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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
SSC    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    The Consumer Price Index
APPI   The Agricultural Producer Price Index
SME    Small and Medium-sized enterprises
NEER   The Nominal Effective Exchange Rate
OPEC   The Organization of the Petroleum Exporting Countries
REER   The Real Effective Exchange Rate
RSM    Real Sector Monitoring
SİQİ    The Industrial Producer Price Index
GDP    Gross Domestic Product
WTO    The World Trade Organization
EXECUTIVE SUMMARY

The monetary policy of the CBA in Half 1, 2020 was oriented towards maintaining inflation within the target band (4±2%).

Over the reported period the monetary policy was implemented on the backdrop of high uncertainties triggered by coronavirus outbreak and sharp fluctuations in international commodity and financial markets.

Inflation was maintained within the target band. Shrunken aggregate demand and low consumer and investment expenses amid pandemic triggered uncertainties acted as the key anti-inflationary factor. Inflation expectations risen in Q1 stabilized in Q2. Stability in the FX market factored in low inflation and inflation expectations.

Corrections made to the interest rate corridor parameters, actions taken to support lending, as well as the dynamics of the balance of treasury account weighed in on the monetary condition. Decisions related to the interest rate corridor parameters were taken in light of the changes in the risks balance and were oriented towards reconciling macroeconomic stability targets with the priorities to support economic activity. The Central Bank adequately used monetary policy tools when applicable to meet demand of the economy for money and safeguard stability in the FX market.

Economic activity slightly declined due to negative effects of the pandemic. Fiscal stimulus packages, adequate monetary policy decisions, synchronized macro prudential actions prevented further drop in economic activity allowing to partially compensate losses in income of economic agents.
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1. Global economic trends

In Q2, 2020 most AEs eased quarantine restrictions, while major EMEs continued lockdown. In general, over the period uncertainties remained high in the global economy, lockdown restrictions had a downward effect on production and trade decreasing consumption and investments. Nevertheless, by the end period economic activity slightly revived, commodity prices recovered and there was slight easing of conditions in financial markets.

Global economic activity and pandemic response. In the first half of 2020 economic activity declined due to pandemic. While business and consumer confidence indices across the OECD countries slightly increased in June, they plummeted vs early year.

Given the observed trends international financial institutions revise down global economic activity related forecasts. According to the World Economic Outlook (WEO) Update June 2020 by the IMF, the global economy is projected to contract by 4.9% due to pandemic, 1.9 pp up vs the April forecast. The reason is that the COVID-19 pandemic is expected to hit economic activity more than expected in Half 1, 2020 and recovery will be more gradual.
According to the IMF, the US economy will contract by 8% (5.9% in April Update) in 2020. The main reasons for worsened expectations are higher pandemic-related uncertainties, and the probabilities that recovery will last longer than expected. The US economy shrank by annual 5% in Q1 2020, ending the longest period of expansion in the country's history. This is the sharpest decline of GDP since the last quarter of 2008. Unemployment peaked to 14.7% in April. In June it declined by 3.6 pp to 11.1%, lower than expected for that month (12.3%). The number of those applied for unemployment within 6 months accelerated in April and reached 23 million. The number of the unemployed decreased in May and June to 17.8 million as of end-June.

Since early year the Dow Jones index has decreased by 10.6%, S&P 500 by 25.9%. The size of investments and industrial production also weakened in the USA. The industrial production index decreased sharply. In response to the crisis the government and the central bank started a wide range of stimulus policies. Amid negatively zoned economic activity the US FED has decreased interest rates from 1.5-1.75% to 0-0.25% stepwise since early year. FED announced an extension of its lending facilities scheduled to expire on or around September 30 through December 31.

