



CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

JANUARY- JUNE 2021

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ACRONYMS

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

EXECUTIVE SUMMARY

In Half I 2021, the Central Bank's monetary policy was oriented towards maintaining inflation within the announced target band ($4\pm 2\%$).

Inflation is still within the target band, albeit being slightly high driven by external factors. The balance of payments surplus and the FX market stability have a stabilizing effect on inflation.

In Half I 2021, the external environment was marked by optimistic expectations related to the introduction of the COVID-19 vaccine, partial easing of social restrictions and global economic recovery. Over the period, the international situation had a positive impact on the domestic macroeconomic situation.

The monetary condition served to maintain an optimal balance between supporting economic growth and maintaining macroeconomic stability. Interest rate corridor parameters related decisions were taken in light of macroeconomic forecasts, transmission of external inflation to the domestic market, the scale of impact of seasonal factors, inflation expectations and change in the balance of risks. The main factor to affect money supply was the change in balance of the single treasury account that depends on state budget revenues and expenditures. The Central Bank adequately applied monetary policy tools to effectively regulate liquidity in the economy.

In general, over the reporting period, macroeconomic and financial stability was safeguarded in the country, as a result of effective anti-crisis measures and amid relative improvement in the epidemiologic situation, economic growth was in the process of recovery.

I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

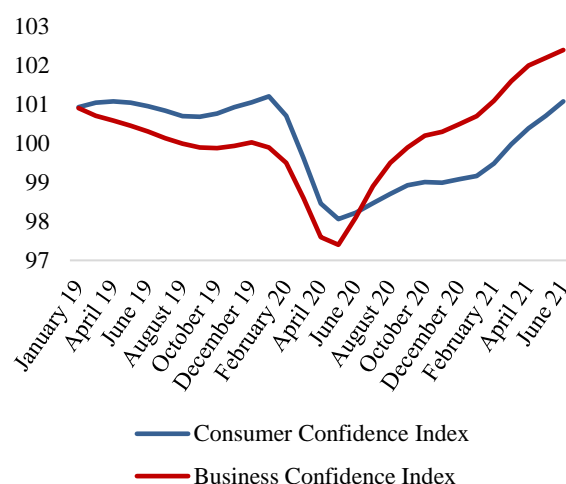
1.1. Global economic trends

In Half I 2021, global economy was in process of recovery. Mass vaccination since early year has pushed optimistic expectations in global economic activity. Prospects for recovery of economic activity will also depend on the speed and scope of vaccination. According to the IMF, economic recovery in AEs that are population actively vaccinated will be faster than in EMEs that are population are currently poorly vaccinated.

Global economic activity. The global economy is already entering the recovery pace after economic contraction of 2020.

Economic activity indicators in OECD countries (over 62% of the global economy) posted growth in Half 1 2021. The BCI on OECD countries exceeded the pre-pandemic level amid rapid recovery expectations after a plunge in

Graph 1. Business and Consumer Confidence indexes in OECD countries

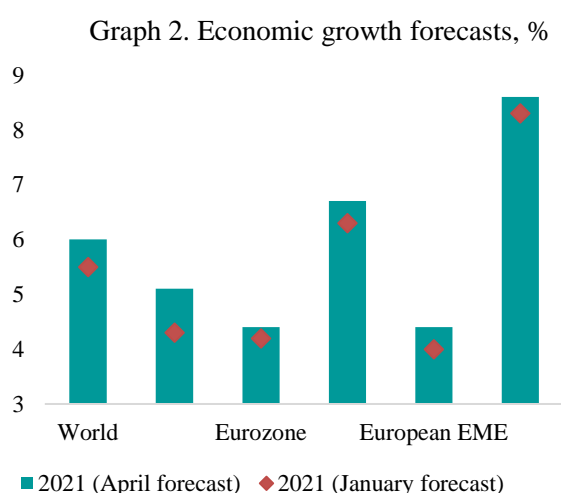


Source: OECD

mid-2020. The CCI also reached the pre-pandemic level.

International organizations are revising up global economic growth outlook across country groups diversely in light of recent trends. The IMF forecasts 6% growth of the global economy in 2021 (the same with the previous forecast) and 4.9% growth of the global economy in 2022 (0.5 pp up vs the previous outlook) in WEO July Update. 0.5% growth revision for 2022 mainly stems from the rise forecasted for AEs. It is particularly attributable to additional fiscal support for economic activity in the USA expected in the second half of 2021. The report revised economic growth outlook up for AEs up and down for

EMEs, in particular for Emerging Asian Markets. These adjustments are put down to the level of vaccination across countries and effectiveness of incentive measures. Over 40% of the population in AEs, 20% in EMEs and a very small part of the population in low-income countries have been vaccinated. In general, the countries like China, the USA and Japan with strong domestic and foreign demand are expected to reach the pre-pandemic activity level earlier.



Source: IMF

Global inflationary pressures have risen, largely due to temporary pandemic related mismatch in supply and demand. Inflation in most countries is expected to reach pre-pandemic levels in 2022.

The IMF July Update forecasts 7% economic growth in the **USA** in 2021 (0.6

pp up vs the previous outlook). Significantly improved forecast for the US economy stems from expectations of legislative changes in the second half of 2021 that will increase infrastructure investment and strengthen social security.

Annual inflation in the USA was 5.4% in June 2021, higher than market expectations (4.9%). The highest price hike was in second hand automobiles and trucks (45,2%), petrol (45,1%), black oil (44,5), utilities (15,6%) and transportation services (10,4%). In June unemployment stood at 5.9%, 0.1 pp down vs the previous month.

The Dow Jones increased by 12.8%, S&P 500 by 25.6% and Nazdaq by 12.9%. In Half I in the USA, industrial production increased by 0.4% in June 2021 vs the previous month and by 9.8% y.o.y.

To accelerate post-pandemic recovery the US government will continue broad incentive policy measures for the rest of 2021. The FED kept interest rates stable at 0-0.25% over Q2.

The IMF forecasts 4.6% economic growth in the **euro area** for 2021, up vs the April Update (4.4%).

In June 12-month inflation in the euro area was 1.9%, the highest annual inflation since March 2018. In June 2021 industrial production in the euro area y.o.y. increased by 9.7%, 0.7 pp lower than market expectations. In June 2021, unemployment in the euro area was 7.7% (market expectations 7.9%). The number of the unemployed decreased by 423 thousand persons to 12.51 million. The highest unemployment rate was in Spain (15.1%), Italy (9.7%) and France (7.3%) and the lowest was in Holland (3.2%) and Germany (3.7%). The FTSE Eurotop increased by 14.6%. The ECB left the interest rate unchanged until inflation approximates 2%. Moreover, the Emergency Purchase Program (€1850B) was extended until March 2022.

The IMF forecasts 2.8% economic growth in **Japan** for 2021, down vs the April Update (3.3%). Unemployment was 2.9% in June 2021 (market expectations 3%). In June, industrial production y.o.y. increased by 23%.

Production of motor vehicles, inorganic and organic chemical products and plastic ware increased most. The Nikkey gained by 5%. The Bank of Japan left the refinancing rate unchanged at negative 0.1%.

The IMF revised economic growth outlook for the **United Kingdom** up by 1.7 pp to 7% (5.3% in April Update). According to the IMF, economic activity in the UK will not return to the pre-pandemic level until the end of 2022. Annual inflation in the UK was 2.5%, higher than market expectations (2.2%). In June, industrial production y.o.y. increased by 8.3%. Unemployment in June was 4.7% (market expectations 4.8%). The Bank of England left the refinancing rate stable at 0.1%.

According to the IMF July Update, in 2021 economic growth in **EMEs** is expected to be 6.3% (6.7% in April Update). Economic growth across EMEs was revised down by 0.4 pp vs the April Update, mainly due to weaker than expected economic recovery in Emerging Asian Countries. In particular, weakening of economic growth outlook in India

amid the next wave of the COVID-19 pandemic in March-May has led to a downward revision of India's growth forecasts. In 2021, Emerging Asian Markets are expected to grow by 7.5% (8.6% in April Update), Emerging European Markets by 4.9% (4.4% in April Update), Latin America and the Caribbean by 5.8% (4.6% in April Update), the Middle East and Central Asia by 4% (3.7% in April Update), and Sub-Saharan Africa by 3.4% (3.4% in April Update).

