CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

JANUARY-MARCH 2020

№ 1

TABLE OF CONTENTS

ACRONYMS

CBA	The Central Bank of the Republic of Azerbaijan
ADB	The Asian Development Bank
ASEAN	The Association of Southeast Asian Nations
EBRD	The European Bank for Reconstruction and Development
ILO	The International Labor Organization
IMF	The International Monetary Fund
NBCI	Non-bank credit institutions
FDI	Foreign direct investments
SSC	The State Statistics Committee
SCC	The State Customs Committee
FED	The Federal Reserve System
EME	Emerging market economies
AE	Advanced economies
OECD	The Organization for Economic Cooperation and Development
CPI	Consumer Price Index
APPI	The Agricultural Producer Price Index
SME	Small and Medium-sized enteprises
NEER	The Nominal Effectice Exchange Rate
OPEC	The Organization of the Petroleum Exporting Countries
REER	The Real Effective Exchange Rate
RSM	Real Sektor Monitoring
IPPI	The Industrial Producer Price Index
GDP	Gross Domestic Product
WTO	The World Trade Organization

EXECUTIVE SUMMARY

The monetary policy of the CBA in Q1, 2020 was oriented towards maintaining inflation within the target band (4±2%).

Uncertainties in the global environment elevated, global oil prices slumped and international financial markets fluctuated under negative effects of the coronavirus outbreak over the quarter.

Though slightly higher as expected, inflation was below the target band center. High food inflation is attributable to short-term higher demand for food amid the tighter quarantine regime and local rise in production and transportation expenses. Low non-food and service inflation is related to appreciated national currencies in certain trade partners and stable administrative prices.

Safeguarded stability in the FX market due to the actions taken in close cooperation with the Government were critical in maintaining low inflation rate and inflation expectations.

State budget surplus and actions taken to stabilize the situation in the FX market weighed on the monetary condition. The CBA adequately applied monetary policy tools to meet demand of the economy for money and safeguard FX market stability. The Bank made necessary corrections to the interest rate corridor parameters, duration of and interest trate formation framework of sterilization tools in light of recent trends in the money market.

Though slightly decreased due to pandemic triggered negative effects, economic activity's positive dynamics continued. Monitoring of real sector enterprises by the CBA display that, positive dynamics of economic activity indicators of January-February in a number of areas of the economy were replaced by negative trends from March onward. The Government adopted a large-scale economic support package to diminish negative effects of the pandemic.

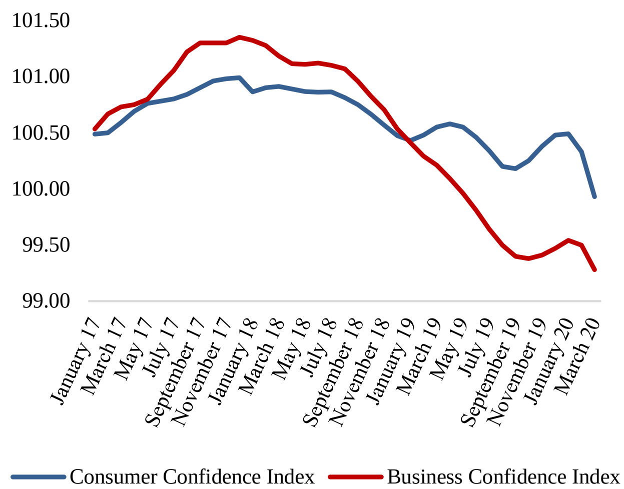
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1. Global economic trends

Q1, 2020 passed on the backdrop of the fight with the COVID-19 virus emerged in China and expanded to become a global pandemic. Global trade slump, supply chain disruptions, job losses and growing uncertainty had a negative impact on global economic activity, and declining global demand was accompanied with a sharp decline in commodity prices due to the epidemiological situation. As a result, the global recession is forecast in 2020, which suggests that the economic situation will be much worse than the 2008-2009 financial crisis. To smooth the downturn some countries announced fiscal stimulus packages to support households and enterprises and started an expansive monetary policy and interest cuts.

Global economic activity and pandemic response. Economic activity plummeted in the first quarter of 2020 due to pandemic. The dynamics of consumer and business confidence indices of the OECD countries also confirms this. The Business and Consumer Confidence Indices sharply decreased in Q1.

Graph 1. Business and Consumer Confidence indexes in OECD countries



Source: OECD

According to the World Economic Outlook (WEO) April 2020 by the IMF, the global economy is projected to sharply contract by – 3% in 2020 due to the pandemic, higher than economic downturn during the 2008–09 financial crisis.

Economic growth in AEs is expected to recess by – 6.1%.

According to the IMF, the **US** economy will contract by –5.9% in 2020. It will shrink by 5% in Q1. In March unemployment peaked in the USA, the highest since 2017. The unemployed increased by 1.35 million to 7.15 million over the quarter. The process accelerated in April – 30 million people applied for unemployment.

Moreover, the Dow Jones index dropped by 22.1%, the S&P 500 by 30.3%. The size of investments and industrial productivity in the USA also weakened. The industrial production index sharply decreased across the country. In response to the crisis, both the Government and the central bank started large-scale fiscal policy measures. Amid negative zoning of economic growth, the US FED held 2 meetings dedicated to interest rates since early 2020 decreasing them from 1.5-1.75% to 0-0.25% stepwise.

About $2.3T worth the Coronavirus Aid, Relief and Economic Security Act (CARES Act) was adopted as part of fiscal measures (11% of GDP), which includes one-time tax relief for individuals, unemployment allowances, provision of food for the most vulnerable groups, preventing corporate bankruptcy by issuing guarantees, aid for employee retention in small businesses, aid to local governments, etc. Also, it is intended to give out $1200 stimulus checks for every citizen who earns up to $75,000 per year and $500 for kids.

According to the IMF, the **euro area** economy will contract by –7.5% in 2020. Italian, Spain and French economies are expected to be the most pandemic hit. They are expected to shrink by 9.1%, 8% and 7.2% respectively by the end-year. Unemployment in March was 7.4% in the region. The FTSE Eurotop100 decreased by 24.1% in Q1.

To smooth the effect of the pandemic on the economy the ECB decided to purchase assets €120B worth on March 12 and an additional €750B worth under Pandemic Emergency Purchase Program (PEPP) on March 18 (7.3% of GDP altogether). €37B Coronavirus Response Investment Initiative allocated from the EU budget, as well as the recent €540B stimulus package by the EC include support for healthcare expenses of the countries of the area, allocating funds for pandemic-affected companies, SMEs and retention of employees and jobs.

The IMF forecasts the **Japanese** economy contract by – 5.2%. The contraction of the Japanese economy started in the last quarter of 2019. Pandemic related global trade slump, low domestic consumer demand and economic sensitivity index pushed additional pressure on the economy. In March 2020 consumer and business confidence indices dropped to the lows of the recent decade. At the same time, the unemployment rate increased considerably. The Japanese Nikkei dropped by 20%. Against the background of all this, the Bank of Japan took some steps to safeguard the sustainable functioning of financial markets and stimulate lending, which includes the decision to increase the purchase of government bonds, targeted corporate bonds and extend the swap line with several central banks to provide dollar liquidity. The Japanese government adopted the ¥117.1T emergency economic package on April 7 for prevention and treatment of the pandemic, economic activity revival and recovery of sustainable economic growth.

