CENTRAL BANK OF
THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

January – March 2016

The main goal of this publicly disclosed quarterly review is to present analysis of current macroeconomic developments and monetary and exchange rate policy conducted by the Central Bank of the Republic of Azerbaijan (CBA) to broad public.

Baku – 2016

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ABBREVIATIONS

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
NBCI	Non-bank credit institution
FDI	Foreign direct investment
SSC	The State Statistics Committee
DGC	Developing countries
DDC	Developed countries
OECD	The Organization for Economic Cooperation and Development
CPI	The Consumer Price Index
APPI	The Agricultural Producer Price Index
SME	Small and medium entrepreneurs
NEER	The Nominal Effective Exchange Rate
OPEC	The Organization of Oil Exporting Countries
REER	The Real Effective Exchange Rate
RSM	The Real Sector Monitoring
UNCTAD	The United Nations Conference of Trade and Development
IPPI	The Industrial Producer Price Index
NFES	The National Fund for Entrepreneurial Support
GDP	Gross Domestic Product
WTO	The World Trade Organization

EXECUTIVE SUMMARY

The CBA operated on the backdrop of ongoing spillover of the global economic distress to the Azerbaijani economy in Q1, 2016. Slack economic growth in the global economy and main trade partners, and excess supply over demand in global energy markets affected foreign exchange inflows to Azerbaijan.

The Central Bank operated in the internal economic environment of slowing growth of aggregate demand.

The activity of CBA directed to achieve macroeconomic stability in line with the 'Statement of the Central Bank of the Republic of Azerbaijan on main directions of the monetary and financial stability policy' amplifying parallel efforts to develop a policy regime allowing sustaining medium term price stability in Q1.

Over the period the CBA started to apply the exchange rate regime, as announced late in 2015, which enabled the exchange rate of the national currency to rest upon macroeconomic fundamentals. With the introduction of the new regime the CBA minimized interventions in the FX market. The flexible exchange rate regime contributed to maintaining of foreign exchange reserves at the critical level. Economic agents adapted to the new regime.

In Q1 the money supply was primarily affected by seasonal factors as in the same periods of previous years. Slowing of dollarization also affected money supply over the period.

Monetary policy decisions of Q1 rested upon the assessment of balance between economic growth and inflationary risks. The CBA made critical corrections to the parameters of monetary policy tools, as well as the interest rate corridor to boost confidence in the national currency, promote the rise in manat deposits, and encourage the improvement of monetary policy tools in the light of the trends in the money market.

Over the period inflationary processes were driven by non-demand factors. The increasing inflation rate of the first month of the quarter was followed by a descending pace. Price hike of food and non-food items prevailed over that of services. Government's disinflationary efforts prevented further rise in inflation.

Overall, the CBA achieved its announced objectives for the most part. The CBA will take preventive policy measures to attain monetary policy objectives and keep improving the monetary policy framework in the remainder of the year.

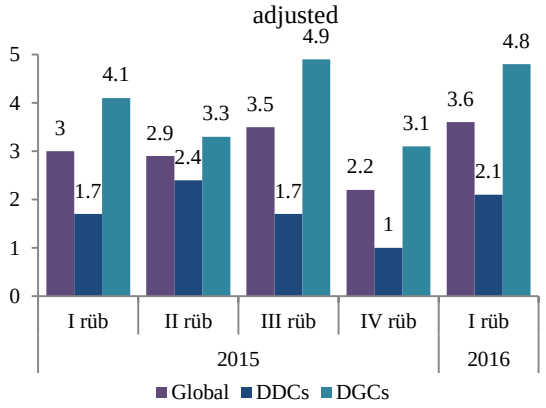
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1 Global economic trends

The global economic growth rate remained slack in the first quarter of 2016. Declining fluctuations in financial markets of DDCs in the first months of the year, faint rise in oil prices and a lingering accommodative monetary policy by leading central banks are critical factors to induce a slight year on year rise in the economic growth in 2016.

Global growth. According to initial estimations by the Barclays, global economic growth was 3.6% in Q1, 2016 (y.o.y. increase 0.6 p.p.).

Graph 1. Global economic growth in the first quarter of 2016, %, annual, seasonally adjusted



Source: Barclays

Growth in DDCs was 2.1% (y.o.y. increase 0.4 p.p.), while DGCs grew 4.8% (y.o.y. increase 0.7 p.p.).

According to the US Bureau of Economic Analysis, the economic growth rate in the USA made 0.5% in Q1, 2016, 0.2 p.p. lower than expected. Slack economic growth was adversely affected by low domestic consumer demand, weak exports and investments to non-residential areas, stronger USD and economic distress in partner countries. However, albeit adverse effects, higher employment in the labor market and lowering unemployment yielded positive results.

Increase in domestic demand and exports, stimulated by the depreciation of euro, triggered economic recovery in Eurozone during the first quarter of the year. Although growth in the employment rate in the last quarter of the previous year kept going in Q1, 2016, the recent refugee crisis and the expected

UK Brexit referendum[1] caused high uncertainties in financial markets and the banking sector in the euro zone.

In Q1, 2016 Japanese economic growth remained slack. Although the appreciated Japanese yen and low demand in DGCs had a downward effect on economic growth over the quarter, low energy prices and lingering fiscal stimuli underpinned growth. Notably, the QE by the Bank of Japan is expected to stimulate demand in the private sector.

In Q1, 2016 economic growth in DGCs remained uneven and weak. Worsening of macroeconomic situation as a result of lower oil prices in oil exporters and tighter external funding conditions, deepening of recession in Brazil and Russia were the main factor of the slack economic growth in DGCs.

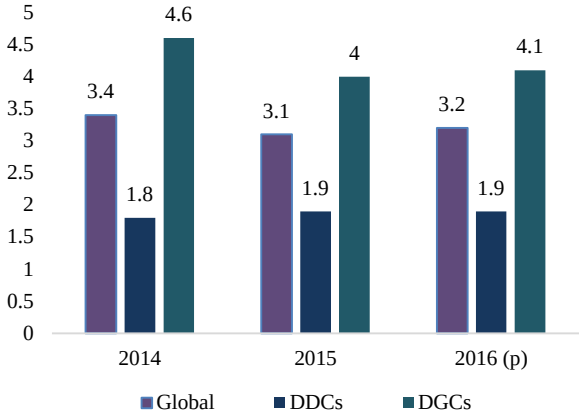
The Chinese economic growth rate was 6.7% for the first quarter of 2016. The drawback in industry, production and real estate in Q1 was accompanied by an upward effect of the rise in services on economic growth. The rebalancing started with the transition of China from investment to consumer-led economy in 2015 continued Q1, 2016.

Recession in Russia was 0.2% in Q1, 2016 compared with the previous quarter in the wake of international sanctions, slump in oil prices and non-implementation of structural reforms, which negatively affected other CIS countries.

Given recent trends the IMF made corrections to the world economic outlook for 2016 and in its recent release forecast global economic growth at 3.2%, 0.1 p.p. higher compared with 2015. Economic growth is estimated to be at 1.9% (y.o.y. stable) for DDCs, and 4.1% for DGCs (y.o.y. rise 0.1 p.p.). Spain (2.6%), the USA (2.4%) and England (1.9%) are expected to post the highest growth rate among DDCs over the year.

[1] The UK referendum on June 23 whether or not to remain in the EU

Graph 2. Global growth forecasts for 2016, %



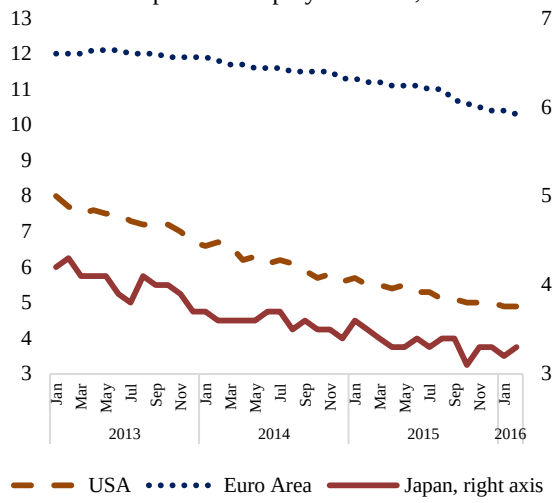
Source: IMF

0.4% recession on 15 trade partner countries in 2015 is expected to be followed by 1.07% growth[2] in 2016.

