CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REPORT

JANUARY-SEPTEMBER

2023
№3

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ACRONYMS

AE	Advanced economy
APPI	Agricultural Producer Price Index
BCI	Business Confidence Index
CBA	Central Bank of the Republic of Azerbaijan
CCI	Consumer Confidence Index
CLI	Composite Leading Indicator
CPI	Consumer Price Index
EME	Emerging market economy
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign direct investment
FED	Federal Reserve System
FX	Foreign exchange
GDP	Gross Domestic Product
ILO	International Labor Organization
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
NDA	Net Domestic Assets
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Assets
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
REER	Real Effective Exchange Rate
RSM	Real Sector Monitoring
SCC	State Customs Committee
SSC	State Statistics Committee
WEO	World Economic Outlook
WTO	World Trade Organization
Y.o.y.	Year over year

EXECUTIVE SUMMARY

Over 9 months of 2023 the Central Bank of the Republic of Azerbaijan operated in the environment of ongoing geopolitical tensions in the world, weaker global economic activity, shrunk access to global finance due to the tight monetary policy. In general, the international conjuncture was favorable for Azerbaijan in terms of the balance of payments, current account surplus and non-oil-gas economic growth continued.

Over the reporting period annual inflation subdued owing to both changes in external factors and the anti-inflationary policy under way. In September, the annual inflation rate dropped by three times compared to the peak rate of the previous year and returned to the target band (4±2%). Relative drop in average weighted inflation across partners, the price slide in global commodity markets and revert of international freight costs to pre-pandemic levels had downward pressure on domestic inflation. At the same time, the FX market equilibrium amid the balance of payments surplus, the appreciated nominal effective exchange rate of the manat and monetary policy decisions eased inflationary pressures through the monetary condition.

Monetary policy tools were used considering the banking system's liquidity position and the balance of inflation risks. The CBA changed interest rate corridor parameters in response to the macroeconomic stance and forecasts and adequately applied monetary policy tools, which contained excessive expansion of aggregate demand. Over the period reforms continued to improve the strategic and operational framework of the monetary policy, thus elevating options to impact inflation. Average interest rates on short-term deals in the secured interbank money market were formed within the interest rate corridor of the CBA for the first time.

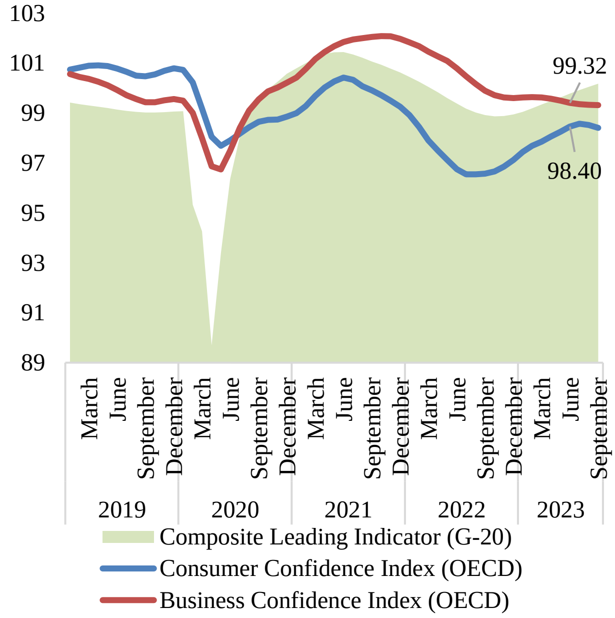
I. GLOBAL ECONOMIC ENVIRONMENT

1.1. Global economic trends

9 months of 2023 were marked with lingering geopolitical and geoeconomic tensions and uncertainties in the global financial system. On the backdrop of the fight with inflation the monetary policy tightening in most countries weighed on economic growth and unemployment. The downward trend of inflation failed to meet expectations in most countries.

In 9 months of 2023 lingering negative effects of the pandemic and downward trend of inflation in major countries weighed on global economic activity indicators. The CCI, economic activity indicator of the OECD countries increased over seven months of the year and was prone to falling starting from August. The BCI, an economic activity indicator on OECD countries decreased on the backdrop of uncertainty in financial markets. However, the Composite Leading Indicator (CLI), the economic activity indicator in G-20 has increased since early year.

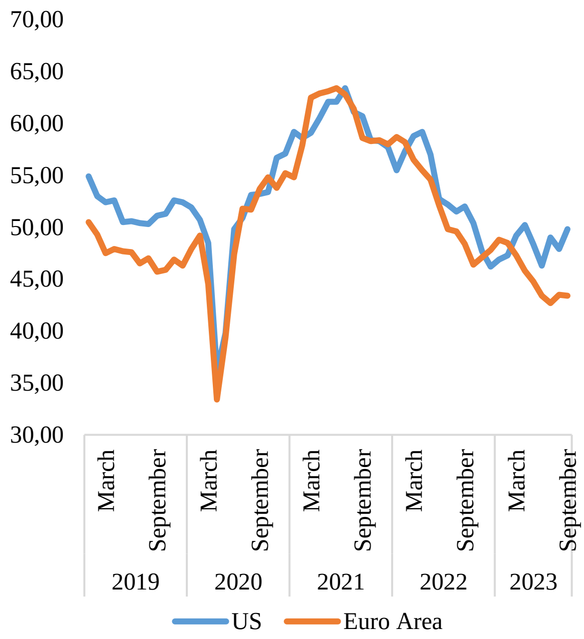
Chart 1. Global economic activity indicators



Source: OECD

The Purchasing Manager's Index (PMI) that shows economic trend in the manufacturing sector increased in the USA and decreased in the euro area in September compared with the beginning of the year. In September 2023, the PMI increased from 47.9 in August to 49.8 (higher than expected 48.9) in the USA. While it dropped from 43.5 in August to 43.4 in September in the euro area.

Chart 2. Purchasing Manager's Index (PMI)



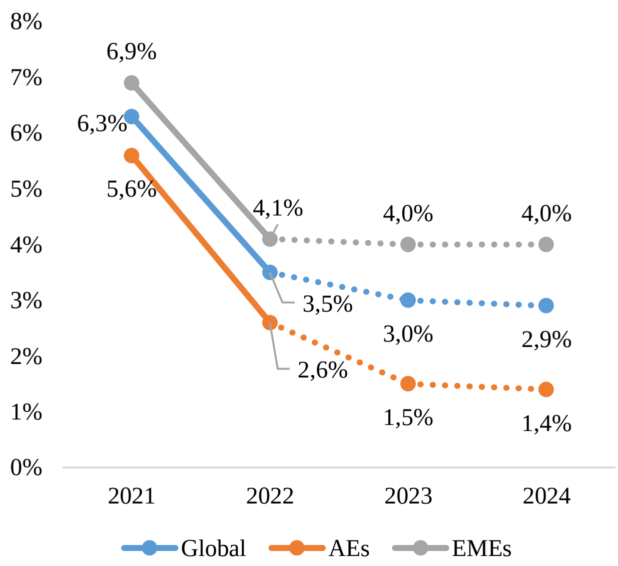
Source: Market Economics

Global economic developments weighed on projections of international organizations. The IMF WEO October 2023 left unchanged global growth forecast for 2023 (3%) compared with the July 2023 forecast. The global economic forecast was revised down by 0.1 pp to 2.9% for 2024.

The IMF WEO October 2023 left unchanged economic growth forecasts across AEs both for 2023 and 2024 compared with the previous forecast (July 2023) (1.5% and 1.4% respectively). In the recent outlook the economic growth trajectory was changed upwards for the US and downwards for the euro area. The upward revision for the USA is attributable to the rise in business investments and higher consumption in the second quarter.

Economic growth forecasts were revised up for France (0.2 pp), Japan (0.6 pp), USA (0.3 pp) and the UK (0.1 pp), down for Italy (0.4 pp) and Germany (0.2 pp) compared with the previous forecast. The growth forecast was left unchanged for Spain (2.5%).

Chart 3. Economic growth projections, %



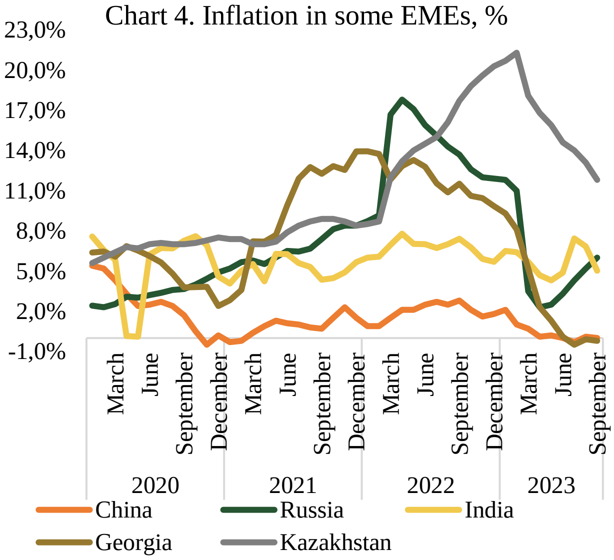
Source: The IMF WEO October 2023

The IMF WEO October 2023 left unchanged economic growth forecasts for EMEs compared with the previous forecast (4%) for 2023 and revised down by 0.1 pp to 4% for 2024.

Economic growth forecast was revised up in Latin America (0,4 pp) and Europe (0,6 pp) and down for Middle East and Central Asia (0,5 pp) and Sub-Saharan Africa (0,2 pp). Economic growth for Asia was revised down by 0.1 pp to 5.3% compared with the July forecast.

The IMF WEO October 2023 revised the global inflation forecast up by 0.1 pp to 6.9% (8.7% in 2022) for 2023 and by 0.6 pp to 5.8% for 2024 compared with the July forecast.

Chart 4. Inflation in some EMEs, %



Source: National Statistic Offices

According to the report, inflation is falling due to the drop in global commodity prices. The monetary tightening is also the main contributor to the fall in inflation.

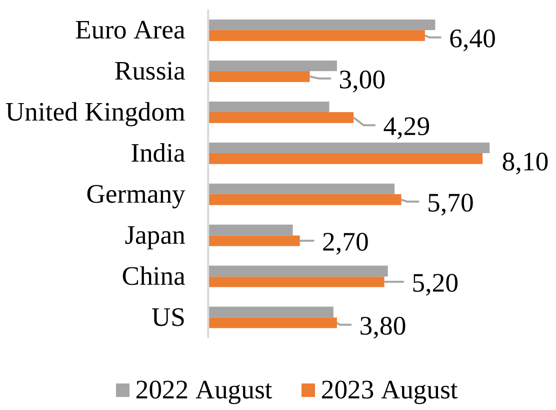
The report forecasts the global core inflation rate to stand at 6.3% in 2023 (average annual 6.4% in 2022) and 5.3% in 2024. Core inflation forecasts were revised up by 0.3 pp and 0.6 pp for 2023 and 2024 respectively compared with the July forecast, attributable to lower-than-expected drop in core inflation. According to the WEO, in more than 50% of country groups, average annual core inflation will not decrease in 2023 and inflation is forecast to remain above target until 2025 in almost all countries with an inflation target.

