CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

JANUARY- MARCH 2022

№1

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ACRONYMS

CBA	The Central Bank of the Republic of Azerbaijan
ILO	The International Labor Organization
BCI	The Business Confidence Index
IMF	The International Monetary Funds
FDI	Foreign direct investments
WEO	World Economic Outlook
SSC	The State Statistics Committee
SCS	The State Customs Committee
FED	The Federal Reserve System
EME	Emerging Market Economy
AE	Advanced Economy
OECD	The Organization for Economic Cooperation and Development
CCI	The Consumer Confidence Index
CPI	The Consumer Price Index
APPI	The Agricultural Producer Price Index
NEER	The Nominal Effective Exchange Rate
OPEC	The Organization of the Petroleum Exporting Countries
Yoy	Year over year
REER	The Real Effective Exchange Rate
RSM	Real Sector Monitoring
IPPI	The Industrial Producer Price Index
GDP	Gross Domestic Product
WTO	The World Trade Organization
FX	Foreign exchange
XDA	Net Domestic Assets
XXA	Net Foreign Assets

EXECUTIVE SUMMARY

In Q1 2022 the Central Bank implemented the monetary policy in line with the 'Statement of the Central Bank of the Republic of Azerbaijan on main directions of the monetary and financial stability policy for 2022'. The environment where the monetary policy is implemented is characterized with the emergence of a large-scale geopolitical tension and its translation to the global economic situation amid the gradual exit of the countries from the pandemic.

Over the reporting period, the impact of new global economic realities on the economy triggered by geopolitical economic realities was not unilateral. On the one hand, high global food prices and transportation-logistic problems elevated inflationary pressures in Azerbaijan too. On the other hand, a favorable conjuncture in the global energy market positively weighed on the balance of payments, the FX market equilibrium and economic activity.

In Q1 2022, the monetary policy of the Central Bank was mainly oriented towards creating an acceptable monetary condition and ease direct and indirect effect of cost factors of foreign origin on price hike by anchoring inflation expectations. On the backdrop of high geopolitical tension, macroeconomic stability was safeguarded as a whole, though inflationary pressures are dominant. The equilibrium in the FX market and a stronger nominal effective exchange rate of the manat were critical in neutralizing the pass-through of high inflation in trade partners to domestic prices. Decisions related to interest rate corridor parameters were made in light of the comparison of the actual and forecast inflation rates with the target, and the effects of demand and supply factors of inflation. Money supply responded to the demand of the economy. The Central Bank adequately used all tools in its arsenal to attain monetary policy targets.

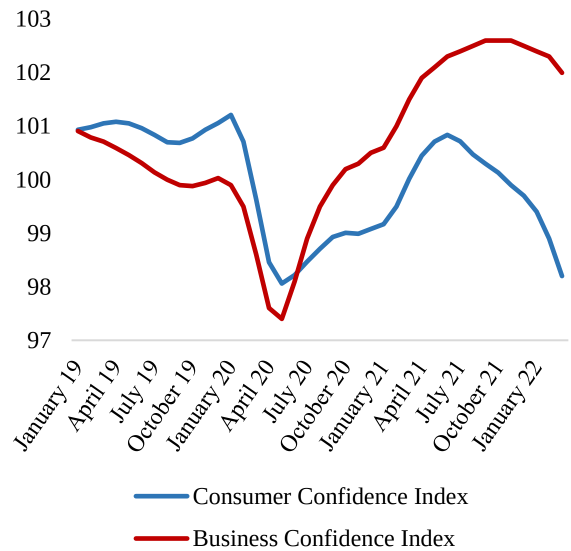
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1. Global economic trends

For the global economy, Q1 2022 was marked with gradual ease of COVID-19 related restrictions, unprecedented political and economic sanctions against Russia amid the Russia–Ukraine conflict and resulting high inflation on a global scale. Energy and food prices peaked in particular. Rising commodity prices and supply chain disruptions due to the conflict resulted in higher than expected and persistent inflation in most countries. At the same time, all of those hinder the recovery of global economic activity.

Global economic activity. Low economic activity indicators in the world amid high uncertainties from the second half of last year continued in first quarter of 2022 as well. Rising geopolitical tension gave additional impetus to the reduction of the CCI and the BCI in the OECD countries over the quarter.

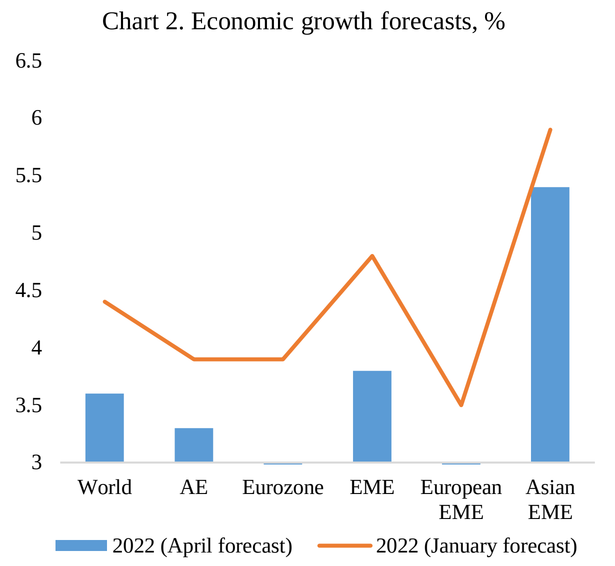
Chart 1. Business and Consumer Confidence indexes in OECD countries



Source: OECD

International organizations and leading think tanks revised global economic growth forecasts down in light of recent trends. The IMF WEO April 2022 projected global growth at 3.6% in 2022 and 2023 – 0.8 and 0.2 pp lower than in the January forecast respectively. Note that, the downgrade reflects sanctions imposed against Russia until March 31 (excluding the energy sector).

Economic growth forecast on EMEs was revised down by 0.6 pp compared with the January forecast, mainly due to the Ukraine-Russia conflict, changes in the monetary and fiscal policies and persistent supply chain disruptions.



Source: IMF

Economic growth in the **USA** is estimated at 3.7% in WEO April 2022 (0.3 pp down vs the previous update). In March 2022, annual inflation in the USA increased to 8.5%, the highest inflation rate since December 1981. The highest contributors to inflation were rising energy, food and car prices. Most analytics expect that inflation will subdue after March despite the tense geopolitical situation and high consumer demand. The unemployment rate in the USA dropped to 3.6% in March 2022 (market expectations 3.7%), the lowest unemployment rate since February 2020.

The Dow Jones decreased by 3.5% and NASDAQ by 8.4%, while the S&P 500 increased by 0.3%. Industrial production in the USA increased by 5.5% on annual in March 2022. The processing industry increased by 4.9%, mining by 7% and utilities by 7.5%.

The FED increased interest rates from 0-0.25% to 0.25-0.5% over the quarter. Amid persistent elevated inflation, the US Government and the FED announced that they would continue to withdraw stimulus for the rest of 2022.

The IMF forecasts 2.8% economic growth in the **euro area** in 2022, down compared with the January Update (3.9%). The geopolitical and geoeconomic policies impacted the euro area mainly through rising global energy prices and energy security. Since these countries are absolute energy importers, high global commodity prices triggered negative trade shocks for most European countries, leading to low production and high inflation. Supply chain disruptions, conflicts and sanctions have severely damaged industrial production, including the automotive industry, important for the region. Countries, such as Germany and Italy, highly dependent on energy imports from Russia, were hit hardest.

In March 12-month inflation in the euro area was 7.4%, the highest annual rate of recent 30 years. Industrial production in the euro zone yoy decreased by 0.8% in March 2022. The unemployment rate plunged to historical lows – to 6.8% in March 2022. Unemployment was the lowest in Spain, Italy and France. The FTSE Eurotop decreased by 2.8% in the first quarter. Over the quarter, the ECB left the policy rate unchanged.

According to the updated forecast, in 2022 economic growth in **Japan** is expected to be 2.4%, down by 0.9 pp compared to the January forecast (3.3%). The forecast was revised down mainly due to weak domestic demand, the expectation that high oil prices will have a negative impact on consumption and investment and low net exports. In March 12-month inflation in Japan was 1.2%, the highest inflation rate since October 2018. Unemployment exceeded market expectations and stood at 2.6% in March 2022. Industrial production yoy decreased by 1.7% in March. Nikkei depreciated by 3%. The Bank of Japan left the refinancing rate unchanged at negative 0.1%.

The IMF revised economic growth forecast in the **United Kingdom** down by one pp to 3.7% for 2022 (4.7% in January forecast). Consumption is predicted to be weaker than expected as high inflation reduces real wages and tighter fiscal conditions slow down investment. In March 2022, annual inflation exceeded market expectations (6.7%) and stood at 7%, the highest inflation rate since March 1992. Main price hike was in energy, transport, food, garments, and furniture and hotel prices. In March industrial production yoy increased by 0.7%. The unemployment rate dropped to 3.8% from the beginning of the year. Over the quarter, the Bank of England increased the policy rate from 0.25% to 0.75%.

The IMF WEO April 2022 revised down the growth forecast on EMEs by one pp to 3.8% for 2022, mainly due to high global uncertainty, tighter global financial condition, lingering geopolitical tension, more sanctions against Russia, new lockdowns related to the zero-COVID strategy in China and economic growth slowdown. In 2022, Emerging European Markets are forecast to go into recession by 2.9% (3.5% growth in January forecast). Countries of the Middle East, South Africa, the Caucasus and the Central Asia will be considerably impacted by global food prices, in particular by wheat prices, expected to remain high until 2023. Whereas oil-exporting countries compensate rising food prices with high oil prices, oil-importing countries of the region are facing the risk of food shortage. Economic growth forecast for Emerging Asian Markets was revised down for 2022 due to weaker than expected economic recovery, in particular due to weaker economic growth outlook in India and China. In 2022 economic growth is forecast to be 5.4% in Emerging Asian Markets (5.9% in January forecast), 2.5% in Latin America and the Caribbean (2.4% in January forecast), 4.6% in the Middle East and Central Asia (4.3% in January forecast), and 3.8% in Sub-Saharan Africa (3.7% in January forecast).

