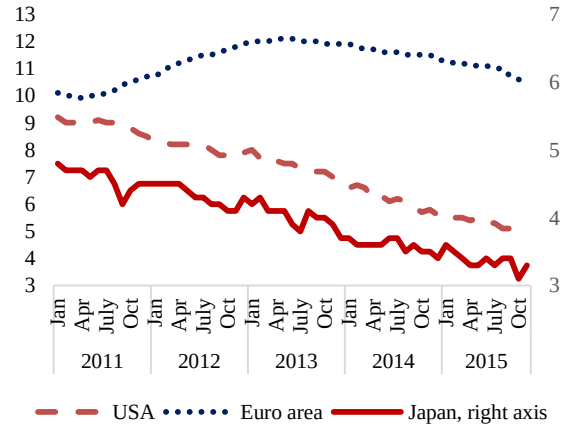
Economic growth in our key trade partners continued weakening in 2015. Whereas average economic growth [1] on 15 trade partners was 1.7% in 2014, it was replaced by 0.65% recession in 2015. Although employment dropped in developed trade partners (the USA, the Euro Zone etc.), it rose in developing partner countries (Russia, Iran etc.).

[1] *Non-oil export weighted*

Drops in global commodity prices and lasting international sanctions had a negative impact on economic growth in Russia – the key trade partner in the last quarter of the year, resulting in lower investment and employment indicators. Most partner countries devalued their national currencies over the year.

Global employment. A high economic growth rate in most DDCs contributed to low unemployment in the last quarter of 2015.

Graph 2. Unemployment rate, %



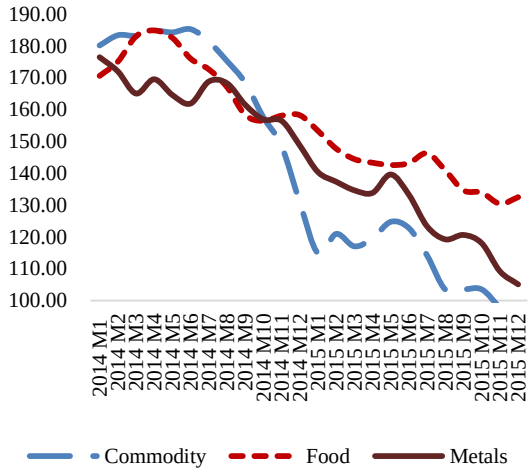
Source: OECD

As of end-December unemployment in the Euro Zone decreased 0.9 p.p. to 10.4%, 0.7 p.p. to 5% in the USA, and 0.3 p.p. to 3.3% in Japan versus the beginning of the year.

Global commodity prices. Low demand, high global supply and the stronger US dollar in the wake of a low economic growth rate in leading DGCs in 2015 amplified drops in global commodity prices.

Global commodity prices decreased 30.7%, food prices 16.3% in 2015. Wheat prices fell 29.7%, and agricultural raw materials price index dropped 16.2%.

Graph 3. Price indices, 2005=100



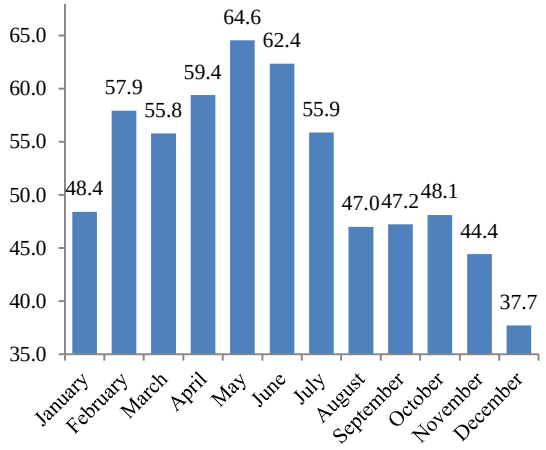
Source: IMF

Metal prices dropped 29.3%, including the aluminum price dropped 21.6%, and gold prices (1 ounce) dropped 12%. Increase of the Federal Funds Rate by the US Fed

considerably affected gold prices in Q4 of the year, high interest rates are negatively correlated to the price of gold. Demand for gold in China and India is still low.

Oil prices kept declining over the reported period. The price for Brent oil plunging to historical lows of the recent decade decreased 39.3% as of end-2015 versus the beginning of the year.

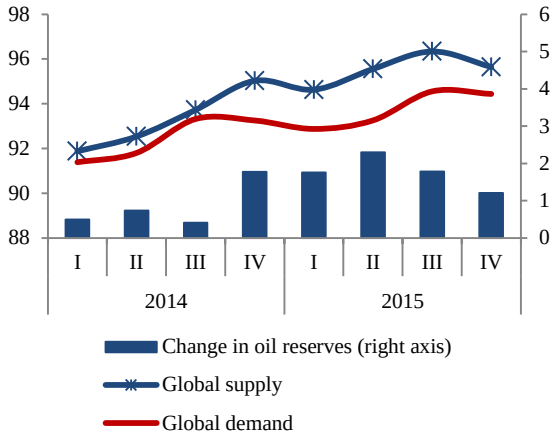
Graph 4. Average monthly price of Brent oil, 2015, $/barrel



Source: IMF

Overall, the average price for 2015 was y.o.y. 47% low.

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



Source: IEA

Oil prices slide due to the economic distress in DGCs, high production by the OPEC, the stronger USD, and additional supply in global markets resulting from removal of sanctions against Iran.

Inflation. Targeted inflation indicators are not in horizon despite lingering monetary expansion in most DDCs. As of end-December average inflation was 0.7% in the USA, 0.2% in the Euro Zone, and 0.3 % in Japan (as of end-November).

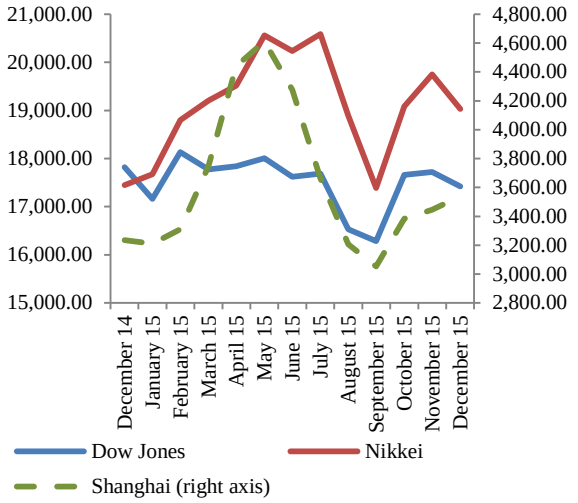
While low global production, drops in commodity prices and weak local demand had a downward effect, depreciation of national currencies in most countries had an upward effect on inflation in DGCs.

Global financial markets. Global financial markets became highly volatile in 2015. Whereas DDCs are more stable, the gap between developed and developing financial markets is widening with the spillover of financial risks in the BRICS[2] countries to other DGCs.