GDP is expected to contract by 6.5% in the **UK** in 2020, the lowest indicator since 1955 when economic growth rate statistics was disclosed (Source: IMF). A sharp global economic deterioration decreased demand for UK exports; uncertainties had a downward effect on investments. Unemployment in March was 3.9%. Due to pandemic related high risks the pound depreciated against the USD by 6.2%. The Government and the Bank of England started wider fiscal and monetary support measures as part of anti-crisis actions. The Bank of England cut interest rates by 0.65 pp from 0.75% to 0.1%, and increased its government and non-financial corporate bond purchases by £200B. Fiscal incentives include additional funding for public services and charity, property tax holidays, direct grants for small businesses most hit by the pandemic and sick pay and social security measures to support socially vulnerable people.

According to IMF, EMEs are expected to shrink by 1% in 2020 due to pandemic triggered economic crisis. Emerging Asian markets are expected to contract by 1%, while emerging European markets by 5.2%. In 2020 Latin America and the Caribbean are expected to recess by 5.2%, the Middle East and Central Asia by 2.8% and Sub-Saharan Africa by 1.6%.

Growth rate of the **Chinese** economy is expected to stand at 1.2%, 4.8 pp down compared to WEO 2020 January update. As the first country to suffer from the Covid-19 pandemic, negative effects on the Chinese economy can be seen in the economic activity indicators for Q1, 2020 – the country's economy shrank by 6.8% in Q1. Just in March domestic industrial production decreased by 8.4%, fixed investment by 16.1%. Unemployment in the country was 5.9% in March. Amid slumped economic activity the People's Bank of China took anti-crisis actions to support the economy and safeguard financial stability, which includes providing liquidity to banks via open market operations, cutting medium-term lending facility rate to 2.95% from 3.25% stepwise, as well as reduction of reserve requirements for banks. At the same time, the Chinese Government allocated 2.6 trillion yuan stimulus package epidemic prevention, production of medical equipment, fast unemployment insurance payment and introduction of tax relief.

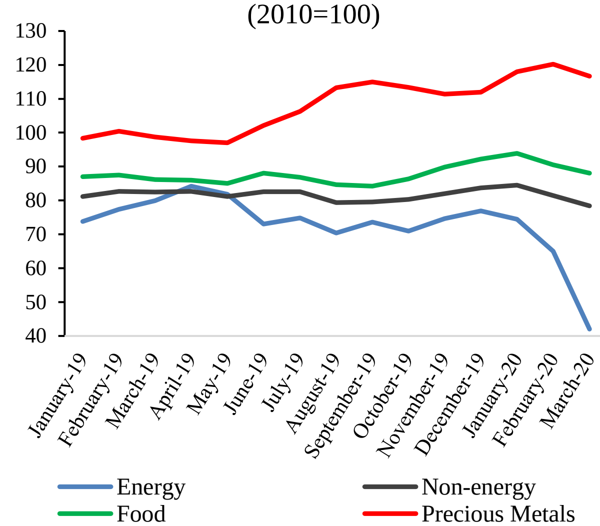
The IMF forecasts 5.5% shrinkage in **Russia** in 2020. Slump in commodity prices and widespread of the COVID-19 pandemic had a very negative effect on the Russian economy and took down economic growth expectations for 2020. Drop of oil prices from the point of fiscal neutrality (currently $42.5) increased budget deficit expectations in the Russian economy. On the backdrop of falling oil prices, on March 10 the Bank of Russia started selling foreign currency reserves from the National Welfare Fund and eased liquidity attraction rules for systemically important credit institutions. At the same time, the Bank temporarily simplified regulation of banks that supply lending of pandemic hit areas. Moreover, the Russian Government developed a fiscal stimulus which amounts to 3% of GDP with respect to making additional payments to healthcare staff and quarantined patients, providing unemployment benefits equal to at least three-month minimum salary, introduction of interest rate subsidies for SMEs and mitigating measures oriented towards other pandemic hit businesses.

Turkey is expected to recess by 5%. In parallel to rising unemployment and the declining industrial production index inflation stood at 11.9% in March. The Turkish lira depreciated by 10.5% over the quarter due to pandemic pushed uncertainty. To mitigate macroeconomic damage of the epidemic and as part of anti-crisis measures the Bank of Turkey shifted the interest rate to 9.75% from 12%, a fiscal stimulus package was adopted.

Uncertainty over the duration of recession and the pandemic weigh on global trade and investments. The IMF forecasts 11% drop in global trade in 2020. According to the United Nations Conference on Trade and Development (UNCTAD) global FDIs will decrease by over 30% in 2020-2021.

Commodity markets. In Q1, 2020 commodity prices dropped in the global market. According to the WB's recent Commodity Markets Outlook, energy prices fell by 45.4%. Non-energy commodity prices decreased by 6.3%, food prices by 4.5%, while precise metal prices increased by 4.2%. The price of gold increased by 7.6%.

Graph 2. Commodity price index (2010=100)

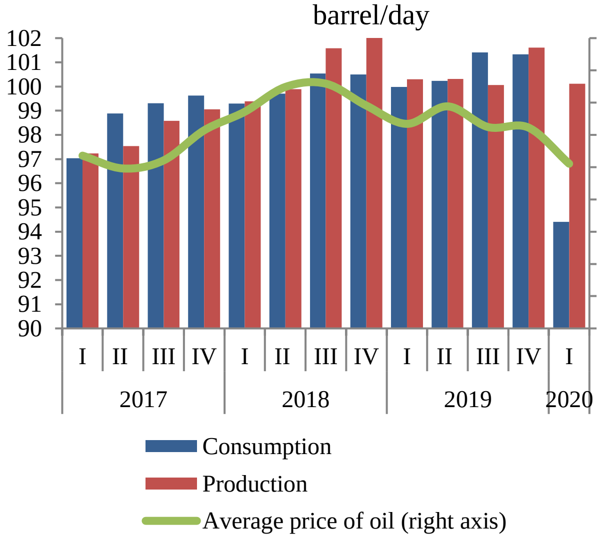


Source: World Bank

The Food and Agriculture Organization of the United Nations (FAO) also confirm food price slides. According to the FAO Food Price Index, in Q1, 2020 food prices decreased by 5.1%. Over the recent 3 months, global prices hiked by 2.3% on dairy products and diminished by 7.7% on meat products, 15.6% on vegetable oils and 10.9% on sugar.

Energy price swings mainly stemmed from oil and natural gas price slump. According to the WB's recent commodity price data, the natural gas price index decreased by 26.1% in Q1, 2020.

Graph 3. World oil market, million barrel/day



Source: Energy Information Administration (EIA)

Average global Brent oil price was $ 51 in Q1, 2020, y/y down by 19.6%. Sharp decline in global demand due to the COVID-19 pandemic and higher than demand extraction are the main reasons for oil price slump. Due to failure to reach an agreement on supply cut at the OPEC+ meeting on March 6, oil prices plunged by 26% over 1 day. The "Oil Market Report" April 2020 of the International Energy Agency forecasts 9.3 mln b/d drop in demand for oil in 2020. The IMF and the EIA forecast average oil price to be $35.6 and $33 respectively in 2020. [1]

Risks and policy recommendations. According to the WEO April Update 2020 translation of the pandemic on the global economy may be stronger and longer than expected. In this case, it may challenge central banks to support the financial system. Moreover, unemployment risk remains relevant. According to the IMF, global unemployment will keep rising in other quarters of 2020 as well.

