THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

The key goal of the review is to express analyses and expectations of the Central Bank of the Republic of Azerbaijan (CBA) on current macroeconomic processes. Another goal of the present review, which is open to the public, is to regularly convey impacts of the policy pursued by the CBA on the economy to the public. The review is quarterly disclosed to the public.

JANUARY - JUNE 2014

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Executive Summary

In H1, 2014 the Central Bank of Azerbaijan pursued its policy amid ongoing global economic growth, growth-prone interest rates in advanced economies, changes in the geography of capital flows, strengthened macroeconomic sustainability and diversification.

The country economy continued to develop dynamically on the backdrop of new challenges for global economic growth. The non-oil economy was the main driver for economic growth. In the environment of high oil prices in the world market the balance of payments of the country was in surplus, and strategic foreign exchange reserves kept growing. Economic diversification and the creation of employment accelerated.

In H1, 2014 the CBA implemented an adequate policy, keeping an eye on factors affecting macro-economic and financial stability. Thus, the CBA directed its activity to aims as low-level inflation, the stable exchange rate of Manat – a significant anchor for macro-financial stability, and maintenance of stability of the banking-financial system, and promoted the development of financial intermediation. The stable exchange rate of Manat was the key factor in maintaining a single-digit level of inflation (average annual inflation was as little as 1.6%).

I. Global economic processes and the national economy

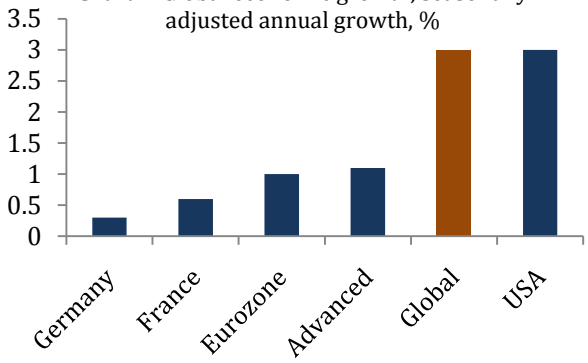
1.1. *Global economic trends*

While the global economic growth rate was below expectations in Q1, 2014, it increased due primarily to economic revival in the U.S. and China from the Q2. However, as a result of the weak economic activity in the first quarter international organizations revised down growth forecasts for the current year. Necessary measures taken to ensure macroeconomic stability in advanced economies led to an improvement in the global risk balance. Nevertheless, further geopolitical tensions may increase several risks.

In H1, 2014 global economic growth remained fragile and continued at uneven rates. A relatively high economic activity in the world economy is mainly attributable to a gradual increase in employment, the elevated consumer confidence index, and a positive impact of accommodative monetary policy on domestic demand in the light of growth friendly fiscal consolidation in DDCs, and an increase in external demand in DGCs.

Initial estimates suggest that the global economy grew by 3% in H1, 2014 (JP Morgan). Advanced economies made further contribution to the global economic growth. Early warning indicators of the OECD display that economic growth has accelerated in major DDCs, and fallen behind the sustainable level in DGCs over the last period.

Chart 1. Global economic growth, seasonally adjusted annual growth, %



Source: JPMorgan

Slack economic growth in DGCs is linked to tight funding terms, closeness of the economic activity to its potential level, and lower prices for some commodities. According to the WB estimates the contribution of DGCs to the global economic growth is likely

to reach 50% in 2015, with an increase of 10% relative to 2013.

The key growth impulses come from the U.S. While harsh winter weather conditions decreased export potential in the U.S., thereby resulting in economic recession for the first time over the last three years, retail sales and manufacturing have seen revival from the second quarter. Positive trends in the U.S. economy is attributable primarily to accommodative fiscal consolidation, improved employment indicators and confidence indexes, and revival of domestic demand in light of favorable financial conditions. In the environment of enhanced economic perspectives the Federal Reserve System reduced monthly purchase of state securities for the next time by USD 10 bn. and set USD 35 bn. norm.

In Japan the unsynchronized economic activity continued due to the application of the Abenomics concept. Expectations of an increase of the VAT from 5% to 8% from Q2, 2014 caused the revival of the consumer demand and higher than forecast economic growth in Japan in Q1. Thus, expectations of an increase in prices because of high taxes encouraged customers to buy more goods and services. As a result, retail sales and manufacturing dropped in Q2.

The first phase of the revival process in the euro area continues at fragile and uneven paces. While consumption and investment expenditures in peripheries were lower over the reporting period compared to the pre-crisis period, revival of private demand in leading economies was the key factor in the economic activity.

Box 1. Countercyclical Fiscal Rules for Oil-Exporting Countries

Analyses suggest that countercyclical budget policy is the most successful fiscal policy regime to ensure macroeconomic stability in oil exporting countries. This fiscal policy rule is best suited to adjust the impact of oil price volatility on tax revenues and overall budget expenditures. By applying the fiscal policy rule, budget revenues increase (decrease) and expenditures are balanced on the backdrop of high (low) oil prices or economic activity. Additionally, the significant share of oil products in the consumer basket requires making choices between aggregate output and inflation in the face of sharp price changes. In other words, an aggressive anti-inflation policy might cause recession in the non-oil sector.

According to researches by Barnett and Ossowski (2003), policy recommendations surrounding commodity price uncertainty and volatility in oil-exporting countries have focused on reducing pro-cyclicality by establishing sovereign wealth funds and targeting the non-oil fiscal balance. Bi and Kumhof (2011) show that welfare gains from optimizing the fiscal rule are larger than those from the monetary policy in commodity-exporting economies. Economists often recommend responding counter cyclically to external demand due to the larger positive impact on the non-oil economy. Another point is that most of the oil rents accrue to the government in countries involved in the research, which in turn enables the government to further stimulate the economy and supports macroeconomic stability.

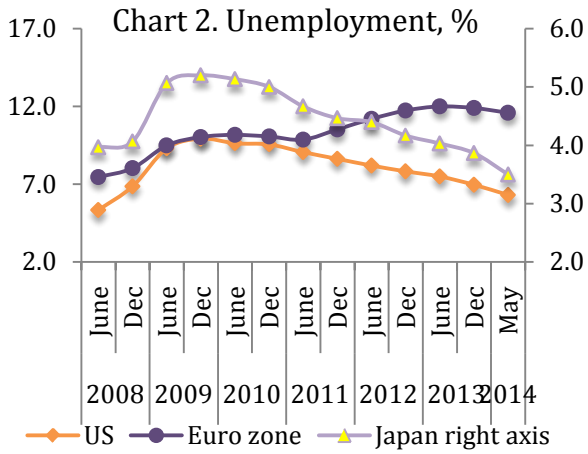
Coletti and others (2012) find that it is difficult for a small open economy to address the contradiction between inflation and economic growth due to external oil-price shocks. Monetary policy is not effective in this case; in contrast, the use of fiscal policy can remove volatility and overheating through various policy instruments and different fiscal multipliers. Kumhof and Laxton (2009) find that a more open economy with diversified exports in the face of oil shocks would have a larger gain (GDP growth) from the countercyclical budget policy rule.