Financial risks in developing markets elevated at the end of 2015 resulting from tighter global financial conditions. High domestic debt and fiscal consolidation challenges in these countries add up to risk factors.

Dynamics of financial indices was volatile amid the processes in the global economy. While the Nikkei and Shanghai indexes gained 9.1% and 9.4% over the year, the Dow Jones index dropped 2.2%. Investors do not yet fully confide in financial markets in the aftermath of August – October sharp drops in financial indices. Continuing slides in oil prices heighten uncertainties in financial markets and the risk of this drop's spillover to other sectors.

Graph 6. Dynamics of financial indexes



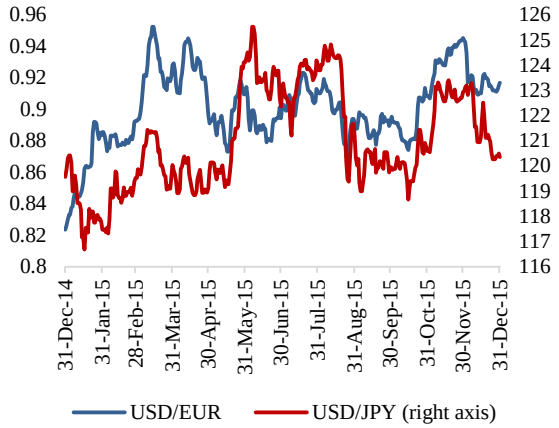
Source: Bloomberg

The depreciation of national currencies in major DGCs, Fed's raising Federal Funds Rate and low capital flows urged investors to be more conservative and make safer investments over the year.

Uneven global economic growth, sustained strengthening of the US dollar, economic downturn in China and geopolitical tensions were critical factors to affect global currency markets.

[2] BRICS – Brazil, Russia, India, China and South Africa

Graph 7. Exchange rate of USD



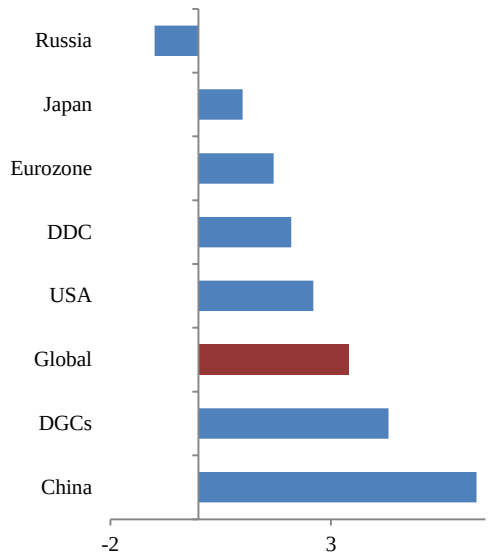
Source: Bloomberg

Changes to the monetary policy by the Fed and low commodity prices strengthened the US dollar in global markets over the period. The parallel QE in the Euro Zone continued to underpin the economic activity resulting in 11.1% appreciation of the USD against EUR. The accommodative monetary policy and the spillover of the economic conjuncture in China to the region contributed to the depreciation of the Japanese Yen. The USD appreciated against the Japanese yen by 0.43% over the year. The USD considerably strengthened against other currencies as well – 25.4% against the Turkish Lira, 85.8% against the Kazakhs Tenge, 22.4% against the Russian Ruble, 29.6% against the Georgian Lari, 68% against the Belarus Ruble and 17.3% against the Norway krone in 2015.

Global forecasts. The IMF in its recent outlook predicts 3.4% global growth in 2016, which is 0.2% lower than the previous forecast. Economic growth will be at 2.1% in DDCs and 4.3% in DGCs.

Global economic growth will be driven by DDCs in 2016. Growth in the USA is supported by a sustained economic activity, moderate financing conditions and high employment.

Graph 8.Global growth forecasts for 2016, %



Source: IMF

Low oil prices, the loose fiscal and monetary policy will contract output gap and contribute to economic growth in the Euro Zone.

Most risks are still lingering albeit more optimistic economic growth expectations for 2016 versus 2015. According to estimations stronger than expected slowdown in China would have negative impacts on global trade and financial markets in 2016.

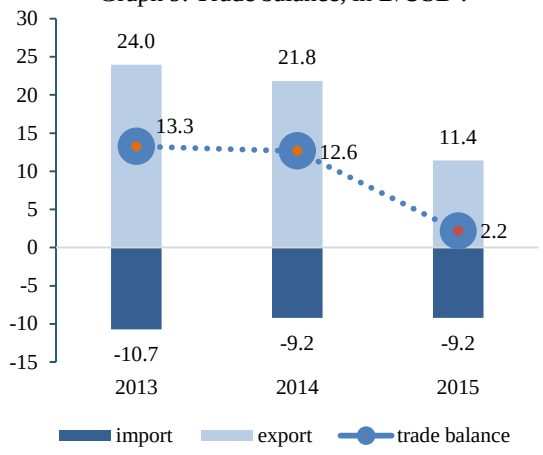
International financial institutions issued a number of policy proposals given economic growth forecasts and risks for 2016. According to recommendations, durable low inflation rates in most DDCs necessitate continuance of the loose monetary policy there. The fiscal policy should support growth on the assumption that the fiscal balance will not be in excess of the risk limit. DGCs should make way to broader policy proposals given the economic situation. Raw material exporting countries are recommended to cut and optimize budget expenditures.

1.2 Azerbaijan's external sector dynamics

The Azerbaijani external sector was affected by developments in the global economy, including processes in trade partner countries in 2015.

According to the State Customs Committee (SCC), foreign trade turnover constituted USD 20.7 B in 2015, of which export accounts for USD 11.4 B. and import accounts for USD 9.2 B.

Graph 9. Trade balance, in B/USD .

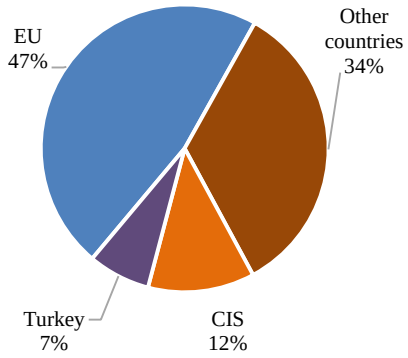


Source: SCC

Surplus of trade balance was USD 2.2 B., with export prevailing over import by 24%.

Azerbaijan traded with up to 165 countries over the period.

Graph 10. Share of main partner countries in tradeover in 2015, %



Source: SCC

EU countries account for 47% of trade turnover. Breakdown of trade turnover with EU: Italy 29%, Germany 20%, France 11%, Czech Republic 6%.

