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ACRONYMS

CBA The Central Bank of the Republic of Azerbaijan
ADB The Asian Development Bank
ASEAN The Association of Southeast Asian Nations
EBRD The European Bank for Reconstruction and Development
ILO The International Labor Organization
IMF The International Monetary Fund
NBCI Non-bank credit institution
FDI Foreign direct investment
SSC The State Statistics Committee
FED The Federal Reserve System
DGCs Developing countries
DDC Developed countries
OECD The Organization of the Petroleum Exporting Countries
CPI Consumer Price Index
APPI Agricultural Producer Price Index
SME Small and medium entrepreneurs
NEER Nominal Effective Exchange Rate
OPEC The Organization of the Petroleum Exporting Countries
REER Real Effective Exchange Rate
RSM Real Sector Monitoring
IPPI Industrial Producer Price Index
NFES The National Fund for Entrepreneurial Support
UNCTAD The United Nations Conference of Trade and Development
GDP Gross Domestic Product
WTO The World Trade Organization
EXECUTIVE SUMMARY

Macroeconomic stability was safeguarded in Azerbaijan in 2018. Inflation stabilized at a low one-digit rate, positive trends in the external sector and economic growth continued, the exchange rate of the national currency sustained, surplus of the balance of payments contributed to rise in strategic foreign exchange reserves.

The monetary policy of the Central Bank of the Republic of Azerbaijan for 2018 aimed low and stable inflation. The Central Bank strived to realize the targets specified in the ‘Statement of the Central Bank of the Republic of Azerbaijan on main directions of the monetary policy for 2018 and the medium term’ in its 2018 monetary policy. The ultimate target of the monetary policy was to maintain inflation at a 6-8% range. Inflation decreased at a higher than expected rate and stabilized at a single-digit level in 2018. Average annual inflation was 2.3%. Main factors that had a downward effect on inflation were the sustained exchange rate of the manat, optimal management of money supply and low inflation expectations.

The Bank took decisions on easing monetary policy in view of considerable drop in inflation and inflation expectations over the year, which served to support economic growth without prejudice to macroeconomic stability.

Hence, the Bank indirectly underpinned social welfare, economic growth and employment by continuing its stabilizing monetary and exchange rate policy.

Ongoing economic growth was mainly driven by non-oil trade – industry and agriculture. An acceptable level of oil prices, high external demand and public investments, as well as rising real income also contributed to growth.
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1. Global economic trends

Global economic growth continued in 2018. Global activity weighed in on global trade and investment flows, though slightly slowed down. Yet global economy is still subject to certain risks. Main threats include higher trade tension and divergence from the global trade system.

Global economic growth. Though high early in 2018, global economic growth has weakened to the level of 2017 since Quarter II on the backdrop of trade wars between the USA and China (estimated 3.7%), evident from the dynamics of OECD consumer and business confidence indices.

The business and consumer confidence indices dropped, attributable to a relatively subdued growth rate of economic activity relative to 2017.

Economic activity started to slow down starting from autumn in DDCs. Specific factors (new fuel emission standards in Germany, natural disasters in Japan) had a negative effect on economic activity in large economies. Broader fiscal incentives render additional support for economic activity. Economic expansion continues due to deeper fiscal stimuli, despite the tightened monetary policy in DDCs, that are in a two-year growth phase.
Divergence in economic growth rates in the USA, Japan and Europe is deepening. According to the WEO Update January 2019, GDP grew by 2.9% in the USA, 1.8% in Europe, and 0.9% in Japan in 2018.

As for the developing markets, economic behavior remained positive in the ASEAN, Southeastern Asia, aided by strong domestic demand and the labor market. Despite negative effects of the economic situation in Turkey, most Eastern European economies managed to grow healthily with strong demand support from the EU. Economic activity in Latin America continued with political and financial uncertainties in core economies like Argentine, Brazil and Venezuela. Middle East, North Africa and SSA benefited from high prices of main export products.