To revert inflation to the target band most central banks decided to either tighten or leave unchanged their monetary policy over the nine months.

Unemployment y.o.y. increased in the UK (4.3%, August), Japan (2.7%, August), USA (3.8%, August) and

Germany (5.7%, August) and decreased in Russia (3%, August), China (5.2%, August), India (8.1%, August) and the euro area (6.4%, August) as of the end-period.

Chart 5. Unemployment rate, %



Source: Trading Economics

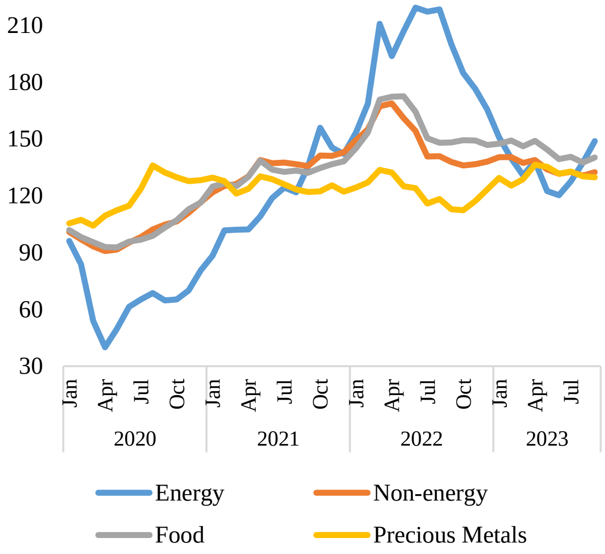
According to the September 2023 OECD report central banks will continue maintaining high policy rates in case inflation expectations rise in the upcoming period. As a result, economic agents will face financial challenges, which in turn will slow down economic growth and increase unemployment.

1.2. Global commodity markets

Global commodity prices were mainly prone to falling over the past period of 2023, attributable to the drop in global economic activity and the tight monetary policy pursued by most central banks. In the following periods uncertainties related to price volatility remain high, associated with geopolitical tensions and climate changes.

Weaker global economic growth, a tense geopolitical situation, negative effects of unfavorable weather conditions on productivity, as well as the tight monetary policy by most central banks contributed to the dynamics of commodity prices. According to the World Bank Commodity Markets Outlook October 2023 overall commodity price index decreased by 8.2% compared with the beginning of the year and y.o.y. by 19.8% in September 2023. In January-September 2023 price indices fell by 10.1% on energy products, by 4.1% on non-energy products, by 4.5% on food products, by 0.8% on raw products, by 15.6% on fertilizers and by 6% on metals and minerals. Moreover, prices hiked by 11.7% on beverages and by 5.2% on precious metals.

Chart 6. Global commodity indices
(2019 december=100)

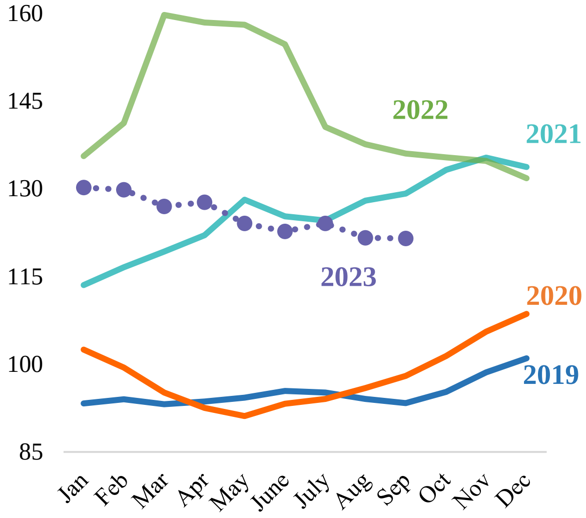


Source: World Bank

According to the UN FAO, in September 2023, the food price index decreased by 7.8% since the beginning of the year. This indicator decreased by 10.7% on annual and by 23.9% since the peak in March of last year. The highest price slide was observed on wheat, vegetable oils and dairy products. However, the sugar price index reached the highest of recent ten years in

September 2023 and increased by 38.9% over nine months.

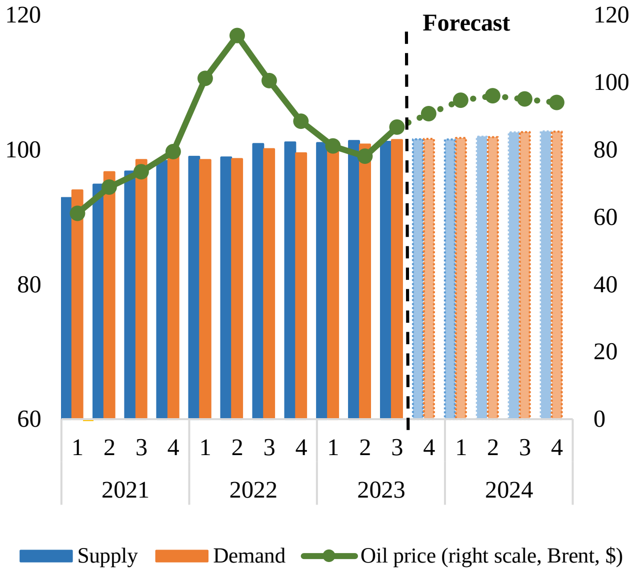
Chart 7. The FAO food price index (2014-2016 = 100)



Source: FAO

In Q3 2023, oil prices hiked unlike the first half of the year. In September, the Brent oil price exceeded $95/b, the highest level since December 2022. However, over 9 months of 2023 the average Brent oil price was $82/b, down by 17.3% compare with average price of 2022 ($99.2/b).

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

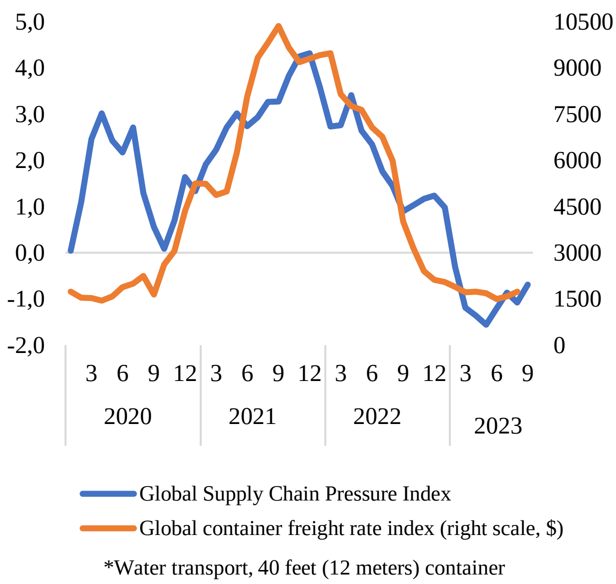


Source: The US Energy Information Administration (EIA)

The US EIA, in its October report predicts that oil prices will increase in upcoming periods. The average Brent oil price is expected to be $84/b in 2023 and $94/b in 2024 (in July forecast $79/b and $84/b respectively). The main reason for upward revision of forecasts for upcoming periods is attributable to the expectation on extension of cuts in oil output by OPEC+ in 2024 as well. Moreover, voluntary oil cuts by Saudi Arabia and Russia will also have an upward effect on crude oil prices. The report also highlights that, potential drop in oil reserves in the first quarter of 2024 will be eliminated due to increased crude oil supply by non-OPEC countries in the following quarters.

Higher-than-average natural gas reserves in storage because of mild winter in Europe, more supply in the region due to natural gas import from Norway and North Africa were critical in normalization of gas prices over the past period of 2023. In 2023, the average gas price for 1000 cubic meters on the Dutch TTF gas index y.o.y. decreased by 70% to €428 (€1405 in 2022).

Chart 9. Dynamics of global supply and transportation indices (2019-2023 September)



Source: New York FED, Statista

With recovery of the global supply chain transportation costs and durations reverted to pre-pandemic levels, which in turn had contributed to drive inflation down. The Global Supply Chain Pressure Index, released by the Federal Reserve Bank of New York, dropped over 9 months of 2023. Whereas the index slightly increased in Q3 2023, it continued to be in a negative zone.

According to the IMF WEO October 2023, energy prices are expected to fall due to weaker global economic activity, and main metal prices are expected to fall due to real estate crisis in China. Oil prices are forecast to decrease by 17%, natural gas prices by 61% and main metal prices by 4.7% in 2023. According to the report, food prices that, peaked in 2022, are expected to decrease by 6.8% in 2023, but still to stand higher than the pre-pandemic level.

The IMF in its recent release highlighted the fragmentation of commodity markets related to geopolitical tensions and climate change as the biggest risk likely to affect commodity prices. Trade disruptions may both trigger high price volatilities and eventually weigh on economic activity. Moreover, global trade disruptions may have significant effects on economies dependent on commodity exports and elevating uncertainties related to food security in low-income countries. According to the IMF, strengthened macroeconomic, structural, and fiscal policy frameworks, building fiscal and financial buffers, and elaboration of the blueprint of readiness against sudden interruptions in supply of commodities may make countries more resilient and help mitigate the effects of commodity shocks. Countries should also strengthen social safety nets to protect vulnerable households from high commodity price swings.

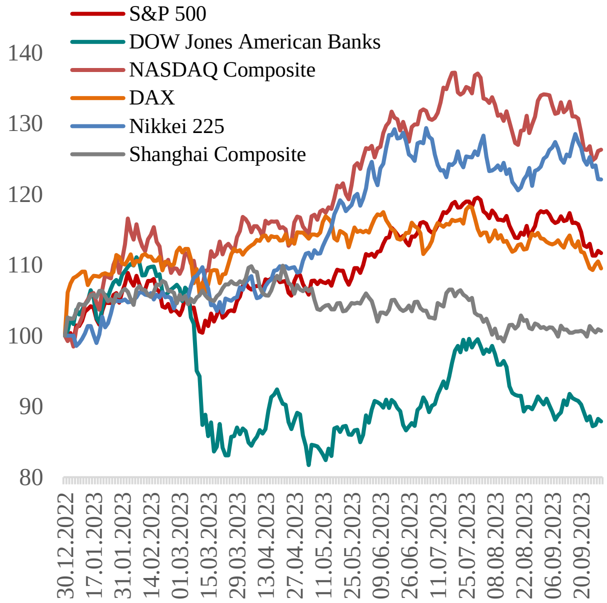
1.3. Global financial markets

Despite the easing of stress stemmed from the banking sector in the global financial system early in 2023, the tight monetary policy pursued by central banks to fight high inflation had a considerable effect on the financial system over the past period of the year.

