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ACRONYMS

CBA  The Central Bank of the Republic of Azerbaijan
ILO  The International Labor Organization
IMF  The International Monetary Fund
FDI  Foreign Direct Investments
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
CPI  The Consumer Price Index
APPI The Agricultural Producer Price Index
IPPI The Industrial Producer Price Index
NEER Nominal Effective Exchange rate
OPEC The Organization of the Petroleum Exporting Countries
REER Real Effective Exchange Rate
RSM  Real Sector Monitoring
GDP  Gross Domestic Product
WTO  The World Trade Organization
FX   Foreign Exchange
REPO Repurchase Agreement
CCI  Consumer Confidence Index
BCI  Business Confidence Index
NFA  Net Foreign Assets
NDA  Net Domestic Assets
WEO  World Economic Outlook
YOY  Year Over Year
EXECUTIVE SUMMARY

The Azerbaijan economy encountered a combination of unprecedented shocks amid the fight against the COVID-19 virus, declared a global pandemic in 2020. Measures taken by the Central Bank in close coordination with the government ensured macroeconomic stability, including price stability.

In a complicated environment, monetary policy decisions in 2020 served to neutralize external and internal threats to macroeconomic stability amid the pandemic and prevent a sharp decline in aggregate demand by keeping inflation within the target band.

Over the year inflation fluctuated within the target band (4±2%). The FX market remained balanced. Monetary easing continued at the expense of both the value and the quantity of money.

Aggregate supply and demand were driven down due to the pandemic, resulting in weak economic activity. Anti-crisis measures to support the households and businesses, monetary and macro-prudential easing prevented further fall in economic activity and allowed to partially compensate losses in the income of economic agents.

In general, pandemic-driven shocks that had a strong effect on all spheres of social life and economic activity were effectively managed over the year. The anti-crisis measures allowed to minimize the negative effects of the pandemic, ensuring macroeconomic and financial stability in the country.
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1. Global economic trends

The year 2020 was marked by the struggle against the COVID-19 virus, declared a global pandemic. Dramatic global trade slump, supply chain disruptions, loss of jobs and rising uncertainties had a downward effect on global economic activity, commodity prices fluctuated sharply. To avoid the sharp decline in economic activity a number of countries announced fiscal stimulus packages to support households and enterprises, maintained an expansive monetary policy and interest rate cuts. Relatively slowed down mid-year COVID19 pandemic situation worsened again in the last quarter forcing many countries to restore restrictive measures.

Global economic activity. Global economic activity decreased due to the pandemic. The BCI across the OECD countries (62% of the global economy) returned to the early year level after a plunge mid-year. But, the CCI remained below the early year level, despite slight increase in Q4.

Source: OECD

The International Monetary Fund (IMF) in its January 2021 World Economic Outlook estimated the global economic recession at 3.5% for 2020, which is optimistic compared to the forecast presented in the October Outlook (4.4%), reflecting slightly higher than expected recovery across the regions after the first half of the year.

Graph 1. Business and Consumer Confidence Indexes in OECD countries

Source: OECD
After shrinkage in 2020 the global economy is predicted to grow by 5.5% (0.3 pp higher vs the previous outlook) in 2021 and by 4.2% (unchanged vs the previous outlook) in 2022.

According to the ILO World Employment Report, overall employment decreased by 114 mln. persons in 2020.

According to the IMF’s January 2021 Outlook, ending the longest expansion in its history the US economy shrank by 2.5% in 2020 Q4 and by 3.4% in 2020. Unemployment was 6.7% in December, lower than expected for the month (6.8%), higher than the pre-pandemic rate (3.5%).