Global employment. Slack economic growth in DGCs and low commodity prices abate the global employment rate.

In February 2016 unemployment in the euro zone y.o.y. decreased 0.9 p.p. to 10.3%, 0.6 p.p. to 4.9% in the USA, and 0.2 p.p. to 3.3% in Japan.

Graph 3. Unemployment rate, %



Source: OECD

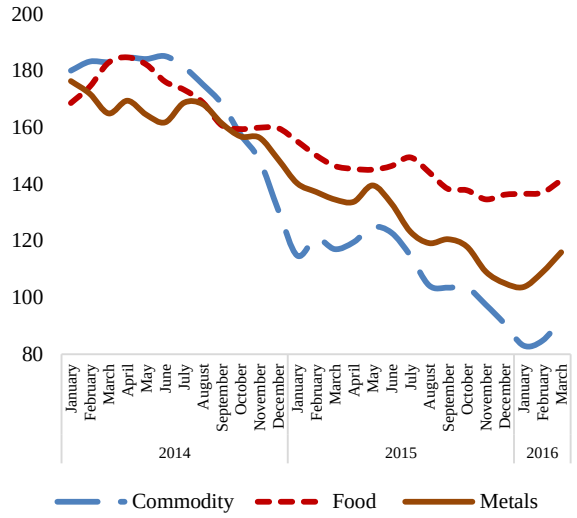
The ILO forecasts nearly 2.3 M rise in global unemployment in 2016.

Global commodity prices and inflation. In Q1, 2016 key commodity prices hiked for the first time in recent 9 months.

In Q1, 2016 global commodity prices rose 1.7%, (y.o.y. down 21.1%), and the food price index rose 3.7% (y.o.y. -3.4%). Wheat prices rose 0.15% (y.o.y. -19.1%), while the agricultural raw materials price index rose 0.9% (y.o.y. -13.6%).

[2] *Non-oil weighted, CBA estimations based upon IMF data*

Graph 4. Price indices (2005=100)



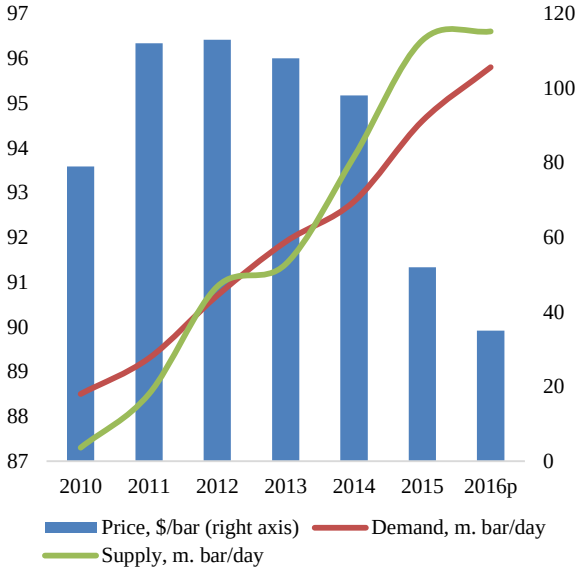
Source: IMF

Continuing economic instability in DGCs, a negative interest rate policy by leading central banks elevated demand for gold as alternate investment taking the price for gold 16.6% up relative to the beginning of the year (1 ounce) (y.o.y. 5.6%).

Global oil prices kept slumping in the wake of lingering high oil production by the OPEC, Iran's entry to oil markets and still unchanged global demand at the beginning of Q1. However, initial agreement between the OPEC and Russia to freeze oil production at the February 2016 level, as well as the Fed's decision not to change the federal funds rate over the quarter had relatively upward effect on prices.

Albeit 3.6% rise in the Brent oil price end-March 2016 versus the early year, it decreased 30% to 39.07$ year over year.

Graph 5. Situation in oil market



Source: IEA

The average price for Q1 was 34.4$, y.o.y. down by 36.4%. The IMF in its recent outlook predicts average annual oil price 35$ for 2016 and 41$ for 2017.

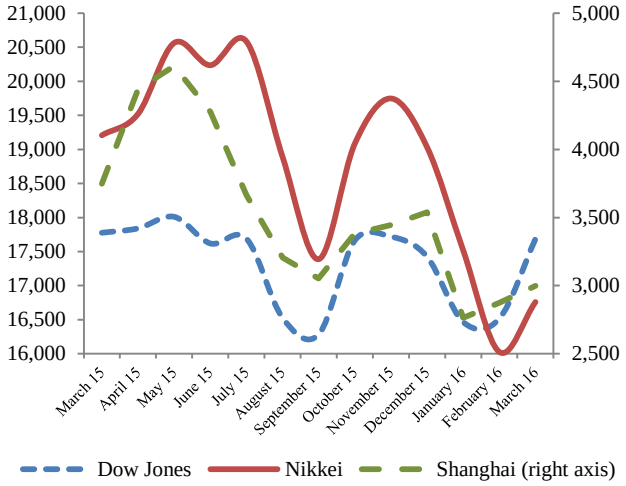
Inflation affected by low commodity prices was 0.9% in the USA as of end-March, -0.2%

(February) in the euro zone, and 0.3% (February) in Japan.

Global financial market. Global financial stability risks have elevated since October 2015 including tighter funding conditions, the subdued risk appetite, increased credit risks, and limited the space for the improvement of accounting balance. Depreciation of exchange rates in DGCs triggered foreign exchange outflows and had a downward effect on reserves.

Volatility in DDCs' financial markets of early 2016, notably sharp drops in bank shares led to considerable losses across global securities markets. From December 2015 to February 2016 the Japanese Nikkei index decreased 11%, the Chinese Shanghai Composite decreased 20%, and Frankfurt DAX decreased 10%. Although prices slightly recovered over March (positively zoned in DGCs), overall share prices fall far below the peak of the spring of 2015, primarily due to declining economic growth and lowering income of companies.

Graph 6. Dynamics of financial indexes

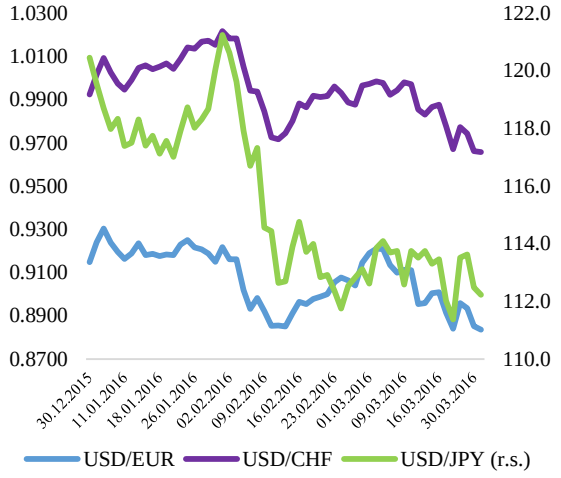


Source: ft.com

Currencies of DDCs have been prone to appreciation since early year, while those of DGCs (notably oil exporters) kept depreciating. Over the quarter the Japanese yen gained 6.8%, the euro 3.9%, and the Swiss franc 3.2% against the US dollar. The English pound depreciated 3.5% on the backdrop of potential exit of Great Britain from the EU and introduction of a new monetary policy. Whereas of DGCs currencies of South Africa, Mexico, Kazakhstan, Ukraine, and Belarus depreciated, the Russian ruble appreciated 7.1% against the US

dollar compared to the beginning of the year.

