THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

January – March 2014

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

Baku – 2014

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ACRONYMS

CBA – The Central Bank of Azerbaijan
ADB - The Asian Development Bank
EBRD – The European Bank for Reconstructon 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 Organziation 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

Executive Summary

In Q1, 2014 the Central Bank of the Republic of Azerbaijan (CBA) implemented its policy amid macroeconomic stability and continued diversification prosess of the economy.

The country economy continued to develop dynamically on the backdrop of new challenges for global economic growth. Over the reporting period the foreign economic position of the country was favorable and economic growth continued.

In Q1 of the current year the CBA directed its activity to aims as low-level inflation, the stable exchange rate of manat, and maintenance of financial stability. The Bank accomplished the targets, and average annual inflation made up only 2%. The stable exchange rate of manat was the key factor in maintaining a single-digit level of inflation.

I. Global economic trends and the national economy

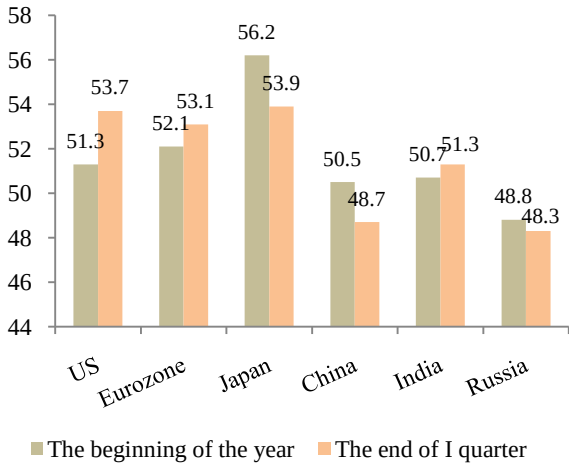
1.1. *Global economic trends*

In Q1, 2014 the global economy was prone to growing at a fragile and uneven pace. The risk balance bettered in the environment of improved economic growth outlook and relatively tenuous uncertainties in DDCs. However, geopolitical tensions and accelerated capital outlows from DGCs created new macroeconomic risks.

Global economic revival, resulted from remedial actions in leading countries, keeps going. A relative increase in economic activity is mainly attributable to positive impact of accomodative monetary policy on domestic demand in the light of growth friendly fiscal consolidation, partially subdued uncertainty and elevated business confidence in DDCs and increase in external demand in DGCs. According to initial estimations, the global economy is expected to grow by 3% in Q1, 2014 (J.P.Morgan).

Early warning indicators of the OECD display that economic growth has accelerated in major DDCs, and slackened in DGCs over 3 months of the current year. Slack economic growth in DGCs is linked to low capital inflows and tight funding terms and conditions due to gradual reversion from the loose monetary policy in the USA.

Chart 1. Purchasing Managers' Index, I quarter 2014



Source: HSBC

Although an unfavorable weather pattern in the USA in the first month of the reporting year had a negative impact on the economic activity, the following months witnessed recovery trends in retail sales and industrial production. Positive trends in the US economy are primarily related to loose fiscal consolidation and a favorable financial condition that revived domestic demand. Amid improved economic outlook, the

Fed decreased monthly purchase of government securities once again by USD 10 billion to USD 55 billion.

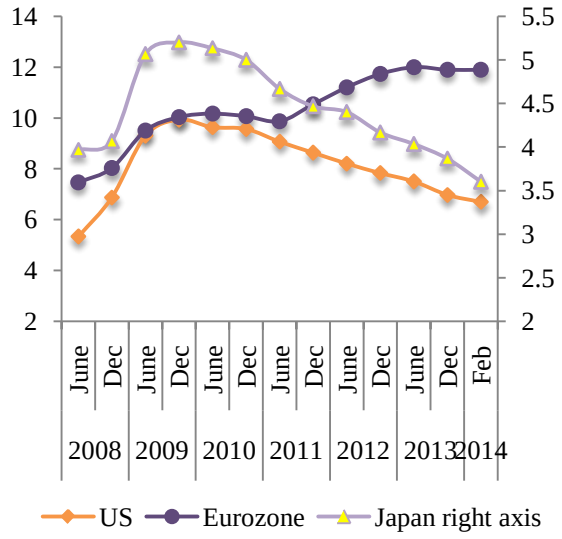
Expectations on shift of the VAT in Japan from 5% to 8% from Q2, 2014 revived consumption demand in Q1 and boosted the economic activity. However, lower-than-expected external demand having peaked the trade deficit (USD 134.5 billion) weakened positive trends.

The economic stance in the Euro zone is relatively positive. High consumption expenditures over the reporting period may be attributed to higher than sustainable level of the consumer confidence index.

The economic activity in China is seemingly slackened on the backdrop of structural reforms aimed at balanced and sustainable economic growth for the medium-run. Hence, in Q1 of the current year industrial production, retail sales and the business confidence index maintained a lower than expected level. Moreover, export was weak due to seasonal factors in January – February (the Chinese New Year and unfavorable weather conditions in North America, particularly in the USA). Sluggish economic growth of Q1 aggravates accomplishment of an official 7.5% economic growth target of 2014.

Albeit fragile positive trends in the global economy, unemployment is still a critical challenge. In February 2014 unemployment was 11.9% in the Euro zone, 6.7% in the USA and 3.6% in Japan. To note, in recent 5 years unemployment in the Euro zone has maintained the same level, while in the USA it jumped upon 3 month decline in a row.

Chart 2. Unemployment, %



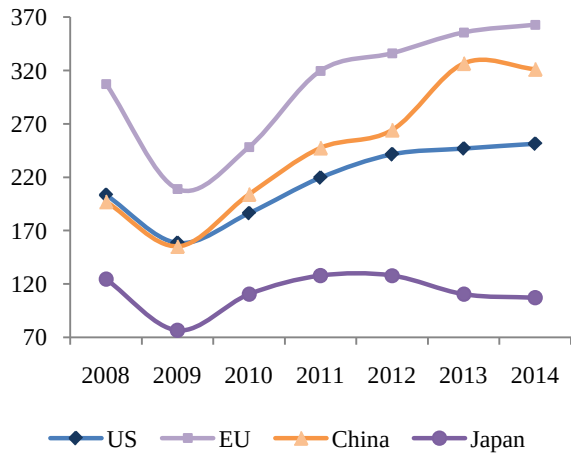
Source: OECD

A 1.2 p.p. drop in unemployment in the US since the end-2012 was not accompanied with improved quality indicators. Over the reporting period drop in unemployment was primarily

related to exit of a portion of the unemployed from the group of economically active population. Hence, there is an increase in the number of the aged population as a result of demographic changes, beneficiaries of social net programs and young people who continue their study to find job.