The Dow Jones increased by 6.2%, while the S&P 500 decreased by 5.4% during the year. The volume of investments and industrial production in the USA also contracted. In December 2020 production decreased annually by 3.6% on industrial products, by 12.3% on mining, by 2.8% in processing, and increased by 2.7% on utilities. In response to the crisis, the government and the central bank took a wide range of stimulus policy measures. On the backdrop of negative zoning of economic growth, the FED has decreased interest rates from 1.5-1.75% to 0-0.25% stepwise since early year. The FED expanded overnight and term REPO operations, reduced the cost of existing swap lines with major central banks and extended the maturity of FX operations, broadened U.S. dollar swap lines to more central banks and announced the purchase of Treasury securities in the amount as needed. Given the fact that the outcome of Q3 exceeded expectations and additional stimulus packages provided at and-of-year, the IMF forecasts 5.1% economic growth in the USA in 2021, up vs the October Outlook (3.1%).
According to the IMF January Outlook 2021, the euro area economy shrank by 7.2% in 2020. Industrial production in the euro area yoy decreased by 0.8%, attributable to industrial production drop in Germany (2.6%), France (4.6%) and Spain (3.8%). Dramatically increasing in H1, being prone to decreasing from H2 in line with expectations, unemployment stood at 8.3% in December, the number of unemployed reached 13.6 mln. Due to the pandemic, the Economic Sentiment Index \(^1\) sharply decreased early year, failed to recover the previous year level, though was prone to recovery end-year. Moreover, the FTSE Eurotop decreased by 9.1% over the year. Both monetary and fiscal measures were taken against the negative effects of the pandemic. As part of the anti-pandemic anti-crisis program, on December 10 the ECB decided to increase the package of the Pandemic Emergency Purchase Program (PEPP) by €500 billion to a total of €1.9 billion and extended the horizon for net purchases under the PEPP to March 2022.

Over the year the ECB left the policy rate unchanged at 0% and announced to keep it at this level until inflation approximates 2%. The IMF forecasts 4.2% economic growth in the euro area in 2021, down vs the October Outlook (5.2%).

The Japanese economy is estimated to have shrunk by 5.1% in 2020 (5.3% in the IMF October Outlook). Unemployment in Japan was 2.9% in December 2020. In December industrial production yoy decreased by 3.2%. Production of motor vehicles, chemicals and industrial machinery declined most. There has been a significant decline in tourism. Postponement of the Tokyo Olympics, scheduled for July 2020, had a negative effect on tourism. The Nikkei has gained 15.8% over the year. To support the economy the Bank of Japan on 18 December decided to extend ¥110T worth coronavirus stimulus package for 6 months until the end-September 2021. Over the year the Bank of Japan left the interest rate at negative 0.1%. The Bank will continue to purchase a necessary

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\(^1\) The ESI is a weighted average of answers to selected questions addressed to companies and consumers in 5 sectors.
amount of 10-year Japanese government bonds (JGBs) without setting an upper limit so that 10-year JGB yields will remain at near zero percent. The IMF predicts 3.1% economic growth for Japan in 2021, up vs the October Outlook (2.3%).

The IMF WEO January Outlook 2021 estimated a 10% reduction in GDP in the United Kingdom in 2020 (9.8% reduction in October Outlook 2020), the lowest indicator since 1955 when economic growth rate statistics were published. The sharp deterioration of the global economic condition reduced demand for UK exports and uncertainties had a negative effect on investments in the country. Net external demand had a positive effect on GDP due to a lower decline in exports than imports. Industrial production yoy decreased by 3.3% in 2020. In December unemployment was 5.1%, the highest unemployment rate since the last quarter of 2016. The pound appreciated by 3.7% against the USD during the year. As part of the anti-crisis measures, the government and the central bank continued wider fiscal and monetary support measures. The Bank of England cut the interest rate by 0.65 pp from 0.75% to 0.1% and increased its government and non-financial corporate bond purchases to £450B in 3 tranches (March, June and November). The IMF predicts 4.5% economic growth in the UK for 2021, down from the October Outlook (5.9%).

According to the latest estimations by IMF the growth in EME’s shrank by 2.4% in 2020 due to the pandemic-driven economic crisis (3.3% shrinkage in October Outlook). Emerging Asian Markets contracted by 1.1%, and emerging European Markets by 2.8%. Latin America and the Caribbean recessed by 7.4%, the Middle East and Central Asia by 3.2%, and Sub-Saharan Africa by 2.6%.