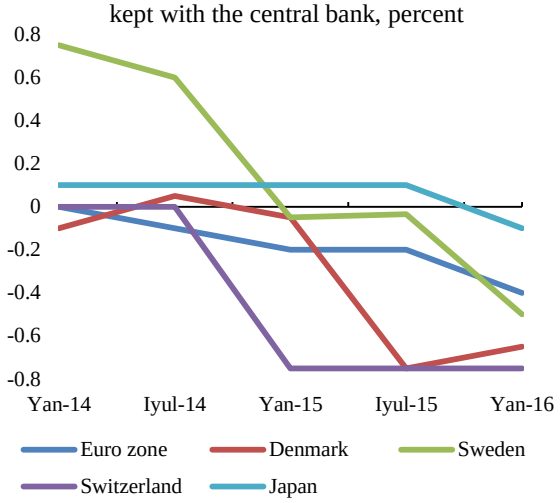
Graph 7. Exchange rate of USD



Source: Bloomberg

Despite overall accommodative monetary policy in DDCs, policy rates underwent asymmetric changes. Although the US Fed removed the policy rate from the "zero level" in December 2015, it was considered to be a sign for recovery of a growth rate rather than a signal for tightening. The ECB announcing another stimulus package in March disclosed that it will remain the policy of lowering interest rates. The Bank of Japan applied a negative interest rate on excess reserves, England maintained a Bank Rate at 0.5%. Raw material exporters (Mexico, South Africa, Peru, Chile, and Columbia, Kazakhstan) raised policy rates to subdue inflation risks emerging from depreciated national currencies. While Russia left the refinancing rate unchanged, it was reduced in India and Indonesia, and China reduced the reserve requirement.

Graph 8.Interest rates on excess reserves kept with the central bank, percent

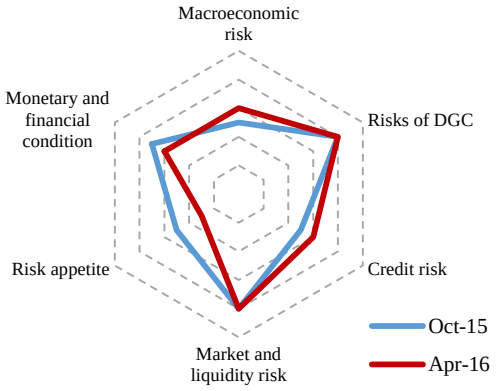


Source: World Bank, Bloomberg, ECB

While the macroeconomic situation was relatively stable in DDCs, economic growth and financial stability related risks in DGCs are still on the air. Increasing global risk aversion suggests that capital will keep flowing from DGCs to less risky DDCs. Low prices for raw materials heighten recession risks in still

vulnerable mineral exporters and further tighten financing conditions by lowering investment ratings.

Graph 9. Global financial risks



The farther from the center, the higher the risk, the more accommodative the monetary and financial condition

Source: IMF

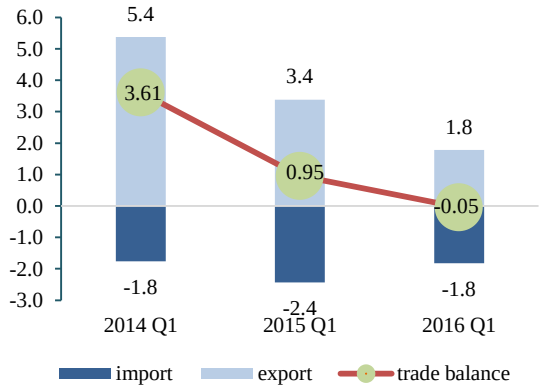
Credit and liquidity risks in DDCs have been high for the first time since 2011. Most banks operated in the environment of decreasing share prices and rising interest rate spreads. High debt burden of the private sector elevate accounting balance risks of banks and credit institutions.

1.2 Azerbaijani external sector developments

Slack economic growth in the global economy and key trade partners and high supply in global energy markets affected foreign exchange receipts in Q1, 2016.

According to the State Customs Committee (SCC), foreign trade turnover amounted to USD 3.6 B, where export accounts for USD 1.78 B and import for USD 1.83 B.

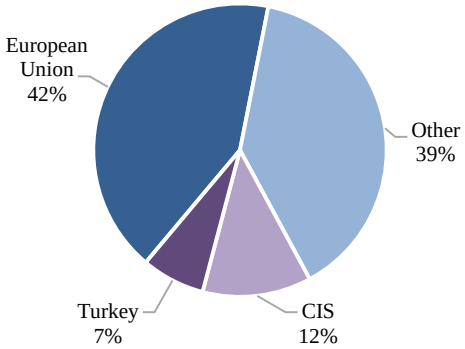
Graph 10. Trade balance, USD bn.



Source: SCC

The country traded up with 140 countries over the period.

Graph 11. Main trade partners, 2016 I Q, in-%



Source: SCC

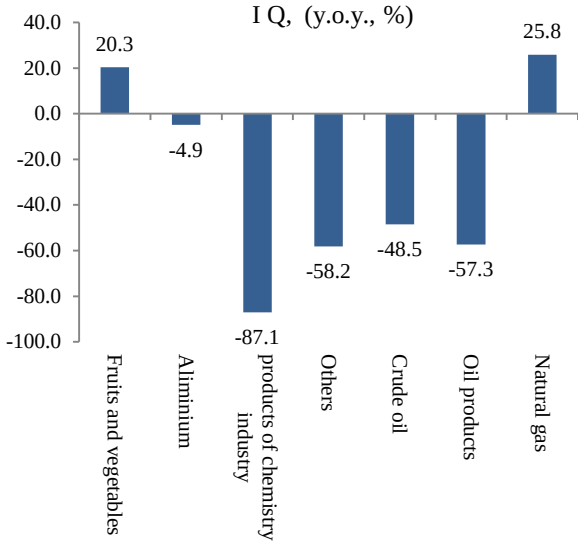
EU countries account for 42% of trade turnover: Italy 30%, Germany 16%, France 15%, and the Czech Republic 9%.

CIS countries account for 12% of total trade turnover: Russia 60%, and Ukraine 10%.

Other countries account for 39% of trade. Key partners in this peer group are the USA (12%), Singapore (12%), China (9%) and Georgia (9%).

Exports of commodities declined 47.4% over the period, primarily on the oil sector which has a considerable share in exports. Export dropped 48.5% on crude oil and 57.3% on oil products.

Graph 12. Change in export of goods. 2016 I Q, (y.o.y., %)



Source: SCC

Exports of fruits and vegetables, natural gas, cotton yarn, ferrous materials and products posted growth – fruits and vegetables 20.3 %, natural gas 25.8%, cotton yarn 2.5 times, ferrous materials and products about 3 times.

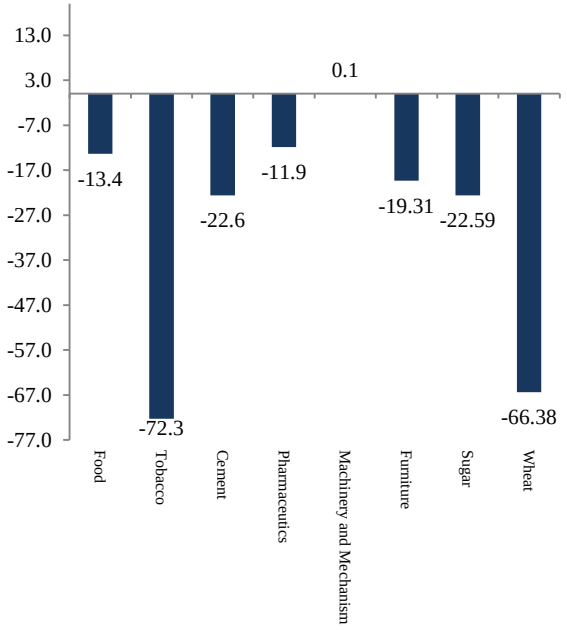
Over the period key export partners were: Italy (20.7%), France (11%), Germany (9.7%), the Czech Republic (7%), and Georgia (6.6%).