According to June Update of the IMF, the euro area economy will contract by 10.2% in 2020, 2.7 pp up vs the April Update. In April 2020 industrial production decreased by 18.2% vs the previous month, due to drop in industrial production in Spain (22.8%), France
(21%) Italy (20.5%) and Germany (20.2%). Over the period following the rising trend unemployment in the area was 7.8% in June. Gradual easing of lockdown restrictions in the region had an upward effect on both consumer and business confidence indices. In June 2020 economic sentiment indicator increased from 67.5 to 75.7 over a month. Moreover, the FTSE Eurotop gained 13.7% over the Q 2. 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. On June 3 the EC changed the budget and decided to allocate additional €11.5B against the crisis.

According to the June Update 2020 IMF, in 2020 the Japanese economy is expected to contract by 5.8%, 0.6 pp up vs the April Update. Unemployment in the country increased by 0.3 pp in March to 2.8% in June. In May the industrial production index decreased by 8.9% vs April, and y/y by 26.3%. At the same time, tourism decreased considerably – the number of foreign tourists visiting the country y/y decreased by 99.9% in June 2020. Postponement of the Tokyo Olympics, scheduled for July 2020, had an additional negative effect on the tourism sector. Gradual removal of lockdown restrictions by the end of Q2 had a positive effect on consumer confidence. In addition, the Japanese Nikkei gained 18.3% in Q2. 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 June Update, GDP is expected to shrink by 10.2% in the UK (6.5% in April Update), the lowest indicator since 1955 when economic growth rate statistics was disclosed. Demand for UK exports declined due to sharp deterioration of the global economic condition and uncertainties had a negative
effect on investments in the country. In Q2, 2020 unemployment was 3.9%, surpassing 4.2% expectations. The pound depreciated by 6.7% against the USD due to pandemic triggered higher risks in half 1, 2020. 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.

The IMF predicts 3% economic shrinkage in EMEs in 2020 because of the pandemic triggered economic crisis (1% shrinkage in April Update). Emerging Asian markets are expected to contract by 0.8% and Emerging European markets by 5.8%. In 2020, Latin America and the Caribbean are expected to recess by 9.4%, the Middle East and Central Asia by 4.7%, and Sub-Saharan Africa by 3.2%.

The June Update as the April Update expects positive economic growth (1%) in China in 2020. On the backdrop of removed lockdown restrictions in the country in Q2, a number of economic activity indicators recovered – economic growth rate y/y was 3.2% in Q2, 2020, 10 pp up vs Q1. While industrial production declined by 8.4% in March vs the previous month, this indicator decreased to 2.8% in May. Similar trend was observed in investment to capital stock. Unemployment in the country was 5.7%, 0.2 pp down vs the previous month. Despite all this, in Q2, 2020 consumer confidence index dropped, to be attributable to lingering 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.

According to the IMF June Update, in 2020 the Russian economy will shrink by 6.6%, 1.1 pp up vs the April Update. According to the estimations of the Ministry of Economic Development of Russia, economic growth rate y/y was -
12.1% in April 2020 and -10.9% in May. Unemployment increased to 6.2% in June, the highest indicator since March 2013. Compared to the previous month industrial production decreased by 9.2% in April and 5.5% in May 2020. At the same time, over the period consumer confidence index dropped. However, over Q2 rise in oil prices due to eased lockdown measures in a number of countries and oil production cut by major producers is expected to have a positive effect on fiscal revenues. On 19 June 2020, the Central Bank of Russia eased the monetary policy and cut the interest rate to 4.5%. 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 5% in 2020. To note, there was recorded 4.5% economic growth in Q1. In parallel with high unemployment and low industrial production, in June inflation rose to 12.6%. The Turkish lira depreciated by 15.2% over 6 months due to pandemic triggered uncertainty. To reduce macroeconomic effects of the epidemic and as part of anti-crisis measures the Central Bank of Turkey cut the interest rate from 12% to 8.25%, adopted a fiscal stimulus package.

Uncertainty over the duration of recession and the pandemic weigh on global trade and investments. The IMF forecasts 11.9% 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.

**Commodity markets.** Commodity prices hiked in the global market. According to the WB’s recent Commodity Markets Outlook in Q2, 2020 energy prices hiked by 15%, non-energy prices by 2.1%, food prices by 0.2%, and precious metal prices by 10%. The price of gold increased by 8.8% over Q2, 2020.
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 16.7% in April-June 2020.