The Chinese economy grew by 2.3% in 2020. With this indicator, China is considered to be the only major economy that has prevented recession amid the pandemic. The IMF predicts 8.1% economic growth in China in 2021. Recovery in China is faster than in other countries. In December 2020 industrial
production in the country yoy increased by 7.3%. A similar trend was observed in investment to capital stock. In December unemployment stood at 5.2%. Though decreased in 2020H1, the CCI was prone to increasing from H2 onward due to lower uncertainties. The People’s Bank of China also employed the monetary policy to support the economy in 2020 due to the pandemic. Main measures include – injection of liquidity to the banking system via open market operations (reverse REPO operations and medium-term lending), wider refinancing opportunities and subsidization of a part of unsecured loans issued by local banks to Small and Medium Enterprises with over 6-month maturity.

The IMF estimated 3.6% economic shrinkage in Russia. Unemployment increased to 5.9% by the end-year, up by 1.2% vs early year. The BCI and the CCI dropped to a negative zone. Due to pandemic-driven uncertainties and unfavorable oil prices the Russian ruble depreciated by 19.6% against the USD. The oil price rise in H2 of the year had an upward effect on fiscal revenues. In 2020 the Bank of Russia eased the monetary policy, cut the interest rate to 4.25% from 6.25% and left it unchanged by the yearend.

According to the latest IMF estimates, the Turkish economy recessed by 5% in 2020. Industrial production increased by 9%. Unemployment was 12.9% in November, the unemployed reached 4 mln as of end-2020. In December inflation increased to 14.6%. During the year the Turkish lira depreciated by 24% against the USD due to pandemic caused uncertainty and geopolitical tensions. Depreciation of the lira is one of the main reasons for rising inflation expectations. To reduce the impact of the pandemic and as part of anti-crisis measures, the Central Bank of Turkey cut the interest rate from 12% to 8.25%, but to avoid sharp depreciation of the lira increased the rate by 8.75 pp stepwise to 17% in the last quarter of the year.

Uncertainty over the duration of recession and the pandemic weigh on global trade and investments. According to the IMF’s recent Outlook, global trade
contracted by 9.6% in 2020. In line with the revival in economic activity, global trade is expected to increase by 8% in 2021 and by 6% in 2022. According to the World Investment Report by the United Nations Conference on Trade and Development (UNCTAD) global FDIs will decrease by over 40% in 2020 and by 5-10% in 2021 and recovery will start in 2022.

Commodity markets. In 2020 commodity prices in the global market were very volatile. According to the World Bank’s Commodity Markets Outlook, in 2020 energy prices slid by 18.3%, while non-energy prices hiked by 16.1% and food prices by 14.9%. The gold price increased by 25.6% in 2020.

The average Brent oil price was $43 per barrel in 2020, which is 33% lower than the average price in 2019.

Amid the pandemic, the pause in the OPEC+ agreement in March and a sharp increase in oil supply contributed to the price shock. In April, oil prices plunged to historical lows of the recent decades. A new OPEC++ deal, progress in the development of the effective COVID-19 vaccine and the relative recovery of the economic activity in H2 of the year led to a slight increase in oil prices.
According to the Oil Market Report December 2020 of the International Energy Agency, global demand was 92.8 mln. barrels/day in 2020, 7.8 mln barrels/day lower vs the previous forecast. The Agency forecasts daily demand to surge considerably to 96.4 mln barrel in 2021.

**Risks.** According to the IMF WEO January 2021, although the Covid-19 vaccination has begun, some uncertainties and risks to the global economy remain. In general, international financial institutions note that the following major risks currently exist for the global economy:

- Liquidity and bankruptcy risks;
- Rising unemployment and poverty;
- Late start of vaccination in EMEs and still low economic activity there;
- High interest rates and risk premiums.

International financial institutions recommend intensifying efforts in several directions to recover economic activity, as well as reduce the damage caused by risks.

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

Second, policies should tend to prevent economic damage on a regular basis. People who lost their jobs due to the pandemic should be supported by the state to improve their skills. Unemployed people should be helped to re-enter the labor market.

Third, fiscal support in AEs should continue until the process of recovery is complete. In EMEs public authorities should continue asset purchases and be guided by price stability.

Finally, when implementing all these policies, it is important to focus on sustainable economic growth in the medium and long term. In addition, loose fiscal and monetary policies should be used in conjunction with macroprudential instruments to avoid additional financial risks.
1.2 External sector developments of the Azerbaijani economy

The external position of Azerbaijan was driven by impacts of the COVID-19 pandemic and price swings of key export products in 2020.

