CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

JANUARY- JUNE 2022

№2

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ACRONYMS

CBA	The Central Bank of the Republic of Azerbaijan
ILO	The International Labor Organization
BCI	The Business Confidence Index
IMF	The International Monetary Fund
FDI	Foreign direct investments
WEO	The World Economic Outlook
SSC	The State Statistic Committee
SCC	The State Customs Committee
FAO	The Food and Agriculture Organization of the UN
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	World Trade Organization
FX	Foreign exchange
NDA	Net Domestic Assets
NFA	Net Foreign Assets

EXECUTIVE SUMMARY

The monetary policy environment of the reporting period is marked with multilateral effects of global economic developments on the country economy. Rising prices in global commodity markets, high inflation in trade partners and persistent supply-logistic disruptions had an upward effect on domestic inflation. The international conjuncture was favorable for Azerbaijan in terms of the balance of payments and the support for domestic economic activity. High global prices for main export products and realization of the non-oil export potential led to improved external sector indicators and the rise of FX reserves of the country.

The monetary policy of the CBA was oriented towards easing inflationary pressures through monetary factors. The decisions related to interest rate corridor parameters were made in light of actual and forecasted inflation and the balance of risks. Money supply was managed in response to the demand of the economy. The CBA adequately used the tools in its arsenal to reach monetary policy targets. On the backdrop of better external sector indicators, more supply in the FX market and a stronger NEER of the manat played a special role in containing inflation importation. De-dollarization of deposits continued in the environment of the expectations catalyzed by recent trends in the FX market.

I. THE GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

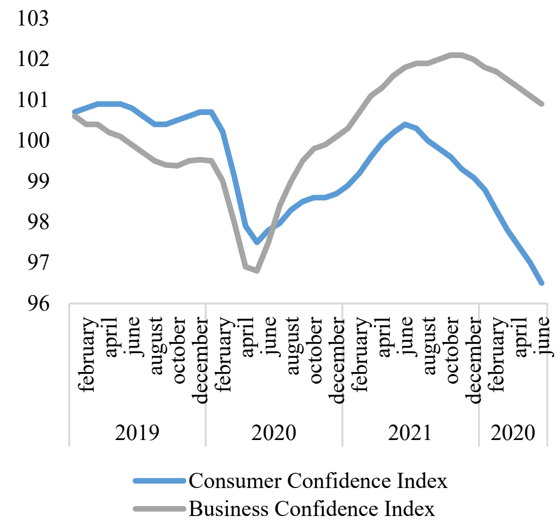
1.1. Global economic trends

In the first half of 2022 the global economic landscape was portrayed by high geopolitical tension and its multilateral effects in addition to pandemic-triggered challenges. Persistent high energy and food prices in world markets, lingering supply chain disruptions, low output in Russia and China in Q2 and fallen consumption expenditures in the USA elevated stagflation risks.

Amid high uncertainties, global economic activity indicators were prone to falling in the first half of the year. Rising geopolitical tension gave additional impetus to the reduction of the CCI and the BCI in the OECD countries.

In particular, higher than targeted inflation in advanced economies, tightened financial conditions, geopolitical and geo-economic tension triggered reduction in economic growth indicators.

Chart 1. Business and Consumer Confidence indexes in OECD countries

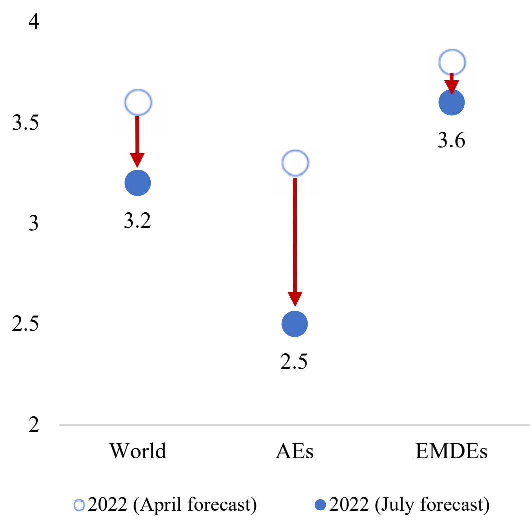


Source: OECD

Given recent trends, international organizations revised down global economic growth forecasts. The IMF WEO July 2022 projected global growth at 3.2% for 2022 and 2.9% for 2023, down by 0.4 and 0.7 pp respectively compared to the April forecast.

The IMF's recent economic growth forecast for AEs stands at 2.5%, down by 0.8 pp compared with the April Update. Economic growth forecasts were revised down by 2.3% for the USA, by 2.6% for the euro area, by 1.7% for Japan and by 3.2% for the UK, attributable to high energy prices triggered by geopolitical and geo-economic tension, changes to the monetary and fiscal policy, and ongoing supply chain disruptions.

Chart 2. Economic growth forecasts, %



Source: IMF

The euro area, more affected by geopolitical tensions, is looking for the ways to save energy and replace natural gas with alternative sources in order to reduce energy dependence on Russia and ensure energy security.

However, unemployment in a number of AEs dropped to historical lows – 3.6% in the USA, 6.6% in the euro area, 2.6% in Japan and 3.8% in the UK (June 2022). Despite rising nominal income of the population in most AEs, real income is falling. At the same time, stricter investment conditions also weigh in on economic growth.

Deteriorated economic activity indicators translate to fund indices as well – the Dow Jones depreciated by 14.96%, the S&P 500 by 19.09%, the NASDAQ by 29.10%, the FTSE Euro top by 1.46% and the Nikkei by 8.3%.

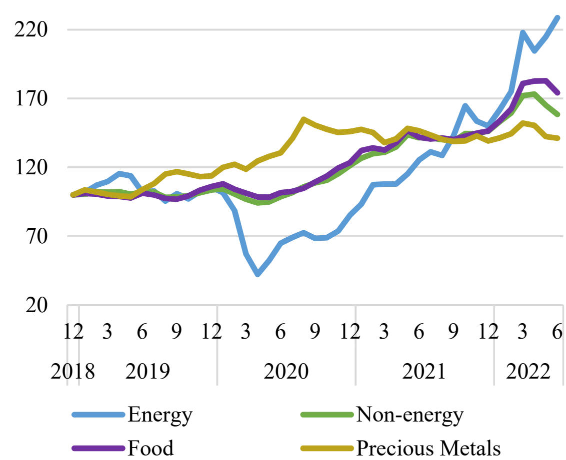
The IMF WEO July 2022 revised the economic growth forecast for EMEs for 2022 down by 0.2 pp compared with the April Update to 3.6% due to more expensive lending from AEs and real estate crisis in China along with the geopolitical tension. Moreover, movement restrictions related to the zero-COVID strategy in China due to resurgence of COVID-19 cases, are considered one of the factors containing economic growth in EMEs. Financial sanctions against Russia, as well as export and import bans both decrease foreign revenues of Russia and have serious impact on its economy. It has a downward effect on EMEs that are dependent on the Russian economy.

Inflationary pressures continued throughout the world over the reporting period. Actual inflation significantly exceed central bank targets in most both AEs and EMEs.

In light of the above mentioned, the IMF WEO July 2022 revised up inflation forecasts for 2022 – 6.6% for AEs and 9.5% for EMEs, up by 0.9 and 0.8 pp compared with the April Update.

Rising inflationary pressures mainly relate to more tense geopolitical situation, rising global commodity prices triggered by sanctions and supply chain disruptions. According to the World Bank's recent Commodity Markets Outlook, energy prices hiked by 52%, non-energy prices by 8%, and food prices by 19%. According to the Food and Agriculture Organization of the United Nations (FAO), in H1 2022 food prices increased by 15.4%. Prices for butter, cereals and dairy products posted the highest growth.

Chart 3. Commodity price index (2018 December =100)

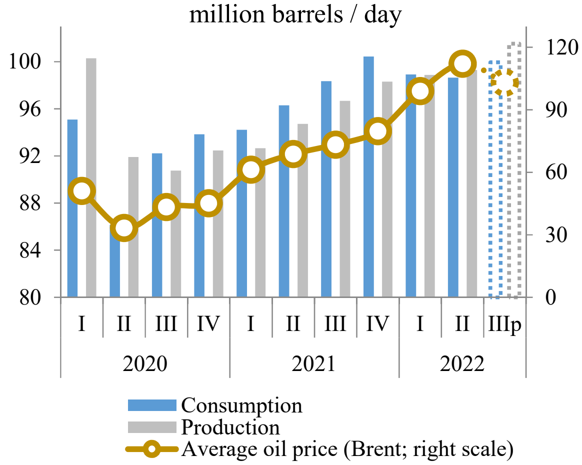


Source: World Bank

As we see, energy prices posted the highest growth. The average Brent oil price was about $105/b in H1 2022, 49% higher than the average price for 2021 ($70.9). The IMF in its recent release forecasted average $103.9/b in 2022 ($106.8 in April forecast), and $91.1 in 2023 ($92.6 in April forecast).

