



**CENTRAL BANK**  
OF THE REPUBLIC OF AZERBAIJAN

# **MONETARY POLICY REVIEW**

*JANUARY- MARCH 2021*

*No 1*

# TABLE OF CONTENTS

<b>Executive summary</b>	<b>3</b>
<b>I. Global economic environment and the external sector</b>	<b>4</b>
1.1.    Global economic trends	4
1.2.    External sector developments of the Azerbaijani economy	12
<b>II. Macroeconomic development in Azerbaijan</b>	<b>17</b>
2.1.    Aggregate demand	17
2.2.    Aggregate supply and employment	22
2.3.    Inflation	26
<b>III. The monetary and exchange rate policy</b>	<b>31</b>
3.1.    The FX market and the exchange rate of manat	31
3.2.    Monetary policy tools	34
3.3.    Money supply	36
<b>Charts and tables</b>	<b>38</b>

## ACRONYMS

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

## **EXECUTIVE SUMMARY**

*In Q1 2021 the monetary policy of the Central Bank was implemented in accordance with the 'Statement of the Central Bank of the Republic of Azerbaijan on main directions of the monetary and financial stability policy for 2021' and was oriented towards managing inflation within the announced target band ( $4\pm 2\%$ ).*

*Over the reporting period, macroeconomic stability in the country was safeguarded, inflation remained within the target band, albeit being slightly high driven by external factors. The balance in the FX market played a key role in maintaining inflation within the target.*

*The effect of external conditions on the national economy and inflation processes in the country was not unilateral. Rising economic activity in the world, including in partner countries, and favorable conjuncture in the global oil market had an upward effect on the balance of payments, the balance in the FX market and economic activity through positive expectations, export revenues and investment flows. On the other hand, high global food prices had an upward effect on internal inflation.*

*In Q1 2021, the monetary condition served to maintaining an optimum balance between supporting economic growth and safeguarding macroeconomic stability. Decisions related to interest rate corridor parameters were taken in light of assessment of actual and expected inflation rate in relation to the target, aggregate demand recovery rate, and changes in external and internal risks. Dollarization kept declining amid macroeconomic stability.*

*Anti-crisis measures started last year and relatively improved international conjuncture, as well as gradual adjustment of economic agents to the new conditions are weighing in on gradual recovery of economic activity. The non-oil sector witnessed economic growth in Q1 2021. Alternate statistics confirm the recovery of economic activity.*

# I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

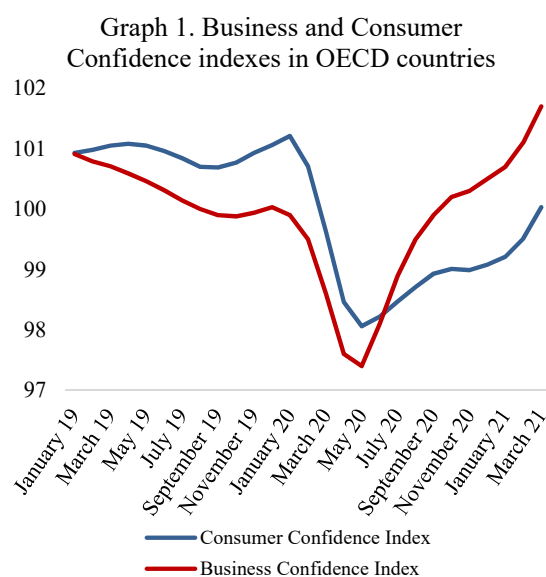
## 1.1. Global economic trends

*Q1 2021 may be characterized as the launch of the COVID-19 vaccination and the beginning of economic recovery. Mass vaccination from the first days of the year pushed optimistic expectations in global economic activity. Economic recovery rate varies across country groups. Looking ahead, this process is expected to occur with different dynamics depending on the structure of economies of AEs and EMEs and effectiveness of stimulus measures.*

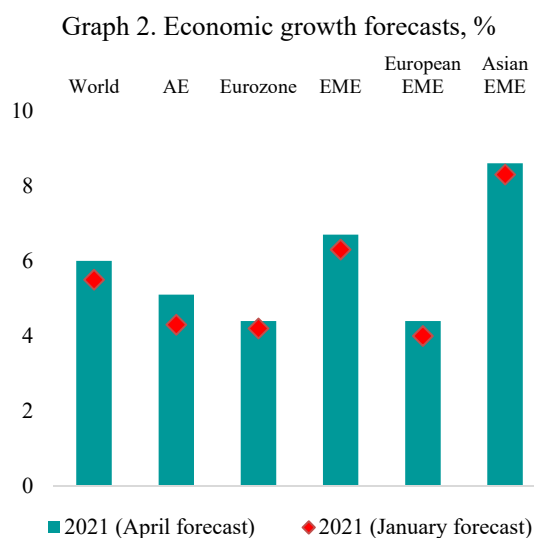
**Global economic activity.** After economic contraction in 2020, the global economy is entering a recovery pace.

Economic activity indicators in OECD countries (over 62% of the global economy) posted growth in Q1 2021. The BCI on OECD countries reached the highest level since early 2019 amid rapid recovery expectations after a plunge mid-2020. Though still following a recovery

trend, the CCI is below the pre-pandemic level.



International organizations are revising up global economic growth outlook in light of recent trends. The IMF forecasts 6% growth of the global economy in 2021 (0.5 pp up vs the previous forecast) and 4.4% growth of the global economy in 2022 (0.2 pp up vs the previous outlook) in WEO April Update.



Source: IMF

It is attributable to the fact that the additional stimulus measures of a number of AEs and vaccination are expected to accelerate the process of recovery. The COVID-19 pandemic hit EMEs and low-income country groups severely. It is not ruled out that these countries will suffer additional losses in the medium term. In general, the countries with strong domestic and external demand (China, the USA, and Japan) are expected to reach the pre-pandemic level earlier. Tourism based countries (Thailand, Greece, Italy, Spain) are expected to recover comparatively slower.

According to the IMF April report, the US economy contracted by 3.5% in 2020 (3.4% contraction in January 2021

report). Annual inflation was 2.6% in March 2021, exceeding the market expectations (2.5%). Unemployment was 6% in March, 0.2% down vs the previous month.

Over the quarter the Dow Jones increased by 8.7%, the S&P 500 by 17.9%. In March 2021, industrial production in the USA increased by 1.4% vs the previous month, and yoy by 1%, the first annual growth since August 2019.

To accelerate the recovery in post-pandemic period the US government will continue broad incentive policy measures in 2021. The FED kept interest rates at 0-0.25%. Taking into account the results of Q1 and additional stimulus packages injected to the economy, the IMF in April Update forecasts 6.4% economic growth in the US economy in 2021, up from the January forecast (5.1%). According to the IMF, economic activity in the USA will return to the pre-pandemic level as of the end of the first half of 2021.

According to the IMF April Update, the **euro area** contracted by 6.6% in 2020 (7.2% in January Update).

In March 2021, 12-month inflation was 1.3%, the highest annual inflation since January 2020. In March 2021, the industrial production yoy increased by 10.9%, due to the drop in industrial production in Germany (6.4%), France (6.6%) and Netherlands (2.7%). Unemployment was 8.3% in March, higher than the market expectations (8.1%), the number of the unemployed reached 13.6 million. The highest unemployment rate was in Spain (16.1%), Italy (10.2%) and France (8%), and the lowest in Netherlands (3.6%) and Germany (4.5%). The Economic Sentiment Index<sup>1</sup> maintained an upward trend over the quarter increasing from 54.4 early year to 74 as of end-March. The FTSE Eurotop increased by 7.9% in Q1. The ECB left the interest rate unchanged until inflation approximates 2%. Moreover, the Emergency Purchase Program (€1850B) was extended until March 2022. The IMF forecasts 4.4% economic growth in the euro area in 2021, up from the January Update (4.2%). According to the IMF April

Update, economic activity in the euro area will not reach the pre-pandemic level by the end of 2022.

In 2020, the **Japanese** economy shrank by 4.8% (5.1% in IMF January Update). Unemployment was 2.6% in March 2021 (market expectations 2.9%). In March, industrial production yoy increased by 4%. Production of motor vehicles, inorganic and organic chemical products and plastic ware increased most. The Nikkei gained 6.4% over the quarter. The Bank of Japan left the refinancing rate unchanged at negative 0.1%. The IMF forecasts 3.3% economic growth in Japan, up from January Update (3.1%). According to the IMF April Update, economic activity in Japan will reach the pre-pandemic level in H2 2021.

According to the IMF April 2021 Update, GDP decreased by 9.9% in the **United Kingdom** in 2020 (10% fall in January 2021 Update). In March 2021, annual inflation in the UK was 0.7%, lower than market expectations (0.8%). In March industrial production in the

<sup>1</sup> The ESI is a weighted average of answers to selected questions addressed to companies and consumers in five sectors.

country yoy increased by 3.6%. Unemployment decreased to 4.8% in March (market expectations 5.1%). The Bank of England left the refinancing rate stable at 0.1%. The IMF predicts 5.3% economic growth in the UK in 2021, up from the January Update (4.5%). According to the IMF, economic activity in the UK will not return to pre-pandemic levels until the end of 2022.