The **Chinese** economy grew by 18.3% in Q1 and by 7.9% in Q2 2021. With this indicator, China is considered to be the largest economy to achieve the fastest recovery after the COVID-19 pandemic. In June 2021, industrial production y.o.y. increased by 8.3%. Unemployment was 5% in June, the lowest rate of recent 2 years. Annual inflation was 1.1% in June 2021, lower than market expectations (1.3%). The IMF in July Update forecasts 8.1% economic growth in China in 2021 (8.4% in April Update).

The IMF forecasts 4.4% economic growth in **Russia**, up vs the April Update (3.8%). In June 2021, the unemployment rate stood at 5%, lower than market expectations (5.1%). Although over the period the CCI was prone to recovering, it is still negatively zoned. The BCI moved to the positive zone to 0.70 as of end-June. Annual inflation was 6.5% in June 2021, higher than the central bank target (4%) and market expectations (6.3%). In June industrial production y.o.y. increased by 10.4%. The Russian ruble appreciated by 2% against the USD. The Bank of Russia tightened the monetary policy in light of inflation expectations, and shifted the interest rate from 4.25% to 5.5%.

Economic growth in **Turkey** is forecasted to be 6% in 2021. In June 2021, 12-month inflation in Turkey was 17.5% (market expectations 17%). Industrial production y.o.y. increased by 23.9%. Production of durables (30.9%), interim products (28.3%), machinery and equipment (25%), nondurables (18.1%) and energy products (16.8%) increased. In June, unemployment decreased to

10.6% vs the previous month. The Turkish lira depreciated by 18.5% against the USD. The Central Bank of Turkey shifted the interest rate to 19% from 17% over the quarter.

According to the IMF's recent update, global trade is expected to grow by 9.7% (8.4% in previous outlook) in 2021 and by 7% in 2022 (6.5% in previous outlook) in line with revival in global economic activity.

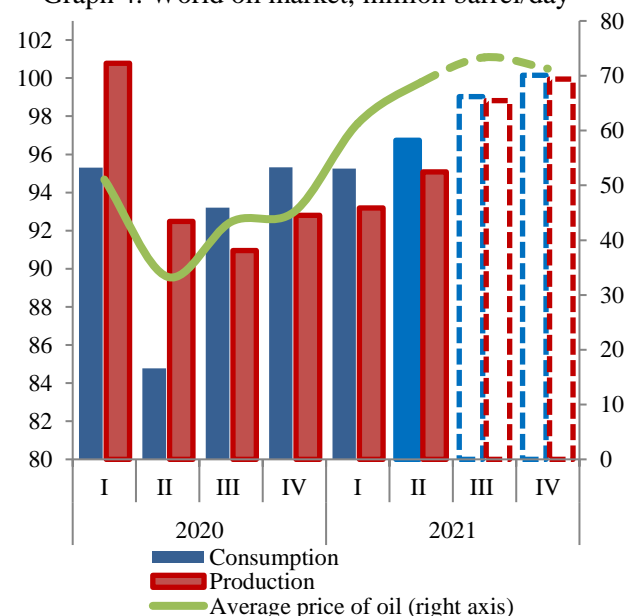
Commodity markets. Commodity prices in the world market have generally risen. According to the World Bank's Commodity Markets Outlook, in January-June 2021 energy prices increased by 48%, non-energy prices by 17.1%, food prices by 15.4%, precious

metal prices by 0.4%. The gold price decreased by 1.3%.

Source: World Bank

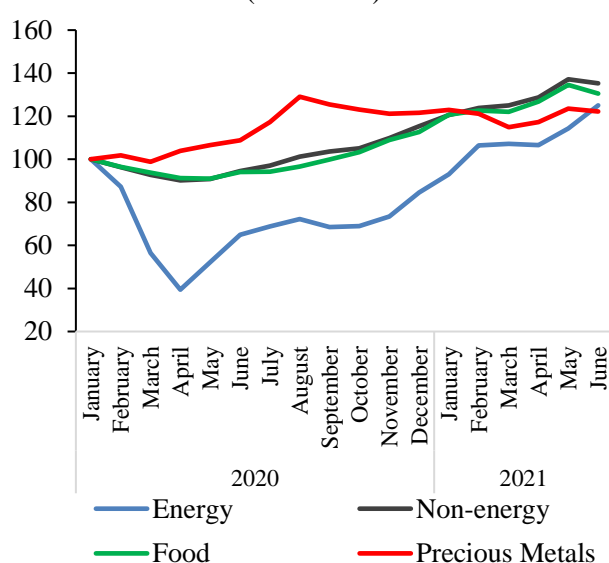
The average Brent oil price was \$65.2 per barrel in the first half of 2021, 51.3% higher than the average price in 2020 (\$43.1).

Graph 4. World oil market, million barrel/day



Source: Energy Information Administration (EIA)

Graph 3. Commodity price index (2020=100)



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

dramatically since early year. According to the Oil Market Report of the International Energy Agency (IEA), as of end 2021 oil consumption may jump to the pre-pandemic level increasing by 5.4 mln barrel/day as of end-2021 and by 3.1 mln barrel/day as of end-2022.

Risks. According to the IMF July Update, although the peak of the pandemic is behind us, the risks it poses to the global economy are still on the agenda. Weak vaccination in EMEs, in its turn, continues to create conditions for new mutations. As a result, uncertainties about the level and pace of recovery in the global economy remain relevant. In general, risks posed by the current macroeconomic and epidemiological situation are as follows:

- Households continue austerity measures and low consumption provides low support for economic growth;
- The monetary and fiscal policy stepped to the phase of contraction across countries due to high inflation.

High expenses of businesses due to the pandemic-driven supply and demand

mismatch in the global market (low recovery of supply amid rising demand), as well as the epidemiological situation and the rising cost of fuel and energy products have an upward effect on global inflation. For instance, growing demand for home appliances and the supply that fails to meet them.

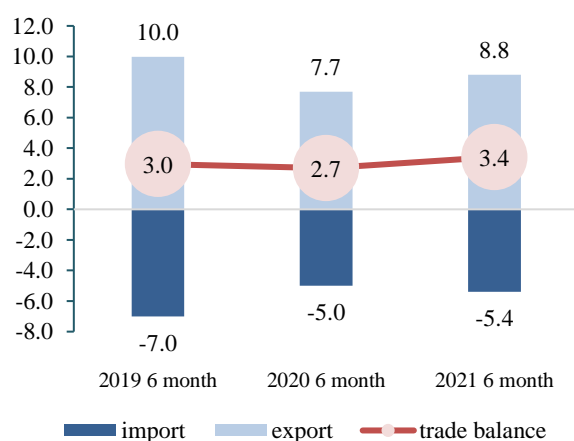
Other factors contributing to high inflation are increase in commodity and home prices from Q2 2021 onward after their sharp fall during the pandemic.

1.2 External sector developments of the Azerbaijani economy

In Half I 2021, the external economic position of Azerbaijan shaped amid realization of country's non-oil export potential, high global oil prices and accelerated global economic recovery.

According to the SCC, in Half I 2021 foreign trade turnover amounted to \$14.2B – export \$8.8B (62%) and import \$5.4B (38%). Foreign trade surplus made \$3.4B.

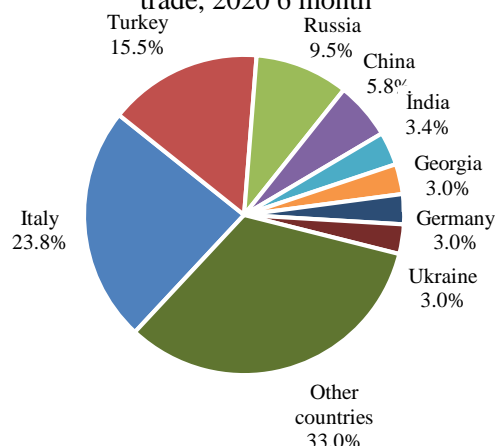
Graph 5. Trade balance, USD bn.