According to the SCC, foreign trade turnover amounted to $24.5B – exports $13.7B (56%), imports $10.7B (44%). Foreign trade surplus made up $3B.

Azerbaijan traded with 183 countries.

Source: SCC

Graph 5. Trade balance, USD bn.

Graph 6. Trade turnover of the main countries, 2020

Source: SCC

Italy, Turkey, Russia, China, Germany and Ukraine account for over half of trade turnover. As in previous year, Italy takes the highest share in trade turnover: it yoy increased by 0.6 pp to 18.7%. The share of Turkey in total trade turnover increased by 3.5 pp to 17%, Russia by 1.9 pp to 10.9%, China by 1 pp to 7.6% and Ukraine by 0.7 pp to 3.2%. The share of trade turnover with Germany decreased by 1.6 pp to 3.3% of total turnover.

Due to pandemic-driven global demand shrinkage exports decreased by 30%. The value of export decreased by 36.8% on crude oil, by 36.2% on oil products and by 7.4% on natural gas.

Oil-gas sector exports decreased by 32.6%, and non-oil exports by 5.3%.
1.2. External sector developments of the Azerbaijani economy

The main export partners include Italy (30.4%), Turkey (18.9%), Russia (5.2%), Greece (3.8%), Croatia (3.4%), and Georgia (3.4%).

The value of exports increased by 7.5% on cotton fiber, and by 0.3% on fruits and vegetables.

Commodity imports decreased by 21.5%. Import on the public sector decreased by 2.3 times to $1.8B, on the private sector by 6.5% to $7.9B, and on individuals by 4.7% to $1B.

The rate of decline in imports was higher in 2020H1.
Import increased by 27.2% on pharmaceuticals, by 23.8% on vehicles and parts, 4.8% on fruits and vegetables, by 0.2% on food products and decreased by 27% on tobacco and products, 22.7% on furniture, by 14.4% on plastics and products, 12.8% on wheat, and by 4.7% on machinery and mechanisms.

Russia accounts for 18.3%, Turkey for 14.6%, China for 13.2%, the USA for 5.9%, Germany for 5.4%, France for 4.2% and Ukraine for 3.9% of imported products.

According to external sector data, money remittances to the country yoy increased by 17% to $1094M.

Capital inflows from foreign enterprises and organizations kept on during the year. According to the SSC, FDIs amounted to AZN5.1B equivalent (30.1% of total investments).
Norway account for the essential part of capital investments by foreign countries and international organizations.

Strategic foreign exchange reserves exceeding internationally accepted adequacy norms sufficed for 40-month import of goods and services (taking import of goods and services for 9 months of 2020). Strategic reserves exceeded money supply in manat (M2) by 4.3 times (taking M2 money aggregate as of 01.01.2021), and by 120% annual GDP.
II. MACROECONOMIC
DEVELOPMENTS IN
AZERBAIJAN

2.1. Aggregate demand

*Domestic demand, the main driver of economic growth shrank in 2020 due to the pandemic.*

*Consumption expenditures* decreased in 2020. Goods and services sold in the market to meet consumer demand yoy decreased by 8.1% in real terms to AZN47.9B. The private sector accounts for 96.7% of goods sold and services supplied by economic agents (52.1% individual entrepreneurs).

Every consumer spent on average AZN400.4 in the consumer market (yoy down by 6.1%).

*Source: SSC*

The size of trade turnover yoy decreased by 1.3% to AZN40.2B. Retail trade turnover increased by 3.4% on food, beverages and tobacco products, nonfood turnover decreased by 6.1%.

Restrictions imposed to prevent the spread of the coronavirus led to changes in consumer spending in our country and around the world. While due to social isolation measures, distant working, online education, traveling restrictions etc., expenses allocated on food, computer and telecommunication devices, pharmaceuticals and medical supplies increased, expenses allocated on knitwear and clothes, furniture, fuel and other non-food items decreased.
The share of consumer spending on food, beverages and tobacco products in retail trade outlets increased from 50.7% to 54% last year, while the share of other spending items decreased.

