CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REPORT

JANUARY-JUNE

2023
№2

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ACRONYMS

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

EXECUTIVE SUMMARY

Over the past period of 2023, the Central Bank of the Republic of Azerbaijan discharged the functions under its mandate and implemented the policy oriented towards safeguarding macroeconomic and financial stability in the country. The operational environment of the CBA was marked with weakened global economic activity, drop in global energy prices and the tight monetary policy in most countries.

Over the reporting period, inflation fell due to combination of internal and external factors. Low inflation in partner countries, falling prices in global commodity markets, revert of international freight costs to pre-pandemic levels exerted downward pressure on inflation. Simultaneously, maintaining the FX market equilibrium, the appreciated nominal effective exchange rate of the manat, and monetary policy decisions alleviated inflationary pressures through enhanced monetary condition. A favorable external environment and higher non-oil export potential of the country was vital in maintaining FX market equilibrium.

The Central Bank continued the anti-inflationary monetary policy and its reforms to elevate opportunities to affect inflation. The behavior of interest rate corridor parameters and adequate application of monetary policy tools is containing excessive expansion of agregate demand. Average interest rates on money market operations are still responding to the change in the interest rate corridor.

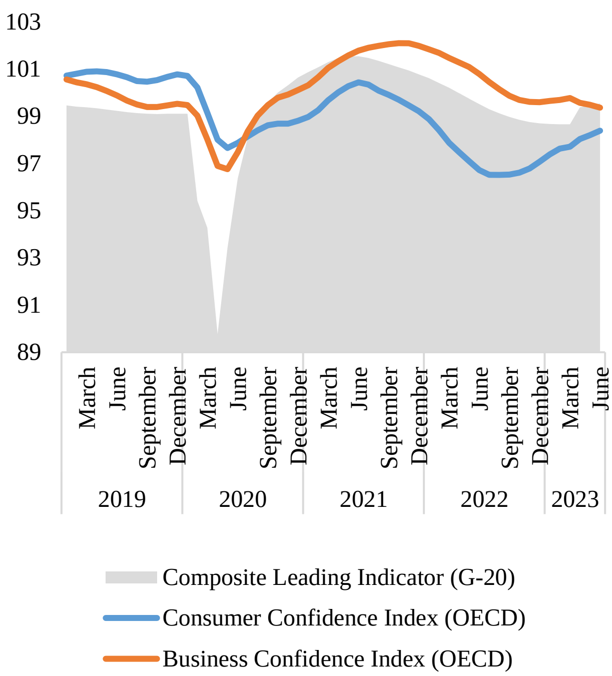
I. GLOBAL ECONOMIC ENVIRONMENT

1.1. Global economic trends

The first half of 2023 is characterized lingering geopolitical and geoeconomic conflicts and uncertainty in the financial sector. Global economic uncertainty and monetary policy tightening in most countries amid fighting inflation, created various impediments for economic recovery and the rate of decrease in inflation-failed expectations.

In H1 2023, indicators inherent to global economic activity, behaviors of producers and consumers varied. The CCI, economic activity indicator of the OECD countries and the G-20 Composite Leading Indicator increased. At the same time, the BCI, an economic activity indicator on OECD countries decreased on the backdrop of uncertainty in financial markets.

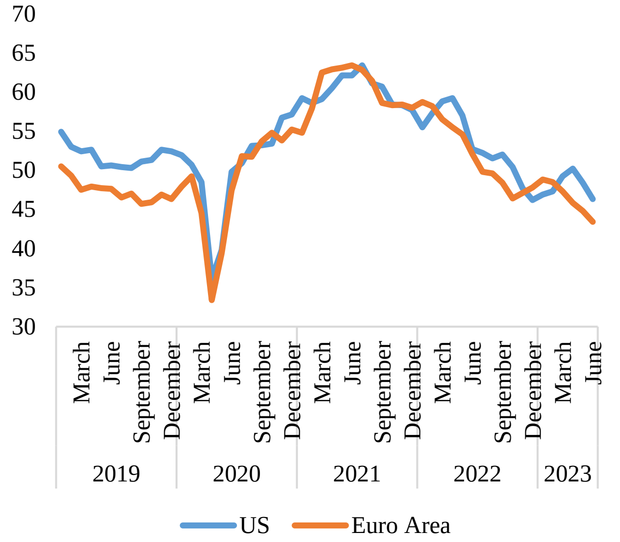
Chart 1. Global economic activity indicators



Source: OECD

The Purchasing Manager's Index (PMI) that shows economic trend in the manufacturing sector, decreased faster in the euro area than in the United States in June compared to the beginning of the current year. This dramatic slump in manufacturing in the euro area is attributable to a sharp decline in factory output since October of last year amid rising concerns about the price and supply of energy resources.

Chart 2. Purchasing Manager's Index (PMI)

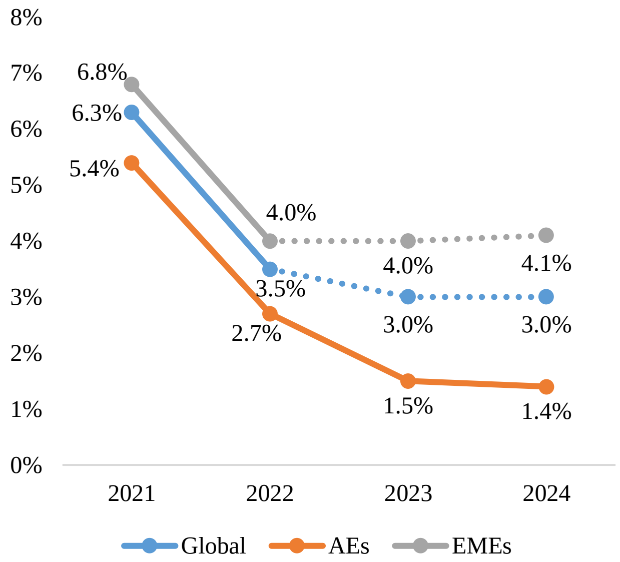


Source: Market Economics

Global economic developments weighed on economic projections of international organizations. The IMF WEO July 2023 revised global growth forecast for 2023 up to 3% (up by 0.2 pp compared with April forecast). The main reason for this increase was the change in economic growth of AEs and the development of the service and tourism sectors in the euro area. Global growth forecast for 2024 was left unchanged at 3%. Global growth for 2023 was forecasted lower than in 2022 due to weakened global trade growth and the increased of policy rates in leading countries.

The IMF WEO July 2023 forecasts 1.5% economic growth in AEs (up by 0.2 pp compared with April forecast). The reason for this revision is the boom in the services and tourism sectors in Italy and higher confidence in economic growth due to the drop in energy prices and low uncertainty after Brexit along with higher than expected consumption and investment in the UK. The economic growth forecast for 2024 was lower than that of 2023 and the IMF left the forecast unchanged at 1.4% compared with April forecast. According to the recent release by the IMF, weaker economic growth is expected in 93% of EMEs in 2023.

Chart 3. Economic growth projections, %

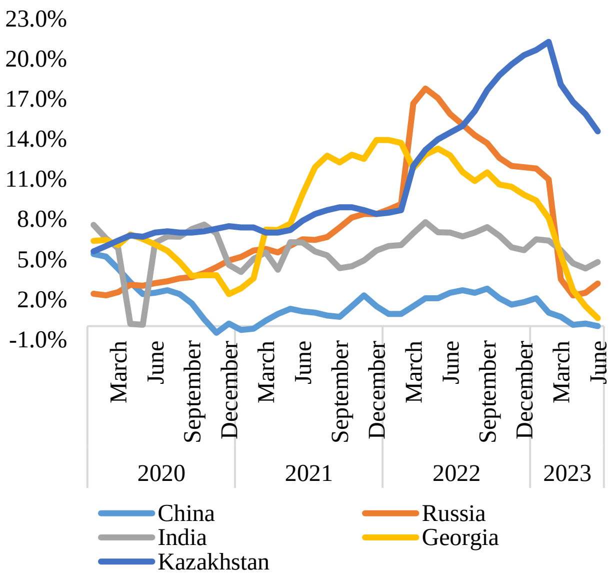


Source: IMF, WEO July 2023

The IMF WEO July release predicts 4% economic growth in EMEs in 2023 (up by 0.1 pp compared with April forecast) and 4.1% in 2024 (drop by 0.1 pp compared with April forecast). The upward revision of forecasts for 2023 is attributable to higher activity in retail trade, construction and industrial production and a large-scale fiscal stimulus in Russia in the first half of the year, and agricultural production and high-rise in services in Brazil in the first half of the year. Economic growth forecast varied accross regions of EMEs. Economic growth forecast was revised up in Latın America (0,3 pp) and Europe (0,6 pp) and down for Middle East and Central Asia (0,4 pp) and Sub-Saharan Africa (0,1 pp), and left unchanged for Asia (5.3%) for 2023.

The IMF in July release revised global inflation outlook down by 0.2 pp (compared with the April forecast) to 6.8% (8.7% in 2022). It was revised up by 0.3 pp to 5.2% for 2024. Moreover, the report predicts that in 75% of country groups the average annual inflation indicator is expected to decrease in 2023, driven by low global commodity prices. However, the monetary tightening will also contribute to low inflation.

Chart 4. Inflation in some EMEs, %



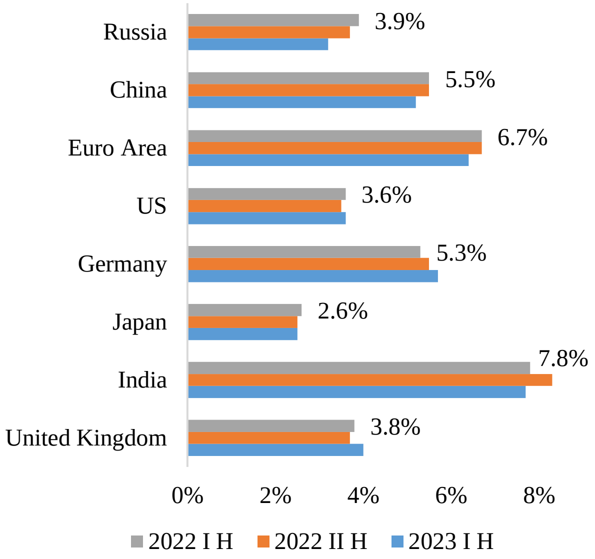
Source: National Statistic Offices

The report forecasts that core inflation will gradually decrease to 6% in 2023 (6.5% in 2022) and to 4.7% in 2024. Core inflation was revised up by 0.3 pp and by 0.4 pp for 2023 and 2024 respectively compared with April forecast, due to weaker than expected decrease in core inflation particularly in AEs. According to the WEO, in 50% of country groups, average annual core inflation will not decrease and in 96% of country groups with inflation targeting inflation is forecast to be higher than targets in 2023.