Source: SCC

Azerbaijan traded with 171 countries.

Graph 6. The main partner countries in trade, 2020 6 month



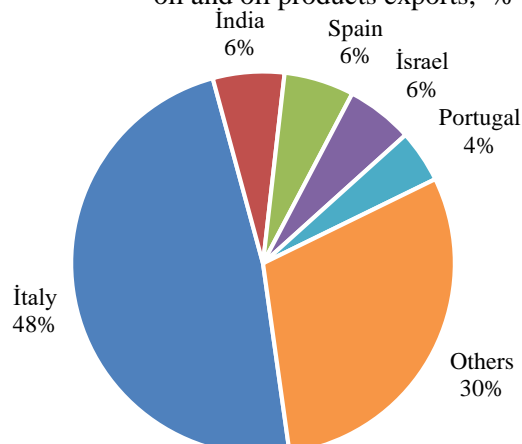
Source: SCC

Italy, Turkey, Russia, China, Germany, Georgia, India and Ukraine account for over half of trade turnover. Italy takes the highest share in trade turnover as in previous periods – its share in total trade turnover y.o.y. increased by 0.8 pp to 23.8%. Turkey accounts for 16%, Russia for 9%, China for 6%, Ukraine for 3%, Germany 3.4%, Georgia 3% and India 3% of total turnover.

Export increased by 14.6%, non-oil export by 27.5%. The value of export increased by 7.6% on crude oil, by 73.7% on oil products and by 25.8% on natural gas.

48% of crude oil and oil products was exported to Italy, 6% to India, 6% to Spain, 6% to Israel and 4% to Portugal.

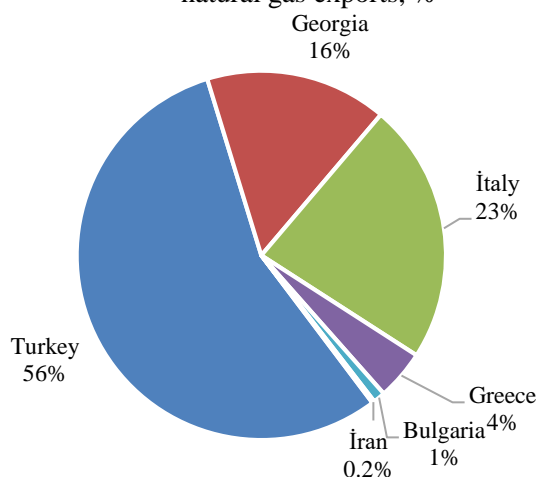
Graph 7. Main partner countries in crude oil and oil products exports, %



Source: SCC

Main export partners on natural gas were Turkey, Georgia, Italy, Greece and Bulgaria. Turkey accounts for 55.5%, Italy for 22.9%, Georgia for 15.9%, Greece for 4.4%, Bulgaria for 1.1% and Iran 0.2% of natural gas export.

Graph 8. Main partner countries in natural gas exports, %

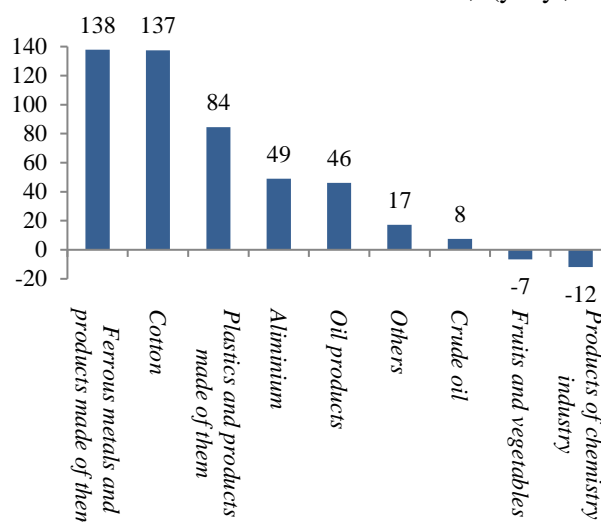


Source: SCC

The value of export increased by 2.4 times on ferrous metals and products and cotton yarn, by 84% on plastics and

products, by 49% on aluminum, and by 46% on oil products.

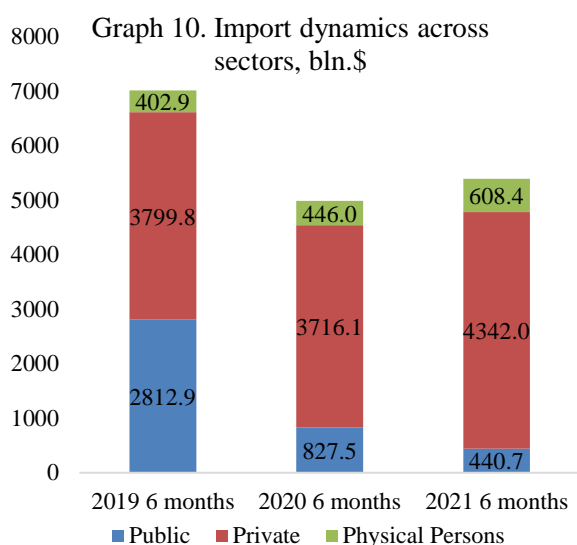
Graph 9. Change in export of commodities. 2021 6 month, (y.o.y., %)



Source: SCC

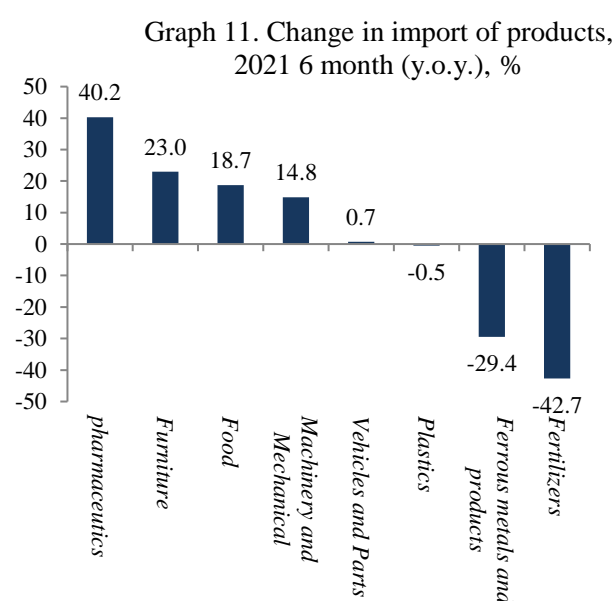
In general, over the reporting period the main export partners included Italy (35.9%), Turkey (15.7%), Russia (4.8%), Georgia (4.4%), India (4%) and Spain (3.9%).

Commodity import increased by 8%. Commodity import decreased by 1.9 times to \$0.4B on the public sector, increased by 16.8% to \$4.3B on the private sector and by 36.4% to \$0.6B on individuals.



Source: SCC

Import increased by 40.2% on pharmaceuticals, by 23% on furniture, by 18.7% on food products, by 14.8% on machinery and mechanisms, by 0.7% on vehicles and their parts, and decreased by 42.7% on fertilizers, by 29.4% on ferrous metals and products, and by 0.5% on plastics and products.

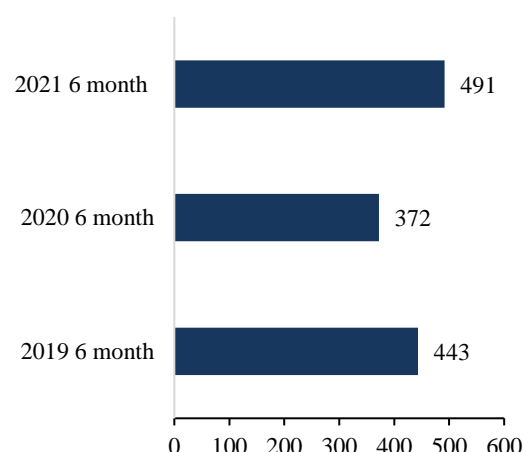


Source: SCC

Russia accounts for 17.1%, Turkey for 15.2%, China for 12.9%, Germany for 6.3%, the USA for 4.3%, Ukraine for 4.1% and Italy for 4% of imported products.

