CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REPORT

JANUARY-DECEMBER

2023
№4

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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
CIS	Commonwealth of Independent States
CLI	Composite Leading Indicator
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
PMI	Purchasing Managers’ Index
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

EXECUTIVE SUMMARY

In 2023, the Central Bank of the Republic of Azerbaijan operated in the environment of persistent global geopolitical tension, relatively sluggish global economic activity, monetary policy tightening in major countries and decently moderate global inflationary pressures. The international conjuncture was favorable for Azerbaijan in general in terms of the balance of payments and economic activity continued.

Over the reporting year, annual inflation was prone to declining due to changes both in external and internal factors, including the anti-inflationary policy. Inflation started to shape within the target band over last months of the year. The appreciated nominal effective exchange rate of the manat was critical in the fall in inflation import, in addition to the slack in price hikes in partner countries.

Monetary policy decisions were oriented towards managing inflation within the target band through the monetary condition. First upward, followed by downward revisions were made to interest rate corridor parameters over the year considering updated macroeconomic forecasts. Efforts continued to enhance the monetary policy transmission. Average interest rates on money market operations remained responsive to changes in the interest rate corridor.

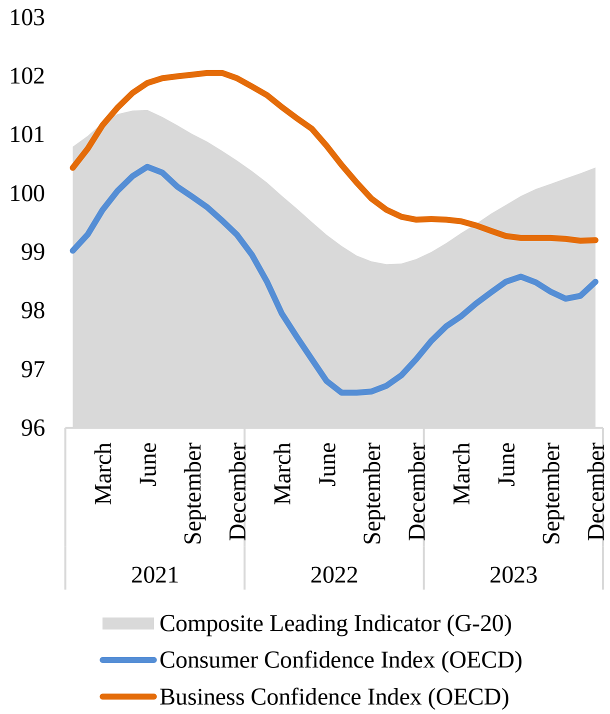
I. GLOBAL ECONOMIC ENVIRONMENT

1.1. Global economic trends

The year of 2023 is characterized by a weak recovery of global economic activity and international trade amid geoeconomic and geopolitical tensions. In response to high demand, international commodity market fluctuations and inflationary pressures most central banks tightened the monetary policy last year. As of the end of the reporting year, global inflation significantly fell compared to the peak in 2022, but it remained higher than the pre-pandemic level.

In 2023, persistent adverse effects of the pandemic, monetary policy of central banks and a downward trend in inflation across most countries weighed on global economic activity indicators. The CCI, an economic activity indicator of the OECD countries was prone to rising.

Chart 1. Global economic activity indicators

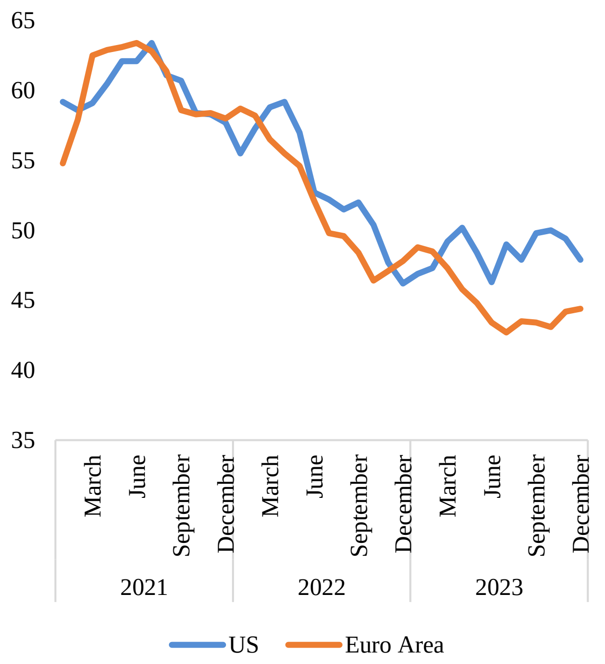


Source: OECD

The BCI, an economic activity indicator in OECD countries decreased amid uncertainty in financial markets. However, the Composite Leading Indicator (CLI), the economic activity indicator in G-20 increased.

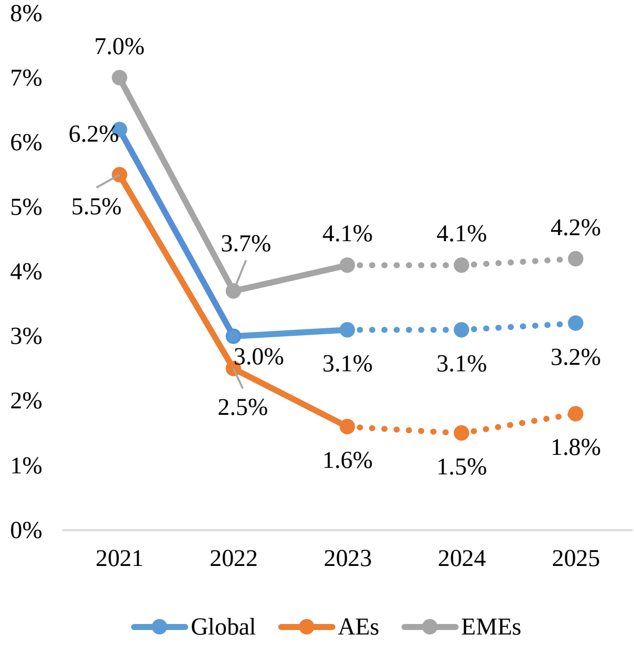
The Purchasing Manager's Index (PMI) the indicator of economic trends in the production sector, increased in the USA and decreased in the euro area at the end of the year compared to the beginning of the year.

Chart 2. Purchasing Manager's Index (PMI)



Source: Markit Economics

Chart 3. Economic growth projections, %



Source: IMF WEO January 2024

Global economic developments weighed on projections of international organizations. According to the IMF WEO January 2024, global growth was estimated to stand at 3.1% in 2023, up by 0.1 pp compared to the October 2023 forecast. The report revised up global economic growth forecast by 0.2 pp to 3.1% for 2024 and left the global economic growth forecasts for 2025 unchanged at 3.2%.

The IMF WEO January 2024 estimated economic growth forecast for AEs to be 1.6% for 2023, up by 0.1 pp compared to the October 2023 forecats. Economic growth forecast for AEs for 2024 was revised up by 0.1 pp to be 1.5% compared to the October 2023 forecast. Economic growth forecast for 2025 was left unchanged at 1.8%.

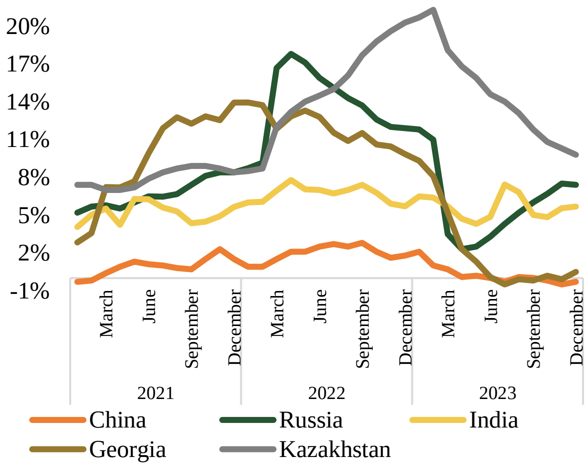
Economic growth forecast was revised down by 0.3 pp on the euro area, by 0.1 pp on Japan and up by 0.6 pp on the USA for 2024 compared with the previous report. The growth forecast was left unchanged for the UK.

The IMF WEO January 2024 estimated global economic growth to by 4.1% for EMEs in 2023 (up by 0.1 pp compared to the previous forecast). Economic growth forecast for 2024 and 2025 was revised up by 0.1 pp to 4.1% and 4.2% respectively. Economic growth is estimated to stand at 5.4% in Asia, at 2.7% in Emerging Europe, at 2.5% in Latin America, at 2.0% in Middle East and Central Asia and at 3.3% in Sub-Saharan Africa in 2023. Economic growth forecasts were revised up for Asia (0.4 pp) and Emerging Europe (0.6 pp), and down for Latin America (0.4 pp), Middle East and Central Asia (0.5 pp) and Sub-Saharan Africa (0.2 pp) for 2024.

According to the IMF WEO January 2024, global inflation is estimated to stand at 6.8% in 2023 (down by 0.1 pp compared to the October forecast). The global inflation forecast was left unchanged for 2024 (5.8%) and revised down by 0.2 pp to 4.4% for 2025.

In 2024, inflation is expected to decrease at a higher rate in AEs compared to EMEs – it will decrease by 2 pp to 2.6% in AEs and by 0.3 pp to 8.1% in EMEs in 2024.

Chart 4. Inflation in some EMEs, %



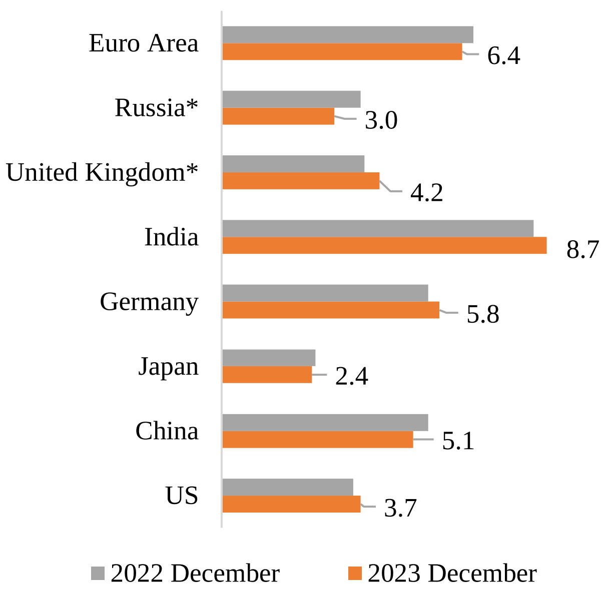
Source: National Statistic Offices

The report revised down inflation forecast for AEs both for 2024 and 2025, while revised it up for EMEs for 2024.

Although main factors contributing to decline in inflation vary across countries, according to the IMF report, the primary reason for the decline in inflation is the monetary policy tigthening by central banks and persistent slides in global commodity prices.

According to the report, average annual and core inflation is expected to decrease in about 80% of countries in 2024. Inflation is estimated to be 1.7 pp higher than the target at the end of 2023 in the countries with inflation targeting. Deviation from the target is projected to be 0.6 pp in Q4 2024. Most countries are expected to reach inflation targets (or the median of the target band) in 2025.