To counteract inflation to the target most countries decided to either tighten or leave unchanged the monetary policy in the first half of the year. Differences in the speed of the fall in inflation across countries depend on factors, such as diverse changes in commodity prices, exchange rates of currencies, and various degrees of economic overheating across countries. Accordingly, the drop in inflationary indicators was not on a desired level despite the tightening.

In H1 2023, unemployment varied across countries. Unemployment increased in the UK (4% May), Germany (5.7% June), India (8.5% June), Japan (2.5% June) and the USA (3.6% June) and decreased in Russia (3.2% May), China (5.2% June) and the euro area (6.5% May) as of the end of the half year compared with the beginning of the year.

Chart 5. Unemployment rate, %



Source: Trading Economics

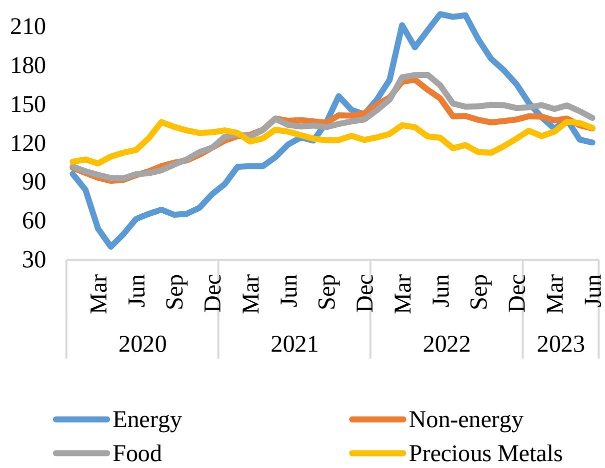
According to the OECD report in May 2023, the unemployment rate is 3pp up compared with the pre-crisis level (2019). The report forecasts relative rise in unemployment across OECD countries in parallel with weak economic growth expectation by the end of 2023 and 2024.

1.2. Global commodity markets

In the first half of 2023, prices fell in global commodity markets owing to weak global economic growth, the tight monetary policy implemented by central banks and mild winter. However, the probability of a number of negative shocks in upcoming periods elevate uncertainties related to the future of commodity markets. Further geopolitical and geoeconomic tension, as well as climate change may increase uncertainties in commodities, in particular food and energy prices.

Because of high natural gas storage in Europe, weakened global economic growth, in particular, weaker than expected recovery of the Chinese economy, as well as the tight monetary policy implemented by most central banks energy and food prices underwent a considerable drop from the peak of last year. However, food prices are still higher than average indicators. According to the World Bank Commodity Markets Outlook July 2023, overall commodity price index decreased by 19.1% in H1 2023. In June, this indicator y.o.y. decreased by 37.1%. Price indices fell by 26% on energy products, by 3.2% on non-energy products, by 1.1% on raw materials, by 18.3% on fertilizers and by 6.6% on metals and minerals. However, over the period price hike was 9.7% on both beverages and precious metals.

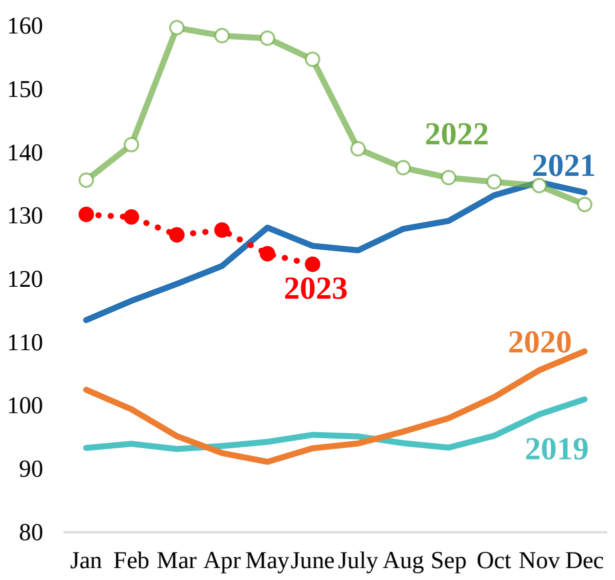
Chart 6. Global commodity indices
(2019 december=100)



Source: World Bank

According to the UN FAO, in June 2023, the food price index decreased by 7.2% compared with the early year. This indicator decreased by 20.9% on annual and by 23.4% from the peak in March of last year. The drop in the food price index in the first half is driven by drops in prices of grain, vegetable oils and dairy products. However, in contrast to overall tendency, the sugar price index reached highs of recent 10 years in May 2023 and increased by 30% over six months.

Chart 7. The FAO Food Price Index

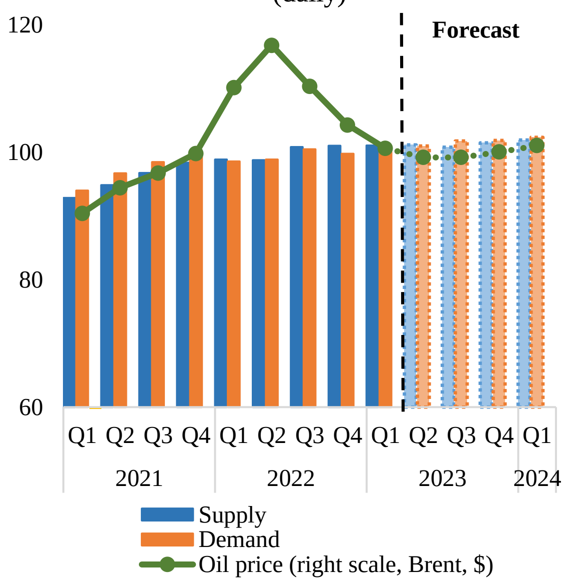


Source: FAO

According to the IMF WEO July 2023, weak global demand, revert of transportation costs and durations to pre-pandemic levels with large supply chain recovery contributed to the drop in commodity prices. The report says that monetary policy tightening is expected to gradually subdue inflation. The WEO highlights that downward revision of the inflation forecasted for 2023 is driven by fallen commodity prices. The IMF predicts that in 2023 global food prices will slide by 5.6%, oil prices by 20.7% and non-energy prices by 4.8%, mainly due to global economic slowdown.

The highest price drop was in energy prices over six months. The average price for the Brent oil was about $79.8 per barrel, down by 19.6% compared with the average price of 2022 ($99.2).

Chart 8. Dynamics of demand and supply in the global oil market, mln. barrel (daily)

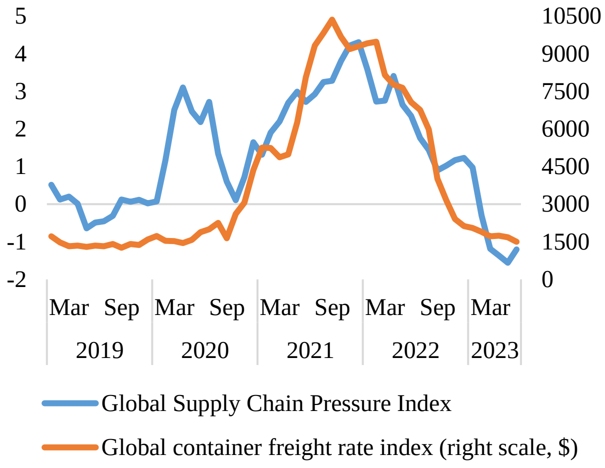


Source: US Energy Information Administration (EIA)

The US EIA, in its July report predicts that the average Brent oil price will be $79 in 2023 and $84 in 2024 ($79 and $74 respectively in the May release). The main reason for upward revision of the price for the upcoming year is attributable to extension of cuts in oil output by OPEC++ until 2024. Global oil inventories are projected to decline slightly in each of the next five quarters, likely to have a relatively upward pressure on crude oil prices at the end of 2023 and early in 2024. Moreover, according to the report, in 2023 global daily oil consumption will increase by 1.8 mln.barrels, while output will increase by 1.2 mln.barrel, which puts upward pressure on global oil prices over the forecasting period.

Natural gas prices, peaked to historical highs of recent years in 2022, consideraby receded over the past period of 2023 due to lower-than-average consumption and, as a result, higher-than-average natural gas reserves in storage because of mild winter in Europe. In H1 2023, the average gas price for 1000 cubic meters on the Dutch TTF gas index y.o.y. decreased by 66% to €473 (€1405).

Chart 9. Dynamics of global indices (2019-2023 march)



*Water transport, 40 feet (12 meters) container

Source: New York FED, Statista

The reversion of transportation costs and durations to pre-pandemic levels with large recovery of the global supply chain, affected by several consecutive negative shocks over recent years had a downward effect on inflation pressures. The Global Supply Chain Pressure Index, released by the Federal Reserve Bank of New York, slumped to historical lows following consecutive decrease.

Despite price slides in global commodity markets inflation remains higher than targets of most central banks. Uncertainties related to expected behavior of prices persist. The IMF in its recent release addressed some negative shocks likely to affect commodity prices. Higher than expected temperature due to climate change, fragmentation of the global economy amid geopolitical tensions may further escalate commodity prices, in particular food and energy prices. At the same time, the report highlights that termination of the Black Sea Grain Initiative may also put additional pressure on food prices.

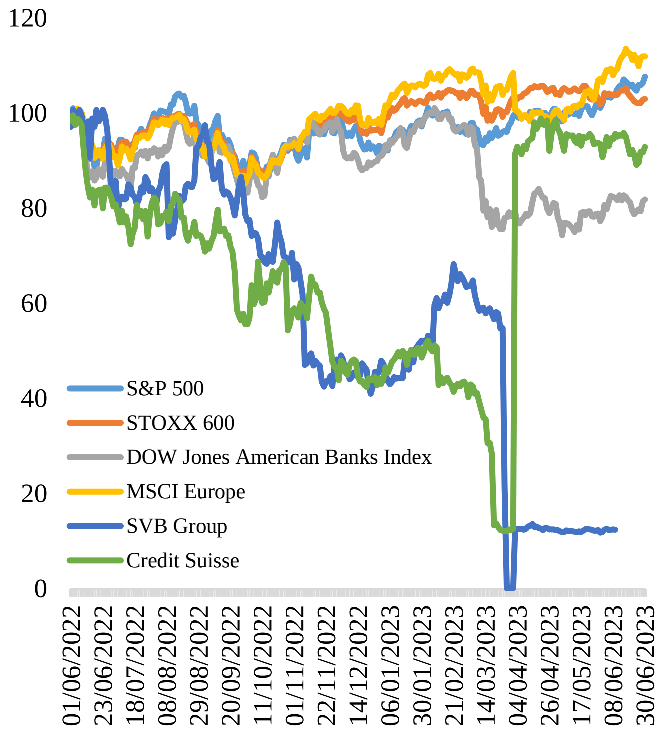
1.3. Global financial markets

On the backdrop of rising geopolitical tension among large economies concerns about global economic and financial fragmentation, the tight monetary policy implemented by central banks to curb inflation, as well as its rapid pace continued keeping the financial sector under pressure in the first half of the year, which weighed on global financial markets. Although financial stability risks have become up-to-date in certain leading countries, flexible response of authorities allowed regulating those risks.