According to the IMF April Update, in 2021 economic growth is expected to be 6.7% in EMEs (6.3% in January Update). The report emphasizes that the post-pandemic recovery will depend on profiles, regional differences, structures of the economy and effectiveness of the stimulus measures of EMEs. In 2021, Emerging Asian Markets are expected to grow by 8.6%, Emerging European Markets by 4.4%, Latin America and the Caribbean by 4.6%, the Middle East and Central Asia by 3.7%, and Sub-Saharan Africa by 3.4%.

The **Chinese** economy grew by 18.3% in Q1 2021, following the growth of 2.3% in 2020. With this indicator, China is considered the only large

economy that has achieved growth in the context of the COVID-19 pandemic – being the highest growth rate since 1992, it is driven by stronger domestic and global demand, strict measures against the epidemic and ongoing financial support. Recovery in China is faster than in other countries. Industrial production in the country yoy increased by 14.1% in March 2021. A similar trend was observed in investment to capital stock. Unemployment was 5.3% in March. In February, the CCI increased from 122.8 (January) to 127. The BCI also maintained its growth trend – it was 51.9 in March (50.6 in February). According to the IMF April Update, in 2021 China is expected to grow by 8.4% (8.1% in January Update).

According to the IMF April Update, in 2021 the economic growth in **Russia** contracted by 3.1%. The unemployment rate fell to 5.4% in March 2021, lower than the market expectations. Although the CCI and the BCI were prone to recovering, they are still in a negative zone. Annual inflation in Russia in March 2021 was 5.8%, higher than the



central bank target (4%). In March 2021, industrial production yoy increased by 1.1%. The Russian ruble depreciated by 2.1% against the US dollar. Towards the end of Q1, the Bank of Russia tightened the monetary policy in light of inflation expectations, and shifted the interest rate from 4.25% to 4.5%. The IMF forecasts 3.8% economic growth in Russia in 2021, higher than in the January Update (3%).

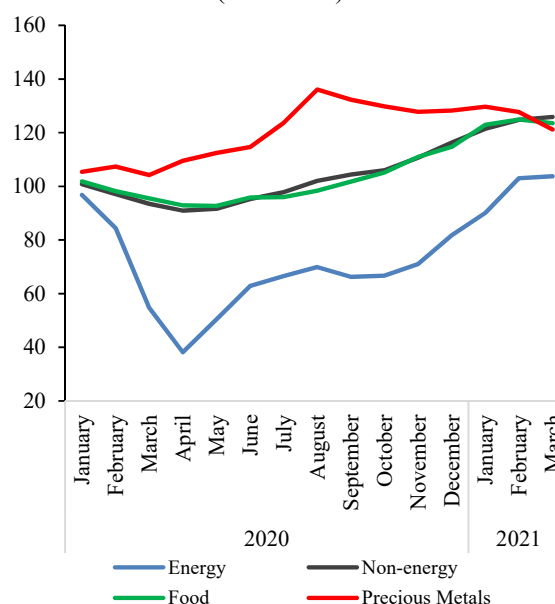
According to the IMF April Update, the economic growth was 1.8% in **Turkey** in 2020. In March 2021, 12-month inflation was 16.2%. In March 2021, the industrial production yoy increased by 16.6%. Unemployment slightly decreased to 13.1% in March vs the previous month. The Turkish lira depreciated by 12.9% against the US dollar. To fight inflation and avoid sharp depreciation of the lira the Central Bank of Turkey shifted the interest rate to 19% from 17% over the quarter. The IMF forecasts 6% economic growth in Turkey in 2021, as in the previous outlook.

According to IMF's updated recent outlook, in 2020 global trade fell by 8.5%. In line with revival in global

activity, the global trade is expected to grow by 8.4% (8% in the previous update) in 2021 and 6.5% (6% in the previous update) in 2022.

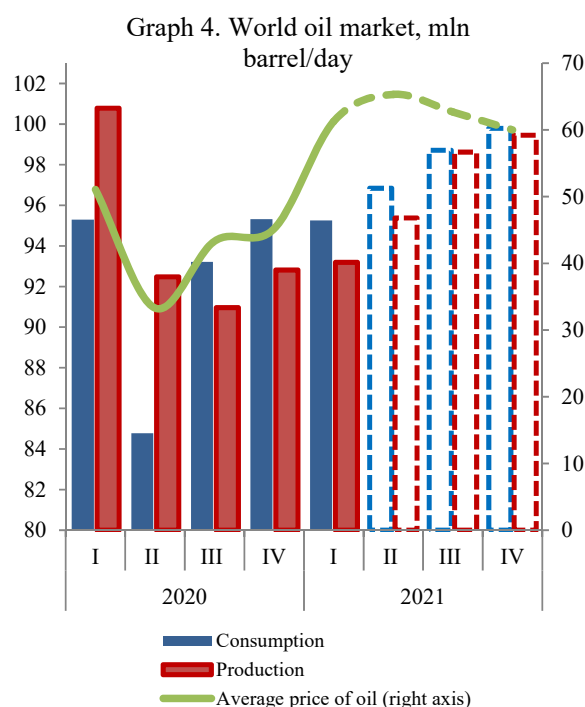
**Commodity markets.** In Q1 2021, commodity prices in the world market have generally risen. According to the World Bank's Commodity Markets Outlook, energy prices increased by 27.1%, non-energy prices by 8.3%, and food prices by 7.8%, whilst the prices for precious metals decreased by 5.5%. The gold price decreased by 7.5% over first three months of 2021.

Graph 3. Commodity price index (2020=100)



Source: World Bank

The average Brent oil price was \$61.3 per barrel in Q1 2021, 42.1% higher than the average price in 2020 (\$43.6).



Source: Energy Information Administration (EIA)

Oil price hike is mainly attributable to the expected positive results of vaccination and high economic activity in Asian countries. Decisions within the OPEC++ also support the current dynamics of prices. On the backdrop of rising global demand, oil reserves, which increased during the pandemic, have been declining dramatically since an early year. According to the Oil Market Report of the

International Energy Agency (IEA), as of early 2021, the oil reserves of OECD countries decreased by 14.2 million barrels per month to 3023 million barrels.

The March release of the IEA's Oil Market Report forecasts 94.9 million b/d global oil demand in Q2 2021 and 96.5 million barrel average daily demand for oil in 2021.

**Risks.** According to the IMF April Update 2021, although the COVID-19 vaccination has started, some global economy related uncertainties and risks are still actual. In general, international financial organizations note that the following major risks currently exist for the global economy:

- Liquidity and bankruptcy risks;
- Late recovery of employment and high poverty;
- Late start of vaccination and low economic activity in EMEs;
- High interest rates and risk premiums.

Countries should not suspend fiscal support to avoid the above risks and safeguard financial stability using macro-prudential tools. Although the

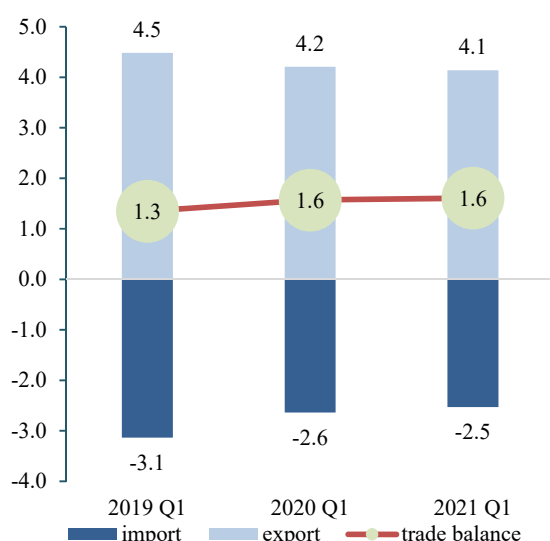
vaccination in AEs is available to the entire population, certain EMEs do not have these opportunities. Stronger international cooperation should solve the problem.

## 1.2 External sector developments of the Azerbaijani economy

*In Q1 2021, the external position of Azerbaijan shaped amid relatively improved international conjuncture.*

According to the SCC, in Q1 2021, the foreign trade turnover amounted to \$6.6B – export \$4.1B (61.2%), import \$2.5B (38.8%). Foreign trade surplus made up \$1.6B.

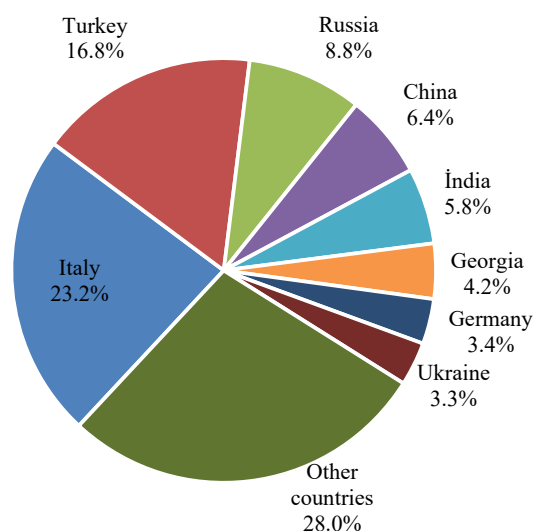
Graph 5. Trade balance, USD bn.



Source: SSC

Azerbaijan traded with 153 countries.