Source: Stephen Snudden "Cyclical Fiscal Rules for Oil-Exporting Countries", IMF, WP, 2013

While economic growth trends relatively slackened in China in Q1, 2014 due to seasonal factors (Chinese New year and unfavorable weather conditions in North America, and particularly in the U.S.), those trends strengthened owing to fiscal and monetary stimuli and increased external demand from Q2. Over the reporting period China continued structural reforms to ensure well-balanced and sustainable economic growth.

Over the first half of 2014, low unemployment supported positive trends in the global economy. While labor markets in advanced economies posted growth, unemployment still remains high. Thus, the level of unemployment in the U.S. decreased 0.6% against the early year and made 6.1%, and in Japan and the euro area decreased 0.2% and amounted to 3.5% and 11.5% respectively.

Note that, notwithstanding the slackened economic activity more than half million jobs were created in the U.S. over the first quarter of the current year. Overall, 2.6 million new jobs are expected to be opened in 2014, the highest number over the last 15 years.

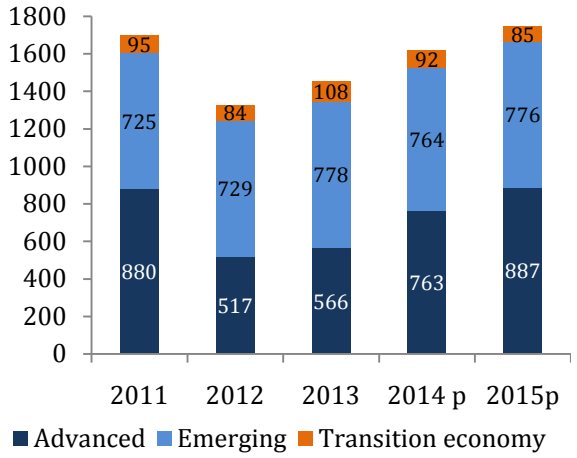


Source: OECD

The slackened economic activity and increased risk of bankruptcy in the shadow banking system, devaluation of Argentine peso, and heightened geopolitical tensions in February, 2014 resulted in a decline in capital inflows to DGCs. However, capital inflows to DGCs were restored from March, 2014 and constituted USD 54 billion. This can be attributed to investors' high interest in DGCs to earn higher income. Note that the ECB's decision to cut interest rates to prevent deflation risk, and accelerate

revival was among the key factors in channeling capital flows to DGCs.

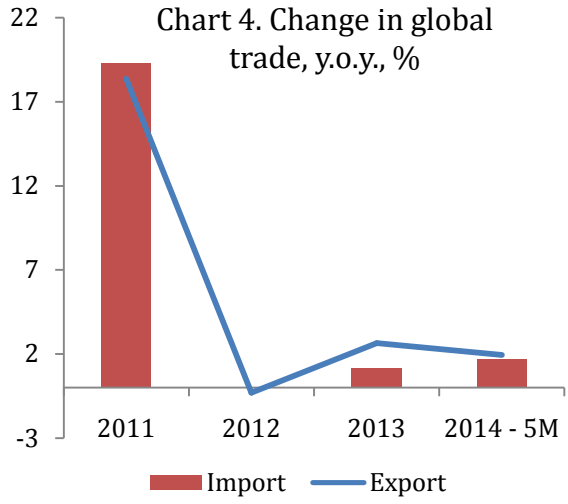
Chart 3. Global FDI flows, USD bln.



Source: UNCTAD

Over 5 months of 2014 the volume of global trade remained almost unchanged. Between January and May the scale of trade remained unchanged in China relative to the previous year, while it increased 3% y.o.y. in the U.S. and decreased 3% and 1% y.o.y. in Japan and the EU respectively. Note that unfavorable weather conditions in China and the U.S. also had a negative impact on growth of global trade at the beginning of the current year.

Chart 4. Change in global trade, y.o.y., %



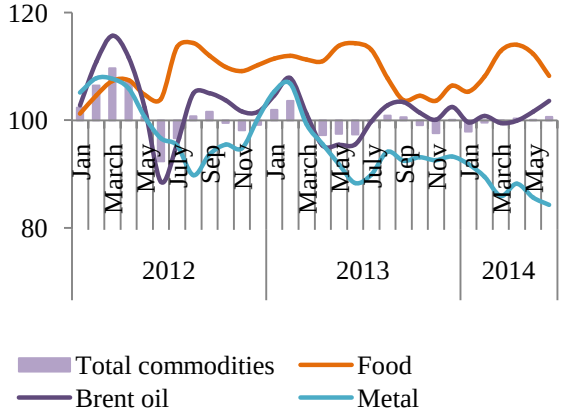
Source: WTO

Growth of global trade has lagged behind overall global growth over recent years. Thus, whilst the ratio of global trade growth to global economic growth was 1.8 between 1981 and 2007, it constituted 1.1 between 2011 and 2013. This is due to the fact that the role of factors contributing to trade growth (a decrease in transportation expenses and prices of trade products, liberalization of international trade) between 1981 and 2007 weakened in later years.

Amid the current global economic conjuncture global commodity prices were volatile, with a drop in metal prices and rise in oil and

food prices. Thus, in H1, 2014 metal prices went down 9.6% due to lower demand in China, and the food price index rose 1.7% due to unfavorable weather conditions. Over the period the price for Brent oil averaged USD 109, with a 5.8% y.o.y. increase. Notwithstanding high supply of alternative and traditional energy carriers, and wider use of green technologies oil prices remained at high levels. The price for gold increased 8.8% and made USD 1316 (per ounce) over the quarter.

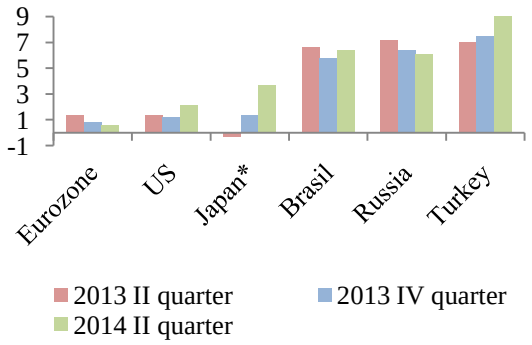
Chart 5. Commodity price index (2011 dec=100)



Source: IMF

While the global inflation has risen under the impact of energy and food prices from the second quarter of the current year, it remained below its sustainable level due to negatively zoned output gap. Deflation trends pose hazards for economic growth in DDCs, particularly in the euro area. Thus, under deflation conditions people limit their consumption, waiting for further decrease in prices, which ultimately results in excess commodity. Japan has finally ended the long-term deflation era as a result of the Abenomics policy. Note that 3.7% annual inflation in Japan is considered to be the highest indicator for the last 32 years. Inflation rates varied in DGCs relative to the early year, while were prone to decrease in Russia and, prone to increase in Turkey and Brazil.