[1] *Average of Brent, Dubai Fateh and Western Texas interim crude oil prices*

Pandemic triggered risks can cause serious and long-term damage to financial stability. The risk of bankruptcy of some companies increases due to their failure to generate income and meet foreign liabilities. Despite fiscal stimulus packages in AEs and EMEs fund indices are declining and uncertainties about when the pandemic will end increases the risk of a further drop in stock exchanges. Credit institutions, one of the main external funding channels, may also face liquidity risk. Market rates are rising on a global horizon due to the risk of failure to meet credit liabilities.

To mitigate the effect of the pandemic on the global economy countries, if necessary, should stand ready to expand fiscal stimulus packages in light of the economic situation. Temporary and targeted policies need to be implemented for pandemic affected individuals and legal entities (cash transfer, tax holidays, salary support, postponing debt payments etc.).

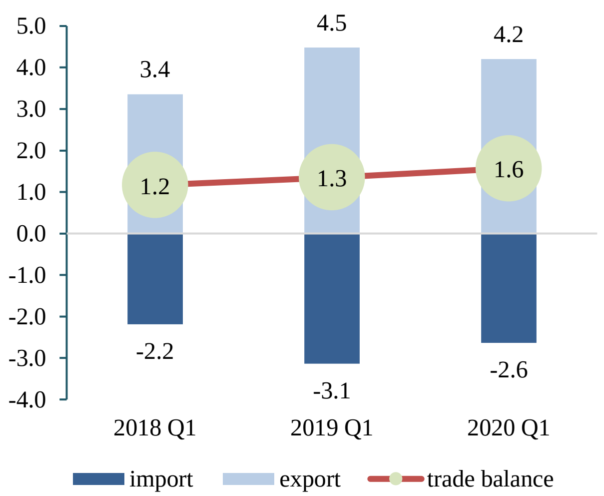
Central banks must continue the use of long- and short-term REPO operations, currency swaps and asset purchase programs to supply liquidity support for credit institutions that in particular deal with SMEs. In their turn, financial markets supervisory authorities should promote local banks to ease and restructure credit terms and conditions for shock affected borrowers. Moreover, they may issue low-interest rate loans for SMEs and support the expansion of the lending portfolio in question.

1.2 External sector developments of Azerbaijan economy

Global oil price slump and COVID-19 outbreak weighed in on Azerbaijani external economic position in Q 1, 2020.

According to the SCC, the foreign trade turnover amounted to \$6.8B –\$4.2B (61.8%) export, \$2.6B (38.2%) import. Foreign trade surplus amounted to \$1.6B.

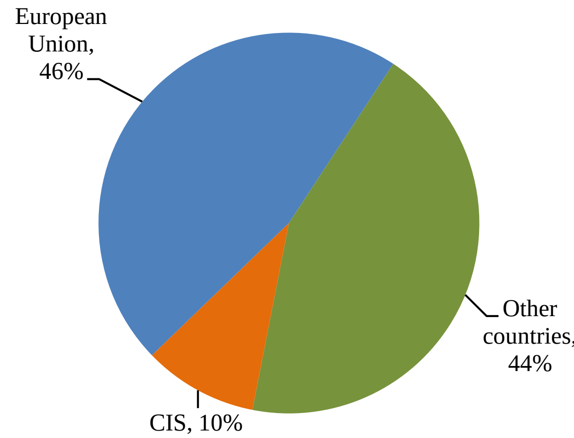
Graph 4. Trade balance, USD bn.



Source: SCC

Azerbaijan traded with 153 countries over the period.

Graph 5. Main trade partners, 2020 I quarter %



Source: SCC

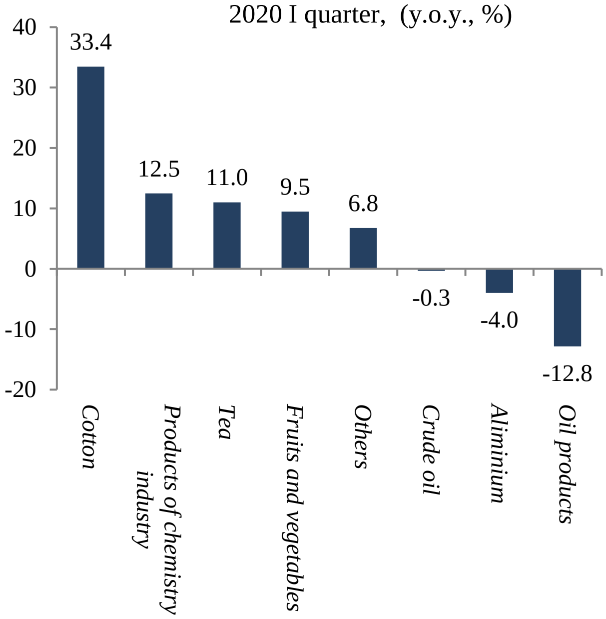
The EU accounts for 46% of trade turnover, of which – Italy 61%, Germany 7%, Greece 6% and the Czech Republic 5%.

The CIS accounts for 10% of overall trade turnover. Russia owns 86% of this turnover, Belarus 5.1% and Kazakhstan 4.6%.

Other countries account for 44% of trade ties, of which – Turkey 25%, China 14%, USA and Israel 10% and 9% respectively.

Exports decreased by 6.2%, while non-oil export increased by 3.3%. The value of export decreased by 0.3% on crude oil, 12.8% on oil products and by 2.6 times on natural gas.

Graph 6. Change in export of commodities, 2020 I quarter, (y.o.y., %)



Source: SCC

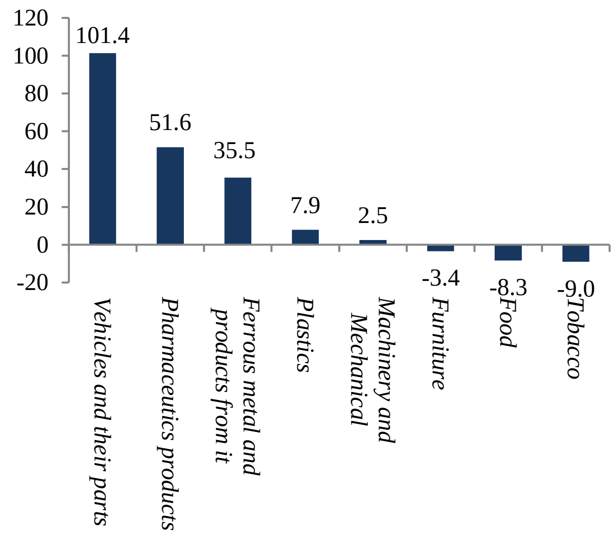
Non-oil export increased on cotton fiber by 33.4%, chemical products by 12.5%, tea by 11% and fruits and vegetables by 9.5%.

Main export partners include Italy (43.5%), Turkey (8.3%), Israel (6%), Greece (4.5%), India (4%), the Czech Republic (3.4%) and Russia (3.3%).

Commodity import decreased by 15.9%: import decreased by 2.2 times on public sector, increased by 3% on private sector.

Import increased by 2 times on vehicles and spare parts, 51.6% on pharmaceuticals, 35.5% on ferrous metals and products, 7.9% on plastics and products; decreased by 9% on tobacco, 8.3% food products and 3.4% on furniture.

