CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW

January – March 2018

The main goal of this publicly disclosed quarterly review is to release the analysis of currenct macroeconomic developments and information on the monetary policy implemented by the Central Bank of the Republic of Azerbaijan to broad public.

Baku – 2018

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ACRONYMS

CBA	The Central Bank of Azerbaijan
ADB	The Asian Development Bank
EBRD	The European Bank for Reconstruction and Development
ILO	The International Labor Organization
IMF	The International Monetary Fund
NBCI	Non-bank credit institution
FDI	Foreign direct investments
SSC	The State Statistics Committee
DGCs	Developing countries
DDCs	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-sized enterprises
NEER	The Nominal effective exchange rate
OPEC	The Organization of the Petroleum Exporting Countries
REER	The Real effective exchange rate
RSM	Real Sector Monitoring
IPPI	The 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	World Trade Organization

EXECUTIVE SUMMARY

Macroeconomic stability strengthened in Quarter I, 2018 – inflation hit single-digit, the external sector indicators maintained positive dynamics, and stability in the FX market continued. Economic recovery started in 2017 gained much more sustainability in Quarter I, 2018. These positive outcomes were the result of the target-oriented and flexibly coordinated macroeconomic policy.

Annual inflation kept decreasing in the current year as well. İnflation fell back to single digit level, owing to exchange rate stability, optimal management of money supply, dynamics of global food prices, higher supply in the goods and services market, and relative drop in inflation expectations. Lower inflation underpinned rise in real income of the population.

Improvement process of external sector indicators that started in 2017 continued in 2018 amid higher export potential and favorable international economic conjuncture in commodity markets.

Positive trends taken place in the external sector translated into the exchange rate stability of the manat. The stable exchange rate was one of critical factors to have a downward effect on both the inflation rate and inflation expectations. The exchange rate stability was also accompanied with the decrease of dollarization.

The monetary condition in place maintained the best possible balance between the realization of macroeconomic stability targets and liquidity coverage of the economy. Rise in money supply fueled economy's demand for money and sustained uninterrupted payments in the first instance. Higher money supply was not accompanied with rise in lending activity, the banking system is going through the accumulation of excess liquidity in parallel with increase of saving trends. Excess liquidity triggered high demand for CBA's financial tools in 2018 too.

Strengthened macroeconomic stability and increased economic activity paved a way for gradual normalization of monetary condition. Over the reported period the CBA made critical corrections to the parameters of the interest rate corridor on its liquidity operations in view of recent macroeconomic trends and forecasts. Policy decisions were taken in light of the monetary policy's transmission specifications.

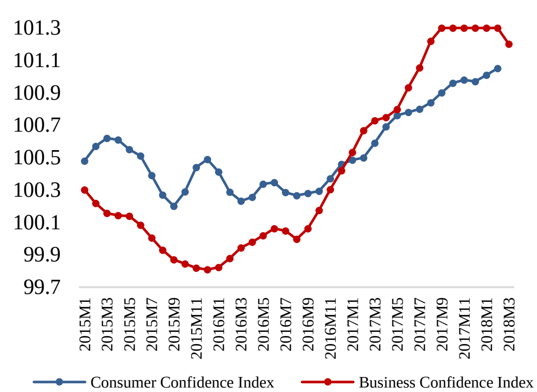
I. GLOBAL ECONOMIC ENVIRONMENT AND THE EXTERNAL SECTOR

1.1 Global economic trends

The global economic environment continued improving in Quarter I, 2018. Economic growth came amid higher global trade and investment flows. Yet global economic growth is still subject to certain risks.

Global economic growth. Global economic activity remained on the mend amid a favorable monetary condition, higher investment flows and stronger growth in developing Asian countries.

Graph 1. Business and Consumer Confidence indexes in OECD countries

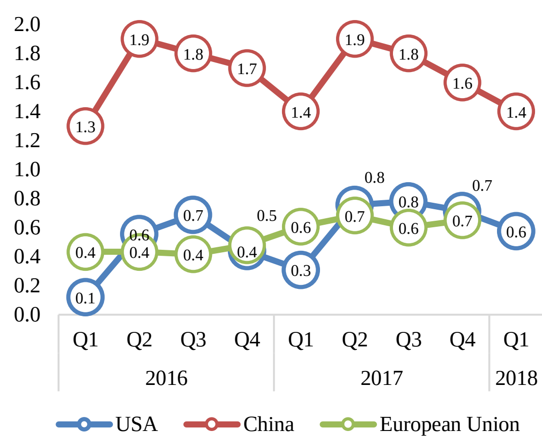


Source: OECD

On the backdrop of rising global investment growth rates of global trade and global industrial production continue elevating. Inflation is stabilizing both in DDCs and DGCs.