Due to more than expected persistence of high inflation in national economies and lower drop in the core inflation rate over 9 months of 2023 major central banks pursued a tight monetary policy. The monetary policy was tightened more in certain countries, while policy rates that were already high enough were left unchanged in some of them. However, after the second half of the year certain central banks decided to ease policy rates. The FED has increased the policy rate from 4.25-4.5% to 5.25-5.5%, the Bank of England from 3.5% to 5.25% and the ECB from 2.5% to 4.5% since early year. Amid weaker economic growth in the country, further regress in the property sector and rising challenges on the financing of the local government the People's Bank of China decreased the policy rate from 3.65% to 3.45%.

Amid diminished expectations on global economic crisis and accelerated decrease in inflation since the beginning of the year, global economic recovery related optimism had a positive effect on the value of assets.

Chart 10. Dynamics of the stock markets (December 2022 = 100)



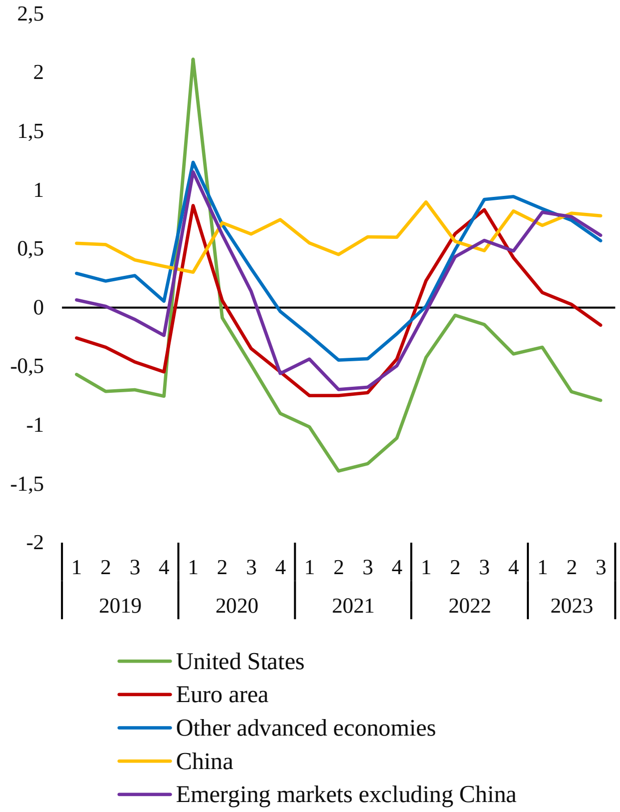
Source: Investing.com

Stock prices increased in Europe and the USA over the past period of the year. The rise in stock prices in Japan surpassed the similar indicator in other AEs due to ongoing policy easing and high corporate profit. Since the beginning of the year the NASDAQ has appreciated by 26%, Dow

Jones by 1.34%, FTSE Eurotop by 6.1%, DAX by 8.9%, Nikkei by 21.2% and MSCI World by 9.3%. The real estate crisis in China and weaker than expected recovery of its economy weighed on the Shanghai Composite, which has slightly increased since early year (0.6%). The highest value increase was in Russian and Turkish stock exchanges that MOEX RX has appreciated by 87.9% and BIST 100 (XU100) by 50.1% respectively since early year.

The regional instability experienced in the banking sector early year and concerns about the contagion of stress on a global horizon were eliminated due to swift reactions by regulatory authorities. However, high interest rates weakened solvency of the corporate sector and households and triggered additional concerns in the financial system. Consequently, financial stability risks are still as high now as at the beginning of the year.

Chart 11. Financial conditions indices

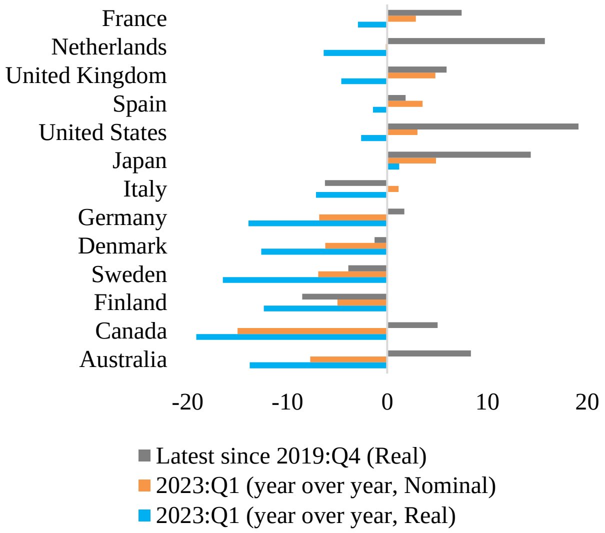


Source: IMF

According to the IMF WEO October, despite the ongoing tight monetary policy, the financial condition indices, the indicator of financing cost in capital markets, eased in AEs, particularly in the USA. Such easing is an exceptional case compared with the monetary tightening in previous years and stems from expectations of investors. Investors expect that the inflationary pressure will recede and that central banks will ease policy rates in upcoming quarters. On the contrary, albeit recent slight policy easing in China, weak economic recovery related concerns, as well as financial stability risks associated with the property market stress, reduced investors’ confidence. Although foreign funding costs remain to be the key source of concern in other EMEs, lower interest rate expectations and higher corporate assessments loosened the financial condition on net.

The IMF in its October release noted that, housing prices have been falling globally since the end of 2022, i.e., since the time when central banks started to aggressively tighten the monetary policy. Weaker access of borrowers in the real estate sector, which needs financing, lower issuance of mortgage-backed securities and tightening of lending standards by banks surfaced the funding risk related concerns in the sector.

Chart 12. Real and nominal hike in housing prices



Source: IMF

The report highlights that, the stress in the real estate sector is likely to have a significant effect on financial stability. It is attributable to the sector’s size and concentration, and its strong ties with the financial system.

According to the stress-testing by the IMF, in October the global banking system was resilient under the baseline scenario. However, the testing revealed the potential for significant capital losses related to marketable securities and loans in most banks in AEs. The global stress-test under the adverse scenario, characterized with sharp stagflation, found out that there will be significant capital losses in most banks, including banks in China, Europe, and the USA.

The report also provides several policy recommendations to safeguard global financial stability.

Optimal policy combinations may vary depending on the nature of the economic shock and country specifics. Any response measures should be a part of a single plan eliminating key macroeconomic imbalances.

Private sector creditors should find out the ways of orderly debt restructuring and preemptive coordination to avoid costly hard defaults and prolonged loss of financial market access.The IMF also emphasizes the need to implement international standards to prevent the risk of insolvency of weak banks from contagion to healthy institutions in the global financial system. The fulfillment of adequate minimum capital and liquidity requirements is critical to prevent financial stability risks. In addition, prudential norms and requirements regarding the capital maintained against the interest rate risk should be tightened, authorities should be prepared for early intervention to eliminate bank stresses, as well as, if necessary, provide banks' access to central bank funds.

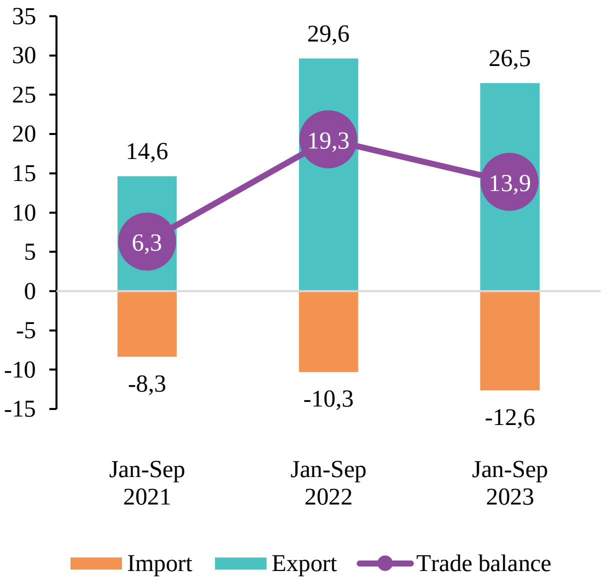
II. INTERNAL MACROECONOMIC CONDITION

2.1 External sector

A favorable international conjuncture and rising non-oil-gas export paved the way for foreign trade balance, the main component of the balance of payments, to remain in surplus in January-September 2023.

According to the SCC, foreign trade turnover amounted to $39.1B – export $26.5B (67.7%), import $12.6B (32.3%). Foreign trade surplus stood at $13.9B.

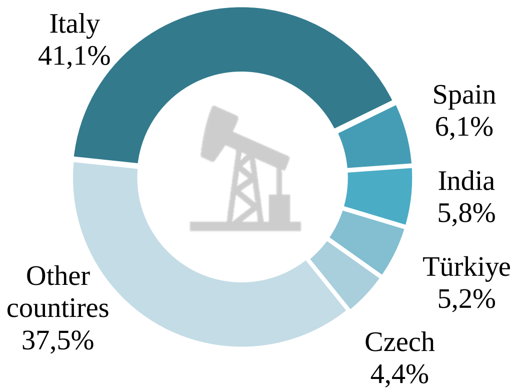
Chart 13. Trade balance, $ billion



Source: SCC

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

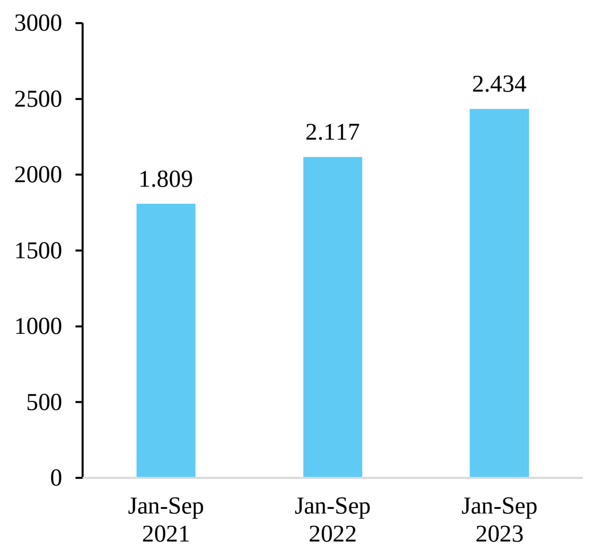
Chart 14. Countries to which crude oil and oil products were exported, (%)



Source: SCC

The value of the oil-gas export decreased by 12.2%, driven by the change in export prices. The value of crude oil export decreased by 18.6%, and natural gas exports decreased by 5.7%. 41.1% of crude oil and oil products was exported to Italy, 6.1% to India, 5.8% to Spain, 5.2% to Türkiye and 41.8% to other countries.