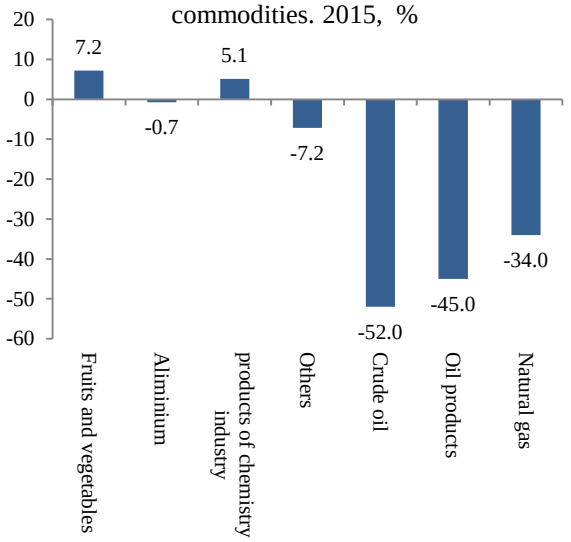
CIS countries account for 12% of trade turnover. Breakdown of trade turnover with CIS: Russia 75%, Ukraine 13%.

Other countries account for 34% of trade ties. Key partners in this peer group are the USA (17%), Israel (12%), China 8% and Georgia (6%).

Commodity export declined 48% over the reported period, primarily on the oil-and-gas-sector

with a high share in export. Export dropped 52% on crude oil, 45% on oil products and 34% on natural gas.

Graph 11. Change in export of commodities. 2015, %



Source: SCC

Export of fruits – vegetables and chemicals posted 7% and 5% growth respectively.

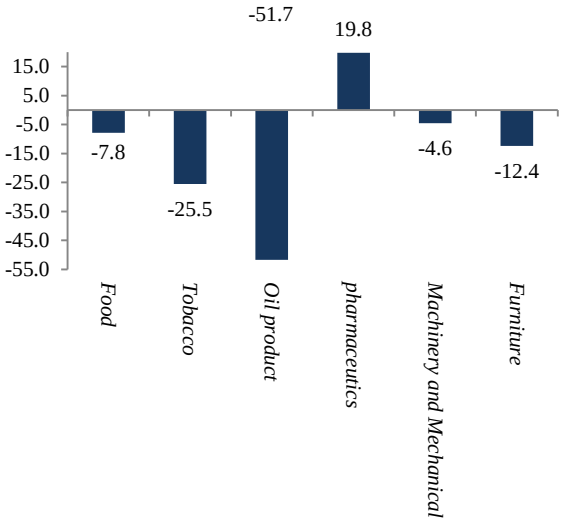
Over the period key export partners included Italy (20%), Germany (11%), France (8%), Israel (7%), and Czech Republic (5%).

Commodity import rose 0.4% over the reported period, while import on the public sector dropped 30%.

Russia accounts for 16%, Turkey 13%, the USA 9%, Germany 8%, Italy 6% and Japan 6% of imported products.

Import increased on vehicles and parts, fruits and vegetables, wood and wooden products, black metals and metal ware, while import on food products, cement, tobacco products and furniture declined due to expansion of domestic production over the year.

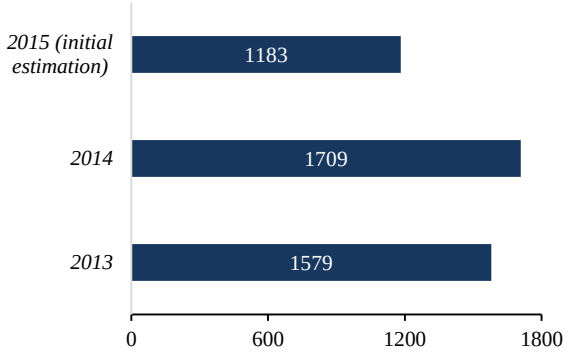
Graph 12. Change in import of commodities, 2015, %



Source: SCC

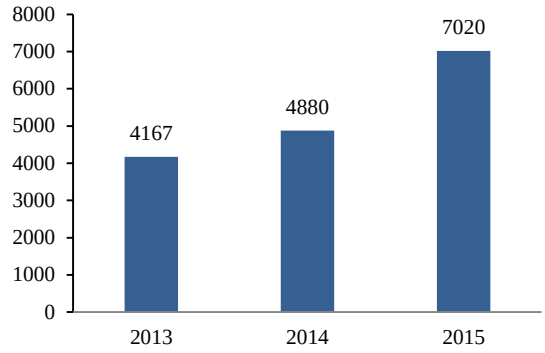
The situation in trade partner countries affected the dynamics of remittances in 2015, which constituted USD 1183 M.

Graph 13. Inflow of remittances, mln.$



Source: CBA

Graph 14. Foreign direct investments, mln. manat



Source: SSC

FDI inflows by foreign enterprises and organizations continued over the reported period as well. According to the SSC, the size of direct investments from foreign sources equalled AZN 7 B. in 2015, which accounts for 44% of total direct investments. The growth rate of foreign investments made 43.8%. Maintenance of the country's international rating positively factored in foreign investment inflows.

Investors from Great Britain, Norway, Turkey, Russia, Iran, the USA, Malaysia and Sweden account for major part of investments to fixed capital by foreign countries and international organizations.

Over the reported period country's foreign exchange reserves were maintained on an essential level. As of end-2015 strategic foreign exchange reserves sufficed for 26 month import of goods and services surpassing the country's foreign debt by 5.2 times. Azerbaijan was still taking the lead in the world in terms of the strategic foreign exchange reserves to GDP ratio.

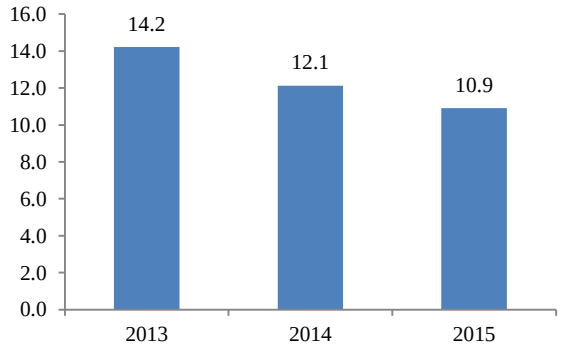
II. MACROECONOMIC PROCESSES IN AZERBAIJAN

2.1. Aggregate demand

Internal demand made critical contribution to economic growth in 2015.

Final consumption expenditures. The growth rate of final consumption expenditures y.o.y. decreased in 2015, the size of which was AZN 30.1 B., accounting for 72.1% of household income. Over the reported period every consumer purchased on average AZN 300 worth of commodities and chargeable services with y.o.y AZN 34.6 increase.