Import of goods dropped 24.9% in Q1, 2016, including 2.8 times in public sector.

Russia accounts for 11.3%, Turkey 10.8%, Singapore 9.4%, Great Britain 7.7%, the USA 7.4%, China 6%, Italy 5% and Japan 5% of imported products.

Imports increased on fruits and vegetables, tea, vegetable and animal oils and fats, butter and other oils made from milk, while it decreased on food products, cement, tobacco products and furniture.

Graph 13. Change in import of products, 2016 Q1, (y.o.y.), %

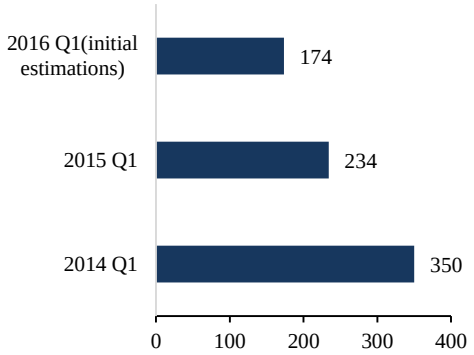


Source: SCC

The situation in economic trade partners in Q1, 2016 affected dynamics of remittances to the

country, along with exports of goods and services. According to initial data, remittances constituted USD 173.5 M in Q1, 2016.

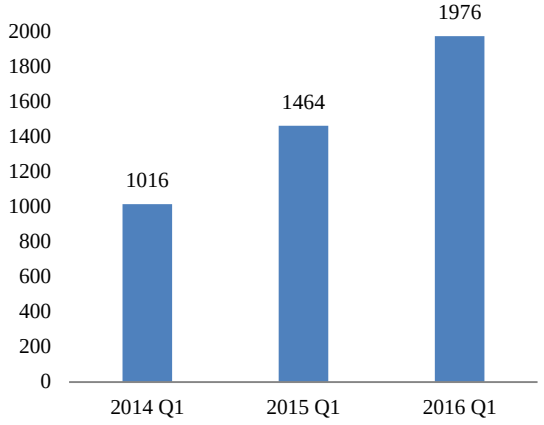
Graph 14. Inflow of remittances, m. $



Source: CBA

FDI inflows by foreign enterprises and organizations continued over the reported period as well. According to the SSC, the size of direct investments from foreign sources constituted AZN 2 B equivalent in Q1, 2016 (68.7% of total direct investments). Foreign investments increased 35%.

Graph 15. Foreign direct investments, m. manat



Source: SSC

Investors from Great Britain, Turkey, Russia, Iran, the USA, Japan, Malaysia and Sweden account for the major part of investments to fixed capital among foreign countries and international organizations.

Over the reported period country's strategic foreign exchange reserves were maintained at a critical level. As of end-Quarter I, 2016 strategic foreign exchange reserves sufficed for 25 months import of goods and services exceeding country's foreign debt by 5 times as much.

II. MACROECONOMIC PROCESSES IN AZERBAIJAN

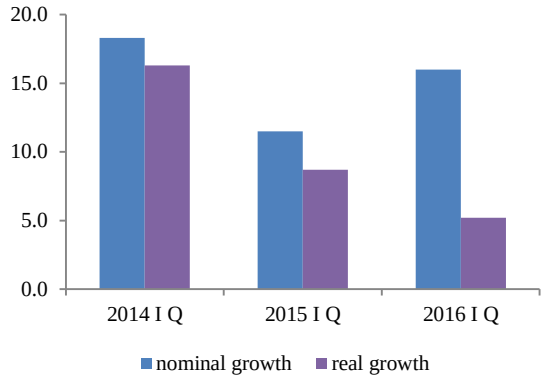
2.1. Aggregate domestic demand

New trends in key domestic demand components affected economic growth in Q1, 2016.

Final consumption expenditures year over year rose 16% in nominal terms in Q1, 2016. The real growth rate of consumption expenditures was 5.2% in Q1, 2016 (down from 8.7% in Q1, 2015).

The nominal size of final consumption expenditures was AZN 8.3 B accounting for 81% of household income. Every consumer purchased on average AZN 306.5 worth of commodities and chargeable services monthly (y.o.y. rise AZN 37.5).

Graph 16. Dynamics of final consumption, %, over previous year



Source: SSC

Over the quarter the size of goods and services sold in the consumer market to meet consumer demand rose 3.2 % to AZN 8.8 B.

Retail trade turnover increased 3.4% to AZN 6.8 B. The growth rate of retail trade turnover however decreased 6.2 p.p., and 1.6 p.p. on food products compared with Q1, 2015. Retail non-food commodities turnover y.o.y dropped 15.5 p.p.

Consumers spent 50.5% of their funds on food, beverage and tobacco in retail trade over the reported period.

Table 1. Share of spending items in trade facilities in Q1, 2016, %

Spending item	Share, %	
	Q1, 2015	**Q1, 2016**
Food, beverage and tobacco	50.2	50.5
Knitwear, clothing and shoes	17.8	16.9
Electric appliances and furniture	5.7	6.3
Computers, telecom-munication equipment and other	0.8	0.8
Pharmaceuticals and medicals	1.2	1.3
Fuel	6.6	5.8
Other non-food staff	17.7	18.4

Source: SSC

CBA's real sector surveys suggest that sales expectations on the sale of automobiles and household appliances, despite rise, were negatively zoned, while furniture sales expectations improved.

Over the quarter every consumer monthly purchased on average AZN 119.1 worth of food, beverage and tobacco and AZN 116.8 worth of non-food items for private consumption in retail trade.

To note, a portion of non-food products was purchased via e-trade. Whereas the size of consumer purchases via e-trade network increased 1.7 times in Q1, 2015, growth in the first quarter of the current year was 3.1%.

In Q1, 2016 catering turnover rose 4.7% (down from 14.4% in Q1, 2015), and paid services to the population rose 2.4% (down from 5.3% in Q1, 2015).

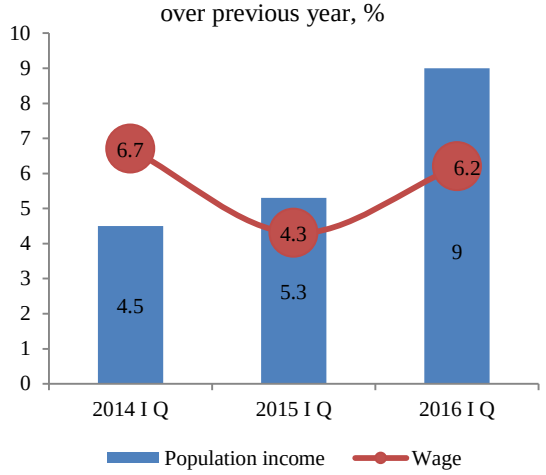
Consumer demand was driven by rise in population's nominal income. In Q1, 2016 population's income rose 9% in nominal terms. Per capita income increased 7.7%. Population's disposable income increased 8.6% to AZN 0.9 B.

The income to expenses ratio was prone to declining compared with the relevant periods of previous years (1.4 Q1, 2014, 1.3 Q1, 2015, 1.2 Q1, 2016).

Nominal average monthly salary year over year increased 6.2% to AZN 472.2 in January - February.

Bank loans to households, one of the components of consumer demand have dropped by 10.5% since early year. The consumer lending portfolio constituted AZN 7 B as of end- Quarter I, 2016.

Graph 17. Population income and wage, over previous year, %



Source: SSC

The population channeled AZN 6.6 B worth of income (15.9%) to savings (y.o.y. decrease 5.6 p.p.).

Government spending. In Q1, 2016 public expenditures were one of the factors of internal demand. According to the Ministry of Finance of the Republic of Azerbaijan, state budget expenditures amounted to AZN 2.6 B in Q1, 2016.