Chart 5. Unemployment rate, %



** Data for Russia and the United Kingdom refer to November 2023.*

Source: Trading Economics

Unemployment increased in the UK, the USA and India, and decreased in Russia, China, Japan and the euro area at the end of 2023 compared to the end of the previous year.

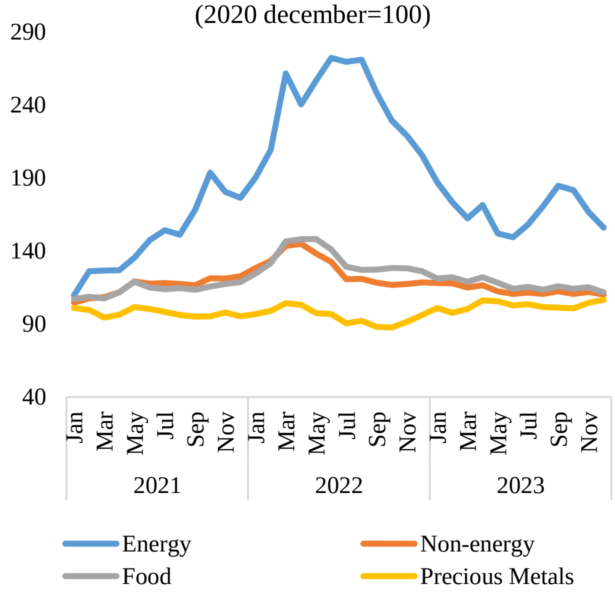
The OECD in its November 2023 report highlights several global economic risks and identifies the escalation of the Middle East tension as a primary concern. Current geopolitical issues may lead to resurgence in commodity, in particular energy prices, disrupt the global economic supply chain and force a reassessment of risks in financial markets.

1.2. Global commodity markets

The monetary policy tightening by most central banks, the slowing economic growth, the adaptation of the global economy to persistent geopolitical tensions and the removal of certain restrictions stemming from the pandemic contributed to the fall in prices of major commodities in global markets in 2023. Forecasts suggest that the future trajectory of commodity prices will be responsive to climate changes and geoeconomic uncertainties.

In 2023, weak economic growth, negative effects of unfavorable weather shocks on productivity in certain regions, and the return of international freight costs to pre-pandemic levels were key factors to transmit to prices in commodity markets. According to the World Bank Commodity Markets Outlook January 2024, the overall commodity price index decreased by 18.4%. The decrease in commodity prices occurred across various sectors: energy prices by 24%, non-energy prices by 5.2%, food prices by 7.4%, fertilizers by 36%, and metals and minerals by 4.9%. However, prices for beverages increased by 24.7% and precious metals by 10.8%.

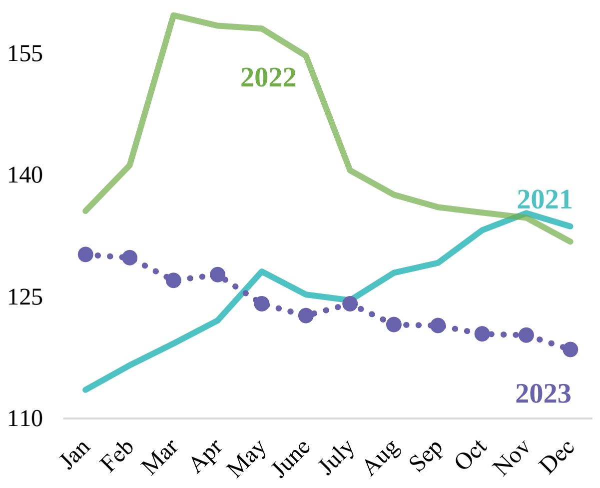
Chart 6. Global commodity indices
(2020 december=100)



Source: World Bank

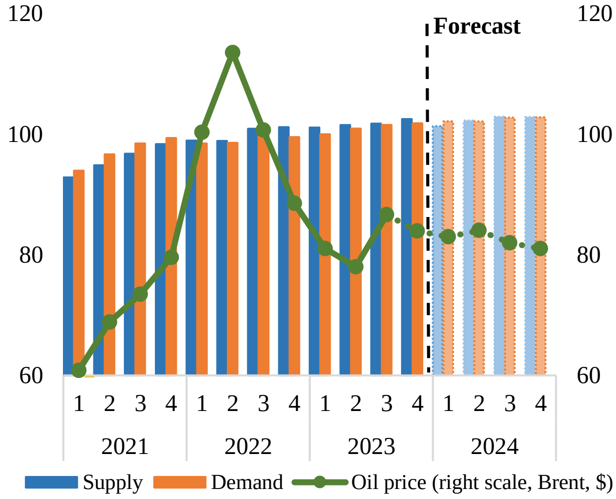
The food price index published by the FAO decreased by 10.1% last year, driven by the drop in prices for grain, vegetable oils and dairy products. However, due to extreme weather conditions sugar prices reached the peaks of recent years. The sugar price index, that slightly decreased at the end of the year, in total grew by 14.9% on annual.

Chart 7. The FAO food price index (2014-2016 = 100)



Source: FAO

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



Source: The US EIA

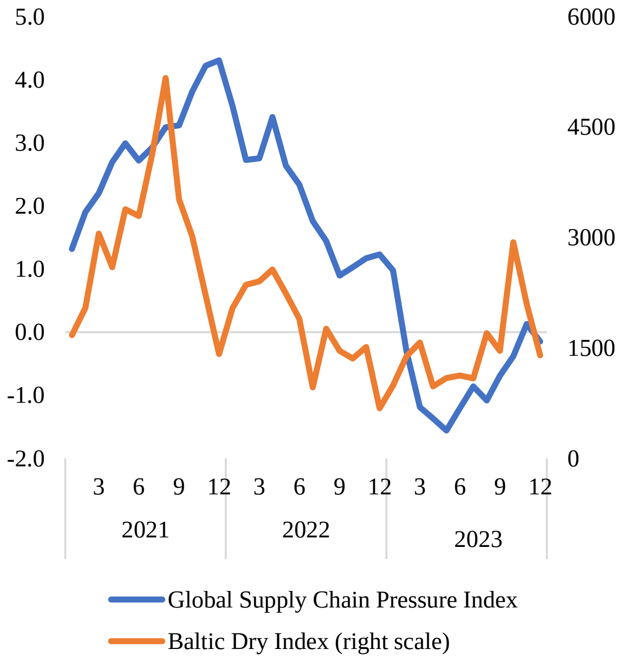
The previous year was marked by dramatic oil price volatilities. Oil prices which were prone to decreasing in the first half of the year increased in the second half of the year. In general, oil prices, that reached highs of recent years in 2022, slightly fell in 2023. Hence, the average Brent oil price was $82.2/b in 2023, down by 17.1% compared with the average price of 2022 ($99.2/b).

The US Energy Information Administration (EIA) predicts that oil prices will be more stable upcoming years in its January report. The Brent oil price is expected to be $82/b in 2024 ($94/b in October forecast) and $79/b in 2025.

The report highlights that, forecasts were made amid current uncertainties, also underlines ongoing geopolitical tensions, particularly the likelihood that the conflict flaring up in the Middle East region may push oil prices. At the same time, rising oil output in non-OPEC+ countries and lower global demand for oil may lead to oil output cut initiatives by OPEC+ countries in 2024 as well. In general, since the risks that may increase or decrease oil prices balance each other, significant changes in oil prices are not expected in upcoming periods.

The slackening economic growth in Europe and mild winter paved the way to lower demand for natural gas, as a result natural gas reserves in storage remained higher-than-average and prices slumped dramatically; the average gas price for 1000 cubic meters on the Dutch TTF gas index decreased by 70% to €429 (€1405 in 2022).

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



Source: New York FED, Statista

With the recovery of the global supply chain, affected by several negative shocks over recent years, marked by intense geopolitical and geoeconomic developments, the return of transportation costs and durations to normal levels contributed to faster than expected drop in inflation from the second half of the year. The Global Supply Chain Pressure Index, released by the Federal Reserve Bank of New York, significantly decreased to pre-pandemic levels in 2023.

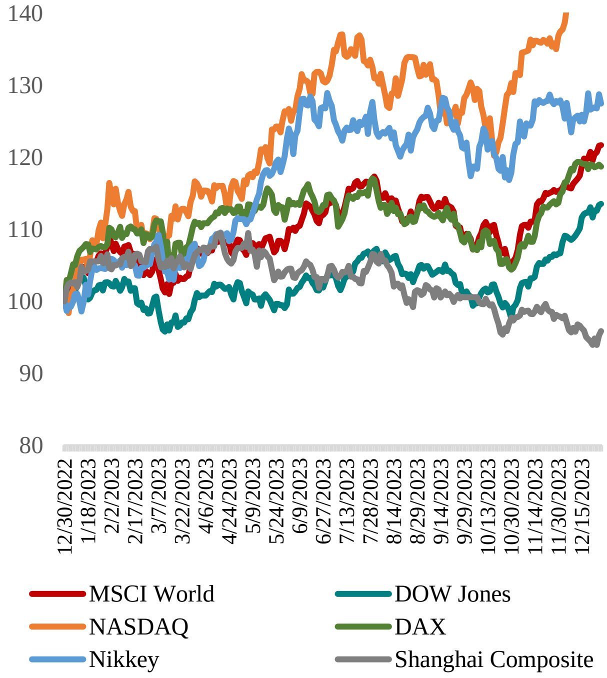
According to the recent release by the IMF, energy and non-energy commodity prices are expected to decrease in upcoming years – the average oil price is predicted to decrease 2.3% and 4.8%, and non-energy prices 0.9% and 0.4% in 2024 and 2025, respectively.

1.3. Global financial markets

Global financial markets showed higher than expected resilience in 2023. Despite persistent tight monetary policy by central banks the prices for major shares rose. Downturn related concerns of investors early in the year were replaced with soft landing expectations of the global economy in the year-end.

Due to higher-than-expected inflation in most countries major central banks kept tight monetary policies in 2023. The monetary policy was further tightened in the first half of the year. While in the second half of the year the policy rates that had been increased enough were left stable. However, policy decisions of central banks became increasingly more asynchronous. Policy rates started to be decreased in the second half of the year in the countries where central banks begun to tighten the monetary policy earlier than others and inflation was low enough. To stimulate the economy, the Bank of Japan, which pursues an accommodative monetary policy, continued to use a negative policy rate (-0.1), while the People’s Bank of China shifted the policy rate to 3.45% from 3.65% on the backdrop of real estate crisis and dramatic decline in inflation. However, the FED continued monetary tightening by increasing the policy rate from 4.25-4.5% to 5.25-5.5%, the Bank of England from 3.5% to 5.25% and the ECB from 2.5% to 4.5% over the year.