Graph 6. Trade turnover with main countries, 2021 Q1, %



Source: SSC

Italy, Turkey, Russia, China, India, Georgia, Germany and Ukraine account for over half of the trade turnover. As in previous year, Italy takes the highest share in trade turnover.

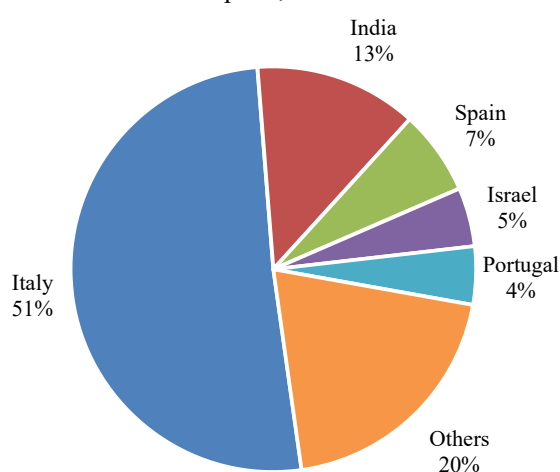
The share of Italy in total trade turnover yoy increased by 5.1 pp to 23.3%, Turkey by 6 pp to 16.8%, Russia by 0.4 pp to 8.8%, China by 0.2 pp to 6.4%, India by 2.8 pp to 5.8%, Georgia by 2.4 pp to 4.2%, Ukraine by 0.5 pp to 3.3%. The share of Germany in the trade turnover remained unchanged.

Total export decreased by 1.6%, while non-oil export increased by 16.9%. The value of export increased by 3.6% on

oil products, 5.4 times on natural gas, and decreased by 24.4% on crude oil.

51% of crude oil and oil products was exported to Italy, 13% to India, 6.8% to Spain, 4.7% to Israel, and 4.6% to Portugal.

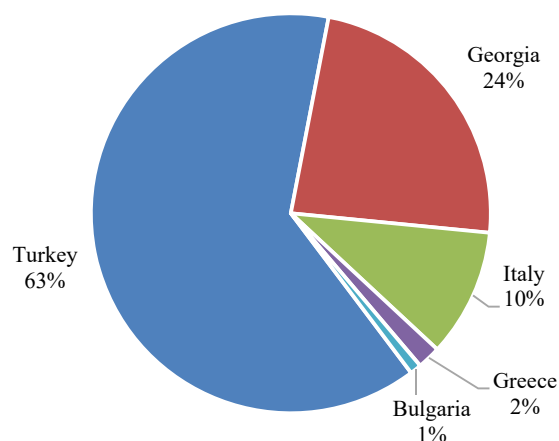
Graph 7. Crude oil and oil products exports, %



Source: SSC

Main export partners on natural gas were Turkey, Georgia, Italy, Greece and Bulgaria. Turkey accounts for 63%, Georgia for 24%, Italy for 10%, Greece for 2% and Bulgaria for 1% of natural gas exports.

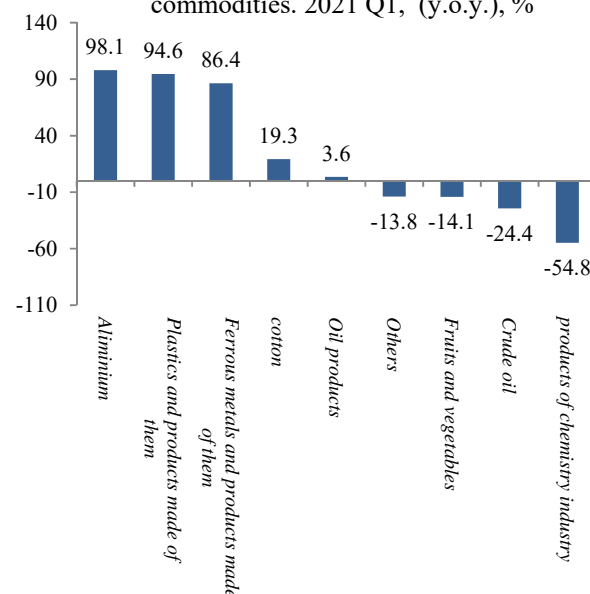
Graph 8. Natural gas exports, %



Source: SSC

Export of aluminum (98.1%), plastics and products (94.6%), ferrous metals and products (86.4%), cotton yarn (19.3%) increased.

Graph 9. Change in export of commodities. 2021 Q1, (y.o.y.), %

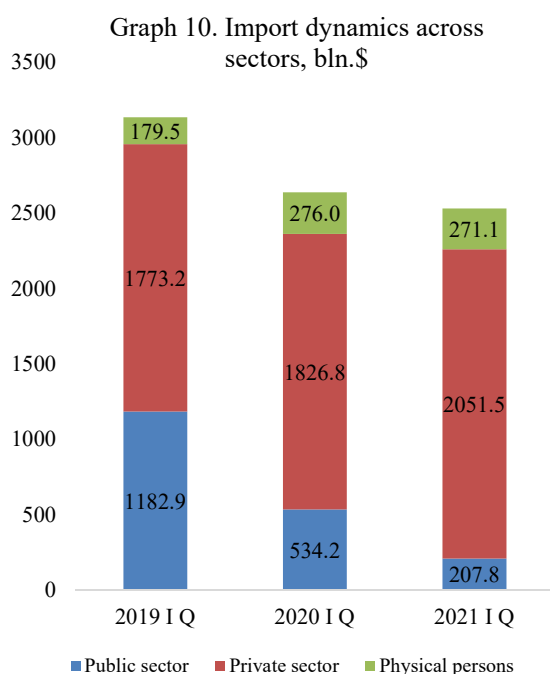


Source: SSC

In general, over the reporting period, the main import partners included

Italy (35.5%), Turkey (17.9%), India (8.4%), Georgia (6.3%), Spain (4.4%), and Russia (3.3%).

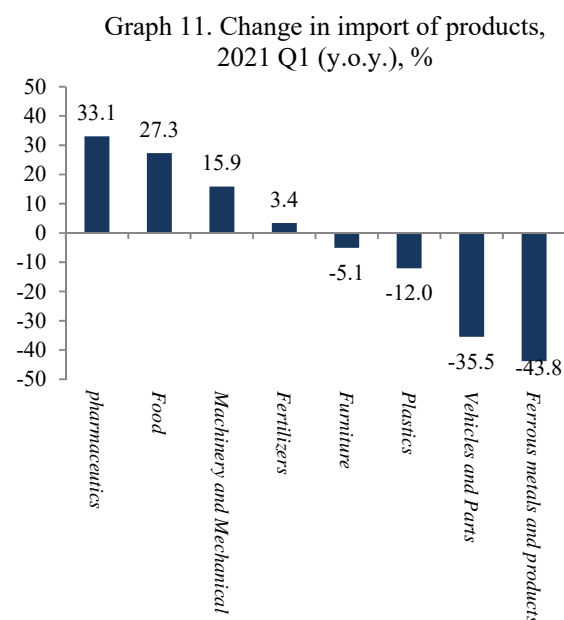
Commodity import declined by 4% - commodity import decreased by 2.6 times to \$0.2B on the public sector, increased by 12.3% to \$2.1B on the private sector and decreased by 1.8% to \$0.3B on individuals.



Source: SSC

Import increased by 33.1% on pharmaceuticals, by 27.3% on food products, by 15.9% on machinery and mechanisms, 3.4% on fertilizers, and decreased by 43.8% on ferrous metals and products, by 35.5% on vehicles and parts,

by 12% on plastics and products, by 5.1% on furniture.

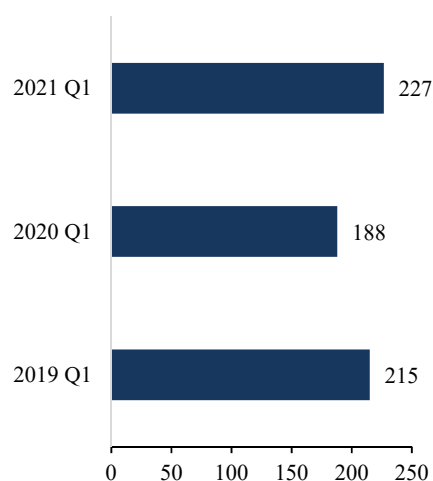


Source: SSC

Russia accounts for 17.8%, Turkey for 15%, China for 12.4%, Germany for 7.3%, the USA for 4.6%, Ukraine for 4% and Iran for 3.8% of imported products.

According to initial data, money remittances to the country amounted to \$213.6M.

Figure 12. Inflow of remittances, mln.\$



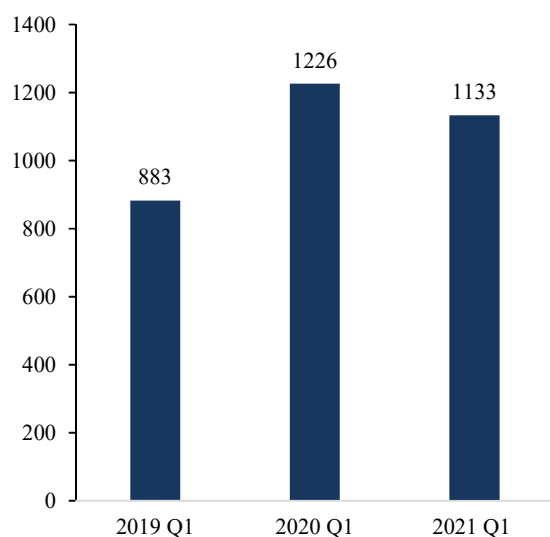
Source: CBA

Capital inflows from foreign enterprises and organizations kept on over the reporting period. According to the SSC, FDIs amounted to AZN1.1B equivalent (48% of total investments).