Economic growth rates are uneven across DGCs, owing to the change in expectations due to rising oil prices and trade protectionism, trade wars among countries and geopolitical uncertainties. Economic growth in China in QIV, 2018 was estimated to be the weakest in 28 years – GDP growth made up 6.4%, and annual growth was 6.6%. In 2018 economic growth in Russia and CIS countries was 2.3% and 2.6% respectively. In Turkey economic growth was 3.5%.

**Employment.** High employment and maintenance of qualitative jobs for workforce is still one of the core priorities for many countries. According the ILO, global unemployment is numbering 192.7 million people (global unemployment rate is 5.6%). Global unemployment is expected to drop to 5.5% as of the end-2018 due to high economic activity in DDCs. In December unemployment in the USA increased by 0.2% to 3.9%, higher than market expectations. In Japan unemployment was 2.4% in December, in line with expectations, while in the Eurozone this indicator remained stable at 7.9% in December.
According to the ILO, more than 600 million jobs should be created in upcoming 10 years to reduce unemployment and ensure entry of the youth to the labor market.

**Changes in global commodity prices and inflation.** According to the WB’s recent Commodity Markets Outlook, in 2018 energy prices fell down by 7%, non-energy prices by 4.1%, food prices by 2.4%, precious metal prices by 2.5%.

The highest price slide in non-energy commodity prices was in metals and minerals – 10.2%.

The price for gold dropped by 1.4% in 2018.

Drop in energy prices stemmed from cheaper oil prices. Though hiked over 9 months of 2018, the Brent oil price slumped from mid-October to the end-year.

Prior to this price swing, the average oil price was $73 over first 9 months of 2018.

OPEC at its 7 December 2018 meeting with Russia and non-OPEC countries decided to adjust the overall oil production by 1.2 mb/d effective as
of January 2019 for an initial period of six months. The contributions from OPEC and non-OPEC countries will correspond to 0.8 mb/d and 0.4 mb/d respectively.

In general, the average Brent oil price was $71.8 in 2018 (y/y up 30.6%).

Oil prices are expected to react to US leadership in the oil market and its sanctions on Iran, lower output in Venezuela and Mexico, high output in Nigeria and Libya, and how other OPEC members and Russia may influence the output in addition to global activity in 2019.

Higher energy prices over first 9 months of the year had an upward effect on inflation in oil importing DDCs and DGCs. High inflation in the USA also resulted from new job creation in addition to global commodity prices. Core inflation in DGCs increased on the backdrop of the transmission of the depreciated exchange rate and high impact of oil prices.

**Global financial markets and the monetary policy.** At the end of 2018 financial conditions toughened in DDCs compared to autumn. Concerns related to US Government’s end-year shutdown made the financial sector more sensitive. Over the year major central banks adopted a more cautious approach.

Risk aversion and changes in policy expectations amid weaker growth outlook led to low return on government bonds in most countries (mainly in the USA, Germany and the UK). Oil prices related concerns in the energy sector and lower optimism resulted in wider credit spread on US corporate bonds.

Financial conditions relatively toughened in DGCs. Stocks were sold at lower prices there due to actions taken to lower risks and higher tension in international trade. Net capital outflow from the said countries in QIII 2018 amplified due to the fact that investors do not invest to riskier assets.
The monetary policy stance between the USA and other countries, divergences between long-term yields and economic growth triggered appreciation of the USD exchange rate. Moreover, countries face local pressures on the backdrop of weak macroeconomic fundamentals and huge political uncertainties.

The FED raised the key rate to a range of 2.25-2.5% in December, signaling ‘some further gradual increases’ in 2019 and 2020.

The tight monetary policy in the USA continues to reroute international capital flows from DGCs to DDCs. In particular, due to tensions in FX markets, although non-resident portfolio investment flows were higher in 2017 and early in 2018 in most DGCs, they subdued later on. Depreciation of the Turkish lira and the Argentine peso had negative impact on investors’ expectations triggering capital outflow.