Chart 6. Annual inflation, %

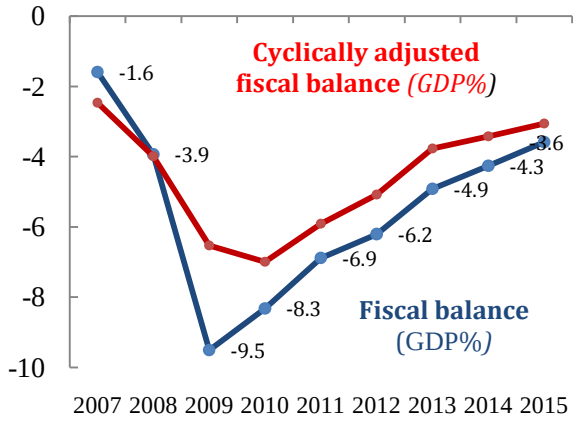


** Figure for May, 2014* Source: IMF

Amid low inflation central banks of advanced economies have

continued accommodative monetary policies. The Federal Reserve carried out gradual monetary tightening, reducing monthly purchase of government securities, but left the refinancing rate unchanged. The ECB reduced the deposit rate to a negative level (-0.1) as an unconventional policy measure. Implemented fiscal consolidation measures have already yielded. The state budget deficit in DDCs, which accounted for 9.5% of GDP in 2009, is likely to be 4.3% in 2014.

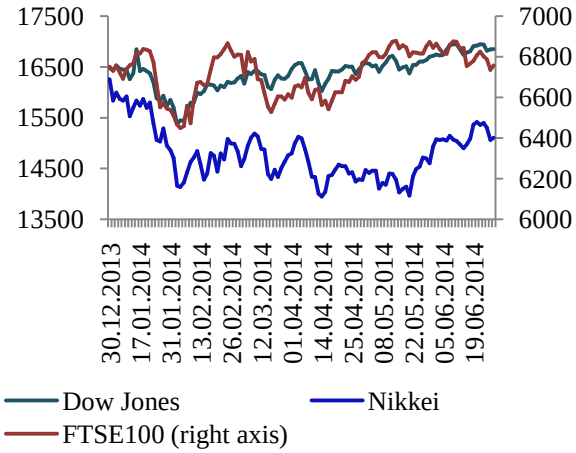
Chart 7. Fiscal balance in DDCs
(share of deficit in GDP, %)



Source: IMF

Global economic dynamics has also affected financial markets. The activity continuously increased in financial markets of the U.S. and were volatile in Europe and Japan from the early year, with drops in Q2. Over the reporting period, the Dow Jones index rose 2.3%, the FTSE 100 0.1%, while the Nikkei dropped 7.1%.

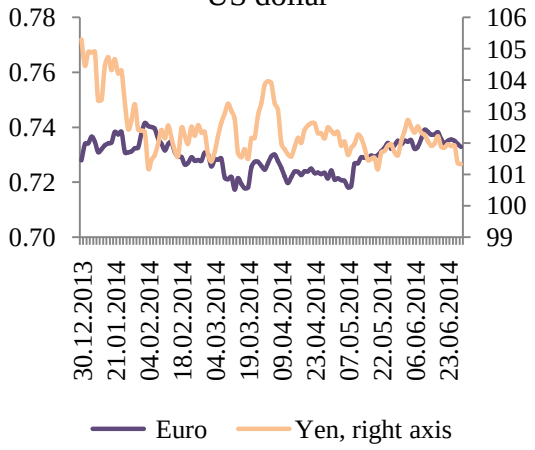
Chart 8. Global financial indices



Source: Bloomberg

In H1, 2014 currencies of certain advanced economies remained volatile. Over the period the pound sterling appreciated 3.2%, and the Japanese yen 3.8% against the US dollar, while the euro and Chinese Yuan depreciated 0.7% and 2.3% respectively. A depreciation of the euro can be attributed to the ECB's unconventional monetary policy.

Chart 9. Exchange rates against US dollar



Source: Reuters

Table 1. Corrections to the global growth projections for 2014 by IMF

	April release, , %	July release, , %	Difference p.p.
World	**3.7**	**3.4**	**-0.3**
DDCs	**2.2**	**1.8**	**-0.4**
USA	2.8	1.7	-1.1
Euro zone	1.2	1.1	0.0
Japan	1.3	1.6	0.3
DGCs	**4.8**	**4.6**	**-0.2**
China	7.6	7.4	-0.2
CIS	1.9	0.9	-1.0
Brazil	1.9	1.3	-0.6

Source: IMF

In the light of the global economic processes in H1, 2014, the IMF, in its Global Economic Outlook release, revised down growth predictions for the current year. Main risks in DDCs are related to stagnation, debt burden and the risk of deflation in the euro area, while in DGCs to geopolitical tensions, worsened financing conditions and capital flows.

Given the existing risks, international organizations recommend that DDCs maintain accommodative monetary policies, continue growth friendly fiscal consolidation and conduct structural reforms. DGCs are recommended to effectively regulate capital flows, keep an eye on the dynamics of asset prices, and conduct countercyclical monetary and fiscal policies.

1.2. Macroeconomic processes in Azerbaijan

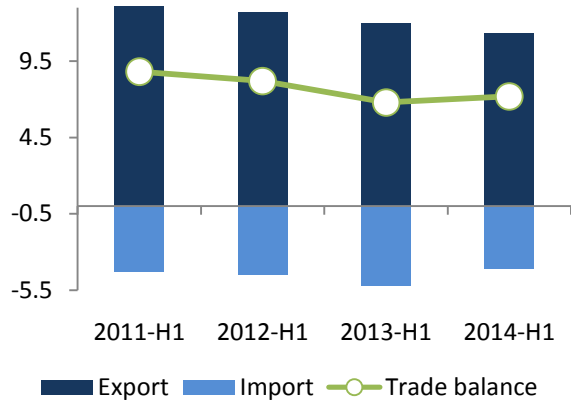
In H1, 2014 the country economy continued to grow on the backdrop of a favorable foreign position. In January – June overall economic growth was driven by high growth of the non-oil economy.

1.2.1. External sector

In H1, 2014 the country's foreign trade balance was in surplus and foreign exchange reserves kept growing.

According to the State Customs Committee (SCC), in H1, 2014 the foreign trade turnover constituted USD 15.4 billion, of which USD 11.3 billion falls to the share of export and USD 4.1 billion to import. Over the period net export was USD 7.1 billion, while export exceeded import by 3 times.

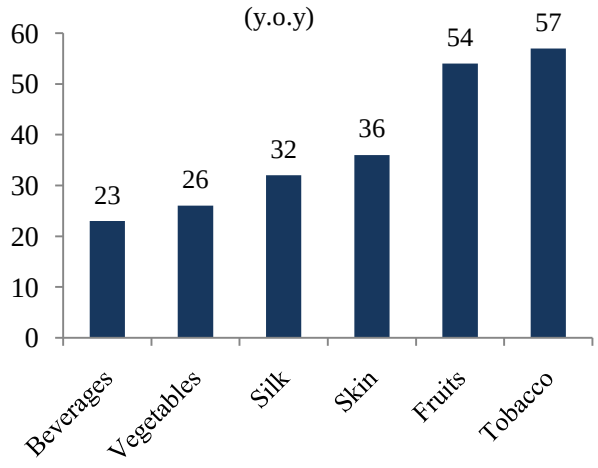
Chart 10. Trade balance, USD bn.



