MONETARY POLICY REVIEW
JANUARY-SEPTEMBER 2020
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ACRONYMS

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

The monetary policy of the CBA over 9 months of 2020 was oriented towards maintaining inflation within the target band (4±2%).

The monetary policy was implemented on the backdrop of sharp fluctuations triggered by coronavirus (COVID-19) outbreak and considerably high uncertainties in the global and domestic economic environment.

Inflation remained below the target center amid predominance of factors in the economy that have a downward effect on inflation. In the environment of pandemic triggered uncertainties low consumer and investment expenses and shrinkage of aggregate demand acted as the main anti-inflationary factor. On the other hand, an economic policy framework oriented towards safeguarding price and macroeconomic stability supported price stability. Though varied across sectors inflation expectations were close to actual indicators on all economic agents. FX market stability contributed to low inflation and inflation expectations.

Over the reported period monetary policy decisions were taken to ease the monetary condition. Changes made to interest rate corridor parameters were oriented towards reconciliation of macroeconomic stability targets with the priorities of supporting economic activity. To safeguard macroeconomic stability the CBA adequately applied monetary policy tools depending on the situation.

Negative effects of the pandemic translated into economic activity indicators as well. Economic activity was supported by stimulating fiscal and monetary policy and ongoing macro prudential easing. Macro prudential regulatory concessions introduced to support pandemic affected businesses and financial sector, provided additional support for monetary easing transmission and improvement of real sector lending conditions.
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1. Global economic trends

Over 9 months of 2020 the dynamics of the global economy reacted to the severity of quarantine measures by national governments. Relatively slowed down to the middle of the year the COVID-19 pandemic strengthened again from August forcing many countries to restore restrictive measures again. Despite faster than expected recovery in China, pace of return of global economic activity to pre-pandemic levels is very slow. In general, the global economy remained highly uncertain, lockdown measures both decreased consumption and investments and had a negative effect on production and trade.

**Global economic activity.** Activity in the global economy lessened due to pandemic. Though the Business Confidence Index (BCI) across OECD countries (62% of the global economy) in Q3 returned to its early year level after a sharp decline in Q2, the Consumer Confidence Index (CCI) is still much lower than in early year, despite a slight increase in Q3.

![Graph 1. Business and Consumer Confidence indexes in OECD countries](image)

*Source: OECD*

International financial institutions revise their global economic activity related forecasts differently in light of observed trends. The IMF revised up its global economy forecast in October. According to new forecast released with the World Economic Outlook (WEO) the global economy will shrink by 4.4% in 2020. The reason for revising up was that early in Q3 COVID-19 pandemic related restrictions were gradually removed and
the process of recovery was expected to accelerate by the end-year.

According to IMF October Update, the US economy will shrink by 4.3% in 2020 (8% in June Update). The main reasons for better expectations are due to gradual decrease in pandemic related restrictions. The US economy shrank by 9% in Q2 and by 2.9% in Q3, ending the longest period of expansion in its history. In September unemployment decreased by 0.5% vs August to 7.9%, lower than expectations for the month (8.2%). The number of the unemployed decreased by 1 million to 12.6 million.

The Dow Jones dropped by 4.2%, S&P 500 by 22.8%, while they gained by 7.3% and 4.2% respectively in Q3. The size of investments and industrial production also weakened in the USA. In September industrial production decreased by 7.3% on annual and by 0.6% vs August. In response to the crisis, the government and the central bank continued a wide range of stimulus policy measures. On the backdrop of negative zoning of economic growth, the FED has decreased interest rates from 1.5-1.75% to 0-0.25% stepwise since early year. The FED has announced that it will extend the lending facilities scheduled to expire by 30 September until 31 December, and short-term liquidity lines and temporary repurchase agreements by 31 March 2021.

According to the IMF October Update, the euro area economy will shrink by 8.3% (10.2% in June Update) in 2020. Industrial production in September decreased by 0.4% vs August, and y/y by 6.8%, mainly attributable to drop in industrial production in Germany (9.6%),
France (6.2%) and Spain (5.7%). Following market expectations, unemployment in the euro area was prone to rising (8.3% in September). Gradual ease of lockdown measures in the region positively weighed in on both consumer and business confidence indices as of the end-period. In September 2020 the economic sentiment indicator shifted from 87.5 to 90.9 within a month showing recovery trends. Moreover, the FTSE Eurotop has lost 17.2% since early year, and 2.4% in Q3. Both fiscal and monetary measures continued in response to pandemic. On 4 June 2020 the ECB took a decision to increase the Pandemic Emergency Purchase Program (PEPP) to €1350B. At its 10 September meeting the ECB decided to leave the policy rate unchanged at 0% and leave at this level until inflation approximates 2%.