The IMF WEO April 2022 forecasts 4.4% economic growth in **China** in 2022, down by 0.4 pp from the January forecast. The main reasons are, as mentioned above, a tight zero-COVID strategy and restrictions in major manufacturing and trade centers, such as Shenzhen and Shanghai, swings in the Chinese housing market and the expectation that external demand will weaken against the background of geoeconomic and geopolitical risks. Annual inflation in China stood at 1.5%, exceeding market expectations (1.2%) in March 2022. Industrial production yoy increased by 5% in March 2022. Unemployment was 5.8%, the highest inflation rate since May 2020.

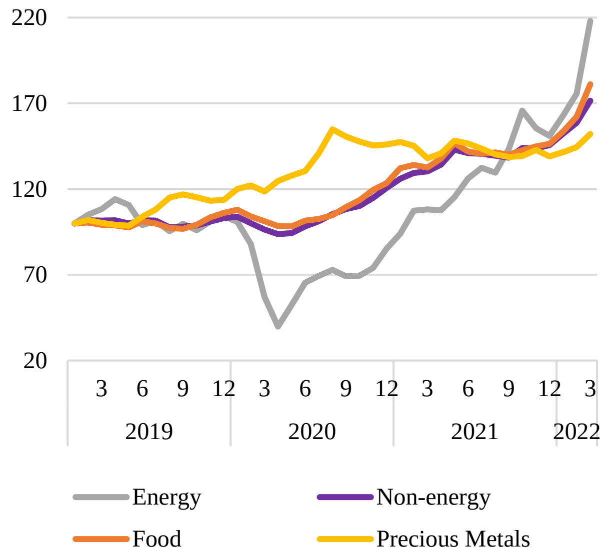
The IMF WEO April 2022 forecasts 8.5% recession in **Russia** in 2022**.** In 2023, recession is forecast to dwell and stand at 2.3%. Severe trade and financial sanctions, including loss of correspondent banking privileges, disconnection of certain Russian banks from the SWIFT, ban on central bank assets and oil and gas embargo of certain countries will severely hit the Russian economy. Plans announced by major consumers to abandon Russian energy will also hit economic growth in the medium run. Foreign companies' leaving poses challenges in many areas, including aviation, finance, software and agriculture. Moreover, the damage to the financial intermediation and loss of investor confidence will lead to a significant reduction in private investment and consumption. Annual inflation in Russia soared to 16.7% in March 2022, the highest inflation since March 2015. The unemployment rate fell to 4.1% in line with market expectations. Industrial production yoy increased by 3% in March 2022. The RUB depreciated by 8.9% against the USD. Taking into account inflation expectations, the Bank of Russia shifted the policy rate from 8.5% to 20% to reduce exchange rate volatility and prevent capital outflow and imposed strict capital control measures.

According to the IMF WEO April 2022, economic growth is forecast to be 2.7% in **Turkey** in 2022. Annual inflation was 61.1% in March 2022. Industrial production was 9.6% on annual in March 2022, higher than market expectations (6.5%). Unemployment stood at 11.5%. The Turkish lira depreciated by 14.6% against the USD. The Central Bank of Türkiye left the interest rate unchanged at 14%.

The dynamics of global economic activity will weigh on global trade. The IMF in WEO April 2022 forecasts 5% growth of global trade in 2022, (6% in the previous forecast). Global trade is expected to grow by 4.4% (4.9% in the previous forecast) in 2023 in line with global economic activity.

Prices in commodity markets and global inflation. Under the influence of the tense geopolitical situation in Q1 2022 and on the backdrop of global uncertainty triggered by sanctions, commodity prices increased in the world market. According to the World Bank's Commodity Markets Outlook, in the first quarter energy prices increased by 44%, non-food prices by 18%, and food prices by 24%. The price for gold increased by 8.8% over the quarter.

Chart 3. Commodity price index (2019 January =100)

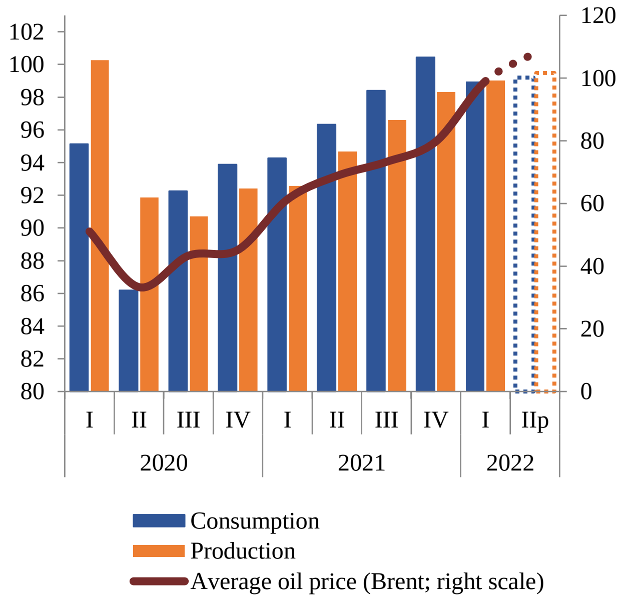


Source: World Bank

According to the Food and Agriculture Organization of the United Nations (FAO), food prices have climbed to the highest level since 1990 when the report started to be developed. As per the FAO, in Q1 2022 global food prices hiked by 19.1%. The largest price hike was in butter, cereals and dairy products. Supply chain impediments triggered by geopolitical and geo-economic developments and a high share of Russia and Ukraine in the global wheat and vegetable oils market played a significant role in price hike. Fertilizer prices climbed by 128% compared with March of the previous year. Producers' response by reducing the use of fertilizers may ultimately lead to lower productivity.

The average Brent oil price was about $99 per barrel in Q1 2022, 40% higher than the average price for 2021 ($70.9). The IMF, in its recent release forecasts on average $106.8 in 2022 ($77.3 in January forecast) and $92.6 in 2023 ($71.3 in January forecast) per barrel for Brent oil price.

Chart 4. World oil market and its forecast, million barrels / day



Source: Energy Information Administration (EIA)

According to the Energy Information Agency (EIA), a sharp rise in crude oil prices was the response to expectations of how geopolitical and geoeconomic risks will affect global energy markets. As a result, oil extraction and export in Russia declined. According to the recent release of the International Energy Agency (IEA), global oil reserves have been declining for 14 consecutive months, February reserves fell by 714 million barrels from the level of the end of 2020, and OECD countries account for about 70% of the decline.

According to the recent release of the IEA, oil demand is expected to increase by 1.9 mln barrel/day to 99.4 mln barrel/day in 2022 vs 2021.

In Q1 2022, gas prices increased in Europe and Asia in the context of energy and geopolitical crises. Although market conditions relatively relaxed in January and February, in early March prices fluctuated sharply as geopolitical and geoeconomic risks and related European energy security concerns widened from end-February. In Europe, natural gas prices exceeded $2,000 per 1,000 m3 in March, and prices fell at the end of the quarter. In the US market, price rose at the end of the quarter, due to the increase in gas exports (LNG) to Europe.

Another pressure on natural gas prices in the US market is attributable to the struggle between Europe and Asia for the increase in liquefied natural gas reserves. According to the IMF, ending gas dependence on Russia and the attempt of mutual sanctions by the parties may keep prices high until mid-2023.

Geopolitical tension weighs on transportation-logistic expenses too. Whereas the Baltic Dry Index (dry freight transportation index), that increased in 2021, decreased early in 2022, it rose again in February. Prolongation of the conflict may further increase prices in the transportation-logistics and supply chains as a whole. The IMF recommends the countries to play a key role in resolving supply chain disruptions, provide more communication to reduce uncertainty, invest in infrastructure and reduce tariffs.

Global aggregate demand is forecast to decline amid rising production prices, lockdowns in China as part of the ‘zero-COVID’ strategy, and geopolitical and geo-economic risks, which translates to inflation.

In light of the above, the IMF WEO April 2022 predicts that inflation will persist longer compared with the previous forecast. Inflation is predicted at 5.7% in AEs and at 8.7% in EMEs in

2022 (up by 1.8 and 2.8 pp vs the January forecast). The main factors to trigger inflation are additional logistic challenges caused by the military conflict and price pressures. In general, deterioration of the supply and demand balance and continuous commodity price hikes give rise to inflation expectations. In many AEs, including the USA and certain European countries inflation hit 40 year high. In the medium run, if high inflation lingers, central banks will have to react more flexibly than expected. Geopolitical and geoeconomic risks force countries to make tough policy choices.

The causes of inflation are in most cases beyond control of central banks (conflicts, sanctions, pandemic, and supply chain disruption). Transmission of the shock of the conflict is distributed among countries in different degrees depending on the size of trade and financial relations, rise in domestic commodity prices. Accordingly, the appropriate monetary policy response is expected to vary across countries. Amid dwelling supply chain disruptions and high-energy prices, it is not ruled out that high inflation will persist longer.

Risks and policy recommendations. According to the recent release by the IMF, global risks elevated due to the tense geopolitical and geoeconomic situation in Europe. On the other hand, despite the weakening of the pandemic, a threat of new strains of the virus is still a possibility. According to the IMF, these issues pose a risk of global stagflation.

In general, the IMF classifies the risks triggered by the geopolitical, macroeconomic and epidemiologic situation as follows:

- Conflict-related tensions will result in high social expenses in EMEs and poor countries owing to the rise in global energy and food prices. On the other hand, the countries that receive an increasing influx of refugees may face social unrest in the long run;
- Increasing international polarization and escalating conflict will hamper global economic integration, essential for long-term welfare. This will increase distrust in international rules after the WW2. Consequently, there is a risk of losing economic

benefits to be achieved by globalization;

- High inflation expectations in the medium term may further exacerbate inflation. In this case, central banks will have to be tougher;
- Rising interest rates, high social and military spending, and calls for fiscal consolidation in the medium term increase the burden on state budgets. According to the IMF, global public debt has now reached record highs. At the same time, the tight monetary policy pursued in AEs increases inflation expectations in EMEs. This will push these countries to pursue a tight policy at the risk of depreciation of their national currencies;
- Despite the relative slowdown of the pandemic, an increase in infections in East Asia and the Pacific could lead to a new strains of the virus;
- The risk of economic slowdown due to the pandemic rules in China could translate to global expectations through commodity exporters and emerging markets;

Continuous rise in commodity prices and supply chain disruptions could slow economic growth in energy and food importing countries and pose serious threats to food security in low-income countries. Global risks also include climate change, cyber security and vaccination levels of countries.