The global trade is still growing at weak pace. Whereas in January – February 2014 the y.o.y. increase in trade was 2% in the USA and the EU, it dropped 2% in China and 3% in Japan. The New Year in China and an unfavorable weather pattern in the USA had a negative impact on the global trade growth rate.

Chart 3. Export, Jan.-Feb., bln. $



Source: WTO

Box 1. Reducing Transatlantic trade barriers: is it possible?

The Transatlantic Trade and Investment Partnership (TTIP) or the Transatlantic Free Trade Area (TAFTA) is an agreement, implying a free trade zone between the EU and the US, the key goal of which is to simplify sale and purchase of commodties and services between the EU and the US, as well as harmonize global trade regulations through elimination of trade barriers on various segments of the economy. Currently, although tariff levels between the US and the EU are relatively low already, various tariff and non-tariff barriers (NTBs) constitute important impediments to deepening transatlantic trade and investment linkages. This study examines the impact of the reduction of such barriers.

Estimates are provided with regards to expected changes in GDP, sector output, aggregate and bilateral trade flows, wages, and labour displacement, among other issues. The comprehensive option includes two scenarios: 1) a ***less ambitious (limited scenario) agreement*** that includes a 10% reduction in trade costs from NTBs and nearly full tariff removal (98% of tariffs); 2) an ***ambitious (comprehensive) scenario*** that includes the elimination of 25% of NTB related costs and 100% of tariffs.

Under model estimations, GDP is estimated to increase by between 68.2 and 119.2 billion euros for the EU and between 49.5 and 94.9 billion euros for the US. Overall, total exports would increase 6% in the EU and 8% in the US. However, if the trade initiative would be limited to tariff liberalisation only, or services or procurement liberalisation only, the estimated gains would be significantly lower. Comprehensive nature would bring significantly greater benefits to both economies.

Lower NTB related costs for firms would raise productivity, which will benefit the US and EU markets both in terms of overall wages and new job opportunities. Labour displacement will be within normal labour market movements (0.2-0.5% of the EU labour force).

Liberalizing trade will have a positive impact on worldwide trade and incomes, increasing global income by almost USD 100 billion. Depending on the level of EU and US cooperation, impact of regulatory rules on business costs may decline, which may ease access to third markets through changes to standards. The more global standards the US and the EU set, the more the world will benefit from them.

In general, the EU – US trade liberalization may contribute not only to the transatlantic economy, but also to the overall global economy.

Source:'Reducing Transatlantic Barriers to Trade and Investment'. Joseph Francois, Miriam Manchin, Hanna Norberg, Olga Pindyuk, Patrick Tomberger. Centre for Economic Policy Research, London. March 2013.

Amid current global economic conjuncture global commodity prices were volatile, with a rise in metal and oil prices and drop in food prices. Thus, over the quarter metal prices went down 7.9% due to lower demand in China, and the food price index rose 6% due to unfavorable weather conditions. The average price for the Brent oil made USD 108, y.o.y. drop being 4.4%. Drops in oil prices may be put down to reduction in global demand, and high oil supply in non-OPEC countries. The price for gold rose 7.1% and made USD1296 (1 ounce) over the quarter.

Box 2. Resource Dependence and Fiscal Effort in Sub-Saharan Africa

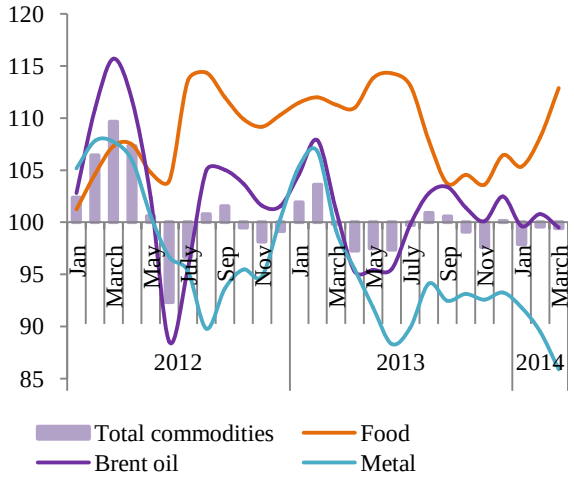
Nearly 10% of the annual output of Sub-Saharan African (SSA) countries and 50% of their exports come from non-renewable natural resources. Natural resources are a major export in about 20 of the 45 countries in the region. Seven of these countries are oil exporters.

High resource prices in recent years have resulted in sizeable increases in fiscal revenue for countries that collect revenue from natural resources. However, this revenue source is volatile and resource countries must diversify their income sources to help fund public expenditures.

IMF studies suggest that revenues from natural resources in SSA economies led to drops in tax collection on other income. The IMF experts estimated the empiric correlation between non-resource tax income and revenues from natural resources. The statistic base of the model comes from the data of African Department of the IMF for 2000-2011. The key finding of the study is that a 1% increase in resource revenue to the GDP ratio reduces nonresource revenue by 0.12 p.p.

Source: 'Resource Dependence and Fiscal Effort in Sub-Saharan Africa' Alun Thomas and Juan P. Treviño. İMF working paper 13 August and CBA studies.

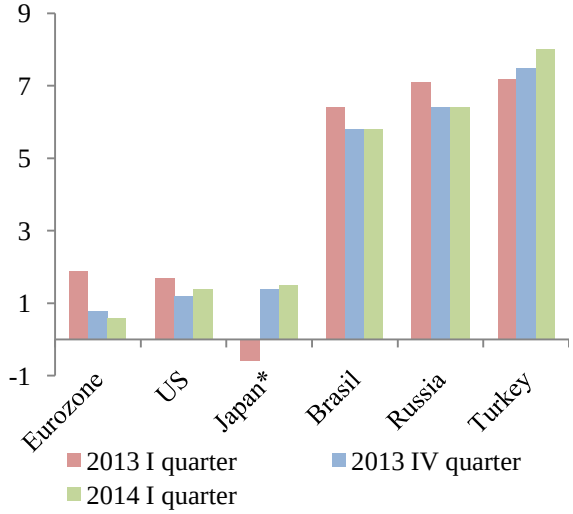
Chart 4. Commodity price index (2011 Dec=100)



Source: IMF

Negative output gap in DDCs and price crashes of energy carriers translated into slowdown of inflation rates in major advanced economies. Inflation rates varied in DGCs relative to the early year, remained stable in Brazil and Russia, while were prone to increasing in Turkey.