Graph 15. Dynamics of final consumption, %, annual

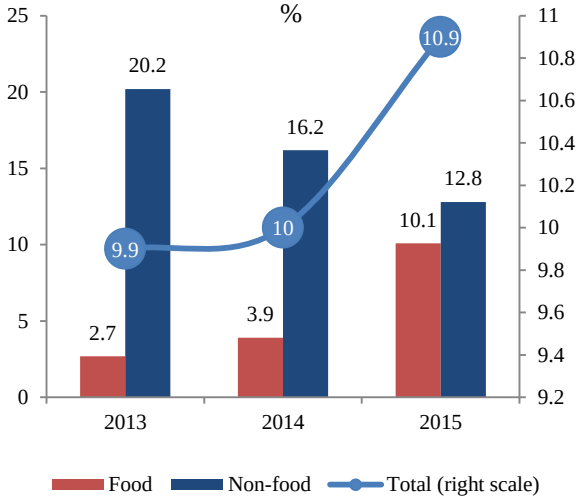


Source: SSC

Over the year the size of commodities and services sold in the consumer market to meet consumer demand rose 9.7% to AZN34.3B.

Retail trade turnover increased 10.9% to AZN 25.7 B.

Graph 16. Retail trade turnover, annual, %



Source: SSC

Consumers spent 50% of their funds on food, beverage and tobacco in retail trade over the reported year.

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

Spending item	Share, %	
	2014	**2015**
Food, beverage and tobacco	50.1	50
Knitwear, clothing and shoes	18.7	17.8
Electric appliances and furniture	4.7	6

Computers, telecommunication equipment and other devices	0.6	0.8
Pharmaceuticals and medicals	1.4	1.2
Fuel	7.1	6.7
Other non-food staff	17.4	17.5

Source: SSC

Over the reported year every consumer monthly purchased on average AZN 112.5 worth of food, beverage and tobacco and AZN 112.4 worth of non-food products for private consumption in retail trade.

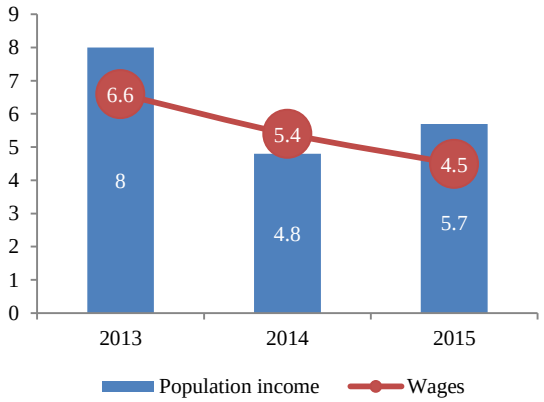
To note, a portion of non-food products was purchased via e-trade. Y.o.y increase in consumer purchases via e-trade network was 1.9 times in 2015.

In 2015 the catering turnover rose 14% and paid services to the population rose 5.1%.

High consumer demand firstly stemmed from rise in income of the population. Over the year, income of households rose 5.7% in nominal and 1.7% in real terms. Per capita income having risen by 4.5% in nominal terms prevailed over price rise in the consumer market by 0,5 p.p.. Disposable income of households rose 5.6% to AZN 37.9 B.

Average monthly salary increased 5% to AZN 466.4 over the year, including 0.5% rise in the public and 8.1% rise in the private sector.

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



Source: SSC

Over the year consumer demand was also supported by bank loans to households, the volume of which as of end-2015 approximated AZN 7.9 B.

The population channeled AZN 6.6 B. worth of income (15.9%) to savings.

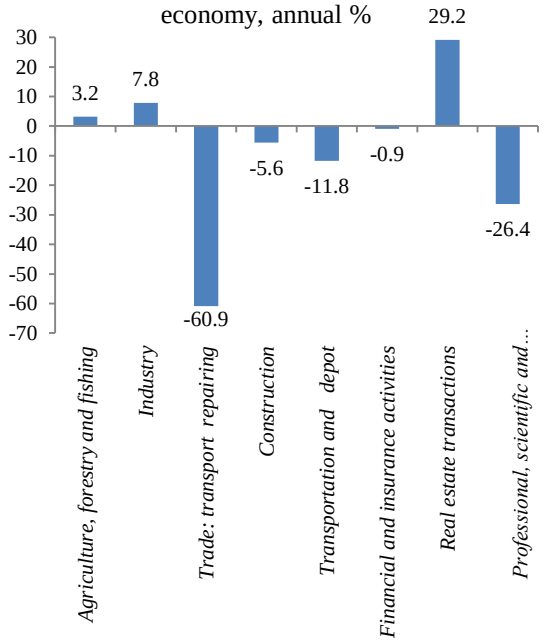
Government spending. Public expenditures were of critical factors of internal demand in 2015. According to the Ministry of Finance of the Republic of Azerbaijan, state budget expenditures constituted AZN 17.8 B. in 2015. *(Source: www.maliyye.gov.az)*

AZN 10.4 B. (58.2 %) of state budget expenditures were channeled to current expenditures, AZN 6.7 B. (37.8 %) to capital expenses, AZN 0.7 B. (4%) to expenses on sovereign debt service and liabilities over the year.

31.9% (AZN 5.7 B.) worth of state budget expenditures were channeled to financing of social expenditures (the wage fund, pension and social allowances, expenses on drugs and food), with 3.4% y.o.y. rise.

Investment expenditures. Investments to the country's economy y.o.y. decreased 11.1% to AZN 16 B. in 2015. Over the period investments to the oil sector constituted AZN 7.2 B., while investments to the non-oil sector made up AZN 8.8 B.

Graph 18. Investments in the fields of economy, annual %



Source: SSC

The volume of investments increased 7.8% in the industry, 2.2 times in information and communication, 29.2% in real estate related operations, 3.8 times in tourism and catering, and decreased 11.8% in transportation and depot, 60.9% in trade, 5.6% in construction. 7.7% of total non-oil investments were used for the development of the non-oil industry.

56% of funds channeled to capital stock stemmed from domestic, while 44 % from foreign sources.

Table 2. Investment sources

	2014	**2015**
Funds of entities and organizations	9654	10615.5
Bank loans	540.9	1299
Budget funds	6452.2	3005
Off-budget funds	324.6	272.3
Population's own funds	566.9	573
Other funds	77.2	192.2

Source: SSC

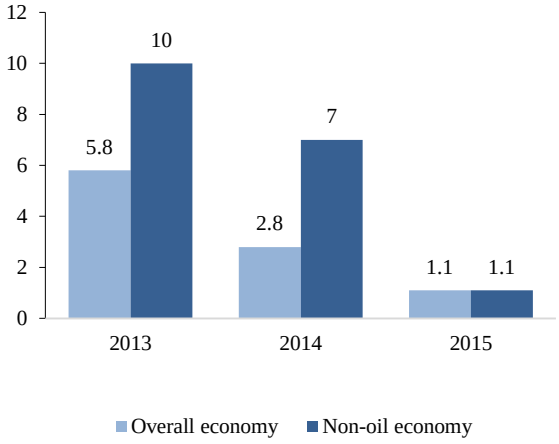
Over the year funds of entities and organizations prevailed in total investments (66.5%).

2.2. Aggregate supply and employment

Economic growth was maintained in the country in 2015, though at a lower rate.