**Graph 4. Key rates of central banks**

(Source: http://www.global-rates.com)

**Graph 5. Dynamics of financial indices**

(Source: Reuters)

In the euro zone and other lead economies financial conditions were relatively favorable due to high risk appetite and an accommodative monetary policy amid political uncertainty. Volatility of the exchange
rate of the pound increased due to higher Brexit related uncertainties. As had been announced, the ECB completed active purchase of assets in December 2018. Accordingly, the bank noted that it will continue the accommodative monetary policy at least until summer of 2019.

The Central Bank of Japan announced that it will pursue a highly accommodative monetary policy that supports the lowest policy rate in the long run. The Bank of Canada raised the interest rate by 25 p.p., while the Bank of England raised the interest rate in August for the second time over the recent decade.

In the environment of price transmission of rising oil prices and cheaper exchange rates and in view of high inflation pressures most central banks in DGCs (Chile, Indonesia, Mexico, Philippines, Russia, South Africa, Thailand) raised policy rates. The Central Banks of China and India left the policy rate unchanged altering lending conditions (reserve requirements were appropriately reduced and the non-bank sector was provided with liquidity).

Of DGCs the market was under pressure in Argentine and Turkey. In Argentine global financial conditions, uncertainty regarding realization of the stabilization plan implemented with the IMF led to volatility in the financial market. Despite 2000 p.p. rise in short term interest rates and increase of the reserve requirement, the REER of the Argentine peso depreciated 40% in February – September. Political tension between Turkey and the USA led to 27% depreciation of the REER of the lira in February – September. The government, in response, decreased reserve requirements to elevate liquidity in foreign currency and contained banks’ swap and forward operations.

The USD strengthened 4.3% against the euro, 40.1% against the Turkish lira, 17.5% against the Iranian
1.1 Global economic trends

Monetary Policy Review ● January – December 2018

rial, and 5.2% against the Chinese yuan in 2018.

The cryptocurrency market also was volatile in 2018. The price for Bitcoin dropped by 73%: to historical lows $3266 (end-December) from its historical highs – $17135 (since January) (down by 81%). Prices for other cryptocurrencies, like Ethereum, Ripple and Litecoin followed the same behavior.

Forecast. In the World Economic Outlook January 2019 update the IMF reduced growth forecasts for certain countries, though global growth was forecasted to be 3.7% for 2018.

The slowdown in global economic growth in the second half of 2018 is expected to linger in upcoming quarters and stand at 3.5% in 2019 and 3.6% in 2020 (0.2 and 0.1 p.p. reduction to 2018 October Update respectively).

Growth dropped in DGCs, due to circumstances in Argentine and Turkey, and trade tensions between China and other Asian countries, leading to a slower growth rate in DDCs.

In particular, in DDCs growth is forecast to decrease to 2% in 2019 and 1.7% in 2020 from 2.3% in 2018, 0.1 p.p. lower than in 2018 October Update, owing to reduction of the euro zone growth forecast.

Economic growth is forecast to be 4.6% in 2018, 4.5% in 2019 and 4.9% in 2020.

Table 1. Economic growth forecast

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World</strong></td>
<td>3.7</td>
<td>3.5</td>
</tr>
<tr>
<td><strong>DDCs</strong></td>
<td>2.3</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>USA</strong></td>
<td>2.9</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>Euro zone</strong></td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>DGCs</strong></td>
<td>4.6</td>
<td>4.5</td>
</tr>
<tr>
<td><strong>Russia</strong></td>
<td>1.7</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>China</strong></td>
<td>6.6</td>
<td>6.2</td>
</tr>
<tr>
<td><strong>CIS</strong></td>
<td>2.4</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: IMF, WEO, January update, 2019

Economic growth in DGCs will react to rising oil prices, stronger USD, import tariffs imposed by the USA on trade partners and geopolitical conflicts. However, economic growth varies more
and more across these countries, reflecting favorable environment for oil exporters on the one hand, and capital outflow in certain countries, devaluation pressures, geopolitical conflicts and US applied protectionist measures on the other. Recovery is expected to last for two upcoming years in commodity exporters.