Source: SCC

52.2% of export was channeled to the EU countries, 3.8% to the CIS. 31% of import falls to the share of the EU, 24% to the CIS. The sectors of export with high growth rates include fruits and vegetables, beverages, tobacco, leather, silk, glass, cement etc.

Chart 11. Change in main export commodities, H1 2014, % (y.o.y)



Source: SSC

Box 2. Non-Price Competitiveness of Exports: *Experience of DGCs*

DGCs account for an ever-increasing share of world trade. Thus, the share of DGCs in total world exports was just 32% in 1996, but 49% in 2011. Over the period 1996-2011, annual real export growth in DGCs averaged 8.2%, which was among the key contributors to growth. However, the said export growth cannot be attributed only to price factors. Studies suggest that non-price factors played a greater role in growth of economies of DDCs.

ECB experts have conducted researches on the above issue covering the nine largest emerging economies (Argentina, Brazil, Chile, China, India, Indonesia, Mexico, Russia and Turkey) over the period 1996-2011.

Primarily, REER dynamics in DGCs has been reviewed to assess the role of the price factors in growth of competitiveness. The evidence suggests that, apart from Argentina, most of the DGCs experienced growth in the REER over the period 1996-2011, which, in turn, demonstrates that the traditional REER indicator cannot explain the performance of DGCs and we should add other indicators to analyses.

An adjusted relative export price index has been proposed in the analysis in order to assess foreign performance of a country. The key advantage of the index is that it takes into account non-price factors (quality, taste and variety), besides price factors, in calculations.

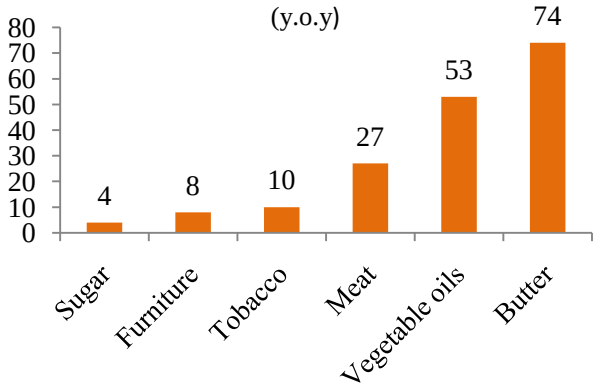
Findings of empirical assessment conducted through the adjusted relative export price index suggest that when considering solely price factors competitiveness in most DGCs has declined over the last 15 years, but increased when taking into account non-price factors. This was the case particularly for the Chinese economy. Thus, the adjusted relative export price index for China has declined 40% since 2000, due primarily to quality improvement and other non-price factors. Consequently, China became the world's largest exporter in 2009.

Thus, analyses show that growth in the share of DGCs in total world exports can be primarily explained by non-price factors.

Source: Konstantins Benkovskis and Julia Wörz., Non-Price Competitiveness of Exports from Emerging Countries. European Central Bank,. Working Paper Series.,November 2013

Import of meat, vegetable oils, butter, sugar, tobacco, furniture and others increased.

Chart 12. Change in main import commodities, H1 2014, % (y.o.y)

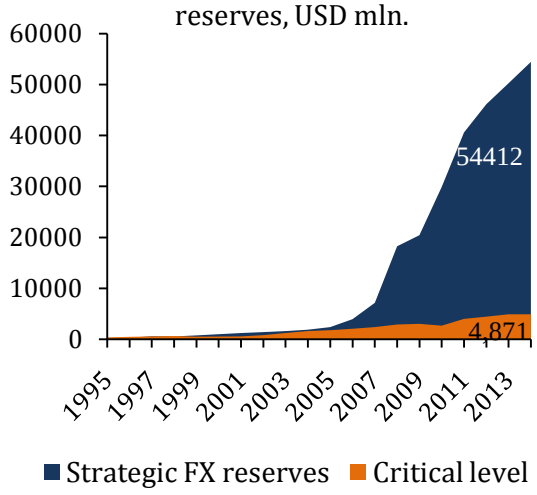


Source: SSC

The country maintains high activity of foreign investors. According to the SSC, the scale of foreign investments to the country economy exceeded USD 2.8 billion in January – June 2014, which takes 30% of total investments.

The dynamics of FX reserves reflects positive processes in the external sector. As seen from the below Chart, in H1, 2014 country's FX reserves rose USD 4.2 billion or 8.3% and reached USD 54.4 billion. CBA's FX reserves grew by 7% to USD 15.2 billion.

Chart 12. Sufficiency of strategic FX reserves, USD mln.



**Critical threshold – three-month import of goods and services.*

Source: CBA

Strategic FX reserves of the country are sufficient for about three-year import of goods and services.

1.2.2. Aggregate demand

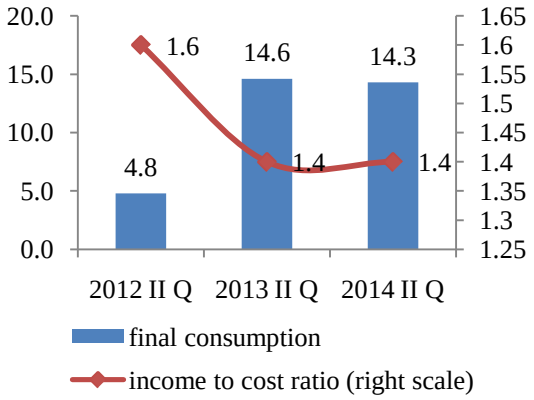
In H1, 2014 growth of income of the population and investments in the economy, and favorable foreign position manifested themselves in demand components of GDP.

Final consumption expenditure. In H1, 2014 a y.o.y. increase in money income of the population was 4.7% in nominal terms and 3.1% in real terms. Per capita nominal money income of the population increased 3.3% and real money income 1.7%. In January – May, 2014 average salary in the country rose 4.9% in real terms and made AZN 488.

In H1, 2014 total consumer activity was high owing to an increase in real income. Y.o.y increase in consumption expenditures made up 14.3% (14.6% - H1, 2013).

Y.o.y increase in disposable income of the population was 5% and made up AZN 16.1 billion. The income to expenses coverage ratio of the population remained at the level of previous H1 (1.4).

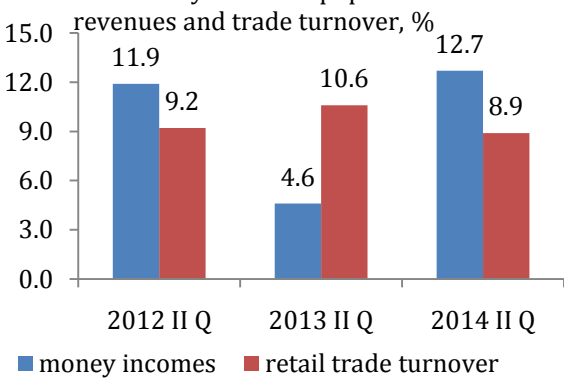
Chart 14. Final consumption, in %



Source: SSC

In January-June 2014 the scale of goods and services sold in the consumer market to meet consumer demands increased 8.6% y.o.y. Y.o.y. increase in retail trade turnover was 8.9%, including 9% on the private sector.