Economic growth. Real GDP increased 1.1% to nominal AZN 54.4 B. in 2015.

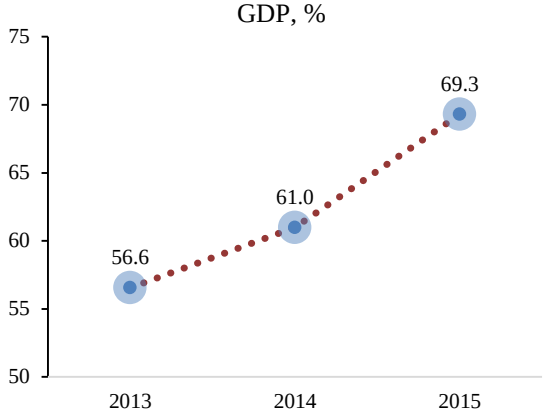
Graph 19. Economic growth in 2015, annual, %



Source: SSC

The value added in the non-oil sector worth AZN 37,7 B., the share of which rose to 69,3% of GDP in 2015.

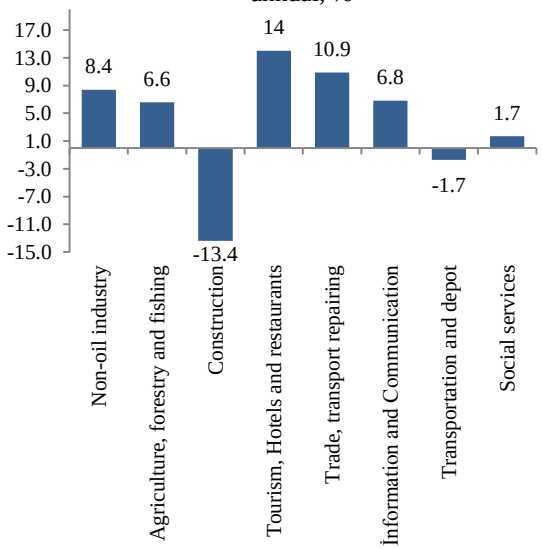
Graph 20. Share of the non-oil sector in GDP, %



Source: SSC

Agriculture, forestry and fishery, trade, communication, social and other sectors posted growth, while transportation and construction declined over the reported year.

Graph 21. Sectoral growth of economy, annual, %

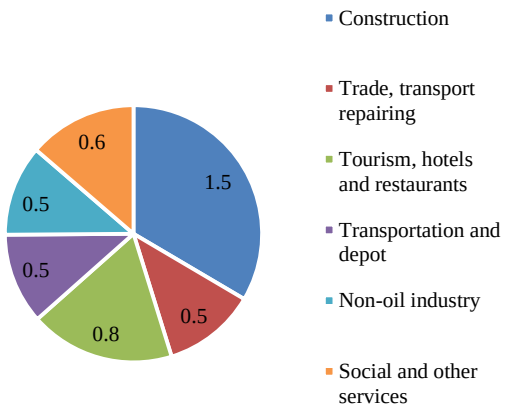


Source: SSC

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

Trade and repairs of vehicles made 1.5 p.p. contributions to growth of the non-oil economy.

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



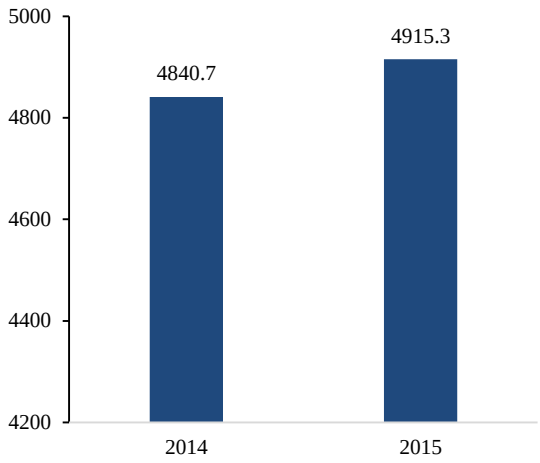
Source: CBA calculations based on SSC data

Efforts of previous years yielded ongoing positive trends in the non-oil industry in the reported year; increase in the value added in the non-oil industry was 10% in 2015.

Over the reported period the mining industry yielded 41.7 M. ton crude oil, and 26.7 M/m^3 natural gas.

Employment. As of end-2015 economically active population was numbering 4915.3 thousand people, of which 95% was engaged in various sectors of the economy.

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



Source: SSC

According to the SSC, the number of hired labor was 1495.8 thousand persons as of 1 January 2016.

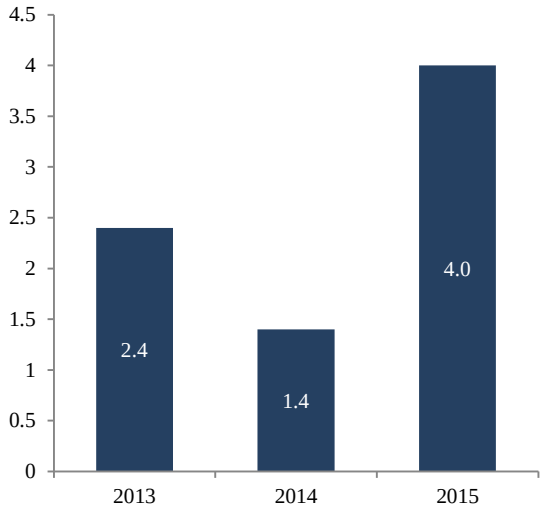
21.6% of the hired labor in enterprises and organizations are engaged in production, 6.4% in construction, 6.4% in processing and 3% in agriculture. 78.1% of hired labor is concentrated in services.

2.3. Inflation

Despite slight increase compared to previous years, inflation was overall maintained on an acceptable level in 2015.

Consumer Price Index. According to the SSC, average annual inflation was 4% in 2015, which 3.5 p.p. lags behind average annual CPI of recent 10 years.

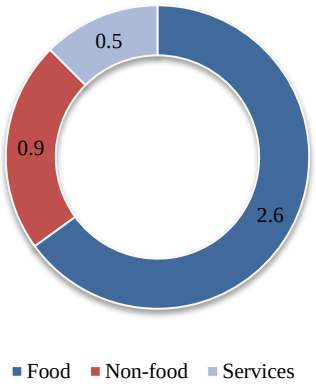
Graph 24. Annual average inflation, %



Source: SSC

The CPI components - food prices changed on average annual 6.1%, non-food prices 3.8%, and services 1.2%.