Chart 5. Annual inflation, %

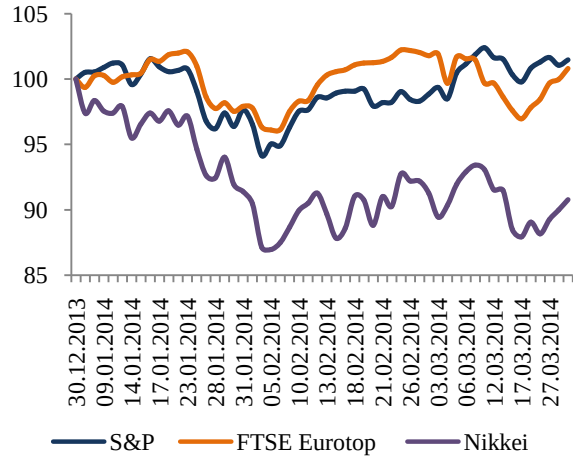


* *Index for February of 2014*

Source: IMF

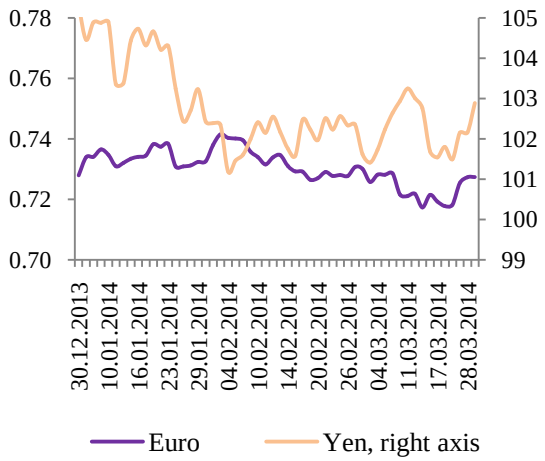
Amid global economic processes and geopolitical tensions financial markets were more volatile, fund indices grew slightly in the US and Europe, while in Japan they underwent sharp declines. Over the reporting period, the S&P index rose 1.5%, FTSE Eurotop – 0.8%, while the Nikkei dropped 9.2%.

Chart 6. Global financial indices, 2013 Dec=100



Source: Reuters

Chart 7. Exchange rates against the US dollar



Source: Reuters

In Q1, 2014 currencies of certain advanced economies remained volatile. Over the period the euro appreciated 0.1%, the pound sterrling 0.9% and the Japanese yen 2.3% against the US dollar, while the Chinese yuan depreciated 2.7%.

In the light of the recent global economic trends the IMF in its recent Global Economic Outlook (April 2014) release kept growth predictions for DDCs stable, while revised them down for DGCs.

Table 1. Corrections to the IMF global growth predictions for 2014

	January release, %	April release, %	Difference p.p.
World	**3.7**	**3.6**	**-0.1**
DDCs	**2.2**	**2.2**	**0**
USA	2.8	2.8	0
Euro zone	1.1	1.2	0.1
Japan	1.7	1.4	-0.3
DGCs	**5.1**	**4.9**	**-0.2**
China	7.5	7.5	0
CIS	2.6	2.3	-0.3
Brazil	2.3	1.8	-0.5

Source: IMF

New risks are emerging albeit slight improvements in global growth expectations on the backdrop of positive economic growth outlook in DDCs and relative slack in uncertainties. The key risks in DDCs are linked to high unemployment, threat of deflation, and debt burden, and in DGCs to volatile financial markets and devaluation pressures arisen from capital flows. Over the period geopolitical tensions elevated global risks through financial markets and trade channels (transportation of energy carriers).

Given lingering risks, international organizations recommend DDCs to keep to the acomodative monetary policy, continue with the economic growth friendly fiscal consolidation and conduct structural reforms. DGCs are recommended to effectively regulate capital flows, depreciate national currencies in response to weaker external borrowing capacity and harmonize the monetary and fiscal policy with the current macroeconomic situation.

1.2. Macroeconomic processes in Azerbaijan

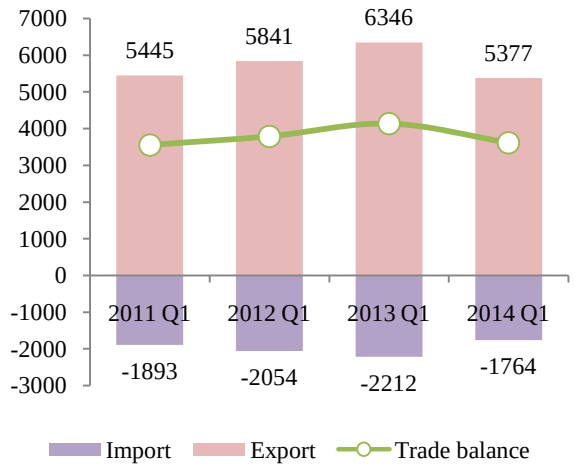
In Q1, 2014 the country economy continued to grow on the backdrop of a favorable foreign position. In January – March overall economic growth was driven by high growth of the non-oil economy.

1.2.1. External sector

In Q1, 2014 the country's foreign position was favorable and foreign exchange reserves kept growing.

According to the State Customs Committee (SCC), in Q1, 2014 the foreign trade turnover constituted USD 7.1 billion, of which USD 5.4 billion falls to the share of export and USD 1.7 billion to import. In Q1, 2014 net export was USD 3.7 billion, while export exceeded import by 3 times.

Chart 8. Trade balance, mln. $

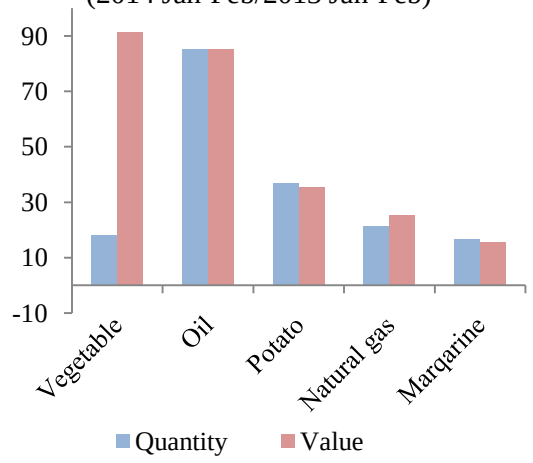


Source: SCC

51% of export was channelled to the EU countries, 3.3% to the CIS, while the remainder to other countries. 31.3% of import falls to the share of the EU, 26.2% to the CIS and the remainder to other countries.

The sectors of export with high growth rates include vegetables, cox oil, potatoes, natural gas, margarine etc. (Chart 9).

Chart 9. Change in main export commodities, %
(2014 Jan-Feb/2013 Jan-Feb)



Source: SSC

Import of sugar, certain home appliances, vegetable oils and others increased.