Chart 15. Dynamics of population revenues and trade turnover, %



Source: SSC

In H1, 2014 y.o.y. rise in retail trade turnover on food was 2.8%

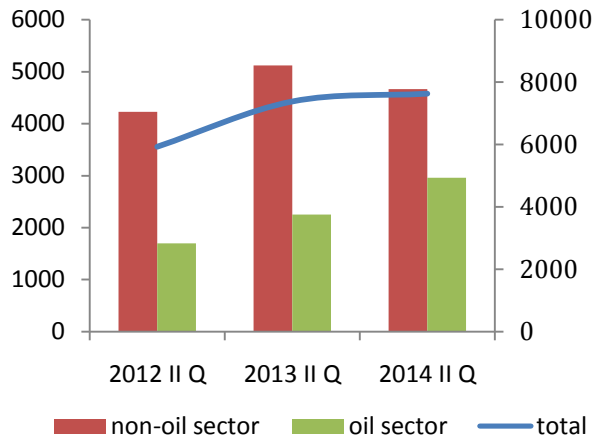
(2.7% in H1, 2013) and 15.5% on non-food products (20.2% in H1, 2013). Off-free services to the population grew by 6.9%, including 8.5% on non-state ownership. The share of the private sector in off-free services to the population was 77%.

The next *"Financial behavior, intentions and inflation expectations of households"* survey conducted among 4250 households (families) in June 2014 suggests that the Consumer Confidence Index (CCI) is at a level (25), considered high enough in international practice and in a positive zone.

Government expenditures: Government's consumption expenditures mainly sourced from expenses on goods and services from the state budget over the reporting period. 11.4% of budget expenditures or AZN 837.3 million was channeled to social expenditures which exceeds the previous year level by AZN 71.2 million or 9.3%.

Investment expenditures. In H1, 2014 total investments to the economy increased by 3.4% and made AZN 7.6 billion, equal to 26.5% of GDP. Investments to the non-oil sector made AZN 4663.9 million. The share of investments to the non-oil sector in total investments was 61.2%.

Chart 16. Investments, mln.manat



Source: SSC

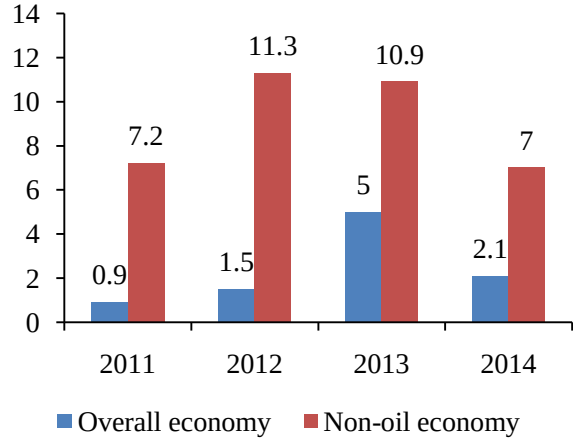
70.7% of funds channeled to capital stock stemmed from domestic sources, out of which 66% relates to public sector, 34% to non-public sector. 29.3% of funds channeled to capital stock stemmed from foreign sources. 55.6% of investments sourced from businesses and organizations, 35.6 % from budget.

1.2.3. Aggregate supply and employment

In H1, 2014 the economy grew at a rate of 2.1%. A 7% increase in the non-oil economy was the key contributor to the overall economic growth. Overall, the two third of the value added falls to the share of production and the one third to services.

1.2.3.1. Economic growth. GDP growth was primarily driven by the non-oil sector over the period. Thus, 56.3% of GDP fell to the share of the non-oil sector.

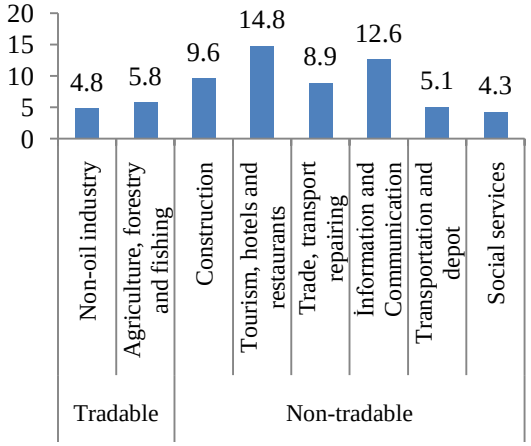
Chart 17. January-June, economic growth, %



Source: SSC

As seen from Chart, in January – June all segments of the non-oil sector posted growth. The highest growth rate among the segments was in tourism, hotels and restaurants, information and communication, as well as construction. Roughly 2.2 p.p. of 7% growth in the non-oil economy stemmed from construction.

Chart 18. Growth of economy by sectors, %



Source: SSC

Excluding the oil industry, the tradable sector grew by 5.3%. The non-tradable sector increased by 7.6%.

Surveys conducted by the CBA demonstrate a high economic activity in the country. The CBA's Real Sector Monitoring (RSM) results suggest that the Business Confidence Index remained positive in H1 2014.

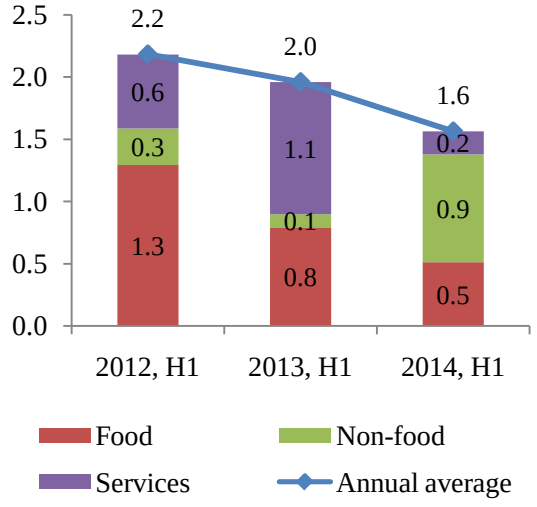
1.2.3.2. Employment. As of the end of the reporting period, economically active population of the country was numbering 4793.8 thousand persons, of which 95.1% was engaged in various segments of the economy and the social sector. According to the SSC, as of the end- May the number of hired labor was 1510.8 thousand persons, y.o.y. increase being 2.1%. 97.6% of hired workers was engaged in the non-oil sector, while 2.4% in the oil sector.

1.2.4. Inflation

In H1, 2014 prices remained stable and inflation was maintained at low levels. Lower than in trade partners growth rate of prices had a positive impact on the competitiveness of the economy.

1.2.4.1. Consumer Price Index (CPI). In H1, 2014 average annual inflation decreased 0.4 p.p. against the relevant period of the previous year and amounted to 1.6%. Components of the CPI – food prices changed 1.2%, non-food prices 3.6%, while services changed 0.3% in January – June.