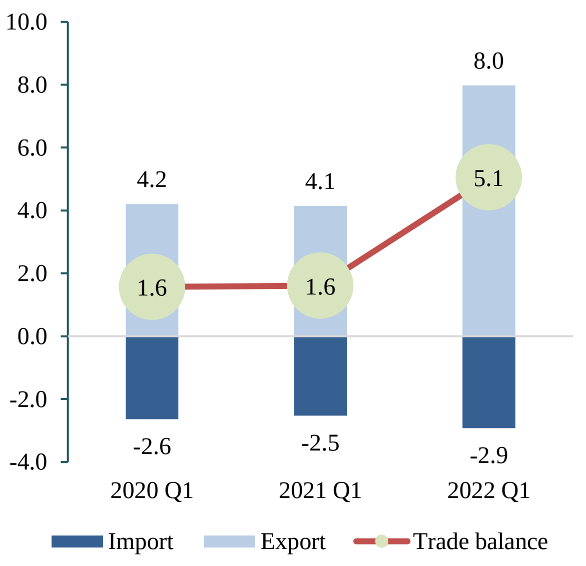
The IMF, in its recent release recommends a number of policy proposals. In fighting high inflation, central banks should carefully monitor the pass-through of rising international prices to domestic inflation and calibrate tools accordingly. In the cases of high inflation expectations central banks should provide a better communication and support these steps with policy measures. Given high uncertainty around the policy path beyond 2022–23, central banks should communicate clearly their perspective on the post-pandemic neutral rate and, if needed, their readiness to maintain policy rates above that benchmark for as long as needed to bring inflation down to target—giving markets some clarity on the likely endpoint for rate hikes. Preparing for tighter financial conditions and geopolitical conditions, regulators should take early actions and tighten selected macro prudential tools to target pockets of elevated vulnerabilities. In general, the IMF argues that the main way out of the economic and social problems created by the geopolitical reality is more peace and international cooperation.

1.2. External sector developments of the Azerbaijani economy

In Q1 2022, the external position of Azerbaijan was shaped in the environment of price hike of main export products in global markets and the impact of geopolitical and geoeconomic tensions.

According to the SCC, foreign trade turnover amounted to $10.9B – export $8B (73.2%), import $2.9B (26.8%).

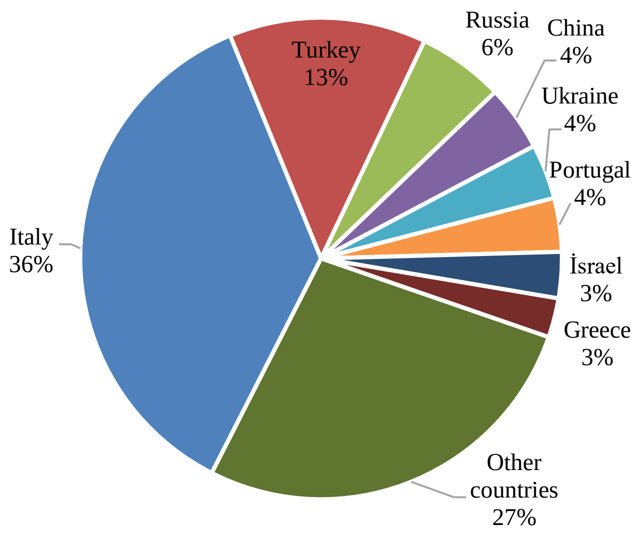
Chart 5. Trade balance, USD bln.



Source: SCC

Foreign trade surplus made up $5.1B, yoy up by 3.1 times. Azerbaijan traded with 152 countries over the period.

Chart 6. Main trade partners, 2022 Q1



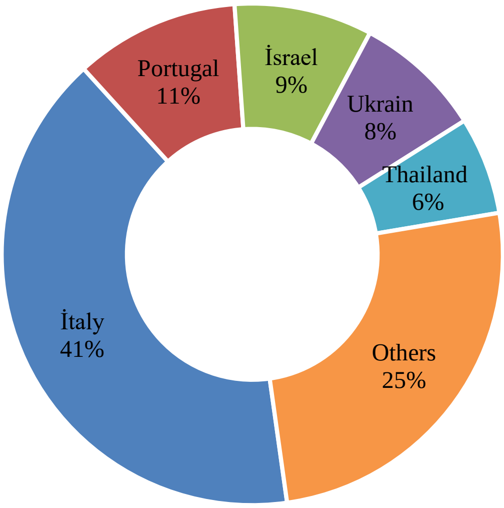
Source: SCC

Italy, Turkey, Russia, China, Ukraine, Portugal, Israel and Greece accounted for over half of trade turnover.

Export increased by 92.9%, nonoil export by 45%. The value of export increased by 38.1% on crude oil, by 2.2 times on oil products and by 4 times on natural gas.

40.5% of crude oil and oil products was exported to Italy, 10.6% to Portugal, 8.9% to Israel, 8.3% to Ukraine and 6.3% to Thailand.

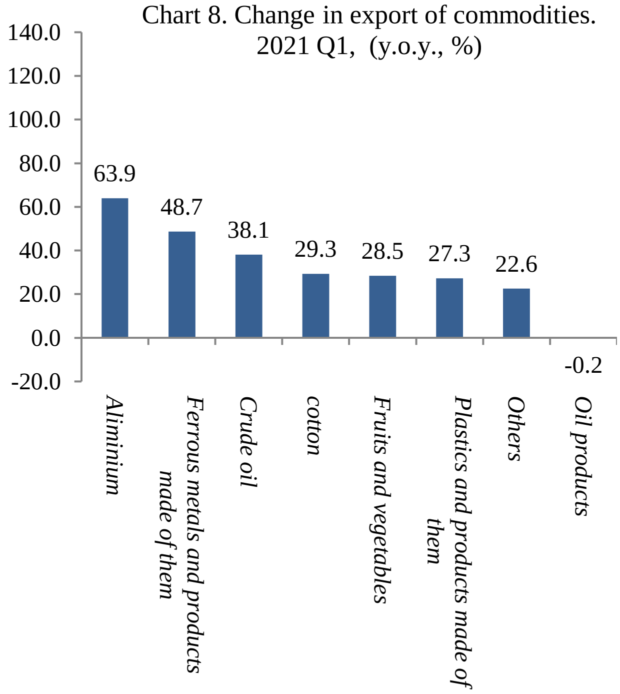
Chart 7. Crude oil and oil products exports, %



Source: SCC

Non-oil export yoy increased by 45%. Export increased on aluminum (63.9%), ferrous metals and products (48.7%), cotton yarn (29.3%), fruits and vegetables (28.5%), plastics and products (27.3%).

Chart 8. Change in export of commodities. 2021 Q1, (y.o.y., %)

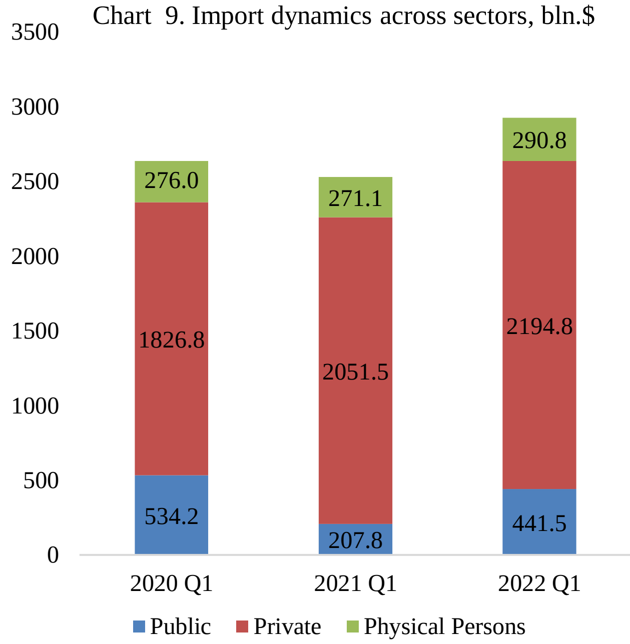


Source: SCC

In general, main export partners were Italy (48.8%), Turkey (12%), Portugal (4.9%), Israel (4.1%), Ukraine (4%) and Greece (3.5%). Non-oil export partners are Turkey (35.1%), Russia (20.6%), Georgia (6.5%), Switzerland (4.6%) and the USA (4%).

Commodity import increased by 15.7% - it increased by 2.1 times to $0.4B on the public sector, by 7% to $2.2B on the private sector and by 7.3% to $0.3B on individuals.

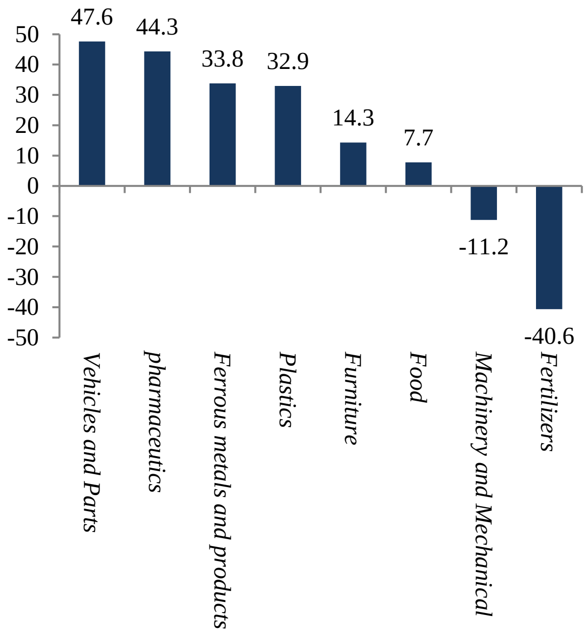
Chart 9. Import dynamics across sectors, bln.$



Source: SCC

Import increased by 47.6% on vehicles and parts, by 44.3% on pharmaceuticals, by 33.8% on ferrous metals and products, 32.9% on plastics and products, by 14.3% on furniture and by 7.3% on food products, and decreased by 11.2% on machinery and equipment and by 40.6% on fertilizers.