Average global Brent oil price was $33.3 per barrel in Q2, 34.8% down from average price in Q1, 2020. In general, average price for Half 1 was $41.7. Main reasons for slump in oil prices are sharp drop in global demand due to COVID-19 pandemic and still higher than demand extraction. According to Oil Market Report July 2020 of the International Energy Agency, demand for oil is forecast to drop by 8.1 mln. b/d in 2020, 1.2 mln b/d lower vs the April forecast.

**Risks.** The pandemic keeps translating to global economic activity. According to the WEO June Update, global economy related uncertainties due to the pandemic are high enough. As a result of high economic and financial risks in countries interest rates may significantly rise. Given historical highs of lending and interest rates, it may lead to a financial crisis as a result of failure of various economies to meet their debt liabilities.

Despite sharp cut of interest rates by central banks and unconventional monetary policies, stress in global
financial markets may last long and lead to mass capital outflow from EMEs.

According to the WEO Update, June 2020, escalating economic and political tensions between the USA and China further increase pandemic related risks. Albeit low inflation and high debt in the global economy, protracted weak aggregate demand could lead to disinflation and debt service difficulties.

Sharp slowdown in the global economy and a hard lockdown continues increasing the global unemployment rate. Due to social isolation still ongoing across most countries, shrunk demand, break in a supply chain and other socio-economic reasons, medium and low income countries are facing the risk of rise in poverty along with the pandemic. According to the UN World Food Program forecast, the number of the people on the brink of starvation may reach 270 million as of the end 2020, y/y up 82%.
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 in Half 1, 2020.

According to the SCC, foreign trade turnover amounted to $12.7B – exports $7.7B (or 60.6%), import $5B (or 39.4%). Foreign trade surplus amounted to 2.7 B.

Graph 5. Trade balance, USD bn.

Source: SCC

Azerbaijan traded with 167 countries over the period.

Graph 6. Main trade partners, 2020 6 month, %

Source: SCC

Italy, Turkey, Russia, China, Ukraine and the USA 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 3.5 pp to 21%, with Turkey by 6.2 pp to 17.5%, with Russia by 2.1 pp to 10.2%, with Ukraine by 1.1 pp to 3.5%, with the USA by 0.8 pp to 3.3%. The share of trade with China in total turnover decreased by 0.3 pp to 7.2%.

Export decreased by 23%, non-oil export by 6.8%. The value of export
1.2. External sector developments of the Azerbaijani economy

decreased by 30.4% on crude oil, and by 37.6% on oil products, and increased by 20.3% on natural gas.

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

Main partners on non-oil export include Russia ($370.3M), Turkey ($177.2 M), Switzerland ($96.1M), Georgia ($76.7 M) and China ($28.3M).

Non-oil export to Russia y/y increased by 4.3%, to Switzerland by 30.7% and to China by 65.5%.

Commodity import decreased by 28.9% in Half 1, 2020: import decreased by 3.4 times on public sector to $0.8B, by 2.2% on private sector to $3.7 B, and increased by 10.7% $0.4 B on individuals.

The decline y/y was higher in Q2.
Russia accounts for 18.3%, Turkey for 14.8%, China for 13.3%, the USA for 8.1%, Germany for 5.3%, Ukraine for 4.3% and Italy for 4.1% of imported products.

The COVID-19 pandemic related situation translated into the services sector in Azerbaijan, as in other countries. According to the State Border Service, over 6 months of 2020 590.1 thousand (y/y down by 2.4 times) tourists from 152 countries visited Azerbaijan. 29.7% of tourists visiting the country were citizens of Russia, 26.7% of Georgia, 14.5% of Turkey, 7% of Iran, 2.1% of India and Ukraine.

The “Azerspace” OJSC exported services (satellite telecommunication services and optical satellite services) to 27 countries of the world. Income earned by the Azerspace OJSC from export of services y/y increased by 16% to $21.5 M.