The UK, Turkey, Virgin Islands, the USA, Japan, Malaysia, France and Norway account for the essential part of the capital investments by foreign countries and international organizations.

Strategic foreign exchange reserves still exceed the internationally accepted adequacy norms. As of end-March, 2021 strategic FX reserves sufficed for 39-month import of goods and services (taking import of goods and services for 2020). Strategic reserves exceeded money supply in manat (M2) by 4.2 times (M2 money aggregate as of 01.04.2021).

Graph 13. Foreign investment in fixed capital, mln. manat



Source: CBA

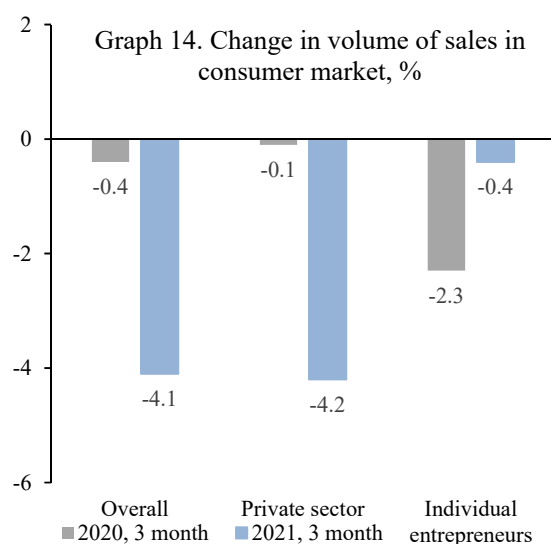
## II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

### 2.1. Aggregate demand

*In Q1 2021 aggregate demand, the main driver of economic growth remained weak amid negative effects of the pandemic.*

**Consumption expenditures** decreased. Goods and services sold in the market to meet consumer demand yoy decreased by 4.1% in real terms to AZN11.5B. The private sector accounts for 96.5% of the goods sold and services supplied by economic agents (47.9% individual entrepreneurs).

Every consumer spent on average AZN383.7 in the consumer market (yoy down by 0.6%) in January-March.

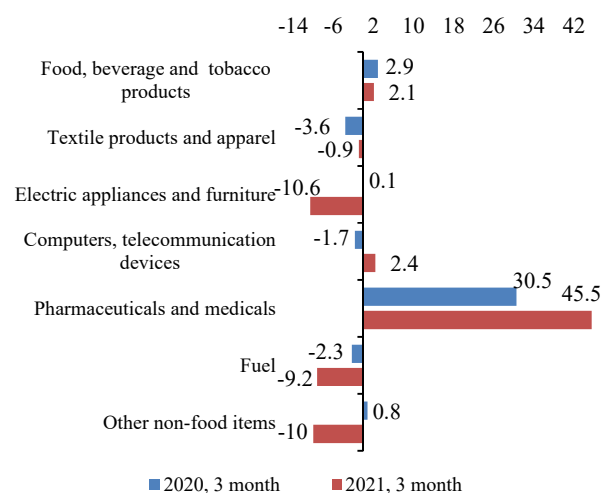


Source: SSC

Trade turnover yoy decreased by 1.1% to AZN9.5B. Retail trade turnover increased by 2.1% on food, beverages and tobacco products, nonfood turnover decreased by 4.7%.

Restrictions imposed to prevent the spread of the coronavirus led to changes in consumer spending in our country and around the world. While due to social isolation measures, distant working, online education, traveling restrictions etc., expenses allocated on food, computer and telecommunication devices, pharmaceuticals and medical supplies increased, while the expenses allocated on knitwear and clothes, furniture, fuel and other non-food items decreased.

Graph 15. Growth of spending items at trade turnover, %



Source: SSC



The share of consumer spending on food, beverages and tobacco products in retail trade outlets yoy increased by 2%, pharmaceuticals and medical devices by 0.4%, fuel by 0.2%, while the share of other spending items decreased.

*Table 1. The share of spending items in trade outlets, %*

Spending item	Share, %	
	2020 3 months	2021 3 months
<i>Food, beverage and tobacco</i>	52.4	54.4
<i>Textile products and apparel</i>	16.7	16.4
<i>Electric appliances and furniture</i>	5.7	5
<i>Computers, telecommunication devices and others</i>	0.7	0.7
<i>Pharmaceuticals and medicals</i>	1.6	2.2
<i>Fuel</i>	5.2	5.4
<i>Other non-food items</i>	17.7	15.9

Source: SSC

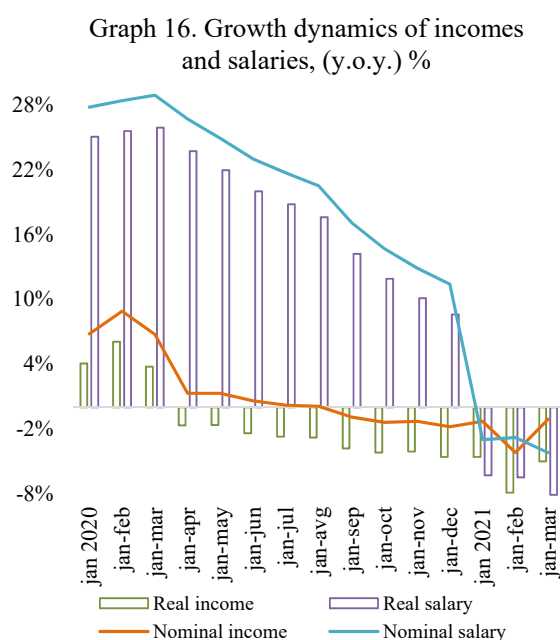
Every consumer purchased on average AZN172.9 worth food, beverage and tobacco, AZN145.2 worth non-food items monthly for private consumption in retail trade.

Catering turnover yoy decreased by 51.2%. Entities accounted for 41.6%, private entrepreneurs for 58.4% of

catering turnover in the private sector. The value of paid services supplied to the population decreased by 11.4% in real terms to AZN1.8B. Per capita paid services consumption yoy decreased by AZN18.7 to AZN182.8 in nominal terms.

According to the SSC, due to the pandemic, money income of the population decreased by 1.1% nominally to AZN13.5B over the past period of 2021. Per capita money income made AZN1344.9. Population's disposable income amounted to AZN12.2B.

The nominal average monthly salary of hired workers kept decreasing and lost positive dynamics both nominally and really since early 2021. In January-March average annual nominal salary decreased by 4.2% to AZN713.2. Average salary of employees involved in public entities was AZN634.6, and those in private entities was AZN810.



Source: SSC and CBA estimates

Loans to households, one of the consumer demand components increased by 2.4% to AZN6.9B as of the end-period.

The lingering pandemic and non-full recovery of economic activity weighed in on the CCI as well. The CCI indicator generated from findings of the 'Households financial behavior and intentions survey held in Q1 2021 decreased vs the previous quarter. To note, this indicator rests upon surveys among various income households 'Family's financial condition

expectation', 'Expectation on country's economic standing', 'Savings probability' and 'Unemployment expectations'.

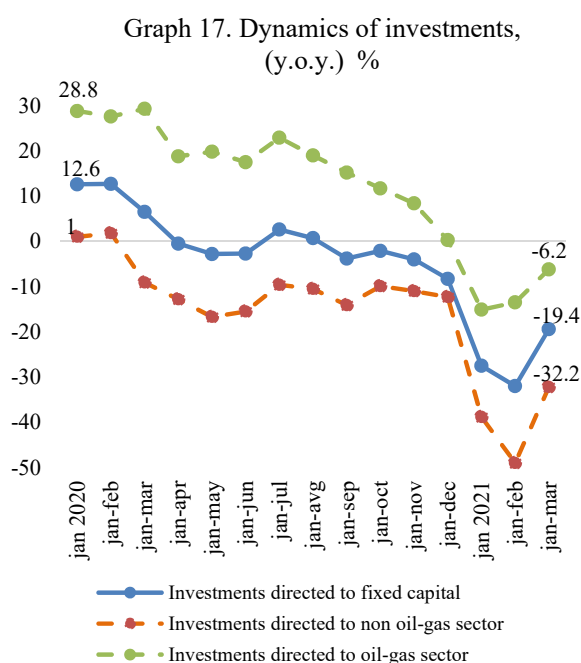
**Government spending** was substantial to support domestic demand. State budget expenditures amounted to AZN5.5B over the period (yoy up by 5.1%)<sup>2</sup>.

Following the economic classification, 48% (AZN2651.6M) of state budget expenditures were allocated to social spending (compensation for employees, pension and social allowances, medicine and food), yoy up by AZN131.8M, or 5.2%.