According to the US Energy Information Administration (EIA), the effect of geopolitical risks, lower than the target oil extraction by the OPEC++ countries and drop in global oil reserves triggered surge in oil prices.

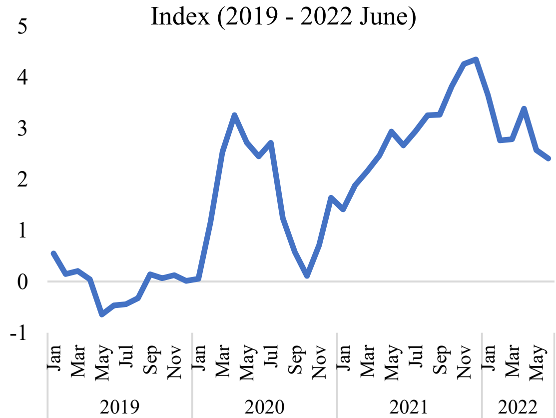
Chart 4. World oil market and its forecast, million barrels / day



Source: US Energy Information Administration (EIA)

Gas prices highly fluctuated in H1 2022. Natural gas prices surpassed $2000 per 1000 cubic meters in Europe. The natural gas price in the US market is also driven by the struggle between Europe and Asia to increase liquefied natural gas reserves.

Chart 5. Global Supply Chain Pressure Index (2019 - 2022 June)



Source: New York FED

Supply lines, not fully restored since the pandemic and high geopolitical tension continue to pass through to inflationary pressures via transportation-logistics cost. The New York Federal Reserve's Global Supply Chain Pressure Index, which has eased somewhat recently albeit still high, indicates high supply chain constraints.

Persistent high inflation and rising inflation expectations forced central banks to tighten the monetary policy. 66 central banks have increased, three central banks (China, Russia, and Uzbekistan) decreased and 16 central banks left unchanged the policy rate since the early year. Over the past period of the year the US FED shifted the policy rate from 0-0.25% to 1.5-1.75%, the Bank of England from 0.25% to 1.25% and the ECB from 0-0.25% to 0.5-0.75%.

According to the recent release by the IMF, global risks elevated because of the tense geo-political and geo-economic situation in Europe, slowdown in growth rate in East Asia and the threat of recession in the USA. In general, we can classify risks as follows:

- High global inflation due to rising energy prices;
- Slowing economic growth amid rising inflation – the risk of stagflation;

- Negative transmission of tight monetary policy decisions by central banks to economic activity;
- High borrowing cost in EMEs;
- Socio-economic challenges amid increasing international polarization, energy prices and food shortage.

The IMF in its recent release recommends a number of policy considerations. The paper notes that protection of socially vulnerable populations should be on focus when taking policy decisions to fight rising inflation. There should be a coordination with macro prudential policy decisions in light of the negative transmission of monetary tightening to capital markets.

Central banks should stand ready to intervene where it is impossible to absorb foreign shocks with a flexible exchange rate.

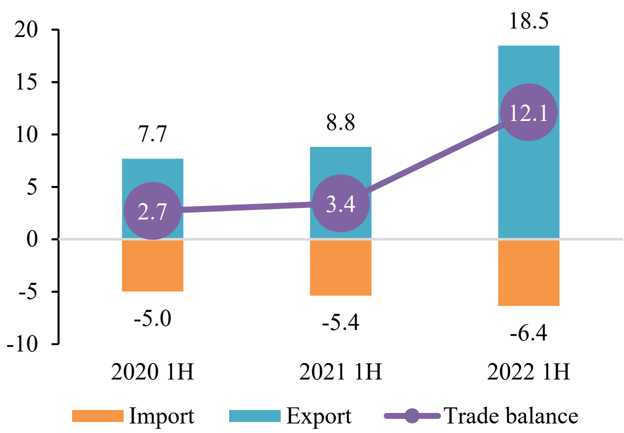
1.2. External sector developments of the Azerbaijani economy

In H1 2022, external sector indicators of Azerbaijan improved considerably year over year.

According to the SCC, foreign trade turnover amounted to $24.9B – export $18.5B (74.4%), import $6.4B (25.6%). Foreign trade surplus made up $12.1B, yoy up by 3.5 times.

Azerbaijan traded with 165 countries over the period.

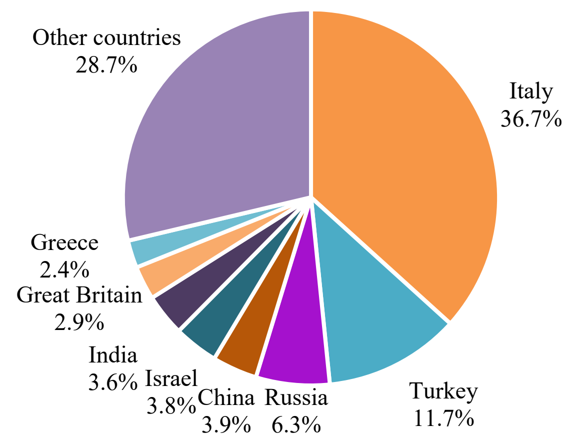
Chart 6. Trade balance, USD bn.



Source: SCC

Italy, Turkey, Russia, China, Israel, India, Great Britain, Greece and Germany accounted for over half of trade turnover. Italy accounted for the highest share.

Chart 7. Main trade partners , 2022 1H

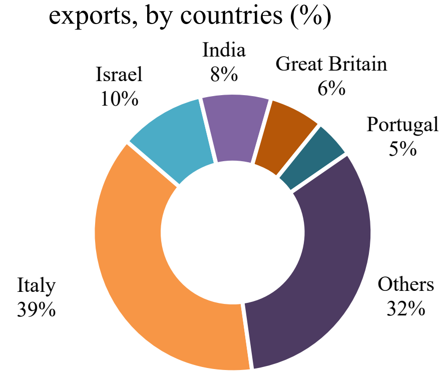


Source: SCC

The share of Italy in total trade turnover yoy increased by 13 pp to 36.7%.

Exports increased by 2.1 times; non-oil exports increased by 25%. The value of export increased by 63% on crude oil and by 4.7 times on natural gas. 38.5% of crude oil and oil products was exported to Italy, 9.9% to Israel, 8.2% to India, 6.4% to Great Britain and 4.6% to Portugal.

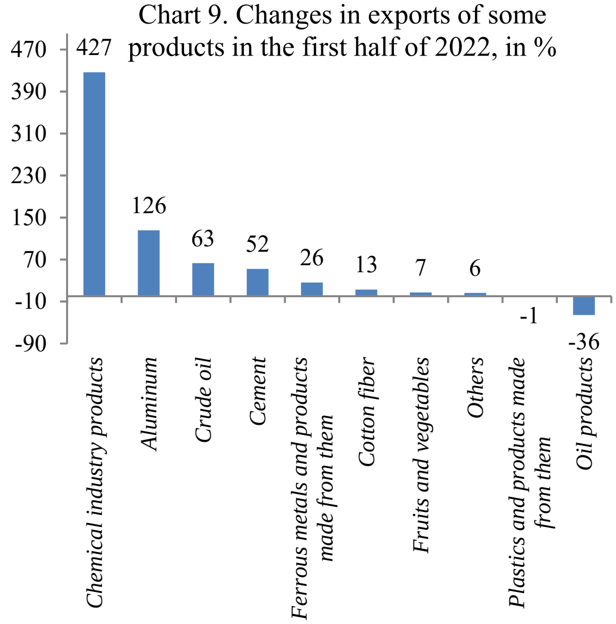
Chart 8. Crude oil and oil product exports, by countries (%)



Source: SCC

Export increased on chemical products, aluminum and processed products, cement, tea, ferrous metals and processed metallic products and cotton yarn. The value of export increased by 5.3 times on chemical products and by 2.3 times on aluminum and products.