Graph 7. Change in import of products, 2020 I quarter, (y.o.y.), %

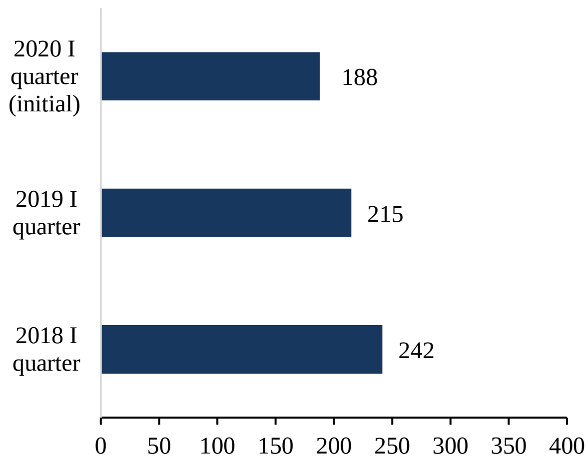


Source: SCC

Russia accounts for 16.5%, Turkey 14.8%, China 13.4%, USA 10.7%, Germany 5.2%, Italy 4.5% and Ukraine 3.9% of imported products.

According to preliminary data, money remittances to the country amounted to $188M in Q1, 2020.

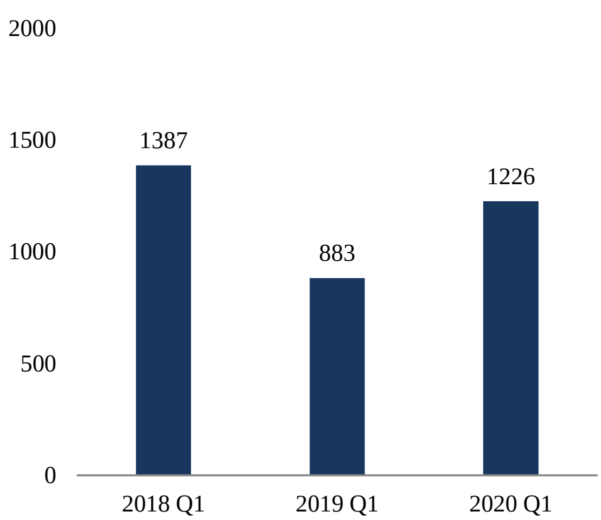
Graph 8. Inflow of remittances, mln.$



Source: CBA

Capital investment from foreign enterprises and organizations kept flowing. According to the SSC, FDIs amounted to AZN1.2B equivalent (41.8% of total investments).

Graph 9. Foreign investments, mln. manat



Source: SSC

Great Britain, Turkey, Russia, Iran, USA, Japan, Malaysia, Switzerland, and Norway accounted for major part of capital investments by foreign countries and organizations.

Strategic foreign exchange reserves continued to surpass internationally recognized sufficiency norms. As of end-Q1, 2020 strategic reserves sufficed to import 34-month goods and services (taking into account import of goods and services following the results of 2019) and exceeded money base in manat (M2) by 5.1 times.

II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

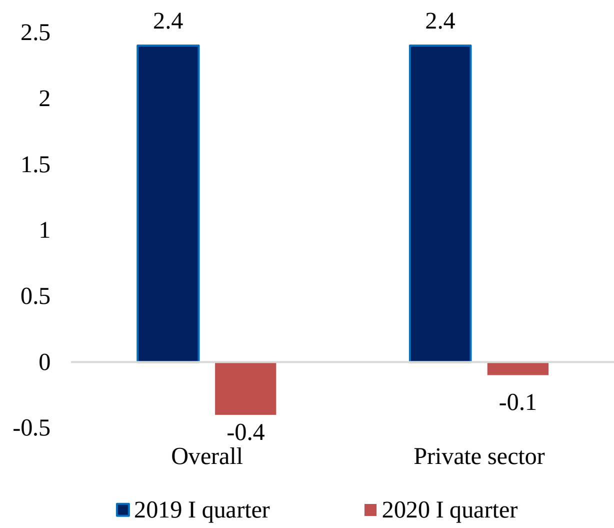
2.1. Aggregate demand

The coronavirus outbreak contained domestic demand, the main driver of economic growth in January-March 2020.

The components of **comsumption expenditures** varied through the period**.** Goods and services sold in the market to meet consumer demand y/y decreased by 0.4% in real terms to AZN11.5B. 96.5% of goods sold and services supplied by economic agents were offered by private businesses.

Every consumer utilized on average AZN386 worth of goods and paid services (y/y up by 1.5%).

Graph 10. Change in volume of sales in consumer market, I quarter, in %



Source: SSC

Food retail trade turnover y/y increased by 2.9%, nonfood turnover decreased by 0.5%. Decline in non-food products was recorded for the first time in recent years.

Consumers spent 52.4% of their funds on food, beverage and tobacco at retail trade outlets (y/y up 2.9%). Expenses decreased by 3.6% in knitwear, clothes and shoes; by 1.7% in telecommunication and computer equipment; increased by 30.5% on pharmaceuticals and medical products and by 0.8% on other non-food items.

Table 1. Share of spending items in trade outlets

Spending item	Share, %	
	2019	2020
Food, beverage and tobacco	50.6	52.4
Knitwear, clothes and shoes	17.7	16.7
Electric appliances and furniture	5.9	5.7
Computers, telecommunication devices and others	0.7	0.7
Pharmaceuticals and medicals	1.3	1.6
Fuel	5.6	5.2
Other non-food items	18.2	17.7

Source: SSC

Every consumer purchased on average AZN162.1 worth food, beverage and tobacco and AZN147.3worth nonfood items monthly for private consumption in retail trade.

Catering turnover decreased by 12.9%. Entities accounted for 40.7%, private entrepreneurs 59.3% of catering turnover in the private sector. The value of paid services to the population decreased by 5.5% to AZN2B in real terms. Per capita paid services consumption y/y decreased by AZN11 in nominal terms.

Consumer demand was driven by rise in population's nominal income – population's money income increased by 6.8% in nominal terms to AZN13.4B. Per capita money income increased by 5.8% to AZN1350.2. Population's disposable income increased by 5.8% to AZN12.2B.

The nominal average monthly salary of hired workers increased by 28.9% to AZN744.5. Salary of employees involved in public entities was AZN634.5, while the salary of those employed with private entities was AZN 893.1.

The loan portfolio of households, one of the consumer demand components amounted to AZN7.7B.

Low activity in most economic areas due to coronavirus pandemic weighed on consumer behavior too. The Consumer Confidence Index (CCI) generated from findings of the 'Households' financial behavior and intentions' survey held in March 2020, decreased vs the previous quarter. To note, this indicator is based on surveys among various income households 'Family's financial condition expectation',

'Expectation on country's economic standing', 'Savings probability' and 'Unemployment expectations'. Analyses suggest that drop in the CCI is mainly attributable to worsened expectations on the financial sitiuation of the country and families, as well as high unemployment expectations.

Government expenditures were critical for domestic demand in Q1 too. State budget expenditures made up AZN5.3B (y/y up by 4.4%).

According to the economic classification 48% (AZN2519.8M) of state budget expenditures were channeled to social spending (compensation for employees, pension and social allowances, medicine and food) (y/y up by 19,7% or AZN415,3M.[2]

Investment expenditures. AZN2.9B worth investments were channeled to the economy. AZN1.5B worth funds were invested in the non-oil sector (y/y down by 9.1%). The public sector accounts for 35.2%, while the private sector for 64.8% of total investments.

58.2% of investments stemmed from internal, while 41.8% from external sources.

Table 2. Investment sources, %

	2019	2020
Funds of enterprises and organizations	65.6	66.9
Bank loans	5	4.5
Budget funds	21.8	17.7
Off-budget funds	0.8	1.8
Population's own funds	6.5	6.4
Other funds	0.3	2.7

Source: SSC

Funds of enterprises and organisations prevailed in total investments (66.9%).