Following the economic classification, over 3 months of the current year 54.4% (AZN 1426,7 M) of state budget expenditures were directed to social spending (the salary, pension and allowances, drug and food) which constitutes 3,8% or AZN 52 M rise compared to the same period of the previous year.

Investment expenditures. In Q1, 2016 investments to the economy y.o.y. decreased 34.2% to AZN 2.9 B. Investments to the oil sector made up AZN 2.3 B, while those to the non-oil sector amounted to AZN 0.6 B. The public sector accounts for 15.1% (30% in Q1, 2015), and the private sector for 84.9% (70% in Q1, 2015) of total investments.

Investments decreased by: 74.1% in agriculture, 12.8% in industry, 87.6% in information and communication, 48.3% in construction, 46.2% in transportation

and depot, 29.2% in real estate related operations, 83.3% in catering and tourism, and 89.5% in trade. 2% of total non-oil sector investments were utilized to develop the non-oil industry.

31.3% of funds channeled to fixed capital stemmed from domestic, while 68.9% from foreign sources.

Table 2. Investment sources

	Q1, 2015	**Q1, 2016**
Funds of entities and organization	70.9	85.7
Bank loans	2.6	6
Budget funds	20.2	4.6
Off-budget funds	2.5	0.6
Population's own funds	2.9	3
Other funds	0.9	0.1

Source: SSC

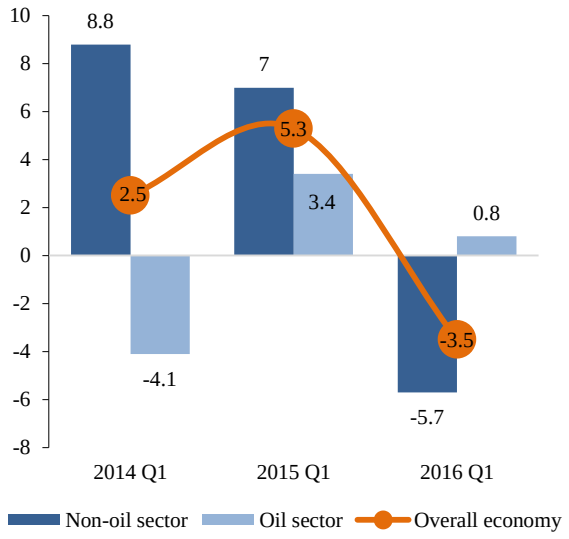
Over the period funds of entities and organizations prevailed in total investments (85.7%).

2.2. Aggregate supply and employment

In Q1, 2016 economic growth kept pace with aggregate demand.

Economic growth. According to the SSC, GDP decreased by 3.5% in real terms to nominal AZN 12.6 B. Per capita GDP made up AZN 1311.6 (USD 827.3).

Graph 18.Economic growth, to corresponding period of previous year, %

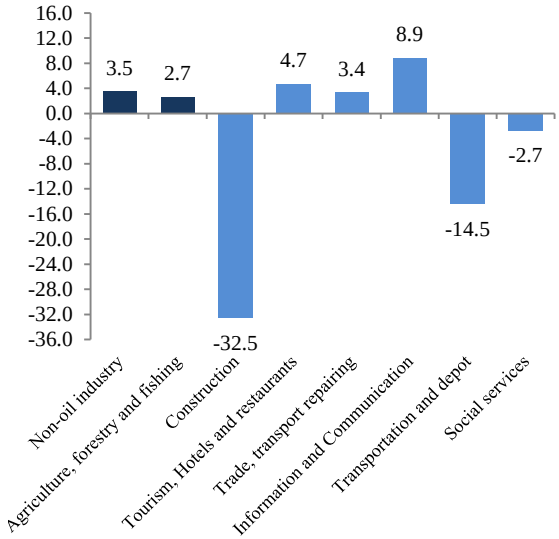


Source: SSC

The value added in the non-oil sector in Q1, 2016 was AZN 8.2 B with a 65.1% share in GDP.

Over the period agriculture, forestry and fishery, trade, communications, tourism and catering posted growth, while construction and transportation declined.

Graph 19. Sectoral growth of economy, to corresponding period of previous year, %



Source: SSC

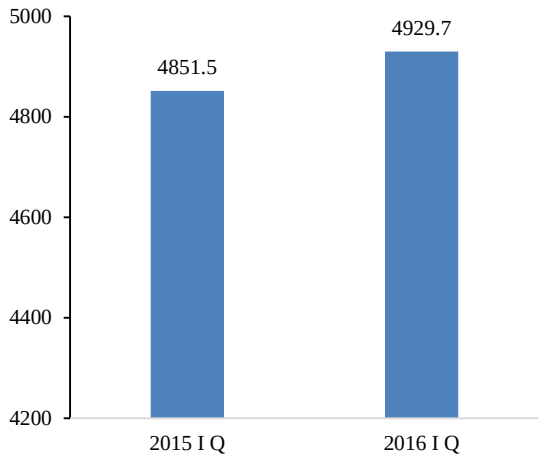
Efforts of previous years yielded ongoing positive trends in the non-oil industry. Overall increase in the value added in the non-oil industry was 3.5% in Q1, 2016.

In Q1, 2016 the mining industry extracted 10.5 M. ton crude oil and 4.8 M. m3 natural gas. Oil extraction dropped 1.5%, while gas extraction dropped 7.9%.

Employment. As of the end-period the number of economically

active population increased 0.3% to 4929.7 thousand persons compared with the beginning of the year, of which 95% was engaged in various sectors of the economy.

Graph 20. Employed persons, end of period, thousand



Source: SSC

According to the SSC, as of 1 March 2016 the number of hired labor was 1494.7 thousand persons across the country, 0.1% less than at the beginning of the year.

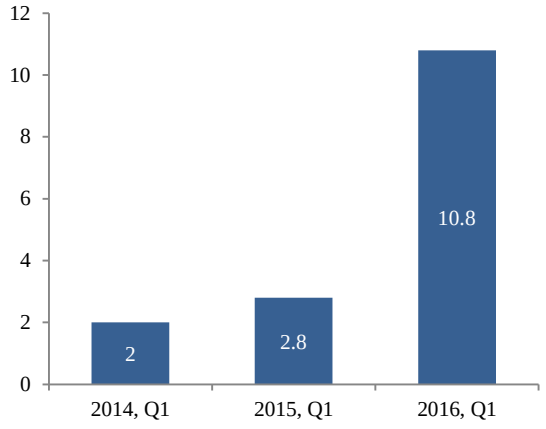
21.3% of the hired labor in enterprises and organizations are engaged in production, of which 6.3% in construction, 6.1% in processing and 3% in agriculture. 78.7% of hired labor is concentrated in services.

2.3. Inflation

In Q1, 2016 inflation was mainly driven by cost factors.

Consumer Price Index. According to the SSC, average annual inflation in Q1, 2016 was 10.8%.

Graph 21. Annual average inflation, %



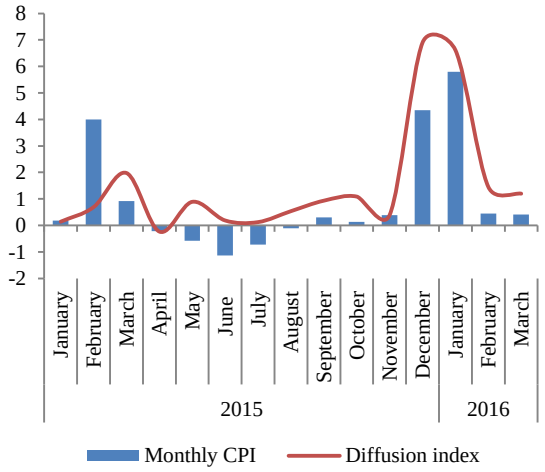
Source: SSC

The CPI components – food prices changed on average annual 13.1%, non-food prices 15.2%, and services 4%.