Chart 9. Changes in exports of some products in the first half of 2022, in %

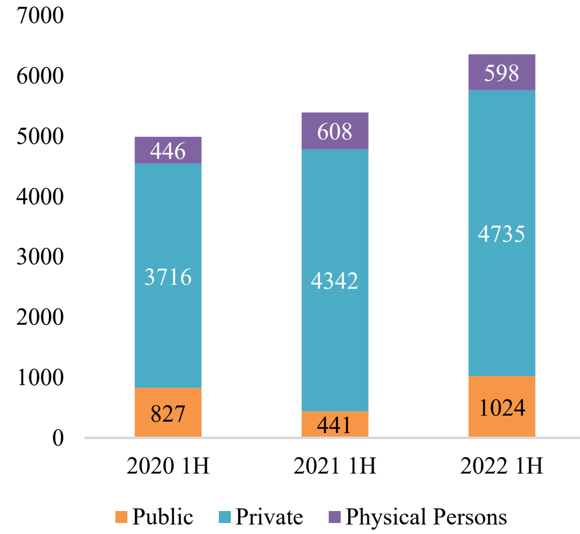


Source: SCC

In general, main export partners were Italy (48.5%), Turkey (10%), Israel (5%), India (4.4%), Great Britain (3.3%) and Greece (3.1%).

Commodity import increased by 18% - by 2.3 times to \$1B on the public sector, by 9% to \$4.7B on the private sector and decreased by 2% to \$0.6B on individuals.

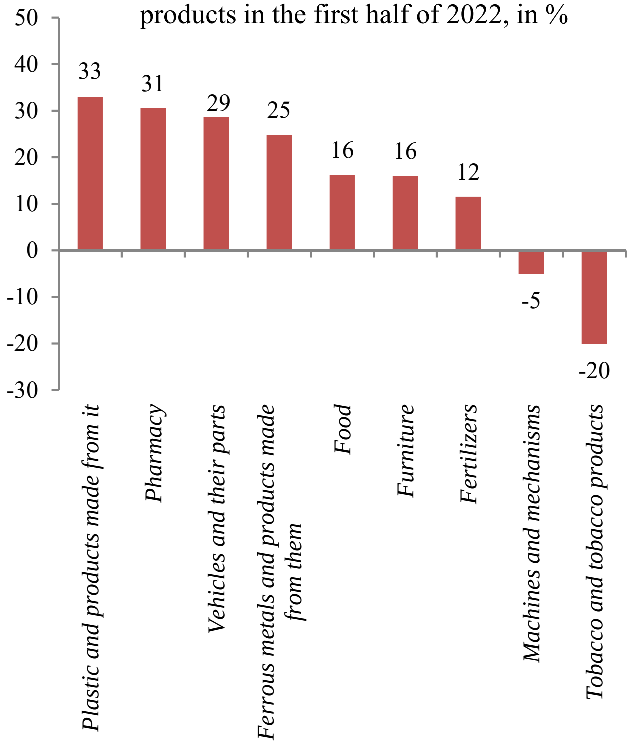
Chart 10. Dynamics of imports by sectors, mln. \$



Source: SCC

Import increased by 32.9% on plastics and products, by 30.5% on pharmaceuticals, by 28.7% on vehicles and parts, by 24.8% on ferrous metals and products and by 16.2% on food products and decreased by 20.1% on tobacco and products and by 5% on machinery and mechanisms.

Chart 11. Changes in imports of some products in the first half of 2022, in %

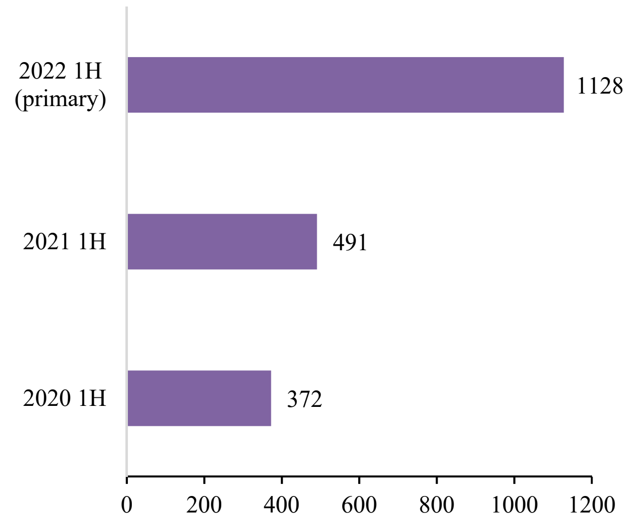


Source: SCC

Russia accounts for 18.6%, Turkey for 16.6%, China for 14.8%, Kazakhstan for 4.8%, Germany for 4.4%, Iran for 3.5%, the USA for 2.7%, Italy for 2.3% and Ukraine for 2.1% of imported products.

According to initial data, in H1 2022 money remittances to the country yoy increased by 2.3 times to $1.1B.

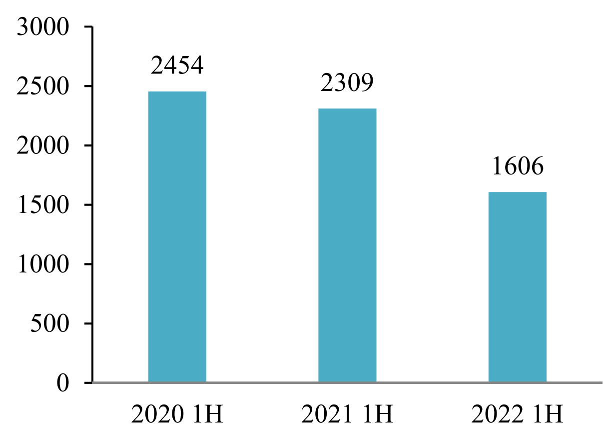
Chart 12. Inflow of remittances, mln.$



Source: CBA

Capital inflows from foreign enterprises and organizations continued over the reporting period. According to the SSC, FDIs amounted to AZN1.6B (25.5% of total investments)

Chart 13. Capital investments from foreign sources, mln. manats



Source: CBA

Great Britain, Switzerland, the USA, Japan, Turkey, Norway, Russia, Iran, India and France take a significant share in capital investments by foreign countries and international organizations.

Strategic FX reserves still exceeded the internationally accepted adequacy ratios. As of 31 July 2022 strategic FX reserves sufficed for 39-month import of goods and services (import of goods and services for Q1 2022 were used). Strategic reserves exceeded broad money supply in manat (M2) by 3.6 times (M2 as of 01.07.2022).

II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

2.1. Aggregate demand

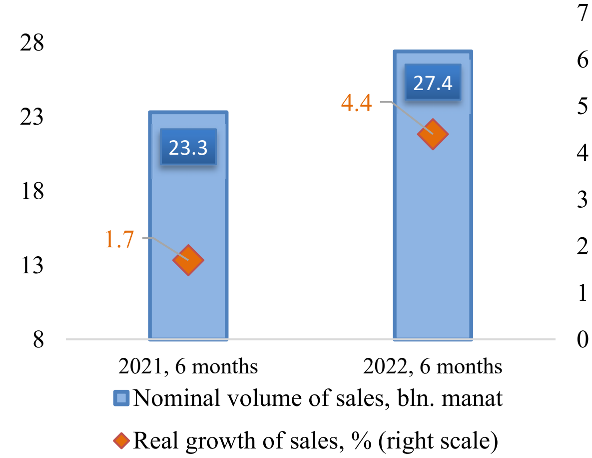
In H1 2022, domestic demand kept expanding but varyingly across different sectors of the economy.

Consumption expenditures continued increasing in January-June 2022. 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 AZN27.4B on a yoy basis. The private sector accounts for 96.4% of the goods sold and services supplied by economic agents (46.4% individual entrepreneurs).

Every consumer spent on average AZN453.7 in the consumer market (yoy up by AZN66).

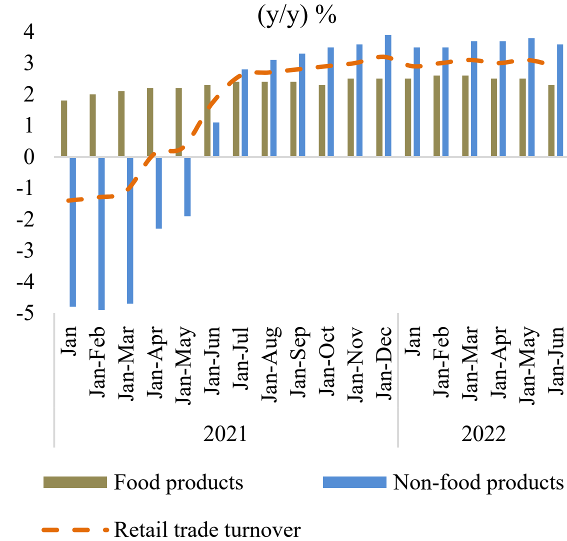
Chart 14. Change in volume of sales in consumer market



Source: SSC

Retail trade turnover yoy increased by 2.9% in real terms to AZN22.5B. Retail commodity turnover on food products, beverages and tobacco products increased by 2.3%, and non-food trade turnover increased by 3.6%.