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

<table>
<thead>
<tr>
<th>Spending item</th>
<th>Share, %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Food, beverage and tobacco</strong></td>
<td>50.7</td>
</tr>
<tr>
<td><strong>Textile products and apparel</strong></td>
<td>17.5</td>
</tr>
<tr>
<td><strong>Electric appliances and furniture</strong></td>
<td>6</td>
</tr>
<tr>
<td><strong>Computers, telecommunication devices and others</strong></td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Pharmaceuticals and medicals</strong></td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Fuel</strong></td>
<td>5.9</td>
</tr>
<tr>
<td><strong>Other non-food items</strong></td>
<td>17.7</td>
</tr>
</tbody>
</table>

Source: SSC

Every consumer purchased on average AZN181.2 worth food, beverage and tobacco, AZN154.4 worth non-food items monthly for private consumption in retail trade.

Catering turnover yoy decreased by 54.6%. Entities accounted for 46.5%, private entrepreneurs for 53.5% of catering turnover in the private sector. The value of paid services to the population decreased by 27.9% in real terms to AZN7B. Per capita paid services consumption yoy decreased by AZN268.3 (27.7%) in nominal terms.

The pandemic weighed in on the nominal income of the population. Nominal income growth has lost its positive dynamics since September, while real growth – since April. In 2020 money income of the population decreased by 1.8% in nominal terms to AZN55.7B. Per capita income decreased by 2.5% to AZN5587.6. Population’s disposable income decreased by 2.9% to AZN50.7B.

Household income decreased mainly due to non-wage income. The nominal average monthly salary of hired workers increased by 11.4% to AZN707.3. The salary of employees
involved in public entities was AZN631.1, while the salary of those employed with private entities was AZN801.8.

Loans to households, one of the consumer demand components decreased by 3.9% to AZN6.7B as of the end-period.

Pandemic-driven low economic activity in various sectors translated into the CCI too. While the CCI generated from findings of the 2020Q4 ‘Households’ financial behavior and intentions’ survey improved against the previous quarter, the average indicator for 2020 yoy decreased to a negative zone. To note, this indicator is based on surveys among various income households ‘Family’s financial condition expectation’, ‘Expectation on country’s economic standing’, ‘Savings probability’ and ‘Unemployment expectations’.

**Government spending** was substantial to support domestic demand. State budget expenditures amounted to AZN26.4B in 2020, (yoy up by 8.2%)2.

36.5% (AZN9652M) of state budget expenditures were allocated to social spending (compensation for employees, pension and social allowances, medicine and food), which means yoy up by 24.4% or AZN1890.7M relative to 2019.

**Investment expenditures.** Investment in the economy decreased by 8.3% to AZN17B, mainly due to yoy decrease in domestic investments, in particular public investments. The public sector accounts for 41.6%, while the private sector for 58.4% of total investments. The positive growth rate of investments to the oil sector relatively offset a sharp decline in investments in

the non-oil sector. AZN11.2B worth investment was directed to the non-oil and gas sector (yoy down by 12.3%).

Source: SSC

Funds of enterprises and organizations prevailed in total investments (50.4%).

69.9% of investments stemmed from internal, while 30.1% from external sources.

Table 2. Investment sources, %

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
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</thead>
<tbody>
<tr>
<td>Funds of enterprises and organizations</td>
<td>52</td>
<td>50.4</td>
</tr>
<tr>
<td>Bank loans</td>
<td>12</td>
<td>6.2</td>
</tr>
<tr>
<td>Budget funds</td>
<td>28.3</td>
<td>27.6</td>
</tr>
<tr>
<td>Off-budget funds</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Personal funds of population</td>
<td>5.7</td>
<td>5.7</td>
</tr>
<tr>
<td>Other funds</td>
<td>0.8</td>
<td>8.6</td>
</tr>
</tbody>
</table>
2.2. Aggregate supply and employment

The pandemic affected the various sectors of the economy differently, depending on the nature of the sector in 2020.

**Economic growth.** According to the SSC, in 2020 GDP decreased in real terms by 4.3% and its nominal value accounts for AZN72.4B. Per capita GDP made up AZN7262.8.

Oil and gas value-added decreased by 7.2% in real terms and its nominal value was AZN21.6B (29.9% of GDP). The mining sector extracted 34.5 m/t crude oil and 26 bln/m3 natural gas. Oil extraction yoy decreased by 7.8% and gas extraction increased by 3.1%.