Chart 10. Change in main import commodities, %
(2014 Jan-Feb/2013 Jan-Feb)

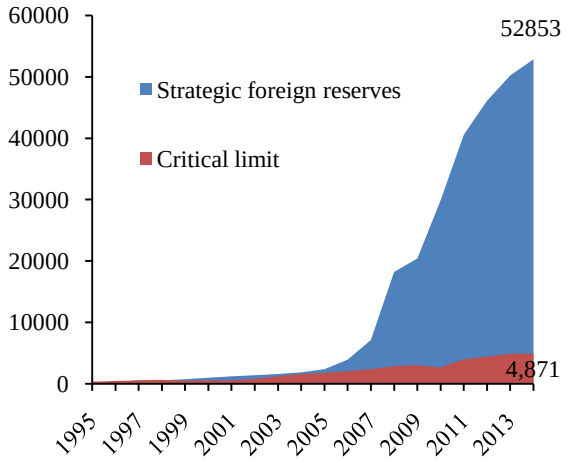
Source: SSC

To note, the IMF predicts the surplus of the country's current accounts balance to GDP ratio to approximate 15% in 2014.

Foreign currency is also channelled to the country through foreign investments. According to the SSC, the scale of foreign investments to the country economy exceeded USD 1 billion in January – March 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 Q1, 2014 country's FX reserves rose USD 2.6 billion or 5.2% and reached USD 52.8 billion. CBA's FX reserves grew by 4% to USD 14.7 billion.

Chart 11. Sufficiency of strategic foreign reserves, mln.$



**Critical limit - import for 3 months*

Source: CBA

Currently, Azerbaijan is in top 20 in terms of the FX reserves to GDP ratio (70%).

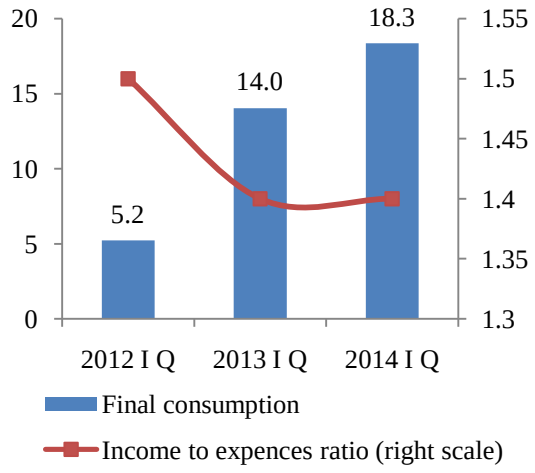
1.2.2. Aggregate demand

In January – March 2014 all components of the aggregate demand, including final consumption expenditures, investments and public expenditures positively contributed to economic growth.

Final consumption expenditures. In Q1, 2014 a y.o.y. increase in money income of the population was 4.5% in nominal terms and 2.5% in real terms. Per capita nominal money income of the population increased by 3.2% and real money income by 1.2%. In January – February, 2014 average salary in the country rose 4.7% in real terms and made AZN 426.4.

In Q1, 2014 total consumer activity was high owing to increase in real income. The share of final consumption expenditures in the structure of money income of the population remained high. Y.o.y increase in consumption expenditures made up 18.3% (14% - Q1, 2013).

Chart 12. Final consumption and expenditure, %

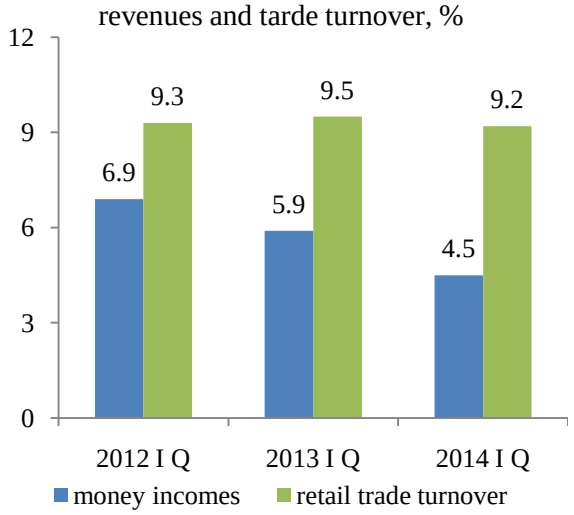


Source:SSC

Y.o.y increase in disposable income of the population was 4.8% and made up AZN 8.3 billion. The income to expenses coverage ratio of the population remained at the level of previous Q1 (1.4).

Increasing income contributed to growth in retail trade turnover as well. Y.o.y increase in overall retail turnover was 9.2% in January – March, 2014.

Chart 13. Dynamics of population revenues and tarde turnover, %

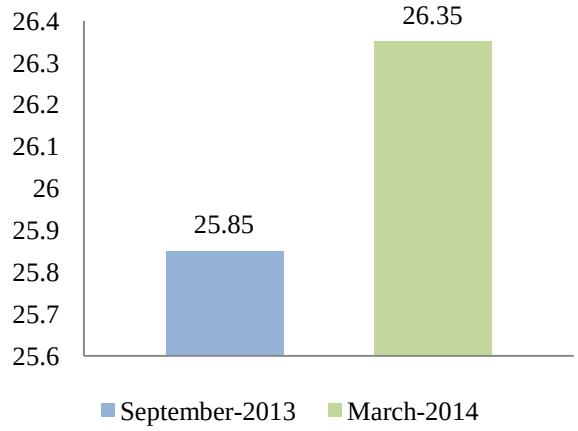


Source: SSC

In Q1, 2014 y.o.y. rise in retail trade turnover on food was 1.2% (2.7% in Q1, 2013) and 19.9% on non-food products (20.6% in Q1, 2013). Off-free services to the population grew by 7%.

The next *"Financial behavior, intentions and inflation expectations of households"* survey conducted among 4250 households (families) in March 2014 suggests that the **Consumer Confidence Index (CCI)** has risen. Respondents across the country were classified in terms of income level, occupation, labor regime, education, age and gender.

Chart 14. Consumer Confidence Index



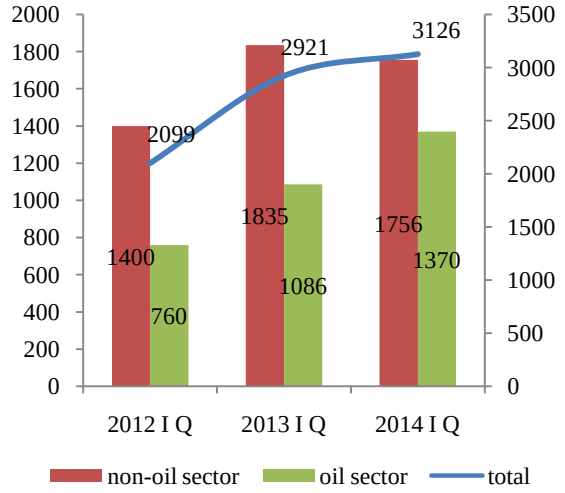
Source: CBA

Government expenditures. Government's consumption expenditures mainly include expenses on goods and services from the state budget. 29.1% of budget expenditures or AZN 1271.9 million was channeled to social expenditures (labor compensation, pension and social allowances, medicine and food expenses), which exceeds the previous year level by AZN108,1 million or 9.3%.