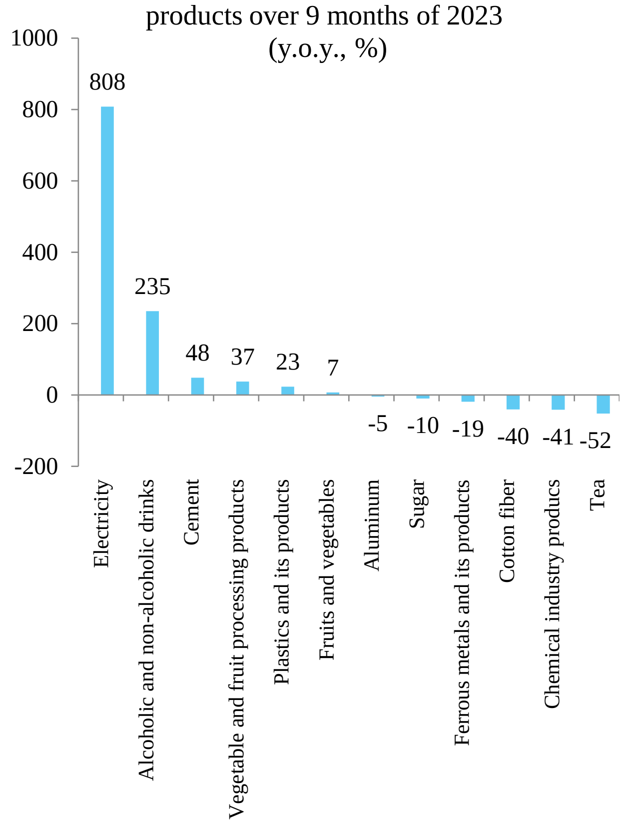
Chart 15. Non-oil-gas exports , $ million



Source: SCC

In the reporting period, non-oil-gas export increased by 15%. Exports of electricity, alcoholic and non-alcoholic beverages, cement, fruits and vegetables and their processed products, plastics and products increased.

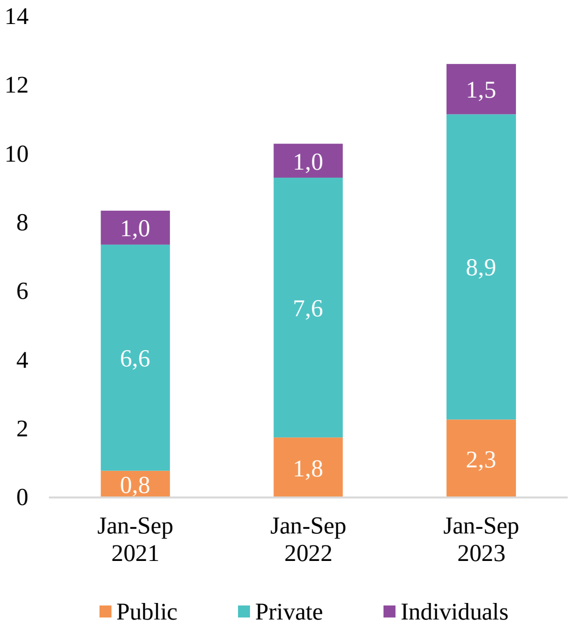
Chart 16. Changes in export of some products over 9 months of 2023 (y.o.y., %)



Source: SCC

In general, over the reporting period main export partners were Italy (44.3%), Türkiye (17.2%), Greece (4.5%) and Russia (3.3%).

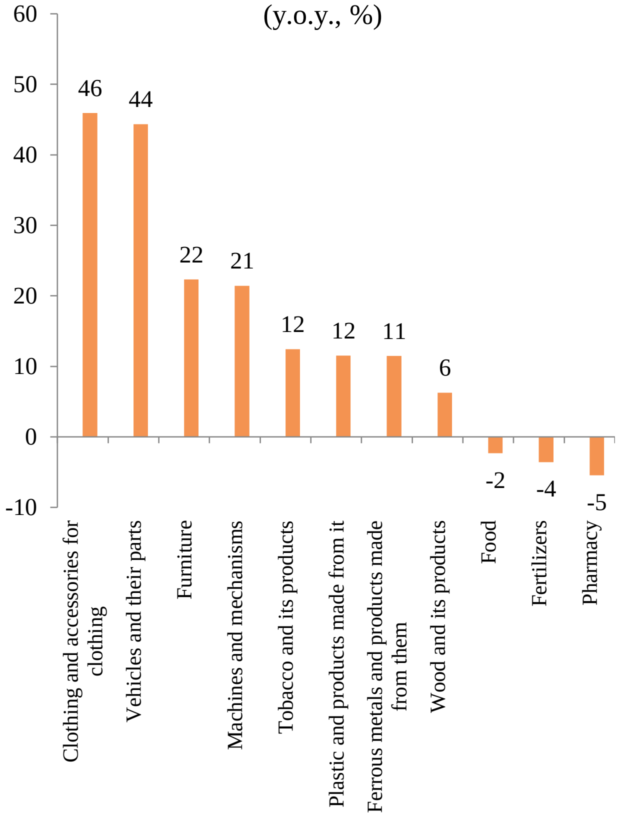
Chart 17. Dynamics of imports by sectors, billion $



Source: SCC

Commodity import y.o.y. increased by 22.6% - by 29.8% to $2.3B on the public sector, by 17.5% to $8.9B on the private sector and by 48.3% to $1.5B on individuals.

Chart 18. Changes in imports of some products over 9 months of 2023 (y.o.y., %)

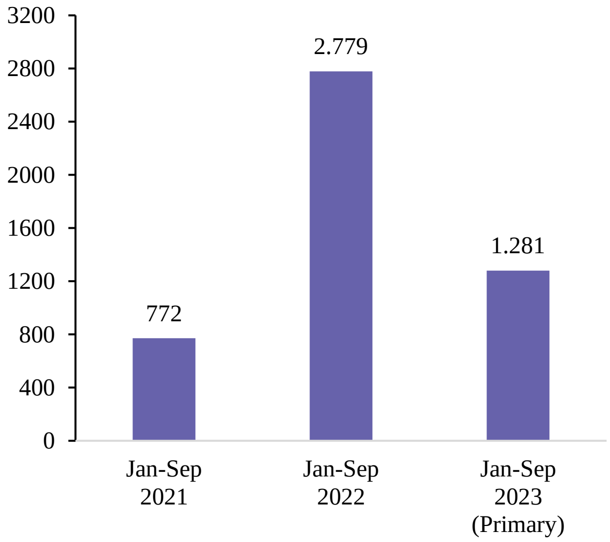


Source: SCC

Import increased by 45.9% on clothes and clothing accessories, by 44.3% vehicles and parts, 22.3% on furniture and parts, by 21.4% on machinery and mechanisms, by 12.4% on tobacco and tobacco products, by 6.3% on wood and wood products, by 11.5% on plastics and products and by 11.5%, on ferrous metals and products. Import decreased by 5.5% on pharmaceuticals, by 3.6% on fertilizers and by 2.3% on food products.

Russia accounted for 18%, China for 17.5%, Türkiye for 13.5%, Germany for 5.6%, Turkmenistan for 4.9%, USA for 3.1%, France for 2.8%, Iran for 2.7%, the Republic of Korea for 2.5%, Italy for 2.5% and Japan for 2.4% of total imported products.

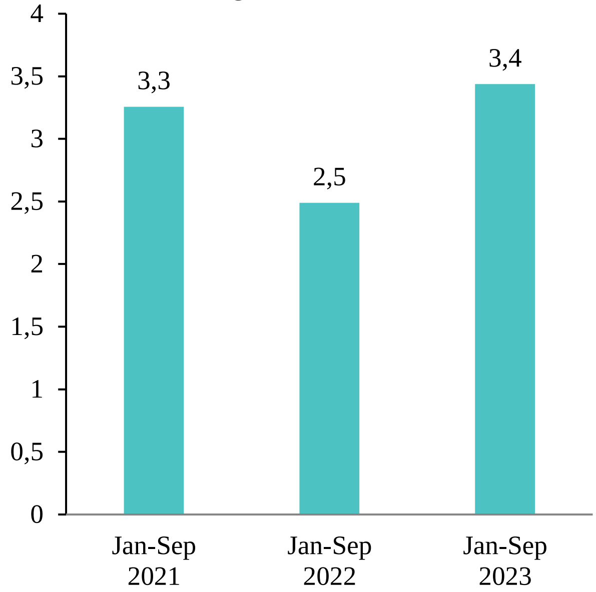
Chart 19. Remittance inflows, $ million



Source: CBA

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

Chart 20. Investments in fixed capital from foreign sources, billion manat



Source: SSC

Capital inflows from foreign enterprises and organizations continued over the period. According to the SSC, total investments from all financial sources amounted to AZN12.7B. FDIs accounted for 22.7% of total investments.

Investor funds from the UK, Türkiye, the USA, Japan, France, Switzerland, Russia, Norway, and Iran accounted for 94% of total FDIs.

The strategic FX reserves still exceed internationally accepted adequacy norms. As of 29 September 2023, strategic FX reserves sufficed for 34-month worth of import of goods and services (considering the import of goods and services for H1 2023). Strategic reserves exceeded broad money supply in manat (M2) by 3.4 times (M2 on 9 months of 2023).

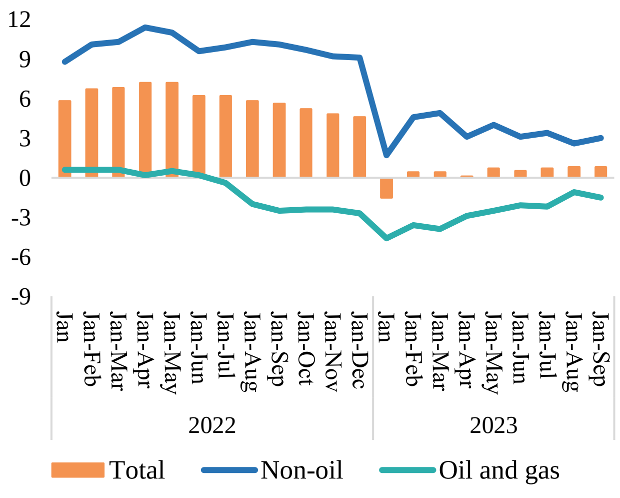
2.2. Economic activity

Economic growth continued in the country over 9 months of 2023, driven by the non-oil-gas sector. All aggregate demand components underpinned economic growth.

Economic growth. According to the SSC, GDP y.o.y. increased by 0.8% in real terms to nominal AZN90.8B in January-September 2023. Per capita GDP stood at AZN8948.8.