Chart 15. Growth in retail trade turnover, (y/y) %



Source: SSC

Consumers spent 56.1% of their funds on food, beverages and tobacco products in retail trade outlets. Expenses increased yoy on computers and tele communication devices, pharmaceuticals and medicals, along with food products, beverages and tobacco products.

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

Spending item	Share, %	
	2021 6 months	2022 6 months
Food, beverage and tobacco	53.8	56.1
Textile products, apparel and shoes	14.3	12.7
Electric appliances and furniture	5.3	4.8
Computers, telecommunication devices and others	0.8	1.1
Pharmaceuticals and medicals	2.2	2.5
Fuel	6.2	5.7
Other non-food staff	17.4	17.1

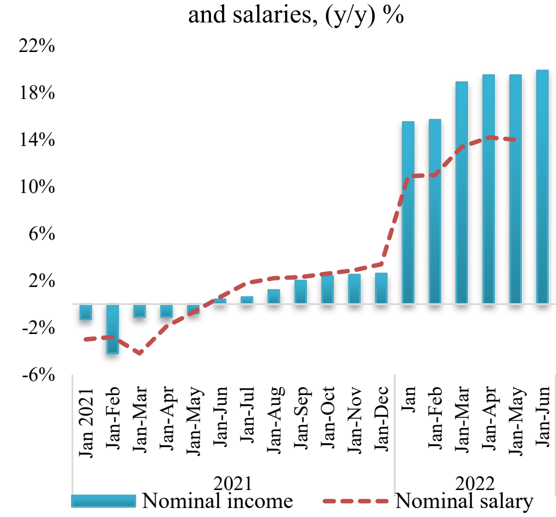
Source: SSC

Every consumer purchased on average AZN373.5 worth of food, beverage and tobacco (yoy up by AZN50.7 in nominal terms) in retail trade – AZN209.6 on food, beverages and tobacco products, and AZN163.9 on non-food staff.

Catering turnover yoy increased by 53.8% in real terms. The value of paid services to the population increased by 7.4% in real terms to AZN4.2B. Per capita paid services consumption yoy increased by AZN63.7 to AZN416.9 on average in nominal terms.

Nominal income of the population kept increasing. The growth rate of household income exceeded average annual inflation, attributable to real increase in income. According to the SSC, over first six months money income of the population increased by 19.9% in nominal terms to AZN33B. Per capita money income was AZN3.3 thousand. Population's disposable income increased by 20.1% to AZN29.4B.

Chart 16. Growth dynamics of incomes and salaries, (y/y) %



Source: SSC

Lending activity also weighed on the consumer demand. Loans to households increased by 15.3% to AZN9.9B.

Lingering economic growth dynamics, rising 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' improved compared to the previous quarter. Note that, this indicator is generated from 'Family's financial condition expectation', 'Expectation on country's economic condition, 'Savings probability' and 'Unemployment expectations' surveys among various income households. All relevant indicators underwent a positive change, translating to the improvement of the index in the last quarter compared with the previous one.

Government spending was crucial in supporting domestic demand. State budget expenditures amounted to AZN12.9B, yoy up by 11.6%.[1]

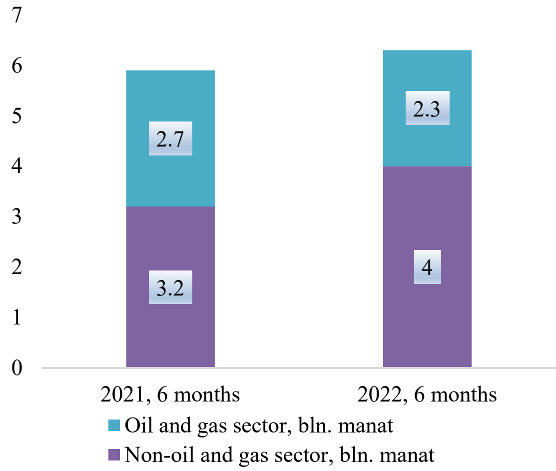
Social spending (compensation for employees, pension and social allowances, medicine and food) accounted for 44.8% of actual state budget expenditures (up by 0.7 pp compared with 2021), or AZN5.8B (yoy up by AZN688M or 13.5%).

Investment expenditures. According to the SSC, the value of funds invested to the country economy yoy increased by 0.7% in real terms to AZN6.3B. Non-oil and gas investment yoy increased by 18.5% in real terms.

AZN570.6M (9.1%) out of total funds were channeled to the non-oil and gas sector. The public sector accounted for 45.3% and the private sector of 54.7% of total investments.

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

Chart 17. Dynamics of investment



Source: SSC

74.5% of investments stemmed from internal, 25.5% from external sources.

Table 2. Investment sources, %

Sources	2021 6 months	2022 6 months
Funds of enterprises and organizations	60.4	53.2
Bank loans	6	3
Budget funds	19.1	31.2
Population's personal funds	7.2	7.6
Other funds	7.3	5

Source: SSC

Funds of enterprises and organizations prevailed in total investments (53.2%).

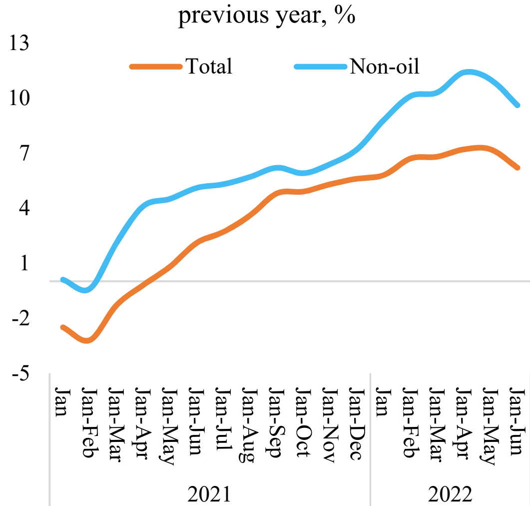
2.2. Aggregate supply and employment

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

Economic growth. According to the SSC, in H1 2022 GDP yoy increased by 6.2% in real terms to nominal AZN63.4B. Per capita GDP was AZN6.3 thousand.

Oil and gas value added increased by 0.2%, its nominal value was AZN31.5B (49.7% of GDP). The mining sector extracted 16.4 m/t crude oil (yoy down by 4.2%) and 17.6 bln/m3 natural gas (yoy up by 17.5%). Cost of production in oil products yoy decreased by 15.4% in real terms.

Chart 18. Economic growth, in comparison to corresponding period of previous year, %



Source: SSC

Non-oil value added yoy increased by 9.6% in real terms to nominal AZN31.9B.

Non-oil output increased by 11.5% - by 30.8% on computers, electronic and optic products, by 58.4% on furniture, by 15.3% on paper and cardboard, by 33.4% on construction materials, by 59% on garment production, by 7.8% on food products, by 26% on metallurgy, by 2.8 times on production of vehicles, trailers and semitrailers, by 53.2% on electric appliances, by 20.4% on the chemical industry, by 12.9% on shoes and by 29.3% on printing products. Installation and repairs of machinery and equipment decreased by 21%, by 7.5% on tobacco products, by 7.8% on production of beverages, and by 22.8% on production of knitwear. Amid high demand for pharmaceuticals due to the pandemic and launch of local enterprises, production of pharmaceuticals increased by 2.1 times. Reconstruction in liberated areas had an upward effect on rise in construction materials production.

Economic growth in agriculture varied across sub-sectors yoy – animal products increased by 2.8%, while plant products decreased by 2.7%.

Services followed positive dynamics in H1 2022. Freight and passenger transport yoy increased by 11.2% and 37.4% respectively. The information and communication sector increased by 14.2%. Tourism and catering increased by 85.8% due to removal of pandemic-related constraints.