Chart 10. Change in import of products, 2022 Q1 (y.o.y.), %

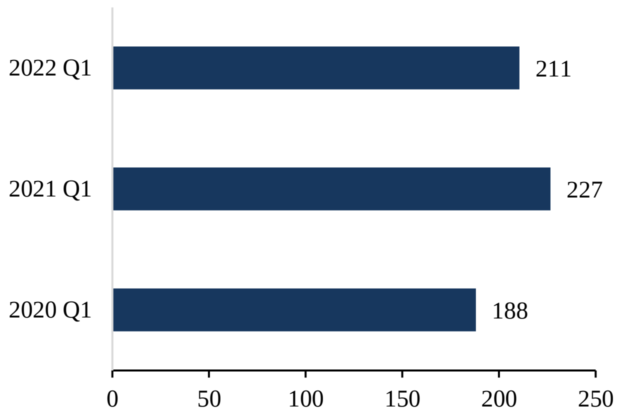


Source: SCC

Turkey accounted for 16.5%, Russia for 16.3%, China for 16.1%, Kazakhstan for 6%, Germany for 4.4%, Iran for 3.9% and Ukraine for 2.9% of imported products.

According to initial data, in Q1 2022 money remittances to the country amounted to $210.6M.

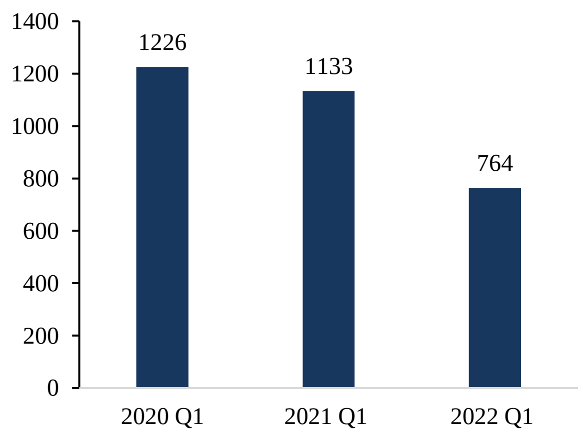
Chart 11. Inflow of remittances, mln.$



Source: CBA

Capital inflows from foreign enterprises and organizations continued over the reporting period. According to the SSC, FDIs amounted to AZN0.8B (31.3% of total investments).

Chart 12. Capital investments from foreign sources, mln. manat



Source: AMB

Strategic FX reserves still exceed the internationally accepted adequacy norms. As of 31 March 2022, strategic FX reserves sufficed for 39 months' import of goods and services (taking import of goods and services for 2021). Strategic reserves exceeded broad money supply in manat (M_2) by 4 times (taking M_2 as of 01.04.2022).

The UK, Turkey, the USA, Japan, Malaysia, Switzerland, France, India, Russia, Iran and Norway accounted for the significant share of the capital investments by foreign countries and international organizations.

II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

2.1. Aggregate demand

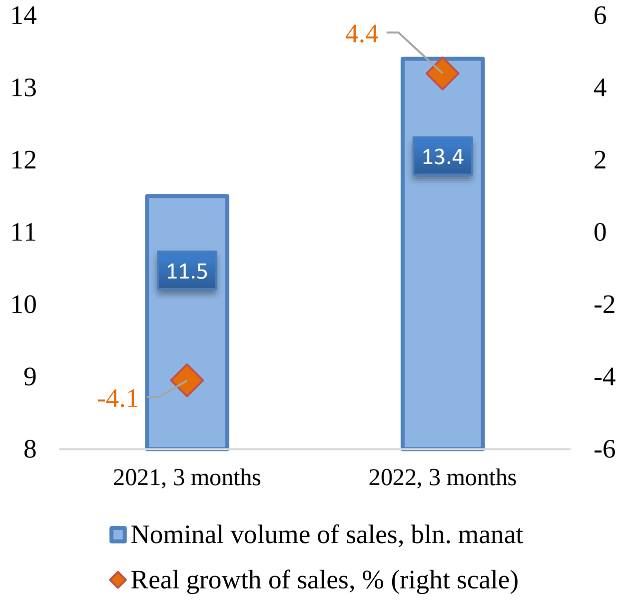
In Q1 2022 aggregate demand continued to expand in response to the rise in the income of the population. Domestic demand was one of the main drivers of economic growth.

Consumption expenditures increased in January-March. According to the SSC, the value of commodities and services sold in the consumer market exceeded the year over year level both in nominal and real terms.

Goods and services sold in the market to meet consumer demand increased by 4.4% in real terms to AZN13.4B on a yoy basis. The private sector accounts for 96.3% of the goods sold and services supplied by economic agents (46.1% individual entrepreneurs).

Every consumer spent on average AZN444.7 in the consumer market (yoy up by AZN62).

Chart 13. Change in volume of sales in consumer market

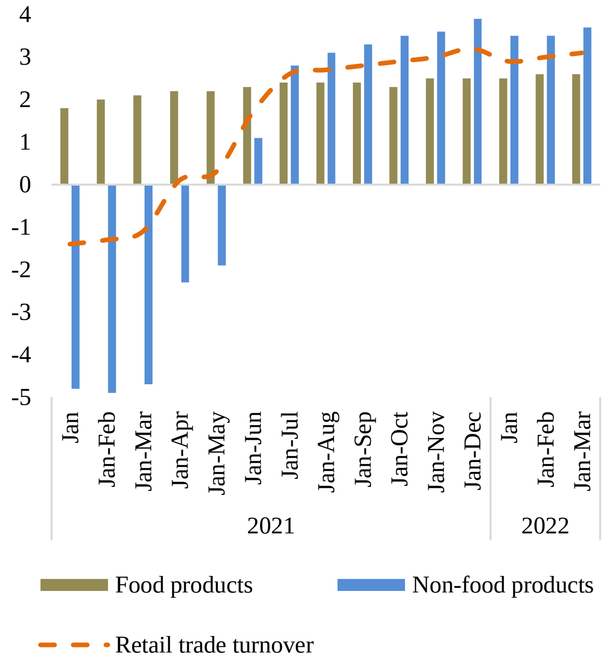


Source: SSC

Gradual easing of the pandemic-related social isolation measures and successful continuation of the process of vaccination paved the way to the rise in consumer demand.

In January-March 2022 retail trade turnover yoy increased by 3.1% in real terms to AZN11B. Retail commodity turnover on food products, beverages and tobacco products increased by 2.6%, and non-food trade turnover increased by 3.7%.

Chart 14. Growth in retail trade turnover, (y/y) %



Source: SSC

Consumers spent 56.5% of their funds on food, beverages and tobacco products in retail trade outlets. Food inflation translated to the share of related expenses. Expenses increased year over year on food products, beverages and tobacco products, computers and telecommunication equipment, pharmaceuticals and medicals.

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

Spending item	**Share, %**	
	2021 3 months	**2022 3 months**
Food, beverage and tobacco	54.4	56.5
Textile products, apparel and shoes	16.4	15.2
Electric appliances and furniture	5	4.7
Computers, telecommunication devices and others	0.7	1.1
Pharmaceuticals and medicals	2.2	2.4
Fuel	5.4	5.2
Other non-food staff	15.9	14.9

Source: SSC

Every consumer purchased on average AZN365.1 worth of food, beverage and tobacco (Yoy up by AZN47.8 in nominal terms) in retail trade – AZN206.2 on food, beverages and tobacco products, and AZN158.9 on non-food staff.

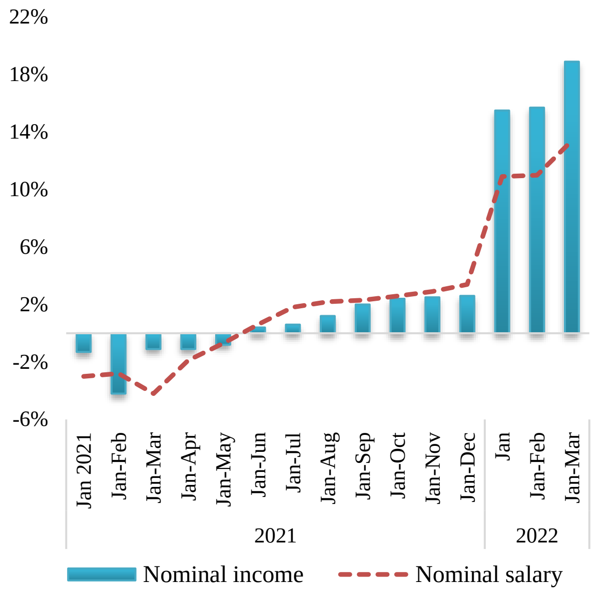
Catering turnover yoy increased by 82.9% in real terms. The value of paid services to the population increased by 5.2% in real terms to AZN2.1B. Per capita paid services consumption yoy increased by AZN27.6 to AZN210.4 on average in nominal terms.

Both nominal income of the population and nominal salary posted growth. The growth rate of household income exceeded average annual inflation, paving the way to real increase in income. According to the SSC, in January-March money income of the population increased by 18.9% in nominal terms to AZN16B. Per capita money income was AZN1593.2. Population's disposable income increased by 19.5% to AZN14.3B.

Lending activity also weighed on the consumer demand. Loans to households increased by 7.6% to AZN9.3B.

High economic growth dynamics and recovery of consumer demand, and price hike related uncertainties translated to consumers' expectations. The CCI estimations based on findings of the survey 'Households financial behavior and intentions' bettered compared to the previous quarter. Note that, this indicator rests upon 'Family's financial condition expectation', 'Expectation on country's economic standing', 'Savings probability' and 'Unemployment expectations' surveys among various income households.