Chart 10. Dynamics of the stock markets indices

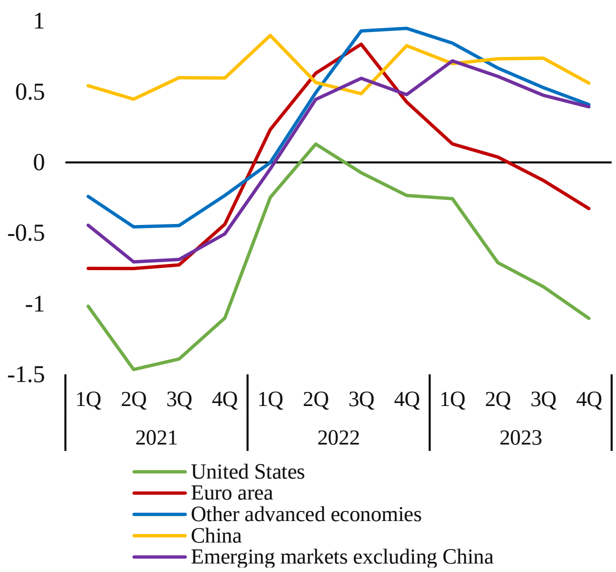


Source: Bloomberg

Expectations related to global economic recession early in 2023 failed to fully materialize, in parallel, the rate of inflation reduction from the second half of the year accelerated, increasing investors' expectations related to interest rate cuts in 2024. Consequently, the dynamics was positive in stock exchanges and most stock indices posted a double-digit growth: the NASDAQ appreciated by 44.1%, the Dow Jones by 13.5%, the FTSE Eurotop by 11.5%, the DAX by 18.7%, the Nikkey by 27.5%, and the MSCI World by 21.7%. The Shanghai Composite depreciated by 4.2% over the reporting year, driven by real estate crisis in China. The highest value appreciation was in the Moscow Stock Exchange, the MOEX RX appreciated by 101.1% last year. Despite criminal cases filed against giant cryptocurrency exchanges, such as FTX and Binance, the value of the Bitcoin cryptocurrency increased by about 1.5 times (149%) in 2023.

Persistent decline in inflationary pressures elevated the expectations in the year-end that AEs will ease their monetary policies in the upcoming quarters. Consequently, the global financial condition has eased net since October.

Chart 11. Financial Conditions Indices



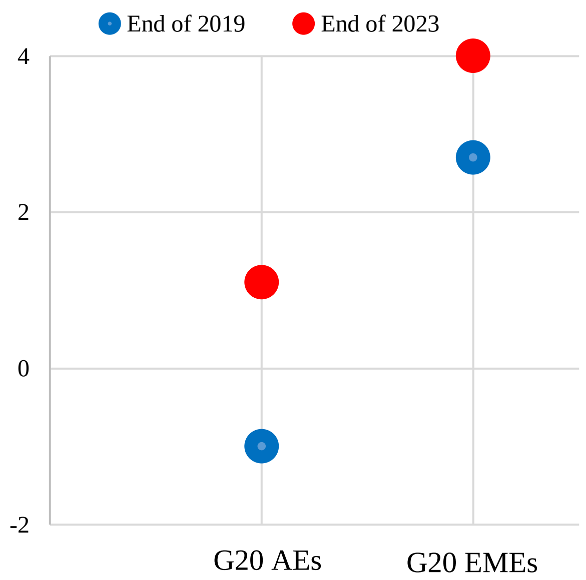
Source: IMF

According to the IMF WEO January 2024, return on bonds plunged globally since October. This phenomenon was particularly evident in longer-duration bonds and was attributed to investors' expectations regarding future policy rate cuts.

The report also specifies that, despite investors' optimism with respect to the macroeconomic outlook, borrowers' financial conditions deteriorated; defaults continued across certain borrower groups. Weak demand and high borrowing costs in certain countries increased default risks among borrowers in the real estate sector and caused concerns in the banking system.

According to the report, on the backdrop of significant interest rate volatility the correlation between yields on assets in EMEs and US treasury yields increased. High yields in AEs caused outflow of assets in EMEs. The financial conditions in this higher interest rate environment may continue to challange certain regions, particularly those of weaker emerging markets and countries with rapidly narrowing differentials against interest rates in the US.

Chart 12. Long term real interest rates, %



Source: IMF

The report emphasizes positive and negative shocks that are likely to affect global growth and, consequently, the financial system. The fast decline in inflation, slower-than-expected fiscal consolidation, rapid recovery of the Chinese economy, the artificial intelligence and supply-related reforms are assessed as positive, while rising commodity prices amid the geopolitical tension and climate changes, persistent core inflation that may lead to tighter monetary policy, slowing growth in China and dramatic fiscal consolidation are assessed as negative factors. The IMF specifies preventive measures against future shocks, maintaining medium-term growth and strengthening resilience through multilateral cooperation as policy priorities.

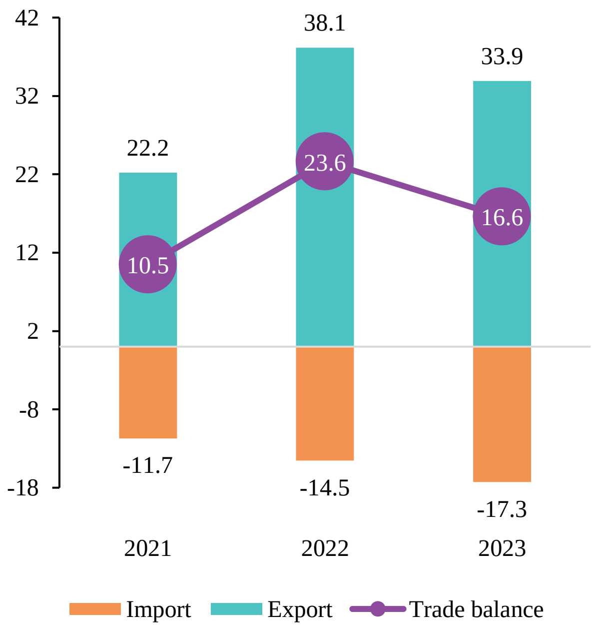
II. INTERNAL MACROECONOMIC CONDITION

2.1. External sector

A favorable international conjuncture and rising non-oil exports resulted in foreign trade surplus, which serves as the primary component of the balance of payments, in 2023.

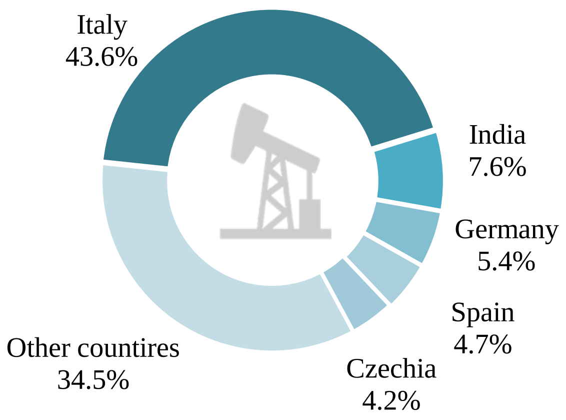
According to the SCC, foreign trade turnover amounted to $51.2B – export $33.9B (66.2%), import $17.3B (33.8%). Foreign trade surplus stood at $16.6B.

Chart 13. Trade balance, $ billion



Source: SCC

Chart 14. Countries to which crude oil and oil products are exported (%)

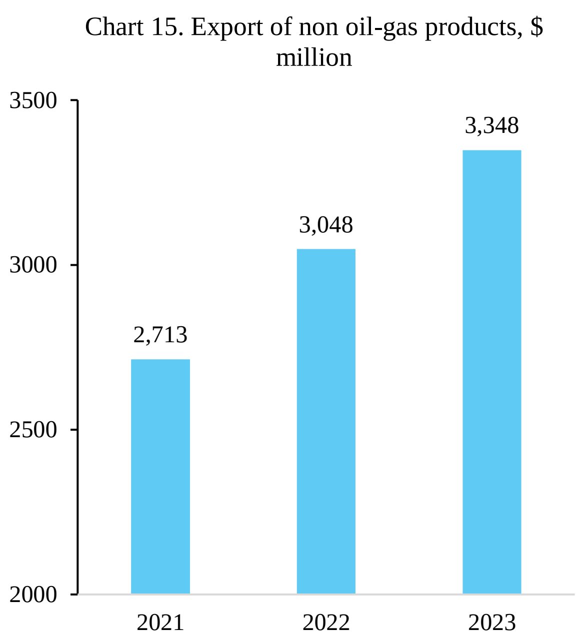


Source: SCC

Italy, Türkiye, Russia, China, Germany, Greece, the USA, India, Spain, and Georgia accounted for over half of trade turnover.

The value of the oil-gas export decreased by 13%, driven by the change in export prices. The value of export decreased by 16.6% on crude oil and by 8.7% on natural gas. 43.6% of crude oil and oil products was exported to Italy, 7.6% to India, 5.4% to Germany, 4.7% to Spain, 4.2% to Czechia and by 34.5% to the other countries.

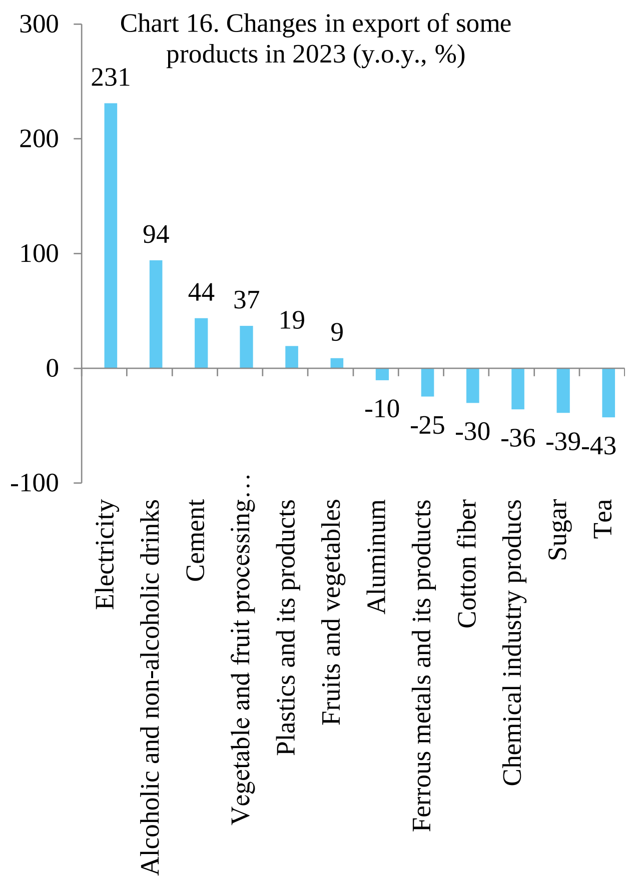
The non-oil-gas exports increased by 9.9%.



Source: SCC

Exports of electricity, alcoholic and non-alcoholic beverages, cement, fruits and vegetables and their processed products, plastics and products increased.