In 2020 the Japanese economy will shrink by 5.3% (5.8% in the June Update). Unemployment in September 2020 remained unchanged at 3%. In September industrial production increased by 4% vs August, and y/y decreased by 9%. There has been a significant decline in the country's tourism sector. The number of foreign tourists visiting the country in August 2020 y/y declined by 2 times. Postponement of the Tokyo Olympics, scheduled for July 2020, had an additional negative effect on the tourism sector. Gradual removal of lockdown measures in Q2 had an upward effect on consumer confidence. While the Nikkey has lost 1.6% since early year, it gained 4% in Q3. To support the economy the Bank of Japan decided to increase the size of coronavirus lending to ¥110T from ¥75T on June 16. Moreover, ¥117.1T worth emergency economic package announced by the Japanese government on May 27 was designed to support businesses, households, and healthcare, and make transfers to local governments.

According to the IMF October Update, GDP will shrink by 9.8% in the United Kingdom in 2020 (10.2% in June Update), the lowest indicator since 1955 when economic growth rate statistics was
disclosed. In Q3 2020 GDP y/y decreased by 9.6%. Sharp deterioration of the global economic condition reduced demand for UK exports and uncertainties had a negative effect on investments in the country. In the UK industrial production in September 2020 increased by 0.5% vs August, and y/y decreased by 6.3%. In September unemployment stood at 4.8%, the highest indicator since the last quarter of 2016. The pound appreciated by 4.3% against the USD in Q3. As part of the anti-crisis measures, the government and the central bank continued wider fiscal and monetary support measures. The Bank of England cut the interest rate by 0.65 pp from 0.75% to 0.1%, and increased its government and non-financial corporate bond purchases by £200B.

According to the IMF October Update EMEs will shrink by 3.3% in 2020 as a result of the pandemic triggered economic crisis (3% in June Update). Emerging European Markets will contract by 1.7%, while Emerging European Markets will contract by 4.6%. Latin America and the Caribbean are expected to recess by 8.1%, the Middle East and Central Asia by 4.1%, and Sub-Saharan Africa by 3%.

As in the June Update in the October Update as well the Chinese economy is expected to have positive economic growth (1.9%). Amid removal of lockdown measures in Q3 economic activity indicators followed recovery trends. Recovery in China is faster than in other countries; in Q3 economic growth rate y/y stood at 4.9%, up by 1.7 pp vs Q2. In September industrial production increased by 1.2% vs the previous month, and y/y by 6.9%. Similar trend was observed in investment to capital stock. Unemployment in September stood at 5.4%, down by 0.2 pp vs the previous month. The CCI in September increased vs the previous month, attributable to low uncertainties in people’s economic expectations. To support the economy in June 2020 the People’s Bank of China decided to temporarily purchase 40% of unsecured loans issued by local banks to
SMEs with 6-month maturity due to pandemic.

Economic shrinkage in Russia will stand at 4.1% according to the October Update. In Q3 economic shrinkage y/y was 3.6%, down by 0.9 pp vs expectations. Unemployment decreased to 6.3% in September, down by 0.1 pp vs the previous month. In September industrial production remained unchanged vs the previous months, y/y decreased by 5%. At the same time, the BCI was negatively zoned too. In Q3 the BCI shifted to -22 from -30 in Q2. Pandemic triggered uncertainties and unfavorable oil prices resulted in 27.4% depreciation of the ruble over 9 months. In Q3 easing of lockdown measures in certain countries and less oil price volatility due to oil production cut by major producers is expected to have an upward effect on fiscal revenues of the country. On 19 June 2020, the Central Bank of Russia eased the monetary policy and cut the interest rate to 4.5% and left unchanged in Q3. At the same time, the Russian government developed Economic Recovery Plan to reduce unemployment and increase economic growth rate by end 2021.