According to initial estimations, the US economic growth rate of Quarter I prevailed over the same indicator of the similar period of previous years. The US tax cut contributed to population's higher income and savings.

Graph 2. Quarterly economic growth (quarter on quarter)



Source: OECD and statistics committees of relevant countries

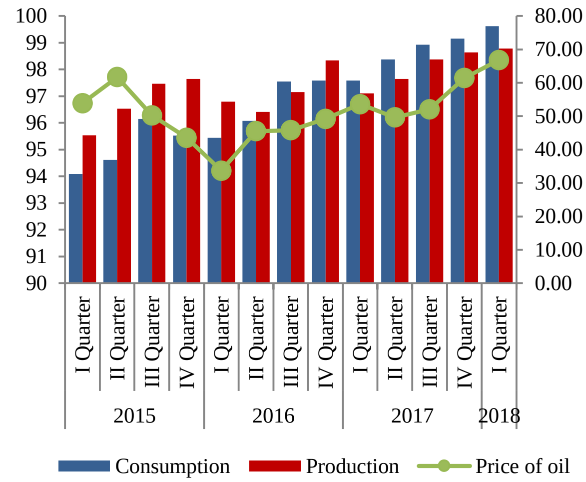
High consumer confidence in the euro zone is indicative of lingering sustainable growth. Economic indicators of Quarter I released both in France and Germany display that revival in manufacturing in particular is ongoing. Unemployment is going down with parallel accelerated growth in Japan.

The volume of exports in DGCs is increasing in response to high imports in DDCs. Initial data show that growth of commodity exporting DGCs in 2017 continues in 2018 as well. Economic growth in China was higher than expected in Quarter I, 2018 – 6.8% (y/y). Economic growth is picking up speed under the influence of governmental support in the fiscal and monetary policy. However, economic revival is supplemented by rising inflation.

According to recent estimations by the ILO, the global unemployed are numbering 192.7 million, i.e. global unemployment stands at 5.6%. Despite high work force, global unemployment is expected to drop to 5.5% by the end of 2018 due to high economic activity in DDCs in particular.

Global commodity prices. The commodity price index by the IMF has increased by 4.8% since early year mainly owing to rising oil prices.

Graph 3. World oil market, production-consumption, thousand barrels/day



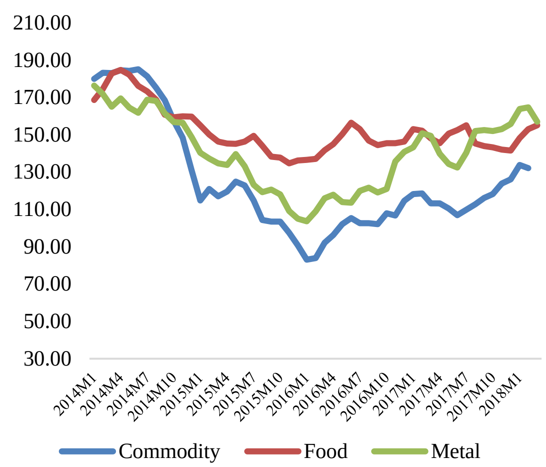
Source: Energy Information Agency (EIA)

Brent oil prices continued to rise in 2018 too, they increased by 3.4% as of the end-quarter compared to early year. The average price for Brent oil stood at $67 (y/y up by 25%).

The price for natural gas has increased by 3% since the beginning of the year. In general, the average price for natural gas y/y was up by 13.1%.

Introduction of restrictions on the use of coal in China weighed in on high demand for gas. Metal prices increased about 1% compared to the early year. Relative drop in supply of certain products due to weather conditions contributed to an increase in prices of agricultural products.