According to initial data, money remittances to the country y.o.y. increased by 32% to \$491M.

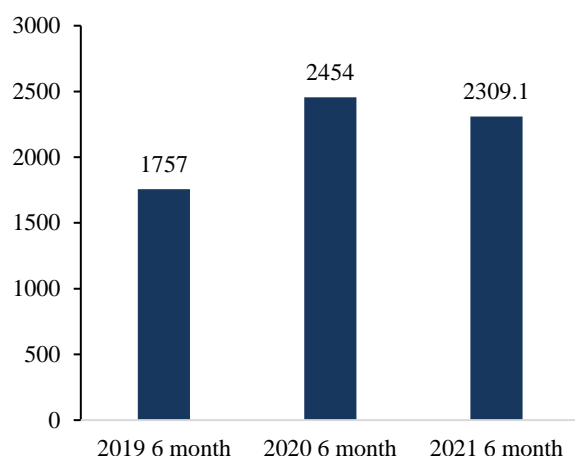
Figure 12. Inflow of remittances, mln.\$



Source: CBA

Capital inflows from foreign enterprises and organizations kept on over the reporting period. According to the SSC, FDIs amounted to AZN2.3B equivalent (39% of total investments).

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



Source: CBA

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

Strategic foreign exchange reserves still exceed the internationally accepted adequacy norms. As of end-June, 2021 strategic FX reserves sufficed for 41-month import of goods and services (taking import of goods and services for 2020). Strategic reserves exceeded money supply in manat (M2) by 4.2 times (M2 money aggregate as of 01.07.2021).

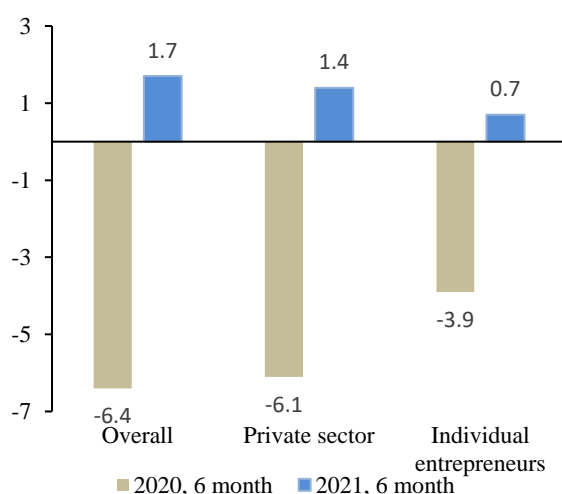
II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

2.1. Aggregate demand

In Half I 2021 aggregate demand posted growth.

Consumption expenditures increased in January-June 2021. Goods and services sold in the market to meet consumer demand y.o.y. increased by 1.7% in real terms to AZN23.3B. The private sector accounts for 96.1% of the goods sold and services supplied by economic agents (48% individual entrepreneurs). Every consumer spent on average AZN387.7 in the consumer market (y.o.y. up by 5.5%).

Graph 14. Change in volume of sales in consumer market, %

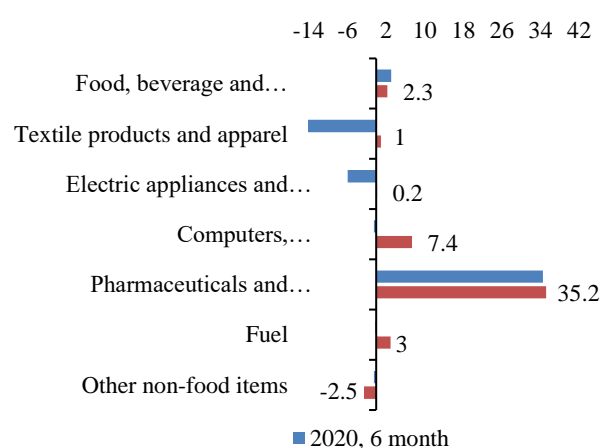


Source: SSC

Continuation of the vaccination process in the country and partial easing of pandemic-related social isolation measures have created conditions for increasing consumer demand.

Retail trade turnover y.o.y. increased by 1.7% to AZN19.4B – by 2.3% on food products, beverages and tobacco products, and by 1.1% on non-food products. Low consumer spending on certain product groups (textile and clothing, furniture, motor fuel, etc.) due to the pandemic was replaced by an increase again.

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



Source: SSC

The share of consumer spending on food, beverages and tobacco products in retail trade outlets y.o.y. increased by 0.5%, pharmaceuticals and medical devices by 0.5%, fuel by 0.8%.

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

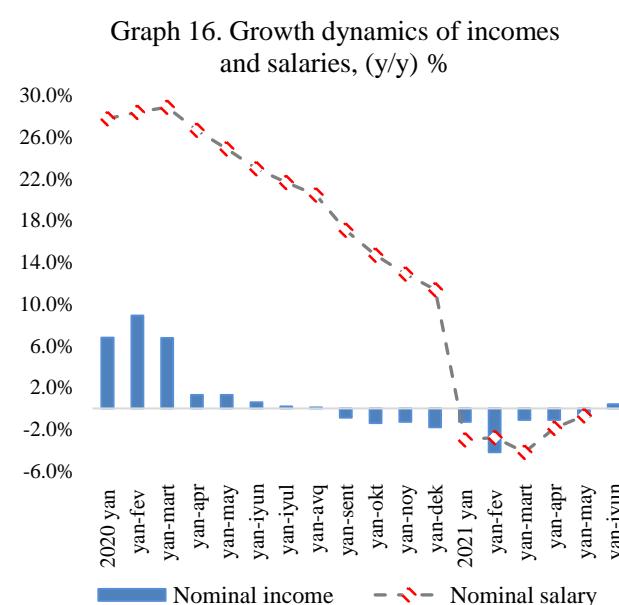
| Spending item | Share, % | |
|-------------------------------------------------|---------------|---------------|
| | 2020 6 months | 2021 6 months |
| Food, beverage and tobacco | 53.3 | 53.8 |
| Textile products and apparel | 14.7 | 14.3 |
| Electric appliances and furniture | 5.5 | 5.3 |
| Computers, telecommunication devices and others | 0.8 | 0.8 |
| Pharmaceuticals and medicals | 1.7 | 2.2 |
| Fuel | 5.4 | 6.2 |
| Other non-food items | 18.6 | 17.4 |

Source: SSC

Every consumer purchased on average AZN173.8 worth food, beverage and tobacco, AZN148.9 worth non-food items monthly for private consumption in retail trade.

Catering turnover y.o.y. decreased by 4.5%. Entities accounted for 49.4%, private entrepreneurs for 50.6% of catering turnover in the private sector. The value of paid services supplied to the population increased by 2.3% in real terms to AZN3.5B. Per capita paid services consumption y.o.y. increased by AZN17.9 to AZN353.2 in nominal terms.

Consumption recovery is supported by an increase in income of the population. According to the SSC, over the past period of 2021 money income of the population increased by 0.4% to AZN27.6B in nominal terms. Per capita money income made AZN2755.4. Population's disposable income amounted to AZN24.8B.



Source: SSC

Recovered lending activity also contributed to consumer demand. Loans to households increased by 9.1% to AZN7.3B.

Gradual recovery of economic activity and easing of lockdown measures weighed on the CCI as well. The CCI indicator generated from findings of the

“Households financial behavior and intentions survey” held in Q2 2021 improved vs the previous quarter. To note, this indicator rests upon surveys among various income households ‘Family’s financial condition expectation’, ‘Expectation on country’s economic standing’, ‘Savings probability’ and ‘Unemployment expectations’.