### **Investment expenditures.**

According to the SSC, AZN2.4B worth investment was channeled to the economy (yoy down by 19.4%). The drop is mainly attributable to the dynamics of investments made to the oil and gas sector. AZN1B worth investment was channeled to the non-oil and gas sector (yoy down by 32.2%). The public sector accounts for 26% and the private sector for 74% of total investments.

<sup>2</sup> <http://www.maliyye.gov.az>



Source: SSC

52.1% of investments stemmed from internal, 47.9% from external sources.

Table 2. Investment sources, %

	2020 3 months	2021 3 months
<i>Funds of enterprises and organizations</i>	66.9	67.5
<i>Bank loans</i>	4.5	8.9
<i>Budget funds</i>	17.7	10.6
<i>Off-budget funds</i>	1.8	-
<i>Personal funds of population</i>	6.4	8.1
<i>Other funds</i>	2.7	4.9

Source: SSC

Funds of enterprises and organizations prevailed in total

investments (67.5%). The share of bank loans increased year over year.

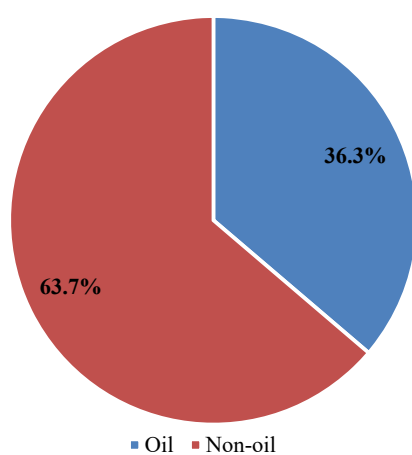
## 2.2. Aggregate supply and employment

*Although economic activity subdued due to the negative impact of the pandemic relatively recovered in Q1 2021, the process varied across sectors.*

**Economic growth.** According to the SSC, in Q1 2021, GDP decreased in real terms by 1.3% to nominal AZN18.9B. Per capita GDP made up AZN1891.1.

Oil and gas value added decreased by 7.3% and its nominal value was AZN6.9B (36.3% of GDP). The mining sector extracted 8.8 m/t crude oil and 7.8 bln/m<sup>3</sup> natural gas. Oil extraction yoy decreased by 5.3% and gas extraction increased by 12%. Total cost of production in oil products was AZN810.3M (yoy down by 13%).

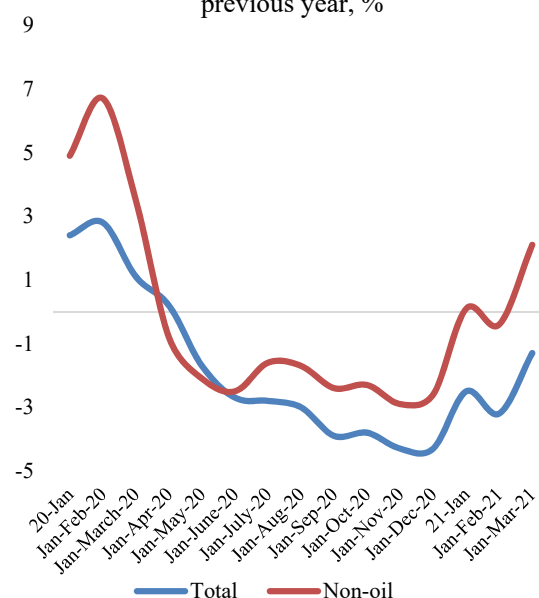
Graph 18. Sectoral growth of value added, %



Source: SSC

Recession in the non-oil and gas economy ended. Non-oil value added yoy increased by 2.1% in real terms and its nominal value was AZN12.1B (63.7% of GDP).

Graph 19. Economic growth, in comparison to corresponding period of previous year, %



Source: SSC

Non-oil output increased by 11.9%, while oil-gas output decreased by 5.9%. Output increased by 4.8 times in production of shoes, 2.5 times on computers, electronic and optic products, 2.4 times on machinery and equipment, 83.1% on tobacco products, 81.4% on installation and repairs of machinery and equipment, 32.5% on paper and cardboard, 14.1% on electrical appliances, 10.8% on garments, 10% on

construction materials, 6.3% on food products, 0.6% on metallurgic products. Moreover, production of furniture decreased by 6.3%, production of chemical products decreased by 12.5%, oil products by 13%, production of beverages by 13%, printing products by 62.3%, production of vehicles, trailers and semitrailers by 63.3%. Amid high demand for pharmaceuticals due to the pandemic and establishment of local enterprises production of pharmaceuticals increased by 7.3 times.

Yoy growth in agriculture was 2.2%, including 2.2% growth on animal products and 2.5% on plant products.

*Table 3. GDP structure, weight in percentage*

Sectors	2020 Q1	2021 Q1
Industry	40.2	40.5
Construction	4.9	5.3
Agriculture, forestry, fishery	3.2	3.1
Trade, repair of vehicles	10.7	10.5
Transport and warehousing	6.9	7.6
Tourism and catering	2.2	0.8
Information and communication	2	1.9

Other	19.7	20.1
Net taxes on products and import	10.2	10.2

*Source: SSC*

CBA's real sector survey findings confirm that the negative effect of the pandemic gradually subdues. The BCI varied across sectors.

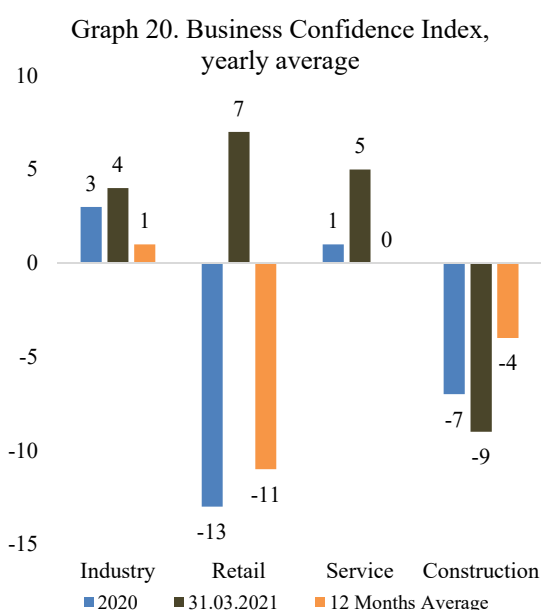
The BCI in the industry was positively zoned over the first three months of 2021. Production of chemicals, metallurgy, food and beverages, non-metal mineral products contributed to this outcome. Average quarterly index was negatively zoned in construction, production of plastic ware and machine building.

The BCI on trade with averagely negative behavior was replaced by growth in February and March. Economic activity indicators entered a positive zone across all trade sectors (automobile, furniture, electric appliances and houseware) in Q1 2021.

The BCI on services in general settled in a positive zone. The BCI was positively zoned in communication, healthcare and transportation, and negatively zoned on other sectors (postal

service, hotels and tourism) quarterly. According to RSM findings, in general, services (hotels in particular) were one of the most pandemic-affected sectors.

The BCI on construction was in a negative zone as in 2020.



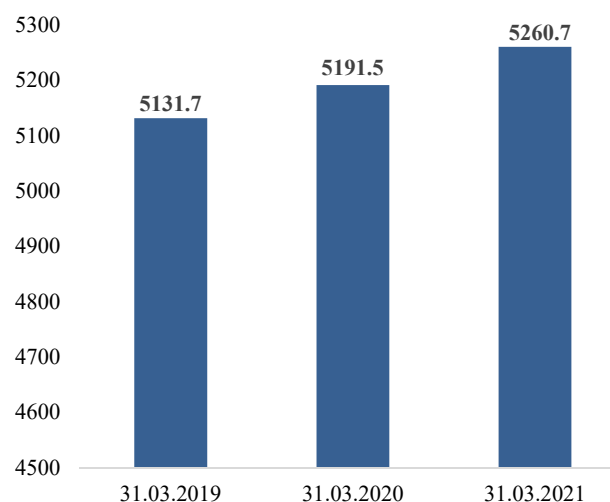
Source: RSM findings based CBA estimations

**Employment.** As of 1 April 2021, labor force was numbering 5260.7 thousand persons, yoy up by 69.2 thousand persons. The number of employed population was 4890.4 thousand persons, yoy down by 46 thousand persons.

The number of hired labor was 1679.7 thousand persons as of 1 April 2021, yoy up by 2%: those involved in

the public sector was 915.3 thousand, non-public sector 764.4 thousand.

Graph 21. Labor force, end of period, in thousands



Source: SSC

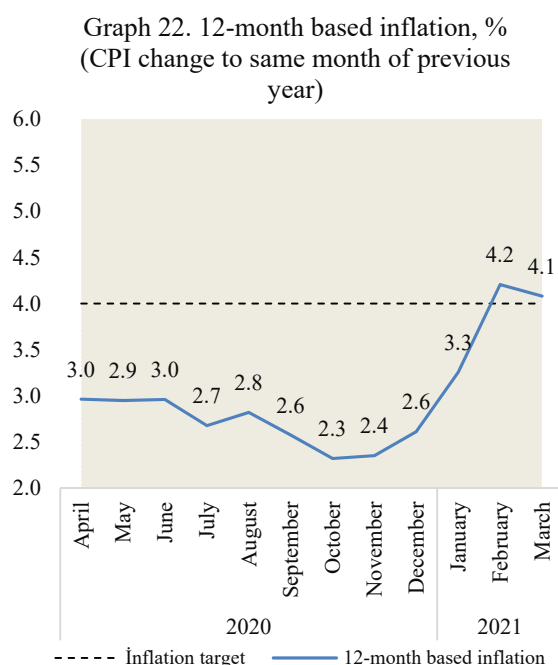
23.5% of the hired labor in enterprises and organizations was involved in production: 7.4% in processing, 7.3% in construction, 3.5% in agriculture, forestry and fishery, 2% in mining, 1.7% in water supply and waste management.