Yoy drop in both oil and non-oil economic growth in 2020 is attributable to the impact of the COVID-19 pandemic.

The non-oil industry yoy grew by 12.5%. Output increased by 9.6 times in the production of electric equipment, by 32.7% in garment production, by 20.5% in the chemical industry, by 35.7% in the production of vehicles, trailers and semitrailers, by 36.9% in the production of paper and cardboard, by 11.9% in metallurgy, by 35.4% in production of computers, electronic and optic products.

| Source: SSC |
Production of oil products decreased by 3.6%, tobacco products by 7.9%, beverages by 13.7%, furniture by 26.2%, installation and repairs of machinery and equipment by 5.1%. Amid high demand for pharmaceuticals due to the pandemic and establishment of local enterprises production of pharmaceuticals increased by 10.7 times. Production of intermediate consumer goods in industry yoy increased by 40.7%, production of means of production decreased by 15.5%, and production of energy products by 6.1%.

Annual real growth in agricultural sector was 2%, including 3.1% on animals and 0.8% on plant products.

Table 3. GDP structure, share, %

<table>
<thead>
<tr>
<th>Sectors</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>41.4</td>
<td>33.7</td>
</tr>
<tr>
<td>Construction</td>
<td>7.3</td>
<td>7.7</td>
</tr>
<tr>
<td>Agriculture, forestry, fishery</td>
<td>5.7</td>
<td>6.9</td>
</tr>
<tr>
<td>Trade, repair of vehicles</td>
<td>10</td>
<td>11.5</td>
</tr>
<tr>
<td>Transport and warehousing</td>
<td>6</td>
<td>7.1</td>
</tr>
<tr>
<td>Tourism and catering</td>
<td>2.4</td>
<td>1.2</td>
</tr>
<tr>
<td>Information and communication</td>
<td>1.8</td>
<td>2</td>
</tr>
<tr>
<td>Others</td>
<td>16.7</td>
<td>20.2</td>
</tr>
<tr>
<td>Net taxes on products and import</td>
<td>8.7</td>
<td>9.7</td>
</tr>
</tbody>
</table>

Source: SSC

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

The BCI in the non-oil industry was positively zoned end-2020. Production of food and beverages, as well as textile, contributed to this outcome. The BCI was negatively zoned in the chemical industry and production of plasticware.

While in January-February positive dynamics of the BCI in the trade sector were replaced by a decline over the next 7 months due to the pandemic, it was neutral over the recent 3 months. Economic activity indicators in the trade of automobile, furniture and houseware remained in a negative zone. Trade of electric home appliances followed a positive trend.

The BCI in services was positively zoned over the first 4 months followed by negative zoning, except for November. The BCI on communication was positively zoned across all months of the year, while all other sectors (post, transportation, hotels, tourism and
2.2 Aggregate supply and employment

healthcare) were negatively zoned. RSM findings suggest that services were one of the most pandemic-affected sectors.

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

![Graph 19. BCI, annual average](image)

Source: CBA estimations based upon RSM findings

**Employment.** As of end-2020 economically active population (labor force) were numbering 5252.5 thousand persons, yoy up by 62.4 thousand persons. The number of employed population was 4876.6 thousand persons, yoy down by 61.9 thousand persons.

According to the SSC, as of end-2020 the number of hired labor was 1691.8 thousand persons, yoy up by 9.2%: those involved in the public sector was 910.8 thousand, non-public sector 781 thousand.

24.3% of hired labor in enterprises and organizations was involved in production: 7.5% in processing, 7.8% in construction, 3.6% in agriculture, forestry and fishery, 2% in mining, 1.7% in water supply and waste management.

According to the SSC, the average number of hours worked per employee was 151.8 hours in 2019 and 139.5 hours in 2020.
2.3. Inflation

In 2020 inflation remained below the center of the annual target band (4±2%).

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

![Graph 21. 12-month based inflation, in % (CPI change to same month of previous year)](image)

Graph 21. 12-month based inflation, in % (CPI change to same month of previous year)

According to SSC, average annual inflation was 2.8%.