According to initial data, money remittances to the country made up $372 M.
External sector developments of the Azerbaijani economy

Monetary policy review

January – June 2020

Source: CBA

Capital investment from foreign enterprises and organizations kept flowing. According to the SSC, FDIs amounted to AZN2.5B equivalent (41.2% of total investments).

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 Half 1, 2020 strategic reserves sufficed to import 37-month goods and services (taking into account import of goods and services following the results of Q1, 2020) and exceeded broad money in manat (M2) by 5 times (M2 money aggregate as of 01.07.2020).
II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

2.1. Aggregate demand

In January-June 2020, domestic demand indicators decreased due to the COVID-19 pandemic.

The components of consumption expenditures decreased.

Goods and services sold in the market to meet consumer demand y/y decreased by 6.4% in real terms to AZN22B.

Every consumer utilized on average AZN367.5 worth goods and paid services (y/y down by 4.4%).

The size of retail trade turnover y/y decreased by 1.9% to AZN18.2B. Food retail turnover increased by 3.1%, nonfood turnover decreased by 6.9%.

Consumers spent 53.3% of their funds on food, beverage and tobacco at retail trade outlets (y/y up by 3.1%). Expenses decreased by 19.4% in knitwear, clothes and shoes; by 5.9% on electrical goods and furniture; 0.5% on other non-food stuff; and increased by 34.5% on pharmaceuticals and medical products.

Table 1. Share of spending items in trade outlets, %

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<tr>
<th>Spending item</th>
<th>Share, %</th>
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<tr>
<td></td>
<td>2019, 6 months</td>
</tr>
<tr>
<td>Food, beverage and tobacco</td>
<td>49.8</td>
</tr>
<tr>
<td>Knitwear, clothes and shoes</td>
<td>18</td>
</tr>
<tr>
<td>Electric appliances and furniture</td>
<td>5.9</td>
</tr>
<tr>
<td>Computers, telecommunication devices and others</td>
<td>0.8</td>
</tr>
<tr>
<td>Pharmaceuticals and medicals</td>
<td>1.3</td>
</tr>
<tr>
<td>Fuel</td>
<td>5.5</td>
</tr>
<tr>
<td>Other non-food items</td>
<td>18.7</td>
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Source: SSC
Every consumer purchased on average AZN162.8 worth food, beverage and tobacco AZN142.5 worth nonfood items monthly for private consumption in retail trade.

Catering turnover decreased by 45.6%. Entities accounted for 45.3%, private entrepreneurs 54.7% of catering turnover in the private sector. The value of paid services to the population decreased by 19.2% to AZN3.3B in real terms. Per capita paid services consumption y/y decreased by AZN78.7 in nominal terms.

Dynamics of population’s nominal income factored in dynamics of consumption – money income of the population nominally increased by 0.6% to AZN27.4B. Per capita money income decreased by 0.2% to AZN2749.7. Population’s disposable income decreased by 0.9% to AZN24.7B.

Nominal average monthly salary of hired workers increased by 23% to AZN720. Salary of employees involved in public entities was AZN627 (y/y up by 31%), while the salary of those employed with private entities was AZN839.8 (y/y up by 16%).

The loan portfolio of households, one of the consumer demand components has decreased by 6.3% since early year to AZN7.2B as of end-period.

Shrinkage of economic activity due to the coronavirus pandemic also weighed on consumer behavior. The Consumer Confidence Index (CCI) generated from findings of the “Households’ financial behavior and intentions” June 2020 decreased vs the previous quarter significantly. 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 Q2 is mainly attributable to worsened expectations on the financial situation of the country and families, and deteriorated savings probability.

Government spending was critical for domestic demand in Half 1, 2020 too.
State budget expenditures amounted to AZN11.7B, (y/y up by 7.1%).