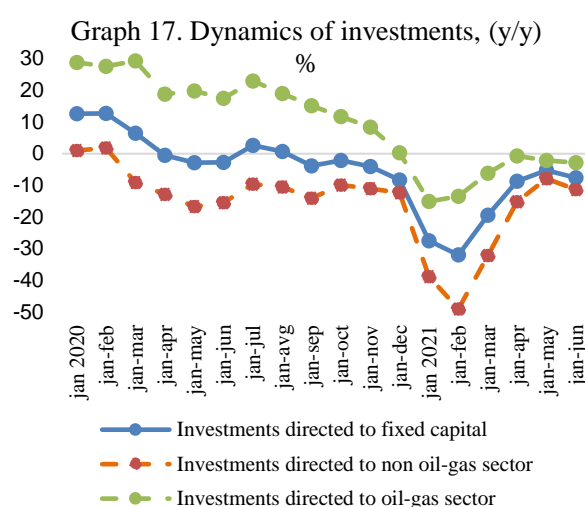
Government spending was substantial to support domestic demand. State budget expenditures amounted to AZN11.6B in Half I 2021.¹

Social spending (compensation for employees, pension and social allowances, medicine and food following the economic classification) accounts for 44.1% (AZN5.1B) of actual state budget spending (y.o.y. up by 2.6%).

Investment expenditures.

According to the SSC, in January-June 2021 AZN5.9B (y.o.y. down by 7.6%) was channeled to the economy. AZN3.2B worth funds were channeled to the non-oil and gas sector (y.o.y. down by 11.3%). The public sector accounts for

34.6% and the private sector for 65.4% of total investments.



Source: SSC

61% of investments stemmed from internal, 39% from external sources.

Table 2. Investment sources, %

| | 2020 6 months | 2021 6 months |
|-----------------------------------------------|---------------|---------------|
| <i>Funds of enterprises and organizations</i> | 61.6 | 60.4 |
| <i>Bank loans</i> | 5.4 | 6 |
| <i>Budget funds</i> | 22.2 | 19.1 |
| <i>Off-budget funds</i> | 2.4 | - |
| <i>Personal funds of population</i> | 6.2 | 7.2 |
| <i>Other funds</i> | 2.2 | 7.3 |

Source: SSC

Funds of enterprises and organizations prevailed in total investments (60.4%). The share of bank loans increased year over year.

¹ <http://www.maliyye.gov.az>

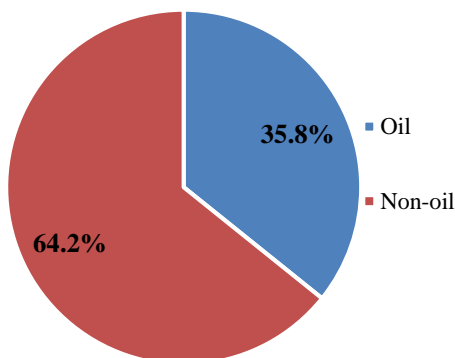
2.2. Aggregate supply and employment

Aggregate demand kept pace with economic activity. The process varied across sectors.

Economic growth. According to the SSC, in Half I 2021, GDP y.o.y. increased by 2.1% in real terms to nominal AZN39.9B. Per capita GDP was AZN3987.6.

Oil and gas value added decreased by 4.7% and its nominal value was AZN14.2 (35.8% of GDP). The mining sector extracted 17.1 m/t crude oil and 15 bln/m3 natural gas. Oil extraction y.o.y. decreased by 3.7% and gas extraction increased by 8.8%. Total cost of production in oil products was AZN1977M (y.o.y. down by 5.5%).

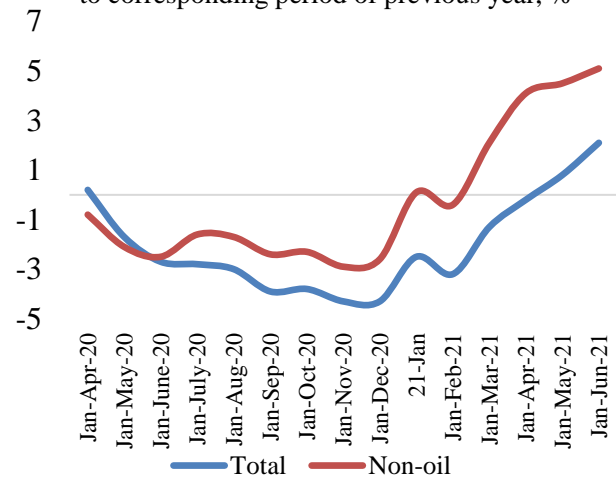
Graph 18. Shares of sectors in GDP, in Half I 2021, %



Source:SSC

Non-oil and gas value added y.o.y. increased by 5.1% in real terms to nominal AZN25.7B (64.2% of GDP).

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



Source:SSC

Non-oil output increased by 16.6%, while oil-gas output decreased by 3.2%. Non-oil output increased by 2.2 times in shoemaking, by 2.5 times on computers, electronic and optic devices, by 48.3% on machinery and equipment, by 80.8% on tobacco products, by 78.2% on installation and repairs of machinery and equipment, 34.2% on paper and cardboard, by 60.6% on electrical appliances, by 10.7% on garments, by 40.2% on construction materials, by 5.5% on oil products, by 8.1% on food products, by 9.4% on metallurgic products. Production of furniture decreased by 24.6%, production of

chemical products decreased by 5.3%, production of beverages by 5%, printing products by 52.9%, production of vehicles, trailers and semitrailers by 47.1%. Amid high demand for pharmaceuticals due to the pandemic and establishment of local enterprises production of pharmaceuticals increased by 3.1 times.

Y.o.y. growth in agriculture was 5.6%, including 2.4% growth on animal products and 8.9% on plant products.

Table 3. GDP structure, weight in percentage

| Sectors | 2020 6 months | 2021 6 months |
|-----------------------------------|---------------------|---------------------|
| Industry | 35.7 | 39.9 |
| Construction | 5.6 | 5.1 |
| Agriculture, forestry and fishery | 7.0 | 6.4 |
| Trade, repair of vehicles | 11.3 | 10.3 |
| Transport and warehousing | 7.5 | 7.3 |
| Tourism and catering | 1.5 | 1.0 |
| Information and communication | 2 | 1.8 |
| Other | 19.1 | 18.9 |
| Net taxes on products and import | 10.3 | 9.3 |

Source:SSC

CBA's real sector survey findings confirm that the negative effect of the

pandemic gradually subdues. The BCI was positive across all sectors.

The BCI in the industry was positively zoned over the first six months of 2021. Production of chemicals, metallurgy, construction, plastics, food and beverages, nonmetal mineral products contributed to this outcome. The BCI on machine building was negatively zoned in Q2.

Positive dynamics in the BCI on trade has continued since the beginning of the reporting period. Economic activity indicators entered a positive zone across all trade sectors (automobile, electric appliances and houseware), except for furniture.

The BCI on services varied. The BCI was positively zoned on communication, tourism and transportation, and negatively zoned on other sectors (postal, hotels and healthcare). According to RSM findings, in general, services (hotels in particular) were one of the most pandemic-affected sectors.

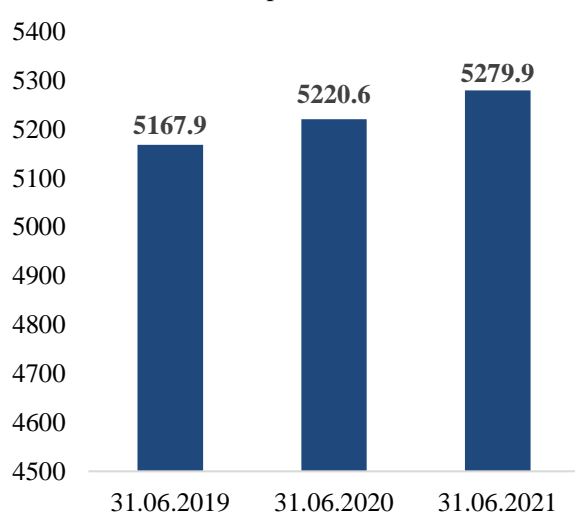
Despite being negatively zoned in Q1, the BCI on construction was positive in Q2.