Turkey is expected to recess by 5% in 2020. Economic shrinkage in Turkey stood at 9.9% in Q2. In parallel to rising unemployment and low industrial production in September inflation was 11.75%. Pandemic triggered uncertainty and geopolitical tensions resulted in 31.3% depreciation of the Turkish lira over 9 months. To reduce macroeconomic effects of the pandemic and as part of anti crisis measures the Central Bank of Turkey has cut the interest rate from 12% to 8.25% since early year, but to avoid sharp depreciation of the lira increased the t rate by 2 pp to 10.25% at the end of Q3.

Uncertainty over the duration of recession and the pandemic weigh on global trade and investments. The IMF’s updates forecast more than 10% drop in global trade in 2020. According to the World Investment Report by the United Nations Conference on Trade and Development (UNCTAD) global FDIs will decrease by over 40% in 2020 and by 5-
10% in 2021 and recovery will start in 2022.

**Commodity markets.** In 2020 commodity prices in the global market were very volatile. According to the WB’s recent Commodity Markets Outlook, over 9 months of 2020 energy prices decreased by 33.7%, non-energy prices increased by 4.5%, and food prices by 1.5%. Price changes varied across months. In Q3 energy prices increased by 5.4%, non-energy commodity prices by 9.6%, food prices by 6.1%, precious metal prices by 15.4%. The price for gold increased by 6.8% in Q3.

Energy price swings mainly stemmed from oil and natural gas prices. According to WB’s recent commodity price data, the natural gas price index decreased by 17.2% in Jan-Sep 2020.

Average global Brent oil price was $42.3 per barrel over 9 months 2020. Oil prices varied across quarters too. In Q3 average price was $43.3, up by 30.1% from the average price for Q2. According to Oil Market Report October 2020 of the International Energy Agency, global demand is expected to be 97.2 mln. b/d in 2020, 1.2 mln b/d lower vs the previous year forecast.

*Source: Energy Information Agency (EIA)*
Risks. The pandemic keeps translating to global economic activity. According to the WEO October Update, global economy related uncertainties due to the pandemic are relatively diminishing.

The risk of global poverty continues to remain relevant. 90 million people are at risk of falling below $1.9 income a day. Moreover, effects of the pandemic on schools and universities seriously damage the quality of human capital.

In general, international financial institutions note that the following major risks currently exist for the global economy:

- Break in supply chain;
- Liquidity and bankruptcy risks;
- Further rise in unemployment and poverty;
- Inability of weak economies to borrow;
- High interest rates and risk premiums.

In this situation, it is necessary to intensify efforts in several directions.

First, countries must work together internationally for vaccination and treatment. International cooperation must contribute to production of sufficient vaccines and their availability for all countries.

Second, policies should tend to prevent economic damage on a regular basis. Authorities should continue to provide financial support to households and companies to prevent bankruptcy and rising unemployment.

Finally, implementation of all these policies should base upon medium and long term sustainable and stable economic growth. In addition, accommodative fiscal and monetary policies should be used in conjunction with macro prudential instruments to avoid additional financial risks.
1.2 External sector developments of the Azerbaijani economy

The foreign economic position of Azerbaijan was driven by the COVID-19 pandemic and price swings of key export products over 9 months of 2020.

According to the SCC, over 9 months of 2020 foreign trade turnover amounted to $18.4B – exports $10.6B (or 57.6%), imports $7.8B (or 42.4%). Foreign trade surplus amounted to $2.8B.

Azerbaijan traded with 178 countries over the period.

Source: SCC

Italy, Turkey, Russia, China, Germany and Ukraine account for over half of trade turnover. As in previous periods, Italy took the highest share in trade turnover.

The share of trade turnover with Italy in total trade y/y increased by 0.7 pp to 18.6%, with Turkey by 4.3 pp to 17.6%, with Russia by 2.2 pp to 10.5%, with China by 1.2 pp to 7.8% and with Ukraine by 0.7 pp to 3.2%. The share of trade turnover with Germany in total trade decreased by 1.5 pp to 3.4%.
Export decreased by 28.8%, while non-oil export decreased by 9.3%. The value of export decreased by 36.5% on crude oil, by 35.2% on oil products and increased by 4.5% on natural gas.

Oil export y/y decreased by 7% in Q1, by 25% in Q2, and by 31% in Q3. While non-oil export increased by 3% in Q1, it decreased by 7% in Q2 and by 9% in Q3.