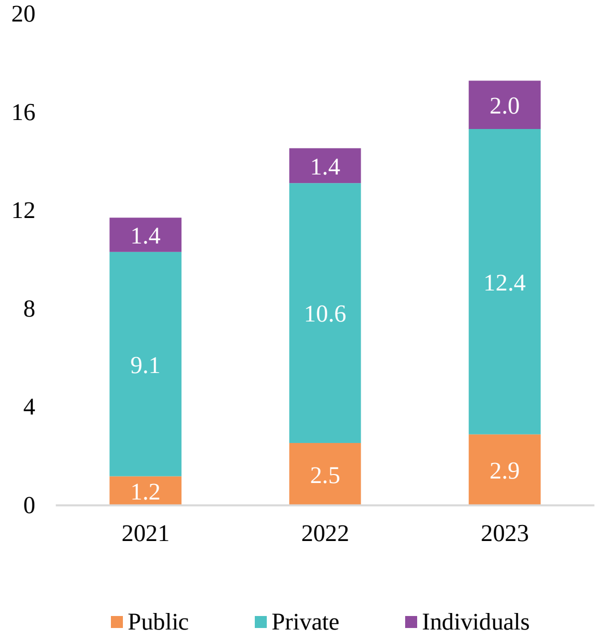
In general, over the reporting period main export partners were Italy (44.8%), Türkiye (15.8%), Greece (4.0%), India (3.6%) and Russia (3.5%).



Source: SCC

In 2023, commodity import y.o.y. increased by 18.9%; it increased by 13.9% to $2.9B on the public sector, by 17.4% to $12.4B on the private sector and by 38.8% to $2.0B on individuals.

Chart 17. Dynamics of imports by sectors, billion $



Source: SCC

Chart 18. Changes in imports of some products in 2023 (y.o.y., %)

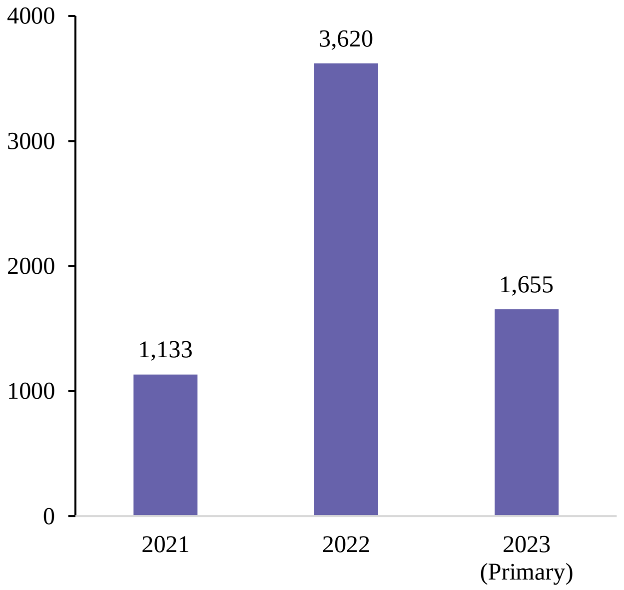
Source: SCC

Import increased by 61.6% on vehicles and their parts, by 42.8% on clothes and clothing accessories, by 23.5% on tobacco and tobacco products, by 19.8% on machinery and mechanisms, by 12.8% on furniture and parts, by 7.6% on plastics and products, by 5.8% on ferrous metals and products, and by 1.0% on wood and wood products, and decreased by 17.6% on fertilizers, by 14.1% on pharmaceuticals, and by 8.6% on food products.

Russia accounted for 18.3%, China for 17.5%, Turkiye for 13.3%, Germany for 5.3%, the USA for 5.1%, Turkmenistan for 4.0%, Italy for 2.8%, Iran for 2.7%, Japan for 2.5%, the South Korea for 2.5% and France for 2.3% of total imported products.

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

Chart 19. Remittances entering the country, $ million



Source: CBA

Capital inflows from foreign enterprises and organizations continued over the period. According to the SSC, total investments from all financial sources amounted to AZN20.3B. Foreign investments accounted for 19.1% of total investments (y.o.y. up by 9.3%).

Investor funds from the UK, Türkiye, the USA, Japan, Switzerland, Russia, France, Norway, and Iran accounted for 94.1% of total foreign investments.

According to estimations, if current trends persist, the current account of the balance of payments forecasted to be in surplus in 2024 as well. As in the previous year, the balance of payments of Azerbaijan will be driven by the global geopolitical situation, world prices on main export products, macroeconomic stance in trade partners, and the non-oil-gas export potential in 2024 as well.

The strategic FX reserves still exceed internationally accepted adequacy norms. As of the end of December 2023, strategic FX reserves were sufficient for 34 months' worth of import of goods and services (considering the import of goods and services for 9 months of 2023). Moreover, the strategic reserves exceeded broad money supply in manat (M2) 3.3 times (M2 money aggregate as of 01.01.2024).

2.2. Economic activity

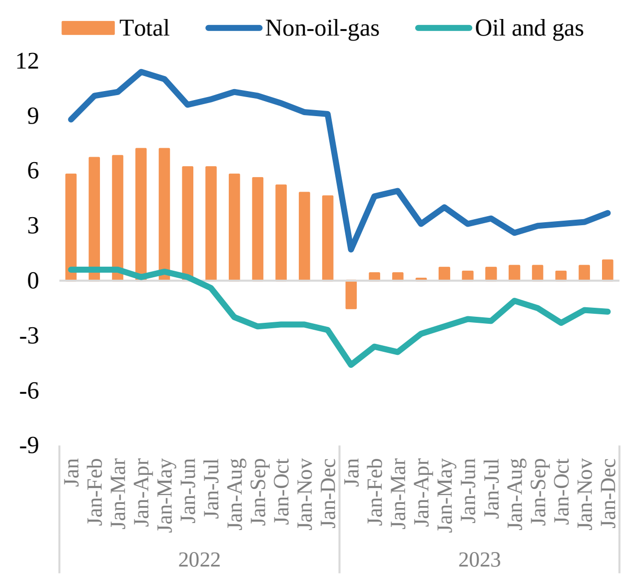
Economic growth continued in the country in 2023 driven by the non-oil-gas sector. Main aggregate demand components underpinned economic growth.

Economic growth. According to the SSC, GDP increased by 1.1% in real terms to nominal AZN123B in 2023. Per capita GDP stood at AZN12114.5.

Oil and gas value added made AZN45.3B. 30.1 million/ton crude oil (y.o.y. down by 7.6%), 36.4 billion cubic meters natural gas (y.o.y. up by 4.2%) was extracted in 2023.

Non-oil-gas value added y.o.y. increased by 3.7% in real terms to nominal AZN77.7B. Production in the non-oil-gas industry increased by 8%.

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



Source: SSC

Agriculture grew by 3%. Livestock products increased by 3.2%, and plant products increased by 2.7%.

The services sector demonstrated high growth. Freight and passenger transport increased by 5.3% and 18.7% respectively, information and communication increased by 16.3%. The value added in tourism and catering y.o.y. increased by 21.8%.

The share of service sectors in the structure of GDP increased in 2023.

Table 1. GDP structure, weight, %

Sectors	2022	2023
Industry	51.1	40.5
Construction	4.8	6.2
Agriculture, forestry, and fishery	4.8	5.5
Trade, repair of vehicles	8.2	10
Transport and warehousing	6	6.2
Tourism and public catering	1.6	2.2
Information and communication	1.4	1.7
Other	14.7	18.6
Net taxes on products and import	7.4	9.1

Source: SSC

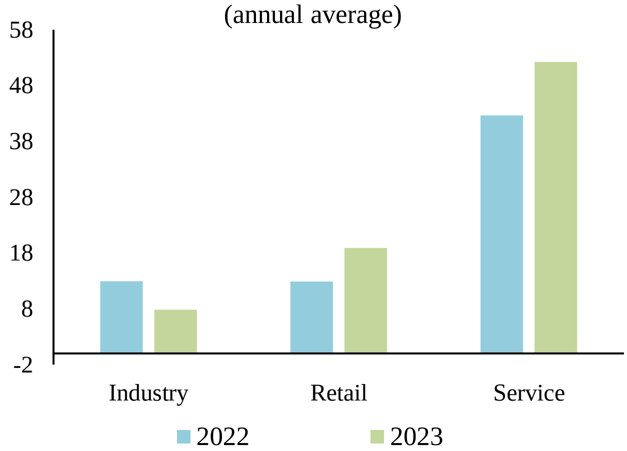
CBA's real sector survey results confirm that economic activity continues. The BCI was positive across sectors.

Whereas the BCI was higher in the chemical industry, food products and beverages, machine building, construction, and production of other non-metal products sub-sectors, it was relatively weak in metallurgy, plastic, and textile sub-sectors.

The trade BCI was positively zoned and rose year over year. The BCI was higher in furniture and electric appliances sub-sectors and relatively weak in automobiles and household goods.

The BCI in services significantly increased year over year. The Index was positively zoned in all sub-sectors of the service sector.

Chart 21. Business Confidence Index, (annual average)



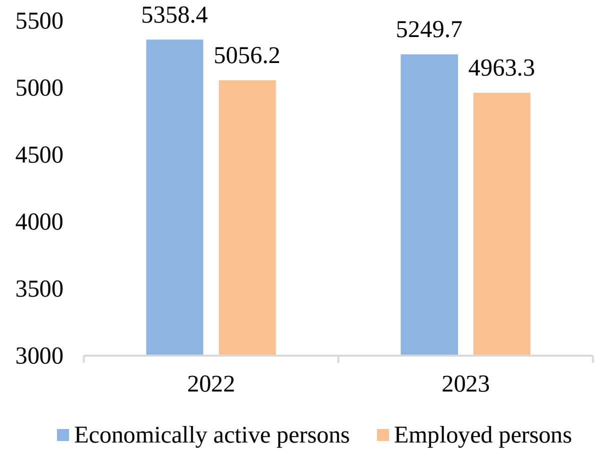
Source: RSM findings-based CBA estimations [1]

Employment. As of January 1, 2024, total labor force was 5249.7 thousand persons, employed population numbered 4963.3 thousand persons.

[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

As of December 1, 2023, hired labor was 1732.6 thousand persons – 899.8 thousand persons were engaged in the public and 832.8 thousand persons in the non-public sectors.

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



Source: SSC

22.8% of hired labor in enterprises and organizations are engaged in production.

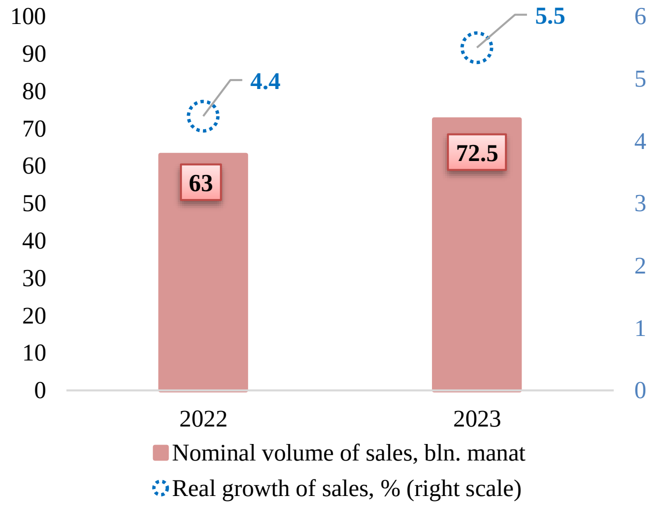
As of January 1, 2024, the number of registered unemployed persons was 217.6 thousand persons, out of which 41.8% were women.

Results of RSM by the CBA indicate that, employment expectations of economic agents surpassed average indicators of the previous year in the industry, trade, and services in 2023.