The monetary policy of central banks. In H1 2023, most central banks continued tightening the monetary policy. Over the period 48 central banks increased, 23 banks left unchanged and 12 banks decreased policy rates. The FED has shifted from 4.25-4.5% to 5-5.25%, the Bank of England from 3.5% to 5% and the ECB from 2.5% to 4% since the beginning of the year. However, certain central banks decided to keep policy rates stable.

Stock exchanges. Stock exchanges in different countries reacted diversely to economic activity and interest rate changes. The value loss of the last year was followed by the appreciation of key stock indices in H1 2023. The NASDAQ has gained 28.8%, the Dow Jones 3.6%, FTSE Eurotop 8.8%, DAX 14.8%, Shanghai Composite 3.5%, and Nikkey 26.8% since the beginning of the year.

Chart 10. Dynamics of the stock markets

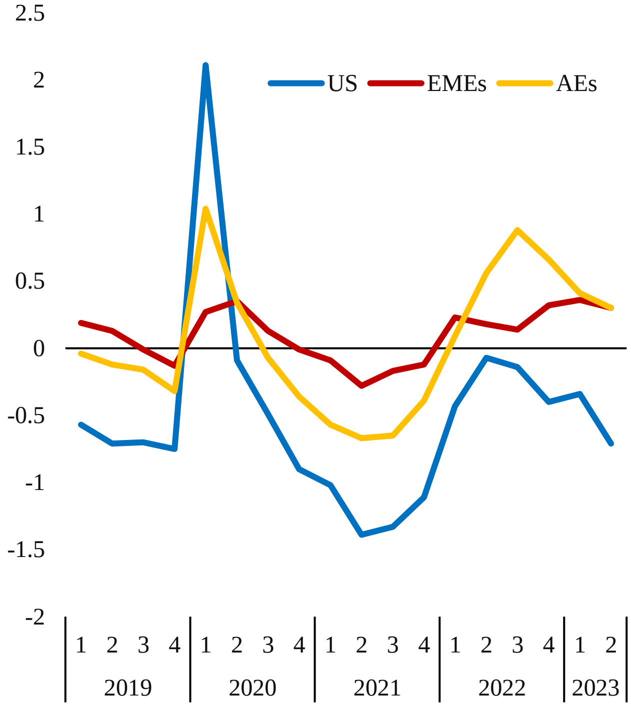


Source: Investing.com

Global financial system. Over the period, liquidity issues intensified in certain regional US and European banks. Consequently, H1 2023 went down to history as the year of bankruptcy of several regionally important banks that do not pose serious threat to the global financial system. Over six months four regional banks have gone bankrupt in the USA alone and regulators took them over. The four banks in question failed mainly due to depreciation of cryptocurrencies coupled with interest rate hikes by the FED, decline in bond prices and losses from bond sales, as well as withdrawal of deposits by depositors.

Financial system instability manifested itself in a number of European banks as well. Stocks of the Deutsche Bank depreciated by 9% amid a rise in insurance cost against the bank defaulting. The UBS acquired Credit Suisse, one of the largest banks of Europe and the world in March. The bank went bankrupt because deposit outflow from the bank intensified after the decision of the Saudi National Bank not to allocate additional investments to Credit Suisse resulting in slump in stock prices.

Chart 11. Financial Conditions Index



Source: IMF

The IMF WEO July 2023 specifies that strong action by authorities to contain turbulence in US and Swiss banking reduced the immediate risks of financial sector turmoil and moderated adverse risks to the outlook. The report also says that since the April 2023 WEO, global financial conditions have eased, a sign that financial markets may have become less concerned about risks to financial stability coming from the banking sector. Major emerging markets have generally remained resilient in this uncertain environment and largely avoided the banking sector turmoil in

March 2023. However, borrowing costs for EMEs remain high, constraining room for priority spending and raising the risk of debt distress. Tight monetary policy continues to put some banks under pressure, both directly (through higher costs of funding) and indirectly (by increasing credit risk). Immediate concerns about the health of the banking sector have subsided, but high interest rates in AEs and significantly tightened lending standards extend to public finances, especially in poorer countries grappling with elevated debt costs, constraining room for priority investments. As a result, economic growth keeps falling across the world's poorest nations compared with pre-pandemic forecasts.

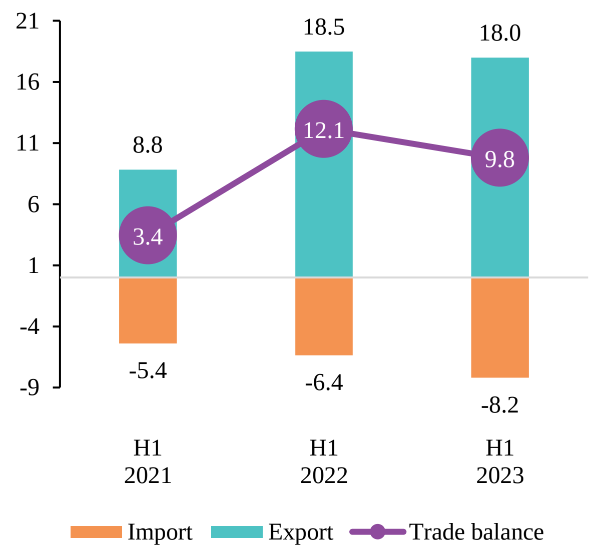
The report also provides a number of policy recommendations to safeguard global financial stability. In most economies, the priority remains dampening inflation while ensuring financial stability. Therefore, central banks should remain focused on strengthening financial supervision and risk monitoring. The intensity of supervision must be commensurate with banks' risks and systemic importance, and it is essential to address oversight gaps in the nonbank financial sector. Macroprudential policy measures could be employed preemptively to address emerging risks in banks and nonbank financial institutions. Where market strains emerge, deploying tools that provide liquidity support promptly would limit contagion. Countries at risk of external shocks can make full use of the global financial safety net afforded by international financial institutions, including IMF precautionary financial arrangements.

II. INTERNAL MACROECONOMIC CONDITION

2.1 External sector

In H1 2023 foreign trade balance, the key balance of payments component, remained in surplus, driven by a favorable international conjuncture and rising non-oil and gas export.

Chart 12. Trade balance, (bln. $)



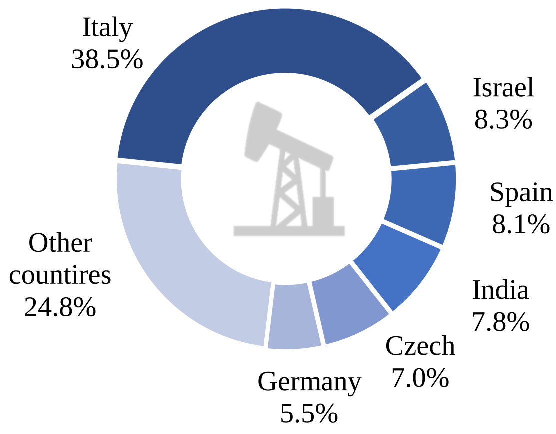
Source: SCC

According to the SCC, foreign trade turnover amounted to $26.2B – export $18.0B (68.7%), import $8.2B (31.3%) in H1 2023. Foreign trade surplus stood at $9.8B.

Source: SCC

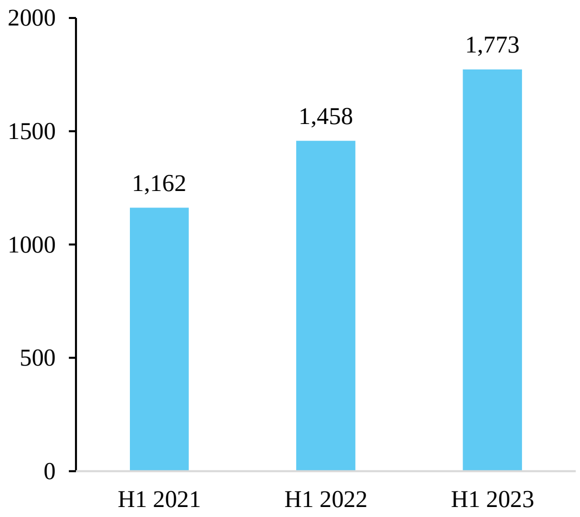
Italy, Türkiye, Russia, China, Germany, Greece, India, Spain, Israel and Turkmenistan accounted for over half of trade turnover.

Chart 13. Countries to which crude oil and oil products are exported, (%)



Source: SCC

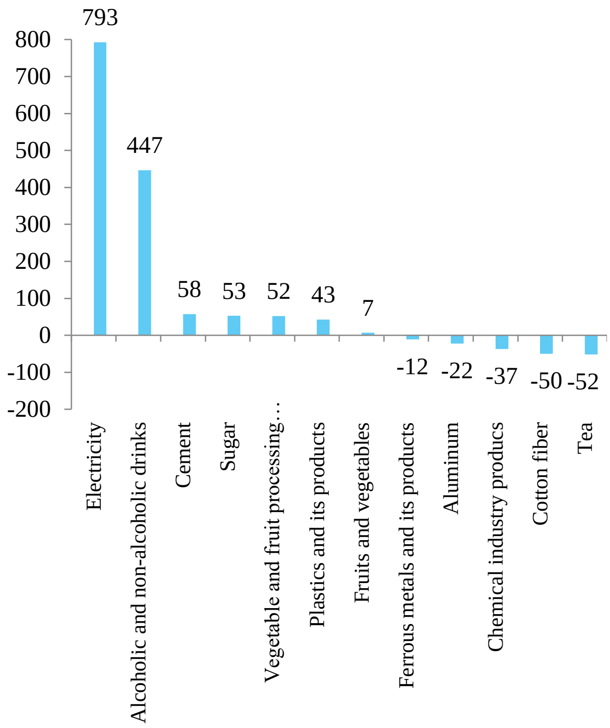
Chart 14. Export of non oil-gas products, (mln. $)



Source: SCC

The value of the oil-and-gas export decreased by 4.9%, driven by the change in export prices. The value of export decreased by 16.6% on crude oil and increased by 7.9% on natural gas. 38.5% of crude oil and oil products was exported to Italy, 8.3% to Spain, 8.1% to Israel, 7.8% to India, 7% to Turkey, 5.5% to Czechia and 24.8% to other countries.