Export of fruits and vegetables increased; the value of export increased by 3.2% on fruits and vegetables.

Commodity import decreased by 24.6%; import on the public sector decreased by 2.8 times to $1.3B, by 3.6% to $5.8B, and increased by 1.3% to $0.7B on individuals.

Main export partners were Italy (29.4%), Turkey (19.9%), Russia (4.7%), Greece (4.1%), China (4%) and India (3.9%).
External sector developments of the Azerbaijani economy

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Import y/y decreased by 15.9% in Q1, by 28.9% in Q2 and by 24.6% in Q3.

Import increased by 30.8% on pharmaceuticals, by 21.8% on vehicles and parts, by 3% on food products, and by 0.8% on ferrous metals and products, while it decreased by 27.9% on furniture, by 21% on fertilizers, by 14.2% on plastics and products, and by 3.8% on machinery and mechanisms.

Russia accounts for 18.4%, Turkey 14.4%, China 13%, the USA 6.7%, Germany 5.3%, France 4.3% and Ukraine for 4% of imported products.

According to initial data, money remittances to the country made up $641 M.
1.2. External sector developments of the Azerbaijani economy

The UK, Turkey, Russia, Iran, the USA, Japan, Malaysia, Switzerland and Norway account for major part of capital investments by foreign countries and international organizations.

Strategic foreign exchange reserves continued exceeding internationally accepted sufficiency norms. As of end-September 2020 strategic foreign exchange reserves sufficed to import 41-month goods and services (taking into account import of goods and services for Half I 2020). Strategic reserves exceeded broad money in manat (M2) 5 times (taking M2 money aggregate as of 01.10.2020). Strategic foreign exchange reserves exceed annual GDP.

Capital investments from foreign enterprises and organizations kept flowing. According to the SSC, FDIs amounted to AZN3.8B equivalent over 9 months (36.1% of total investments).

Source: CBA

Graph 11. Inflow of remittances, mln.$

Source: CBA

Graph 12. Foreign investments, mln. manat
II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

2.1. Aggregate demand

Aggregate demand and investment expenses decreased over 9 months of 2020 due to ongoing pandemic.

Consumption expenditures decreased in January-September.

Goods and services sold in the market to meet consumer demand y/y decreased by 7.7% in real terms to AZN33.5B. Cost of goods sold and services supplied by private entrepreneurs y/y decreased by 7.4% to AZN32.3 B (49.6% individual entrepreneurs).

Every consumer utilized on average AZN373.5 worth goods and paid services (y/y down by 6%).

The size of retail trade turnover y/y decreased by 1.6% to AZN28.1B. Food retail turnover increased by 3.1%, non-food turnover decreased by 6.3%.

Consumers spent 53.9% of their funds on food, beverages and tobacco at retail trade outlets (y/y up by 3.1% ). Expenses decreased by 14.2% on knitwear, clothes and shoes; 7.2% on electrical goods and furniture, 3% on other non-food staff. Expenses increased by 37.4% on pharmaceuticals and medical products.
Table 1. Share of spending items at trade outlets, %

<table>
<thead>
<tr>
<th>Spending item</th>
<th>2019, 9 months</th>
<th>2020, 9 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food, beverage and tobacco</td>
<td>50.6</td>
<td>53.9</td>
</tr>
<tr>
<td>Knitwear, clothes and shoes</td>
<td>18.1</td>
<td>15.7</td>
</tr>
<tr>
<td>Electric appliances and furniture</td>
<td>6.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Computers, telecommunication devices and others</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Pharmaceuticals and medicals</td>
<td>1.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Fuel</td>
<td>5.5</td>
<td>5.3</td>
</tr>
<tr>
<td>Other non-food items</td>
<td>17.5</td>
<td>16.8</td>
</tr>
</tbody>
</table>

Source: SSC

Every consumer purchased on average AZN168.5 worth food, beverage and tobacco, AZN144.1 worth nonfood items monthly for private consumption in retail trade.

Catering turnover y/y decreased by 2.1 times. Entities accounted for 46.3%, private entrepreneurs for 53.7% of catering turnover in the private sector. The value of paid services to the population decreased by 25.7% in real terms to AZN4.9B. Per capita paid services consumption y/y decreased by AZN169.1 in nominal terms.