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

Aggregate demand expanded mainly due to consumer demand. Goods and services sold in the market to meet consumer demand y.o.y. increased by 5.5% in real terms to AZN72.5B. Every consumer spent on average AZN594.6 monthly in the consumer market (y.o.y. up by AZN74.5).

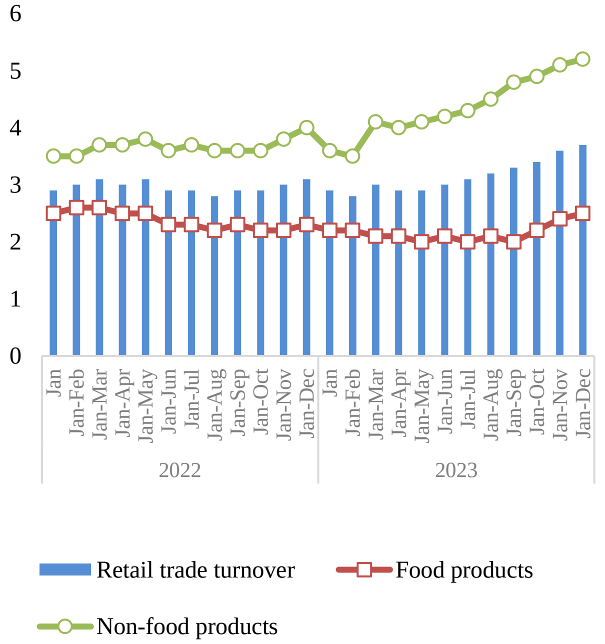
Chart 23. Change in volume of sales in consumer market



Source: SSC

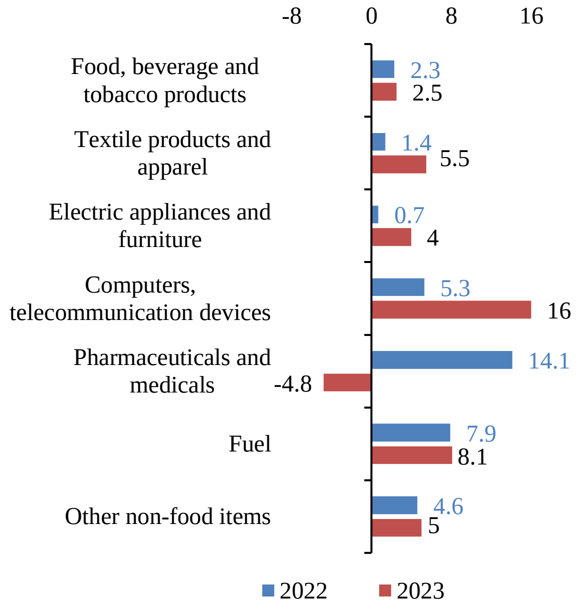
Retail trade turnover y.o.y. increased by 3.7% in real terms to AZN59B. Retail commodity turnover on food products, beverages and tobacco products increased by 2.5%, and non-food trade turnover increased by 5.2%.

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



Source: SSC

Chart 25. Growth of spending items at trade turnover, %



Source: SSC

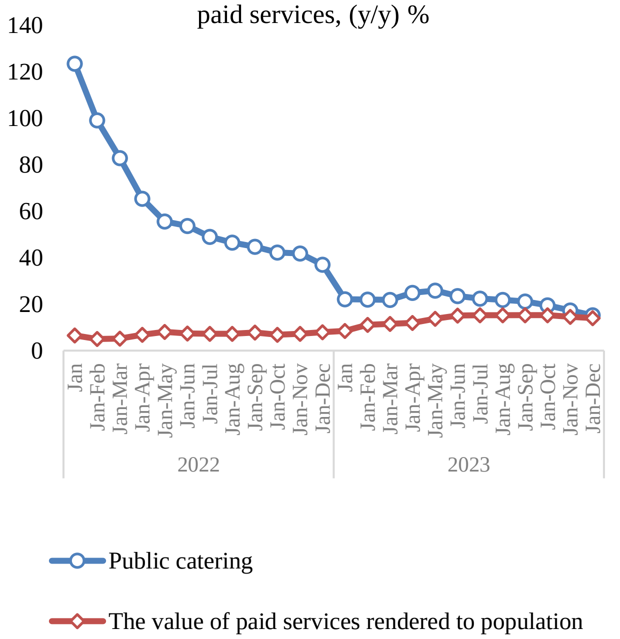
In 2023, consumers' expenses in retail trade outlets decreased year over year for the purchase of pharmaceutical products and medical supplies, while expenses increased for other spending items.

Consumers spent main part of their funds (56%) on food, beverages, and tobacco products in retail trade outlets. Every consumer spent, on average, AZN484.2 worth of goods (y.o.y. up by AZN53.5) per month in nominal terms in retail trade – AZN270.9 on food, beverages, and tobacco products, and AZN213.3 on non-food stuff.

Over the reporting year, public catering turnover y.o.y. increased by 15.2% in real terms. Paid services to the population increased by 14% in real terms to AZN11.4B. Per capita paid services consumption y.o.y. increased by AZN204.8 to AZN1123.9 on average in nominal terms.

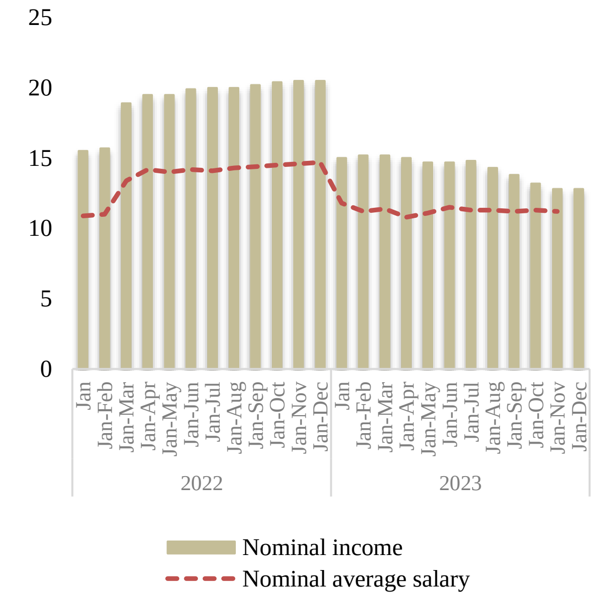
salary of hired labor y.o.y. increased by 11.2% to AZN923.1 in January-November 2023.

Chart 26. Dynamics of public catering and paid services, (y/y) %



Source: SSC

Chart 27. Growth dynamics of incomes and salaries, (y/y) %



Source: SSC

The growth dynamics of income of the population both in real and nominal terms was one of the main factors in the rise of consumer demand.

According to the SSC, money income of the population increased by 12.8% to AZN78.1B in nominal terms. Per capita money income was AZN7686.9. Population's disposable income increased by 12.8% to AZN69.3B. Average monthly nominal

Lending dynamics also weighed on the consumer demand. In 2023, loans to households increased by 24.2% year over year.

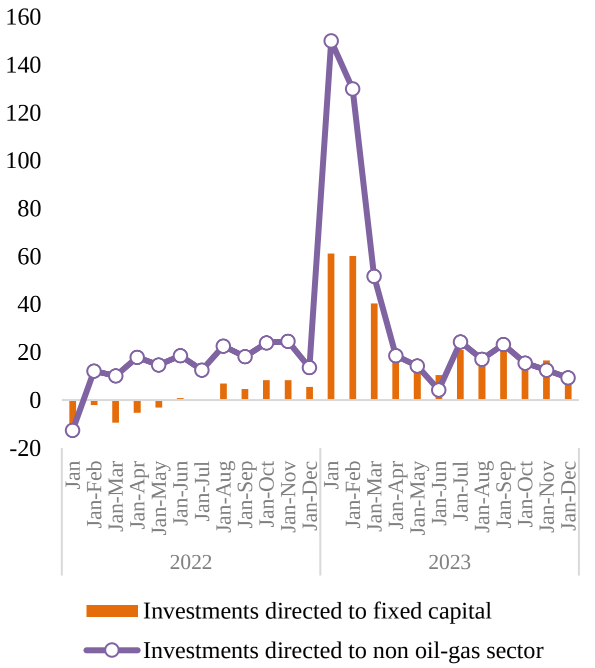
Government spending was critical in supporting domestic demand. State budget expenditures amounted to AZN36.5B (y.o.y. up by 13.7%). [2] AZN13.1B (35.8%) of state budget expenditures were channeled to social expenses (labor compensation fund,

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

pensions, social benefits, and costs of purchasing medicine and food products) (y.o.y. up by AZN1.5B or 12.7%).

Investment demand also posted growth, along with consumer demand. According to the SSC, funds invested to the economy y.o.y. increased by 9.8% (AZN20.3B). Investment in the oil-gas sector y.o.y. increased by 10.9% and investment in the non-oil-gas sector increased by 9.3% in real terms.

Chart 28. Dynamics of investment , (y/y) %



Source: SSC

AZN1.9M (9.2% of total investments) out of AZN14B worth funds channeled to the non-oil-gas sector was used in the non-oil-gas industry. The public sector accounts for 56.1% and the non-public sector for 43.9% of total investments.

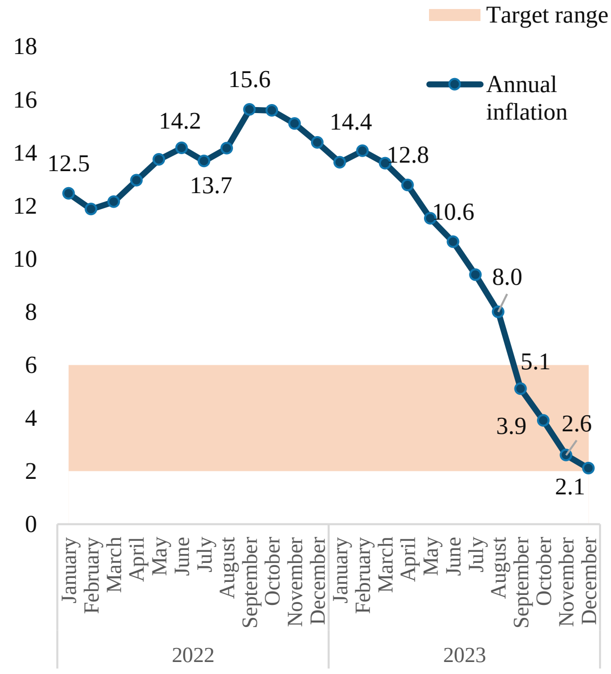
80.9% of investments stemmed from internal and 19.1% from foreign sources. Funds of enterprises and organizations prevailed in total investments (48.5%).

2.3. Inflation

In December 2023, annual inflation was close to the lower bound of the target band. Global economic developments, a slowdown in inflation imported from trade partners, and the anti-inlfationary policy underway in the country contributed to the decline in inflation.

Consumer price index (CPI). According to the SSC, annual inflation stood at 2.1% in December 2023 (December 2023 vs December 2022). Average annual inflation stood at 8.8% in December 2023 (January-December 2023 vs January-December 2022).