Graph 25. Components of annual average inflation, %

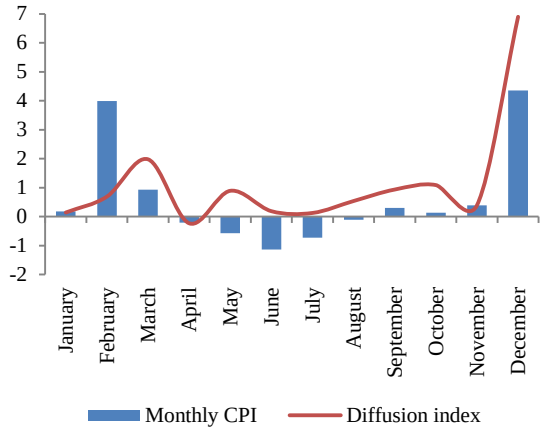


Source: CBA calculations based upon SSC data

Apparently, food prices made higher contribution to average annual inflation over the reported year. Over the period prices for breadstuffs and cereals gained 10.7%, oils and fats 14.3%, fruits 6.7%, coffee, tea and cacao 12.1%, while prices for vegetables declined.

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

Graph 26. Scale of inflation, %

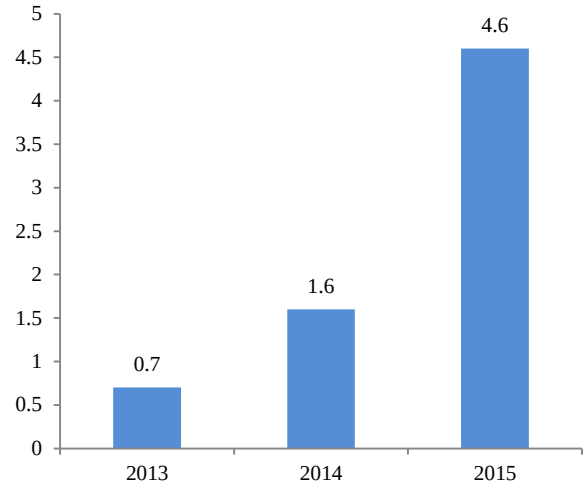


Source: SSC, CBA calculations based upon SSC data

Overall, average prices for 50 goods and services included to the basket, as well as 27 foods, 8 non-food staff and 15 services dropped over the year. Average prices for 38 goods and services, including 3 non-food and 35 services, remained unchanged.

Average annual core inflation, which is inflation adjusted from fluctuations in prices for commodities regulated by the Government and seasonal factors made 4.6%.

Graph 27. Annual average core inflation , %



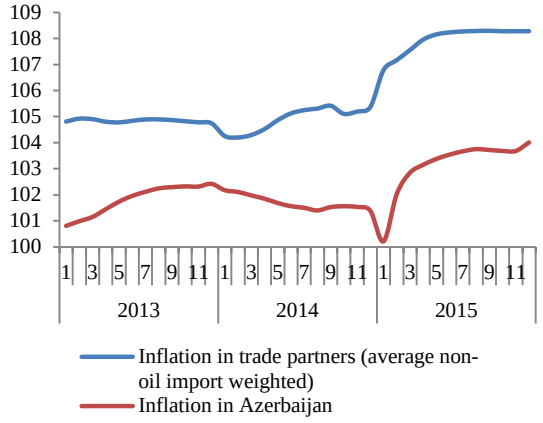
Source: SSC

The Government regulated prices for medicinal products in the current year, which resulted in drops in prices for pharmaceuticals in 2015. The Tariff (price) Council adjusted retail and wholesale prices of total 5050 drugs. It set prices for 1510 drugs on 25 December 2016, as well as new prices for 3540 drugs, whose prices were previously approved, owing to changes to the exchange rate of Manat. Efforts to drop prices for medications over the year prevented possible high rise in their prices. Accordingly, the price for 21% medications, adjusted by the recent resolution of the Tariff Council,

decreased over twofold, 9% dropped over threefold, overall prices for 60% of drugs were reduced, while prices for 40% rose on average 30% due to changes to the exchange rate.

In 2015 the NEER, inflation expectations and high inflation in trade partners had an upward effect on prices, with a downward effect by money base and global food prices.

Graph 28. Annual average domestic and foreign inflation, %

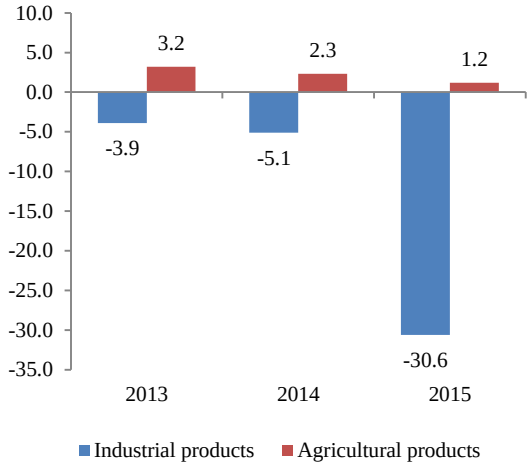


Source: SSC, CBA calculations based upon data from relevant central banks and statistics committees

Inflation in Azerbaijan was below the average annual inflation in trade partner countries by 4.3 p.p. (average non-oil import weighted - 8.3%), making a positive effect on the competitiveness of the economy.

Producer Price Index. The PPI dropped 30.6% in 2015. Prices declined 34.5% in mining, mostly due to slump in oil prices, and 8.1% in processing.

Graph 29. Annual average change in Producer Price Index, %



Source: SSC

In 2015 agricultural producer prices rose 1.2%. Price hike was 1% on animal products, 0.8% on plant products, and 2.9% on fish and fishery products.

III. THE MONETARY AND EXCHANGE RATE POLICY

3.1. The FX market and the exchange rate of Manat

FX policy of the CBA was conducted in response to increase international competitiveness and maintain macroeconomic sustain-ability of the country, amid contained foreign exchange supply channels and sharp rise in demand for foreign currency in 2015.

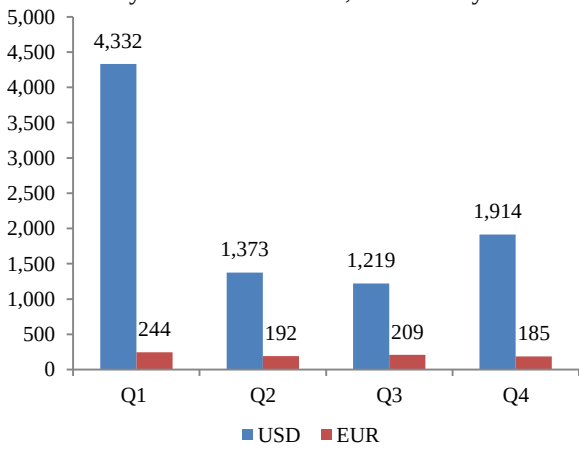
2015 was the year of nosedive supply and sharp rise in demand in the FX market.

Low foreign exchange supply is above all attributable to reduced foreign currency income due to slump in oil prices and the deteriorated economic situation in partner countries. Transfers from oil revenues – the vital source of public expenditures were significantly low amid reduced surplus of the balance of payments.