As a result of the negative effect of the pandemic on the country economy over the reported period for the first time population’s nominal income declined – in Jan-Sep 2020 money income of the population decreased by 0.9% in nominal terms to AZN41.6B. Per capita money income decreased by 1.7% to AZN4173. Population’s disposable income decreased by 2.1% to AZN37.6B.

Nominal average monthly salary of hired workers increased by 17.1% to AZN706.6. Salary of employees involved in public entities was AZN624.1 (y/y up by 26.1%), while the salary of those employed with private entities was AZN810 (y/y up by 12.9%).

The loan portfolio of households, one of the consumer demand components has decreased by 3% since early year to AZN7.5B as of end-period.

Low economic activity and shrinkage of aggregate demand due to the coronavirus pandemic also weighed on
consumer behavior. The CCI generated from findings of the “Households’ financial behavior and intentions” September 2020 decreased vs the previous quarter. This index has been in a negative zone for the 4th quarter in a row. 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’. Drop in the CCI in Q3 is mainly attributable to worsened expectations on the financial situation of the country and families, and high unemployment expectations.

**Government spending** was critical for domestic demand too. State budget expenditures amounted to AZN18.6B, (y/y up by 11.7%).

According to the economic classification, 38.5% (AZN7171.7M) of state budget expenditures were allocated to social spending (compensation for employees, pension and social allowances, medicine and food) (y/y up by 21.8% or AZN1283M).¹

**Investment expenditures.** Investment to the country economy decreased by 3.8% to AZN10.4B. AZN6B worth funds were invested to the non-oil and gas sector, out of which 19.1% was used in the non-oil and gas industry. The public sector accounts for 38.8%, while the private sector for 61.2% of total investments.

![Graph 14. Dynamics of investments, (y.o.y.)](image-url)

Source: SSC

63.9% of investments stemmed from internal, while 36.1% from external sources.

Table 2. Investment sources, %

<table>
<thead>
<tr>
<th></th>
<th>2019, 9 months</th>
<th>2020, 9 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds of enterprises and organizations</td>
<td>57.5</td>
<td>59.9</td>
</tr>
<tr>
<td>Bank loans</td>
<td>7.3</td>
<td>6.5</td>
</tr>
<tr>
<td>Budget funds</td>
<td>26.9</td>
<td>22.3</td>
</tr>
<tr>
<td>Off-budget funds</td>
<td>1.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Population’s own funds</td>
<td>6.6</td>
<td>6.1</td>
</tr>
<tr>
<td>Other funds</td>
<td>0.2</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Source: SSC

Funds of enterprises and organizations still prevailed in total investments.
2.2. Aggregate supply and employment

As a result of negative effects of the pandemic that began to manifest itself from the last month of Q1 2020 real change of GDP is negatively zoned.

**Economic growth.** According to the SSC, in January-September real GDP y/y decreased by 3.9% to nominal AZN52.1 B. Per capita GDP made up AZN5222.5.

Oil and gas value added decreased by 6.4%. The mining sector extracted 26 m/t crude oil and 19.4 bln/m3 natural gas. Oil extraction y/y decreased by 7.65% and gas extraction increased by 8.3%.

Non-oil value added y/y decreased by 2.4% in real terms to nominal AZN36.3B.

**Graph 16.** Economic growth for 9 months in 2020, to corresponding period of previous year, %

Y/y drop in both oil and non-oil economic growth rate on the results of 9 months is attributable to the impact of the COVID-19 pandemic.

The non-oil industry y/y grew by 10.8%. Output increased by 13.5% in production of tobacco products, 29.2% in garment production, 20.1% in the chemical industry, 72.2% in production of vehicles, trailers and semitrailers, 30.4% in production of paper and cardboard, 74.9% in metallurgy, 39.7% in production of

**Graph 15.** Sectorial distribution of value added, %

Source: SSC
computers, electronic and optic products. Production of oil products decreased by 5.5%, electronic devices by 9.8%, furniture by 26.6%, installation and repairs of machinery and equipment by 41.8%. Amid high demand for pharmaceuticals due to the pandemic and establishment of local enterprises production of pharmaceuticals increased by 8.2 times. In general, production of intermediate consumer goods in industry y/y increased by 27.8%; production of means of production decreased by 6.9%, and production of energy products by 5.6%.

Agricultural production y/y rose by 1.5%; 3.1% on animal and 0.1% on plant products.