Economic growth outlook remains optimistic for Azerbaijani trade partners. However, sharp devaluation in Turkey, one of the main partners, resulted in considerable reduction of IMF growth forecast for Turkey for 2018 compared to the April release.

Economic growth is expected to average 1.8% in 2019 (non-oil export weighted) in trade partners, which is expected to positively translate to both Azerbaijani non-oil trade and investment flows.

1.2. Azerbaijani economy’s external sector developments

High global oil prices, rising geopolitical tension, global trade policy uncertainty and their translation to neighboring economies, main trade partners weighed in on the Azerbaijani economy’s external sector position.

According to the State Customs Committee (SCC), foreign trade turnover increased by 37% to $31 B – exports $19.5 B (63.1%), import $11.5 B (36.9%). Foreign trade surplus amounted to $8 B (y/y up 58.9%).

Azerbaijan traded up with 185 countries.

The EU accounts for 42% of trade turnover – of which Italy 48%, Germany 11%, Czech Republic 8%, Switzerland 5%.

The CIS countries account for 13% of trade turnover – of which Russia 64%, Ukraine 21%.

Other countries account for 34% of trade turnover – of which Israel (10%), China (9%), India (7%).

Export jumped 40.9%, non-oil export jumped 9.8% driven by the oil sector – the value of export rose 46.8% on crude oil and 53.5% on oil products.
Seco4ne: SCC

Exports of cotton fiber and yarn, electricity and fruits and vegetables posted growth – the value of exports increased by 2.4 times on cotton fiber, 48.6% on cotton yarn, 28.8% on electricity and 19.3% on fruits and vegetables.

Main export countries include Italy (30.2%), Turkey (9.4%), Israel (6.7%), India (4.2%), Czech Republic (4.8%), Germany (4%).

Commodity import increased by 30.6%; by 2.2 times to AZN 2.6 B on the public sector and 14.6% to AZN 8.1 B on the private sector.

Russia accounted for 16.4%, Turkey 13.8%, China 10.4%, Germany 5.8%, the USA 4.6%, Switzerland 4.5% and Ukraine 4.1%.

Import increased across major products – by 40.7% on cement, 38.7% machinery and mechanisms, ferrous products 35.7% and decreased on food products, vehicles and parts.

The situation in economic partners weighed in on both non-oil export and money remittances.
According to rough data, money remittances to the country y/y increased by 6% to $1080 M.

Capital investment from foreign enterprises and organizations kept flowing. According to the SSC, the size of capital investments from foreign sources amounted to AZN5.2 B equivalent (30.3 of total investments).

Great Britain, Turkey, Russia, Iran, USA, Japan, Malaysia, Switzerland, Norway and Czech Republic accounted for major part of capital investments by foreign enterprises and organizations.

Positive developments in the external sector translated into dynamics of foreign exchange reserves – strategic foreign exchange reserves increased by 7.1 % ($3 B) to $ 44.9 B end-year, sufficient for 31-month import of goods and services, exceeding the sovereign foreign debt by 3 times, and broad money supply in manat by 5.3 times.

Source: SSC

Graph 11. Inflow of remittances, mln.$

Source: CBA
II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

2.1. Aggregate demand

Economic growth was driven by domestic demand factors in 2018 accompanied by activity trends on aggregate demand.

Consumption expenditures kept increasing.

Goods and services sold in the market to meet consumer demand y/y increased by 3.7% in real terms to AZN47.8B. 96% of goods sold and services supplied by economic agents was offered by private businesses (50.2% by private entrepreneurs).

Source: SSC

Every consumer purchased on average AZN405.3 worth of goods and paid services monthly (y/y up by AZN17.4).