Sharp rise in foreign exchange demand is explained by high dollarization. Slump in oil prices in global commodity markets, and the waves of devaluation in our main trade partners heightened expectations of the devaluation of the national currency in the country triggering high dollarization.

Sharp rise in foreign exchange demand weighed on cash and cashless segments of the FX market alike.

Graph 30. Net cash foreign currency sold by banks FX divisions, M. currency unit



Source: CBA

Cash foreign currency sold by banks to the population in USD over the year y.o.y. increased 47.4% to USD 8.8 B. Quarter I accounts for

50% of net USD and 29% net EUR sold in 2015.

The Management Board of the CBA decided to set the exchange rate of USD against AZN at AZN 1.05 as of 21 February 2015 in light of the serious pressures on the FX market and exchange rate of AZN. The CBA also moved towards pegging national currency to a dual currency basket, comprising USD and EUR.

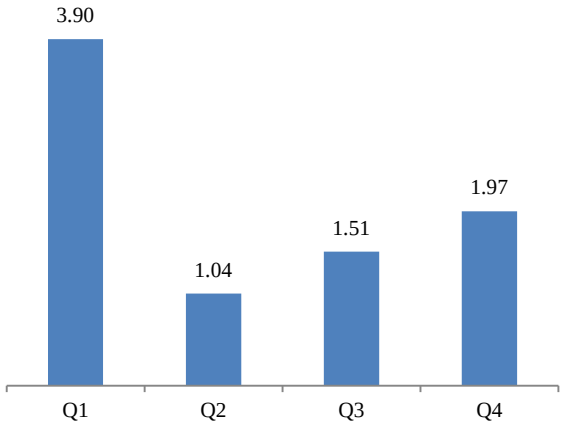
The FX market and the exchange rate of Manat started adapting to the oil price of USD 50-55 in the aftermath of the February devaluation and transition to a new operational technique. In May – July of the 2015 the CBA bought certain amount of foreign currency

However, starting from end-July slump in oil prices refreshed the pressure on the FX market elevating the expectations on changes of the exchange rate of Manat. Ongoing devaluations in trade partners amplified parallel negative impact on the international competitiveness of the national economy. National currencies of a number of trade partner countries have depreciated over 100% since the beginning of 2014.

The new environment necessitated tailoring of the FX market and the exchange rate of Manat to new oil prices and the Board of Directors at CBA took a decision to move to a floating exchange rate regime on 21 December 2015, which induced alignment of the new exchange rate of Manat to the conjuncture in the FX market. To note, transition to the new exchange rate regime put an end to the dual-currency basket of USD and EUR as an operational framework.

Under the new regime the CBA substantially diminished interventions to the FX market.

Graph 31. CBA's net FX sales, in B. $



Source: CBA

Overall, the CBA sold USD 8.4 B. worth of net currency in 2015.

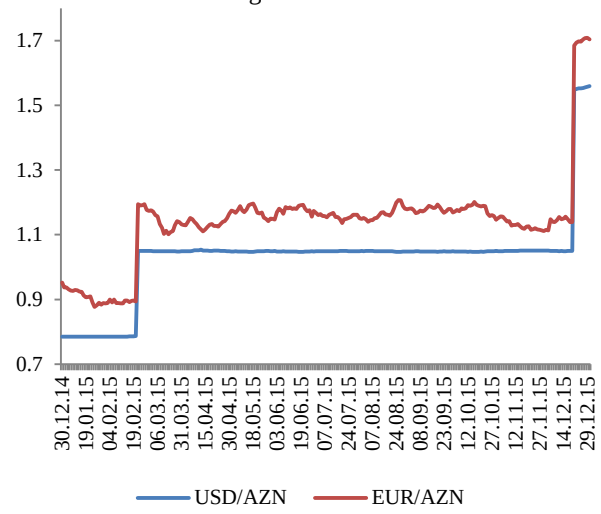
The size of CBA's foreign exchange reserves constituted USD 5 B. as of end-2015. CBA's foreign exchange reserves amounted to 90.3% of broad money supply in Manat (M2) (internationally 10-20% minimum).

The operational framework of the CBA's exchange rate policy was adjusted to the new regime late in 2015. Currently, the CBA sells foreign exchange only through auctions. With no exchange rate related quantitative targets in mind the CBA only strives to smooth sharp exchange rate fluctuations. Average weighted exchange rate on interbank operations is set to be an official exchange rate.

The main advantage of the floating exchange rate regime is that it allows absorbing the impacts of global shocks to the economy through exchange rate. In the meantime, it promotes the development of the domestic financial market and the use of a number of new financial tools. Also, transition to the floating regime makes possible to achieve equilibrium level of the exchange rate.

Manat depreciated against most currencies in 2015. USD appreciated 98.8%, while EUR appreciated 79% against AZN.

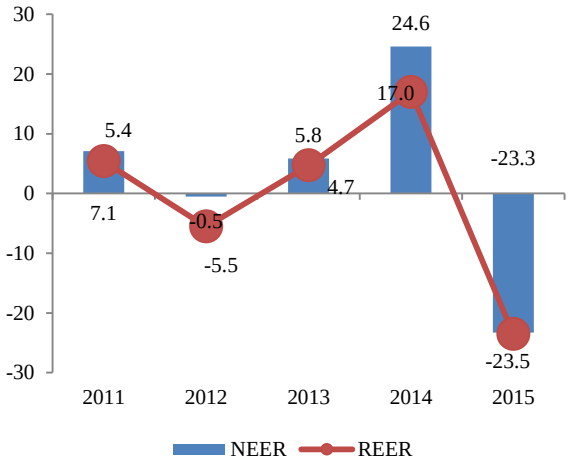
Graph 32. Exchange rate of USD&EUR against manat



Source: CBA

The NEER of Manat on the non-oil sector dropped 23.3%.

Graph 33. Dynamics of non-oil sector REER and NEER, %



Source: CBA

With the 0.2% downward effect of price gaps, the REER on the non-oil sector dropped 23.5%.

To note, the depreciated REER positively affects the development of the non-oil export and import substitution.

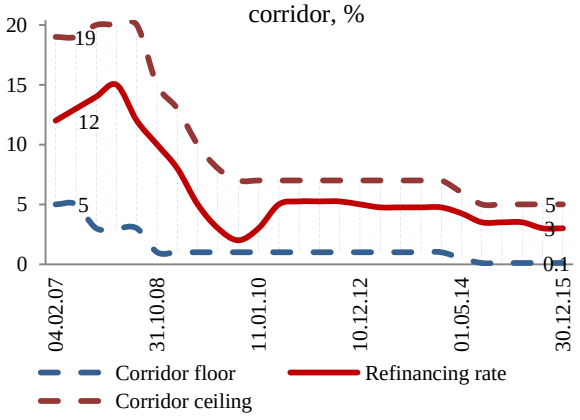
3.2. Monetary policy tools

As in previous years, monetary policy decisions were taken in light of the environment in which monetary policy was implemented and the possibility of the achievement of the price stability.