![Graph 22. Components of annual inflation, %](image)

Graph 22. Components of annual inflation, %

Source: SSC

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

Source: SSC

The price index across food products with a considerable share in the consumer basket increased by 4.5%. An annual price hike on non-food stuff and services, other inflation components,

\[3\text{ According to SSC, average annual inflation was 2.8%.}\]
The price hike was 4.1% on food, 4% on alcoholic drinks and 18.5% on tobacco products.

The diffusion index – a measure of the change in dynamics pertaining to the number of goods and services with rising and falling prices in the consumer basket decreased since an early year. The price hike for 58.7% of products was below 2%.

Low domestic demand, a stable exchange rate, monetary condition, and inflation expectations had stabilizing, while additional costs faced by economic agents to protect against the virus and global food price hike had an upward effect on inflation.

Average annual core inflation calculated by excluding swings in regulated prices and prices for seasonal agricultural products was 2%.

Source: SSC, CBA

\[ \text{The index is calculated as } \frac{(\text{increasing-decreasing})}{\text{decreasing+unchanged}}. \]
2.3 Inflation

Inflation expectations elevated amid negative effects of the pandemic in Q1 dropped as of end-year. According to RSM, in December inflation expectations increased in the non-oil industry and services, decreased in trade and unchanged in construction vs November. Households’ twelve-month inflation expectations were higher in Q1, but have been declining since Q2. According to December survey among households the share of respondents expecting an increase in inflation decreased by 13 pp to 12.3% vs September.

According to the latest forecast by CBA, inflation will remain within the target band (4±2%) by the end of 2021, if the current macroeconomic policy framework is maintained.

**Producer Price Index.** In December APPI decreased by 0.2% over the recent 12 months. Since June annual growth rate of the APPI has been declining. In December prices increased by 0.1% on animal products on annual basis and, by 1.1% on plant growing products. In parallel, the PPI on forest products decreased by 2.7%, and increased by 2.6% on fish and other fishery products.

In December the IPPI decreased by 16.8% on annual basis, mostly due to the
mining industry (down by 27.2%). Price slide in the mining industry mainly relates to an oil price slump in world markets.

The PPI on processing decreased by annual 5.7%. The highest price slide was in the production of oil products (20.3%), the polygraphy service (9.6%) and the production of tobacco products (6%).

Source: SSC

Prices for transportation services remained almost unchanged. Prices for postal and courier services decreased by 0.1%, prices for communication services remained unchanged.
II. THE MONETARY AND EXCHANGE RATE POLICY

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

The exchange rate of the manat against foreign currencies shaped by supply and demand in the FX market in 2020. Albeit the negative effects of external environment developments, thanks to preventive measures by the Government and the CBA, stability was safeguarded in the FX market.

FX market operations decreased, attributable to weaker foreign economic operations due to the pandemic.

Cashless transactions in the FX market yoy decreased by 6.7% to $25.9B equivalent\(^5\): 86.5% of cashless operations were in the USD, and 13.5% in other currencies. The Interbank FX market accounts for 34.7% and the Intrabank FX market for 65.3% of operations.

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

Intrabank FX market operations made $16.9B equivalent (79.7% in USD). Legal entities account for 94.2% of foreign currency operations in the Intrabank FX market.

Cash currency traded by banks yoy decreased by 13.3% to $5.2B equivalent ($4.5B, or 86.7% in USD). Cash currency was mainly traded in Q1.

Graph 28. Net sales of cash foreign currency by banks, mln.manat

Source: CBA
Note: positive zone stands for sell, negative zone for buy operations.

The CBA continued currency auctions to arrange the sale of foreign

\(^5\) Including USD, EUR, GBP, RUB denominated operations
currency provided by the State Oil Fund of Azerbaijan Republic (SOFAZ). Market participants were informed on auction parameters via the Bloomberg terminal prior to auctions. The Bank held a total of 102 currency auctions in 2020. Though increased in Q1, demand in the FX market has decreased since April and stabilized by the end-year.

The official exchange rate of the manat was set on the basis of the average exchange rate on interbank transactions in 2020 (both auction and over-the-counter on the Bloomberg platform). The average official AZN/USD exchange rate was AZN1.7 in 2020. Buy-sell exchange rates set by banks were close to the official one. Commercial banks’ average buy/sell rate was 1.6991/1.7025. The difference between average official buy/sell exchange rates and those of commercial banks was 0.009/0.0025.