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

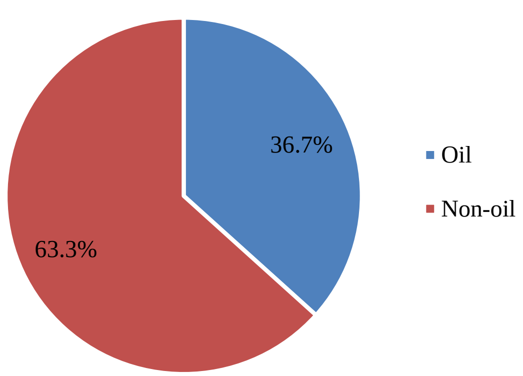
2.2. Aggregate supply and employment

Economic activity indicators varied across months in Q1, 2020. The upward trend in economic activity begun in previous years, continued in January-February 2020, but slowed down in March, due to the negative effects of the pandemic.

Economic growth. According to the SSC, real GDP y/y increased by 1.1% to nominal AZN18.3B in Q1, 2020. Per capita GDP was AZN1840.2. 40.2% of GDP was produced in the industry.

Non-oil value-added y/y decreased by 2.1%. The mining sector extracted 9.3 m/t crude oil, 7 bln/m3 natural gas. Oil production y/y decreased by 3.9%, while gas extraction increased by 15.3%.

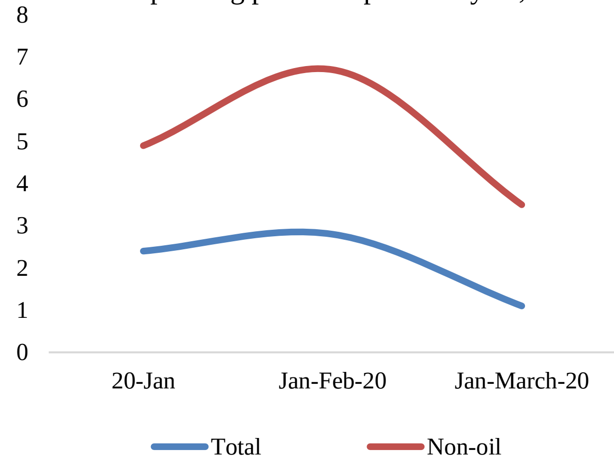
Graph 11. Sectoral growth of value added, %



Source: SSC

Non-oil value added y/y increased by 3.5% in real terms to nominal AZN11.6B.

Graph 12. Economic growth to corresponding period of previous year, %



Source: SSC

Low non-oil economic growth rate at quarter-end vs first two months is attributable to negative effects of the pandemic.

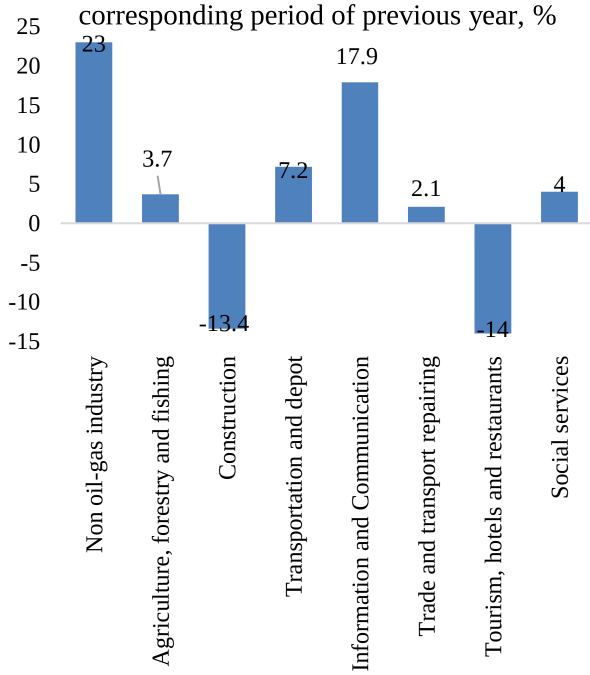
Most non-oil sectors posted growth, the sector accounts for 63.3% of GDP. The non-oil and gas industry, agriculture, information and communication posted the highest growth.

The non-oil and gas industry y/y grew by 23%. Output y/y increased by 28% in the production of tobacco products, 10.5% in the textile industry, 36.7% in production of pharmaceuticals, 25.7% in the chemical industry, 7.3 times in production of vehicles, trailers and semi-trailers, 2.1 times in metallurgy and 2.1 times in the production of beverages.

Production of durables y/y increased by 17.1%, non-durables by 20%. Production of industrial products accounts for 86,3% and supply of industrial services for 13,7% of total production.

Agricultural production y/y increased by 3.7%, of which 3.2% on animal products, 13.4% on plant products.

Graph 13. Sectoral growth, to corresponding period of previous year, %



Source: SSC

The CBA's RSM survey findings suggest that the business confidence index (BCI) was positively zoned in industry and services across all months of Q1, 2020. However, the BCI plunged in March and negatively zoned in trade.

The BCI was positive in manufacturing of textile, food and beverages in the first two months of the quarter. Production of plastic ware, metallurgy and construction materials was low across all months of the quarter, while mechanical engineering turned the negative dynamics of January into a positive one in the last two months.

Whereas economic activity indicators were positive in the trade of automobiles, furniture, household goods and electrical home appliances in the first two months, they plunged in March.

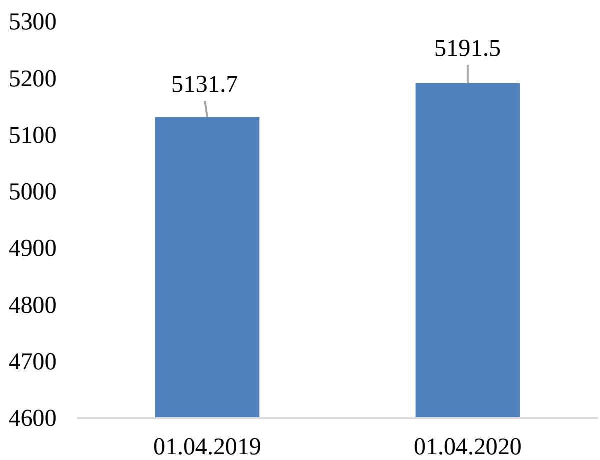
Economic activity was high in healthcare and communication across all months of the quarter. Though positively zoned in January and February tourism and hotels suffered most due to plunge in March.

Though still negatively zoned over Q1, the BCI in construction improved compared to the previous quarter.

Employment. As of end-March 2020 economically active population were numbering 5191.5 thousand persons (y/y up 59.8 thousand persons).

According to the SSC, the number of hired labor y/y increased by 4.1% to 1646.1 thousand persons as of 1 April 2020; those involved in the public sector was 911.7 thousand, non-public sector 734.4 thousand. 20.3% of hired labor was involved in education, 17.9% in trade, repair of vehicles, and 13% in industry.

Graph 14. Economically active persons, end of period, thousands



Source: SSC

23.6% of hired labor in enterprises and organizations was involved in production: 7.4% processing, 7.3% construction, 3.2% agriculture, forestry and fishery, 2.1% mining and 1.8% water supply and waste management.