Table 3. GDP structure

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Share, %</th>
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<tbody>
<tr>
<td></td>
<td>2019 Jan-Sep</td>
</tr>
<tr>
<td>Industry</td>
<td>42.5</td>
</tr>
<tr>
<td>Construction</td>
<td>6.1</td>
</tr>
<tr>
<td>Agriculture, forestry, fishery</td>
<td>6.2</td>
</tr>
<tr>
<td>Trade, repair pf vehicles</td>
<td>10</td>
</tr>
<tr>
<td>Transport and warehousing</td>
<td>6.3</td>
</tr>
<tr>
<td>Tourism and catering</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Information and communication    1.8   2
Others                           15.7  19.1
Net taxes on products and import 8.9   10.2

Source: SSC

The CBA’s survey findings confirm that that the pandemic continues to have a negative impact on the economy. The BCI varied across sectors.

The tendency of the BCI to remain in the negative zone in the industry due to the pandemic from Q1 neutralized in September. Production of food and beverages, as well as production of construction materials had an upward effect on this neutralization. The chemical industry, production of textile, machinery and plastic ware was negatively zoned during the recent quarter.

The positive behavior of the BCI in trade in Jan-Feb was replaced by a decline over the next 7 months due to the pandemic. Economic activity indicators in trade of automobiles, furniture, household goods and home appliances remained in the negative zone in Q3.
The BCI in services was positively zoned over first 4 months and negatively zoned over the following 5 months. The BCI on communication was positively zoned across all months of the year, while all other sectors (post, transportation, hotels, tourism and healthcare) were negatively zoned. RSM findings suggest that services was one of the most pandemic affected sectors.

Though negatively zoned in January-July the BCI in construction followed a positive dynamics over recent 2 months and was positively zoned for the first time over recent 4 years.

Employment. As of end-September 2020 economically active population were numbering 5249.1 thousand persons, y/y up by 53.8 thousand persons. The number of employed population was 4884.9 thousand persons, y/y down by 58.7 thousand persons.

According to the SSC, as of 1 October 2020 the number of hired labor y/y increased by 2.6% to 1681.6 thousand: those involved in the public sector was 902.3 thousand, non-public sector 768.6 thousand. The oil-gas sector employed 34 thousand, non-oil gas sector 1636.9 thousand.

Graph 17. Economically active persons, end of period, thousands

24.9% of hired labor in enterprises and organizations was involved in production: 7.7% in processing, 8.3% in construction, 3.4% in agriculture, forestry and fishery, 2.1% in mining, 1.7% in water supply and waste management.

According to the SSC, average number of hours worked per employee was 151.8 hours at the end of 2019 and 136 hours over 9 months of 2020.
2.3. Inflation

In January-September 2020 inflation was below the announced target band center.

**Consumer Price Index (CPI).** According to SSC estimations 12-month inflation was 2.6% in September 2020 (Sep 2020 vs Sep 2019), below the center of the target band announced by the CBA (4±2%).

According to SSC, average annual inflation was 2.9%. Annual price hike on non-food stuff and services, other inflation components, considerably falls behind the target band center (1.4% and 1.2% respectively). Low non-food inflation is due to low demand amid pandemic. Stable administrative prices also factor in low non-food and service inflation.

Food prices contribute 1.9 pp, nonfood 0.3 pp, and services 0.4 pp to annual inflation.

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2 According to SSC, average annual inflation was 2.9%.
2.3 Inflation

Monetary Policy Review  ●  January-September 2020

Source: SSC, CBA

Food inflation was 3.9% on food products, 3.7% on alcoholic drinks and 18.4% on tobacco products.

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. Prices for 56 out of 520 items of goods and services declined and remained unchanged for 48 items. Price hike for 55.5% of products was below 2%.

\[ \text{Diffusion index} = \frac{(\text{increasing} - \text{decreasing})}{\text{decreasing} + \text{unchanged}}. \]

A stable exchange rate, monetary condition, dynamics of administrative prices and inflation expectations had stabilizing, while additional costs faced by economic agents to protect against the virus had an upward effect on inflation.

Average annual core inflation calculated by excluding swings in regulated prices and prices for seasonal agricultural products was 2.1%.