Table 3. GDP structure, weight in percentage

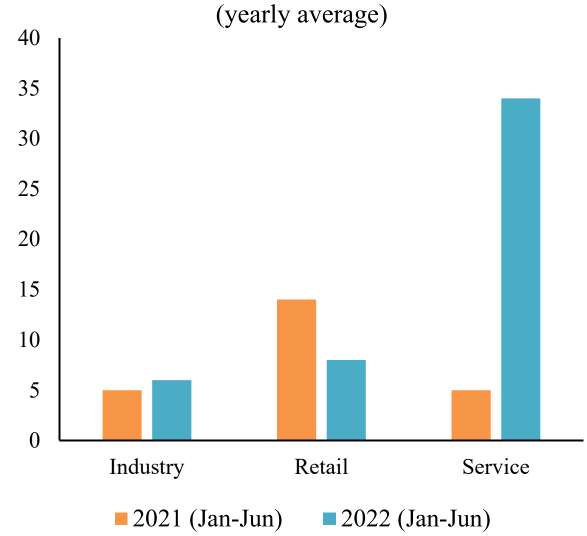
Sectors	2021 H1	2022 H1
Industry	39.9	53.3
Construction	5.1	3.8
Agriculture, forestry and fishery	6.4	4.7
Trade, repair of vehicles	10.3	7.7
Transport and warehousing	7.3	5.8
Tourism and catering	1.0	1.3
Information and communication	1.8	1.3
Other	18.9	14.5
Net taxes on products and import	9.3	7.6

Source: SSC

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

The BCI in the industry was positive, driven by production of chemical products, metallurgy, food and beverages, non-metal mineral products. The BCI was negative in machinery, construction, knitwear and plastic products and improved yoy in food and beverages, machinery and production of non-metal mineral products.

Chart 19. Business Confidence Index (yearly average)



Source: RSM findings based CBA estimations[2]

[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

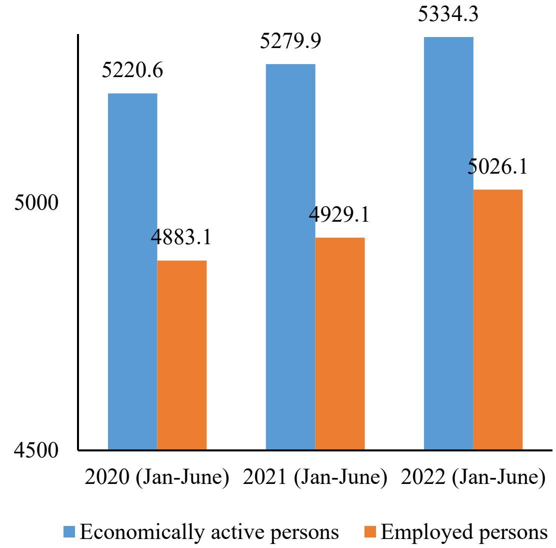
The BCI was positively zoned in trade. In particular, the BCI was positive in production of electric appliances and household goods.

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

Employment. As of 1 July 2022 total labor force was 5334.3 thousand persons, yoy up by 54.4 thousand persons. The number of employed population was 5026.1 thousand persons, yoy up by 97 thousand persons.

The number of hired labor was 1706.0 thousand persons as of 1 June 2022, yoy up by 1.7%: those involved in the public sector were 903.5 thousand and 802.5 thousand persons in the non-public sector.

Chart 20. Economically active persons and employed persons, end of period, in thousands



Source: SSC

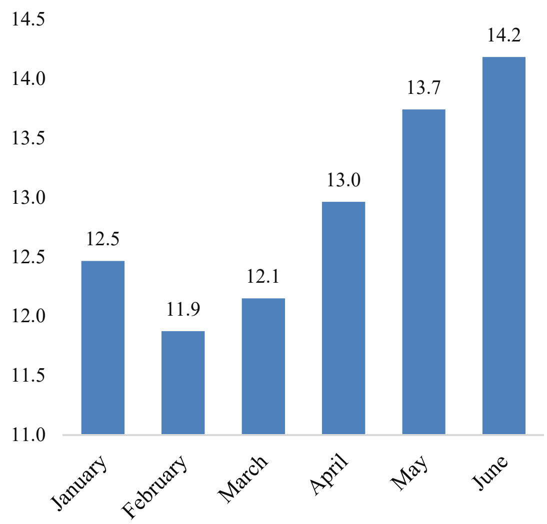
23.5% of the hired labor in enterprises and organizations was involved in production: 7.5% in construction, 7.1% in processing, 3.5% in agriculture, forestry and fishery, 1.9% in mining, 1.9% in water supply and waste management and 1.6% in generation, distribution and supply of electricity, gas and steam.

2.3. Inflation

Rising inflationary pressures in most countries weighed on domestic inflationary developments and expectations.

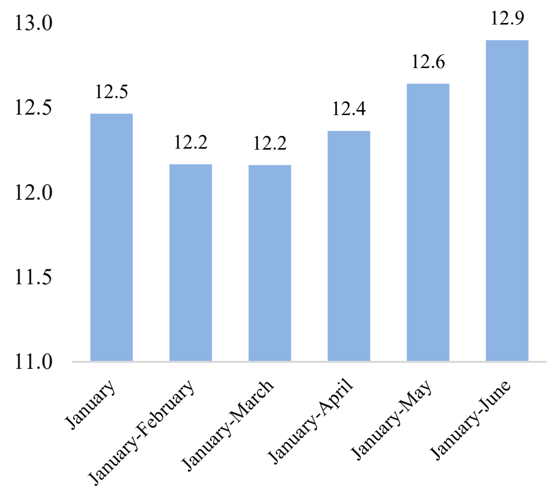
Consumer Price Index (CPI). According to the SSC, in June 2022 annual inflation stood at 14.2% (June 2022 vs June 2021). Average annual inflation was 12.9%.

Chart 21. 12-month inflation in 2022, in %



Source: SSC

Chart 22. Average annual inflation in 2022, in %



Source: SSC

Food price hike made more contribution to overall inflation. Annual food inflation was 20.6%; average annual food inflation was 18.4% in June.

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

	April	May	June
Bread, bakery products and cereals	18.2%	18.7%	18.9%
Meat and meat products	10.2%	10.7%	10.9%
Fish and fish products	15.5%	16.0%	16.2%
Milk and dairy products, eggs	7.5%	6.5%	10.2%
Butter and vegetable oils	14.2%	15.3%	16.0%
Fruits	10.0%	17.5%	20.9%
Vegetables	71.5%	80.3%	71.1%
Sugar, jam, honey, chocolate and candies	11.4%	11.3%	11.9%
Food products not included to other categories	10.5%	11.2%	11.9%
Tea, coffee and cocoa	7.4%	7.6%	7.6%
Mineral waters, soft drinks and juices	9.2%	10.0%	10.9%
Vodka, brandy (cognac)	6.2%	6.5%	6.7%
Wine	3.7%	3.4%	2.9%
Beer	5.8%	7.6%	9.1%
Tobacco products	3.4%	3.4%	6.6%

Source: SSC

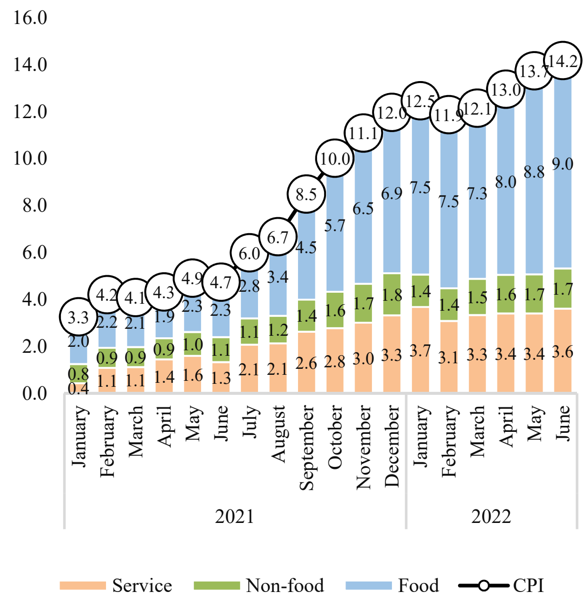
Rising world food prices had a severe impact on domestic food inflation via imports. According to the recent release of the FAO, in H1 world food prices hiked by 15.4%: prices for butter and vegetable oils hiked by 18.6%, cereals by 18.4%, dairy products by 16.1%, and meat products by 12.3%.

Non-food prices rose by 7.4% in June on annual and by 6.7% on average annual. The highest increase was in stationery and photo accessories (43.6%), fabrics (13.6%) and construction materials (12.3%).