Investment expenditures. In Q1,2014 total investments to the economy increased by 7% and made AZN 3.1 billion, equal to 23.8% of GDP. Investments to the non-oil sector

made AZN1756.3 million, including AZN 168.5 million (5.4% of total investment) to development of the non-oil industry. The share of investments to the non-oil sector in total investments was 56.2%.

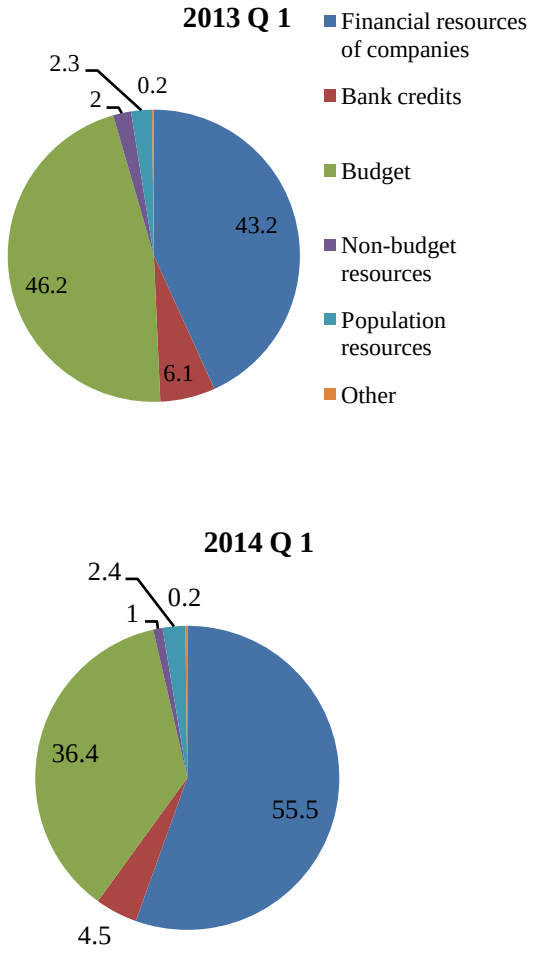
Chart 15. Investment, mln.manat



Source: SSC

67.5% of funds channeled to capital stock stemmed from domestic sources, while 32.5% from foreign sources.

Chart 16. Funding sources of investment, %



Source: SSC

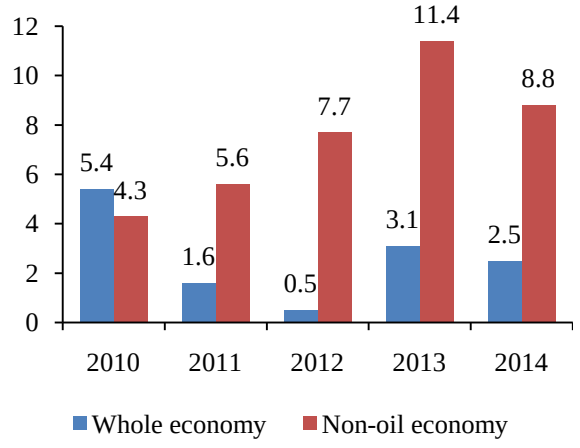
55.5% of investments sourced from businesses and organizations, 36.4 % from budget.

1.2.3. Aggregate supply and employment

In Q1, 2014 GDP rose 2.5% in real terms and nominally made AZN 13.2 billion. Over the reporting period the non-oil sector rose 8.8%. 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, 54.8% of GDP fell to the share of the non-oil sector.

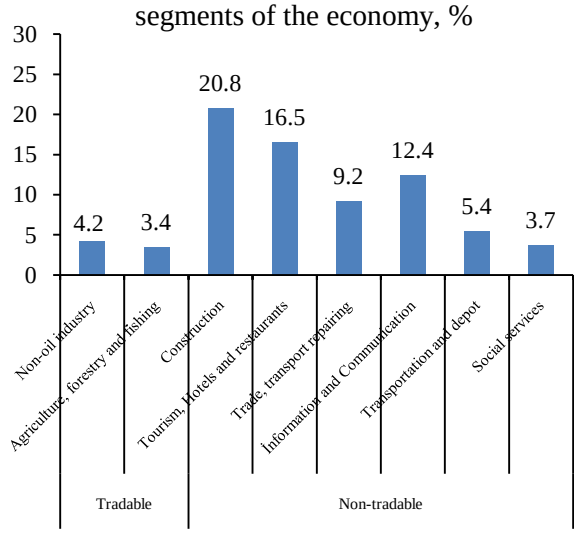
Chart 17. Economic growth, %



Source:SSC

As seen from Chart 18, in January – March all segments of the non-oil sector posted growth. The highest growth rate among the segments was in construction, tourism, hotels and restaurants, trade and transport repairing, as well as information and communication. Roughly 3.4 p.p. of 8.8% growth in the non-oil economy stemmed from construction.

Chart 18. Growth on non-oil segments of the economy, %



Source: SSC

Over the reporting period crude oil production dropped 3.2%, while natural gas production rose 4.2%. 351.8 kg gold and 120.9 kg silver were extracted.

In total, excluding the oil industry, the tradable sector grew by 4%. The non-tradable sector increased by 9.7%.

The CBA's *Real Sector Monitoring (RSM)* displays improved

economic activity expectations. The Business Confidence Index elevated in manufacturing industry in recent 3 months according to March, 2014 conjuncture observations.

According to the CBA and international organizations, the economic activity in the country is expected to keep growing in a medium-run, including the remainder of 2014. The IMF and the World Bank in their recent economic outlooks respectively forecast 5% and 5.3% economic growth in Azerbaijan in current year.