Retail trade turnover increased by 3% to AZN37.1 B, retail food trade turnover 2.5%, while nonfood 3.4%.

Consumers spent 50.3% of their funds on food, beverage and tobacco at retail trade outlets. Spendings of the kind y/y increased by 2.5%. Non-food product sale y/y increased by 3.4% - expenses y/y increased by 3.5% in knitwear, clothes and shoes, 3.1% electric appliances and furniture, 2.8%
telecommunication and 3.9% other non-food staff.

Table 2. The share of spending items in trade outlets, %

<table>
<thead>
<tr>
<th>Spending item</th>
<th>Share, %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2017</td>
</tr>
<tr>
<td>Food, beverage and tobacco</td>
<td>50.7</td>
</tr>
<tr>
<td>Knitwear, clothes and shoes</td>
<td>18.1</td>
</tr>
<tr>
<td>Electric appliances and furniture</td>
<td>6.3</td>
</tr>
<tr>
<td>Computers, telecommunication devices and others</td>
<td>0.7</td>
</tr>
<tr>
<td>Pharmaceuticals and medicals</td>
<td>1.4</td>
</tr>
<tr>
<td>Fuel</td>
<td>5.1</td>
</tr>
<tr>
<td>Other non-food stuff</td>
<td>17.7</td>
</tr>
</tbody>
</table>

Source: SSC

Every consumer purchased on average AZN158.2 worth of food, beverage and tobacco and AZN156.6 worth of non-food items monthly for private consumption in retail trade.

Catering turnover rose by 6.8%. Entities accounted for 43%, private entrepreneurs 57% of catering turnover in the private sector. The value of paid services to the population increased by 3% to AZN9.1 B in real terms. Per capita paid services consumption y/y increased by 4.6% in nominal terms.

Consumer demand was driven by rise in nominal income of the population – it nominally increased by 9.3% to AZN 53.7 B. Per capita income rose by 8.2% to AZN 5467.4, while disposable income increased by 9.4% to AZN 49.6 B.

Nominal average monthly salary of hired workers in the economy increased by 2.9% to AZN 540.1. Salary of employees was AZN 430.5 in public and AZN 687.7 in private entities.

Loans to households, one of the consumer demand components, increased by 15.5%: as of the end year the households’ loan portfolio exceeded AZN 5 B.

The consumer confidence index (CCI) generated from the December ‘Financial behavior and intentions of households’ survey continued improving. To note, this indicator is based on surveys among various
income households ‘Family’s financial condition expectation’, ‘Expectation on country’s economic standing’, ‘Savings probability’ and ‘Unemployment expectations’. Analyses suggest that the CCI y/y increased by 8.5 times, mainly due to better expectations on country’s and family’s financial standing, and lower unemployment expectations.

**Government expenditures** were critical for domestic demand. According to the Ministry of Finance of Azerbaijan, state budget expenditures made up AZN 22718 M.

Following the economic classification, 31.7% (or AZN 7196.6 M) of state budget expenditures were channeled to social spending (compensation for employees, pension and social allowances, medicine and food) (y/y up by 7.6%).

**Investment expenditures.** AZN 17238,2 M worth of investments were channeled to the economy in 2018. AZN 11289,3 M worth of funds were invested to the non-oil sector (y/y up 22%). The public sector accounts for 46.7%, while the private sector for 53.3% of total investments.

69.7% of investments stemmed from domestic, while 31.3% from external sources.