## 2.3. Inflation

*In Q1 2021 inflation moved within the announced annual target band ( $4\pm2\%$ ).*

### **Consumer Price Index (CPI).**

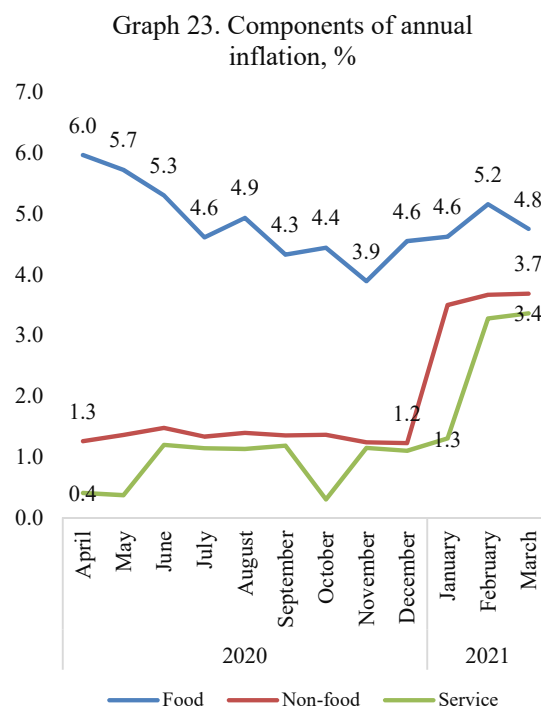
According to the SSC, in March 2021, the 12-month inflation was 4.1% (within the target band announced by the Central Bank ( $4\pm2\%$ )).<sup>3</sup>



Source: SSC

The price index across food products with a considerable share in the consumer basket increased by 4.8% over the recent 12 months. Another inflation components like

non-food stuff and services falls behind the target band center (3.7% and 3.4% respectively). Low non-food inflation is mainly due to the cost factors.

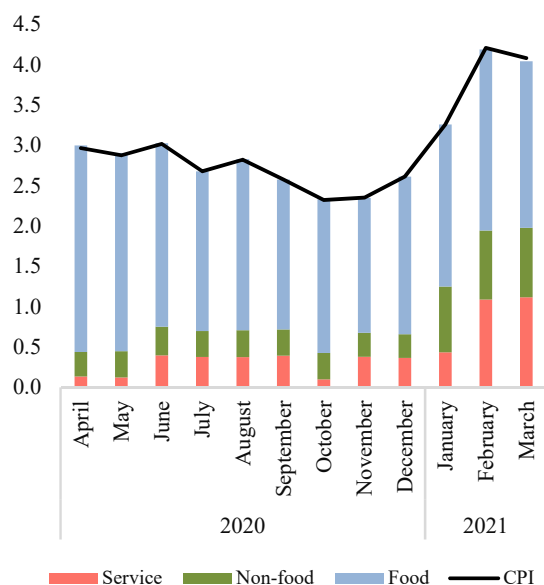


Source: SSC

Food prices contribute 2.1 pp, nonfood 0.9 pp, and services 1.1 pp to the annual inflation. Over the reporting period, the contribution of the price hike of non-food stuff and services to inflation increased.

<sup>3</sup> According to SSC, average annual inflation was 3.9%.

Graph 24. Contributions to CPI , in percentage points



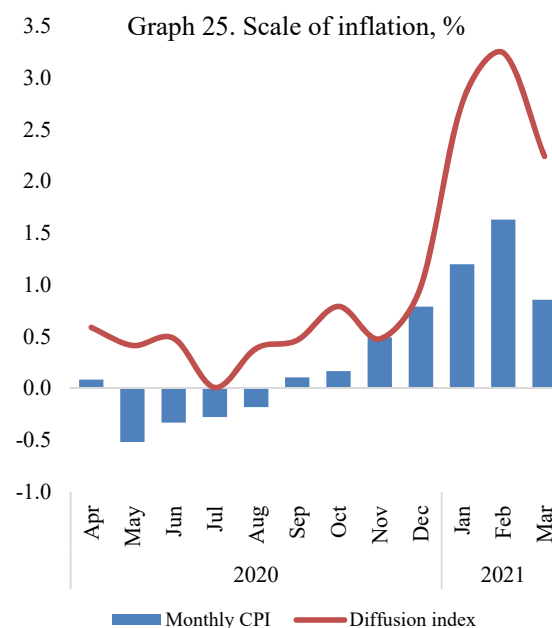
Source: SSC, CBA

Price hike was 4.7% on food products, 1.7% on alcoholic drinks and 8.7% on tobacco products.

The diffusion index – a measure of the change in dynamics pertaining to the number of goods and services with rising and falling prices in the consumer basket

was variable.

4



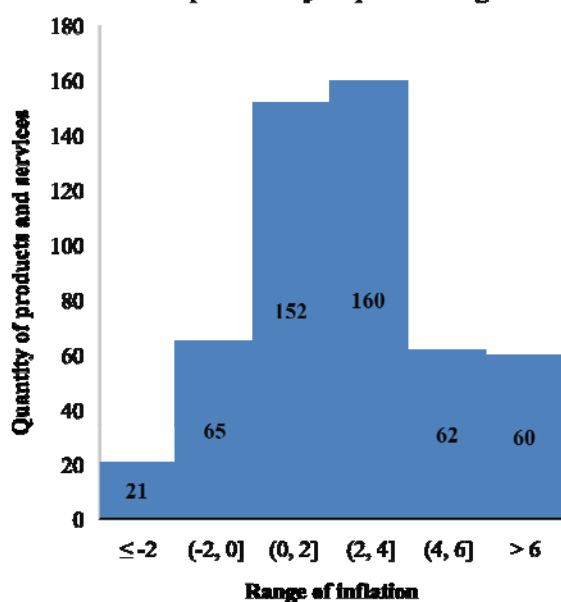
Source: SSC data-based CBA estimates

Of the 520 items of goods and services included in the consumer basket, the prices for 312 or 60% increase in the range of 0-4% annually. In 35% of rising prices, the price increase was less than 2%.

<sup>4</sup> The index is calculated as  $\frac{(\text{increasing} - \text{decreasing})}{(\text{decreasing} + \text{unchanged})}$



**Graph 26. Distribution of annual inflation rate of product and services included in CPI basket, number of products by respective range**



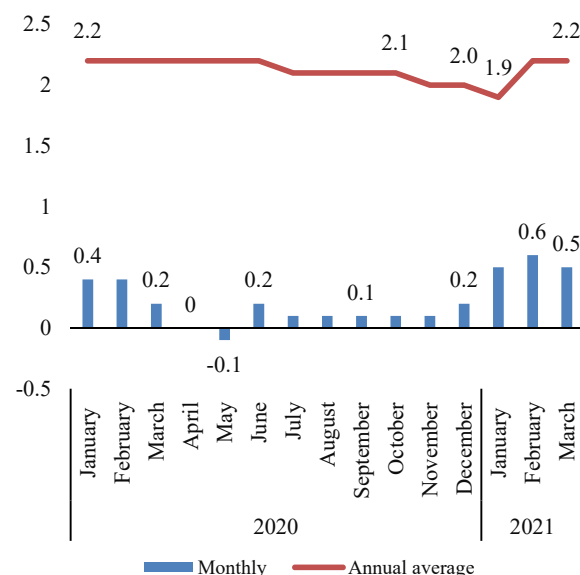
Source: SSC, CBA

Cost factors like the rise of some administrative prices and price hike for global food prices affected the dynamics of inflation over the reporting period. Influence of aggregate demand on inflation may be assessed as neutral since it still falls below supply. The FX market balance continued to play an important role in price stability. Improved balance of payments and a counter-cyclic macroeconomic frame supported this balance.

Average annual core inflation calculated by excluding swings in regulated prices and prices for seasonal

agricultural products was 2.2% in Q1 2021.

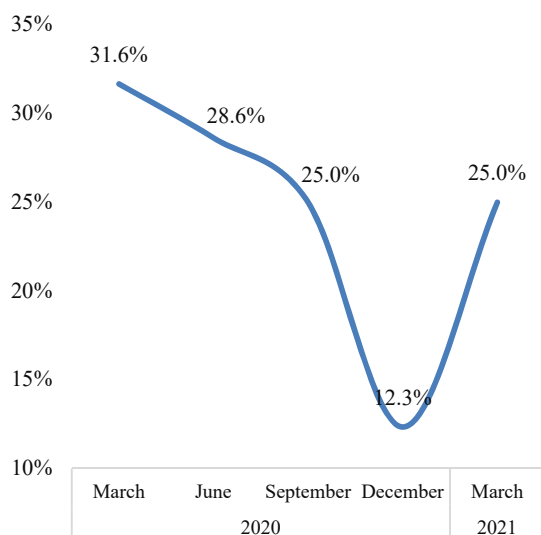
**Graph 27. Change of core inflation in the current year, %**



Source: SSC, CBA

The dynamics of actual inflation over recent months weighed in on inflation expectations. According to RSM, in March, inflation expectations increased in the non-oil industry, construction and trade and decreased in services vs February. The March survey among households suggest that the weight of respondents expecting high inflation slightly increased.