Chart 29. Annual inflation %

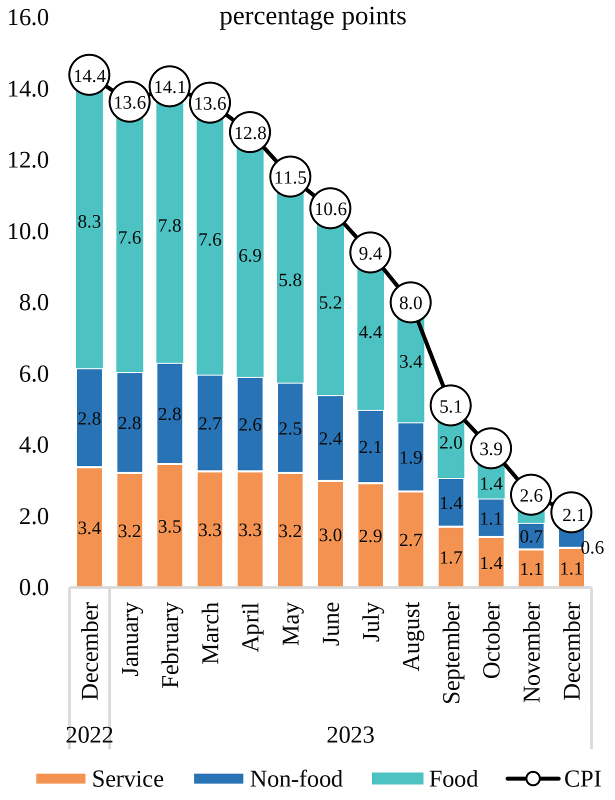


Source: SSC

Annual food inflation stood at 0.8%, while average annual food inflation stood at 9.6% in December. Non-food prices y.o.y. increased by 2.7% in December. Average annual non-food inflation stood at 8.4%. Annual service inflation was 3.7% in December, average annual service inflation was 8.2%.

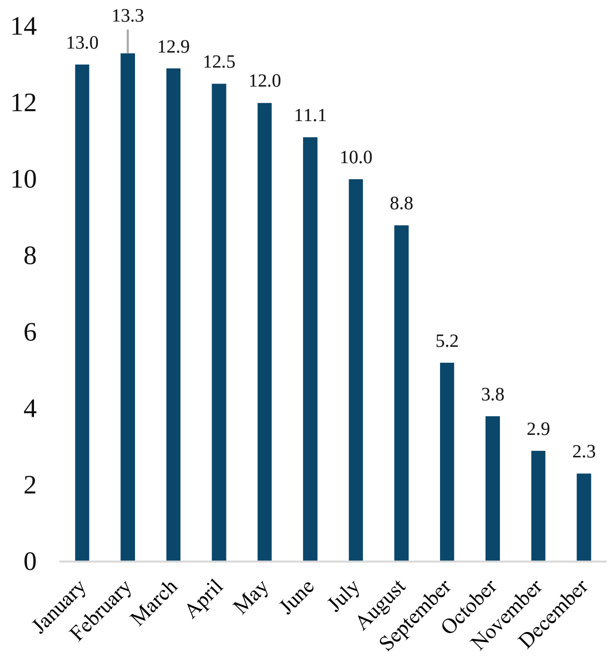
Annual inflation y.o.y. decreased by 12.3 pp, driven by the drop in food (7.9 pp), service (2.3 pp), and non-food (2.1 pp) inflation.

Chart 30. Contributions to CPI , in percentage points



Source: SSC, CBA

Chart 31. Change of core annual inflation, in %



Source: SSC

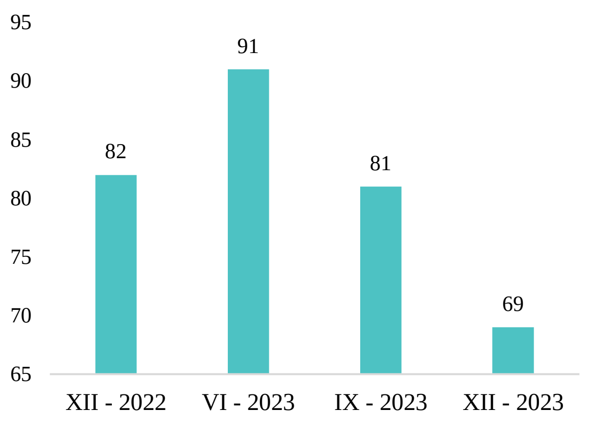
Annual core inflation calculated by excluding changes in regulated prices and prices for seasonally volatile agricultural products was 2.3% in December 2023. Average annual core inflation was 8.8% in 2023.

Annual inflation decreased under the influence of both external and internal factors. The slackening global economic activity, as well as persistent drops in global commodity, energy, and food prices, contained inflation import. According to the World Bank, the commodity price index decreased by 18.4% on an annual basis, and by 24% on energy prices in December. According to the FAO, the food price index decreased by 10.1% on annual in December.

The FX market equilibrium was crucial in containing inflation import. In 2023, the nominal effective exchange rate of the manat appreciated by 19.3%, the primary factor to drive down imported inflation.

The dynamics of actual inflation weighed on inflation expectations of households. According to December 2023 survey findings, the share of households expecting higher inflation made 69%, 22 pp down compared to June 2023.

Chart 32. Housholds that expecting inflation, in %



Source: AMB

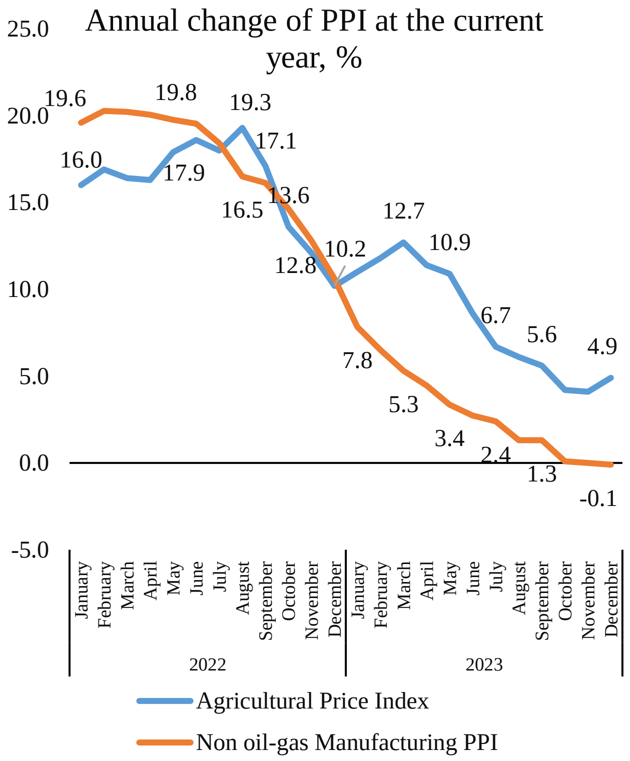
According to recent forecasts by the CBA, annual inflation is expected to remain within the target band in 2024. The Central Bank's January inflation forecast remained unchanged compared to the previous forecast (October). Setbacks in external factors of inflation and the implementation of anti-inflationary measures in collaboration with the government will contribute to maintaining inflation within the target band in the medium term.

Producer Price Index. According to the SSC, APPI y.o.y. increased by 4.9% in December. The price for plant growing products increased annually by 0.6%, and prices for livestock products increased by 8.8% annually. Price hike for plant growing products y.o.y. decreased by 7.6 pp, primarily attributable to lower prices for imported fertilizers.

In December 2023, the IPPI decreased by 1.5% annually. The oil-gas IPPI decreased by 2.4% and the non-oil-gas IPPI decreased by 0.1%. The price index of non-oil-gas industry products decreased by 7.9 pp.

The Producer Price Index (PPI) in processing y.o.y. decreased by 1.1% annually. The food production annual price index decreased by 3%. Note that, this price index grew by 12% annually in January 2023.

The decrease in the annual producer price index of prosessed food products was significantly influenced by the decline in the annual APPI (which dropped from 11% in January to 4.9% in December). These factors have a downward effect on the consumer price index within a certain time frame.



Source: SSC

In December 2023, prices for transport and warehousing y.o.y. increased by 0.6%. Cost of freight transportation increased by 2.6%, and the price of passenger transportation decreased by 18%. The decline in producer prices for passenger transportation is attributable to a sharp decrease in producer prices for foreign passenger transportation by air (in December the relevant annual indicator decreased by 42.8% in Commonwealth of Independent States (CIS) countries and by 32.5% in the other countries). Prices for passenger transport services by car and subway increased by 15.4%.

In December, postal and courier service prices increased by 1.3% annually. The price index of communication and advertising services increased by 0.4% annually in December, while the price index of ICT services decreased by 0.5%.

House price index. According to the SSC, the house price index y.o.y. increased by 9% in Q4 2023. The price index increased by 6.9% in the primary and by 9.1% in the secondary housing market. Comparing to Q3 2023 the price index increased by 1.7% in the overall housing market, by 1.8% in the primary market and by 1.7% in the secondary market in Q4.

III. MONETARY CONDITION

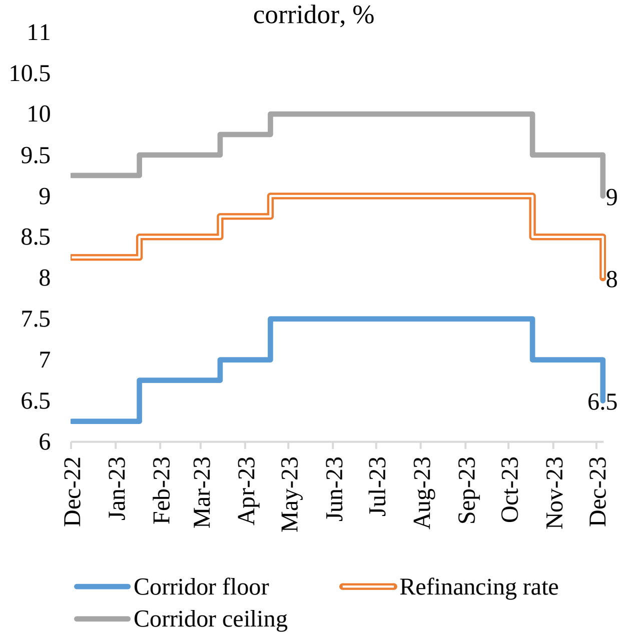
3.1. Monetary policy decisions and tools

In 2023, the monetary policy was oriented towards reverting inflation to the target band and stabilizing inflation expectations through the monetary condition. Over the reporting year reforms to boost options to affect inflation continued. Monetary policy tools were applied in response to the liquidity position of the banking system and the balance of risks.

Decisions on the interest rate corridor parameters of the CBA were taken considering the dynamics of annual inflation and updated macroeconomic forecasts. The nature of monetary policy transmission in Azerbaijan were also considered in the decision-making.

The CBA Management Board has discussed the interest rate corridor parameters 8 times over the reporting year. At the first three discussions the refinancing rate was increased from 8.25% to 9%, the ceiling of the interest rate corridor from 9.25% to 10% and the floor from 6.25% to 7.5%. The following period considering the decline in actual and forecasted inflation the CBA took a break in monetary policy tightening and decided to leave the interest rate corridor parameters unchanged at the next three meetings. The CBA started to decrease policy rates at the recent 2 meetings – the refinancing rate was decreased from 9% to 8%, the ceiling of the interest rate corridor from 10% to 9%, and the floor from 7.5% to 6.5%. The CBA published interest rate related decisions under the pre-announced schedule with appropriate analytical comments.