Over the period food prices made higher contribution to average annual inflation. According to the CBA's food price monitoring, food inflation was driven by imported goods, attributable to depreciation of the NEER.

The diffusion index, which reflects changes in the number of products and services with increasing and decreasing prices in the consumer basket, varied across months.

Graph 22. Scale of inflation, %



Source: SSC, CBA calculations based on SSC information

In total, over the quarter prices for 10 goods and services out of 561 decreased. Annual prices for 65 goods and services, including 10 foods, 3 non-foods and 52 services remained unchanged.

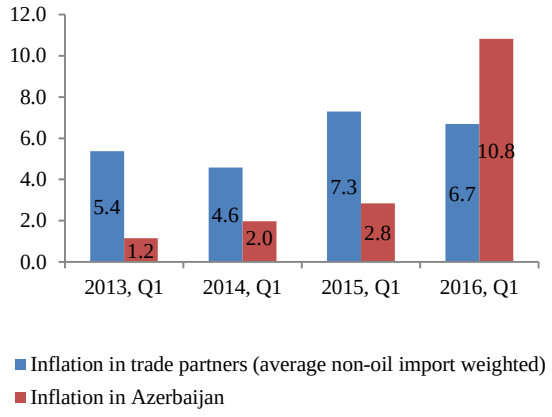
In Q1, 2016 the NEER and inflation expectations had an upward, while money base, global commodity

prices, inflation in trade partners (given the lag effect), government regulation on relevant groups of goods and VAT exemption had a downward effect on prices.

Estimations suggest that the depreciated NEER made 6.5% contribution to average annual inflation in Q1, 2016.

Global commodity prices having decreased by 21.1% y.o.y. in March which in turn induced low inflation rates in trade partners.

Graph 23. Annual average domestic and foreign inflation, %



Source: SSC, CBA estimations based upon data of appropriate central banks and statistic committees

The Government regulated prices for medicinal products in Q1, 2016 too, which resulted in drops in prices for pharmaceuticals. The Tariff (price) Council adjusted retail and wholesale prices of total 5651 drugs. Accordingly, the price for 20% medications, adjusted by the recent resolution of the Tariff Council, decreased over twofold, 8% dropped over threefold, overall prices for 60% of drugs were reduced, compared to prices available prior to changes to the exchange rate.

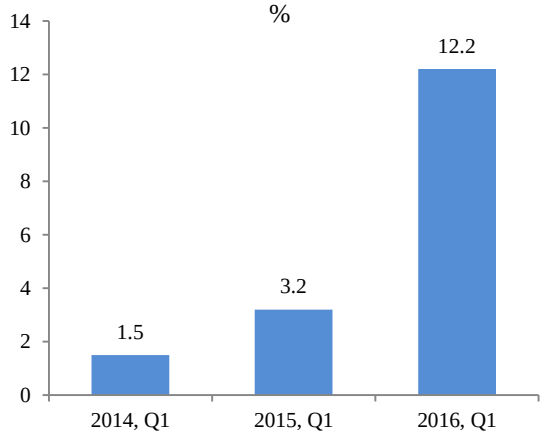
The Government applied VAT exemption on imports and sale of wheat, production and sale of wheat flour and bread from 1 January 2016 for one year meanwhile preventing possible price hikes in bakery.

The list of goods (works, services) whose prices (tariffs) are regulated by the Government underwent changes over the period to exclude regulation of prices for rail transport for freight and passengers and to include transport of transit cargo by railways and by sea, exploitation of transit cargo related

port equipment, freighting by marine terminals and other services rendered at a seaport, as well as prices for freight forwarding services.

Average annual core inflation adjusted for regulated prices and seasonal factors made 12.2%.

Graph 24. Annual average core inflation, %

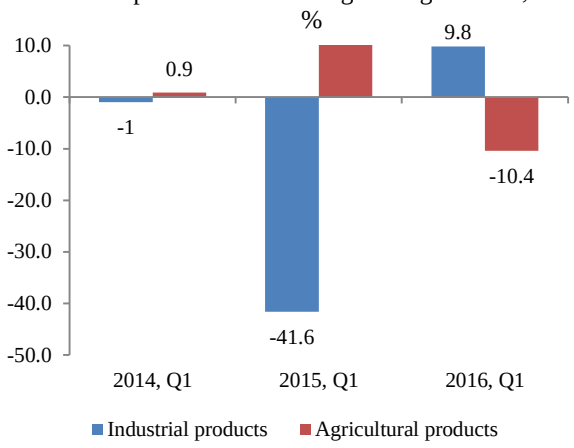


Source: SSC

Although changes to the exchange rate of Manat in general elevated inflation expectations, some sectors witnessed drops in expectations. The CBA's regular RSM revealed that price expectations dropped in textile and chemistry in industry, sale of furniture in trades, post, communication, health and tourism in services over 3 months of 2016.

Producer Price Index. In Q1, 2016 the PPI rose 9.8% - 9.4% in mining, and 8.4% in processing. Prices in mining were driven by the rise in oil prices.

Graph 25. Annual average change in IPPI, %



Source: SSC

In Q1, 2016 agricultural producer prices dropped 10.4% mainly driven by 20.5% cheapening of plant products. Prices hiked 0.1% on animal and 4.7% on fish and fishery products over the period.

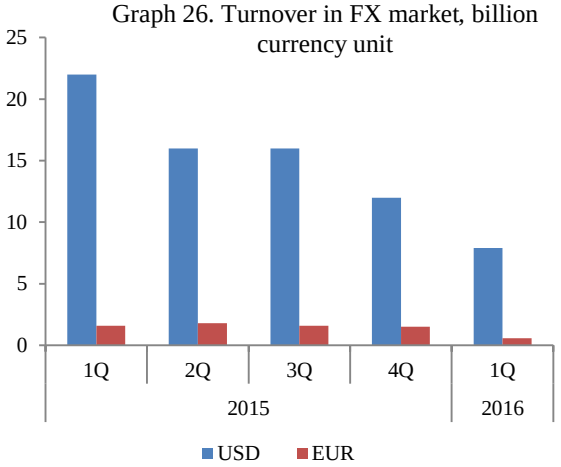
III. THE MONETARY AND EXCHANGE RATE POLICY

3.1. The FX market and the exchange rate of manat

In Q1, 2016 the exchange rate of Manat was determined under the new regime announced by the CBA at the end of the previous year.

In Q1, 2016 the FX market diminished in size year on year. Turnover of FX market in USD denominated dropped 2.8 times, while in EUR turnover dropped 2.7 times.

Graph 26. Turnover in FX market, billion currency unit



Source: CBA

82% of transactions in the FX market were conducted in USD, while 18% in EUR over the period.

The cash foreign exchange market was also affected by the diminished FX market. Cash USD sold by banks y.o.y. decreased 55 times to USD 79 M, while cash EUR sold decreased 3.5 times to EUR 69 M in January – March 2016. Cash USD brought by banks y.o.y. decreased 6.2 times amid low demand for cash foreign currency.

The diminished size of the FX market was driven by supply and demand alike. One of the key factors to contribute to low demand for foreign currency was dropped imports of goods and services. Moreover, slowdown in dollarization also contributed to low demand for foreign currency.

Low foreign currency supply is mainly attributable to low foreign currency sales by the Azerbaijan State Oil Fund (SOFAZ) (y.o.y. decrease 41%) Decrease in foreign currency supply from other sources

(remittances, exports etc.) continued in Q1.

In 2016 the CBA used an operational framework in harmony with the exchange rate regime it had announced. Over the quarter the Bank made minimum interventions to the FX market. Also the SOFAZ sold foreign currency through CBA's auctions. Auctions have been conducted several times a week and parameters of each auction was upfront announced to market players at the Bloomberg terminal. The parameters of foreign currency auctions (the size of supply, deviation range etc.) flexibly adjusted to the situation in the FX market. Results were regularly disclosed to the public upon the completion of auctions.