Inflation expectations elevated amid negative effects of the pandemic in Q1 dropped over recent months. According to RSM, in September inflation expectations
increased in the non-oil industry and trade compared to August, decreased in services and nearly remained unchanged in construction. Although households’ 3-month inflation expectations were higher, they started to drop from Q2. According to September survey among households the share of respondents expecting high inflation decreased 4 pp to 25% vs June.

**Graph 22. Share of households expecting increase of inflation rate**

<table>
<thead>
<tr>
<th></th>
<th>March 2020</th>
<th>June 2020</th>
<th>September 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.6%</td>
<td></td>
<td>28.6%</td>
<td>25.0%</td>
</tr>
</tbody>
</table>

**Source:** CBA estimations based on RSM data

Inflation will remain within the target band (4±2%) by the end of 2020, if the current macroeconomic policy framework is maintained.

**Producer Price Index.** According to the SSC, the GDP deflator, that measures price swings in all domestically produced goods and services decreased by 8.3%, mainly owing to low IPPI.

In September APPI increased by 2.4% over recent 12 months. Since June annual growth rate of the APPI has been declining. In September prices increased by 2.2% on animal products on annual and by 2.6% on plant growing products. In parallel, the PPI on forest products increased by 2.6%, and by 3.6% on fish and other fishery products.

The IPPI y/y decreased on annual by 21.4%, mostly due to the mining industry (down by 31.8%). Price slide in the mining industry mainly relates to oil price slump in world markets.

The PPI on processing decreased by annual 6.3%. The highest price slide was in production of oil products (20.1%), the printing service (9.4%) and production of tobacco products (6.6%).
In September 2020 prices for transportation services increased by 0.8% on annual. Prices for cargo services increased by annual 1%, and decreased by 0.5% for passenger transportation. The price for postal and courier services decreased by 0.1%, prices for communication services remained unchanged.

Source: SSC
II. 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 over 9 months of 2020. Albeit negative effects of external environment developments, due to concerted preventive measures by the Government and the CBA stability was safeguarded in the FX market.

Operations in the FX market decreased, attributable to weak foreign economic operations due to the pandemic.

Cashless transactions in the FX market y/y decreased by 4.1% to $18.7B equivalent\(^4\) - 86.7% of cashless operations were in the USD, and 13.3% in other currencies. The Interbank FX market account for 36.2% and the Intrabank FX market for 63.8% of operations.

99.3% of operations in the Interbank FX market was denominated in USD, 0.5% in EUR and 0.2% in other currencies. Currency operations in the Interbank FX market were conducted over the Bloomberg platform.

Intrabank FX market operations made $11.2B equivalent (79.4% in USD). Legal entities account for 93.6% of foreign currency operations in the Intrabank FX market.

Cash currency traded by banks y/y decreased by 2.6% to $4.2B ($3.7B, or 88.1% in USD). Over recent few months net sale of cash foreign currency (deducting buy currency from sell currency) have stabilized.

\(^4\) Including USD, EUR, GBP, RUB denominated operations.
3.1. The FX market and the exchange rate of the manat

The CBA continued currency auctions to arrange sale of foreign currency provided by the State Oil Fund of Azerbaijan Republic (SOFAZ). Market participants were informed on auction parameters via the Bloomberg terminal prior to auctions. The Bank held total 76 currency auctions over 9 months. Though increased in Q1, demand in the FX market has been decreasing and stabilizing since April.

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 over-the-counter 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 1.6990/1.7025. Difference between average daily official buy/sell exchange rates and those of commercial banks was 0.001/0.0025.

The exchange rate of the manat varied against currencies of trade partners – it appreciated against the Turkish lira, the Kazakhstani tenge, the Russian ruble, the Ukrainian hryvnia and depreciated against the euro, the Swiss franc and the Japanese yen.

Dynamics of bilateral exchange rates influenced that of multilateral exchange rates. Total trade weighted non-oil NEER of the manat appreciated 7.9%, while the REER appreciated 6.2%. Inflation in Azerbaijan being lower than the average inflation in trade partners had a downward effect on the REER.

Graph. 25. Dynamics of REER (annual change)

Source: AMB

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Graph. 25. Dynamics of REER (annual change)

Source: AMB
To note, the REER of manat has depreciated by 30% since end-2014, contributing to non-oil competitiveness.
3.2. Monetary policy tools

Monetary policy tools contributed to maintaining inflation within the target band (4±2%). In general, the monetary condition was eased over the period.