Graph 4. Price indices (2005=100)

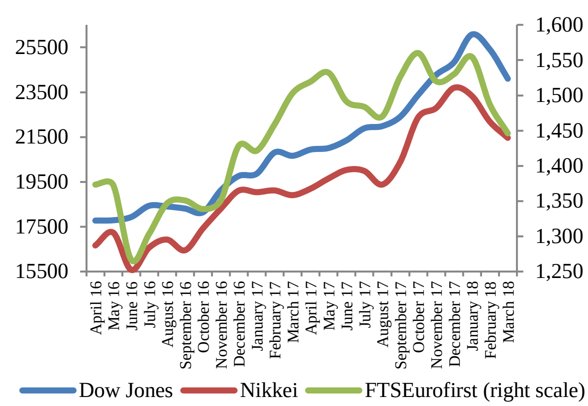


Source: IMF

Global financial markets and the monetary policy. Amid higher global growth central banks of major DDCs kept tightening the monetary policy, while most DGCs reduced the policy rate.

After increasing the benchmark rate 3 times in 2017 (April, June and December) the US Fed increased the rate once again by 0.25 p.p. to 1.5% in March, 2018. At the same time, the Fed sold securities in Quarter I, 2018 as in Quarter IV, 2017 under the decision to reduce its swollen balance sheet in the aftermath of the global financial crisis. Inflation rate exceeded 2% target in UK, which paved the way to transition to the tight monetary policy – the target rate was shifted to 0.5% from 0.25% in November 2017.

Graph 5. Dynamics of financial indexes



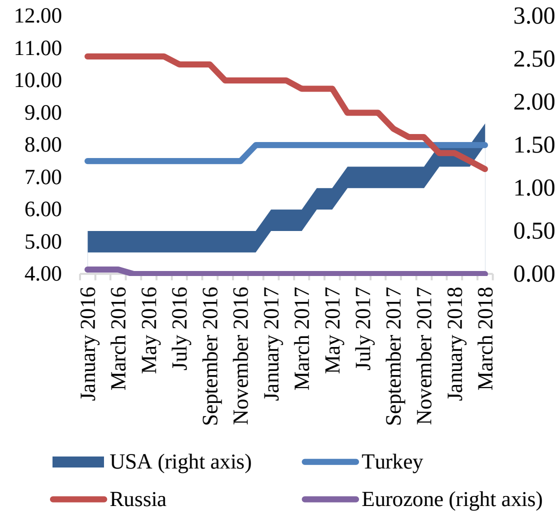
Source: Reuters

The ECB is wary of tightening the monetary policy despite accelerated economic growth and lower unemployment. Over the past period of 2018 the benchmark interest rate was kept unchanged in the euro zone, supplemented by ongoing purchase of assets. The target rate in the Czech Republic was shifted to 0.75% in February 2018 (0.5% in 2017). The interest rate was increased in Canada too (to 1.25% from 1%).

Some central banks of DGCs eased, while others tightened the monetary policy over the period. The refinancing rate was decreased by 0.25 pp. to 6.5% in Brazil, while it was increased to 7.5% from 7.25% in Mexico.

Russia continued to ease the monetary policy – the refinancing rate was once again reduced to 7.25%.

Graph 6. Key rates of central banks



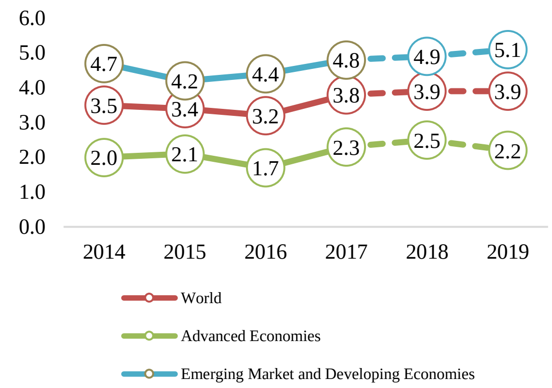
Source: Central banks of relevant countries

Compared to the early year the USD depreciated against the euro, the pound, the Chinese yuan, and the Japanese yen, while it gained against the Turkish lira, the Russian ruble and the Iranian rial.

Forecasts. The IMF kept optimistic global economic growth forecasts for 2018 and 2019 in its Global Economic Outlook released in April, 2018 – global growth will stand at 3.9% amid accelerated growth in DGCs, and sustainable growth in DDCs (0.1% up from growth in 2017). Economic growth is forecast to stand at 2.5% in DDCs and 4.9% in DGCs in 2018.