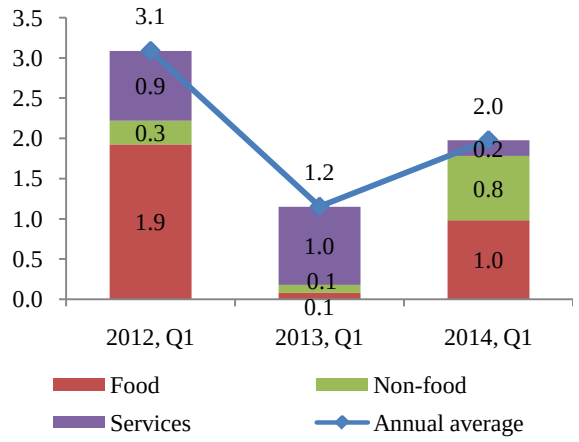
1.2.3.2. Employment. As of the end-Q1, 2014 economically active population of the country was numbering 4765.9 thousand persons, of which 95.1% was engaged in various segments of the economy and the social sector. According to the SSC, as of the end-February the number of hired labor was 1494.1 thousand persons, y.o.y. increase being 1.6%. 97.6% of hired workers was engaged in the non-oil sector, while 2.4% in the oil sector.

1.2.4. Inflation

In Q1, 2014 prices remained stable and inflation was maintained within the forecasts. Lower than in trade partners growth rate of prices supported the competitiveness of the economy.

1.2.4.1. Consumer Price Index (CPI). In Q1, 2014 average annual inflation was 2%. Components of the CPI – food prices changed 2.2%, non-food prices 3.5%, while services changed 0.3% in January – March.

Chart 19. Annual average inflation (%)



Source: CBA estimations based upon SSC data

Estimates suggest that 1 p.p. of 2% average annual inflation relates to rise in food products, 0.8 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 1.5% in January – March. Core inflation grew at low pace and was 0.5 p.p. lower than headline inflation which show that monetary factors do not have significant contributions to headline inflation.

To note, in Q1, 2014 transportation and postal tariff indices decreased by 5.1% on average annual, including cargo and communication tariffs respectively by 6.8%, and by 8.1%; postal and courier tariffs increased by as little as 0.4%.

In Q1, 2014 inflation in foreign trade partner DDCs was 0.9%, in DGCs 6.7%, in oil- exporting countries 7.6%. In total, average inflation in trade partners was 4.6%, which exceeds the average annual inflation in Azerbaijan 2.6 p.p..

1.2.4.2. Industrial Producer Price Index (IPPI): In Q1, 2014 the IPPI decreased 1%, due to 3.1% price downswings in the mining industry. In January – March prices in the processing industry rose 13.4%. Price upswings in processing is attrubuted to 24.8% price

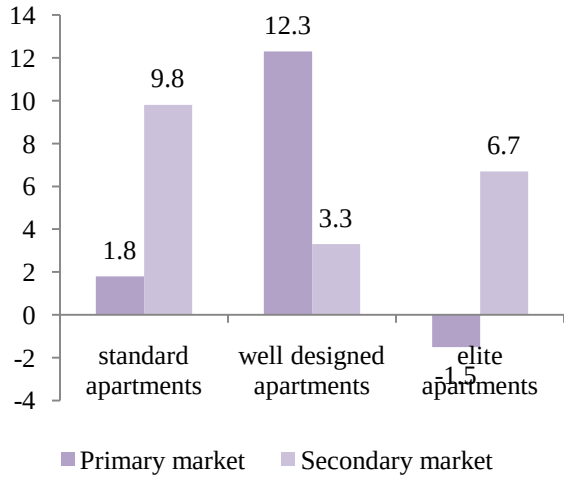
rise in oil products, 18.5% in tobacco, 12.9% rubber and plastic products and 17% in the weaving industry. In parallel, the IPPI declined on certain industrial products. Prices went down 4% on food products, 6% on metallurgy, and 9% on computers and electronic equipment.

1.2.4.3. Agricultural Producer Price Index (APPI): Over Q1 of the current year prices for agricultural products grew slightly (0.9%). Prices for livestock products went up (3.9%). Prices dropped 1.3% on annual plants and 5.1% on perennials.

Although certain regulated prices were raised in the last quarter of 2013, no sharp price hikes were observed in agricultural products. To note, in Q1, 2014 slight price swings of agricultural products pooled to overall price stability.

1.2.4.4. Real Estate Prices. According to the SSC, in Q1, 2014 y.o.y. increase in real estate prices was 8.6%. Prices in secondary and primary markets respectively grew by 8.6% and 6.1%. The highest price hike in the secondary market was observed in standard apartments (9.8%), and in the primary market in well-designed apartments (12.3%) (Chart 20).

Chart 20. Price changes in housing market, %



Source: SSC

Other activity indicators on the real estate market also posted growth. According to the "MBA LTD Appraisal and Consulting Co", y.o.y. increase in rent fees for residential property was 5.7% and 5.1% for commercial property.

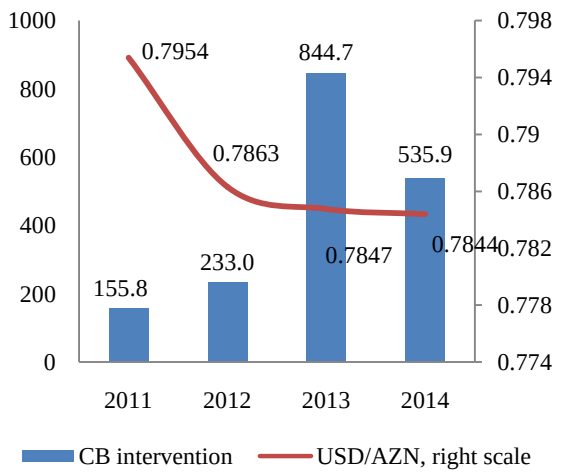
II. Monetary and exchange rate policy

2.1. The FX market and the exchange rate of manat

In Q1, 2014 the exchange rate policy targeted balancing between demand and supply in the FX market and a stable exchange rate of the manat against the US dollar.

Foreign currency supply in the FX market prevailed over demand in the reporting period as well. The CBA sterilized USD 536 million worth currency to prevent considerable strengthening of the exchange rate and eliminate negative impacts on the competitiveness of the non-oil sector.

Chart 21. CBA intervention, mln. $



Source: CBA

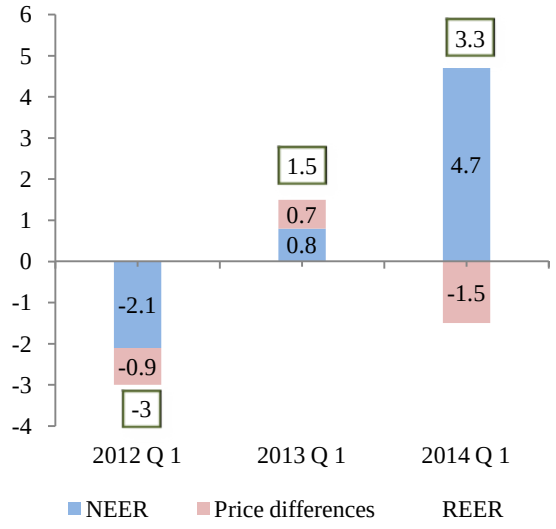
Over the quarter the exchange rate of manat against the US dollar strengthened as little as 0.03%. The stable exchange rate of the national currency had a positive impact on the macroeconomic environment and financial sector stability.