Chart 19. Average annual inflation, %



Source: CBA estimations based upon SSC data

Estimates suggest that 0.5 p.p. of 1.6% average annual inflation relates to rise in food products, 0.9 p.p. in non-food products and 0.2 p.p. in services.

The average annual core price index, which is inflation adjusted from swings in prices for commodities regulated by the government and seasonal factors increased by 1.8% in January – June.

Note that in H1, 2014 transportation and postal tariff indices decreased by 5% on average annual, including cargo and communication tariffs by 6.6%, and by 8.4% respectively; postal and courier tariffs

increased by as little as 0.4%. In January-May 2014 import prices rose 0.6%. Prices of imported consumer goods increased 1.2%.

In H1, 2014 inflation in foreign trade partner DDCs was 1.3%, in DGCs 8%, in oil- exporting countries 8.1%. In total, average inflation in trade partners was 5.2%, which exceeds the average annual inflation in Azerbaijan 3.6 p.p. According to IMF projections Azerbaijan is likely to experience the lowest inflation among CIS countries in the current year.

1.2.4.2. Industrial Producer Price Index (IPPI): In H1, 2014 the IPPI increased 3.8%, due to a 16% price upswing in the processing industry. Price upswings in processing is attributed to 29.4% price rise in oil products, 14.4% in textile products, 14.2% in tobacco, and 9.5% in rubber and plastic products. In parallel, the IPPI declined on certain industrial products. Prices went down 2.6% on food products, 4.3% on metallurgy, and 6.6% on installation and repair of machinery and equipment.

1.2.4.3. Agricultural Producer Price Index (APPI): Over the first 6 months of the current year prices for agricultural products grew 1.1%. Prices for livestock products went up (4.3 %%). Prices dropped 1% on annual plants and 6.2% on perennials.

Note that in H1, 2014 slight price swings of agricultural products pooled to overall price stability.

II. Monetary and exchange rate policy

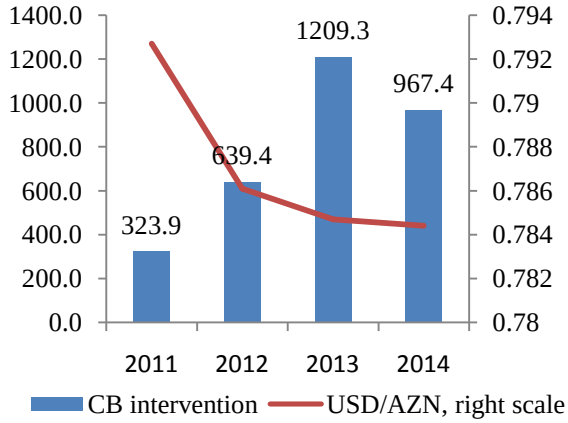
2.1. The FX market and the exchange rate of Manat

In H1, 2014 parameters of the exchange rate policy was determined taking into account the position of balance of payments, and objectives of safeguarding financial stability in the banking sector and competitiveness of the non-oil sector.

Over the reporting period the CBA pursued its exchange rate policy within targeting the bilateral USD/AZN exchange rate.

Amid balance of payments surplus in the country supply prevailed over demand in the FX market. The CBA sterilized USD 967 million worth currency to prevent strengthening of the exchange rate over the first half of the current year.

Chart 20. CBA's intervention, mln. $



Source: CBA

Consequently, the exchange rate of Manat against the US dollar strengthened as little as 0.03%.

Dynamics of the nominal bilateral exchange rate of Manat influenced real bilateral exchange rates. The Manat strengthened both in nominal and real terms against the national currencies of Ukraine, Georgia, Kazakhstan, China and Switzerland, and depreciated against the currencies of the Euro zone, USA, Turkey, Russia, Iran, Japan, Israel, Belarus and S. Korea in real terms.

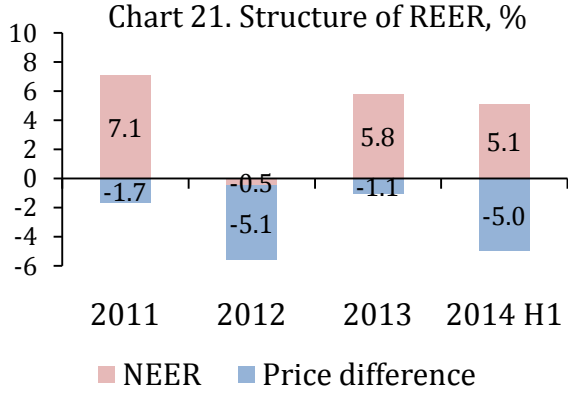
Table 2 . Bilateral nominal and real exchange rate indices of Manat in H1, 2014, %

	Compared to December 2013	
	Nominal bilateral exchange rate index*	Real bilateral exchange rate index*
US	100	97.3
Euro area	100.7	98.9
Great Britain	96.8	95.0
Turkey	102.7	95.9
Russia	104.7	98.5
Ukraine	143.7	127.1
Georgia	103.2	101.9
Iran	103.3	96.2
Kazakhstan	119.1	112.1
Japan	98.5	94.3
Israel	98.6	97.2
China	102.6	100.5
Belarus	107.6	96.3
S. Korea	96.4	94.0
Switzerland	100.1	101.1

In H1, 2014 the NEER on the non-oil sector (on gross trade turnover) appreciated 5.1%. According to model estimations[1] 1% strengthening of the NEER decreases consumer prices by 0.28 p.p.

Inflation differences had a downward impact on the REER. As a result, the REER on the non-oil sector strengthened as little as 0.1% over the period.

Chart 21. Structure of REER, %



Source: CBA

[1]Calculations are based on the result of the VAR (Vector Autoregressive) model.

Box 3. Real Exchange Rate Appreciation in Emerging Markets: Can Fiscal Policy Help?

Exchange Rate is among the most frequently addressed issues in economic analyses and these analyses, in most cases, cover exchange rate determinants. However, the relationship between the exchange rate and fiscal variables has not been sufficiently studied.

DGCs, particularly China, oil exporters, and Latin American countries have seen real exchange rate appreciation in recent years. Several factors explain these trends including improvement in trade conditions and capital inflows. The question of how policies can help manage large capital inflows to prevent sharp appreciation in the exchange rate is being investigated. The overall conclusion is that, effective management of capital flows is primarily dependent on domestic macroeconomic environment of a country.