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

The dynamics of bilateral exchange rates influenced that of effective exchange rates. Total trade-weighted non-oil NEER of the manat appreciated 6.3%, and the REER by 4.1%. Inflation in Azerbaijan being lower than the average inflation in trade partners had a downward effect on the REER.

To note, the REER of manat has depreciated by 30.9% since end-2014, contributing to long-term non-oil competitiveness.
3.2. Monetary policy tools

In 2020 the monetary policy was oriented towards maintaining inflation within the target band (4±2%), the monetary condition was eased in light of macroeconomic forecasts and the balance of risks.

The CBA made necessary corrections to its interest rate corridor parameters of liquidity operations in light of the balance of risks and updated macroeconomic forecasts. The Board of Governors of the CBA discussed interest rate corridor parameters 8 times in 2020 and decided to reduce the refinancing rate stepwise from 7.5% to 6.25%, decrease the ceiling of the interest rate corridor from 9.25% to 6.75% and leave the floor unchanged at 5.75%. This decision served to maintain an optimum balance between macroeconomic stability and economic activity. The CBA's interest rate related decisions were made public under a pre-announced schedule and with relevant analytical comments.

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

![Interest rate corridor parameters, %](Graph 30)

Source: CBA

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

The CBA held 62 deposit auctions on the attraction of excess funds in the national currency. The total outstanding...
amount of funds attracted by deposit auctions was AZN300M as of end-2020.

![Graph 31. Volume and yield of deposits attracted by the CBA](image)

*Source: CBA*

Along with deposit auctions, the CBA held 46 note auctions – 7 long-term (84-, 168-, 252-days), and 28-day notes at other 39 auctions. The total outstanding amount of sterilization via long-term notes was AZN650M as of end-year.

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

Return on sterilization tools becomes an important representative indicator of the money market. Also, CBA notes actively used in the REPO market as collateral have a positive effect on interbank market activation.

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

Money supply varied across months in 2020. Money supply, decreased since an early year, increased end-year, due to high budget expenditures from the treasury account.

Base money in manat increased by 11.6% to AZN13.6B as of the end-period.

Cash in circulation, a structural element of money base in manat increased by 13.8%, stock of correspondent accounts in manat decreased by 1.2%.

Table 4. Money aggregates, bln AZN

<table>
<thead>
<tr>
<th></th>
<th>01.01.20</th>
<th>01.01.21</th>
<th>Growth rate (%)</th>
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<tr>
<td>M0</td>
<td>9.5</td>
<td>10.8</td>
<td>13.4</td>
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<tr>
<td>M1</td>
<td>15.4</td>
<td>17.9</td>
<td>16.0</td>
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<tr>
<td>M2</td>
<td>18.2</td>
<td>20.3</td>
<td>11.3</td>
</tr>
<tr>
<td>M3</td>
<td>28.9</td>
<td>29.2</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: CBA

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

Cash in the structure of broad money supply increased by 13.4% (53.1% of M2), manat denominated demand deposits increased by 20.3% (34.9% of M2), while term deposits decreased by 14.1% (12% of M2). The high growth rate of manat-denominated demand deposits displays the transformation towards a cashless economy.

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

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

Graph 33. Dynamics of broad money supply, billion manat

Source: CBA

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

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Manat denominated deposits of legal entities increased by 15.3%, while manat denominated savings of individuals decreased by 2.6%.

Net Foreign Assets (NFA) had an upward, while Net Domestic Assets (NDA) a downward effect on broad money supply in manat: NFA increased by 8.8% and NDA decreased by 10.4%.

Whereas dollarization of deposits slightly increased early year, it decreased as of the year-end. Foreign currency savings and deposits accounted for 56.5% of total savings and deposits in March, and 48.2% end-December. The share of foreign currency-denominated savings and deposits in M3 money aggregate was 30.4% end-year (36.8% end-2019).

The share of foreign currency in deposits of legal entities decreased from 65.6% to 58.1%. Dollarization of savings and deposits of individuals decreased from 52.2% early year to 50.8% end-year.

Source: CBA
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