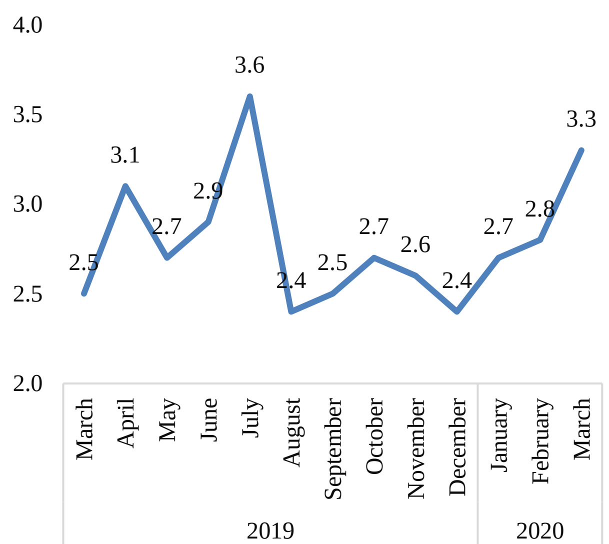
According to CBA RSM survey, employment expectations plunged in construction and trade following the results of the last month of the quarter, the lowest for the recent years for trade.

2.3. Inflation.

In Q1, 2020 inflation was below the announced annual target band center. Low single-digit inflation contributed to the rise in the real income of the population.

Consumer Price Index (CPI). According to the SSC data-based estimations, twelve-month inflation was 3.3% in March 2020 (vs March 2020 – March 2019), below the center of the target band announced by the CBA (4±2%).[3]

Graph 15. 12-month inflation, in % (CPI change to same month of previous year)



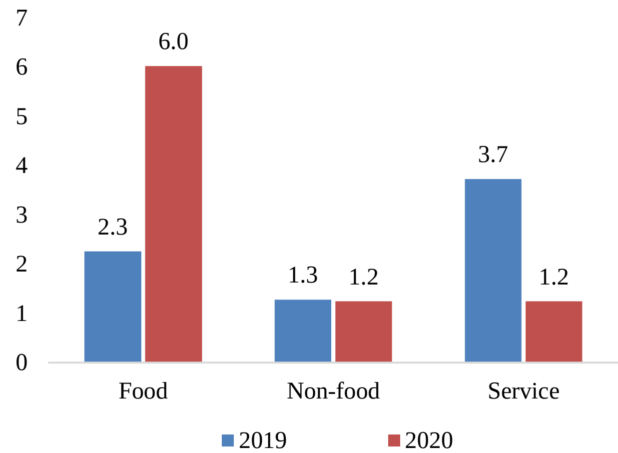
Source: SSC

Price index across food products with a considerable share in the consumer basket increased by 6% on an annual basis. High food inflation is attributable to high demand due to the creation of food stock by the population amid tighter quarantine regime, contained supply sources and certain rise in expenses. Annual price hike on non-food stuff and services, other inflation components, considerably falls behind the target band center (1.2% on both). Low non-food inflation is due to low demand amid pandemic and depreciated national currencies of some trade partners. Stable administrative prices also factor in low non-food and service inflation.

Food prices contribute 2.6 pp, nonfood 0.3 pp, and services 0.4 pp to annual inflation.

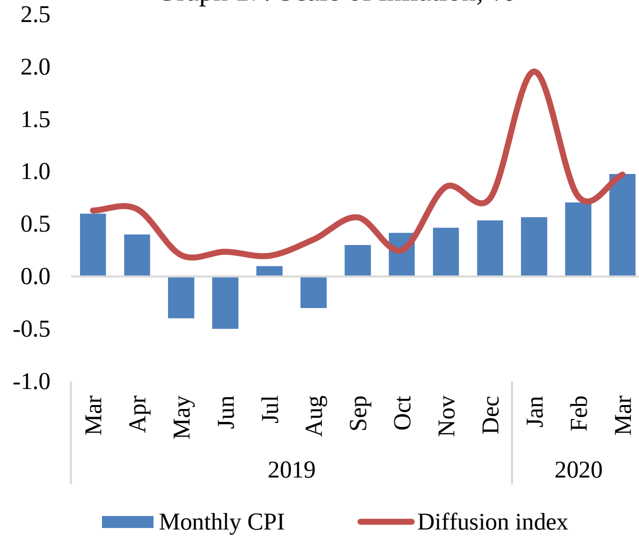
[3] *According to SSC, average annual inflation was 3%.*

Graph 16. Components of annual inflation, %



Source: SSC

Graph 17. Scale of inflation, %



Source: SSC, SSC data based CBA estimations

The diffusion index – a measure of change in dynamics pertaining to the number of goods and services with rising and falling prices in the consumer basket decreased since early year.[4] Prices for 79 out of 520 items of goods and services declined and remained unchanged for 42 items. Price hike for 44% of products was below 2%.

A stable exchange rate, monetary condition, stable administrative prices and low global food prices had stabilizing; while inflation expectations had an upward effect on inflation.

Average annual core inflation calculated by excluding swings in regulated prices and prices for seasonal agricultural products was 2.2%.

Inflation expectations elevated amid negative effects of the pandemic. According to RSM, inflation expectations increased in services, decreased in the non-oil industry and trade in March; remained unchanged in construction vs February. Households' 3-month inflation expectations temporarily increased compared to previous quarter.

[4] *The index is calculated as (increasing-decreasing)/(decreasing +increasing).*

Forecasts suggest that inflation will remain within the target band (4±2%) in 2020, if the current macroeconomic policy framework is maintained.

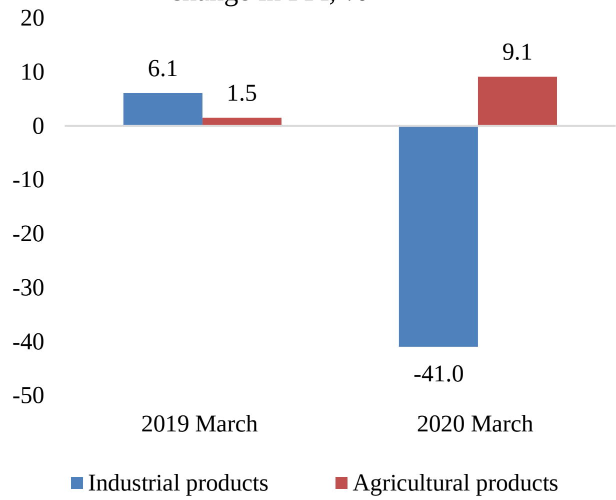
Producer Price Index (PPI). According to the SSC, the GDP deflator, that measures price swings in all domestically produced goods and services decreased by 1.9%, mainly owing to low industrial producer price index.

In March Agricultural Production Price Index increased by 9.1% over the recent 12 months. Over the same period prices increased by 6.8% on animal and 11.4% on plant growing products. In parallel, the PPI on forest products increased by 2.3%, 0.9% on fish and other fishery products.

The Industrial Production Price Index y/y decreased by 41%, the highest swing was in mining (down by 50.7%). Drop in mining mainly relates to global oil price slump due to the coronavirus pandemic.

The PPI on processing increased by annual 1.7%. The highest price hike in processing was in production of construction materials (26.5%), beverages (9.4%) and metalware, excluding machines and equipment (9.2%).

Graph 18. Annual change in PPI, %



Source: SSC

Transportation tariffs increased by annual 2.1% in March 2020. Prices for cargo services increased by annual 2.2%, and by 1.8% for passenger transportation. The price for postal and courier services decreased by 0.1%, prices for communication services remained unchanged.

III. THE MONETARY AND EXCHANGE RATE POLICY

3.1. The FX market and the exchange rate of the manat

The exchange rate of the manat against foreign currencies shaped by supply and demand in the FX market in Q1, 2020. Though increased due to indirect effects of external environment developments in March, demand stabilized the following months.