Oil and gas value added decreased by 1.5% to nominal AZN34.6B. 22.5 million/ton crude oil (y.o.y. down by 7.8%), 26.9 billion cubic meters natural gas (y.o.y. up by 4.6%) was extracted over 9 months of 2023.

Chart 21. Economic growth, (y/y) %



Source: SSC

Non-oil-gas value added y.o.y. increased by 3% in real terms to nominal AZN56.2B. Production in the non-oil-gas industry increased by 6.1%.

Agriculture grew by 3%. Livestock products increased by 3.5%, and plant products increased by 2.5%.

The services sector also followed positive dynamics over 9 months of 2023. Freight and passenger transport increased by 5.9% and 17.1% respectively, information and communication increased by 14.7%. Tourism and public catering y.o.y. increased by 26%.

Table 1. GDP structure, weight, %

Sectors	Q3 2022	Q3 2023
Industry	52.2	41.6
Construction	4	5
Agriculture, forestry, and fishery	5.2	6.4
Trade, repair of vehicles	7.8	9.5
Transport and warehousing	6	6
Tourism and public catering	1.5	2.3
Information and communication	1.3	1.7
Other	14.2	18
Net taxes on products and import	7.8	9.5

Source: SSC

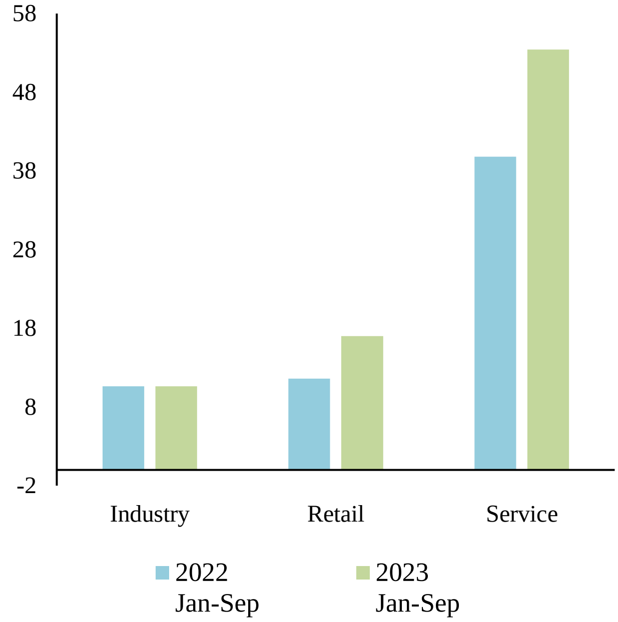
CBA's real sector survey results confirm that economic activity continues. The BCI was positive across sectors.

The BCI on the industry remained in a positive zone year over year. Whereas the BCI was high in the chemical industry, food products and beverages, machine building, construction, and production of other non-metal products sub-sectors, it was relatively weak in metallurgy and plastic sub-sectors.

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

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

Chart 22. The Business Confidence Index , (9 month average)



Source: RSM findings-based CBA estimations [1]

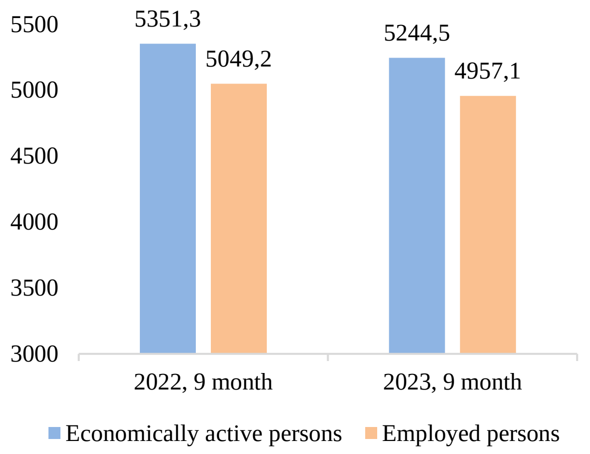
Employment. As of October 1, 2023, total labor force was 5244.5 thousand persons, employed population numbered 4957.1 thousand persons.[2]

As of September 1, 2023, hired labor was 1706.6 thousand persons, y.o.y. down by 0.5% – 887.7 thousand persons were engaged in the public and 818.9 thousand persons in the non-public sectors.

[1] *Industrial BCI = (output – final goods inventory + production expectations)/3*
Services BCI = (business condition + actual demand + demand expectation)/3
Trade BCI = (actual sale – changes in goods inventory+ sale expectations)/3

[2] *The results of the 2019 population census were taken into account*

Chart 23. Dynamics of economically active and employed persons (in thousands)



Source: SSC

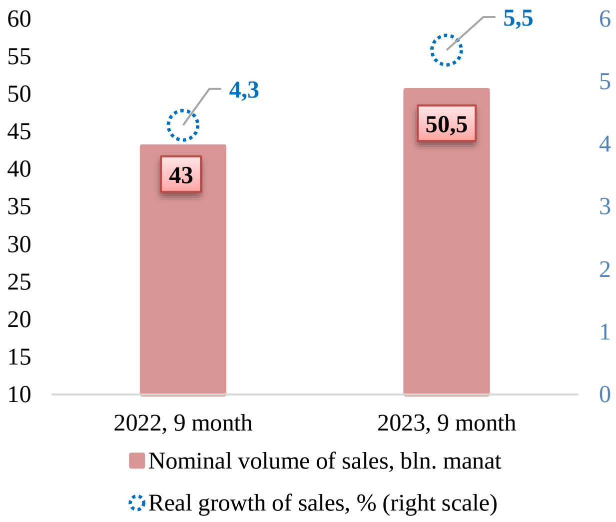
22.6% of hired labor in enterprises and organizations engaged in production.

Results of RSM by the CBA indicate that, employment expectations of economic agents remained positive in the industry, trade, and services over 9 months of 2023.

Aggregate demand. Aggregate demand continued to expand in January-September 2023 as well and supported economic growth.

Aggregate demand expanded due to consumer demand. Goods and services sold in the market to meet consumer demand y.o.y. increased by 5.5% in real terms to AZN50.5B. Every consumer spent on average AZN552.7 monthly in the consumer market (y.o.y. up by AZN78.7).

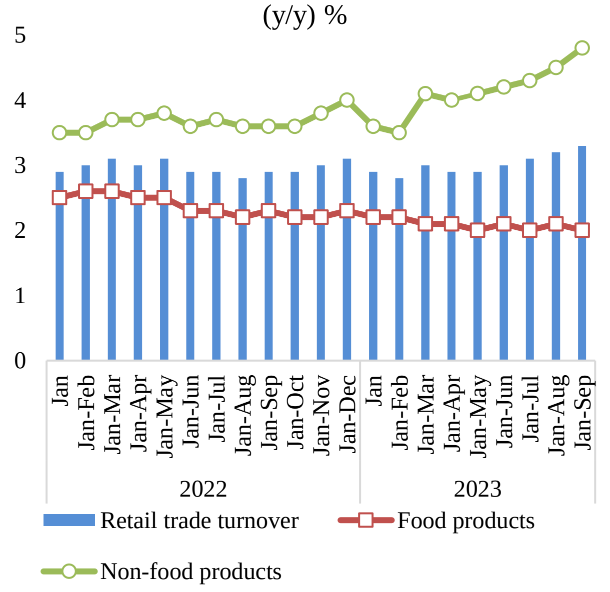
Chart 24. Change in volume of sales in consumer market



Source: SSC

Retail trade turnover y.o.y. increased by 3.3% in real terms to AZN40.9B. Retail commodity turnover on food products, beverages and tobacco products increased by 2%, and non-food trade turnover increased by 4.8%.

Chart 25. Growth in retail trade turnover, (y/y) %



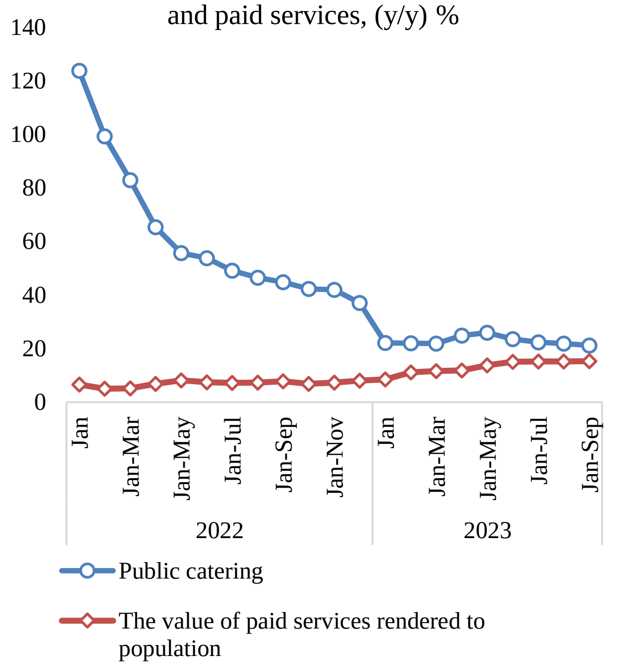
Source: SCC

Consumers spent main part of their funds (56.1%) on food, beverages, and tobacco products in retail trade outlets.

Every consumer purchased, on average, AZN447.7 worth of goods (y.o.y. up by AZN56.1) per month in nominal terms in retail trade – AZN251.3 on food, beverages, and tobacco products, and AZN196.4 on non-food stuff.

In January-September 2023, public catering turnover y.o.y. increased by 21.2% in real terms. Paid services to the population increased by 15.3% in real terms to AZN8.1B. Per capita paid services consumption y.o.y. increased by AZN238.1 to AZN799 on average in nominal terms.

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

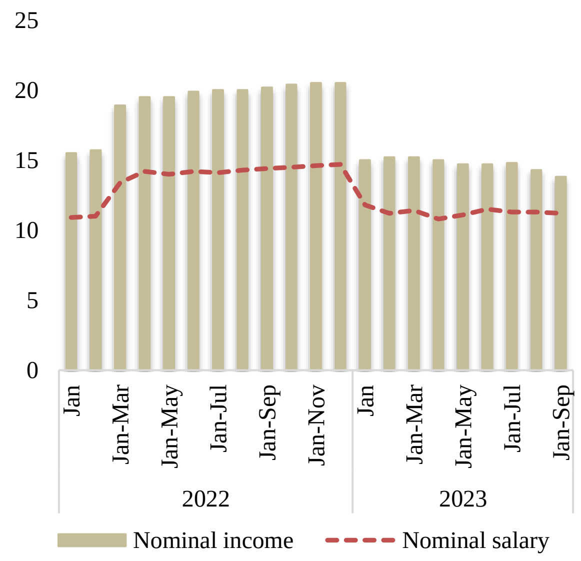


Source: SSC

The growth dynamics of nominal income of the population was one of the main factors in the rise of consumer demand. The nominal growth rate of personal income continues to outpace the average annual inflation rate, which means that incomes are rising in real terms.