High growth forecasts in the euro zone and Japan and spillover of the US fiscal reform to partner countries weighed in on growth forecasts in DDCs. The US fiscal reform contributed to economic growth both through tax cut and high public spending. 2.3% economic growth of 2017 in the USA is expected to increase to 2.9% in 2018. The IMF revised up economic growth forecasts for 2018 for the euro zone by 0.2 p.p. to 2.4%, mainly due to high domestic demand and favorable monetary policy. The ECB also revised up economic growth forecast for 2018 by 0.1 p.p.

Graph 7. Global economic growth, annual



Source: IMF, Global Economic Outlook, April, 2018.

The accommodative monetary policy in DDCs, structural reforms and remediation efforts in the financial sector slowed down the effect of crises of the previous decade, accelerating global recovery.

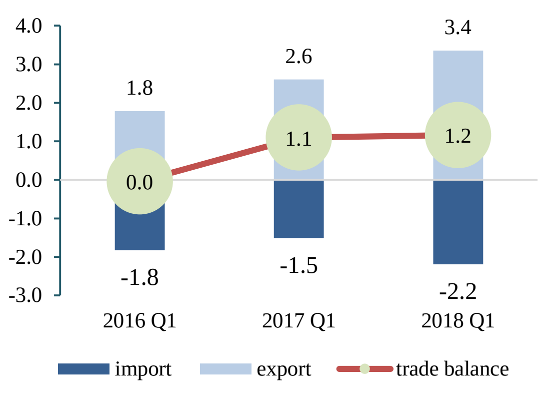
Both revived global economic environment and rising oil prices create favorable conditions for high oil and non-oil exports in Azerbaijan. Economic growth is expected to stand at 2.9% (non-oil export weighted) in 2018 in peer group of trade partners of Azerbaijan.

1.2 Azerbaijani external sector developments

On the backdrop of higher non-oil export capacity and favorable international economic potential, improvement of external sector statistics started last year continued in Quarter I, 2018.

According to the State Customs Committee (SCC), foreign trade turnover amounted to $5.6 billion: exports $3.4 billion (60.7%), import $2.2 billion (39.3%).

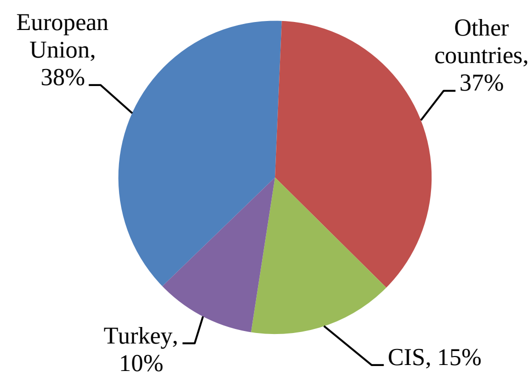
Graph 8. Trade balance, USD bn.



Source: SCC

Azerbaijan traded with 146 countries.

Graph 9. Main trade partners, 2018 I quarter, %



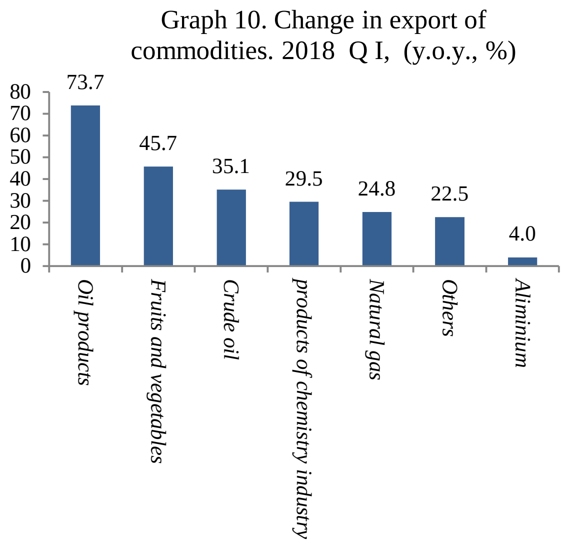
Source: SCC

EU countries accounted for 38% of trade turnover: Italy 34%, Germany 18%, Czech Republic 12% and Austria 9%.