The size of FX market operations increased in the reported period.

Cashless transactions in the FX market y/y increased by 26.1% to $7.7 B equivalent. [5] – 87.7% in USD and 12.3% in other currencies. The Interbank FX market accounts for 43.1%, while the Intrabank FX market for 56.9% of cashless transactions.

99% of operations in the Interbank FX market were denominated in the USD, 0.8% in the EUR and 0.2% in other currencies. Currency operations in the Interbank FX market were conducted over the Bloomberg platform.

The size of Intrabank FX market operations was $4.4B equivalent (79.2% USD denominated operations). Foreign currency operations with legal entities account for 91.6% of currency operations in the Intrabank FX market.

Cash currency traded by banks y/y increased by 60.8% to $2.2B ($2B, or 89.7% USD denominated operations).

The CBA continued organized currency auctions to arrange sale of foreign currency provided by the State Oil Fund of Azerbaijan Republic (SOFAZ). Together with regular auctions over-the-counter auctions also was conducted. Over-the-counter auctions related to sharp rise in demand for foreign currency in March. Market participants were informed on auction parameters via the Bloomberg terminal prior to auctions. The Bank held total 26 currency auctions in Q1. Demand decreased and stabilized from April onward.

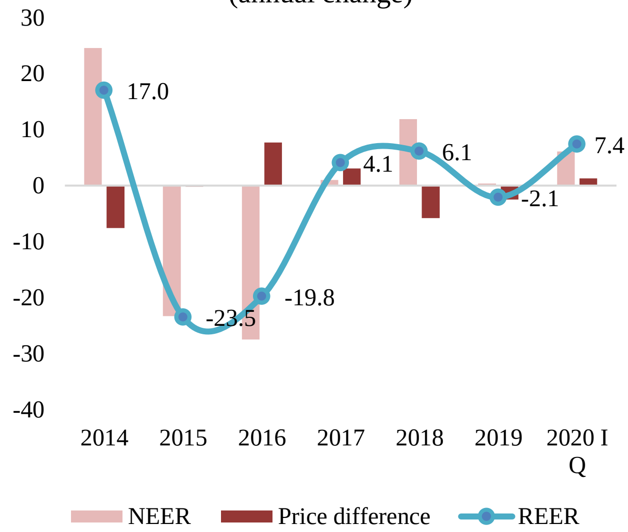
[5] *Including USD, EUR, GBP, RUB denominated operations*

The official exchange rate of the manat was set on the basis of the average exchange rate on interbank transactions over the past period of 2020 (both auction and non-auction on the Bloomberg platform). The average daily AZN/USD exchange rate was AZN1.7. Buy-sell exchange rates set by banks were close to the official one. Commercial banks' daily average buy/sell rate was 1.6986/1.7027. Difference between average daily official buy/sell exchange rates and those of commercial banks was 0.2% (AZN0.0041).

The exchange rate of the manat varied against currencies of trade partners – it appreciated by 10.6% against the Turkish lira, 18.4% against the Kazakhistani tenge, 28% against the Russian ruble, 17.6% against the Ukrainian hryvnia, 14.8% against the Georgian lari and depreciated by 1.3% against the Swiss franc and 0.8% against the Japanese yen.

Dynamics of bilateral exchange rates influenced that of multilateral exchange rates. Total trade weighted non-oil NEER of the manat appreciated 6.1%, while the REER appreciated 7.4%.

Graph 19. Dynamics of REER (annual change)



Source: CBA

To note, the REER of manat has depreciated by 28.7% since end-2014, contributing to non-oil competitiveness.

3.2. Monetary policy tools

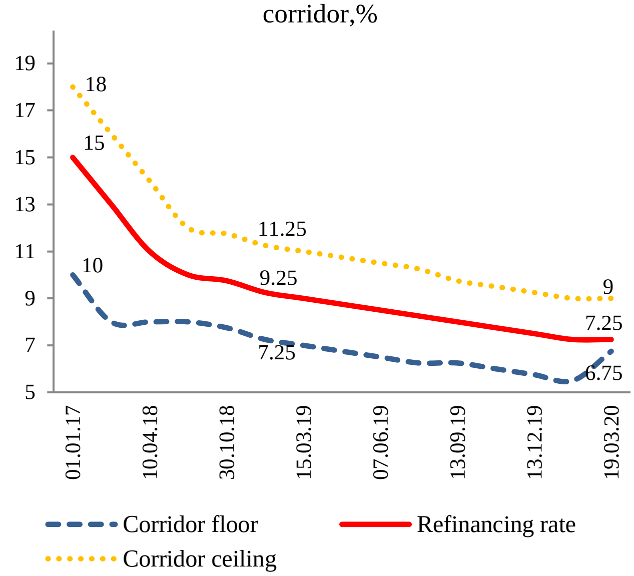
Monetary policy tools were applied in view of internal and external factors affecting achievement of the inflation target and the liquidity position of the banking system in Q1, 2020.

The CBA made necessary corrections to its interest rate corridor parameters of liquidity operations in light of considerable changes in the global environment and their pass-through to the country economy and financial markets.

The Management Board of the CBA discussed interest rate corridor parameters twice over the Q1, 2020, decided to reduce the refinancing rate 25 base points to 7.25% from 7.5%, and set the ceiling and the floor of the interest rate corridor in the range of ±1.75% to the refinancing rate (9% and 5.5%) at the first meeting. The Board decided to leave the refinancing rate unchanged at 7.25%, maintained the ceiling at 9% and increased the floor to 6.75% at the second meeting. The decision serves to maintain an optimal balance between the dilemmas of macroeconomic and exchange rate stability, its main anchor, by prioritizing the support for economic activity and employment.

The CBA kept various term open market operations active to effectively manage liquidity. Demand for CBA's sterilization operations varied across months depending on the banking system's liquidity position.

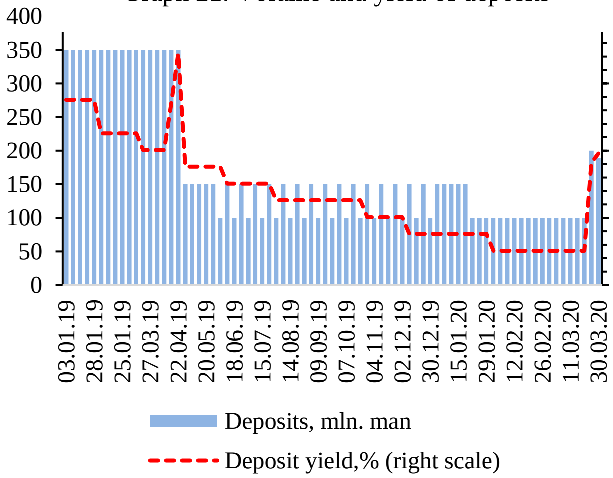
Graph 20. Parameters of interest rate corridor,%



Source: CBA

The CBA held 24 deposit auctions on attraction of excess funds in the national currency. Total outstanding amount of funds attracted by deposit auctions was AZN682.4 M as of the end-period.