The CBA made necessary corrections to its interest rate corridor parameters of liquidity operations in light of the balance of risks and updated macroeconomic forecasts. The Board of Governors of the CBA discussed interest rate corridor parameters 6 times over 9 months and decided to reduce the refinancing rate stepwise from 7.5% to 6.5%, decrease the ceiling of the interest rate corridor from 9.25% to 7% and increase the floor from 5.75% to 6%. The decisions served to maintaining an optimum balance between macroeconomic stability and economic activity. The CBA's interest rate related decisions were made public under a pre-announced schedule and with relevant analytical comments.

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

To ease the threats posed by the coronavirus pandemic to macroeconomic stability and the FX market the CBA changed the term of sterilization tools and reduced their duration. 28-day deposit auctions were replaced with 14-day deposit auctions, long-term note auctions were replaced with 28-day issue of notes.

The CBA held 49 deposit auctions on attraction of excess funds in the national
currency. Total outstanding amount of funds attracted by deposit auctions was AZN 250M as of the end-September.

Along with deposit auctions, the CBA held 33 note auctions – 7 long-term (84-, 168-, 252-days), and 28-day notes at other 26 auctions. Total outstanding amount of sterilization via long-term notes was AZN 709M as of end-quarter.

Demand prevailed over supply to the end of the period at deposit auctions and issue of notes, as a result yield on these tools approached the floor of the interest rate corridor.

Return on CBA’s sterilization tools is translating into interest rates on other financial tools becoming an important representative indicator of the money market. At the same time, CBA notes actively used in REPO market as a collateral have a positive effect on activation of the interbank market.

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

Money supply varied across months over 9 months of 2020. Money supply significantly decreased last month of Q1 mainly due to surplus in the state budget gradually recovered from Q2 onward and smooth growth rate continued across all months of Q3.

Base money in manat increased by 0.6% to AZN12.2B as of end-period.

Cash in circulation, a structural element of money base in manat increased by 2%, stock of correspondent accounts in manat by decreased by 7.2%.

Table 4. Money aggregates, billion AZN

<table>
<thead>
<tr>
<th></th>
<th>01.10.20 B/AZN</th>
<th>01.04.20 (%)</th>
<th>01.07.20 (%)</th>
<th>01.10.20 (%)</th>
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</thead>
<tbody>
<tr>
<td><strong>M0</strong></td>
<td>9.9</td>
<td>-10.2</td>
<td>-2.7</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>M1</strong></td>
<td>15.9</td>
<td>-10.1</td>
<td>-3.0</td>
<td>3.4</td>
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<tr>
<td><strong>M2</strong></td>
<td>18.4</td>
<td>-9.8</td>
<td>-5.9</td>
<td>1</td>
</tr>
<tr>
<td><strong>M3</strong></td>
<td>26.8</td>
<td>-7.4</td>
<td>-9.2</td>
<td>-7.2</td>
</tr>
</tbody>
</table>

Source: CBA

Cash in circulation, demand and term savings and deposits (M2) performed differently and cash accounted for major part of broad money supply in manat.

Cash in broad money supply increased by 3.8% (weight in M2 - 53.5%), manat denominated demand savings and deposits increased by 2.8% (weight in M2 - 32.9%), while term savings and deposits
decreased by 11.9% (weight in M2 – 13.6%).

Manat denominated deposits of legal entities in manat increased by 6.9%, while manat denominated savings of individuals decreased by 12.6%.

Broad money supply (M3) decreased by 7.2% to AZN26.8B.

Net Foreign Assets and Net Domestic Assets had a downward effect on broad money supply: 69% - Net Foreign Assets, 31% - Net Domestic Assets.

Whereas dollarization of deposits slightly increased as of end-Q1, it was prone to decreasing from Q2, and kept declining in Q3 too. While foreign currency denominated savings and deposits accounted for 56.5% in total savings and deposits in March 2020, this indicator dropped to 53.3% end-June, and to 49.4% end-September. The share of foreign currency denominated savings and deposits in M3 money aggregate was 31.2% as of end-period (36.8% - end-2019).

The share of foreign currency in deposits of legal entities decreased from 65.6% at end-Q1 to 58.2% at end of 9 months. Dollarization of individuals decreased as well - 54% end Q1 and 53.9% end of 9 months.

Source: CBA
## Charts and tables

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