Overall 33 auctions were conducted in Q1: in 12 of them demand prevailed over supply, in 21 it was met in full. Average daily demand was USD 132 M, while supply was USD 148 M at auctions. The SOFAZ sold total USD 1253 M worth of foreign currency at CBA initiated auctions.

The interbank FX market operated on a regular basis on non-auction days. Interbank FX market's off-auction operations increased over the quarter.

The new exchange rate regime allowed the CBA to maintain a critical level of reserves, currently amounting to USD 4 B. However, CBA's foreign exchange reserves exceed expected 3 month import for 2016. The foreign exchange reserves to M2 money aggregate ratio is 70%, far above the level required for the newly applied exchange rate regime.

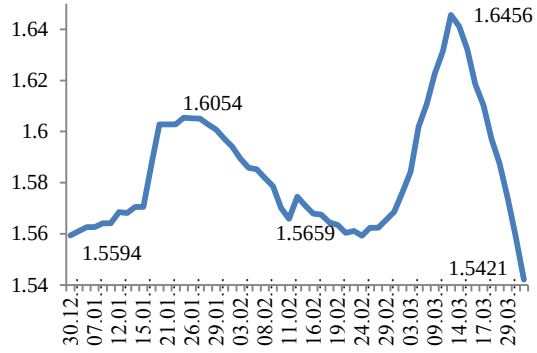
Over the period the official exchange rate of Manat was equal to the average exchange rate on interbank transactions, implying that the official exchange rate fully mirrored the average market exchange rate. Since the beginning of the year the CBA has been announcing an

official exchange rate for the following business day one business day before.

Manat appreciated and depreciated several times in Q1 within the new exchange rate regime. Whereas the exchange rate of USD against Manat was AZN 1.5610 early year, as of 11.03.16 it reached quarterly peak AZN 1.6456, followed by the appreciation of Manat by the end of the quarter. Exchange rate fluctuations of Manat paved the way to active utilization of new financial instruments and better management of exchange rate risks by economic agents.

As of end-Quarter I USD depreciated 1.1%, and EUR appreciated 2.4% against Manat compared to the beginning of the year. Manat depreciated 4.2% against the Russian ruble, and 1.4% against the Turkish lira, while it appreciated 10.4% against the Ukraine hryvna, and 2.2% against the Kazakh tenge.

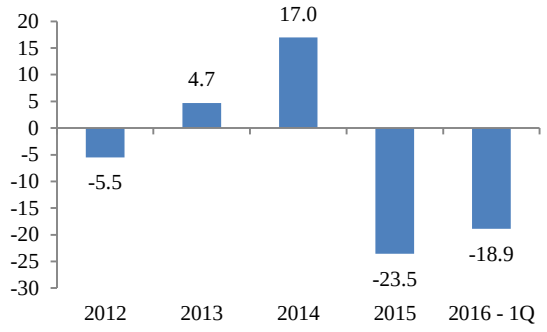
Graph 27. Exchange rate of USD/AZN



Source: CBA

The dynamics of the bilateral exchange rate affected the multilateral exchange rate. The REER depreciated 18.9% on the non-oil sector in Q1.

Graph 28. Dynamics of non-oil sector REER



Source: CBA

The depreciation was driven by 23.1% depreciation of the NEER. Price differences had a 5.4% upward effect on the REER.

The depreciated NEER and REER contribute to import substitution and export stimulation.

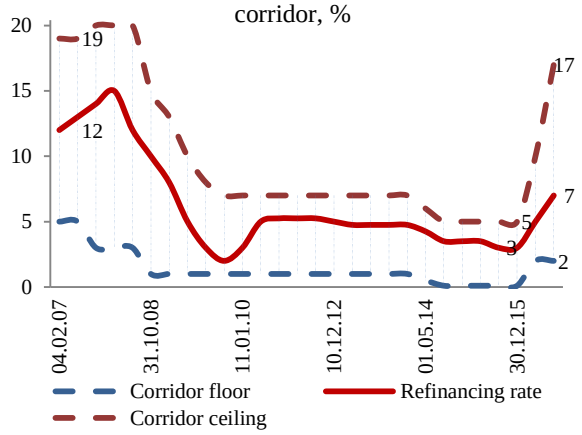
3.2. Monetary policy tools

Maintaining macroeconomic stability and new trends in money and financial markets are considered in monetary policy decisions in Q1, 2016.

Liquidity injections and absorptions between the CBA and the banking system were conducted within the interest rate corridor parameters.

In Q1 interest rate corridor parameters underwent two changes.

Graph 29. Parameters of interest rate corridor, %



Source: CBA

To encourage the improvement of monetary policy tools in the light of the trends in the money market the CBA Management Board decided to stepwise shift the refinancing rate to 7% from 3%, and the floor of the interest rate corridor on liquidity operations to 2% from 0.1% and the ceiling to 17% from 5% meanwhile taking into account yield on government securities.[3]

The Bank also decided to extend the maturity of liquidity injections and absorptions at interest rates within the floor and the ceiling of the interest rate corridor. Banks may initiate 1 – 7 day repo/counter repo operations in an unlimited manner to manage short-term liquidity.

These decisions were also based upon forecasts of key macroeconomic indicators and the objective of sustaining medium term price stability.

The CBA employed reserve requirements to control money supply and liquidity in the banking system.

[3] *In total, in Q1, 2016 7 auctions were held to place securities issued by the Ministry of Finance, where the term of government securities in Manat ranged from 91 to 728 days, while average weighted yield ranged between 7.79% - 16.61%.*

To reduce dollarization and make the banking system financially more stable, the CBA Management Board at the decision of 3 March 2016 moved the reserve requirement on banks' foreign currency denominated liabilities to 1% from 0.5%, decreasing liabilities to the non-resident financial sector and for settlements with international financial institutions to 0% from 0.5% leaving reserve requirements for national currency denominated liabilities, as well as liabilities in precious metals unchanged.

Table 3. Reserve requirements, %

	Liabilities in foreign currency and precious metals	Liabilities in Manat	Non-resident financial sector liability
01.05.2011	2	2	2
01.07.2011	3	3	3
01.08.2014	2	2	2
01.03.2015	0.5	0.5	0.5
30.12.2015	0.5	0.5	0.5
03.03.2016	1	0.5	0

Source: CBA

Banks will provide reports on reserve requirements in line with the new norms from May onward and maintain their reserves under the new norm from June 2016.

Balances of banks' correspondent accounts with the CBA considerably exceeded the size of funds to be maintained as required reserves for the period.

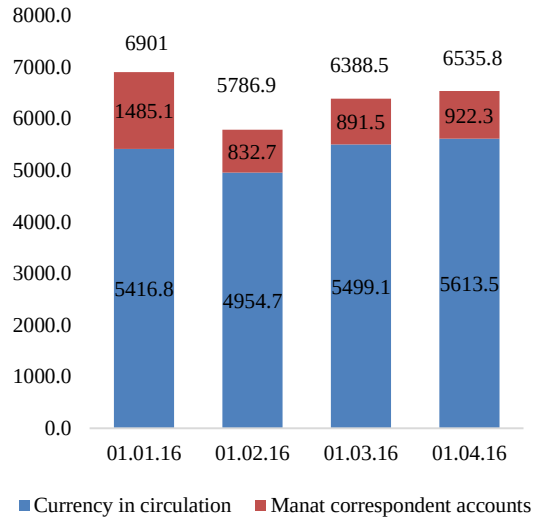
The Bank will keep improving monetary policy tools due to changes made to the monetary policy regime.

3.3. Money supply

The money supply in Manat in Quarter I, 2016 was affected by seasonal factors as in the corresponding periods of previous years. Slowing of dollarization also contributed to the dynamics and structure of money supply.