Employment. As of 1 July 2021, labor force was numbering 5279.9 thousand persons, y.o.y. up by 59.3 thousand persons. The number of employed population was 4929.1 thousand persons, y.o.y. up by 46 thousand persons.

The number of hired labor was 1690.6 thousand persons as of 1 July 2021, y.o.y. down by 0.3%: those involved in the public sector were 908.1 thousand, non-public sector 782.5 thousand.

23.5% of hired labor in enterprises and organizations was involved in production: 7.4% in processing, 7.3% in construction, 3.4% in agriculture, forestry and fishery, 1.9% in mining, 1.9% in water supply and waste management.

Graph 20. Economically active persons, end of period, thousands



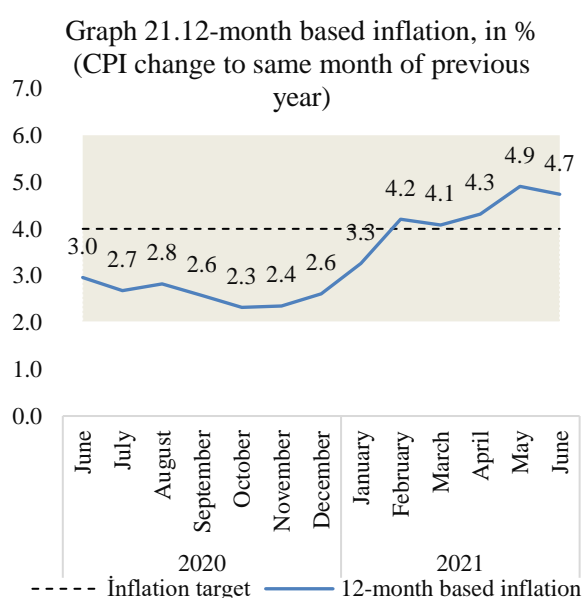
Source:SSC

2.3. Inflation

In Half I 2021, inflation was maintained within the announced annual target band ($4\pm2\%$).

Consumer Price Index (CPI).

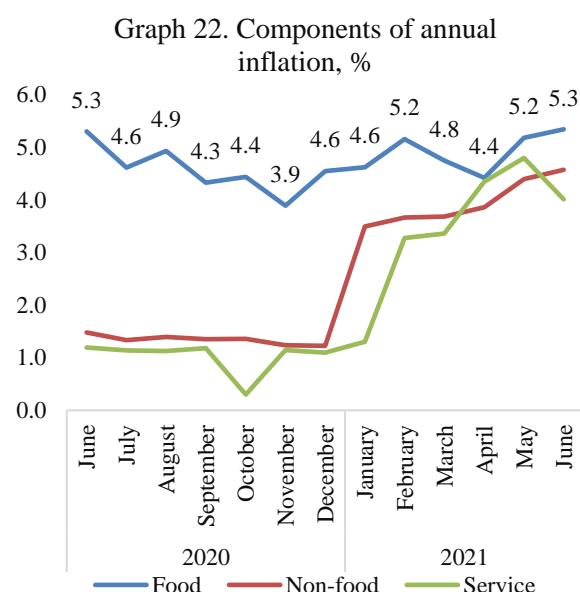
According to the SSC, in June 2021 twelve-month inflation was 4.7% (vs June 2020), within the target band ($4\pm2\%$) announced by the CBA.²



Source: SSC

Food inflation continued to play a key role in overall inflation. However, over the reporting period the effect of non-food and service price hike on inflation has increased. In June, food inflation made 5.3%. Annual price hike

rates on non-food products and services were 4.6% and 4% respectively.

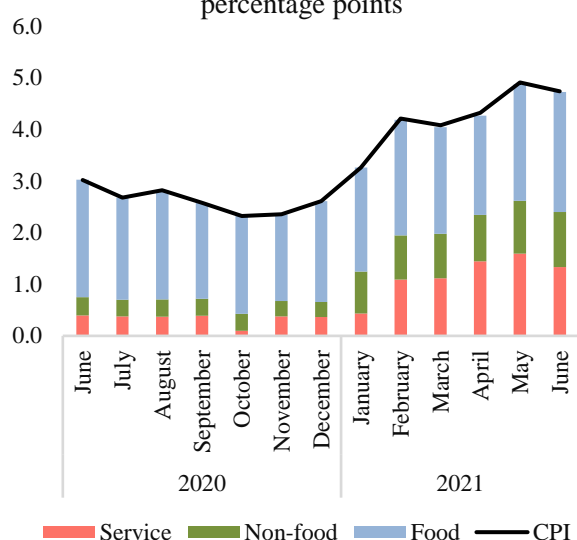


Source: SSC

Food prices contributed 2.3 pp, non-food 1.1 pp, and services 1.3 pp to annual inflation change.

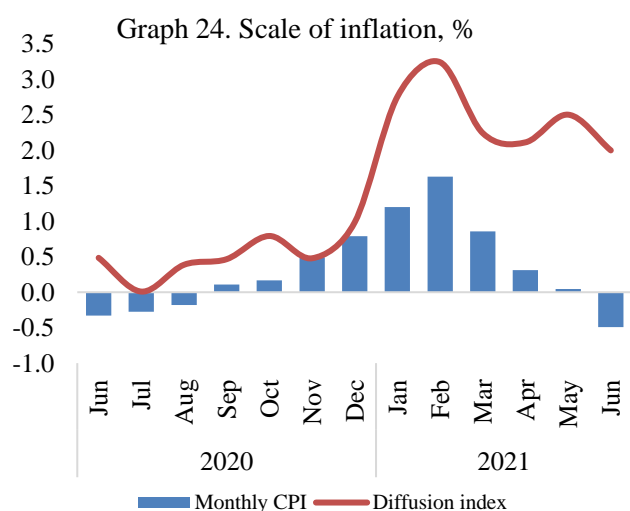
² According to SSC, average annual inflation was 4.3%.

Graph 23. Contributions to CPI, in percentage points



Source: SSC, CBA

The diffusion index – a measure of the change in dynamics pertaining to the number of goods and services with rising and falling prices in the consumer basket decreased.³

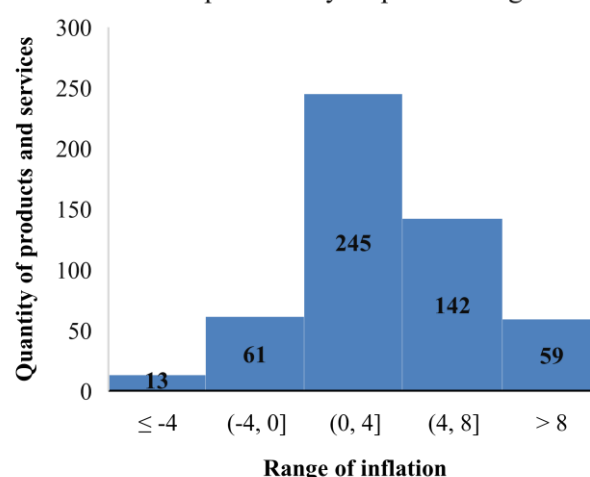


Source: SSC databased CBA calculations

³ The index is calculated as (increasing-decreasing)/(decreasing+unchanged).

Of 520 items of goods and services included in the consumer basket, prices for 245 or 47% increase in the range of 0-4% annually. In 18% of rising prices, the price increase was less than 2%.