Chart 34. Parameters of interest rate corridor, %

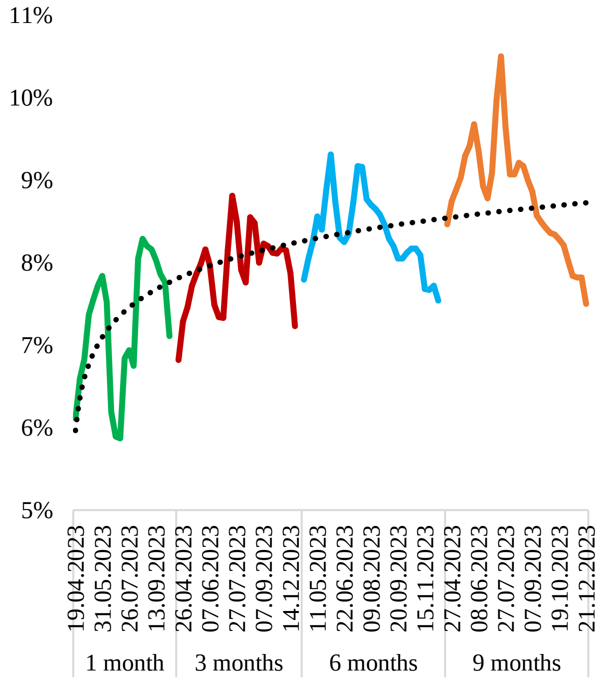


Source: CBA

The Bank continued to apply monetary policy tools within the new configuration. Due to the banks' liquidity position, demand for CBA's liquidity absorbing standing facilities was higher. To enhance the monetary policy operational framework the quota applied to standing liquidity absorbing facility was removed over the reporting year, which was accompanied by an increase in operations. Thus, demand for the standing facility was AZN1175M on the last working day of 2023.

Efforts continued to improve open market operations to achieve monetary policy targets. Certain corrections were made to the conditions of the placement of CBA notes in order to optimize a competitive environment at note auctions, enhance investor confidence and the effectiveness of liquidity absorbing operations. Regular auctions continued on the placement of 28-day (1 months), 84-day (3 months), 168-day (6 months) and 252-day (9 months) notes for liquidity absorbing operations. The CBA held total 125 various term note auctions over the year. In general, demand exceeded supply at note auctions. As of end-2023, total outstanding amount of sterilization via notes was AZN1320M. Yield at recent auctions was 7.11% on 28-day, 7.23% on 84-day, 7.54% on 168-day, and 7.5% on 252-day notes.

Chart 35. The yield of notes of the various maturities in 2023



Source: CBA

To regulate interest rates in the interbank money market and promptly neutralize effects of autonomous factors the CBA held 7-day operations (Repo and 1-week note auctions) for liquidity absorbing purposes. As of end-2023, total outstanding amount of funds absorbed on the beforementioned tools was zero.

In December 2023, to meet banks' liquidity needs reverse Repo operations were also held as a standing facility along with liquidity absorbing operations.

In 2023, the CBA revised the 'Regulation on the ratio, calculation and maintaining required reserves' stepwise to effectively manage banking system liquidity, more effectively regulate money supply and stimulate de-dollarization trends. According to the changes made to the 'Regulation on the ratio, calculation and maintaining required reserves' by Decision No 53/1 of the Management Board of the Central Bank dated 1 November 2023, required reserves were differentiated depending on the share of connected deposits and share of related party deposits of banks in total deposits, in addition to the threshold of total amount of deposits of legal entities in national and foreign currencies (For more details please go to: *https://www.cbar.az/press-release-4407/about-reserve-requirement-ratios*).

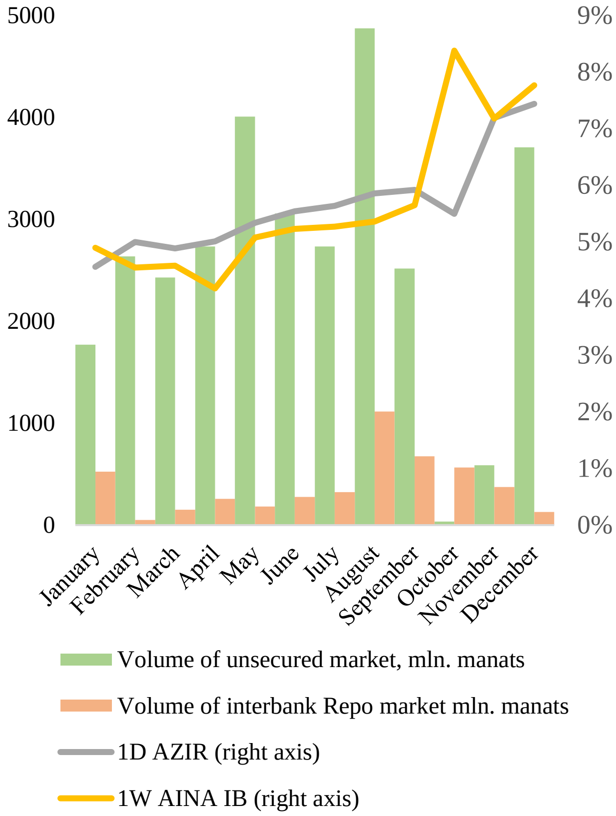
As part of the efforts on the formation of the alternative monetary policy anchor the Management Board of the CBA decided to approve the 'Regulations on calculation and publication of the benchmark rate (AZIR - Azerbaijan Interbank Rate) index at the unsecured interbank money market'. At the same time, the Baku Stock Exchange approved the changes to the 'Regulations on calculation and publication of indexes on transactions concluded in the Repo market', which allows representative interest rate (AINA – AZN INdex Average) indexes to spread at a higher frequency in the secured market. Currently, the CBA and the Baku Stock Exchange regularly publishes the AZIR (Azerbaijan Interbank Rate) and two types of AINA (AINA – AZN INdex Average) indexes.

Interest rates in both unsecured and secured money markets responded to changes in the interest rate corridor during the year. As a result of implemented measures, representative interbank interest rates started to enter the interest rate corridor for the first time during the last quarter of the year. The average interest rate on 1-3-day operations (1D AZIR) in the interbank unsecured money market was 7.4% and average interest rates on 6-8-day operations (1W $AINA_{IB}$) in the interbank Repo market was 7.8% in December 2023. Thus, both formed within the corridor in December 2023.

Analyses suggest that interbank interest rates and interest rates of manat denominated deposits of legal entities of certain bank groups move in the same direction as indicative of the improvement of transmission of monetary policy decisions through the interest rate channel.

In 2023, banks concluded AZN31.1B worth of 2467 transactions in the platform launched for unsecured operations in the Bloomberg system. 95% of them were 1–3-day transactions. AZN4.6B worth of 1240 transactions were concluded at the interbank Repo market. 43% of interbank Repo operations were concluded based upon CBA notes.

Chart 36. Interbank money market in 2023



Source: CBA

The Management Board of the CBA approved the ‘Regulations on assessment and publication of the yield curve’. Now the yield curve estimated on government bonds is published on the website of the Bank weekly. The yield curve is published at 16.00 on the first working day of each week.

Monetary reforms had a positive impact on more effective management of liquidity by banks and interbank market activity. The refinement of the monetary policy operational framework thoughout the year bolstered the pass-through capacity of monetary policy decisions through the interest rate channel. Adjustments of interest rate corridor parameters based on the macroeconomic situation, adequate application of monetary policy tools, increasing reserve requriements contained overexpansion of aggregate demand. The activation of liquidity absorbing operations is critical in terms of balanced growth of credit to economy and maintaining the FX market equilibrium in the medium term.

The CBA will employ monetary policy tools in response to domestic and global situation in upcoming periods too. The Bank will promtly decide on quantitative parameters and duration of the tools depending on regular assessments of the liquidity position of the banking system. Efforts to enhance the monetary policy operational framework will also continue.

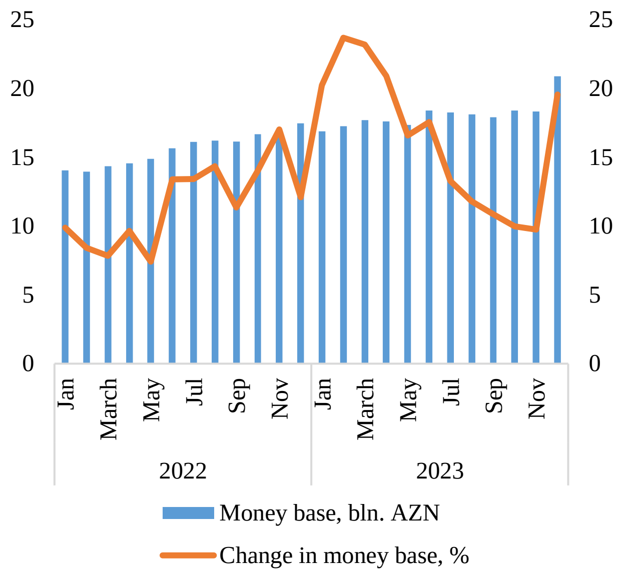
3.2. Money supply

In 2023, money supply was managed in accordance with the demand of the economy. CBA's liquidity absorbing operations both supported activity in the interbank money market and regulation of interest rates and contained overexpansion of money supply.

Base money in manat increased by 19.6% to AZN20.9B in 2023. The FX interventions by the CBA and changes in balances of the single treasury account had an upward, while the CBA's liquidity absorbing operations had a downward effect on base money.

Cash in circulation, a structural element of base money in manat [3] increased to AZN17.3B, while stock of correspondent accounts in manat increased to AZN3.5B. Note that, changes to reserve requirement ratios also affected to the dynamics of the stock of correspondent accounts.

Chart 37. Monetary base and its annual change



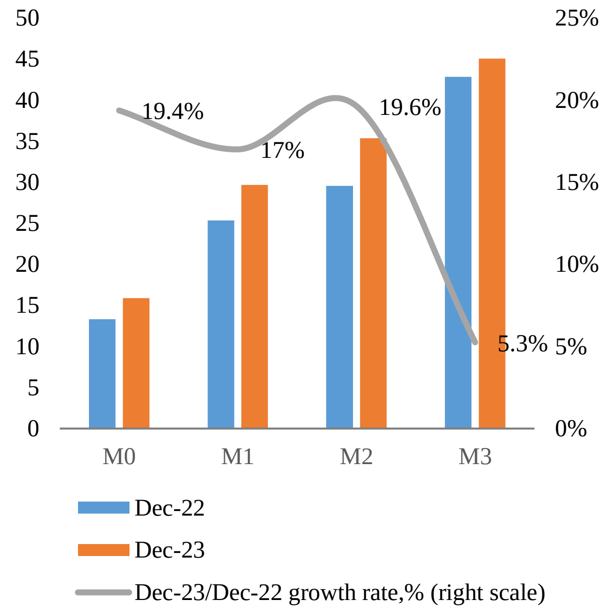
Source: CBA

Money multiplier in manat (broad money supply in manat/base money in manat) has increased by 0.1% since early year to 1.69 by the end-year.