Chart 15. Changes in export of some products in the first half of 2023 (y.o.y., %)

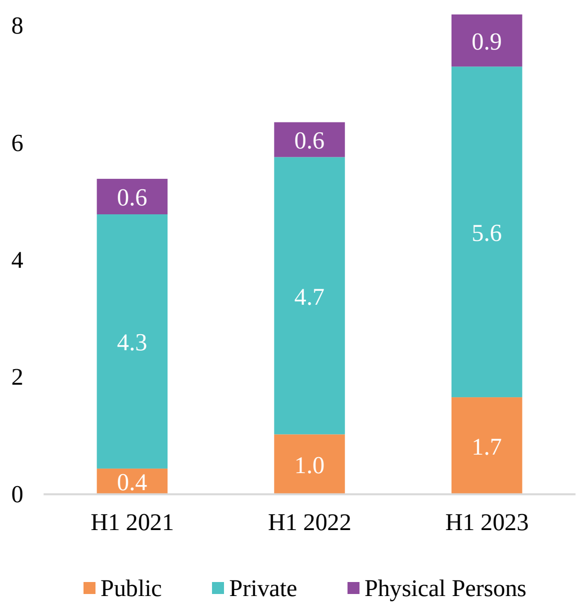


Source: SCC

Non-oil export increased by 21.7%. Exports of electricity, alcoholic and non-alcoholic beverages, cement, sugar, processed fruit and vegetable products, plastics and products and fruits and vegetables increased.

In general, main export partners were Italy (46.6%), Türkiye (15.4%), Greece (4.5%), Spain (3.6%), Israel (3.5%) and Russia (3.5%).

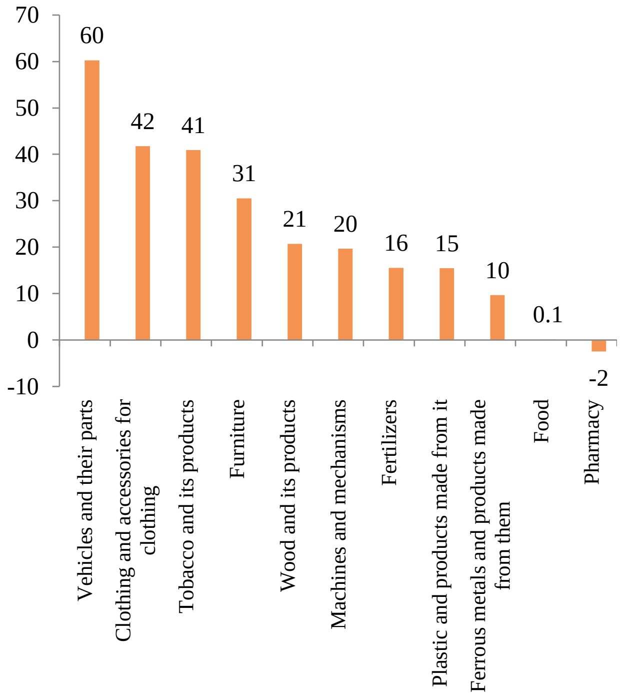
Chart 16. Dynamics of imports by sectors, (bln. $)



Source: SCC

Commodity import y.o.y. increased by 29% - by 61.7% to $1.7B on the public sector, by 19.3% to $5.6B on the private sector and by 49.6% to $0.9B on individuals.

Chart 17. Changes in imports of some products in H1 2023 (y.o.y., %)

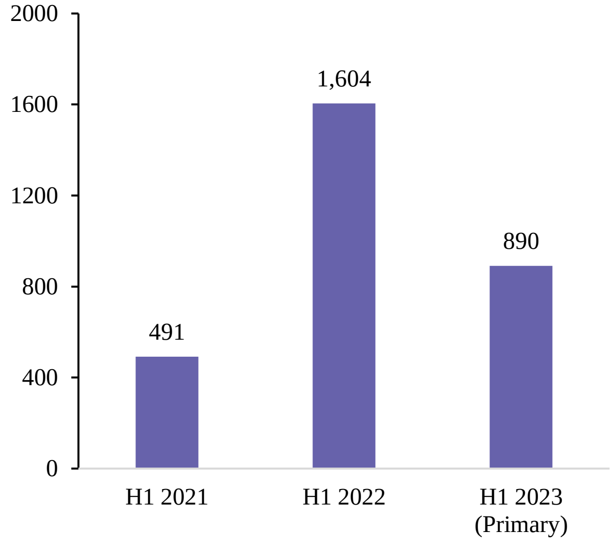


Source: SCC

Import increased by 60.3% on vehicles and parts, 41.7% on clothes and clothing accessories, by 40.9% on tobacco and tobacco products, by 30.5% on furniture and parts, by 20.7% on wood and wood products, by 19.7% on machinery and mechanisms, by 15.5% on fertilizers, by 15.4% on plastics and products, by 9.7% on ferrous metals and products and by 0.1% on food products. Import decreased by 2.4% on pharmaceuticals.

Russia accounts for 18.8%, China for 15.4%, Türkiye for 14%, Germany for 5.9%, Turkmenistan for 5.4%, France for 3.6%, the USA for 3%, Iran for 2.9%, Italy for 2.6% and Japan for 2.4% of total imported products.

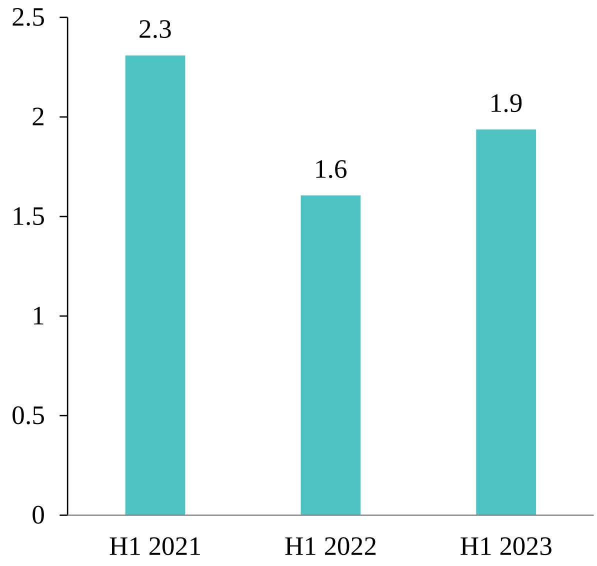
Chart 18. Remittances entering the country, (mln. $)



Source: CBA

According to preliminary data, remittances to the country continued to prevail over the pre-pandemic level.

Chart 19. Investments in fixed capital from foreign sources, (bln. AZN)



Source: SSC

Capital inflows from foreign enterprises and organizations continued over the period. According to the SSC, total investments from all financial sources amounted to AZN7.1B. FDIs accounted for 27.1% of total investments.

Investor funds from the UK, France, the USA, Türkiye, Japan, Switzerland, Russia, Norway, and Iran accounted for 94.8% of total FDIs (AZN1838.3M).

The strategic FX reserves still exceed internationally accepted adequacy norms. As of 30 June 2023, strategic FX reserves sufficed for 34-month worth of import of goods and services (considering the import of goods and services for Q1 2023). Strategic reserves exceeded broad money supply in manat (M2) by 3.6 times (M2 as of 01.07.2023).

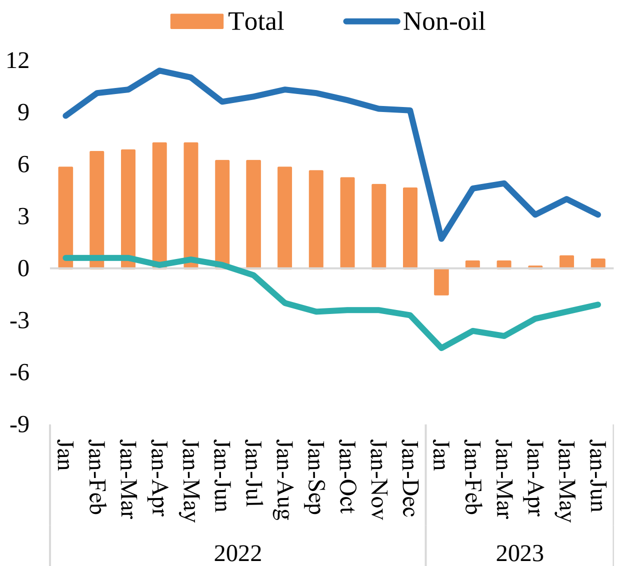
2.2. Economic activity

In H1 2023 economic activity continued in the country. Economic growth was underpinned both by domestic and external demand.

According to the SSC, GDP y.o.y. increased by 0.5% in real terms to nominal AZN60.3B in H1 2023. Per capita GDP stood at AZN5946.9.

Oil and gas value added decreased by 2.1% to nominal AZN24.1B (40% of GDP). 15.2 million/ton crude oil (y.o.y. down by 7.7%), 18.2 billion cubic meters natural gas (y.o.y. up by 3.2%) was extracted in H1 2023.

Chart 20. Economic growth, (y/y) %



Source: SSC

Non-oil-gas value added y.o.y. increased by 3.1% in real terms to nominal AZN36.2B. Production in the non-oil and gas industry increased by 6.5%. Agriculture grew by 3.4%. Livestock products increased by 3.7%, and plant products increased by 3%. Growth dynamics was similarly observed in the service sector.

Freight and passenger transport increased by 6.4% and 17.3% respectively, information and communication increased by 12.9%. Tourism and public catering y.o.y. increased by 32.6%.

Table 1. GDP structure, weight, %

Sectors	H1 2022	H1 2023
Industry	53.3	43.7
Construction	3.8	4.7
Agriculture, forestry and fishery	4.7	5.6
Trade, repair of vehicles	7.7	9.2
Transport and warehousing	5.8	5.9
Tourism and public catering	1.3	2.3
Information and communication	1.3	1.6
Other	14.5	17.7
Net taxes on products and import	7.6	9.3

Source: SSC

CBA's real sector survey results confirm that economic activity continues. The BCI was mainly positive across sectors.