**Table 3. Investment sources, %**

<table>
<thead>
<tr>
<th>Source</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds of enterprises and organizations</td>
<td>67.5</td>
<td>52.7</td>
</tr>
<tr>
<td>Bank loans</td>
<td>12.2</td>
<td>11.0</td>
</tr>
<tr>
<td>Budget funds</td>
<td>12.7</td>
<td>25.8</td>
</tr>
<tr>
<td>Off-budget funds</td>
<td>1.4</td>
<td>1.6</td>
</tr>
<tr>
<td>Population’s own funds</td>
<td>5.5</td>
<td>8.2</td>
</tr>
<tr>
<td>Other funds</td>
<td>0.7</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Source: SSC

Whereas funds of enterprises and organizations prevailed in total investments (52.7%), the share of budget funds y/y doubled.
2.2. Aggregate supply and employment

Economic activity remained buoyant across major sectors of the economy in 2018 as in the previous year, aided by wider supply channels.

Economic growth. According to the SSC, real GDP increased by 1.4% to nominal AZN 79.8 B. Per capita GDP was AZN 8126.2.

The mining industry extracted 38.7 m/t crude oil, 19.2 bln/m3 natural gas. Oil production maintained the previous year’s level, while gas extraction increased by 5.8%.

The value added in the non-oil sector y/y increased by 1.8% in real terms to nominal AZN46.7 B (58.5% of GDP).

Most non-oil sectors posted growth in 2018.

The oil and gas industry posted 9.1%, while agriculture 4.6% growth.

The CBA’s RSM related survey findings suggest that most non-oil sectors, including metallurgy, textile, production of machinery and other
mineral products revived year on year. Activity in these sectors translated into rise in overall business confidence index (BCI). The BCI bettered across most service sectors covered in the survey (communication, postal service, transportation, healthcare, hotel, tourism).

**Employment.** As of the End-December 2018 economically active population were numbering 5133.1 thousand persons (y/y up 59.3 thousand persons).

According to the SSC, the number of hired labor force y/y increased by 2.1% to 1553.6 thousand persons as of 1 December 2018.

23.9% of hired labor in enterprises and organizations was involved in production: 7.2% in construction, 7% processing, 3.2% agriculture, forestry and fishery, 2.5% water supply and waste management, 2.2% in mining.
2.3. Inflation

Inflation kept falling, stabilizing at a single-digit level, one of the most critical factors supporting rise in population’s real income.

**Consumer Price Index (CPI).**

According to the SSC, average annual inflation was 2.3%. CPI components – food prices changed 1.7% on annual average, non-food prices 2.6%, and services 2.7%.

Prices for 121 out of 521 items of goods and services declined, and remained unchanged for 41 items. Price hike in 90% of products with rising prices was below 5%.

Lower inflation is driven by the stronger NEEM, optimal money supply management, dropped inflation expectations, which altogether neutralized the upward effect of global commodity prices, and inflationary processes in trade partners and rise in certain administrative prices on domestic inflation. Having increased since early year, global food prices have been falling since June, 2018.

Source: SSC

Food prices account for 1 pp., non-food 0.6%, and services for 0.7% of average annual inflation.

Source: SSC, CBA estimations based upon SSC data
Average annual core inflation calculated by excluding the goods and services, whose prices are regulated by the government and seasonal agricultural products, was 1.8%.

As noted above, expectations were one of the factors that contributed to swings in consumer prices. Monitoring of households and real sector entities suggest that inflation expectations remained in historical lows of recent years. According to regular RSM by the CBA, price expectations in trade declined across all areas for upcoming 3 months in 2018, mainly in the sale of houseware. Overall price expectations decreased in services across all areas, mostly in transportation, hotels and healthcare. In processing price expectations fell in food and beverages, metallurgy and the chemical industry, construction and rose in machinery, plastic mass and weaving. Expectations elevated in the construction sector in general.

**Producer Price Index (PPI).** According to the SSC, the GDP deflator, that measures price swings in all domestically produced goods and services, was 12.2%, mainly owing to rising global oil prices.

The PPI mostly changed across industrial products. The IPPI y/y increased 26%, driven by upswings in mining and electricity, gas and steam generation (32.8% and 33.4% respectively).

Price hike was 12.4% in processing – tobacco (20.5%),
polygraphy (24.8%), production of oil products (15.3%), and jewellery, musical instruments, sport and medicine equipment (14.1%).