Prices for services rose by 10.9% yoy. Average annual service inflation was 10.3%. Prices for postal services yoy increased by 58%, natural gas supply by 42%, power supply by 12.5%, air transport services by 19.2%, catering services by 17.6%, rent fees by 11.8% and medical services by 8.7%.

Food prices contributed 9 pp, non-food 1.7 pp, and change in prices and tariffs for services 3.5 pp to inflation in June. The contribution of the price hike of non-food stuff and services to total inflation decreased vs June 2021.

Chart 23. Contributions to CPI, in percentage points

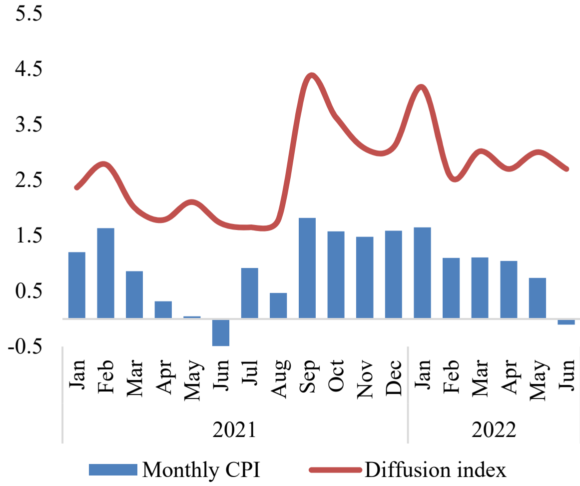


Source: SSC, CBA

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

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

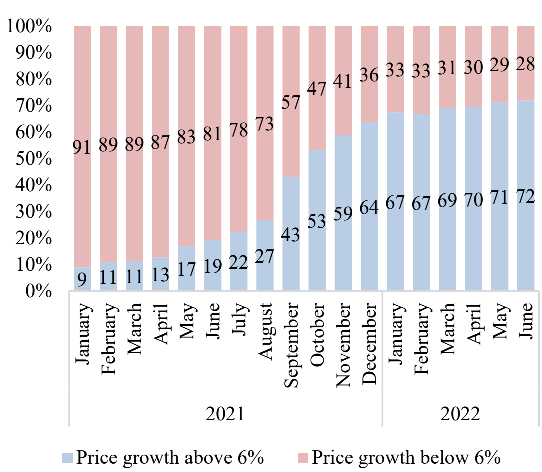
Chart 24. Diffusion index, %



Source: SSC data based estimations of the CBA

Prices for 72% of goods and services included to the consumer basket increased for over 6% on annual.

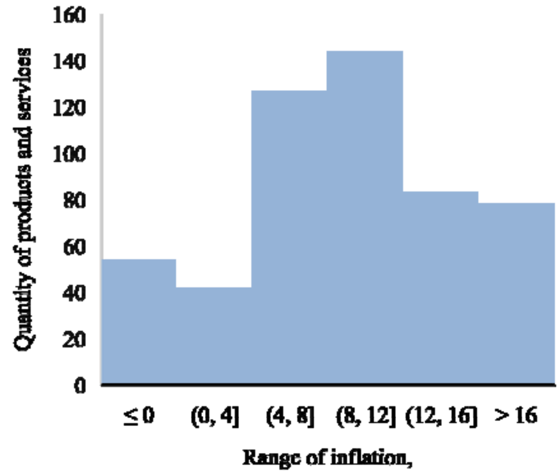
Chart 25. Share of product and services in consumer basket by annual price growth rate, %



Source: SSC data based estimations of the CBA

However, prices for 10.2% of goods and services in the basket either decreased or remained unchanged.

Chart 26. Distribution of annual inflation in terms of the number of goods and services in the consumer basket



Source: SSC, CBA

Average annual core inflation calculated by excluding swings in regulated prices and prices for seasonal agricultural products was 9.7% in January-June 2022. Annual core inflation was 10.7% in June.

Chart 27. Change of core annual average inflation, in %

Source: SSC

The dynamics of actual inflation weigh on inflation expectations as well. According to June surveys covering Q2, 81.9% of households expect inflation. 22% expect the inflation rate to be higher. The share of households that expect higher inflation dropped by 2.5 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. High rate annual hike in import prices (21% in January-May) are attributable to the surge in global commodity prices amid global geopolitical tension, high transportation logistic expenses and high inflation rates in partners. Average weighted (import weighted) inflation in main partners is estimated to shift from 11.9% in 2021 to 24.4% in 2022.

The balance of payments surplus, the FX market stability, the appreciated NEER and the monetary condition shaped in response to monetary policy decisions and anti-inflationary measures by the government had a downward effect on inflation.

According to updated forecasts, annual inflation will fall below the current rate by the yearend. Inflation is predicted to fall gradually to a single-digit level driven by slowing external factors of inflation and concerted anti-inflationary measures with the government in the medium run.

Producer Price Index. According to the SSC, in June the APPI yoy grew by 18.6%. Prices yoy increased by 11.1% on cattle breeding and by 27.2% on plant growing products. In parallel, the PPI on forestry increased by 5.3%, and by 2.6% on fish and other fishery products.

Table 5. Annual change in the PPI across sectors

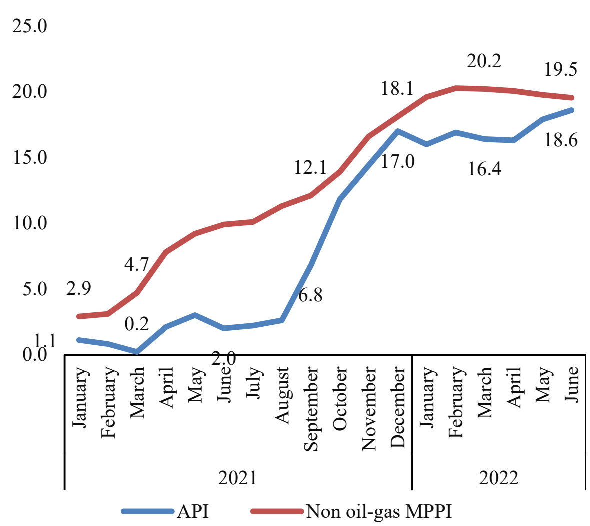
	April	May	June
Oil and gas sector	2.5 times	2.6 times	2.6 times
Non-oil and gas sector	20.1%	19.8%	19.5%
Plant growing products	21.5%	25.3%	27.2%
Livestock products	11.5%	11.3%	11.1%
Forestry	5.1%	5.1%	5.3%
Fish and other fishery products	2.9%	2.2%	2.6%
Cargo transportation	-1.8%	-1.9%	-0.6%
Passenger transport	8.0%	4.1%	10.5%
Warehouse and ancillary transport services	8.2%	6.1%	6.1%
Postal and courier services	50.7%	50.6%	50.5%
Communication services	0%	0%	0%
ICT services	10.7%	9.0%	9.0%
Advertising services	1.4%	1.8%	2.4%

Source: SSC

In June, the IPPI yoy increased by 2.2 times, mostly due to the mining industry (up by 2.7 times). IPPI grew by 2.7 times on oil-gas products, and by 19.5% on non-oil products. Price hike in the mining industry mainly relates to the surge in world oil prices.

The PPI on processing increased by annual 27.8%. The highest price hike was in oil products (47%), in metallurgy (39%), the chemical industry (33%) and wood processing and production of wood ware (29%). On the backdrop of the increase in the APPI, the price index on food production increased by 19%, which contributed to the rise in food prices compared to the early year.

Chart 28. Annual change of PPI at the current year, %



Source:SSC

In June 2022 prices for transport and warehousing yoy increased by 0.2%. Cost of freight transportation decreased by 0.6% and passenger transportation increased by 10.5%. Increase in prices for passenger transportation related to price hike in air transportation in CIS countries (38.8%). The warehousing price index increased by 6.1%. Postal and courier service prices yoy increased by 50.5% in June, due to 58.7% price hike for postal services.

III. THE MONETARY AND EXCHANGE RATE POLICY

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

The exchange rate of the manat against foreign currencies was formed in line with the supply and demand 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 value of FX market operations grew across all segments of the market.