Graph 25. Distribution of annual inflation rate of product and services included in CPI basket, number of products by respective range

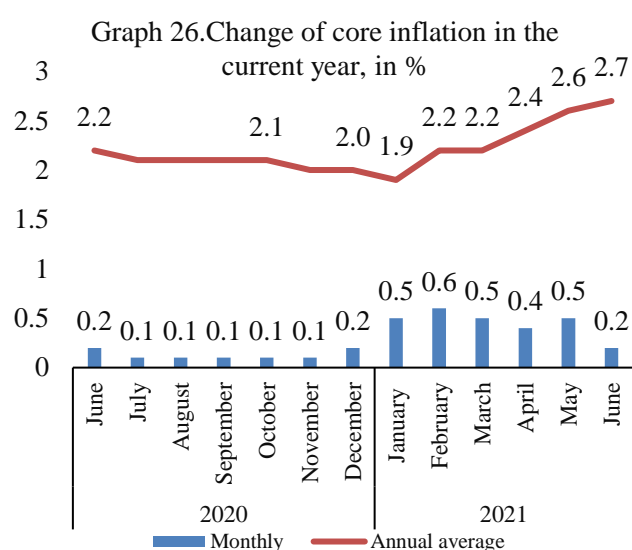


Source: SSC, CBA

Cost factors like the rise of some administrative prices and price hike for global food prices (food, energy and non-energy products) affected the dynamics of inflation over the reporting period. In June 2021 global food prices increased by 34% (FAO) and non-energy by 43% (DB) on annual. Influence of aggregate demand on inflation may be assessed as neutral since it still falls below supply. Stability in the FX market still is the key

in price stability, supported by improved balance of payments and a counter-cyclic macroeconomic frame.

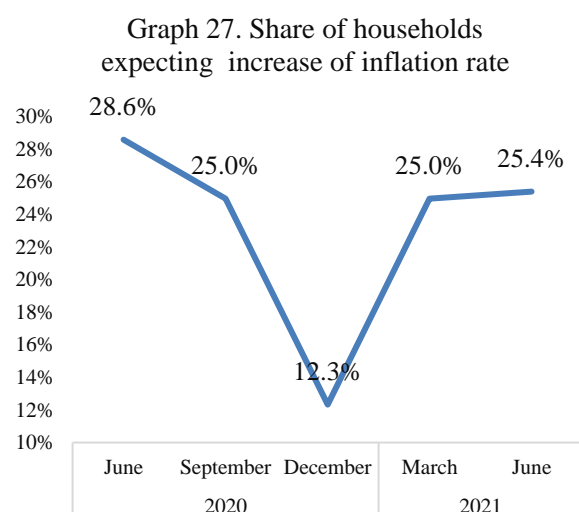
Average annual core inflation calculated by excluding swings in regulated prices and prices for seasonal agricultural products was 2.7%.



Source: SSC, CBA

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

expecting high inflation nearly remained unchanged from March.

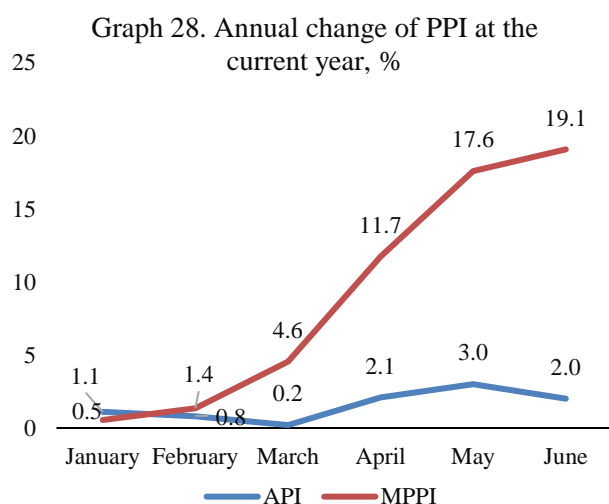


Source: CBA

Producer Price Index. In June the APPI increased by 2% over recent 12 months. Prices increased by 2.6% on animal products and by 1.1% on plant growing products on annual. In parallel, the PPI on forestry decreased by 5.6%, and increased by 4.2% on fish and other fishery products.

In June, the IPPI increased by 61.3% on annual, mostly due to the mining industry (up by 76.1%). The PPI increased by 73.7% on the non-oil and gas industry and by 9.9% non-oil and gas products. Price hike in the mining industry is mainly attributable to dramatic year over year jump in global oil prices.

The PPI in processing increased by annual 19.1%. The highest price hike in processing was in the chemical industry (61%), manufacturing of oil products (34%) and production of metallurgic products (16%).



Source: SSC

In June 2021 prices for transportation services increased by annual 8.3%. The cost of freight transportation increased by 3.9% and passenger transportation by 33.3%. Prices for postal and courier services increased by 1.9%, while for communication services remained unchanged.

II. THE MONETARY AND EXCHANGE RATE POLICY

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

Over 6 months of 2021, the exchange rate of the manat against foreign currencies was shaped by supply and demand in the FX market. Improved balance of payments underpinned supply in the FX market and the main anchor of price stability – the exchange rate stability.

Over the reporting period, FX market operations decreased, mainly attributable to de-dollarization trends.

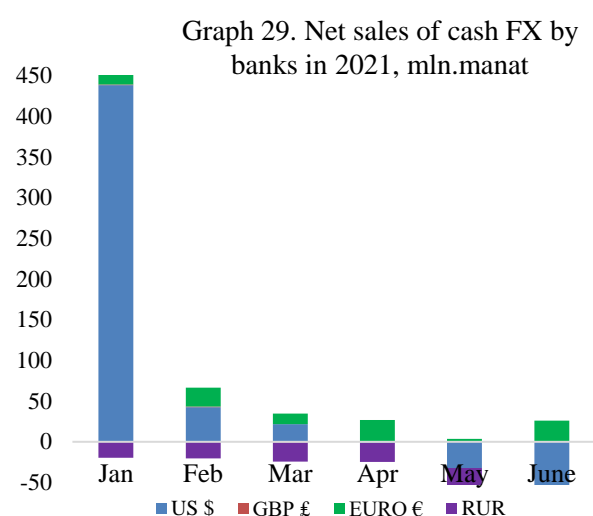
Cashless transactions in the FX market y.o.y. decreased by 4.2% to \$12.2B equivalent⁴: 85.3% in the USD and 14.7% in other currencies. The Interbank FX market accounts for 29.3% and the Intrabank FX market for 70.7% of operations.

99.2% of operations in the Interbank FX market was denominated in the USD, 0.8% in the EUR. Currency operations in the Interbank FX market

were mainly conducted over the Bloomberg platform.

Intrabank FX market operations made \$8.6B equivalent (79.6% in the USD). Legal entities account for 94.9% of the foreign currency operations in the Intrabank FX market.

Cash currency traded by banks y.o.y. decreased by 42% to \$1.9B equivalent (84.2% in the USD). Banks' buying prevailed over selling currency in May and June.



Source: CBA

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

The CBA continued currency auctions to arrange the sale of foreign currency provided by the State Oil Fund of Azerbaijan Republic (SOFAZ).

⁴ Including operations in USD, EUR, GBP, ruble

Market participants were informed on auction parameters via the Bloomberg terminal. The Bank held 47 currency auctions over 6 months of 2021. Though increased in January, demand in the FX market has decreased and stabilized since February.

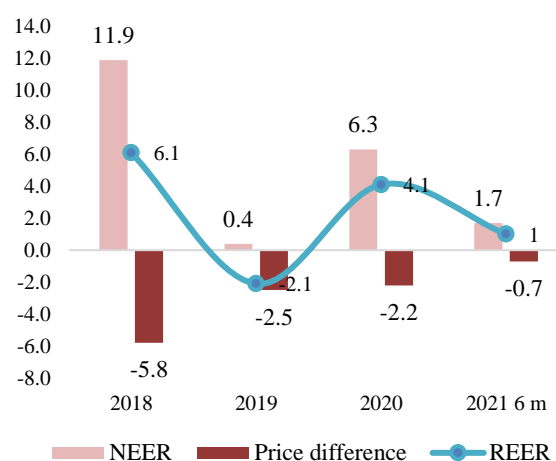
The official exchange rate of the manat was set on the basis of the average exchange rate on interbank transactions (both auction and over-the counter on the Bloomberg platform). The average official AZN/USD exchange rate was AZN1.7. Buy-sell exchange rates set by banks were close to the official one.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

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

The dynamics of bilateral exchange rates influenced that of multilateral exchange rates. Total trade weighted non-oil NEER of the manat

appreciated 1.7%, and the REER by 1%. Inflation in Azerbaijan being lower than the average inflation in trade partners had a downward effect on the REER.