Source: SSC

The APPI increased by 2%, driven by price hikes in cattle-breeding products 4.6%, in forestry 1% and in plant growing 1.2%.

Transportation tariffs decreased by 1%. Prices for cargo services dropped by 1.1%, and prices for passenger transportation dropped by 0.7%. Prices for postal and courier services increased by 0.1%, and decreased by 0.2% for communication services. Slide in communication prices is attributable to 2.1% reduction in Internet pricing.
III. THE MONETARY AND EXCHANGE RATE POLICY

3.1. The FX market and the exchange rate of manat

The FX market operated in a self-regulatory mode in a balanced manner, the exchange rate of manat against foreign currencies responded to balance of payments trends.

The size of transactions increased in FX market’s both segments – cash and cashless currency markets due to rising foreign trade turnover.

Cashless transactions amounted to $25.4 B equivalent\(^1\) – 83.3% in USD and 16.7% in other currencies.

The Interbank FX market accounts for 33%, while the Intrabank FX market for 33% of cashless transactions.

53.5% of USD denominated transactions in the Interbank FX market related to regulation of banks’ currency position. Interbank market operations are mainly conducted over Bloomberg platform.

Intrabank FX operations amounted to $17 B equivalent (77% USD denominated operations). 93% of operations in the Intrabank FX market was currency operations with legal entities.

Cash currency traded by banks amounted to $7 B equivalent ($5.4 B (77%) USD denominated operations).

The CBA continued currency auctions to arrange sale of currency provided by the SOFAZ twice a week; market participants were informed on auction parameters by the Bloomberg terminal prior to auctions.

The CBA held total 101 auctions in 2018.

The official exchange rate of manat was set on the basis of the average exchange rate on interbank transactions (both auction and non-auction on the Bloomberg platform).

\(^1\) Including USD, EUR, GBP, Russian ruble transactions
3.1. The FX market and the exchange rate of manat

The average daily AZN/USD exchange rate was AZN1.7000. Though varied, buy-sell exchange rates set by banks were close to the official one. Commercial banks’ daily average buy rate was 1.6965, while sell rate – 1.7023. Difference between official buy exchange rates and those of commercial banks was 0.2% (AZN 0.0035), and sell rates – 0.1% (AZN0.0023).

AZN gained 0.01% against the USD, 28.6% against the Turkish lira, 4.1% against the euro, 5.9% against the pound, and 16.9% against the Russian rouble.

Dynamics of bilateral exchange rates influenced that of multilateral exchange rates. Total trade weighted non-oil REER appreciated 6.1%.

Source: CBA

11.9% appreciation of the NEER has an upward, while inflation differences in partner countries had a downward effect on the REER. To note, the REER of manat has depreciated 32.3% since end-2014, contributing to non-oil sector competitiveness.
3.2. Monetary policy tools

In 2018 monetary policy tools were employed in light of stabilization of inflation on a single-digit level, stronger macroeconomic stability, financial market developments, and the pass-through capacity of the monetary policy.

Parameters of monetary policy tools were changed to normalize the monetary condition. The Central Bank discussed parameters of interest rate corridor on liquidity operations 6 times over the reported year in view of strengthening macroeconomic stability and recent macroeconomic forecasts. The policy rate was reduced to 9.75% from 15%, the ceiling of the interest rate corridor to 11.75% from 18% and the floor to 7.75% from 10% in phases.

To meet money demand of the economy and effectively manage liquidity, the Bank kept various term (up to 7 days, 14 and 28 day) market operations active. Albeit slightly high lending in 2018, banking sector liquidity was still in surplus, pushing high demand for CBA’s sterilization operations.

The CBA held 53 deposit auctions on attraction of excess funds in the national currency, 50 auctions on issue of notes. Maturity of deposit operations was 14 days, while notes were issued for 28 days. Total outstanding amount of funds attracted by deposit auctions and issue of notes made up AZN1.71 B.