IMF experts have assessed empirically to what extent fiscal policy can help prevent exchange rate appreciation pressures. The assessment covers a panel of 28 DGCs for the period 1983 to 2011. In the set model GDP per capita, balance of goods and services, structural balance[1], public consumption, public investment are defined as key variables, and real effective exchange rate as dependent variable. The empirical assessment suggests that the fiscal policy has a significant impact on the real exchange rate. Thus, over the long term:

- *A 1 p.p. increase in public investment results in a depreciation in the REER by 12.6%;*
- *A 1 p.p. increase in structural balance results in a depreciation in the REER by 1.7%;*
- *A 1% increase in GDP per capita results in an appreciation in the REER by 13.9%;*
- *Balance of goods and services is weakly associated with public consumption.*

***Source: Marialuz Moreno Badia and Alex Segura-Ubierg.* Real Exchange Rate Appreciation in Emerging Markets: Can Fiscal Policy Help? IMF Working Paper. January 2014.**

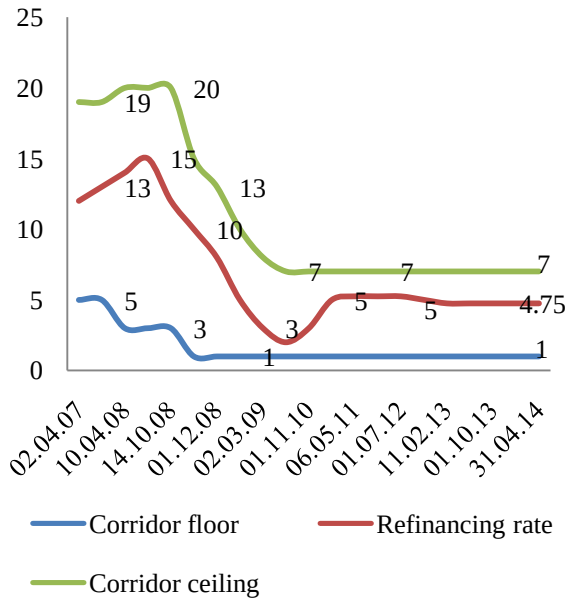
2.2. Monetary policy tools

In H1, 2014 the Bank applied its monetary policy tools considering growth dynamics of the economy, inflation expectations and characteristics of transmission of the monetary policy to aggregate demand and prices.

Amid low inflation the Central Bank used stabilizing and encouraging possibilities of the monetary policy in response to the economic cycle in H1, 2014.

Given the low level of inflation, aggregate demand factors affecting economic growth, and growth rates of money supply, the CBA Management Board decided to reduce the refinancing rate from 4.75% to 4.25%, the corridor ceiling from 7% to 6%, and the corridor floor from 1% to 0.5% from 1 May 2014 to pave the way for further investment activities in the non-oil sector and steady decline in interest rates, and to provide necessary support to economic growth.

Chart 22. Parameters of interest rate corridor, %

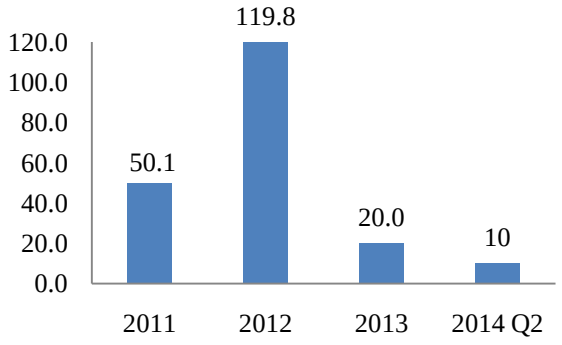


Source: CBA

Open market operations and reserve requirements were regularly used to adjust growth rates of money supply and the liquidity level in the banking system.

In H1, 2014 transactions through notes were conducted within sterilization operations and the size of notes in circulation was AZN 10 million as of the end of the reporting period.

Chart 23: CBA notes, mln. AZN



Source: CBA

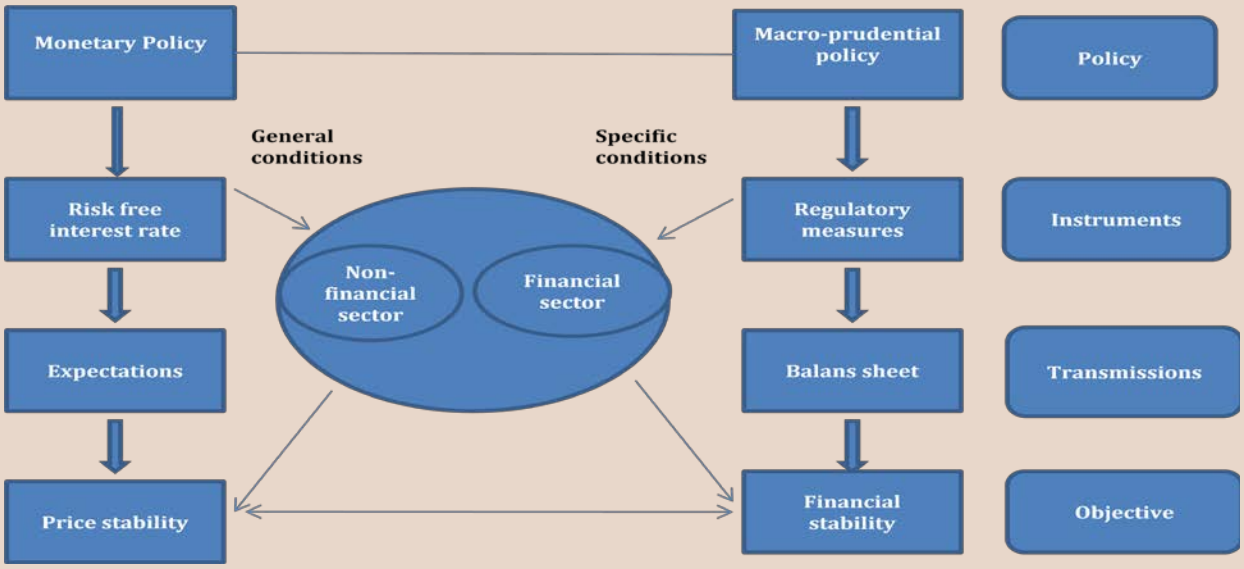
Average return on notes at the latest auction was 0.99%, and at the early-year 1.07%.

Box 4. Financial stability and monetary policy: How closely interlinked?

The 2007-2008 financial crisis and its long-lasting effects have changed the macro-economic policy framework. The crisis showed that ensuring the soundness and safety of individual financial institutions is not enough to guarantee the stability of the whole financial system and that there is a need to reconsider the monetary policy framework targeting price stability. The greatest change caused by the crisis is the establishment of an effective and reliable macro-prudential policy framework that can ensure financial stability.

There are controversial opinions on whether to add financial stability objectives to the monetary policy framework. In line with these opinions, various views and their conceptual framework have been shown.

Figure 1. Interaction mechanism between monetary and macro-prudential policies



View 1: modified Jackson Hole consensus. The first view argues that monetary authorities should keep their mandate of price stability, whereas macro prudential authorities should pursue financial stability, with each having their own instruments. The instruments and the transmission mechanisms of monetary and macro-prudential policy differ from each other and the interaction between monetary policy and macroprudential instruments is limited.

View 2: leaning against the wind vindicated. The second view argues that the monetary policy may affect risks by the financial intermediation sector. In this view, financial stability concerns should be part of the secondary objectives in the monetary policy strategy. The inclusion of financial stability concerns in monetary policy objectives naturally leads to a lengthening of the policy horizon of the monetary authorities.

View 3: financial stability is price stability. The third view proposes a more radical change in the objectives of monetary policy. It argues that financial stability and price stability are so intimately intertwined that it is impossible to make a distinction. Under this view, the key objectives of both standard and non-standard monetary policies are to stabilize the financial system, ensure the proper functioning of financial markets and overcome obstacles in the monetary transmission process.