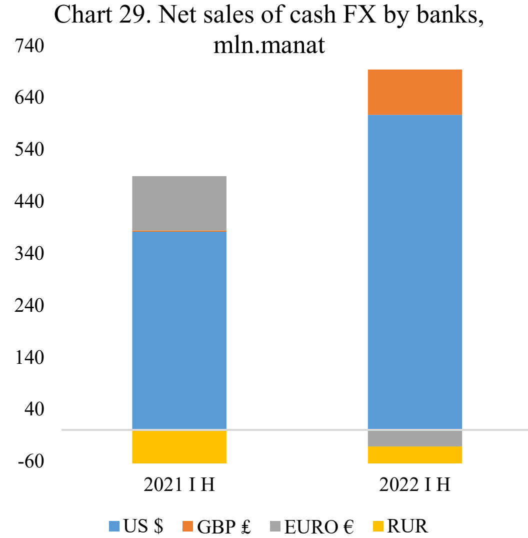
Cashless transactions in the FX market yoy increased by 20% to $14.6B equivalent[4]: 84.9% in the USD and 15.1% in other currencies. The Interbank FX market accounted for 28.4%, the Intrabank FX market for 71.6% of operations.

The value of operations in the Interbank FX market made $4.2B (yoy up by 16.7%). USD denominated transactions account for 98.7% of total operations in this market. FX operations are mainly conducted over the Bloomberg.

Intrabank FX market operations made $10.5B (yoy up by 22.1%) (79.4% in USD). Legal entities accounted for 93.1% of FX operations in the Intrabank FX market.

Cash currency traded by banks yoy increased by 38.2% to $2.6B equivalent (87.6% in USD). Net sale of cash currency yoy increased by 40.8% over 6 months, due to high sales in Q1. However, the situation changed in April-June and banks' currency buy operations exceeded currency sell operations.

Chart 29. 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*

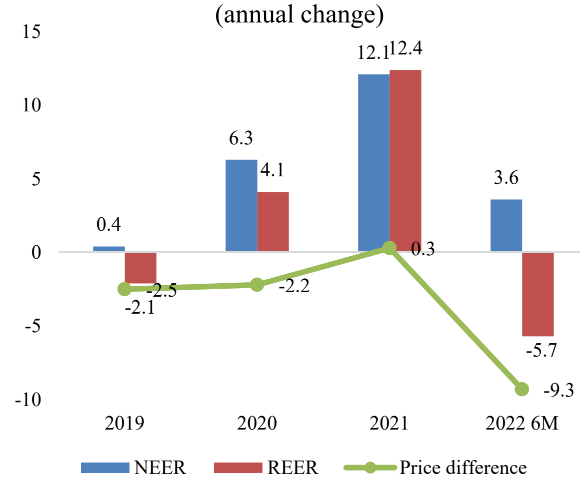
The CBA continued currency auctions to arrange the sale of foreign currency provided by the State Oil Fund of Azerbaijan Republic (SOFAZ). The Bank held total 48 currency auctions in H1. $2739.1M worth funds of the SOFAZ were sold at auctions. The CBA's intervention in the FX market was buy-oriented and amounted to $448M.

The official exchange rate of the manat was set on the basis of the average exchange rate on interbank transactions (both auction and over-the counter on the Bloomberg platform). The average official AZN/USD exchange rate was AZN1.7 in H1. 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 pound, the Kazakh tenge, the Japanese yene, the Swiss franc and the Ukrainian hryvnia, and depreciated against the Russian ruble and the Georgian lari.

The dynamics of bilateral exchange rates influenced that of multilateral exchange rates. In general, total trade weighted non-oil NEER of the manat appreciated 3.6% and the REER depreciated by 5.7%. As inflation in Azerbaijan is lower than the average inflation in partner countries, it had a reducing effect on the REER.

Graph 30. Effective exchange rates
(annual change)



Source: CBA

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

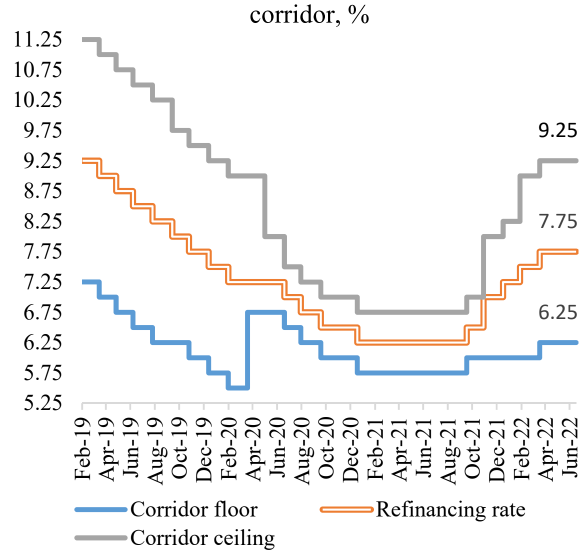
3.2. Monetary policy tools

In H1 2022, monetary policy tools were applied in light of inflation and its factors, macroeconomic forecasts and the balance of risks, as well as the liquidity position of the banking system.

The CBA adequately employed monetary policy tools to alleviate inflationary pressures through monetary factors.

The Bank took interest rate corridor parameters related decisions on liquidity operations, considering global processes and the developments in the country economy, the level of actualization of foreign and domestic inflationary risks, and recent macroeconomic forecasts. The Management Board of the CBA discussed interest rate corridor parameters 4 times in H1 2022. The refinancing rate was decided to be shifted from 7.25% to 7.75%, the ceiling of the interest rate corridor from 8.25% to 9.25% and the floor from 6% to 6.25% at the meetings held in Q1, and the interest rates were left unchanged at the meetings held in Q2. The CBA publicly announced interest rate related decisions under a pre-announced schedule with relevant analytical comments

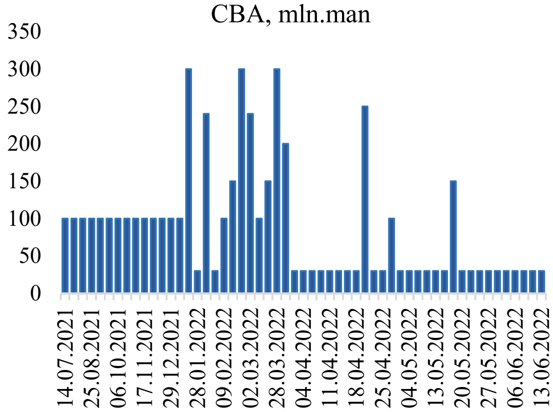
Chart 31. Parameters of interest rate corridor, %



Source: CBA

The CBA continued various term market operations to manage liquidity in the economy effectively. The Bank held 84-, 168- and 252-day note auctions along with 28-day notes. The Bank held 42 note auctions in H1 2022. 84-day notes were issued at 8, 168-day at 10, 252-day at 10 and 28-day notes at 14 of them. In general, total outstanding amount of sterilization via notes was AZN750M as of end-June.

Chart 32. Volume of notes issued by the CBA, mln.man



Source: CBA

Demand prevailed over supply at auctions on placement of notes. Yield on tools varied over the period. Yield at auctions was 2.92% on 84-day, 3.5% on 168-day and 3.78% on 252-day notes. Yield on 28-day notes was 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.

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. In January-June out of AZN1.6B worth 550 transactions concluded in the interbank REPO market AZN1.1B worth 229 transactions were CBA notes based.

Continued application of the reserve requirement on an average basis allows banks to flexibly manage liquidity. Monitoring findings display that banks' cumulative balances on correspondent accounts with the CBA exceeded total funds to be maintained as required reserves.

The Bank decided to more actively use the reserve requirement to regulate money supply effectively on the backdrop of rising inflationary pressures. The entry into force of the changes made to the 'Regulations on the ratio, calculation and maintaining required reserves' at the decision of the Management Board of the CBA dated 6 June 2022 allows to take more flexible decisions related to required reserves. At the same time, the Management Board with its decision of 17 June 2022 set the reserve requirement at 4% on deposits attracted in the national currency and precious metals and at 5% on foreign currency denominated deposits. It was decided that all banks should calculate required reserves in line with the new ratios from August 2022 and ensure it from the next maintenance period onward.