CIS countries accounted for 15% of trade turnover: Russia 60%, Ukraine 17%.

Other countries accounted for 37% of trade ties: Israel (15%), China (11%), USA (11%) and Indonesia (10%).

Commodity export increased by 28.7%, driven by the oil sector – the value of exports rose 35% on crude oil and 74% on oil products.



Source: SCC

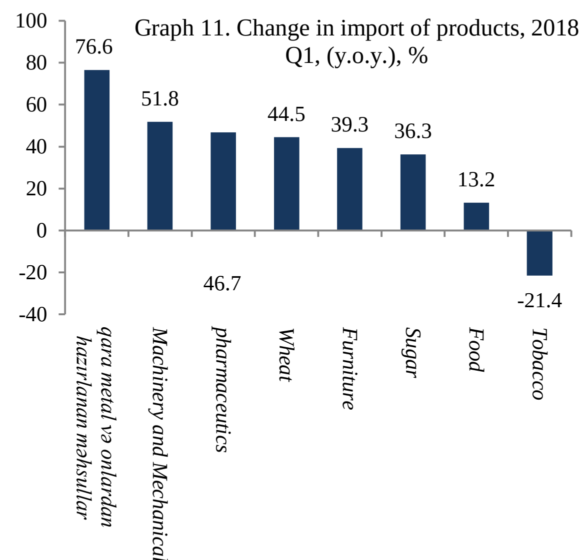
Non-oil exports also posted growth – fruits and vegetables 46%, cotton yarn 25%, chemicals 30%, aluminum 4%.

Main export partners included Italy (19%), Israel (9.2%), Turkey (7.8%), the Czech Republic (6.2%) and Indonesia (6%).

Commodity import jumped 44.8% - import on the public sector increased by 2.7 times to $0.4 billion, while import on the private sector increased by 30.4% to $1.7 billion.

Russia accounted for 17.3%, Turkey 14.3%, China 10%, Germany 8.8%, USA 4.8%, Ukraine 4% and Belarus 3.8% of imported products.

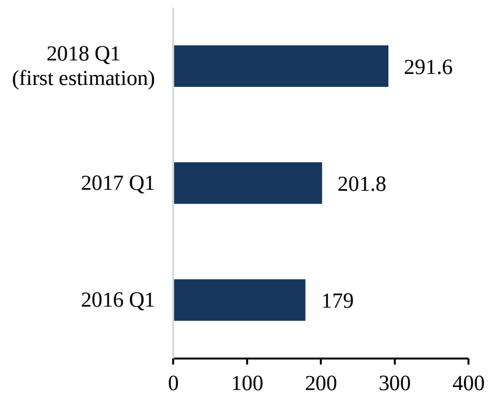
Imports rose on major components: it increased by 3 times on vehicles, 3.4 times on cement, 52% on machinery and mechanisms, 77% ferrous products and 13.2% food stuff, while it decreased by 22% and 4.8 times in tobacco and sugar respectively.



Source: SCC

The situation in economic partners weighed on the dynamics of money remittances along with non-oil exports. According to rough estimations, money remittances to the country amounted to $ 291.6 million.

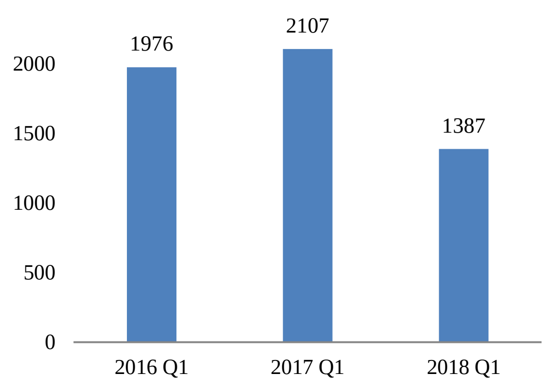
Graph 12. Inflow of remittances, mln.$



Source: CBA

Investments to fixed capital stock from foreign enterprises and organizations kept flowing – according to the SSC, FDIs constituted $1.4 billion (48.3% of total investments).