Chart 15. Growth dynamics of incomes and salaries, (y/y) %



Source: SSC

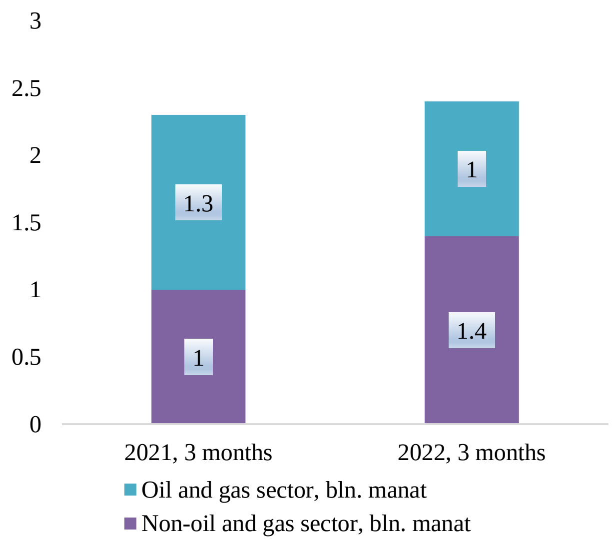
Government spending was crucial in supporting domestic demand. State budget expenditures amounted to AZN5629.5M, yoy up by 1.9%.[1]

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

Social spending (compensation for employees, pension and social allowances, medicine and food) accounted for 49.3% of actual state budget expenditures (AZN2774B), yoy up by AZN122.4M, or 4.6%.

Investment expenditures. According to the SSC, in January-March 2022 AZN2.4B worth of funds were invested to the economy. Investment to the non-oil and gas sector yoy increased by 10.1%. The public sector accounted for 37.5% and the private sector of 62.5% of total investments.

Graph 16. Dynamics of investments



Source: SSC

68.7% of investments stemmed from internal, 31.3% from external sources.

Table 2. Investment sources, %

Sources	2021 3 months	2022 3 months
Funds of enterprises and organizations	67.5	61.8
Bank loans	8.9	1.7
Budget funds	10.6	24.6
Population's personal funds	8.1	8.1
Other funds	4.9	3.8

Source: SSC

Funds of enterprises and organizations prevailed in total investments (61.8%). The share of budget funds nearly doubled year over year.

2.2. Aggregate supply and employment

Economic activity elevated in response to expanded domestic and foreign demand.

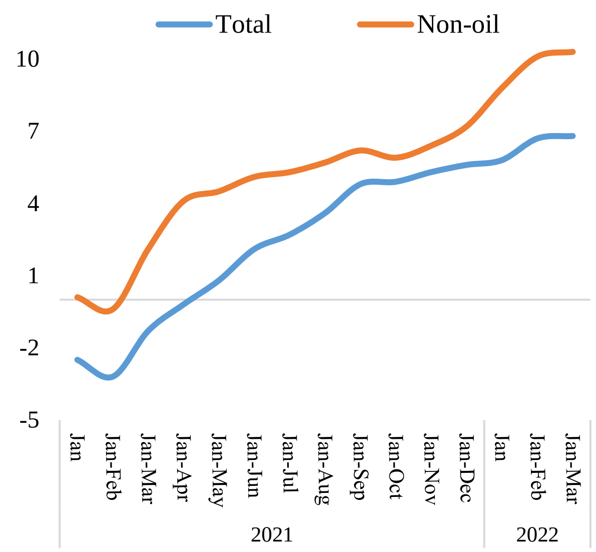
Economic growth. According to the SSC, in Q1 2022 GDP yoy increased by 6.8% in real terms to nominal AZN30B. Per capita GDP was AZN 2990.9.

Oil and gas value added increased by 0.6%, its nominal value was AZN15B (50 % of GDP). The mining sector extracted 8.3 m/t crude oil (yoy down by 5.4%) and 9.1 bln/m3 natural gas (yoy up by 16.4%). Total cost of production in oil products yoy increased by 16.2% in real terms.

Non-oil value added yoy increased by 10.3% in real terms and its nominal value was AZN15B.

Non-oil output increased by 18.1%. Output increased by 4.1% on computers, electronic and optic products,

Chart 17. Economic growth, in comparison to corresponding period of previous year, %



Source: SSC

by 4.5% on tobacco products, by 70% on production of furniture, by 27.3% on paper and cardboard, by 83.8% on construction materials, by 50.2% on garment production, by 9.4% on production of food products, by 34.9% on metallurgic products, by 2.3 times on production of vehicles, trailers and semitrailers, by 2.1 times on production of electric appliances, by 69.1% on the chemical industry and by 25.2% on printing products. Moreover, installation and repairs of machinery and equipment decreased by 14.8%, production of shoes by 21.6 %, production of beverages by 20%, and production of knitwear by 10.1%. Amid high demand for pharmaceuticals due to the pandemic and launch of local enterprises, production of pharmaceuticals increased by 67.4%. Reconstruction in liberated areas had an upward effect on rise in construction materials production.

Yoy growth in agriculture was 3.4%, including 2.8% growth on animal products and 14.4% on plant products (Table 3).

CBA's real sector survey findings confirm that the economic activity elevated. The BCI was mainly positive across sectors.

Table 3. GDP structure, weight in percentage

Sectors	**2021 QI**	**2022 QI**
Industry	40.5	54.1
Construction	5.3	3.7
Agriculture, forestry and fishery	3.1	2.2
Trade, repair of vehicles	10.5	7.9
Transport and warehousing	7.6	5.8
Tourism and catering	0.8	1.3
Information and communication	1.9	1.3
Other	20.1	15.7
Net taxes on products and import	10.2	8

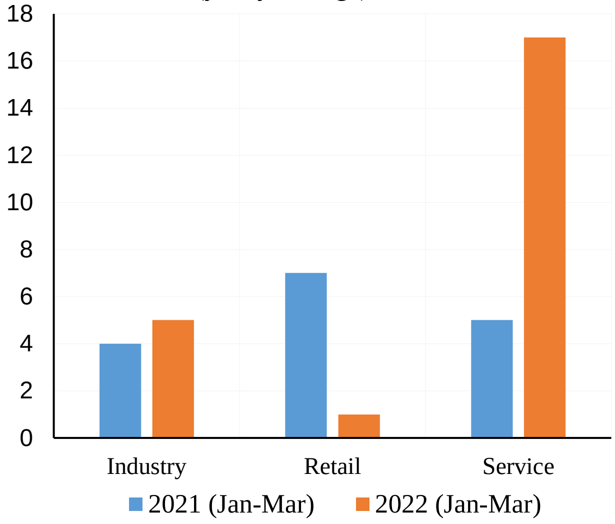
Source:SSC

The BCI in the industry was positively zoned in Q1 2022, driven by the production of chemical products, metallurgy, food products and beverages, non-metal mineral products. The BCI was negatively zoned in machinery, construction, knitwear and plastic products. The BCI relatively improved year over year in all components, except for construction, knitwear and plastics.

The BCI was positively zoned in trade. In particular, the BCI was positive in production of electric appliances and household goods.

The BCI in services significantly improved year over year. Except for postal and healthcare services, the BCI was relatively higher on other areas year over year.

Chart 18. Business Confidence Index (yearly average)

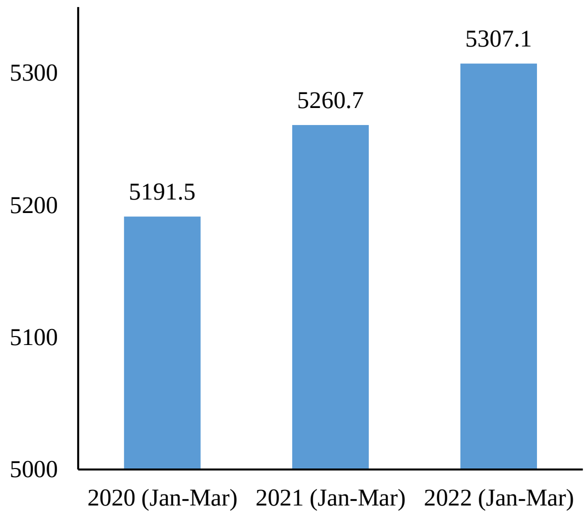


Source: RSM findings based CBA estimations[2]

Employment. As of 1 April 2022 total labor force was 5307.1 thousand persons, yoy up by 46.4 thousand persons. The number of employed population was 4991.7 thousand persons, yoy up by 101.3 thousand persons.

The number of hired labor was 1682.1 thousand persons as of 1 March 2022, yoy up by 0.2%: those involved in the public sector was 902.5 thousand, non-public sector 779.6 thousand.

Chart 19. Economically active persons, end of period, in thousands



Source: SSC

23.2% of the hired labor in enterprises and organizations was involved in production: 7.3% in processing, 7% in construction, 3.5% in agriculture, forestry and fishery, 1.9% in mining, 1.9% in water supply and waste management.

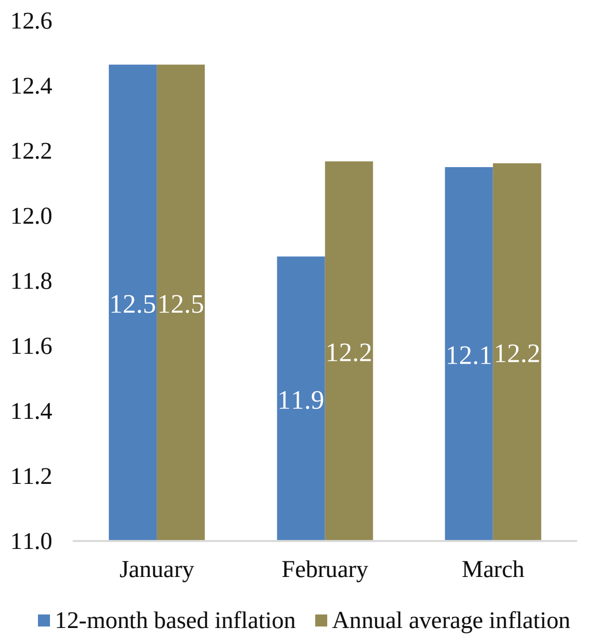
[2] *Industrial BCI = (output – final goods inventory + production expectations)/3*
Services BCI = (business condition + actual demand + demand expectation)/3
Trade BCI = (actual sale – changes in goods inventory+ sale expectations)/3
Construction BCI = (orders received for execution + staff number changes expectations)/2

2.3. Inflation

High inflation in most countries triggered by geopolitical and geoeconomic developments weighed on domestic inflationary developments and expectations. In January-March 2022, there was no considerable change in the growth rate of inflation.