The money base in Manat decreased 5.3% to AZN 6535.8 M as of the end-period, driven by 9.2% drop in net foreign assets. Net domestic assets increased AZN 889.2 M (23.2%) over the period.

Graph 30. Change in Money base components, m. AZN

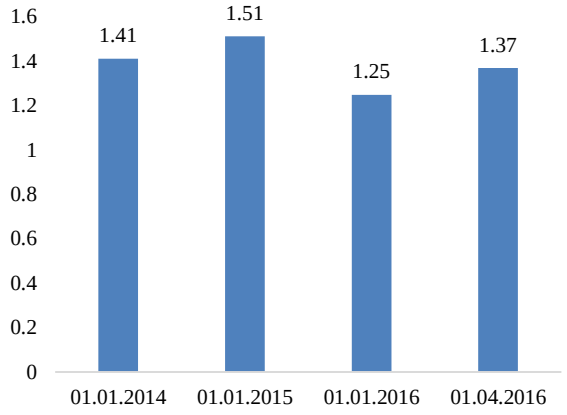


Source: CBA

38% decrease in correspondent accounts in Manat was the key in drop in money base. Cash money supply in circulation (cash outside the banking system and in bank vaults) rose 3.6%.

The money multiplier of the banking system[4] (ability to create money) decreased 9% to 1.37, money supply in Manat posting growth in contrast to money base.

Graph 31. Money multiplier in AZN

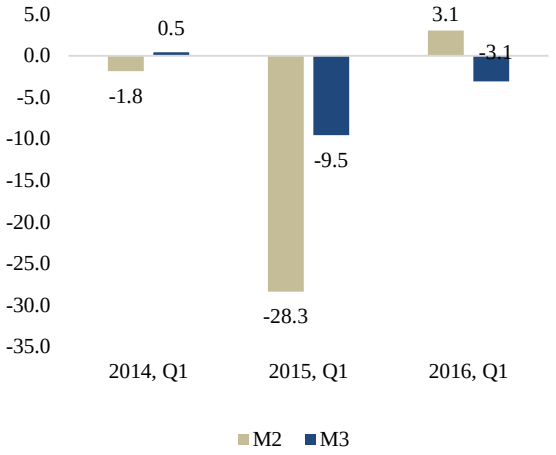


Source: CBA

Broad money supply in Manat (M2) increased 3.1% to AZN 8943 M as of the end-period.

[4] *Broad money supply in Manat/money base*

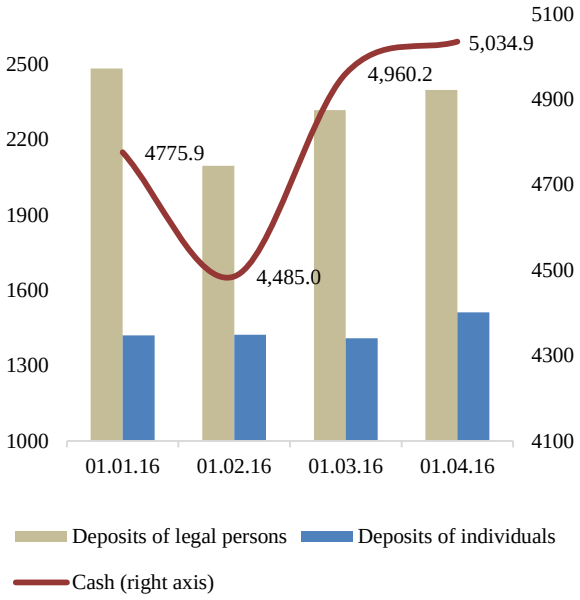
Graph 32. Change in money supply, %



Source: CBA

Cash and deposits of individuals increased, while deposits of legal entities decreased in the structure of money supply in manat (M2).

Graph 33. Dynamic of M2 components in 2016, m. AZN



Source: CBA

Cash money supply increased 5.4% over the period. Manat denominated deposits of individuals rose 6.4%, while those of legal entities declined 3.4%.

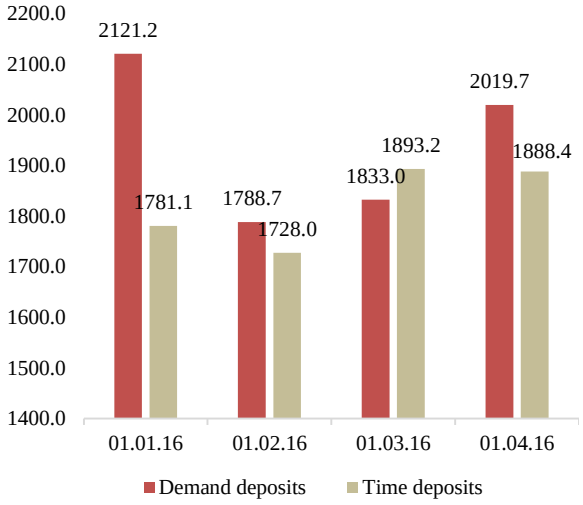
Table 4. Monetary aggregates, M AZN

	01.01.2015	**01.01.2016**	**01.04.2016**
M0	10153	4776	5035
M1	12830	6897	7055
M2	17436	8678	8943
M3	21566	21287	20635

Source: CBA

The term structure of Manat denominated deposits also changed.

Graph 34. Maturity structure of deposits, 2016, Q I, m. AZN

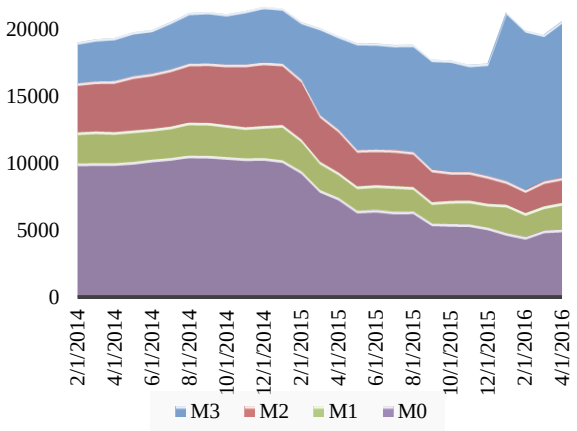


Source: CBA

Term deposits in Manat quarterly increased 6%, and demand deposits decreased 4.8%.

Over the period broad money supply (M3) decreased 3.1% to AZN 20635.1 M.

Graph 35. Dynamics of monetary aggregates, m. AZN

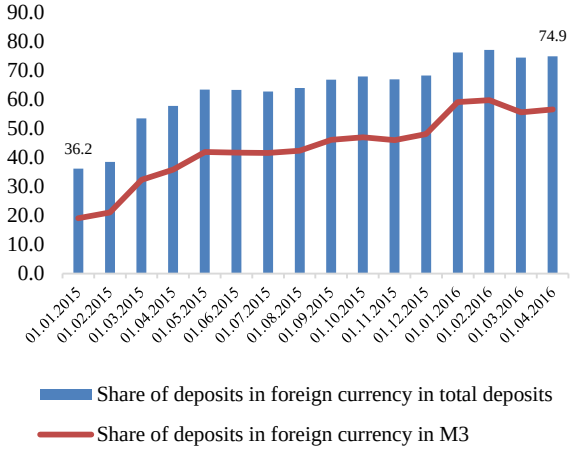


Source: CBA

Unlike M2, M3 money aggregate dropped due to declines in foreign currency denominated savings and deposits in the structure of money supply.

In Q1, 2016 dollarization subdued. Whereas foreign currency denominated savings and deposits accounted for 59.2% of M3 money aggregate early year, their share was 56.7% as of the end of Quarter I.

Graph 36. Dollarization, %



Source: CBA

While foreign currency denominated deposits accounted for 76.4% of total deposits early year, their share was 74.9% end Quarter I.

In Q1 Manat deposits of individuals rose 6.4% against early year, while foreign currency denominated deposits declined 20.8%. Dollarization of deposits of individuals moved to 81% from 85% early year.

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