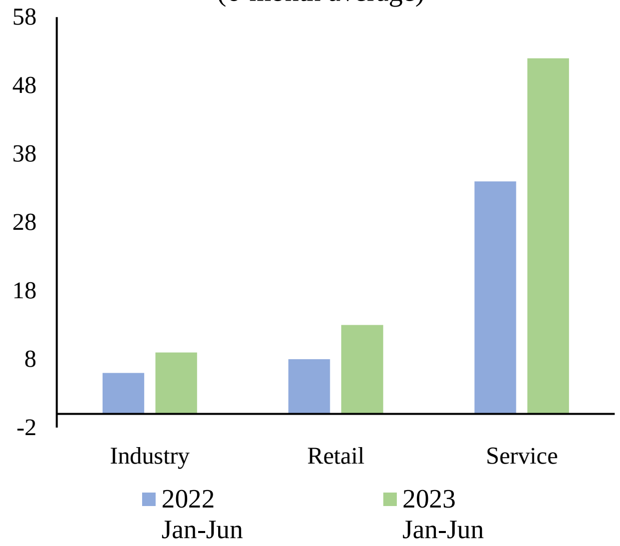
The BCI on the industry was positive and was up year over year, driven by the chemical industry, plastic, food products and beverages, machine building, construction and production of other non-metal products sub-sectors. The BCI was negative in knitted goods and metallurgy sub-sectors.

The trade BCI was positively zoned and higher year over year. The BCI was mainly positive in electric appliances, automobiles, furniture and household goods.

The BCI remained weak in postal services in the services sector, while in other areas the Index was positive. In general, the BCI on services considerably prevailed over the same period of last year.

[1] *Industrial BCI = (output – final goods inventory + production expectations)/3*
Services BCI = (business condition + actual demand + demand expectation)/3
Trade BCI = (actual sale – changes in goods inventory+ sale expectations)/3

Chart 21. Business Confidence Index, (6-month average)



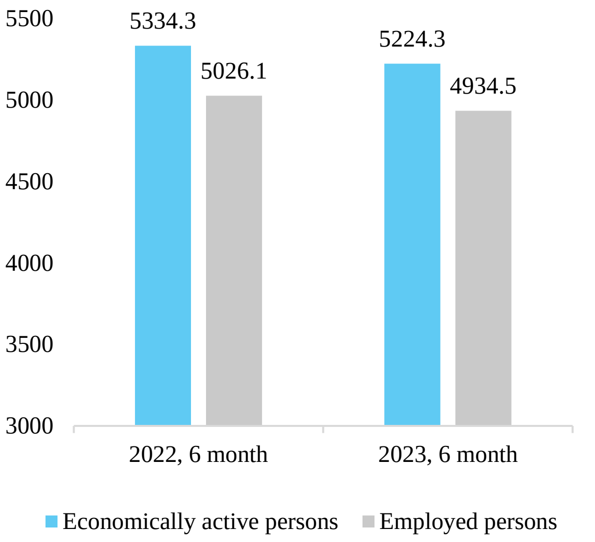
Source: RSM findings based CBA estimations [1]

Employment. As of 1 July 2023, total labor force was 5224.3 thousand persons, employed population numbered 4934.5 thousand persons.[2]

As of 1 June 2023, hired labor was 1726.3 thousand persons, y.o.y. up by 1.2% – 898.6 thousand persons were engaged in the public and 827.7 thousand persons in the non-public sectors.

[2] *The results of the 2019 population census were taken into account*

Chart 22. Dynamics of economically active and employed persons (in thousands)



Source: SSC

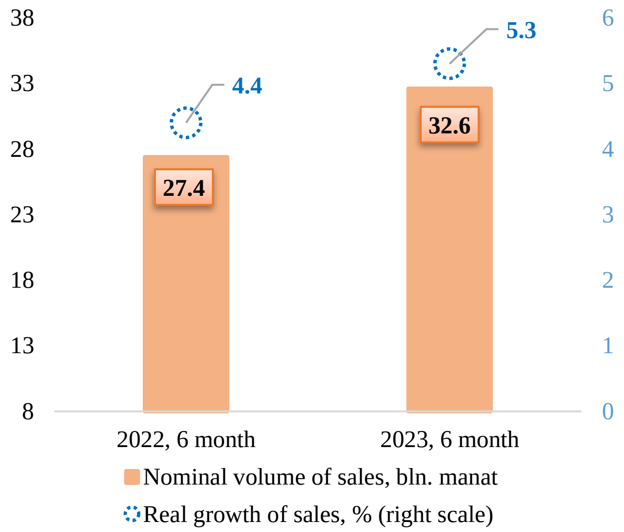
23.1% of hired labor in enterprises and organizations was involved in production.

Results of RSM by the CBA indicate that, employment expectations of economic agents were positive in the industry, trade and services in H1 2023.

Aggregate demand. Aggregate demand continued to expand in H1 2023 as well and supported economic growth.

Aggregate demand expanded due to consumer demand. Goods and services sold in the market to meet consumer demand y.o.y. increased by 5.3% in real terms to AZN32.6B. Every consumer spent on average AZN535.5 in the consumer market (y.o.y. up by AZN83).

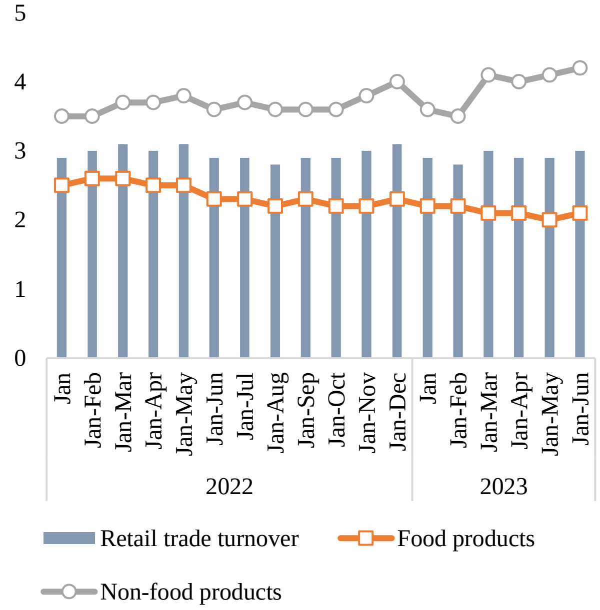
Chart 23. Change in volume of sales in consumer market



Source: SSC

Retail trade turnover y.o.y. increased by 3% in real terms to AZN26.3B. Retail commodity turnover on food products, beverages and tobacco products increased by 2.1%, and non-food trade turnover increased by 4.2%.

Chart 24. Growth in retail trade turnover, (y/y) %



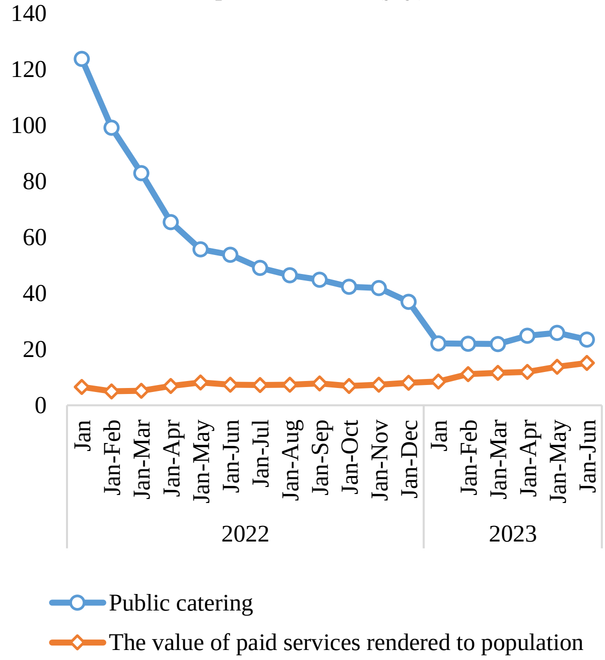
Source: SSC

Consumers spent over half of their funds (56.4%) on food, beverages and tobacco products in retail trade outlets.

Every consumer purchased, on average, AZN432.5 worth of goods (y.o.y. up by AZN60.1) in nominal terms in retail trade – AZN244 on food, beverages and tobacco products, and AZN188.5 on non-food stuff.

Public catering turnover y.o.y. increased by 23.5% in real terms. Paid services to the population increased by 15.1% in real terms to AZN5.3B. Per capita paid services consumption y.o.y. increased by AZN108.5 to AZN525.4 on average in nominal terms in H1 2023.

Chart 25. Dynamics of public catering and paid services, (y/y) %



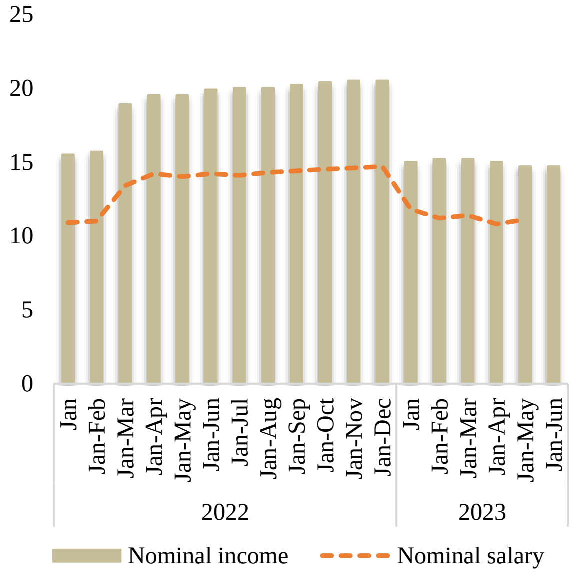
Source: SSC

The growth dynamics of nominal income of the population was the main factor in the rise of consumer demand in H1 2023 too. The nominal growth rate of personal income continues to outpace the average annual inflation rate, which means that incomes are rising in real terms.

According to the SSC, money income of the population increased by 14.7% to AZN37.9B in nominal terms. Per capita money income was

AZN3734.8. Population's disposable income increased by 14.7% to AZN33.4B. Average monthly nominal salary of hired labor y.o.y. increased by 11.1% to AZN916.8 over 5 months of 2023.

Chart 26. Growth dynamics of incomes and salaries, (y/y) %



Source: SSC

Lending activity also weighed on the consumer demand. Loans to households increased by 11.5%.

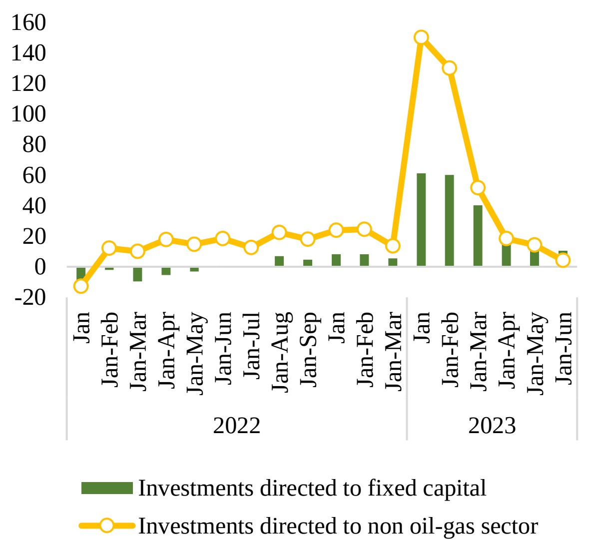
Government spending was critical in supporting domestic demand. Over the period, state budget expenditures amounted to AZN14.1B.[3]

In January-June 2023, AZN9.7B (69.1%) of state budget expenditures were channeled to current expenses, AZN3.9B (27.8%) to capital expenses and AZN430.8M (3.1%) to state debt and liabilities.