Consumer Price Index (CPI). According to the SSC, in March 2022 inflation stood at 12.1% (March 2022 vs March 2021). Average annual inflation was 12.2%.

Chart 20. 12-month and annual average inflation, in %



Source: SSC

Food price hike made more contribution to overall inflation. Annual food inflation was 16.8%; average annual food inflation was 17% in March

Table 4. Annual change in the food price index across product groups, %

	January	February	March
Bread, bakery products and cereals	117%	118%	118%
Meat and meat products	107%	109%	110%
Fish and fish products	114%	114%	115%
Milk and dairy products, eggs	113%	111%	109%
Butter and vegetable oils	114%	113%	113%
Fruits	114%	113%	110%
Vegetables	156%	154%	158%
Sugar, jam, honey, chocolate and candies	111%	111%	111%
Food products not included to other categories	110%	110%	110%
Tea, coffee and cocoa	108%	108%	107%
Mineral waters, soft drinks and juices	106%	107%	108%
Vodka, brandy (cognac)	104%	106%	106%
Wine	105%	104%	104%
Beer	105%	106%	106%
Tobacco products	112%	112%	106%
Price hike:	Low	Middle	High

Source: SSC

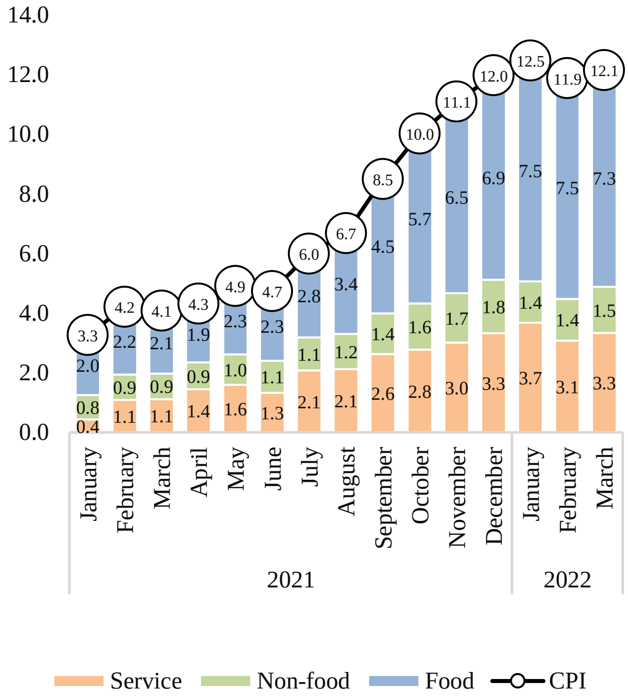
Rising world food prices had a severe impact on domestic food inflation via imports. According to the recent release of the FAO, prices for butter and vegetable oils have hiked by 39%, cereals by 21%, dairy products by 13%, and meat products by 8% in world markets since early year.

Prices on non-food products rose by 6.6% in March on annual and by 6.2% on average annual. The highest increase was in stationery and photo accessories (38.3%), construction materials (15.2%) and fabrics (13.9%).

Prices for services rose by 10% yoy. Average annual service inflation was 10.1%. Prices for postal services increased by 58%, natural gas supply by 42% and power supply by 12.5% year over year. In addition, prices increased by 36.2% for air transport services, by 12.5% for catering services, by 10.7% for rents and by 8.7% for medical services.

Food prices contributed 7.3 pp, non-food prices 1.5 pp, change in prices and tariffs for services 3.3 pp to inflation in March. The contribution of the price hike of non-food stuff and services to total inflation slightly increased compared to March 2021.

Chart 21. Contributions to CPI , in percentage points

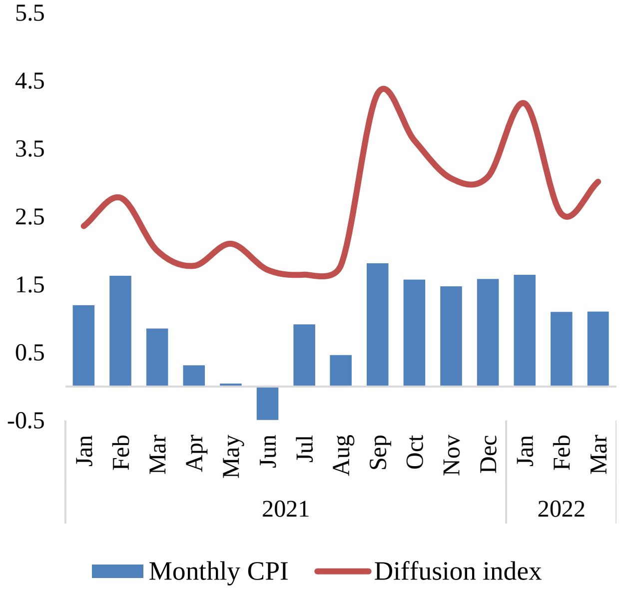


Source: SSC, AMB

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[3] decreased compared to September 2021.

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

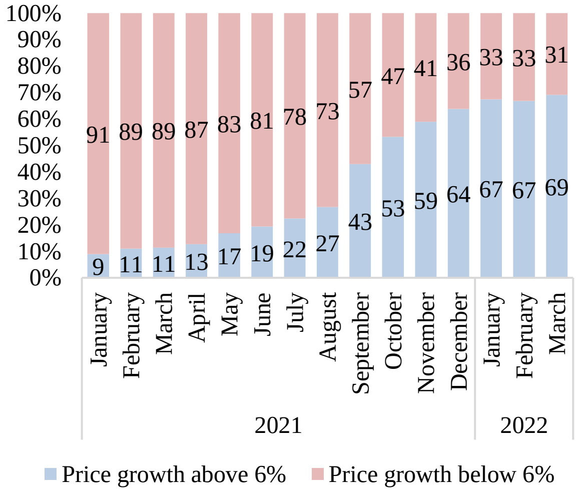
Chart 22. Diffusion index, %



Source: SSC data based CBA estimations

Of the 528 items of goods and services included in the consumer basket, the prices for 275 or 52% increased in the range of 4-12% annually.

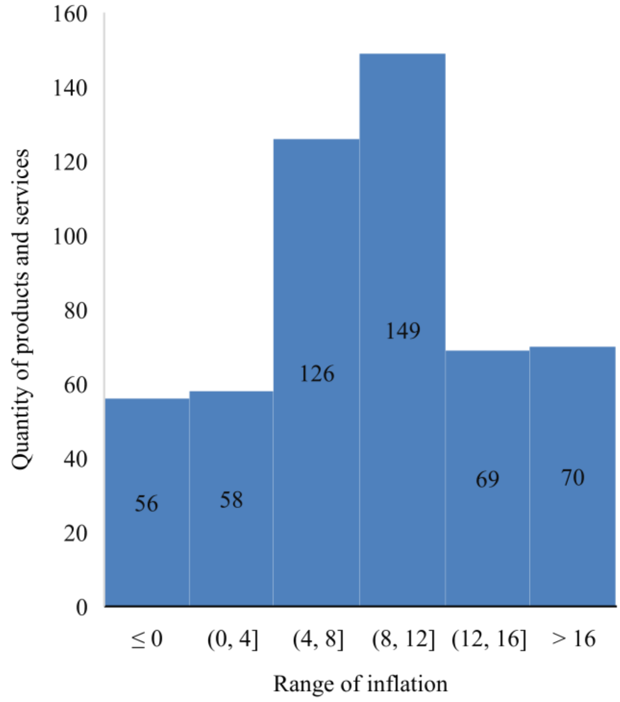
Chart 23. Share of product and services in consumer basket by annual price growth rate, %



Source: SSC data based CBA estimations

In 71% of rising prices, the price increase was less than 8%. Prices for 10.6% of products and services in the basket decreased.

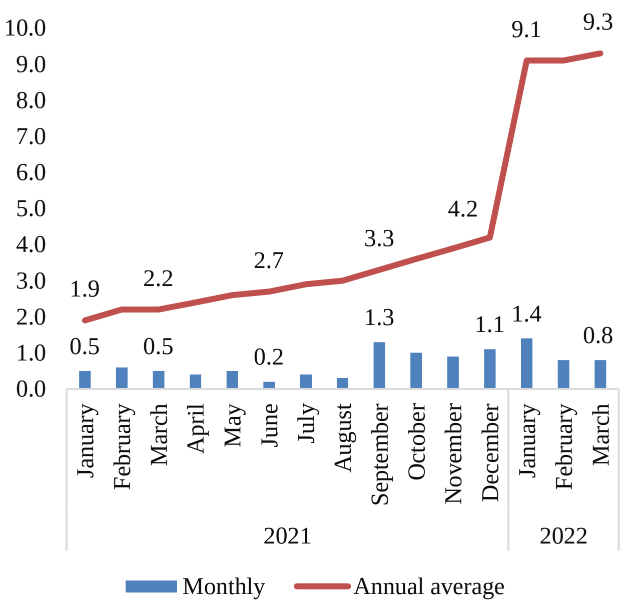
Chart 24. Distribution of annual inflation rate (product and services included in CPI basket)



Source: SSC, AMB

Average annual core inflation calculated by excluding swings in regulated prices and prices for seasonal agricultural products was 9.3% in January-March 2022.

Chart 25. Change of core inflation , in %



Source: SSC

The dynamics of actual inflation weigh on inflation expectations as well. According to March surveys, 80.2% of households expect inflation. 24.5% expect the inflation rate to be higher. The share of households that expect higher inflation dropped by 4.1 pp compared with the previous quarter.

Analysis of inflationary factors suggests that over half of direct and indirect price hike relates to factors of foreign origin. No considerable change has been witnessed in the average annual change in the import price index since last year (20.1% in January-March). High import prices are attributable to hiked global commodity prices amid global geopolitical tension, high transportation logistic expenses and high inflation in partners. Average annual inflation in partners increased from 11.9% in December 2021 to 18.8% in March 2022.

The balance of payments surplus, the FX market equilibrium, the appreciated NEER and the monetary condition shaped in response to monetary policy decisions had a downward effect on inflation.

In the medium term, inflation is predicted to gradually move to the target band because of slowdown of external factors of inflation and anti-inflationary measures taken jointly with the government.