According to the SSC, money income of the population increased by 13.8% to AZN58B in nominal terms. Per capita money income was AZN5717.2. Population's disposable income increased by 13.8% to AZN51.2B. Average monthly nominal salary of hired labor y.o.y. increased by 11.2% to AZN919.8 over 9 months of 2023.

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



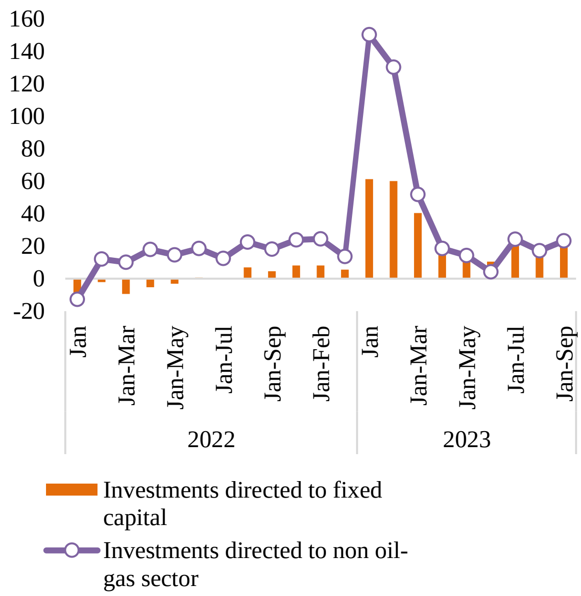
Source: SSC

Lending activity also weighed on the consumer demand. In September-January, loans to households increased by 18.8% compared with the early this year.

Government spending was critical in supporting domestic demand. Over the period, state budget expenditures amounted to AZN23.2B.[3] AZN14.1B (60.8%) of state budget expenditures were channeled to current expenses, AZN8.4B (36.1%) to capital expenses and AZN713.7M (3.1%) to state debt and liabilities.

Investment demand kept expanding. According to the SSC, funds invested to the economy y.o.y. increased by 21.3% (AZN12.7B). Investment in the oil-gas sector y.o.y. increased by 18.1% and investment in the non-oil-gas sector increased by 23.2% in real terms.

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



Source: SSC

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

AZN671M (5.3% of total investments) out of AZN8.3B worth funds channeled to the non-oil-gas sector was used in non-oil-gas industry. The public sector accounts for 55.2% and the non-public sector for 44.8% of total investments.

77.3% of investments stemmed from internal and 22.7% from foreign sources. Funds of enterprises and organizations prevailed in total investments (45.4%).

2.3. Inflation

In September 2023, there was a decrease in annual inflation, bringing it within the target band. Global economic developments and anti-inflationary measures taken in the country put downward pressure on inflation.

Consumer price index (CPI). According to the SSC, annual inflation stood at 5.1% in September 2023 (September 2023 vs September 2022) (down by 10.5 pp from the peak in September 2022). Average annual inflation stood at 10.9% in September 2023 (January-September 2023 vs January-September 2022).

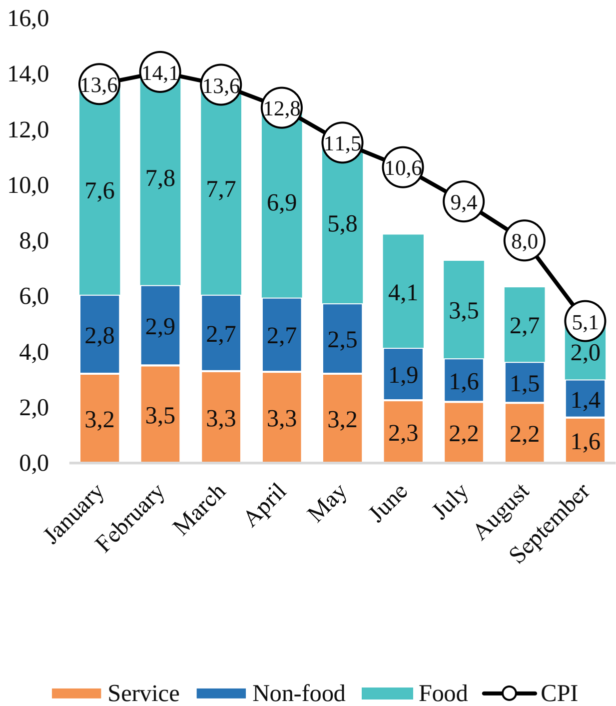
Chart 29. Annual inflation, in %

Source: SSC

Total inflation was driven by food price hike. In September, annual food inflation stood at 4.5% and annual average food inflation stood at 12.4%. In September non-food prices increased by 5.9% on annual and by 10.1% on annual average. Service prices y.o.y. hiked by 5.4%, annual average service inflation was 9.6%.

In general, food prices made 2pp, non-food prices 1.4 pp and changes in prices and tariffs of services 1.7 pp contribution to annual inflation in September.

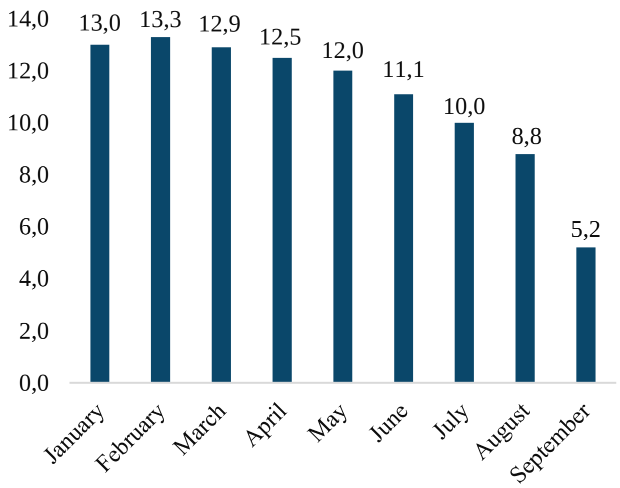
Chart 30. Contributions to CPI , in percentage points



Source: SSC, CBA

Annual core inflation calculated by excluding changes in regulated prices and prices for seasonal agricultural products was 5.2% in September 2023. Average annual core inflation was 10.9% in January-September 2023.

Chart 31. Change of average annual core inflation , in %



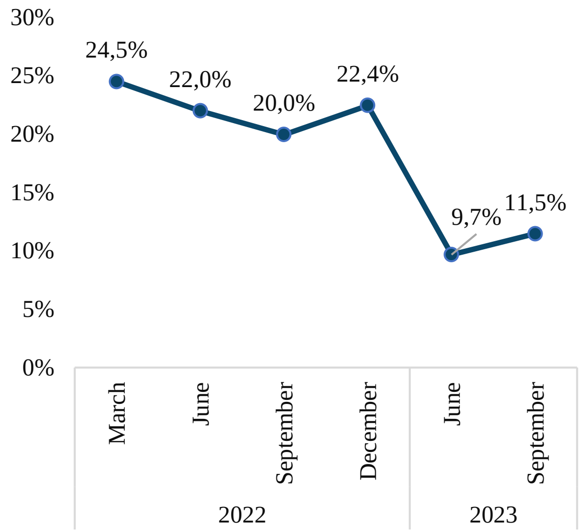
Source: SSC

Annual inflation decreased under the influence of both external factors and implemented anti-inflationary efforts. Ongoing drop in average weighted inflation across trade partners reduced imported inflation, attributable to the slide of global commodity prices, weakened global economic activity and tight monetary policy in most countries. According to the recent Commodity Markets Outlook by the World Bank, overall commodity price index decreased by 19.8%, energy prices by 25.6% and non-energy prices by 3.9% on annual in September. According to the UN FAO, the food price index decreased by 0.1% monthly and by 10.7% on annual in September. At the same time, the domestic FX market equilibrium, the appreciation of the nominal effective exchange rate of the manat and monetary policy decisions alleviated inflationary pressures through the monetary condition.

Additionally, efforts by the government, and the implementation of the actions specified in the Decree of the Cabinet of Ministers of the Republic of Azerbaijan ‘Additional measures on strengthening the monitoring of inflation and prices’ have been putting downward pressures on inflation.

The dynamics of actual inflation weighed on inflation expectations of households. Over recent two years the number of households that are expecting the inflation to be higher has been falling.

Chart 32. Share of households expecting increase of inflation rate, in %



Source: CBA calculation

In general, stronger downward factors in the inflationary environment and stabilized inflation expectations allow forecasting that annual inflation will be within the target band by the end-year and in 2024. According to recent forecasts by the CBA, inflation is expected to stand at 4.3% towards the end of 2023 and at 5.3% in 2024.

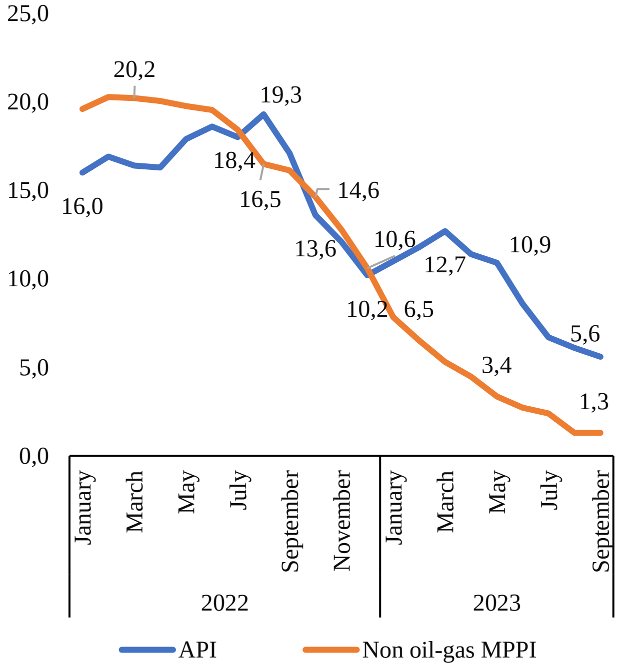
Despite the fall in actual inflation, uncertainties related to the external environment of inflation across the forecast horizon remain high. Larger-scale geopolitical tension, emergence of new points of war, natural anomalies may push food and energy prices up in the world market. International organizations revised up energy price forecasts for 2024, likely to weigh on inflation rates in energy importing partner countries.

The main internal risk, likely to force inflation to deviate from the target band, is the expansion of aggregate demand at a higher rate than supply. The increase in purchase-oriented interventions to the FX market over the remaining period of the year due to fiscal operations may both lead to overexpansion of money supply and put an upward pressure on inflation in the next year. However, expenses in draft state budget for 2024 have been calculated conservatively, which is positive in terms of avoiding overexpansion of aggregate demand.