Graph 30. Effective exchange rates (annual change)



Source: CBA

To note, the REER of manat has depreciated by 30.3% vs end-2014, contributing to the increase of long-term non-oil competitiveness.

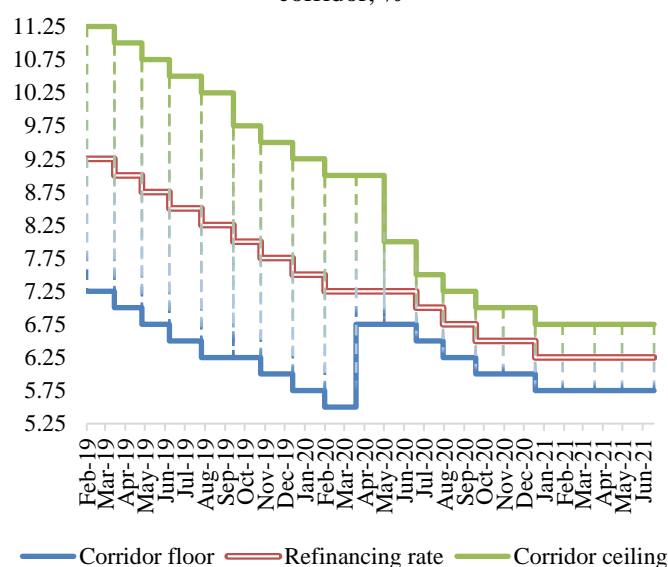
3.2. Monetary policy tools

In Half I 2021, monetary policy tools were applied in light of macroeconomic forecasts and targets, balance of inflation risks, as well as movement of inflation within the target band.

The CBA took interest rate corridor parameters related decisions considering recent macroeconomic forecasts and trends, the balance of risks, changes in the global environment and their potential translation to the country economy. The Management Board of the CBA has discussed interest rate corridor parameters four times in Half I 2021. The Board decided to leave the refinancing rate unchanged at 6.25%, the ceiling of the corridor at 6.75% and the floor at 5.75% in light of the macroeconomic environment, the dynamics of economic activity, risks and the inflation target. The decisions served to maintain an optimum balance between macroeconomic stability and economic activity. The Bank made interest rate related decisions public under a preannounced schedule and with relevant analytical comments.

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

Graph 31. Parameters of interest rate corridor, %



Source: CBA

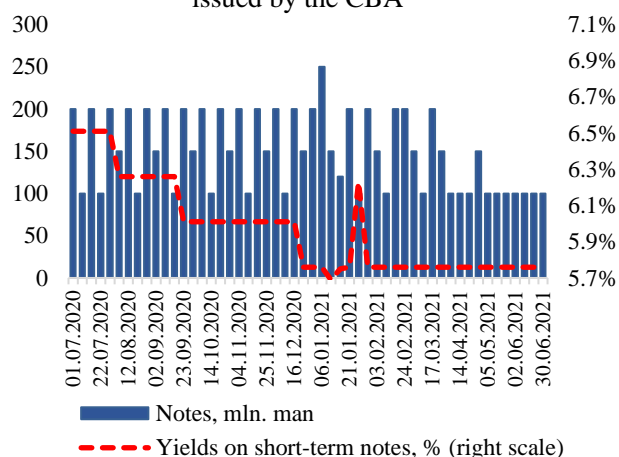
84, 168 and 252-day note auctions were held along with 28-day auctions in January-June 2021.

The Central Bank held 25 note auctions in the first half of 2021 – long-term notes were placed at 3 (84-, 168-, 252-day) and 28-day notes were placed at other 22 auctions. Total outstanding amount of sterilization via notes was AZN520M by the end of the half year.

Demand prevailed over supply at auctions on placement of notes; as a result, yield on these tools was close to the floor of the interest rate corridor (5.76%).

balances on correspondent accounts with the CBA exceeded total funds to be maintained as required reserves.

Graph 32. Volume and yield on notes issued by the CBA



Source: CBA

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

Reserve requirements were left unchanged and are still applied on an average basis to allow banks to flexibly manage the liquidity. Monitoring findings display that banks' cumulative

3.3. Money supply

In Half I 2021, the dynamics of money supply varied across months.

Base money in manat increased by 1.8% to AZN13.8B end-June, mainly owing to the change in the balance of government accounts.

Cash in circulation, a structural element of base money in manat ⁵ decreased by 0.8%, and stock of correspondent accounts in manat increased by 19.7%.

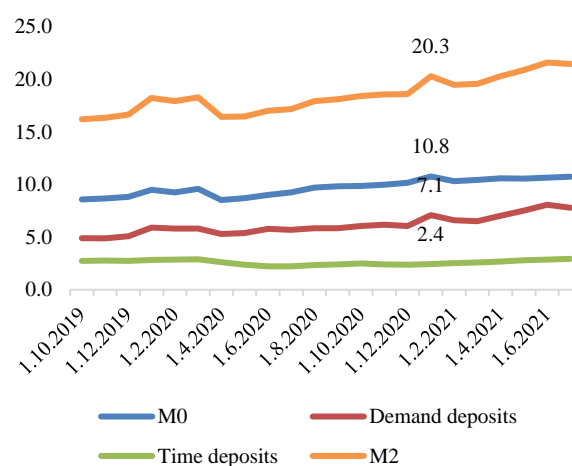
Broad money supply in manat increased by 5.8% to AZN21.5B

Table 4. Money aggregates, billion manat

| | 01.01.21 | 01.07.21 | Growth rate (%) |
|-----------|----------|----------|-----------------|
| M0 | 10.8 | 10.7 | -0.3 |
| M1 | 17.9 | 18.5 | 3.8 |
| M2 | 20.3 | 21.5 | 5.8 |
| M3 | 29.1 | 30.3 | 3.8 |

Source: CBA

Graph 33. Dynamics of broad money supply, billion manat



Source: CBA

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

Cash in the structure of broad money supply decreased by 0.3% (50% of M2), manat denominated demand savings and deposits increased by 10.1% (36.3% of M2), manat denominated term savings and deposits increased by 20.4% (13.7% of M2). These changes in the structure of money supply indicate that the cashless economy is expanding and confidence in the banking system is growing.

⁵ Cash money outside the banking system, cash in bank ATMs and cash offices

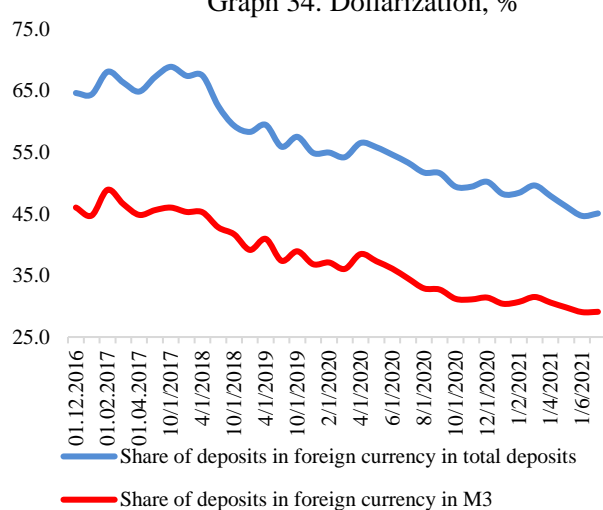
Manat denominated deposits of legal entities increased by 14%, and savings of individuals increased by 13.8%.

Broad money supply (M3) increased by 3.8% to AZN30.3B as of the end-period. NFAs had a downward, while NDAs an upward effect on broad money supply in manat: NFAs decreased by 2.8% and NDAs increased by 15.8%.

The dollarization of deposits kept decreasing. The share of foreign currency denominated savings and deposits in total savings and deposits made 45.1%, while the share of foreign currency denominated savings and deposits in M3 money aggregate made 29.1%.

The share of foreign currency in deposits of legal entities have decreased by 4.7% since early year to 53.4% as of the end-period. Dollarization of savings of individuals has decreased by 5.1% since early year to 45.7%.

Graph 34. Dollarization, %



Source: CBA

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