Graph 28. Share of households expecting increase of inflation rate



Source: CBA

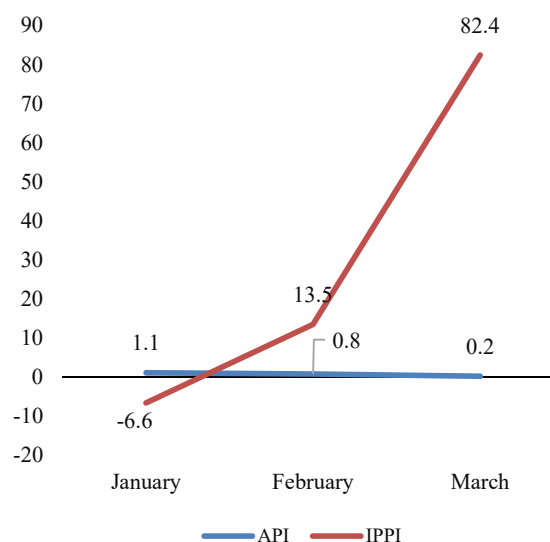
If current macroeconomic policy framework is maintained, forecasts indicate that inflation is expected to be within the target band ( $4\pm 2\%$ ) as of end-2021.

**Producer Price Index.** In March, the APPI increased by 0.2% over the recent twelve months. Annual growth rate of the APPI has been declining since the early year. In March, prices decreased by 0.5% on animal products on annual basis and, increased by 0.4% on plant growing products. In parallel, the PPI on forestry decreased by 2.7%, and increased by 4.5% on fish and other fishery products.

In March, the IPPI increased by 82.4% on annual, mostly due to the mining industry (up by two times). Price hike in the mining industry mainly relates to a year over year rise of the oil price in world markets.

The PPI on processing increased by annual 4.6%. The highest price hike was in the chemical industry (39%), production of pharmaceuticals (14.7%) and food production (7%).

Graph 29. Annual change of PPI at the current year, %



Source: SSC

In March 2021, prices for transportation services increased by 6.7% on annual. The cost of freight transportation increased by 3.7% and passenger transportation by 22.7%.

Prices for postal and courier services increased by 1.8%, while for communication services remained unchanged.

## II. THE MONETARY AND EXCHANGE RATE POLICY

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

*The exchange rate of the manat shaped by the demand and supply in the FX market in Q1 2021. The FX market was in equilibrium over the quarter.*

FX market operations decreased, attributable to de-dollarization trends.

Cashless transactions in the FX market yoy decreased by 24.5% to \$5.9B equivalent<sup>5</sup>: 85.6% in USD and 14.4% in other currencies. The Interbank FX market accounts for 30.6% and the Intrabank FX market for 69.4% of operations.

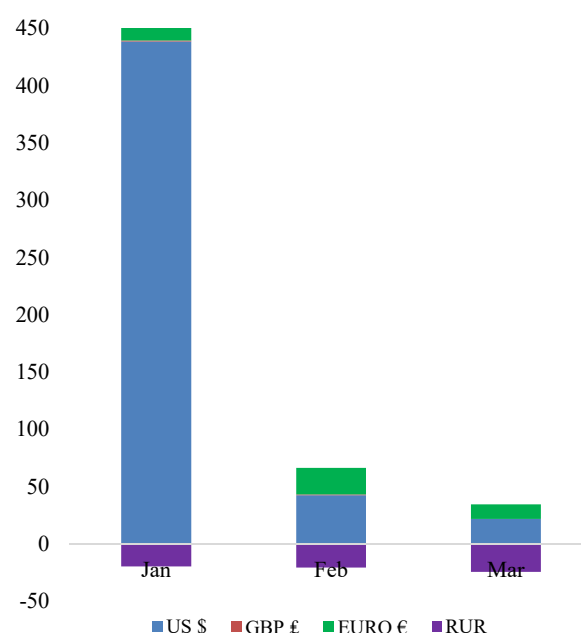
99.5% of operations in the Interbank FX market was denominated in USD, 0.5% in EUR. Currency operations in the Interbank FX market were mainly conducted over the Bloomberg platform.

Intrabank FX market operations made \$4.1B equivalent (79.4% in USD). Legal entities account for 95.2% of the

foreign currency operations in the Intrabank FX market.

Cash currency traded by banks yoy decreased by 2 times to \$1.1B equivalent (89% in USD). Cash currency was mainly traded in January.

Graph 30. Net sales of cash FX by banks in IQ 2021, mln.manat



Source: CBA

Positive zone stands for sell, negative zone for buy operations.

The CBA continued currency auctions to arrange the sale of foreign currency provided by the State Oil Fund of Azerbaijan Republic (SOFAZ). Market participants were informed on auction parameters via the Bloomberg

<sup>5</sup> Including operations in USD, EUR, GBP, ruble

terminal prior to auctions. The Bank held 23 currency auctions in Q1. Though increased in January, demand in the FX market has decreased and stabilized since February.

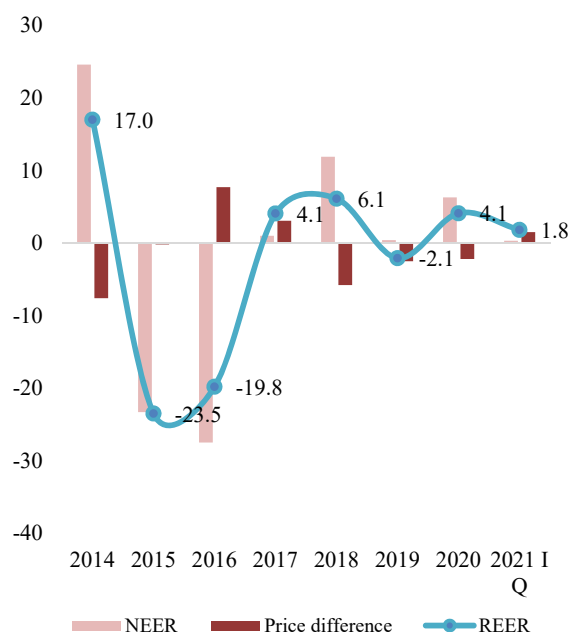
The official exchange rate of the manat was set on the basis of the average exchange rate on interbank transactions in 2020 (both auction and over-the counter on the Bloomberg platform). The average official AZN/USD exchange rate was AZN1.7. Buy-sell exchange rates set by banks were close to the official one. Commercial banks' average buy/sell rate was 1.6993/1.7024.

The exchange rate of the manat varied against the currencies of trade partners. It appreciated against the euro, the Swiss franc, the Japanese yen, the Turkish lira, the Russian ruble and the Georgian lari and depreciated against the Ukrainian hryvnia and the pound.

The dynamics of bilateral exchange rates influenced that of multilateral exchange rates. Total trade weighted non-oil NEER of the manat appreciated 0.3%, and the REER by 1.8%. Inflation in Azerbaijan being lower than the average inflation in trade

partners had a downward effect on the REER.

Graph 31. Effective exchange rates  
(annual change)



Source: CBA

To note, the REER of manat has depreciated by 29.7% since end-2014, contributing to long-term non-oil competitiveness.

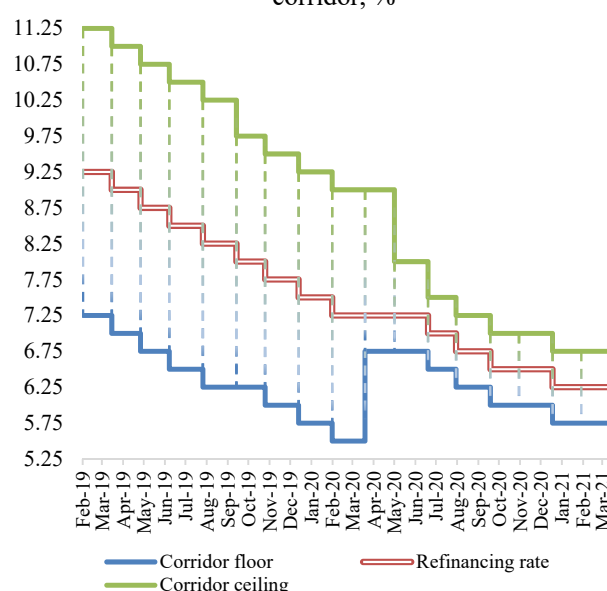
### 3.2. Monetary policy tools

*In Q1 2021, monetary policy tools were applied in light of the inflation target ( $4\pm 2\%$ ) and the trajectory of actual inflation, as well as the liquidity position of the banking system.*

The Central Bank took interest rate corridor parameters related decisions considering pass through of developments in the global environment to the domestic economy, the recovery rate of the economy, and the balance of risks. The Management Board of the Central Bank discussed interest rate corridor parameters twice in Q1 2021. The Board decided to leave the refinancing rate unchanged at 6.25%, the ceiling of the corridor at 6.75% and the floor at 5.75% in light of the macro economic situation and medium term forecasts. The decisions served to maintain an optimum balance between macroeconomic stability and economic activity. The CBA made interest rate related decisions public under a pre-announced schedule and with relevant analytical comments.