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 Turkey, Russia, Ukraine, Georgia, Kazakhstan, China and South Korea, and depreciated against the currencies of the Euro zone, Great Britain and Japan in real terms.

In Q1, 2014 the NEER on the non-oil sector (on gross trade turnover) appreciated 4.7%. According to model estimations[1] 1% strengthening of the NEER decreases consumer prices by 0.28 p.p..

[1] Estimations rest upon the VAR (Vector Autoregressive) model.

Chart 22. Structure of REER, %



Source: CBA

Inflation differences had a downward impact on the REER.

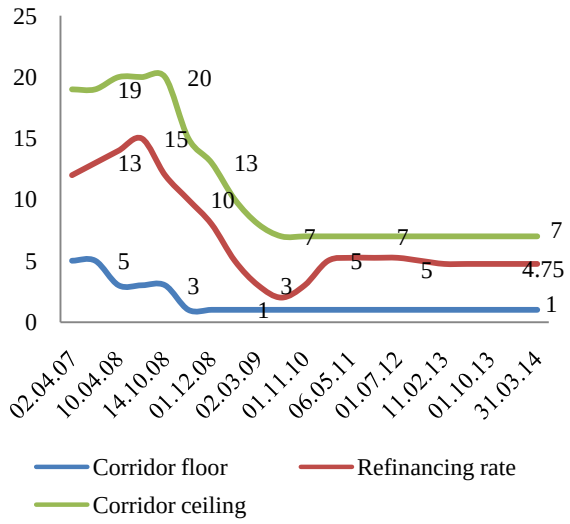
Accordingly, the CBA maintained bilateral exchange rate stability of the manat over the reporting period. The nominal multilateral exchange rate of manat strengthened, which played a positive role in accomplishing the inflation target.

2.2. Monetary policy tools

In Q1, 2014 the Bank applied its monetary policy tools considering the economic activity, inflation expectations and transmission of the monetary policy to aggregate demand.

Since inflation was within the target, the CBA made no changes to parameters of monetary policy tools in Q1, 2014.

Chart 23. Parameters of interest rate corridor, %

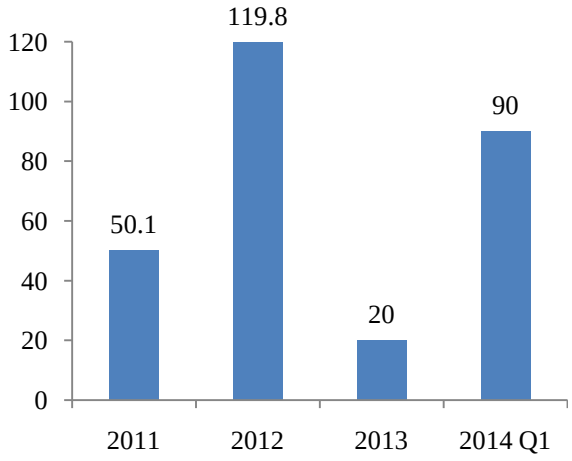


Source: CBA

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

In Q1, 2014 AZN 360 million worth notes were issued within sterilization operations. Out of which AZN66 million worth notes were auctioned and placed.

Chart 24. CBA notes, mln. AZN



Source: CBA

Average return on notes at the latest auction was 1%, and at the early-year 1.06%. As of the end-quarter the scale of notes in circulation constituted AZN 90 million.

Box 3. Exit from the loose monetary policy: *history and global effects*

Most central banks have been implementing monetary easing (ME) for over 5 years, which resulted in their overswollen balance sheets. The long-term accommodative monetary policy accompanied with unconventional monetary tools on the one hand and no visible and sustainable recovery signals of

the global economy on the other hand brought uncertainty and disagreements to ME-related exit debates. While macroeconomists and monetarists say that ME needs to be continued until recovery of the economic activity, certain financial market players being cautious of swollen balance sheets and decending effects of additional monetary stimuli say that it is time for *exit*.

Effects of additional QE. The OECD experts suggest a new frame, which enables to identify pros and cons of additional QE on 4 economies (*USA, Japan, the Euro zone, England*). The frame used 12 indicators for estimations. The estimation found out that in the USA additional QE cause more losses than benefit for the economy, while, on the contrary, in Japan and the Euro zone benefit prevails over losses, the situation for England is uncertain or neutral.

History of exit from monetary easing. According to IMF experts, the USA witnessed 3 similar episodes from 1999 until the crisis. Two conditions need to be available to exit from ME: (i) unchanged or declined refinancing rate for at least 6 months; (ii) followed by rise in the refinancing rate within the next 6 months. Analyses suggest that when the USA exited from the said ME no considerable deterioration was observed in economic and financial indicators. In all 3 episodes the exit from ME had a little effect on the global economic activity and financial markets.

Global impacts of the exit from ME. However, if to delay with proper and timely policy decisions, the exit from the ME may have a fatal impact on the global economy, as well as regions and countries. IMF estimations suggest that if economic growth in the USA is 1% lower than expectations, it will lead to 0.2% drop in average global gtowth (the same simulation yields similar results for the Euro zone). If the financial system encounters post-exit shocks (risk premiums rise to the in-crisis level), its maximum impact on the global economy may be considerable. Such a financial shock in the USA may result in 1.7-1.9% drop in global GDP, if in the Euro zone – the impact may be relatively contained, i.e. 0.5-0.7%. As known, central banks may stop purchasing government T-bills when exiting from ME. At that, fiscal consolidation and huge budget deficit may force governments to increase tax collections. Accordingly, recovery of the economic activity may be considerably damaged. 1 p.p. rise in the tax collections/GDP ratio in the USA will reduce global GDP growth on average 0.6-0.8%, a 1p.p. increase in the Euro zone may decrease global GDP growth 0.2-0.3%.

The historical chronology of the exit from ME displays that, if countries manage to shape good safety buffers, and flexibly utilize the exchange rate as a shock absorbent, negative impacts of the exit from ME may be minimized. In parallel, the objective of DDCs is to synchronize the exit from ME (not simultaneous, but planned and sequential exit, consistent fiscal – monetary policy), succeed in a relevant international cooperation and accelerate the recovery fighting the market panick via an effective communication.