According to the economic classification, 42.5% (AZN4984.4M) of state budget expenditures were allotted to social spending (compensation for employees, pension and social allowances, medicine and food) (y/y up by 26.1% or AZN1030.7M).²

**Investment expenditures.** AZN5.9B worth investments were distributed to the economy. AZN3.2B worth funds were invested in the non-oil sector. The public sector accounts for 39.7%, while the private sector for 60.3% of total investments.

58.8% of investments stemmed from internal, while 41.2% from external sources.

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<th>Table 2. Investment sources, %</th>
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<tr>
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<tr>
<td><strong>Funds of enterprises and organizations</strong></td>
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<tr>
<td><strong>Bank loans</strong></td>
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<tr>
<td><strong>Budget funds</strong></td>
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Funds of enterprises and organizations prevailed in total investments (61.6%).
2.2. Aggregate supply and employment

*The downward trend in economic growth as a result of negative effects of the pandemic, that began to manifest itself in the last month of Q1, 2020, continued in Q2 as well.*

**Economic growth.** According to the SSC, real GDP y/y decreased by 2.7% to nominal AZN33.8B. Per capita GDP was AZN3393.7.

Oil-and-gas value added decreased by 2.9%. The mining sector extracted 17.8 m/t crude oil, 13.8 bln/m3 natural gas. Oil production y/y decreased by 4.9%, while gas extraction increased by 14.9%.

Non-oil value added y/y decreased by 2.5% in real terms to nominal AZN23B.

Y/y drop in both oil and non-oil economic growth rate on the results of Half 1 is attributable to the impact of the COVID-19 pandemic.

Compared to January-June of the previous year non-oil and gas industry grew by 11.2%. Output increased by 16.3% in production of tobacco products, 6.8% in garment production, 20.5% in the chemical industry, 96.1% in production of vehicles, trailers and semitrailers, 21.3% in production of paper and cardboard, 2.2 times in metallurgy, 4.6 times in production of pharmaceuticals. Jump in
production of pharmaceuticals is attributable to high demand for the said goods due to pandemic and establishment of local production enterprises. In general, production of intermediate consumer goods in industry y/y increased by 28.5%, production of means of production decreased by 14.4%, and production of energy products decreased by 2.3%.

Agricultural production y/y increased by 2.2%; 3.2% on animal products, 1.1% on plant products.

The CBA’s survey findings suggest that the business confidence index (BCI) was negatively zoned across all areas over last 2 months of Half 1 due to negative effects of the pandemic. However, activity varied across sectors during this timeframe. On the production of food products and beverages, the BCI increased across all months of the half year, the chemical industry, production of other non-metal mineral products and metallurgy started to increase over recent 2 months.

On trade, positive dynamics of the BCI over the first two months was replaced with downturn due to the pandemic. Whereas economic activity indicators were positive in automobile, furniture, household goods and home appliances over 2 months of Half 1, they slumped in March, April, May and June.

Though increased over first two months in services, the BCI started to decline and was negatively zoned in May and June. While communication and transportation remained positively zoned,
the BCI is still negatively zoned in healthcare, tourism and hotels, and postal services. RSM findings suggest that services was one of the most pandemic affected sectors. Whereas the BCI was negatively zoned in construction across all months of Half 2, it improved vs early 2020.

**Employment.** As of end June 2020 economically active population were numbering 5220.6 thousand persons (y/y up by 52.7 thousand persons). The number of employed population was 4883.1 thousand persons (y/y down by 32.1 thousand persons).

According to the SSC, as of 1 July 2020 the number of hired labor y/y increased by 5% to 1695.1 thousand: those involved in the public sector was 930 thousand, non-public sector 751.7 thousand. The oil-gas sector employed 33.9 thousand, non-oil gas sector 1647.8 thousand.

24% of hired labor in enterprises and organizations was involved in production: 7.3% in processing, 7.8% in construction, 3.4% in agriculture, forestry and fishery, 2% 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 131.4 hours at the end of 6 months of 2020.
2.3. Inflation

In Half 1, 2020 inflation was below the announced annual target band center.