Producer Price Index. According to the SSC, APPI y.o.y. increased by 5.6% in September. The IPPI y.o.y. increased by 0.7%. The IPPI decreased by 0.5% on oil-gas products and increased by 1.3% on non-oil-gas products. The non-oil-gas PPI has decreased by 6.5 pp since early this year.

The PPI in processing y.o.y. decreased by 0.4%. The food production price index decreased by 1.4%. The annual food production price index in processing increased by 12.9% in January and decreased by 0.4% in September. The growth rate of the price index has decreased since early this year (from 12% in January to 0.4% in September) due to the drop in the annual agriculture price index.

Chart 33. Annual change of PPI, in %



Source: SSC

In September 2023, prices for transport and warehousing y.o.y. increased by 8.9%. Cost of freight transportation increased by 9.1% and the price of passenger transportation increased by 4.6%. The warehousing and supplementary transportation price index decreased by 2.1% annually. Postal and courier service prices y.o.y. increased by 1.3% annually in September.

House price index. According to the SSC, the house price index y.o.y. increased by 10.1% in Q3 2023. The price index increased by 7.8% in the primary housing market and by 10.1% in the secondary housing market. Comparing with Q2 2023 the price index increased by 2.8% in the housing market, by 1.8% in the primary market and by 2.8% in the secondary market in Q3 2023.

III. Monetary condition

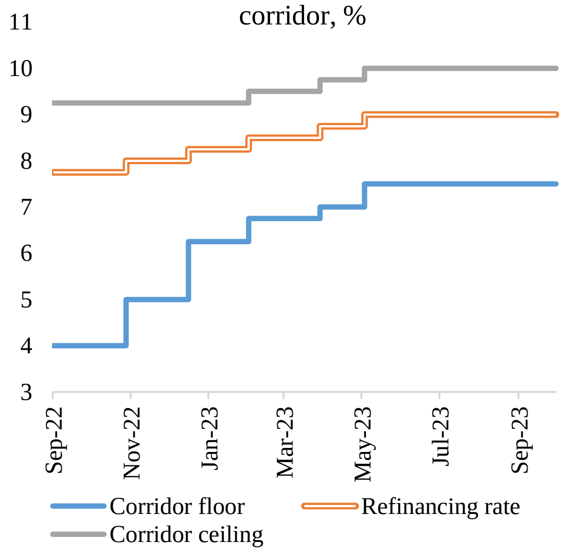
3.1. Monetary policy decisions and tools

Over 9 months of 2023 the monetary policy was oriented towards curbing inflationary pressures through the adequate monetary condition. Reforms to boost opportunities to affect inflation continued. Monetary policy tools were applied in response to the liquidity position of the banking system and the balance of risks.

In January-September 2023 decisions on the interest rate corridor parameters of the CBA were taken considering the dynamics of annual inflation, a liquidity position the banking system, updated forecasts, as well as developments in the global and national economy.

The CBA Management Board has discussed the interest rate corridor parameters six times over the reporting period – at the first three discussions the policy rate was increased from 8.25% to 9%, the ceiling of the interest rate corridor from 9.25% to 10% and the floor from 6.25% to 7.5%. The following period considering ongoing drop in actual and forecasted inflation the Bank decided to leave the interest rate corridor parameters unchanged at the last three meetings dedicated to the monetary policy. The CBA published interest rate related decisions under the pre-announced schedule with appropriate analytical comments.

Chart 34. Parameters of interest rate corridor, %

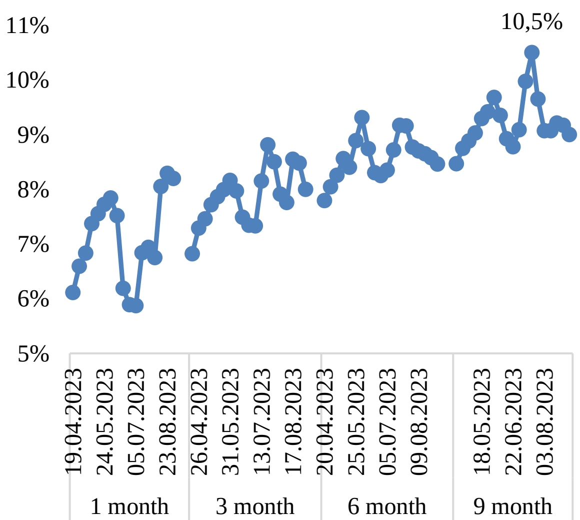


Source: CBA

The Bank continued to apply monetary policy tools within the new configuration. Demand for CBA's sterilization tools, in particular liquidity absorbing standing facilities was higher. The CBA Management Board with its decision on 03.07.2023 removed the limit imposed on CBA's liquidity absorbing standing facility (AZN35M quote) starting from 15 August to improve the monetary policy operational framework.

The CBA held total of 102 various term note auctions over the period. In general, demand exceeded supply at note auctions. As of end-September total outstanding amount of sterilization via notes was AZN1610.4M. Yield at recent auctions was 8.03% on 28-day, 8.13% on 84-day, 8.05% on 168-day, 8.46% on 252-day notes.

Chart 35. Yield on various term note auctions over 9 months 2023



Source: CBA

To boost competition in financial markets the Bank continued improving open market operations as well. Over the period to make liquidity absorbing operations more effective the Management Board of the CBA approved new Terms of Issue of notes with its relevant decisions. Moreover, the Bank conducted AZN302.5M worth 7-day (Repo and one-week note auctions) operations for liquidity absorbing purposes.

Over the past period of 2023, to effectively manage liquidity of banking system changes were made to the 'Regulations on the ratio, calculation and maintaining required reserves'. According to the changes made to the 'Regulations on the ratio, calculation and maintaining required reserves' with the decision of the CBA Management Board dated 03.07.2023, reserve requirements on banks where the amount of deposits of legal entities in the national currency exceed AZN1B and in the foreign currency AZN750M equivalent is set 10% and 12% respectively. For the banks where the amount of deposits of legal entities in the national currency falls below AZN1B and in the foreign currency AZN750M equivalent were left unchanged at 5% and 6% respectively. In addition, the ‘Regulations on the ratio, calculation and maintaining required reserves’ was tailored to the Law of the Republic of Azerbaijan ‘on the Central Bank of the Republic of Azerbaijan’ that took effect on 06.07.2023.

In general, efforts continued over the period to improve the monetary policy operational framework and served to strengthen the transmission of monetary policy decisions to inflation through the interest rate channel. As a result, over the period interbank interest rates and the one-week $AINA_{IB}$ index started to be shaped within the interest rate corridor of the CBA for the first time. Other indices are reacting to the interest rate corridor as well. Currently, the Bank regularly publishes AZIR (Azerbaijan Interbank Rate) and AINA (AINA – Azn INdex Average) indices.

In January-September 2023, banks concluded AZN26.8B worth of 2278 transactions in the platform launched for unsecured operations in the Bloomberg system. 95.5% of them were 1–3-day transactions. AZN3.5B worth of 1071 transactions were concluded at the interbank Repo market. 68% of operations in terms of number and 51% of operations in terms of volume were based upon CBA notes.

All these changes contribute to more effective management of inflation through interest rates in the medium run.

In the upcoming period of the year the CBA will adequately use its monetary policy tools depending on domestic and global developments. The Bank will further strive to contain overexpansion of aggregate demand with all tools and mechanisms at its disposal. Efforts will continue in parallel to improve the monetary policy operational framework.

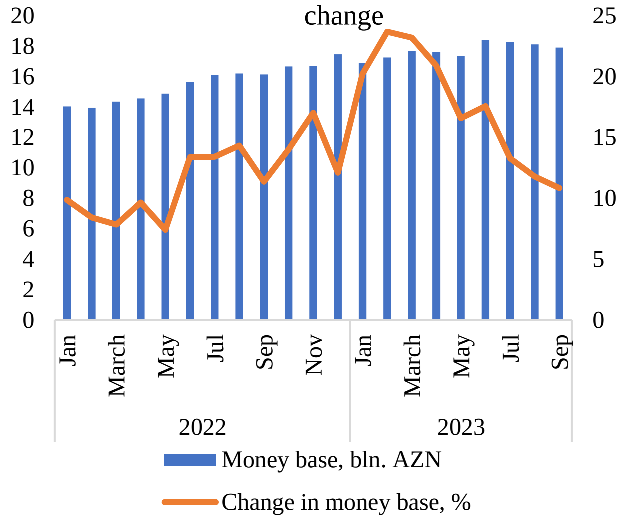
3.2. Money supply

Over 9 months of 2023, money supply was managed in response to the demand of the economy. The CBA regulated money supply swings in line with policy targets through its operations.

Base money in manat increased by 2.5% to AZN17.9B over nine months. The FX interventions by the CBA, changes in balances of the single treasury account, the CBA's liquidity absorbing standing facilities and open market operations factored in the monetary base.

Cash in circulation, a structural element of base money in manat [4] increased by 9.8%, while stock of correspondent accounts in manat decreased by 36.3%.

Chart 36. Monetary base and its annual change

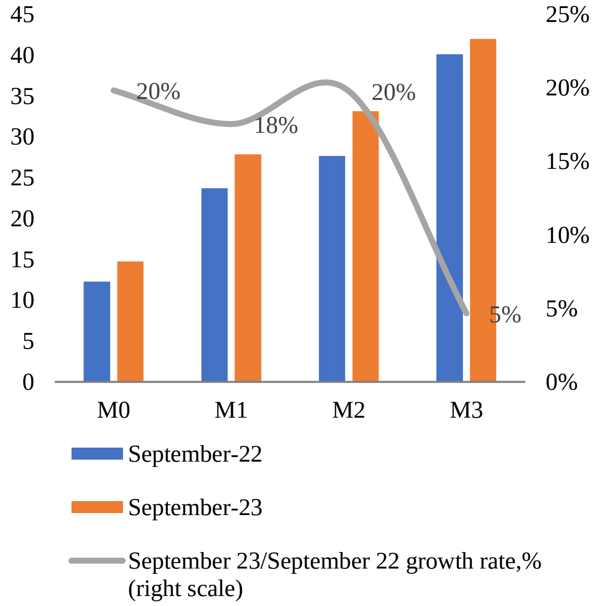


Source: CBA

Money multiplier in manat (broad money supply in manat/base money in manat) has increased by 9.5% since early year to 1.85. Broad money supply in manat (M2) increased by 12.2% to AZN33.2B.