Producer Price Index. According to the SSC, in March the APPI yoy grew by 16.4%. Prices increased by 11.1% on animal and by 22.2% on plant growing products on annual basis. In parallel, the PPI on forestry increased by 2.1%, and by 1.3% on fish and other fishery products.

Table 5. Annual change in the PPI across sectors, %

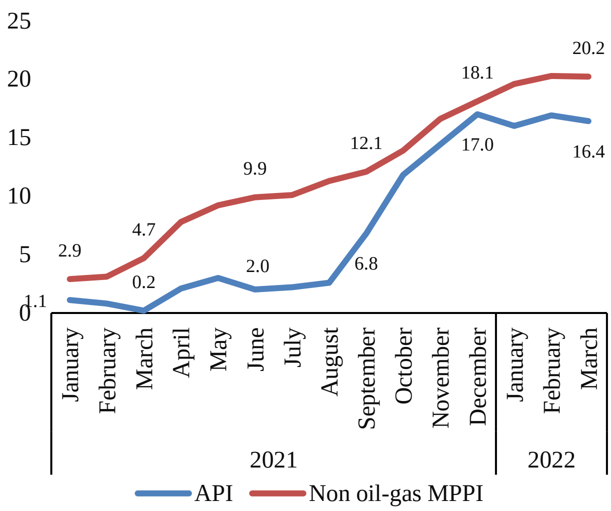
	Jan	Feb	March
Oil and gas sector	242%	250%	274%
Non-oil and gas sector	120%	120%	120%
Plant growing products	120%	117%	122%
Animal products	112%	112%	111%
Forestry	102%	102%	102%
Fish and other fishery products	103%	102%	101%
Cargo transportation	99%	99%	99%
Passenger transport	102%	98%	123%
Warehouse and ancillary transport services	111%	111%	108%
Postal and courier services	153%	151%	151%
Communication services	100%	100%	100%
ICT services	115%	115%	111%
Advertising services	98%	100%	100%
Price hike:	Low	Middle	High

Source: SSC

In March, the IPPI increased by 2.3 times annually, mostly due to the mining industry (up by 2.9 times). IPPI grew by 2.7 times on oil-gas products, and by 20.2% on nonoil products. Price hike in the mining industry mainly relates to an annual sharp rise of the world oil prices.

The PPI on processing increased by annual 24.8%. The highest price hike was in metallurgy (45%), production of oil products (35%), wood processing and production of wood ware (30%) and the chemical industry (27.7%). On the backdrop of the increase in the APPI, the price index on food production increased by 23%, which contributed to the rise in food prices compared to the early year.

Chart 26. Annual change of PPI, %



Source: SSC

In March 2022 prices for transport and warehousing yoy increased by 1.2%. Cost of freight transportation decreased by 1.3% and passenger transportation increased by 23.2%. Increase in prices for passenger transportation related to price hike in air transportation in CIS countries (2 times). The warehousing price index increased by 9.8%. Postal and courier service prices yoy increased by 50.5%, due to 58.8% price hike for postal services.

In addition, prices for ICT services yoy increased by 11%, advertising services by 0.5%. Prices for communication services remained unchanged.

III. THE MONETARY AND EXCHANGE RATE POLICY

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

In Q1 2022, the exchange rate of the manat against foreign currencies was formed in accordance with the supply-demand ratio in the FX market. Huge balance of payments surplus positively influenced the FX market equilibrium, which supported the exchange rate stability – the main price stability anchor.

The equilibrium in the FX market is supported with the BoP surplus and the macroeconomic framework. The value of operations in the FX market increased in various segments of the market.

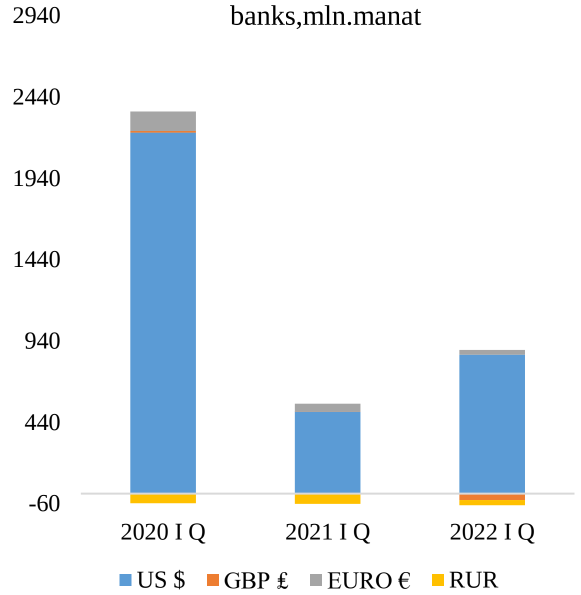
Cashless transactions in the FX market yoy increased by 25.8% to $7.4B equivalent[4]: 86.9% in USD and 13.1% in other currencies. The Interbank FX market accounted for 30.1%, the Intrabank FX market for 69.9% of operations.

99.6% of operations in the Interbank FX market was denominated in USD. Currency operations in the Interbank FX market were mainly conducted over the Bloomberg platform.

Intrabank FX market operations made $5.2B (81.2% in USD). Legal entities accounted for 93.9% of the foreign currency operations in the Intrabank FX market.

Cash currency traded by banks yoy increased by 12.5% to $1.2B (89.7% in USD). Amid easing of pandemic related restrictions net sale of cash currency yoy increased by 66.2% as overall economic activity increased.

Chart 27. Net sales of cash FX by banks,mln.manat



Source: CBA

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

[4] *Including operations in the USD, the euro, the pound, the Russian ruble*

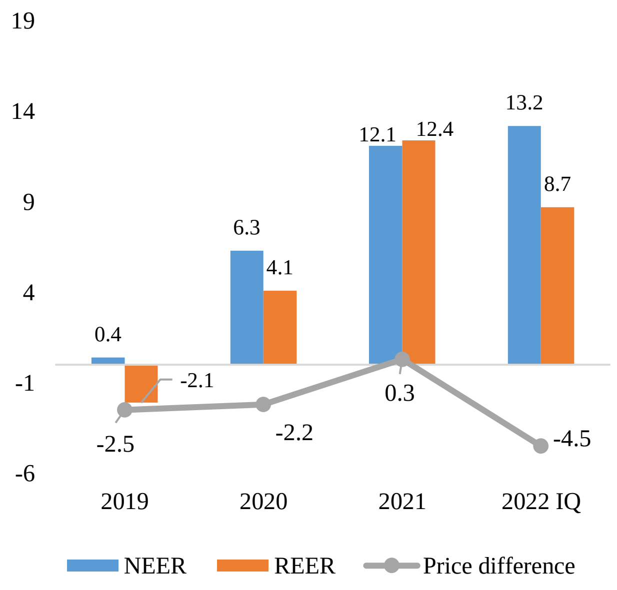
The CBA continued currency auctions to arrange the sale of foreign currency provided by the State Oil Fund of Azerbaijan Republic (SOFAZ). The Bank held total 23 currency auctions in the first quarter. Better expectations resulting from persistent rise in oil prices in the world market had an additional stabilizing effect on the FX market. The CBA's intervention in the FX market was purchase-oriented and amounted to $132.9M.

The official exchange rate of the manat was set on the basis of the average exchange rate on interbank transactions in 2021 (both auction and over-the counter on the Bloomberg platform). The average official AZN/USD exchange rate was AZN1.7 in the first quarter. Buy-sell exchange rates set by banks were close to the official one. Commercial banks' average buy/sell rate was 1. 6979/1.7024.

The exchange rate of the manat mainly strengthened against currencies of trade partners. The manat appreciated against the euro, the Turkish lira, the Russian ruble, the English pound, the Kazakh tenge, the Japanese yene, the Swiss franc, the Ukrainian hryvnia and the Georgian lari, and depreciated against the Chinese yuan and the South Korean won.

The dynamics of bilateral exchange rates influenced that of multilateral exchange rates. In general, total trade weighted non-oil NEER of the manat appreciated 13.2% and the REER by 8.7%. As inflation in Azerbaijan is lower than the average inflation in partner countries, it had a reducing effect on the REER.

Chart 28. Effective exchange rates
(annual change)



Source: AMB

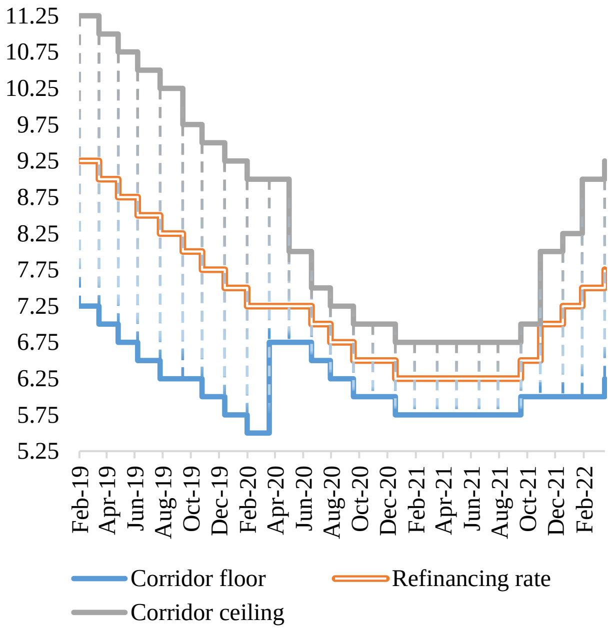
A stronger NEER of the manat was one of the factors to contain the inflation import.

3.2. Monetary policy tools

In Q1 2022, monetary policy tools were applied in light of macroeconomic forecasts and the balance of risks, domestic inflation, and the liquidity position of the banking system.

The Central Bank took interest rate corridor parameters related decisions, considering the situation in the economy, recent macroeconomic forecasts and trends. The Management Board of the Central Bank discussed interest rate corridor parameters twice in the first quarter. The refinancing rate was decided to be shifted from 7.25% to 7.75%, the ceiling of the corridor from 8.25% to 9.25% and the floor from 6% to 6.25% respectively. The CBA publicly announced interest rate related decisions under a pre-announced schedule with relevant analytical comments.