To effectively manage liquidity in the economy the CBA continued the usage of the open market operations. Depending on the liquidity position of the banking system, demand for CBA's sterilization operations varied across months.

Graph 32. Parameters of interest rate corridor, %

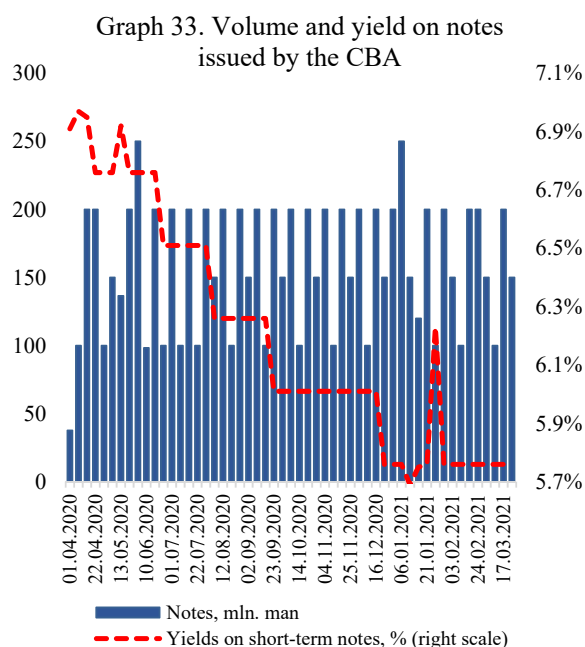


Source: CBA

Under the new framework on regulation of the size of sterilization tools the Bank intends to hold 84-, 168- and 252-day note auctions along with 28-day notes, and if necessary, 14-day deposit auctions.

The CBA held 14 note auctions in Q1 2021 – long-term (84-, 168-, 252-day) notes were placed at 3 and 28-day

notes were placed at other 11 auctions. Total outstanding amount of sterilization via notes was AZN820M as of end-quarter.



Source: CBA

Demand prevailed over supply at auctions on placement of notes; as a result, yield on these tools was close to the floor of the interest rate corridor.

Return on sterilization tools has become an important representative indicator of the money market and is translating to the interest rates on other financial tools. In addition, CBA notes actively used in the REPO market as collateral have a positive effect on interbank market activation.

Reserve requirements were left unchanged and are still applied on an average basis to allow banks to flexibly manage the liquidity. Monitoring findings display that banks' cumulative balances on correspondent accounts with the CBA significantly exceeded total funds to be maintained as required reserves.

### 3.3. Money supply

*In Q1 2021, money supply was driven by seasonal factors. Money supply, considerably fallen early quarter, started to gradually increase from February onward.*

Base money in manat decreased by 1.8% to AZN13.3B end-quarter, mainly owing to increase in balance of the single treasury account due to state budget surplus.

Table 4. Money aggregates, billion AZN

	01.01.21	01.04.21	Growth rate (%)
<b>M0</b>	10.8	10.6	-1.7
<b>M1</b>	17.9	17.6	-1.3
<b>M2</b>	20.3	20.3	0.1
<b>M3</b>	29.2	29.3	0.4

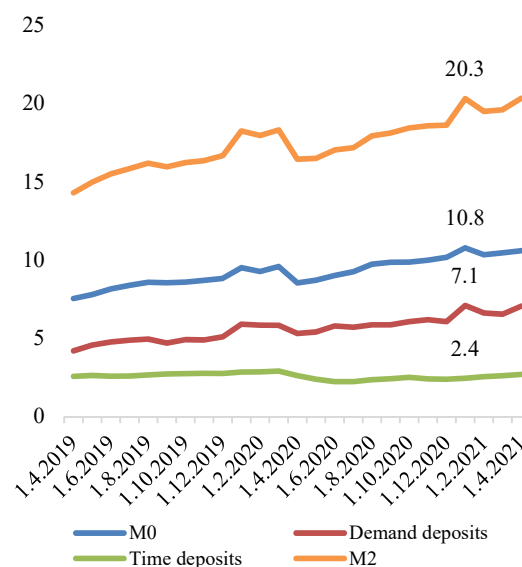
Source: CBA

Cash in circulation, a structural element of base money in manat<sup>6</sup> and stock of correspondent accounts in manat decreased by 0.3% and 19% respectively.

<sup>6</sup> Cash money outside the banking system, cash in bank ATMs and cash offices

Broad money supply in manat increased by 0.1% to AZN20.3B.

Graph 34. Dynamics of broad money supply, billion manat



Source: CBA

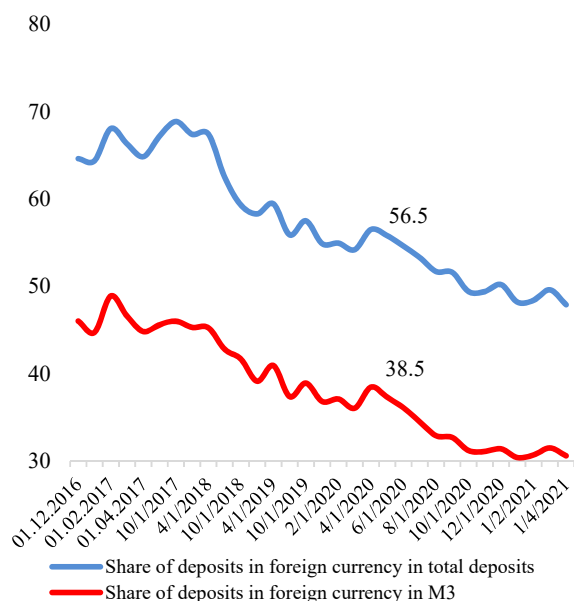
Cash in circulation, demand and term deposits in the structure of money supply in manat (M2) performed differently.

Cash in the structure of broad money supply decreased by 1.9% (52.1% of M2), manat denominated demand savings and deposits decreased by 0.7% (34.7% of M2), while term deposits increased by 10.1% (13.2% of M2). Manat denominated deposits of legal



entities increased by 8%, and savings of individuals increased by 0.5%.

Graph 35. Dollarization, %



Source: CBA

Broad money supply increased by (M3) 0.4% to AZN29.3B. Net Foreign Assets (NFA) had an upward, while Net Domestic Assets (NDA) a downward effect on broad money supply in manat: NFA increased by 1.54% and NDA decreased by 1.7%.

The dollarization of deposits decreased in Q1. The share of foreign currency denominated savings and deposits in total savings and deposits decreased from 48.2% (December 2020) to 47.9% (end-March). The share of foreign currency denominated savings

and deposits in M3 money aggregate was 30.6% as of end-quarter (up by 0.2% vs December 2020).

The share of foreign currency in deposits of legal entities decreased from 58.1% (December 2020) to 56% (March 2021).

Dollarization of savings of individuals also decreased over the quarter – from 50.7% (end of the previous year) to 50.3% (March 2021).

## Graphs and tables

### Graphs

Graph 1	Business and Consumer Confidence indexes in OECD countries -----	4
Graph 2	Economic growth forecast -----	4
Graph 3	Commodity price index -----	8
Graph 4	World oil market -----	9
Graph 5	Trade balance -----	11
Graph 6	Main trade partners-----	11
Graph 7	Crude oil and oil product exports -----	12
Graph 8	Natural gas exports -----	12
Graph 9	Change in export of certain products -----	12
Graph 10	Dynamics of import across sectors -----	13
Graph 11	Change in import of certain products -----	13
Graph 12	Money remittances to the country-----	14
Graph 13	Foreign investments-----	14
Graph 14	Real change in sales in the consumer market -----	15
Graph 15	Rise in spending items in trade turnover -----	15
Graph 16	Growth of income and salaries -----	17
Graph 17	Dynamics of investments-----	18
Graph 18	Sectorial breakdown of value added -----	19
Graph 19	Economic growth in 2021 Q1-----	19
Graph 20	Business Confidence Index -----	21
Graph 21	Economically active persons -----	21
Graph 22	12-month inflation -----	22
Graph 23	Components of annual inflation -----	22
Graph 24	Contribution to CPI-----	23
Graph 25	Scale of inflation-----	23
Graph 26	Distribution of inflation -----	24
Graph 27	Change of core inflation-----	24
Graph 28	Households expecting high inflation-----	25

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Graph 29	Annual PPI change-----	25
Graph 30	Cash foreign currency sale by banks-----	27
Graph 31	Effective exchange rates-----	28
Graph 32	Interest rate corridor parameters -----	29
Graph 33	Volume and yield on notes placed by the Central Bank -----	30
Graph 34	Dynamics of broad money supply in manat-----	31
Graph 35	Dollarization-----	32

### **Tables**

Table 1	Share of spending items in trade outlet-----	16
Table 2	Investment Sources-----	18
Table 3	GDP structure-----	20
Table 4	Money aggregates -----	30

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