Investment demand expanded over the reporting period as well. According to the SSC, funds invested to the economy y.o.y. increased by 10.4% (AZN7.1B). The change in investments both in the oil-gas and non-oil-gas sectors was positive. Investment in the oil and gas sector y.o.y. increased by 21.4% and investment in the non-oil and gas sector increased by 4.2% in real terms.

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

Chart 27. Dynamics of investments , (y/y) %



Source: SSC

AZN405.4M (5.7% of total investments) out of AZN4.3B worth funds channeled to the non-oil and gas sector was used in non-oil and gas industry. The public sector accounts for 47.7% and the non-public sector for 52.3% of total investments.

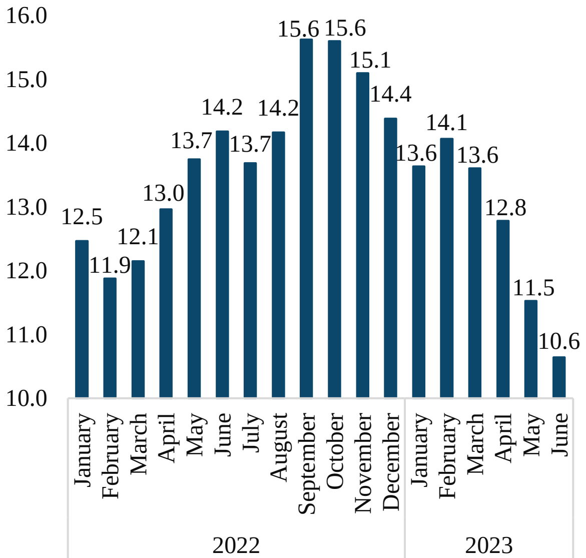
72.9% of investments stemmed from internal and 27.1% from foreign sources. Growth of funding sources of investments was positive across all directions. Funds of enterprises and organizations prevailed in total investments (48.6%).

2.3. Inflation

In H1 2023, annual inflation was prone to falling. Certain developments in global and internal environments paved the way to the drop in inflation. According to recent forecasts, the probabilities that inflation will fall to a single-digit rate in the second half of the year are elevating.

Consumer price index (CPI). According to the SSC, annual inflation stood at 10.6% in June 2023 (June 2023 vs June 2022) (down by 5 pp from the peak in September 2022). Average annual inflation stood at 12.7% in H1 2023.

Chart 28. Annual inflation, %

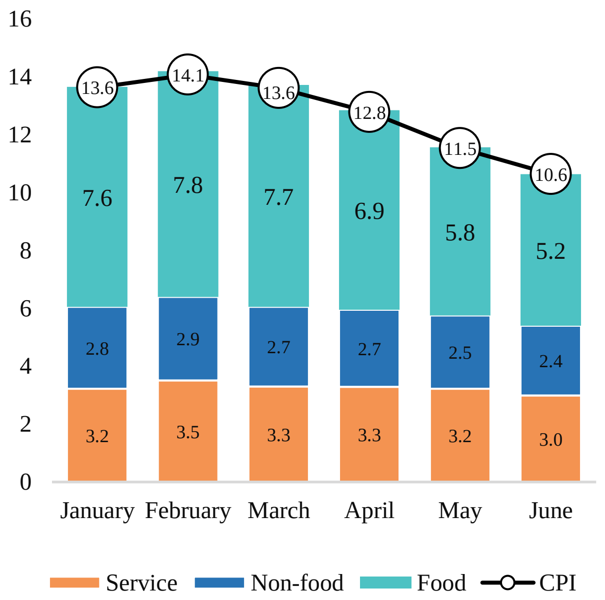


Source: SSC

Total inflation was mainly driven by food price hike. In June, annual food inflation stood at 11.5% and average annual food inflation stood at 15.1%. Non-food prices increased by 10.3% on annual and by 11.4% on average annual. Service prices hiked by 9.8% y.o.y. Average annual service inflation was 10.5%.

In general, food prices made 5.2 pp, non-food prices 2.4 pp and changes in prices and tariffs of services 3 pp contribution to annual inflation in June.

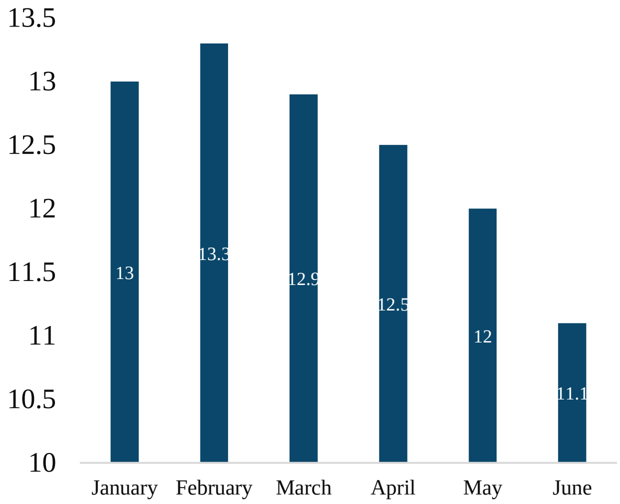
Chart 29. Contributions to CPI
(in percentage points)



Source: SSC, CBA

Annual core inflation calculated by excluding changes in regulated prices and prices for seasonal agricultural products was 11.1% in June 2023. Average annual core inflation was 12.5% in January-June 2023.

Chart 30. Change of core annual average inflation , in %



Source: SSC

Annual inflation decreased under the influence of both external and internal factors. Low inflation in trade partners, price slides in global commodity markets, reversion of international freight costs to pre-pandemic levels had a downward pressure on inflation. Estimations suggest that, in June average weighted inflation among trade partners decreased by more than two times from the peak level in October of last year, attributable to weak global economic activity, falling global energy prices and the tight monetary policy implemented in most countries (See 1.2. Global commodity markets).

In general, strengthening of the factors that decrease inflation allowed revising inflation forecast down. According to recent forecasts, inflation is projected to fall to 6-7% as of end-2023.

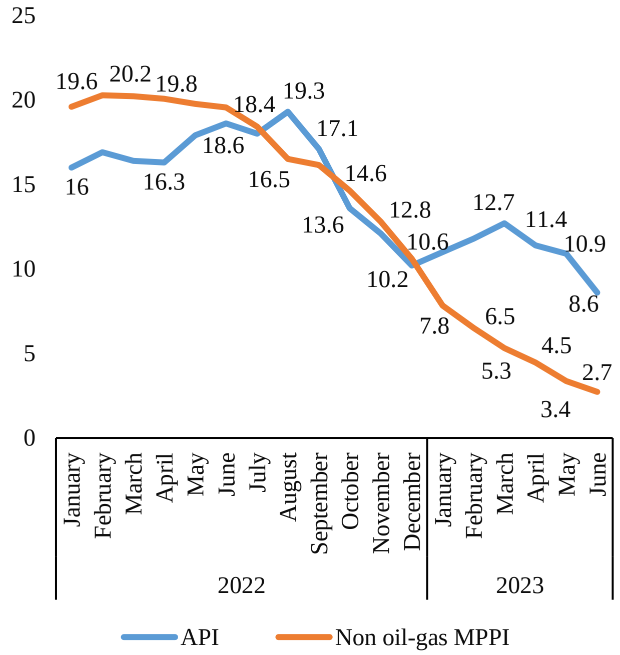
Despite falling inflation, high volatility of the external sector, the risk of excess aggregate demand may be assessed as the factors pushing inflation. On the backdrop of lingering geopolitical tension, international logistic supply chain disruptions and expectations that inflation will remain higher than targets in a number of countries have the potential to affect inflation through various channels.

Producer Price Index. According to the SSC, APPI y.o.y. increased by 8.6% in June. The IPPI y.o.y. decreased by 26.9%. The IPPI decreased by 35.8% on oil-gas products and increased by 2.7% on non-oil-gas products. The non-oil-gas PPI has decreased by 5.1 pp since early year.

The PPI in processing y.o.y. decreased by 1.6%.

The food production price index increased by 4.1%. However, the growth rate of the price index has decreased since early year (from 12% in January to 4.1% in June) due to the drop in agriculture price index.

Chart 31. Annual change of PPI
(at the current year, %)



Source: SSC

In June 2023, prices for transport and warehousing y.o.y. increased by 12.7%. Cost of freight transportation increased by 12.4% and the price of passenger transportation increased by 17%. The warehousing and supplementary transportation price index decreased by 2.1%. Postal and courier service prices y.o.y. increased by 1% in June.

House price index. According to the SSC, the house price index y.o.y. increased by 9.9% in Q2 2023. The price index increased by 8.3% in the primary housing market and by 10% in the secondary housing market. If to compare with Q1 2023 the price index increased by 1.2% in the housing market, by 0.7% in the primary market and by 1.2% in the secondary market in Q2 2023.

III. Monetary Condition

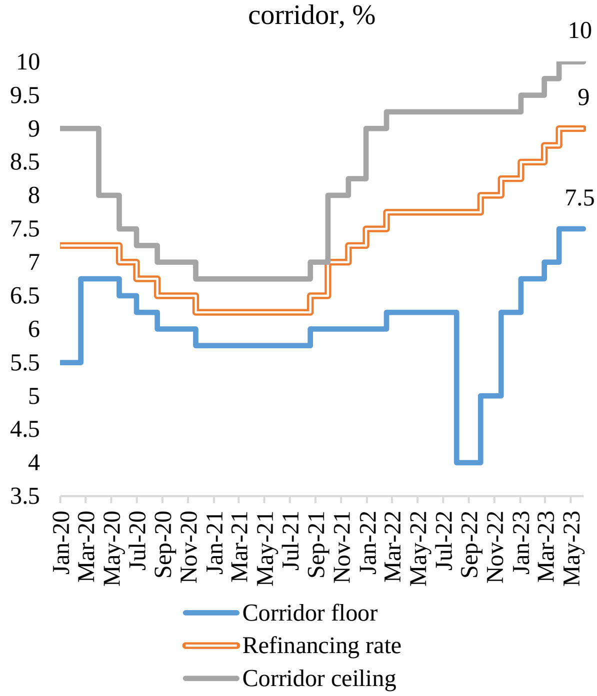
3.1. Monetary policy decisions and tools

In the first half of 2023, the Central Bank implemented an anti-inflationary monetary policy. Reforms continued to boost means to affect inflation. Monetary policy tools were applied in light of the liquidity position of the banking system and the balance of risks.