Graph 13. Foreign investments, mln. manats



Source: SSC

The United Kingdom, Turkey, Switzerland, Malaysia, the Czech Republic, Japan, the USA, Russia and Iran accounted for major part of investments to fixed capital from foreign companies and organizations.

Positive external sector developments weighed on the dynamics of foreign exchange reserves. Strategic foreign exchange reserves increased by 5% amid the improved balance of payments (BoP), sufficient to cover thirty-one-month import of goods and services exceeding the sovereign debt by 3 times.

II. MACROECONOMIC DEVELOPMENTS IN AZERBAIJAN

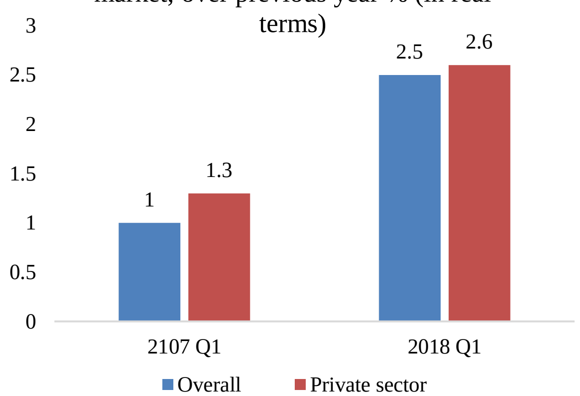
2.1. Aggregate demand

Economic growth was mainly driven by domestic demand as before.

Consumption expenditures kept increasing in Quarter I, 2018 too.

The volume of goods and services sold in the consumer market over the period to meet consumer demand y/y increased by 2.5% to AZN 10.8 million in real prices. 96% of goods sold and services supplied by economic agents was offered by private entrepreneurs.

Graph 14. Dynamics of consumption market, over previous year % (in real terms)



Source: SSC

Average consumer purchased on average AZN 367.7 worth of commodities and services monthly (y/y up by AZN 20).

Retail trade turnover increased by 2.6% to AZN 8.5 billion. Retail non-food trade turnover increased by 3.3% to AZN 4.2 billion.

Consumers spent 50.7% of their funds on food, beverage and tobacco at retail trade outlets (y/y up 2%). Expenses y/y increased by 3.5% in knitwear, clothing and shoes, 3% in electric appliances and furniture, 1.9% in telecommunication.

Table 1. The share of spending items in trade outlets in Quarter I, 2018, %

Spending item	Share, %	
	2017 3 months	2018 3 months
Food, beverage and tobacco	51	50.7
Knitwear, clothing and shoes	17.7	17.6
Electric appliances and furniture	6.1	6
Computers, telecommunication devices and others	0.8	0.7

Pharmaceuticals and medicals	1.3	1.2
Fuel	4.9	5.7
Other non-food stuff	18.2	18.1

Source: SSC

Every consumer purchased on average AZN 146.6 worth of food, beverage and tobacco and AZN 142.6 worth of nonfood items monthly for private consumption in retail trade.

Catering turnover rose by 3.8%. Entities accounted for 40,1%, and private entrepreneurs account for 59,9% of catering turnover in the private sector. The size of paid services to the population increased 1.7% to AZN2 billion. Per capita paid services consumption y/y increased by 3.6% in nominal terms.

Consumer demand was driven by rise in nominal income of the population – it y/y increased by 9.8% to AZN 12.5 billion. Per capita income rose by 8.8%, while disposable income increased by 10.2% to AZN 11.6 billion.

Nominal average monthly salary of hired workers in the economy y/y increased by 2.2% to AZN 510.8. Salary of employees in public entities was AZN 393,8 and in private entities was AZN 674,6.

Bank loans to households, one of consumer demand components increased by 0.6%. The size of consumer lending portfolio made up AZN 4.6 billion as of End-March.

The consumer confidence index, generated from the survey ‘Financial behavior and intentions of households’ of March, 2018 continued improving. To note, this indicator rests upon the surveys on ‘Family’s financial condition expectations’, ‘Expectations on country’s economic situation’, ‘Savings probability’ and ‘Unemployment expectations’ among various income households. Analyses suggest that the consumer confidence index has been prone to rising over recent 3 quarters, mainly due to better expectations related to country and family's financial standing, and lower unemployment expectations.