Broad money supply in manat (M2) increased by 19.6% to AZN35.4B.

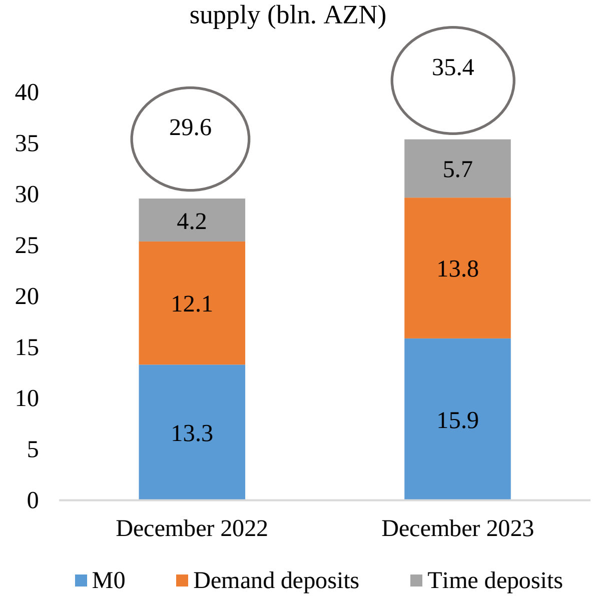
[3] Cash money outside the banking system, cash in bank ATMs and cash offices

Chart 38. Money aggregates (bln. AZN)



Source: CBA

Chart 39. Composition of broad money supply (bln. AZN)

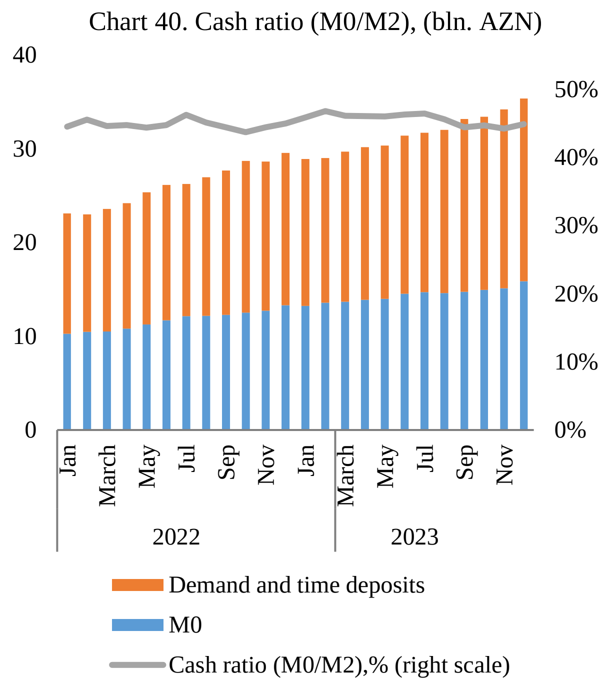


Source: CBA

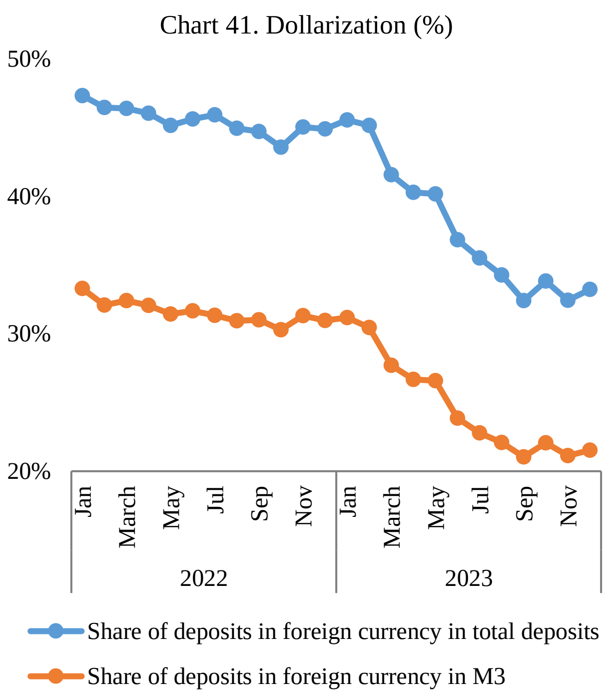
All structural elements of M2 money aggregate grew over the year. M0 cash money supply increased by 19.4%, demand savings and deposits increased by 14.4% and term savings and deposits increased by 35.6%.

Term savings and deposits increased at a higher pace year-over-year, indicative of higher confidence in the national currency and the banking system.

The weight of cash (M0) in broad money supply in manat (M2) did not change significantly and constituted 44.9% as of end-year.



Source: CBA



Source: CBA

Broad money supply (M3) increased by 5.3% to AZN45.1B as of the year-end.

Dollarization kept decreasing. Foreign currency denominated savings and deposits decreased by 26.8% to AZN9.7B, while their weight in total savings and deposits decreased by 11.7 pp to 33.2%. The weight of foreign currency denominated savings and deposits in M3 money aggregate decreased by 9.4 pp to 21.5% by the year-end.

The share of foreign currency in deposits of legal entities was 43.4% at the year-end, y.o.y. down by 9.4 pp. Dollarization of savings of individuals also decreased by 6 pp to 33.2% by the year-end. Dollarization of deposits of households, excluding savings of non-resident individuals decreased by 6.1 pp to 29.5% by the year-end.

The CBA will adequately use the tools at its disposal to ensure the change of the money supply in line with the monetary policy goals in the next year as well.

3.3. The FX market and the exchange rate

The exchange rate of manat against foreign currencies was formed based on supply and demand in the FX market. The balance of payments surplus supported the exchange rate stability, the key price stability anchor.

Cashless transactions in the FX market amounted to $29.5 B equivalent[4] - 79% in the USD and 21% in other currencies. The Interbank FX market accounted for 21%, the Intrabank FX market for 79% of the operations.

Interbank FX market operations (including operations of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) and the CBA)) amounted to $6.2B and 98% of transactions were conducted in the USD. Currency operations in the Interbank FX market were conducted over the Bloomberg platform.

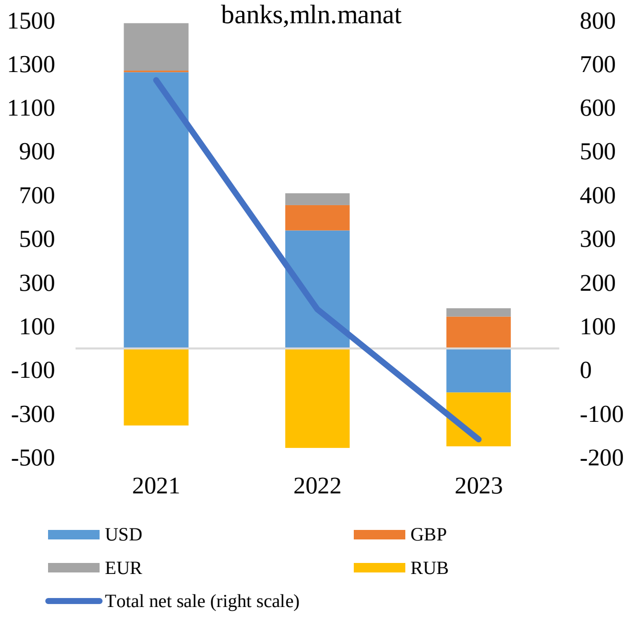
The Bloomberg's BMatch platform was activated while maintaining the existing auction mechanism. The platform allows the CBA to respond flexibly to the FX market. Banks can track supply and demand for foreign currency in a real time mode and conclude deals with the most optimal exchange rate.

Intrabank FX market operations amounted to $23.3B equivalent and 74% of transactions were made in US dollars. Legal entities accounted for 93.8% of Intrabank FX market operations.

Cash currency traded by banks y.o.y. amounted to $3.8B (83.9% in USD). Cash currency purchase operations prevailed over sales for the first time in 2023, resulting in negatively zoned net sales.

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

Chart 42. Net sales of cash FX by banks,mln.manat



Source: CBA

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

The CBA held 96 currency auctions in 2023 to sell foreign currency provided by the SOFAZ. Supply prevailed over demand at 92% of those auctions. The CBA made $2.1B worth purchase-oriented interventions to the FX market in 2023 mainly due to the needs of the fiscal sector. As a result of foreign exchange interventions, CBA's FX reserves increased by 29.1% to $11.6 B at the end of the year.

The official exchange rate of the manat against the USD was 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. Buy-sell exchange rates set by banks were closely aligned with the official rate. Commercial banks' average buy/sell rates were 1.6945 and 1.7020 respectively.

The exchange rate of manat against currencies of trade partners varied over the period. Bilateral exchange rates influenced that of multilateral exchange rates.

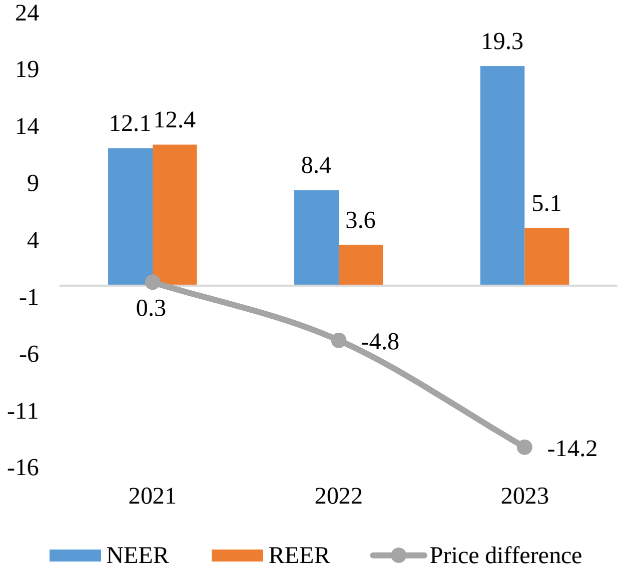
Table 2. Bilateral nominal and real exchange rates of manat against currencies of trade partners in 2023 (December 2022=100), %

	NEER	**REER**
Russian ruble	138.3	131.5
Turkish lira	156	96.7
Euro	96.9	95.8
Chinese yuan	102.2	104.9
Iranian rial	100	72.9
US dollar	100	98.8
Kazakh tenge	98.1	91
Belarus ruble	130.5	126
Japanese yen	106.6	105.5
Georgian lari	100	101.7
Ukrainian hryvnia	100.4	97.6
Swiss franc	92.7	92.5
South Korean wan	100.7	99.7
British pound sterling	96.1	94.4
Israeli shekel	106.4	105.6
Total (NEER, REER)	**119.3**	**105.1**

Source: CBA

In general, the NEER of the manat appreciated by 19.3% and the REER by 5.1%. Since inflation in Azerbaijan was lower than the average inflation in partner countries, it had a reducing effect on the REER.

Chart 43. Effective exchange rates
(since december of previous year, in %)



Source: CBA

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

Charts and tables

Charts

Tables

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