Because of threats of financial dominance, the coordination of monetary policy with financial stability policy is crucial. Each of the above views stresses the importance of coordination between financial stability and monetary policy to ensure price stability. However, the level of interaction varies for each view: i) if the interaction is very intense, there will be one institution (the central bank), pursuing both objectives with the full set of instruments and there will be a larger role for coordination. ii) if macroprudential tools are ineffective in managing the financial cycle, it will be more appropriate for monetary policy instruments to also pursue a financial stability objective. iii) if monetary policy aimed at ensuring price-stability is itself a source of growing imbalances, it will be appropriate to take the financial stability implications of monetary policy into account.

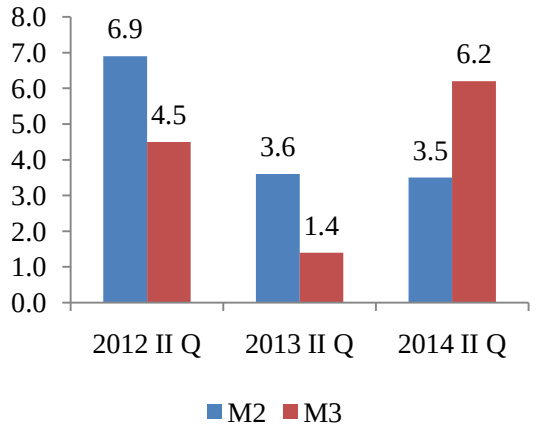
Source: Frank Smets " Financial stability and monetary policy: How closely interlinked?", Svergies Riksbank, "Economic review 2013:3

2.3. Money supply

Over the past period of 2014 broad money supply kept pace with the demand of the economy and inflation, the structure of which continued to improve.

Broad money supply in Manat (M2) rose 3.5% over the half-year, while it grew y.o.y. 18.9% and reached AZN 17005.1 million. The money multiplier of the banking system had increasing trend (0.1% increase compared to the beginning of the year) due to cashless money extension.

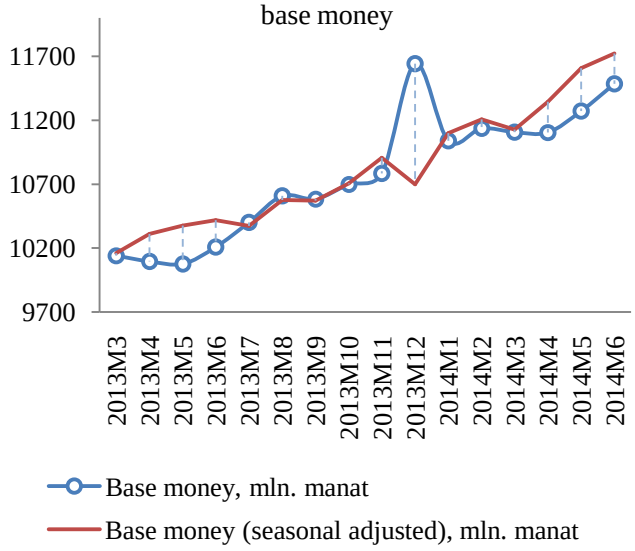
Chart 24. Money supply, %



Source: CBA

Over the period the money base in Manat declined 1.3% due to seasonal factors. The dynamics of the seasonally adjusted money base rose 9.5% relative to the beginning of the year.

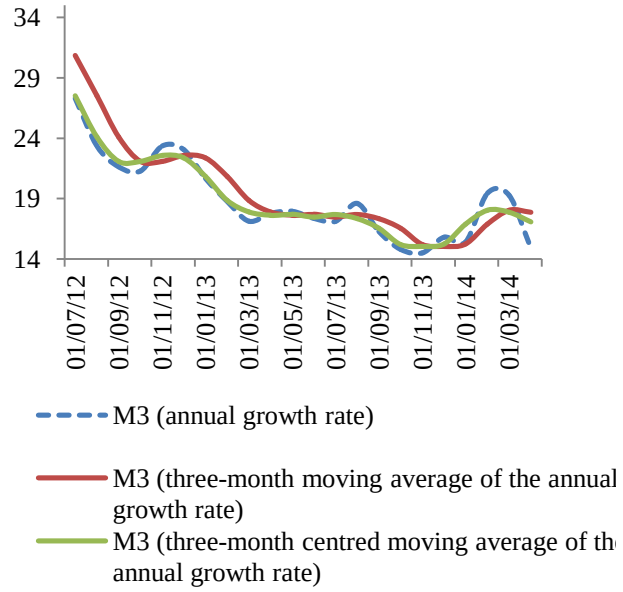
Chart 25. Influence of seasonal factors to base money



Source: CBA

As of 01.07.2014 broad money supply (M3) increased 20.9% y.o.y. and reached AZN 20596.2 million. The share of foreign currency denominated deposits in total deposits remained unchanged against the relevant period of the previous year and constituted 34.8%. The share of foreign currency denominated deposits in M3 money supply rose 1.4 p.p. and made 17.3%.

Chart 26. Broad money (M3), %



Source: CBA

operations through POS-terminals increased 21.4% (AZN 92.6 million) and amounted to AZN 525.6 million. Cashless payments through payment cards reached AZN 306 million with a 20.4% (AZN 51.8 million) y.o.y increase.

Table 1. Monetary aggregates, AZN million

	01.07.2013	01.01.14	01.04.14	01.07.14
M0 (Cash)	9219.7	10458.7	9953.6	10335.5
M1 (Cash, demand savings and deposits)	11356.4	12736.9	12300.5	12710.6
M2 (Cash, demand and term savings and deposits, in AZN)	14299.7	16434.8	16132.3	17005.1
M3 (Cash, demand and term savings and deposits, in AZN and hard currency)	17013.1	19359.8	19377.0	20596.2

Source: CBA

Over the last one year cashless money supply grew 20%, which displays broader use of the cashless payments infrastructure. In H1, 2014 operations through ATMs increased 18.5% (AZN 733 million) y.o.y. and reached AZN 4681 million, and

Charts and Tables used

Charts

Tables

ACRONYMS

CBA – The Central Bank of Azerbaijan

ADB – The Asian Development Bank

EBRD – The European Bank for Reconstruction and Development

ILO – The International Labor Organization

IMF – The International Monetary Fund

FDIs – Foreign Direct Investments

SSC – The State Statistics Committee

DGCs – Developing Countries

DDCs – Developed Countries

OECD – The Organization for Economic Cooperation and Development

CPI – Consumer Price Index

APPI – Agricultural Producer Price Index

SME – Small and medium entrepreneurship

NEER – Nominal Effective Exchange Rate

OG – Output gap

OPEC – The Organization of the Petroleum Exporting Countries

REER – Real Effective Exchange Rate

RSM – Real Sector Monitoring

PPI – Producer Price Index

NFES – The National Fund for Entrepreneurship Support

UNCTAD – United Nations Conference of Trade and Development

GDP – Gross Domestic Product

WTO – World Trade Organization

SCC – The State Customs Committee

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