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

Graph 18. 12-month based inflation, in % (CPI change to same month of previous year)

Graph 19. Components of annual inflation, %

Price index across food products with a considerable share in the consumer basket increased by 5.3% on an annual basis. Annual price hike on non-food stuff and services, other inflation components, considerably falls behind the target band center (1.5% 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 2.3 pp, nonfood 0.3 pp, and services 0.4 pp to annual inflation.

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

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1 According to SSC, average annual inflation was 3%.

Monetary policy review ● January – June 2020
and falling prices in the consumer basket decreased since early year. Prices for 55 out of 520 items of goods and services declined and remained unchanged for 51 items. Price hike for 48.6% of products was below 2%.

A stable exchange rate, monetary condition, dynamics of administrative prices and global food prices had stabilizing; while inflation expectations and 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 2.2%.

Inflation expectations elevated amid negative effects of the pandemic in Q1 dropped over recent months. According to RSM, inflation expectations decreased in construction and services in June vs May, and increased in the non-oil sector and trade. Although households’ 3-month inflation expectations were higher, they started to decline from Q2. According to June survey among households the share of respondents expecting high inflation decreased 3 pp to 29% vs March.

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

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4 The index is calculated as (increasing-decreasing)/(decreasing + unchanged).
decreased by 9.6%, mainly owing to low industrial producer price index.

In June Agricultural Production Price Index increased by 9.6% over recent 12 months. Over the same period prices increased by 7.5% on animal and 11.7% on plant growing products. In parallel, the PPI on forest products increased by 2.3%, and by 3.4% on fish and other fishery products.

The Industrial Production Price Index y/y decreased on annual by 26.2%, mostly due to the mining industry (down by 36.4%). Price slide in the mining industry mainly relates to oil price slump in world markets due to the pandemic.

The PPI on processing decreased by annual 9.5%. The highest price slide was in production of oil products (25.5%), the chemical industry (23.1%) and the textile industry (8.7%).

In June 2020 prices for transportation services increased by 0.4% on annual. Prices for cargo services increased by annual 0.7%, and decreased by 1.4% 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 in Half 1, 2020 too. Albeit negative effects of external environment developments, due to concerted preventive measures by the Government and the Central Bank stability was safeguarded in the FX market.

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

Cashless transactions in the FX market y/y increased by 4.7% to $12.7B equivalent.\textsuperscript{5} 86.5% of cashless operations in the Interbank FX market were denominated in the USD, 13.5% in other currencies. The Interbank FX market accounts for 38.3%, while the Intrabank FX market for 61.7% of cashless transactions.

99.3% of operations in the Interbank FX market was denominated in USD, 0.6% in EUR and 0.1% in other currencies. Currency operations in the Interbank FX market were conducted over the Bloomberg platform.

The size of Intrabank FX market operations was $7.8B equivalent (78.5% USD denominated operations). Legal entities account for 92.6% of foreign currency operations in the Intrabank FX market.

Cash currency traded by banks y/y increased by 16.4% to $3.2B ($2.9B, or 92.2% USD denominated operations).

The CBA continued to organize 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 50 currency auctions in Half 1. Though increased in Q1, demand in the

\textsuperscript{5} Including USD, EUR, GBP, RUB denominated operations
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 in Half 1. Buy-sell exchange rates set by banks were close to the official one. Commercial banks’ daily average buy/sell rate was 1.6988/1.7026. Difference between average daily official buy/sell exchange rates and those of commercial banks was 0.0012/0.0026.

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, the Georgian lari and depreciated against the euro, the Swiss franc and the Japanese yen.

Dynamics of bilateral exchange rates influenced that of multilateral exchange rates. In the environment of stabilization and even strengthening of national currencies of major trade partners in Q2, strengthening rate of multilateral exchange rates of the manat declined. In general, over the reported period total trade weighted non-oil NEER of the manat appreciated 5.76%, while the REER appreciated 5.3%.

To note, the REER of manat has depreciated by 30.1% since end-2014, contributing to non-oil competitiveness.
3.2. Monetary policy tools

Monetary policy tools were applied in light of the macroeconomic stability targets and inflation risks balance in Half 1, 2020.