Government expenditures were critical for domestic demand. According to the Ministry of Finance of the Republic of Azerbaijan, in January – March 2018 state budget expenditures made up AZN 4408 million[1].

Following the economic classification, 40% (AZN 1761.3 million) of state budget expenditures were channeled to social spending (salary fund, pension and social allowances, drugs and food), (y/y up by 7.7%).

Investment expenditures. AZN 2869.2 million worth of investments were channeled to the country economy – AZN 1413 million to the oil and AZN 1456.2 million to the non-oil sector. The private sector accounts for 42.8%, while public sector 57.2% of total investments.

51.7% of investments stemmed from internal, while 48.3% external sources.

Table 2. Investment sources, share, %

	2017 1Q	2018 3 1Q
Funds of enterprises and organizations	75.2	60.4
Bank loans	10.6	13.7
Budget funds	8.5	19.4
Off-budget funds	0.6	0.6
Population's own funds	4.7	5.4
Other funds	0.4	0.5

Source: SSC

Funds of enterprises and organizations prevailed in total investments (60.4%).

[1] *Source: http://www.maliyye.gov.az/*

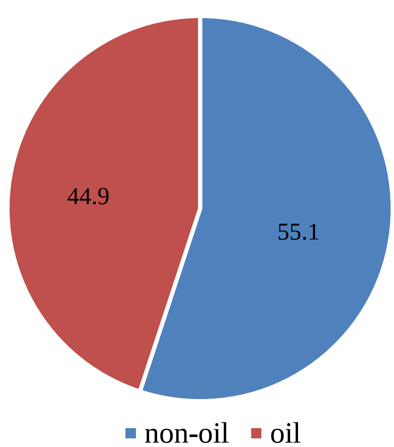
2.2. Aggregate supply and employment

Economic activity started in 2017 remained buoyant in Quarter I, 2018.

Economic growth. According to the SSC, real GDP increased by 2.3% to nominal AZN 17.2 billion. Per capita GDP was AZN 1755.7.

The mining industry extracted 9.6 mln tons of crude oil, 4.4 mln m3 of natural gas. Oil extraction rose by 2.2%, while gas extraction dropped by 5.8%.

Graph 15. Sectoral breakdown of economic growth, %

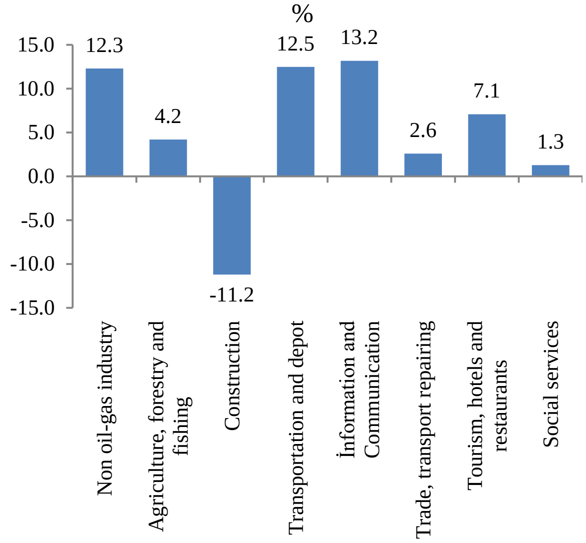


Source: SSC

The value added in the non-oil sector y/y increased by 2.9% in real terms to nominal AZN9.5 billion (55.1% of GDP).

The non-oil sector posted growth on major areas.

Graph 16. Sectoral growth of economy, to corresponding period of previous year, %



Source: SSC

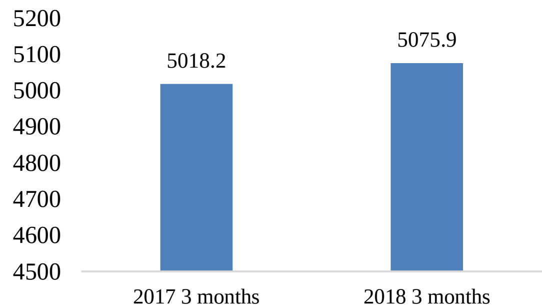
The non-oil and gas industry grew by 12.3%.