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

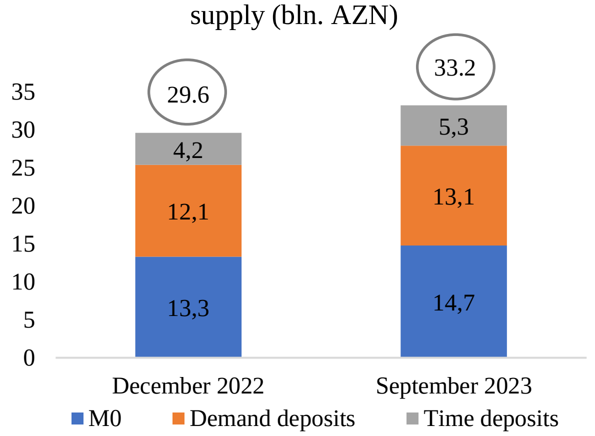
Chart 37. Money aggregates (bln. AZN)



Source: CBA

All structural elements of M2 money aggregate grew over the period. M0 cash money supply increased by 10.9%, demand savings and deposits increased by 8.9% and term savings and deposits increased by 26.2%.

Chart 38. Dynamics of broad money supply (bln. AZN)

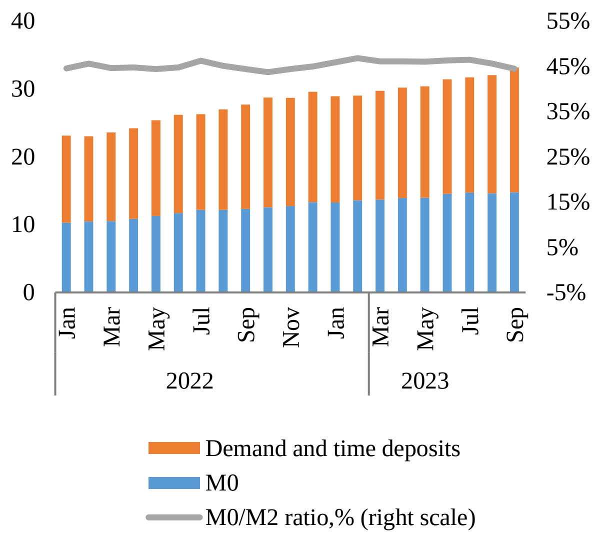


Source: CBA

Term savings and deposits increased at a higher pace both compared to earlier this year and year-over-year (y.o.y. up by 33.1%).

The weight of cash (M0) in broad money supply in manat (M2) decreased by 0.5 pp to 44.4%.

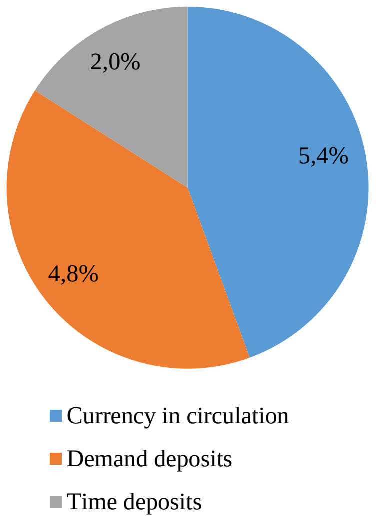
Chart 39. M0/M2 ratio (bln. AZN)



Source: CBA

Since January 2023, term and demand savings and deposits have been the primary contributors to the change in M2 money supply (55.6%), attributable to digitalization in the country.

Chart 40. Contribution to the change in monetary aggregates components ,%

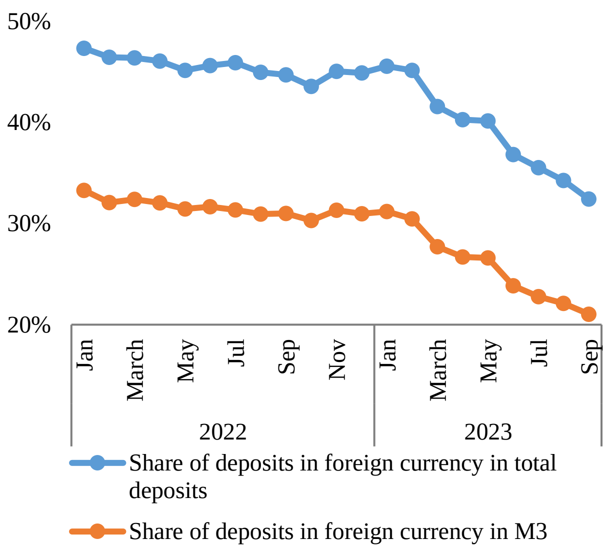


Source: CBA

Broad Money supply (M3) decreased by 1.9% to AZN42B as of end-period. Change in NFAs had a downward, while the change in NDAs had an upward effect on the change in M3.

Dollarization kept decreasing. Over nine months foreign currency denominated savings and deposits decreased by 33.3% to AZN8.8B, while their weight in total savings and deposits decreased by 12.5 pp to 32.4%. The weight of foreign currency denominated savings and deposits in M3 money aggregate has decreased by 9.9 pp since the beginning of the year to 21% to the end-period.

Chart 41. Dollarization (%)



Source: CBA

The share of foreign currency in deposits of legal entities was 41.9% as of the end-period, down by 10.8 pp compared with the early year. Dollarization of savings of individuals also has decreased 4.1 pp since the early year to 35.1%. Dollarization of deposits of households (less savings of non-resident individuals) decreased by 4.8 pp to 30.8% as of end-period.

The CBA will use tools at its disposal over the remaining period of 2023 as well to allow adequate change of money supply in response to monetary policy targets.

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

Over 9 months of 2023, the exchange rate of manat against foreign currencies was formed according to supply and demand in the FX market. The balance of payments surplus supported the exchange rate stability, which is identified as the key price stability anchor.

The size of operations decreased at both cash and cashless FX market over the period. Cashless transactions in the FX market y.o.y. decreased by 6.% to $21B equivalent[5] - 79% in the USD and 21% in other currencies. The Interbank FX market accounted for 20.1%, the Intrabank FX market for 79.9% of operations.

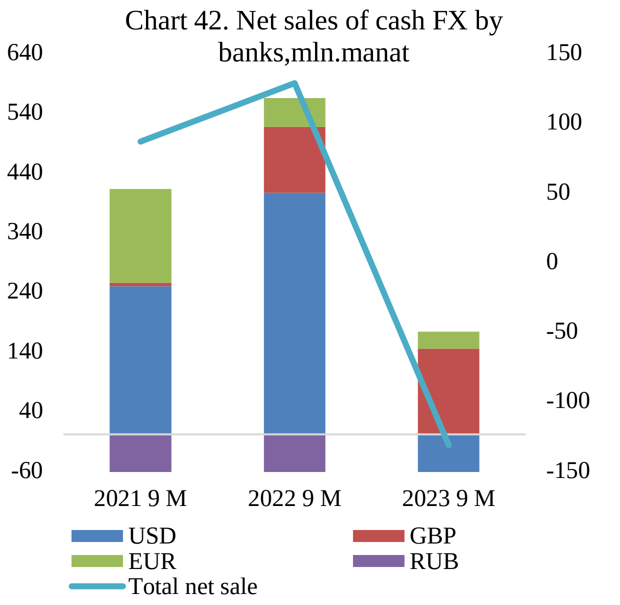
Interbank FX market operations (including operations of the SOFAZ and the CBA) amounted to $4.2B. 97.5% of transactions were conducted in the USD. Currency operations in the Interbank FX market were conducted over the Bloomberg platform.

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

Intrabank FX market operations amounted to $16.8B equivalent and 74% of transactions were made in US dollars y.o.y. Legal entities accounted for 93.6% of Intrabank FX market operations.

Cash currency traded by banks y.o.y. decreased by 29.2% to $2.8 (83.6% in USD). Cash currency purchase operations prevailed over sales for the first time in 9 months over recent years.

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



Source: CBA

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

The CBA held 71 currency auctions to sell foreign currency provided by the SOFAZ. Supply prevailed over demand at 99% of auctions. The CBA made purchase-oriented interventions to the FX market.

The official exchange rate of the manat against the USD was based upon the average exchange rate on interbank transactions (both auction and over-the counter on the Bloomberg platform). The average official USD/AZN exchange rate was AZN1.7. Buy-sell exchange rates set by banks were closely aligned with the official rate. Commercial banks' average buy/sell rates were 1.6946 and 1.7021 respectively.

The exchange rate of manat against currencies of trade partners varied over the period. Manat appreciated against the Turkish lira, the Kazakh tenge, the Russian ruble, the Japanese yen, and the Chinese yuan, depreciated against the euro, the British pound, the Swiss franc, and the Georgian lari in nominal terms.

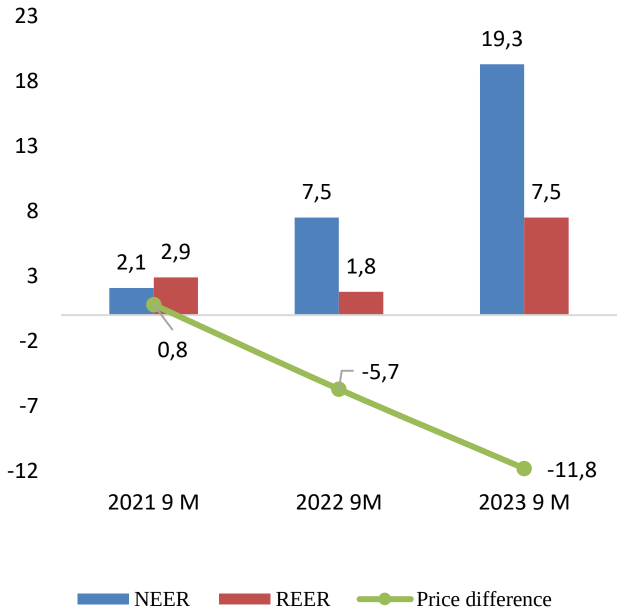
Bilateral exchange rates influenced that of multilateral exchange rates.

Table 3. Bilateral nominal and real exchange rates of manat against currencies of trade partners over 9 months 2023 (December 2022=100), %

	Nominal bilateral exchange rate	Real bilateral exchange rate
Russian ruble	147.1	142.6
Turkish lira	144.6	97.9
Euro	99	96.9
Chinese yuan	104.5	105.6
Iranian rial	100	78.2
US dollar	100	98.5
Kazakh tenge	100.1	94.5
Belarus ruble	100	97.9
Japanese yen	109.3	108.1
Georgian lari	98.4	99.8
Ukrainian hryvnia	100	98.4
Swiss franc	96.2	95.6
South Korean wan	103	100.9
British pound sterling	98	95.8
Israeli shekel	110.7	109.1
Total (NEER, REER)	**119.3**	**107.5**

In general, total trade-weighted non-oil NEER of the manat appreciated by 19.3% and the REER by 7.5%. Since inflation in Azerbaijan was lower than the average inflation in partner countries, it had a reducing effect on the REER.

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



Source: CBA

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

Charts and tables

Charts

Tables

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