In January-June 2023, decisions on the interest rate corridor parameters of the CBA regarding liquidity operations were taken in light of the dynamics of annual inflation, deviation of updated forecasts from the target band, as well as developments in the global and national economies. When monetary policy decisions were taken, the Bank considered the time lag necessary for their translation to the real economy as well.

The CBA Management Board has discussed the interest rate corridor parameters 4 times over the reporting period, and decided to shift the refinancing rate from 8.25% to 9%, the ceiling of the interest rate corridor from 9.25% to 10% and the corridor floor from 6.25% to 7.5%. The CBA published interest rates related decisions under the pre-announced schedule with appropriate analytical comments.

Chart 32. Parameters of interest rate corridor, %



Source: CBA

The Bank continued to apply monetary policy tools within the new configuration. Demand for CBA's sterilization tools, in particular liquidity absorbing standing facilities was higher. Average volume of one-day deposit operations amounted to AZN592M.

In general, demand exceeded supply at note placement auctions. The CBA held total of 52 various term note auctions over the period. As of the end of June, total outstanding amount of sterilization via notes was AZN1335M. Although return on notes was prone to increasing over the period, it decreased in June. Return at recent auctions was 5.89% on 28-day, 7.34% on 84-day, 8.31% on 168-day, 8.85% on 252-day notes. The yield on CBA notes is critical in terms of formation of a yield curve affecting interest rates of other financial tools.

The Bank conducted AZN240M worth two 7-day Repo auctions for liquidity absorbing purposes.

In order to regulate the money supply more adequately and pave the way to the effective application of the new operational framework, the Bank made changes to reserve requirement rates and their differentiation. Banks have been maintaining reserve requirements under new norms since February 2023. Constant application of reserve requirements on an average basis allowed banks to manage liquidity flexibly.

Table 2. Change in reserve requirements

Until September 2022

- 0.5% on deposits in national currency and precious metals, 1% on deposits attracted in foreign currency

September 2022- February 2023

- 4% on deposits in national currency and precious metals, 5% on deposits attracted in foreign currency

From February 2023

- 5% on deposits of individuals and private entrepreneurs attracted in the national currency;
- 6% on deposits of individuals and private entrepreneurs attracted in foreign currency;
- 5% on the part of deposits of legal entities in the national currency with total amount up to AZN1B, 10% on the part of deposits of legal entities in the national currency with total amount over AZN1B;
- 6% on the part of deposits of legal entities in foreign currency with total amount up to AZN750M equivalent, 12% on the part of deposits of legal entities in foreign currency with total amount over AZN750M equivalent;
- 5% on deposits attracted in precious metals

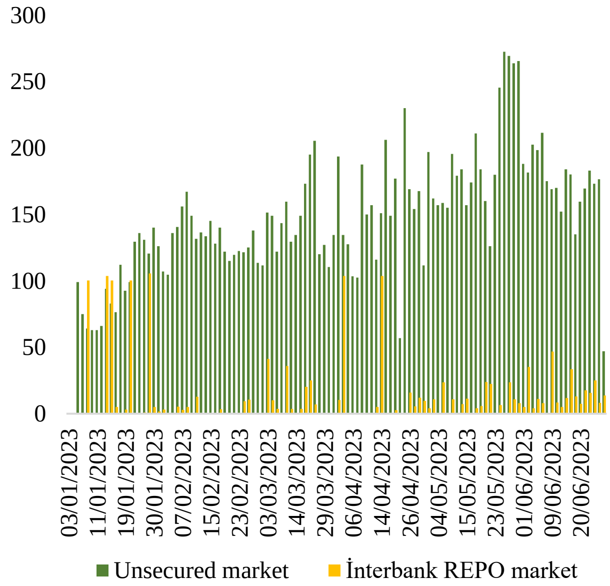
Source: CBA

Actions were taken over the period to formulate representative interbank market rates. As part of the mentioned actions, the ‘Regulations on calculation and publication of the benchmark rate (AZIR - Azerbaijan Interbank Rate) index at the unsecured interbank money market’ was adopted by the decision of the Management Board of the Central Bank based on deals concluded in the national currency over the Bloomberg platform. AZIR indices and information on the volume and number of transactions have been placed daily on the official website of the CBA since May. At the same time, changes to the ‘Regulations on calculation and publication of indices on repo market deals’ were approved by the Baku Stock Exchange. It allows publishing representative interest rate indices (AINA – Azn INdex Average) in the secured market on a higher frequency.

Activity in the money market continues to increase due to application of monetary policy tools under new configuration and their consistent improvement. In January-June 2023, banks concluded AZN16.6B worth of 1536 transactions in the platform launched for unsecured operations in the Bloomberg system. 94.5% of them were 1-3 day transactions. Because of the actions taken, the interest rate corridor parameters highly influenced interest rates in the interbank market. Under the influence of monetary policy decisions, an average interest rate on one-day transactions at the Bloomberg trade system in June was 1.76 higher than at the end of the previous year.

Over the period, the secured money market was active too. AZN1.4B worth of 374 transactions were concluded at the interbank Repo market. Notes issued by the CBA are used as securitization in the Repo market and have a positive effect on activation of the interbank market. The 50% of operations in terms of number and 31% of operations in terms of volume were based upon CBA notes.

Chart 33. The volume of interbank operations, during the first half of 2023, (mln. AZN)



Source: CBA

The CBA will further use all tools and mechanisms in its arsenal adequately to attain the inflation target.

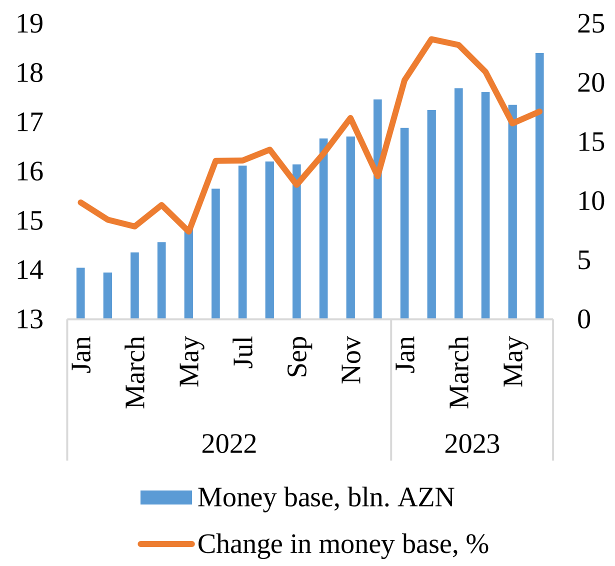
3.2. Money supply

In H1 2023, money supply in manat responded to the demand of the economy. The CBA regulated the change in money supply with its operations in accordance with policy targets.

Base money in manat increased by 5.4% to AZN18.4B as of the end-period.

Cash in circulation, a structural element of base money in manat [4] increased by 8%, stock of correspondent accounts in manat decreased by 8.3%.

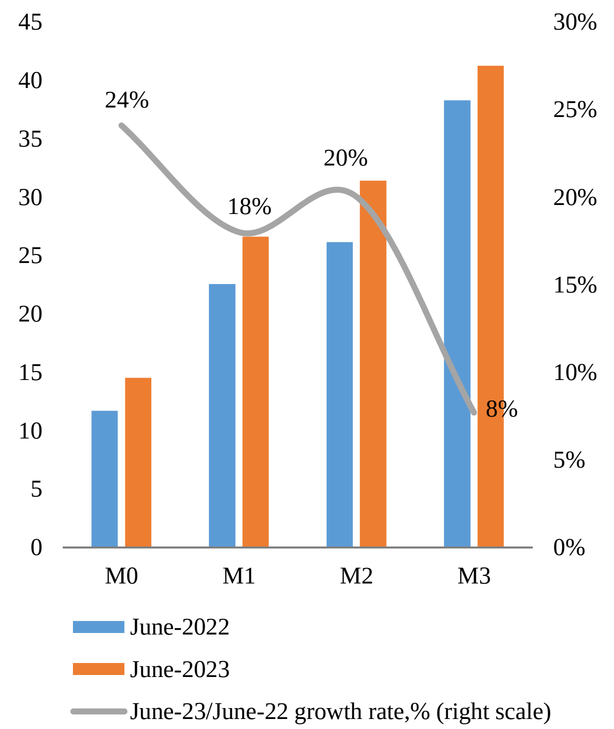
Chart 34. Monetary base and its annual change



Source: CBA

Money multiplier in manat (broad money supply in manat/base money in manat) has increased by 0.8% since early year to 1.71. Broad money supply in manat (M2) increased by 6.2% to AZN31.4B.

Chart 35. Money aggregates (bln. AZN)

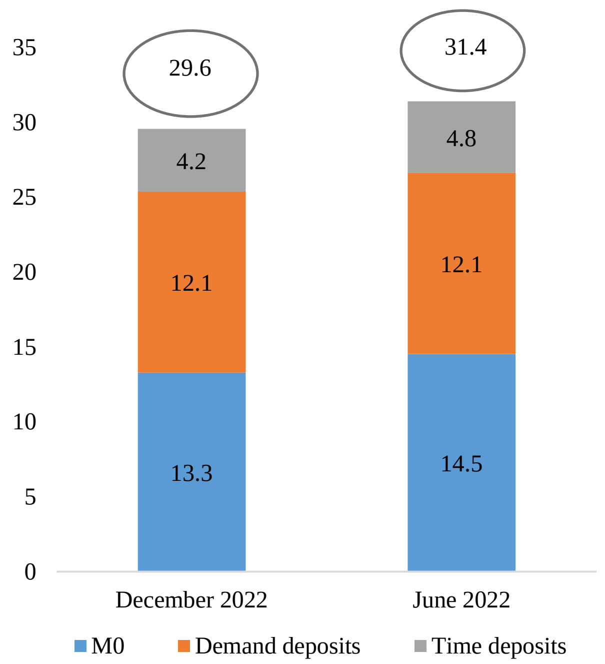


Source: CBA

All structural elements of M2 money aggregate grew over the period. M0 cash money supply increased by 9.3%, demand savings and deposits increased by 0.1% and term savings and deposits increased by 14.2%.