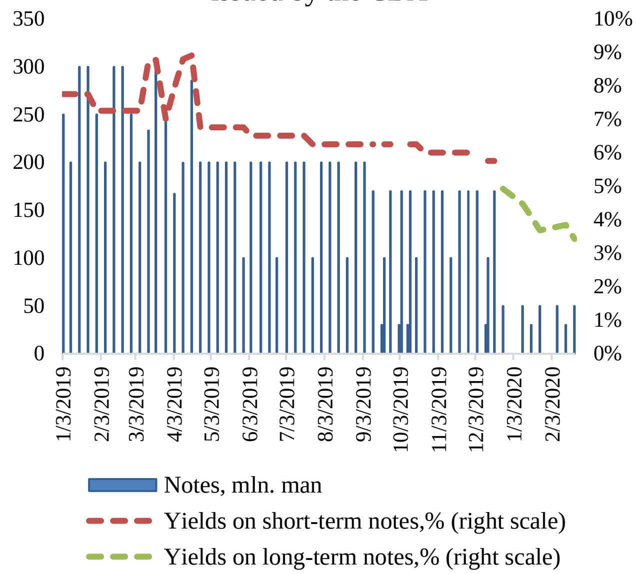
Graph 21. Volume and yield of deposits



Source: CBA

Along with deposit operations, the CBA held 7 long-term note auctions in Q1, 2020. 84-day notes were issued at 2, 168-day at 3 and 252-day at 2 auctions. Total outstanding amount of sterilization via long-term notes was AZN322.3M.

Graph 22. Volume and yield on notes issued by the CBA



Source: CBA

The CBA took adequate decisions with respect to duration of sterilization tools to prevent threats to macroeconomic stability and support rebalancing in the FX market, amid higher effects of the coronavirus outbreak on the global economy from March onward. The duration of sterilization tools was reduced. 28-day deposit auctions were decided to be replaced with 14-day deposit auctions. 84-168-252-day note auctions were replaced with 28-day issue of notes.

Interest rates on deposit operations and issue of notes were driven by supply and demand. On the backdrop of slight drop in demand interest rates on deposits neared the middle of the interest rate corridor to the end-quarter.

Attraction of deposits and issue of notes both sterilize excess money supply and promote money market development contributing to improvement of monetary policy's operational framework and development of the interbank market.

Return on CBA's sterilization tools is translating into interest rates on other financial tools becoming an important representative yield of the money market. At the same time, notes issued by the CBA are being actively used as collateral at the REPO market.

Reserve requirements were left unchanged and were still applied on an averaging basis, to allow flexible management of liquidity by banks. Monitoring findings display that banks' cumulative balances on correspondent accounts with the CBA over 3 months of 2020 exceeded total funds to be maintained as required reserves.

3.3. Money supply

State budget surplus and actions are taken to stabilize the situation in the FX market weighed on the monetary condition in Q1, 2020.

Money base in manat decreased by 17.2% to AZN10.1B as of end-period, mainly attributable to state budget surplus and swings in the balance of a treasury account. Temporary drop in money supply supports FX market stability.

Cash in circulation, a structural element of money base in manat, decreased by 9.1%, and stock of correspondent accounts by 65.8%.

Broad money supply in manat (M2) decreased by 9.8% to AZN16.4B as of end-period.

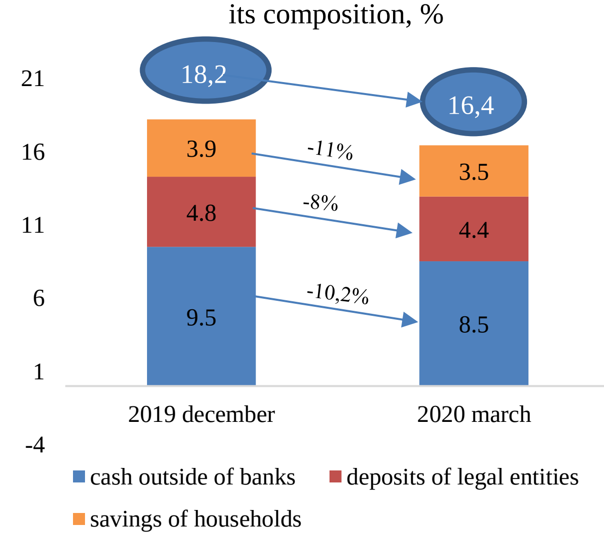
Table 3. Money aggregates, billion manat

	01.01.19	**01.01.20**	**01.04.20**	*Growth rate, %*
M0	7.6	9.5	8.5	*-10.2*
M1	12.3	15.4	13.8	*-10.1*
M2	14.6	18.2	16.4	*-9.8*
M3	24.1	28.9	26.7	*-7.4*

Source: CBA

Cash, savings of individuals and deposits of legal entities in the structure of money supply in manat (M2) performed differently. [6]

Graph 23. Dynamics of M2 according to its composition, %



Source: CBA

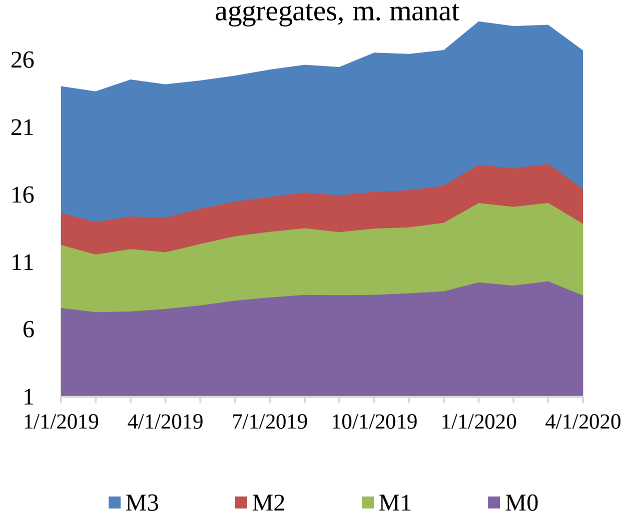
[6] *According to the Monetary and Financial Statistics methodology by the IMF.*

Cash money supply decreased by 10.2%, manat denominated corporate deposits by 8% and manat denominated savings of households by 11%.

Manat denominated demand savings and deposits decreased by 10%, while term savings and deposits decreased by 8.2% (weight in M2 –15.9%).

Broad money supply (M3) decreased by 7.4% to AZN26.7B as of end-period.

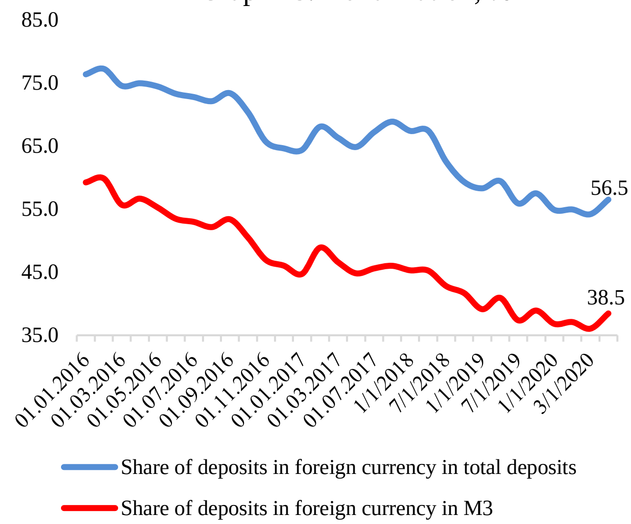
Graph 24. Dynamics of money aggregates, m. manat



Source: CBA

No considerable change was observed in the level of dollarization of bank deposits. Foreign currency denominated savings and deposits account for 38.5% of M3 money aggregate by the end of period. Foreign currency-denominated savings and deposits account for 56.5% of total savings and deposits.

Graph 25. Dollarization, %



Source: CBA

Dollarization of corporate deposits was 65.6% as of end-quarter, the same as early-year. Dollarization of savings of individuals was 55.1% as of end-quarter.

Graphs and tables

Graphs

Tables

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