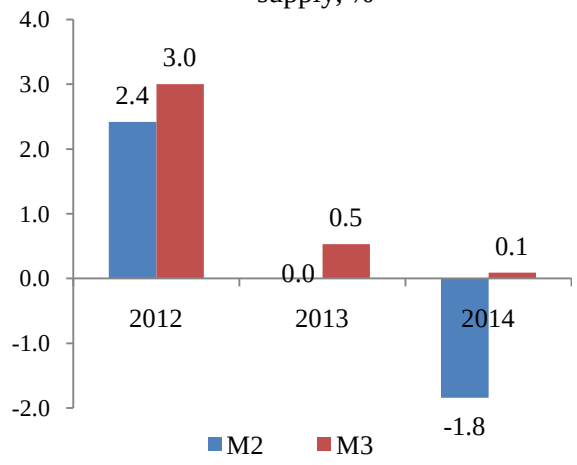
Source:'Box 1.1. Taper talks: What to expect when the United States is tightening', IMF, World Economic Outlook, October 2013.'The Benefits and Costs of Highly Expansionary Monetary Policy', OECD, WP 1082, August2013.

2.3. Money supply

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

Broad money supply in manat (M2) dropped 1.8% over the quarter, while it grew y.o.y. 17% and reached AZN16132.3 million. The money multiplier of the banking system had increasing trend (3% increase compared to the beginning of the year) due to cashless money extension.

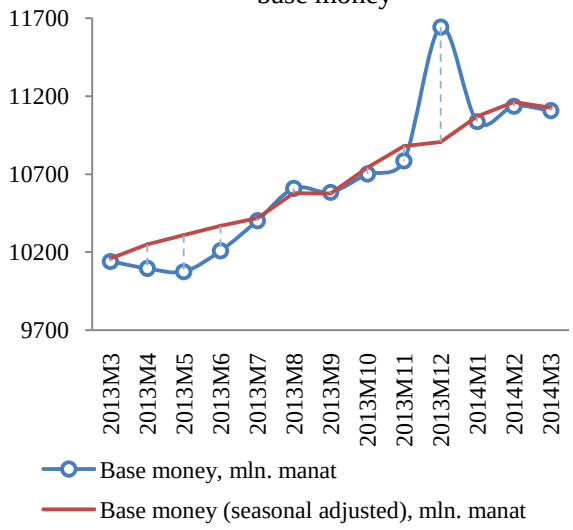
Chart 25. Quarterly change in money supply, %



Source: CBA

Over the quarter the money base in manat declined 4.6% due to seasonal factors. The dynamics of the seasonally adjusted money base was not volatile over the quarter, with 2% rise relative to the beginning of the year.

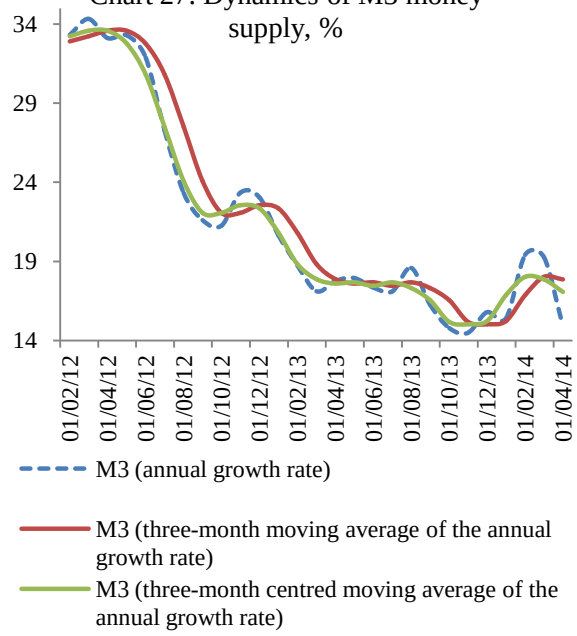
Chart 26. Effect of seasonal factors on base money



Source: CBA

As of 01.04.2014 broad money supply (M3) increased 15% y.o.y. and reached AZN 19377 million.

Chart 27. Dynamics of M3 money supply, %



Source: CBA

In Q1, 2014 dollarization indicators kept declining. The share of foreign currency deposits in total savings and deposits decreased by 4.5 p.p. y.o.y. to 34.4%. The share of foreign currency deposits in M3 money supply decreased by 1.4 p.p. and made up 16.7%. Whereas savings and deposits in foreign currency increased by only 6.1%, those in the national currency increased by 28.6% over the recent year.

Table 2. Monetary aggregates, million AZN

	01.01.12	01.01.13	01.01.14	01.04.14
M0 (Cash)	7158.2	9256.6	10458.7	9953.6
M1 (Cash, demand savings and deposits)	8824.8	11107.9	12736.9	12300.5
M2 (Cash, demand and term savings and deposits, in AZN)	10997.2	13806.4	16434.8	16132.3
M3 (Cash, demand and term savings and deposits, in AZN and hard currency)	13903.2	16775.3	19359.8	19377.0

Source: CBA

Non-cash money supply grew by 20% y.o.y. as a result of the measures taken by the CBA to increase confidence in the banking system.

Box 4. Relationship between cashless payments and macroeconomic indicators

Most international organizations conclude that well-functioning payment infrastructure is crucial to enhance the efficiency of economic and trade relations, cultivate financial markets, and boost consumer confidence. Despite its relative importance and recent developments in the field of payment markets, the empirical literature on retail payments is rather sparse. The study, based on retail payments data from all 27 EU member states, demonstrated a positive relation between the migration from paper to electronic retail payments and the real sector over the period of 1995 – 2009.

An average annual growth rate on payments with debit and credit cards in the EU countries in 1995-2009 was 13.1%. Whereas the share of cards in overall cashless payments was 25% in 1995, it was 45 % in 2009. In contrary, check payments dropped 4.3%.

To note, in 1987-1999 migration to cashless payments in European countries allowed to save USD 32 billion (in other words 0.38% of GDP). If a country shifts from an all paper-based to a fully electronic-based payment system and substitutes branch offices with ATMs, the annual savings may be around 1% of GDP.

If card payments increase by 1 million euro, then the level of GDP would increase by 0.07% or about 6 million euro. Cheque payments are found to have a relatively low macroeconomic impact. Cheque payments have more positive macroeconomic impact in countries beyond the Euro zone. Cards and cheques increase households' final consumption. 1% increase in the use of cards would increase consumption of leisure goods by 0.11%.

The presence and diffusion of ATM and POS machines are found to have a positive impact on GDP, trade and consumption. Moreover, integration to a unified European payments system would have an incremental effect on GDP.

Source: Iftekhar Hasan, Tania de Renzis, Heiko Schmiedel, 'Retail Payments and the Real Economy', The European Central Bank, 2013

Charts and Tables used

Charts

Tables

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