Chart 29. Parameters of interest rate corridor, %

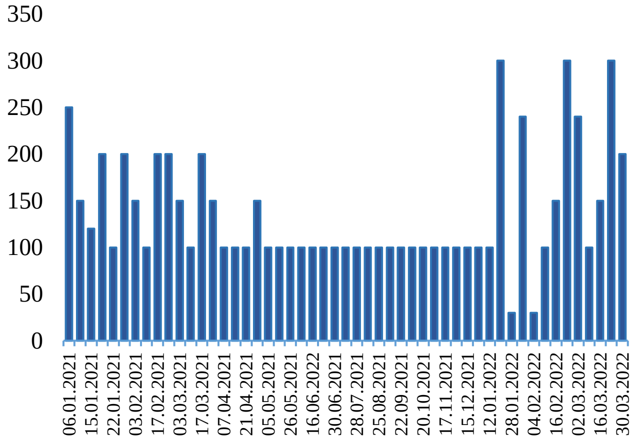


Source: CBA

The CBA continued various term market operations to manage liquidity in the economy effectively. The Bank held 84- and 168-day note auctions along with 28-day notes.

The Bank held 13 note auctions in Q1 2022. Long-term notes (84-, and 168-day) were issued at 2 and 28-day notes at 11 of them. In general, total outstanding amount of sterilization via notes was AZN810M as of end-quarter.

Chart 30. Volume and yield on notes issued by the CBA



Source: CBA

Demand prevailed over supply at auctions on placement of notes.

Yield on tools varied over the quarter. The yield at last auctions was 3.4% on 84-day notes, 4% on 168-day auctions, and 6.26% on 28-day notes (close to the floor of the interest rate corridor).

Yield on CBA notes both influences interest rates on other financial tools and is critical in terms of formation of the yield curve. At the same time, notes issued by the CBA are used as collateral in the REPO market and have a positive effect on the activation of the money market. Out of AZN1.2B worth 391 transactions concluded in the interbank REPO market AZN822M worth 145 transactions were CBA notes based.

Reserve requirements were left unchanged and being applied on an average basis allow banks to flexibly manage the 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

In Q1 2022, money supply in manat mainly reacted to fiscal sector developments and had a downward effect on inflation.

Money base in manat decreased by 19.9% to AZN14.4B as of end-period. Excluding term deposit operations with certain systemically important banks, money base decreased by 7.8%, due to the rise in the balance of government accounts in the environment of the state budget surplus.

Table 6. Money aggregates, billion manat

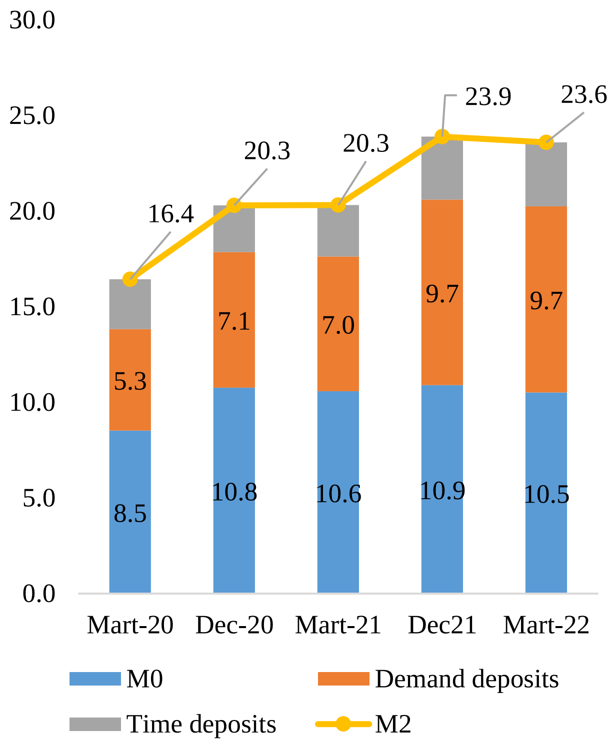
	01.01.22	***01.04.22***	***Growth rate (%)***
M_0	*10.9*	*10.5*	*-3.8*
M_1	*20.6*	*20.2*	*-1.6*
M_2	*23.9*	*23.6*	*-1.2*
M_3	*34.6*	*34.9*	*0.8*

Source: CBA

Cash in circulation, a structural element of base money in manat [5] decreased by 4.2%, while stock of correspondent accounts in manat decreased by 54.4% (excluding term deposit operations in certain systemically important banks, down by 21.3%).

Broad money supply in manat (M_2) decreased by 1.2% to AZN23.6B.

Chart 31. Dynamics of broad money supply (bln. azn)



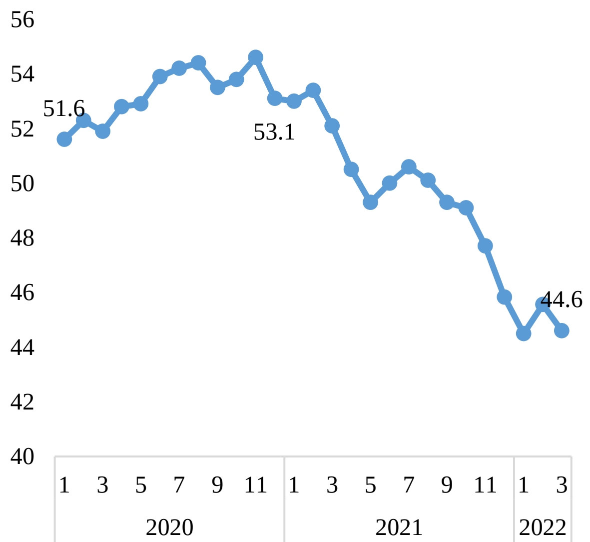
Source: AMB

Cash in circulation, demand and term savings and deposits in the structure of money supply in manat (M_2) performed differently. Cash in the structure of M_2 money supply decreased by 3.8%, while manat denominated demand savings and deposits increased

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

by 1% (the share in M_2 41%), and term savings and deposits increased by 1.4% (the share in M_2 14%) compared to the early year. Encashment (M_0/M_2) has decreased by 1.2% to 44.6% since the beginning of the year. Hence, M_2 decreased at the expense of the drop in money supply.

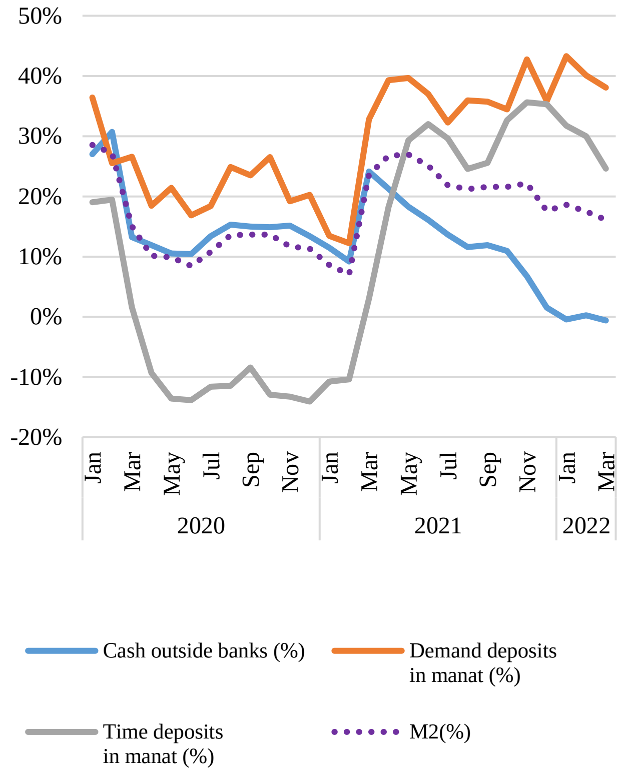
Chart 32. Cash ratio (M_0/M_2), %



Source: CBA

In general, in the long run the growth rate of structural components of M_2 are prone to increase on the basis of deposits and decrease on the basis of cash year over year basis. The growth rate of demand deposits increase more, attributable to digitalization.

Chart 33. Dynamics of M2 and its components (compared to the same period last year), %



Source: AMB

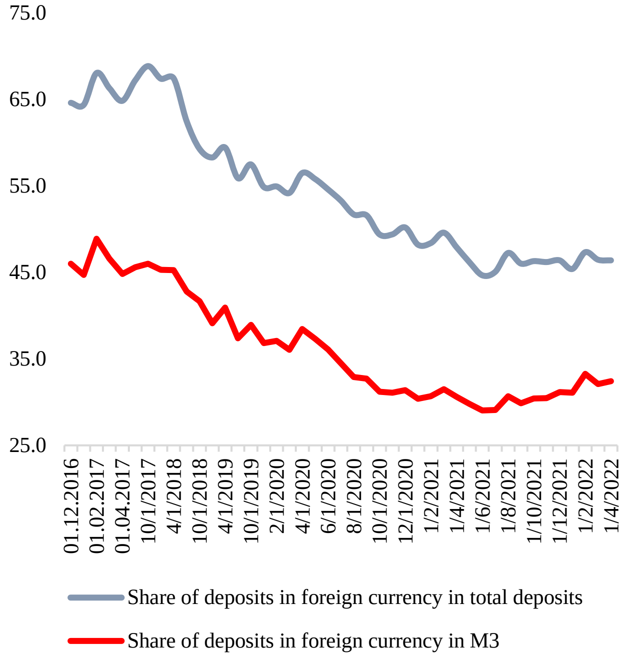
Manat denominated deposits of legal entities in the M_2 decreased by 7.2% and manat denominated deposits of individuals increased by 9.8%.

Broad money supply (M_3) increased by 0.8% to AZN34.9B as of end-period. NFAs (up by 4.9%) had an upward, while NDAs (down by 5.1%) had a downward effect on the M_3.

There was no considerable change in dollarization of deposits in Q1 2022. Foreign currency denominated savings and deposits accounted for 46.4% of total savings and deposits as of end-March. The share of foreign currency denominated deposits in M_3 money aggregate was 32.4% as of end-Q1 2022.

The share of foreign currency in deposits of legal entities made 55.5% as of end-period. Dollarization of savings of individuals was 42.3%.

Chart 34. Dollarization, %



Charts and tables

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