Source: CBA
3.2. Monetary policy tools

Source: CBA

AZN700 M worth of funds were attracted at deposit auctions, while AZN1008 M via note placement. As of end 2018 outstanding amount of funds attracted via deposit auctions and placement of notes increased by 8.2%.

Despite lower return on sterilization operations due to reduction of the floor of the interest rate corridor, excess liquidity remains high, since demand prevailed over supply by 2.7 times at deposit auctions and by 2.6 times at note auctions, attributable to still high liquidity in the banking system.

Source: CBA

Deposit and short-term notes placement operations both sterilize excess money supply and promote development of the money market contributing to improvement of monetary policy’s operational framework and development of the interbank market. As a critical representative indicator, return on CBA sterilization tools influences formation of other interest rates.

Interest rates on deposit operations and notes placement as open market operations were close to the floor of the interest rate corridor.
Reserve requirements were left unchanged in 2018.

### Table 4. Reserve requirement, %

<table>
<thead>
<tr>
<th>Date</th>
<th>Foreign currency denominated liabilities</th>
<th>Liabilities in manat and precious metals</th>
<th>Funds attracted from n/resident financial sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.05.2011</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>01.07.2011</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>01.08.2014</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>01.03.2015</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>30.12.2015</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>03.03.2016</td>
<td>1</td>
<td>0.5</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: CBA

The reserve requirement on liabilities in the national currency and precious metals stood at 0.5%, on foreign currency liabilities at 1%, and on liabilities to the non-resident financial sector and settlements with international financial institutions 0%.

Reserve requirements were still applied on an averaging basis, contributing to more flexible management of liquidity by banks.

Monitoring findings display that banks’ cumulative balances on correspondent accounts with the CBA across all months of the period considerably exceeded over total funds to be maintained as required reserves.
3.3. Money supply

In 2018 changes to money supply maintained an optimal balance between realization of macroeconomic stability targets and covering demand of the economy for liquidity.

Money supply was sufficient to meet demand of the economy for money and ensure uninterrupted payments. Money base in manat increased by 11.7% to AZN 9545.7 M as of the end-period. Demand for money is still driven by demand of the fiscal sector and the banking system for liquidity. The CBA reduced the stock of sterilization operations, that had an upward effect on money base.

Cash in circulation, a structural element of money base, increased by 2.8%, stock of correspondent accounts in manat increased by 13.1 times.

Broad money supply in manat (M2) has increased by 17.5% to AZN 14643.6 M as of the end-period.

<table>
<thead>
<tr>
<th>Table 5. Money aggregates, mln. manat</th>
</tr>
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<tr>
<td></td>
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<tr>
<td>------------------------</td>
</tr>
<tr>
<td>M0</td>
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<td>M1</td>
</tr>
<tr>
<td>M2</td>
</tr>
<tr>
<td>M3</td>
</tr>
</tbody>
</table>

Source: CBA

Cash, savings of individuals and deposits of legal entities in the structure of money supply in manat (M2) performed differently: cash money supply increased by 1.5%, savings of individuals in manat by 24.1%, and deposits of legal entities in manat by 42.9%.

Demand savings and deposits in manat increased by 50.1%, while term savings and deposits – 10.4%.

Broad money supply (M3) increased by 5.7% to AZN 24060.4 M as of the end-period.
Dollarization of bank deposits continued declining – total national currency denominated savings and deposits increased by 33.4%, while those denominated in foreign currency decreased by 4.2%. The share of foreign currency denominated savings and deposits in M3 money aggregate was 45.3% at the beginning and 39.1% at the end of the period.

Source: CBA

Dollarization of savings of individuals shifted to 62.5% as of the end-year from 66.5% early year.

Source: CBA
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The Central Bank of the Republic of Azerbaijan

Tel.: (+99412) 493 11 22

http://www.cbar.az

R.Behbudov Str, 90, AZ1014, Baku