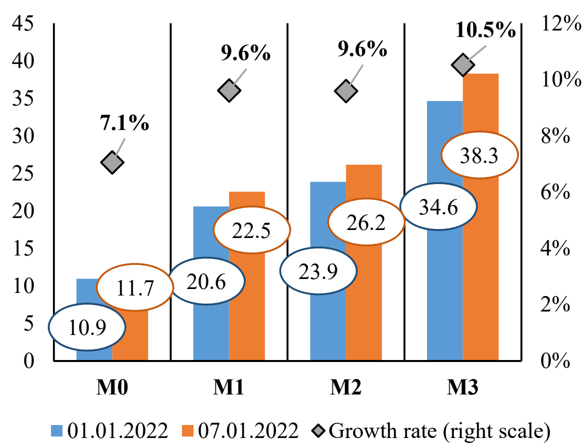
The Bank continued efforts to start the application of a new operating framework of the monetary policy over the reporting period. A new configuration of monetary policy tools should pave the way to more effective management of liquidity by the banking system, more activity in the interbank market and a stronger effect of the interest rate corridor of the CBA in the long run.

3.3. Money supply

In H1 2022, money supply in manat was managed in line with the demand of the economy.

Money base in manat decreased by 12.7% to AZN15.7B end-period. The change in the balance of the treasury account and CBA's sterilization oriented open market operations were critical factors to translate to the change in money base. Money base stood at 0.5% if to skip term deposit operations with certain systemically important banks at the end of the last year.

Chart 33. Money aggregates (bln. azn)

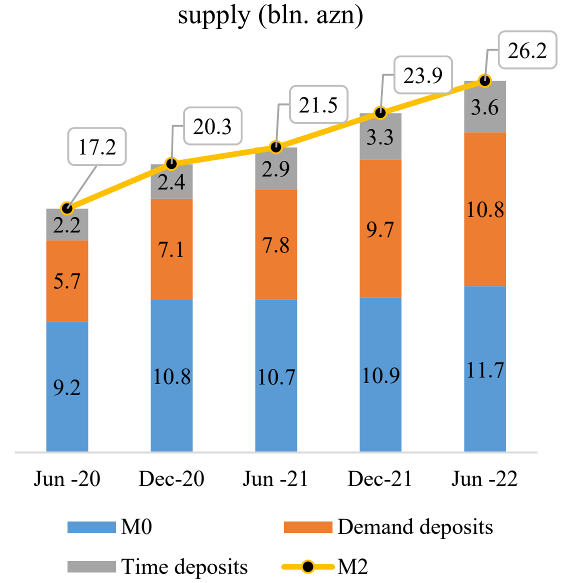


Source:CBA

Cash in circulation, a structural element of base money in manat [5] increased by 4.7%, while stock of correspondent accounts in the manat decreased by 51%.

Broad money supply in the manat (M2) increased by 9.6% to AZN26.2B.

Chart 34. Dynamics of broad money supply (bln. azn)



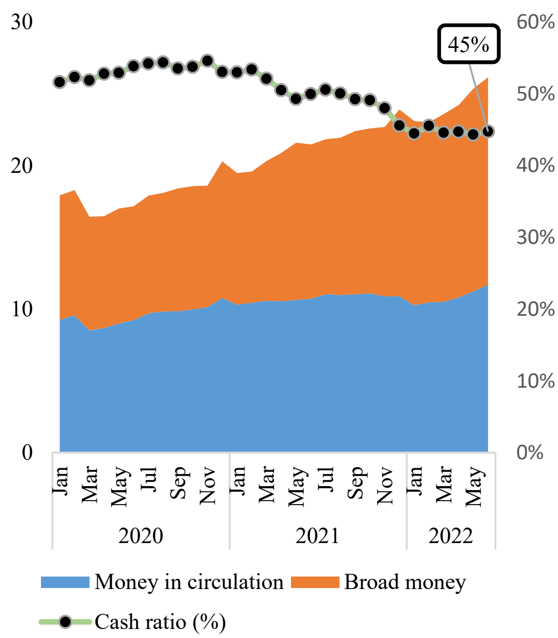
Source: CBA

Structural elements of M2 money aggregate performed differently: M0 cash money supply increased by 7.1%, demand savings and deposits in the manat by 12.5% (41% of M2), and term savings and deposits by 9.5% (14% of M2). M0/M2 ratio has decreased by 1pp since early year to 45% as of the end-

[5] Cash outside the banking system, cash in in banks' cash offices and ATMs

period because savings and deposits outstripped cash.

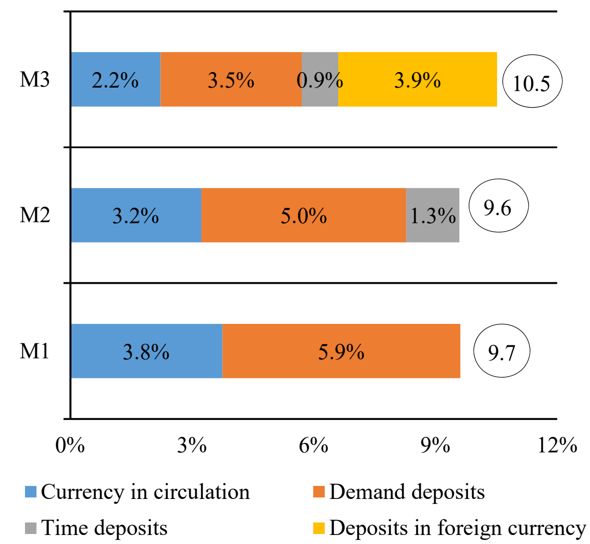
Chart 35. M0/M2 ratio (%)



Source: CBA

Demand savings and deposits made the highest contribution (53%) to the change in M2 money supply, attributable to higher digitalization in the country.

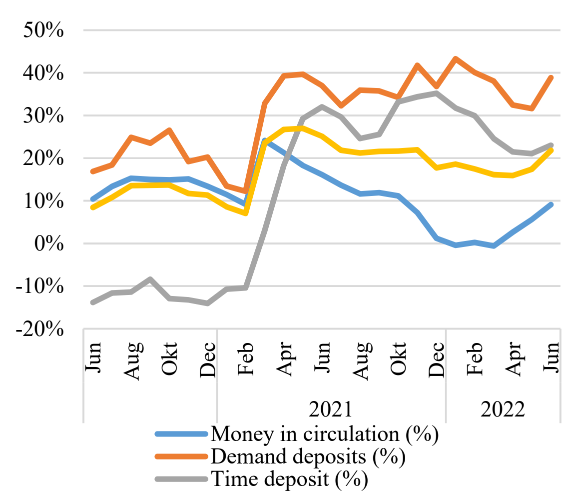
Chart 36. Contribution to the change in monetary aggregates components (%) (2022 I half year)



Source: CBA

In general, demand savings and deposits post a higher growth out of structural components of the M2 in the long run.

Chart 37. Dynamics of M2 and its components compared to the corresponding period of last year (%)

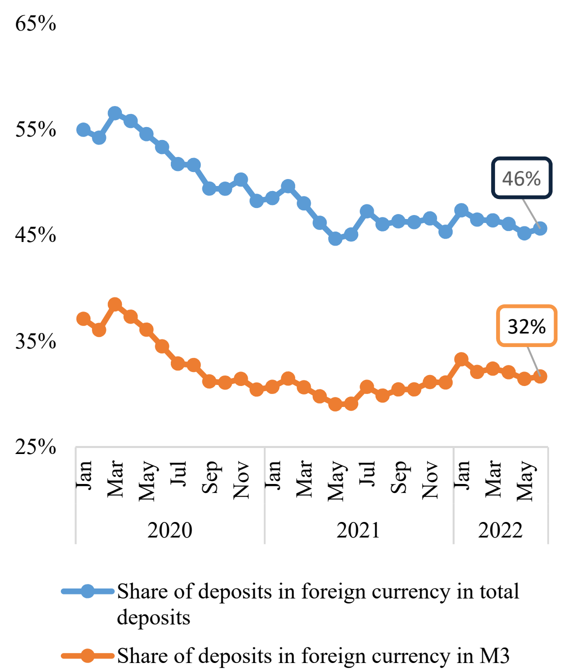


Source: CBA

Broad money supply (M3) increased by 10.5% to AZN38.3B. Both NDAs (up by 13.6%) and NFAs (up by 8.3%) had an upward effect to the change in M_3.

De-dollarization of deposits continued. The share of foreign currency denominated savings and deposits in total savings and deposits decreased by 1pp to 46%. The share of foreign currency denominated savings and deposits in M3 has decreased by 0.6 pp since the early year to 32% as of the end-period.

Chart 38. Dollarization (%)



Source: CBA

Foreign currency denominated deposits account for 54.4% of total deposits of legal entities. Dollarization of savings of individuals made 40.2%. Dollarization of savings of households decreased by three pp to 38% if to skip savings of non-resident individuals.

Charts and tables

Charts

Tables

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