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

Liquidity injections and absorptions through the banking system were conducted within the interest rate corridor parameters.

Graph 34. Parameters of interest rate corridor, %

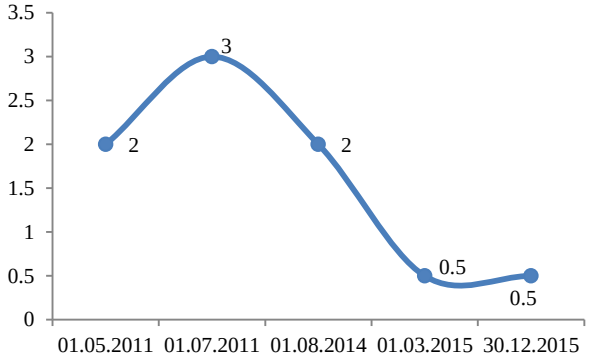


Source: CBA

The CBA shifted the refinancing rate to 3% from 3.5% from 13 July 2015 to ensure higher financial contribution to economic growth in the non-oil industry, stimulate investments by accelerating drops in interest rates on loans, and pave the monetary way to the optimization of SME financing and mortgage lending of the population given the acceptable rate of inflation. Other interest rate corridor parameters were left unchanged - the corridor ceiling remained 5% and the floor 0.1%.

The Bank also employed reserve requirements to adjust the amount of money supply and the liquidity level in the banking system over the reported year.

Graph 35. Ratio of reserve requirements, %



Source: CBA

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

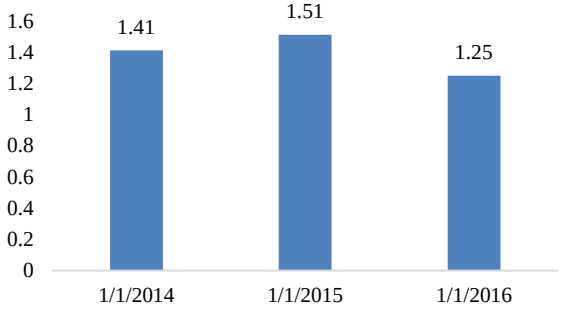
3.3. Money supply

Developments in the FX market were the main factor which affected money supply in Manat in 2015.

Over the reported year the base money in Manat decreased 40.2% to AZN 6901.8 M. as of the end-year. Dollarization and balances of Government accounts had a decreasing, while other factors (CBA's liquidity operations etc.) had an increasing effect on shifts in the base money.

The money multiplier of the banking system (ability to create money) decreased. In this respect, the money supply's declining rate prevailed over that of base money.

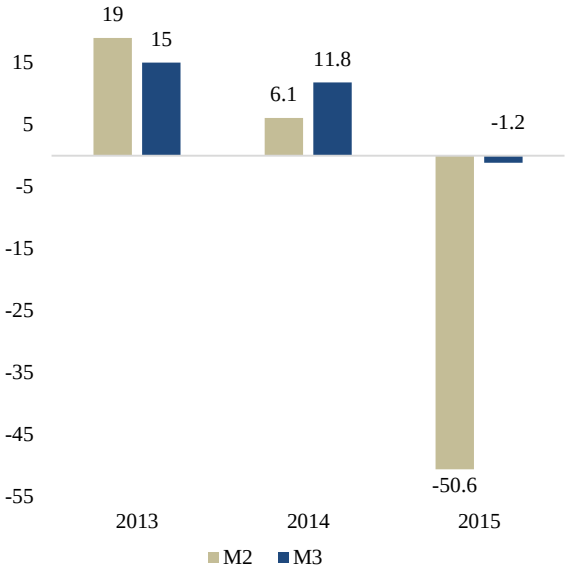
Graph 36. Money multiplier in AZN



Source: CBA

Over the year, broad money supply in Manat (M2) decreased 50.6% to AZN 8613.1 M. as of the end-period, primarily due to cash money supply. However, the encashment indicator (M0/M2) dropped 2.78 p.p. in 2015.

Graph 37. Change in money supply, %



Source: CBA

Over the reported year broad money supply (M3) decreased 1.2% to AZN 21318.6 M. Whereas the M3 money aggregate to GDP ratio was 36.5% in 2014, it increased to 39.2% in 2015.

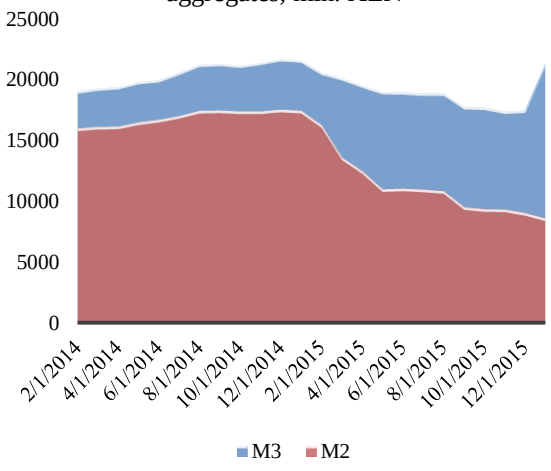
Table 3: Money aggregates, M. Manat

	01.01.2014	01.01.2015	01.01.2016
M0	10459	10153	4776
M1	12737	12830	6897
M2	16435	17436	8613
M3	19289	21566	21319

Source: CBA

M3 money aggregate primarily declined owing to the drop in net domestic assets in 2015, while net foreign assets increased in terms of Manat upon revaluation with an upward effect on money supply.

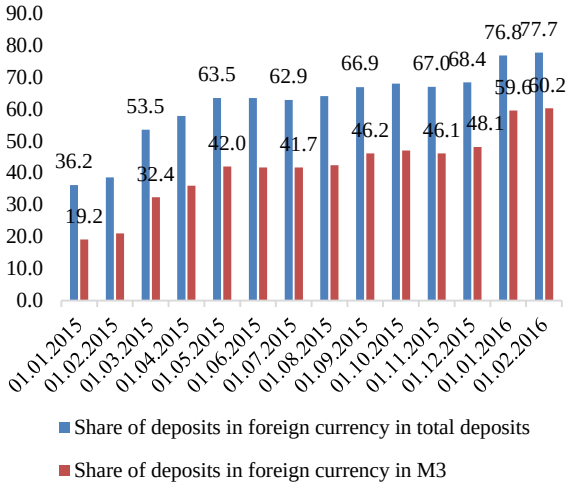
Graph 38. Dynamics of monetary aggregates, mln. AZN



Source: CBA

The dollarization level increased in 2015. The share of foreign currency denominated deposits in total savings and deposits amounted to 76.8% as of the end-year.

Graph 39. Dollarization, %



Source: CBA

The share of foreign currency denominated deposits in M3 money supply made up 59.6% as of the end-period.

The rise in the share of foreign currency denominated deposits in total deposits partially stems from the rise in their value in Manat terms.

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