[4] Cash money outside the banking system, cash in bank ATMs and cash offices

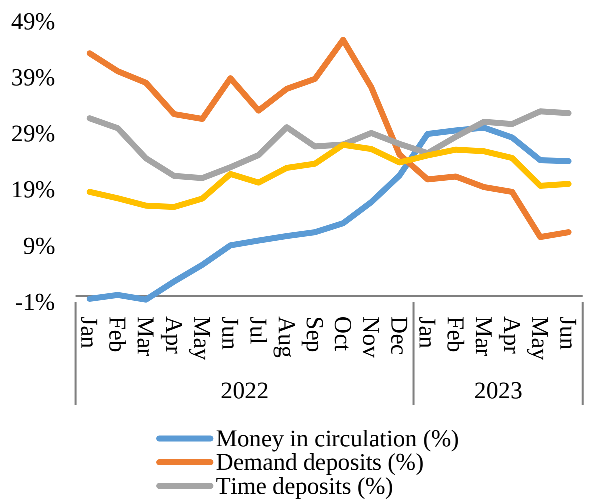
Chart 36. Dynamics of broad money supply (bln. AZN)



Source: CBA

Term savings and deposits increased at a higher pace both compared with the early year and year-over-year (y.o.y. up by 32.6%).

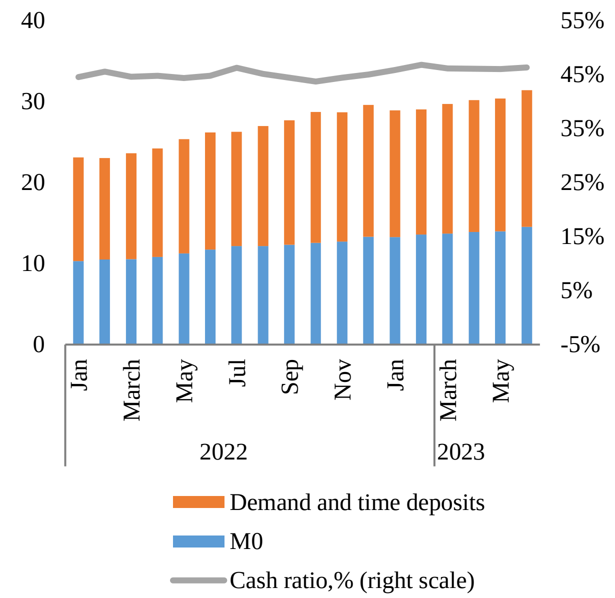
Chart 37. Dynamics of M2 and its components y.o.y. (%)



Source: CBA

The weight of cash (M0) in broad money supply in manat (M2) was 46.3%.

Chart 38. Cash ratio (M0/M2)), (bln. AZN)

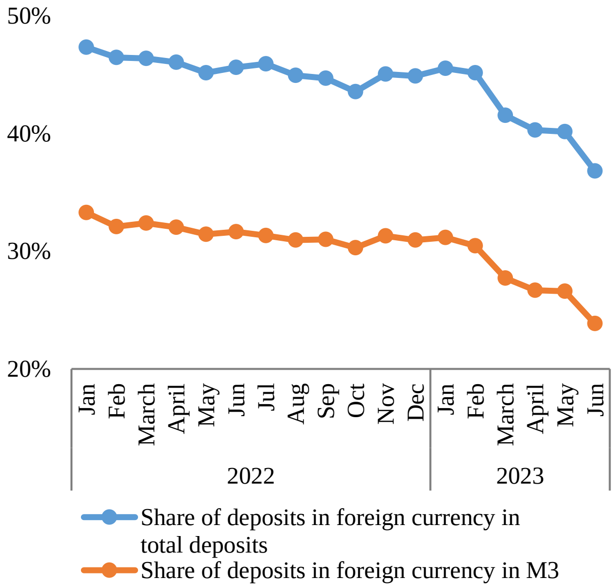


Source: CBA

Broad money supply (M3) decreased by 3.7% to AZN41.2B as of end-period. Change in NFAs had a downward, while the change in NDAs had an upward effect on the change in M3.

Dollarization kept decreasing. In H1 2023 foreign currency denominated savings and deposits decreased by 25.8%, while their weight in total savings and deposits decreased by 8.1 pp to 36.8%. The weight of foreign currency denominated savings and deposits in M3 money aggregate followed the same behavior and has decreased by 7.1 pp, since the beginning of the year to 23.8% to the end-period.

Chart 39. Dollarization (%)



Source: CBA

The share of foreign currency in deposits of legal entities was 46.6% as of the end-period, down by 6.1 pp compared with the early year. Dollarization of savings of individuals also has decreased 2.6 pp since the early year to 36.6%. Dollarization of deposits of households (less savings of non-resident individuals) decreased by 3.3 pp to 32.3% as of end-period.

The CBA will use tools at its disposal in the second half of 2023 as well to allow adequate change of money supply in response to monetary policy targets.

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

In H1 2023, the exchange rate of manat against foreign currencies was formed according to supply and demand in the FX market. The current account surplus of the balance of payments supported the exchange rate stability, which serves as the key price stability anchor.

Operations continued at both cash and cashless FX market over the period.

Cashless transactions in the FX market amounted to $13.4B equivalent[5] - 79.5% in the USD and 20.5% in other currencies. The Interbank FX market accounted for 20%, the Intrabank FX market for 80% of operations.

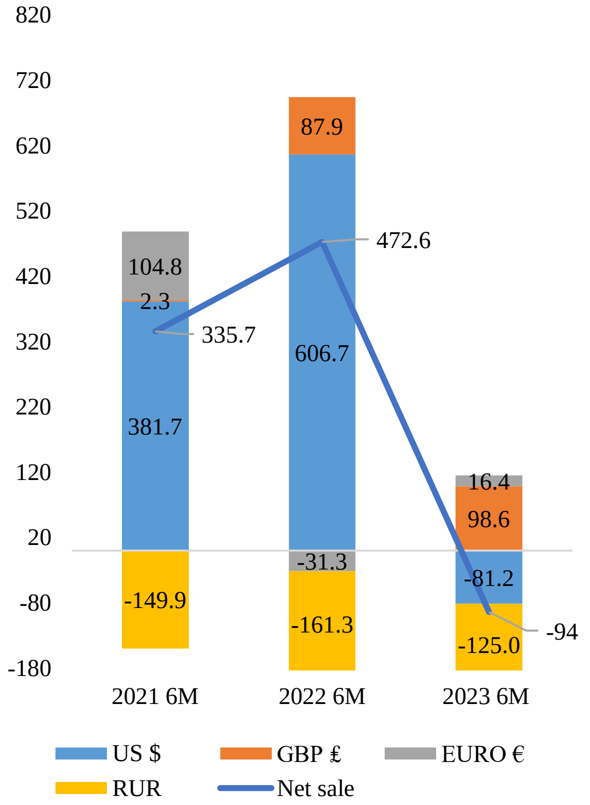
Interbank FX market operations (including operations of the SOFAZ and the CBA) amounted to $2.7B. 97.3% of transactions were conducted in the USD. Currency operations in the Interbank FX market were mainly conducted over the Bloomberg platform.

Over the reporting period, the Bloomberg's BMatch platform was activated maintaining the existing auction mechanism. The platform allows the CBA to respond flexibly to the FX market, banks to track supply and demand for foreign currency in a real time mode and conclude deals with the most optimal exchange rate. Intrabank FX market operations amounted to $10.7B equivalent and 75% of transactions were made in US dollars y.o.y. Legal entities accounted for 93.2% of Intrabank FX market operations.

Cash currency traded by banks y.o.y. decreased by 29% to $1.8 (84% in USD). Cash currency buying operations prevailed over sales for the first time in 6 months over recent years.

[5] *Including transactions with the USD, the euro, the pound, the Russian ruble*

Chart 40. Net sales of cash FX by banks, (mln. AZN)



Source: CBA

Note: Positive zone indicates sell, negative zone indicates buy transactions.

The CBA held 45 currency auctions to sell foreign currency provided by the SOFAZ. Supply prevailed over demand at 98% of auctions. The CBA made purchase oriented interventions to the FX market.

The official exchange rate of the manat against the USD was formed based upon the average exchange rate on interbank transactions (both auction and over-the counter on the Bloomberg platform). The average official USD/AZN exchange rate was AZN1.7 over the period. Buy-sell exchange rates set by banks were close to the official exchange rate. Commercial banks' average buy/sell rate was 1.6955/1.7024.

The exchange rate of manat against currencies of trade partners varied over the period. Manat appreciated against the Turkish lira, the Russian ruble the Japanese yen and the Chinese yuan and depreciated against the euro, the British pound, the Kazakh tenge, the Swiss franc and the Georgian lari in nominal terms.

The dynamics of bilateral exchange rates influenced that of multilateral exchange rates.

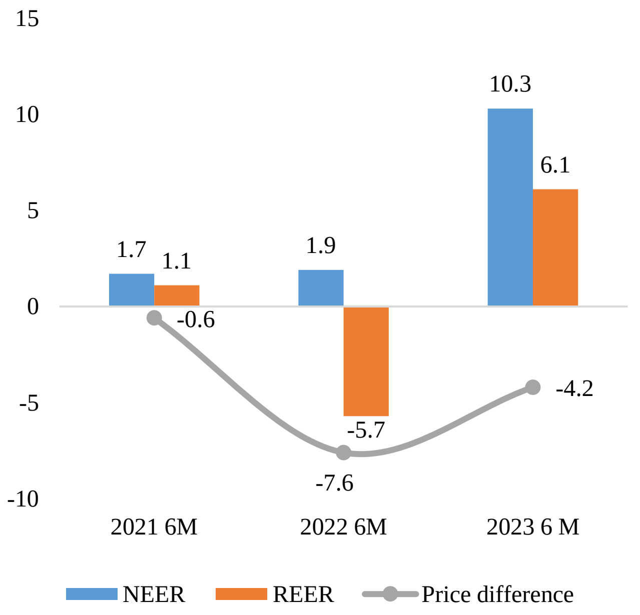
Table 3. Bilateral NEER and REER of manat against currencies of trade partners in H1 2023 (December 2022=100)

	Nominal bilateral exchange rate	Real bilateral exchange rate
Russian ruble	126.4	125.2
Turkish lira	125.3	105.3
Euro	97.7	97.2
Chinese yuan	102.3	104.9
Iranian rial	100	84
US dollar	100	100.5
Kazakh tenge	95.5	92.6
Belarus ruble	100	99.2
Japanese yen	104.5	104.9

Georgian lari	97.5	100.8
Ukrainian hryvnia	100	97.7
Swiss franc	96.6	96.9
South Korean wan	100.2	100.4
British pound sterling	96.4	96.9
Israeli shekel	105.5	105.5
Total (NEER, REER)	110.3	106.1

In general, total trade-weighted non-oil NEER of the manat appreciated by 10.3% and the REER by 6.1%. Since inflation in Azerbaijan was lower than the average inflation in partner countries, it had a reducing effect on the REER.

Chart 41. Effective exchange rates
(annual change, %)



Source: CBA

A stronger NEER of the manat acted as one of the factors to contain the inflation import.

Charts and tables

Charts

Tables

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