The CBA made necessary corrections to its interest rate corridor parameters of liquidity operations in light of recent macroeconomic trends and forecasts, as well as potential risks. The Board of Governors of the CBA discussed interest rate corridor parameters 4 times in Half 1, 2020 and decided to reduce the refinancing rate stepwise from 7.5% to 7%, decrease the ceiling of the interest rate corridor from 9.25% to 7.5% and increase the floor from 5.75% to 6.5%. The decision serves to maintain an optimal balance between macroeconomic stability and economic activity.

To effectively manage liquidity in the economy the CBA conducted 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 prevent the threats posed by the coronavirus pandemic to macroeconomic stability and the FX market the CBA changed the term of sterilization tools from April onward, and decreased duration of the sterilization portfolio. 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 36 deposit auctions on attraction of excess funds in the national currency. Total outstanding amount of
funds attracted by deposit auctions was AZN300M as of the end-June.

Along with deposit operations, the CBA held 20 note auctions – 8 long-term (84-, 168-, 252-days), and 28-day notes at other 12 auctions. Total outstanding amount of sterilization via long-term notes was AZN806.2M as of end-quarter.

Outstanding amount of funds attracted via deposit auctions and issue of notes increased by 16.4% compared early year, which has a downward effect on money supply.

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 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 in Half 1, 2020. Money supply significantly decreased last month of Q1 mainly due to surplus in the state budget, is gradually recovering from Q2 onward as public expenditures are made from the treasury account.

Base money in manat decreased by 7.4% to AZN11.3B as of end-period, mainly attributable to changes in the balance of government accounts. Recall that the rate of decline of money base was 17.2% in Q1.

Cash in circulation, a structural element of money base in manat, decreased by 3.4% and stock of correspondent accounts in manat by 31.5%.

Broad money supply in manat (M2) was AZN17.2B – though 4.4% up compared to March 2020, it is 5.9% down compared to March 2019.

Table 3. Money aggregates, billion AZN

<table>
<thead>
<tr>
<th></th>
<th>01.01.20</th>
<th>01.07.20</th>
<th>Change,%</th>
</tr>
</thead>
<tbody>
<tr>
<td>M0</td>
<td>9.5</td>
<td>9.2</td>
<td>-2.7</td>
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<tr>
<td>M1</td>
<td>15.4</td>
<td>14.9</td>
<td>-3.0</td>
</tr>
<tr>
<td>M2</td>
<td>18.2</td>
<td>17.2</td>
<td>-5.9</td>
</tr>
<tr>
<td>M3</td>
<td>28.9</td>
<td>26.2</td>
<td>-9.2</td>
</tr>
</tbody>
</table>

Source: CBA

Graph 26. Dynamics of M2 according to its composition, %

Cash beyond the banking system, savings of individuals and deposits of legal entities in the structure of money supply in manat (M2) decreased.

---

6 Cash beyond the banking system, cash in bank cash offices and ATMs

7 According to the Monetary and Financial Statistics methodology by the IMF.
Cash money supply decreased by 2.7%, manat denominated corporate deposits by 5.5% and manat denominated savings of individuals by 14%.

Manat denominated demand savings and deposits decreased by 3.4% (weight in M2 - 33.2%), while term savings and deposits decreased by 21.6% (weight in M2 – 13%).

Broad money supply (M3) decreased by 9.2% to AZN26.2B as of end period.

Although foreign currency denominated savings and deposits accounted for 56.5% of total savings and deposits in March 2020, this number decreased to 53.3% as of end-June. Foreign currency denominated savings and deposits account for 34.5% of M3 aggregate as of end Half 1, 2020 (38.5% in March).

Whereas dollarization of deposits slightly increased last month of Q1, 2020, downward trend was observed in Q2.

The share of a foreign currency in deposits of legal entities was 65.6% end Q1 and 62.8% end Q2. Dollarization of savings of individuals was 55.1% end Q1 and 54% end Half 1.
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Charts

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