The CBA's RSM related survey findings also suggest that y/y non-oil economic activity elevated; indicators bettered across major production areas, including chemical industry, weaving, and machinery. All service (communication, postal, transport, hotels, healthcare, tourism) and trade (home appliances, cars, furniture, housewares) areas covered in the survey posted positive dynamics in activity indicators.

Employment. As of End-Quarter I, 2018 the economically active population was numbering 5075.9 thousand persons (y/y up by 57.7 thousand persons).

According to the SSC, the number of hired labor y/y increased by 0.1% to 1516.5 thousand persons.

Graph 17. Economically active persons, end of period, thousands



Source: SSC

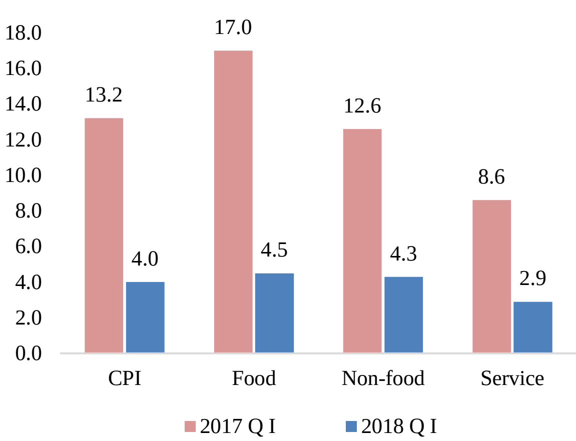
22.4% of hired labor in enterprises and organizations was involved in production, including 6% in construction, 6.6% processing, 3.2% agriculture, 2.2% mining.

2.3. Inflation

As a result of ongoing downward trend in annual inflation rate inflation hit 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 4%. CPI components – food prices changed by 4.5% on average annual, non-food prices by 4.3%, and services by 2.9%.

Graph 18. Average annual inflation, %



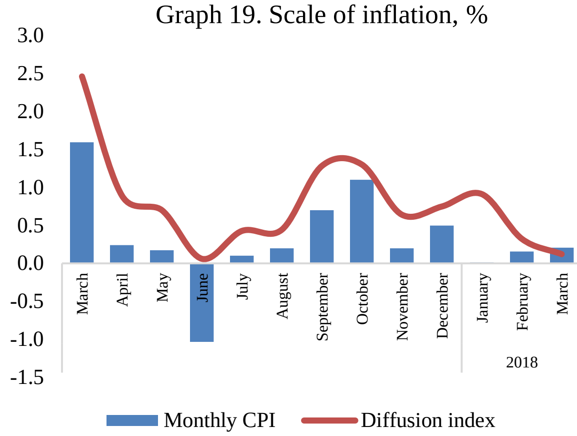
Source: SSC

Food prices account for 1.9%, nonfood 1.1%, and services for 1% of average annual inflation.

Average inflation was 0.1% (y/y down by 1.7%). Inflation peaked in March over the period (0.2%).

The diffusion index – a measure of change dynamics pertaining to the number of goods and services with rising and falling prices in the basket of consumer goods also decreased compared to early year.

Graph 19. Scale of inflation, %



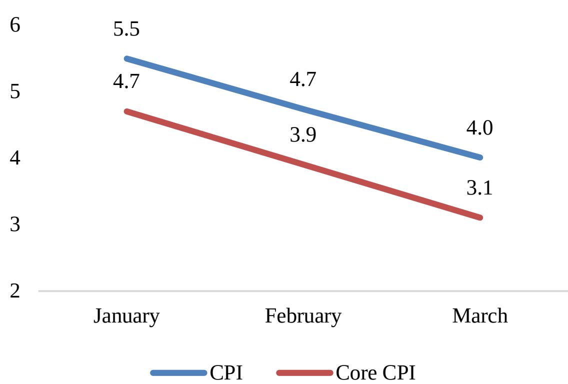
Source: CBA estimations base upon SSC & SSC data

Prices for 170 out of 520 items of goods and services declined and remained unchanged for 142 items in March.

Analyses display that the stable exchange rate, optimal management of money supply, dynamics of global food prices, wider supply of products and services, and lower inflation expectations contributed to single-digit inflation.

Average annual core inflation, calculated by excluding the goods and services whose prices are regulated by the government, and seasonal agricultural products was 3.1%.

Graph 20. Consumer Price Index, 2018, annual average



Source: SSC

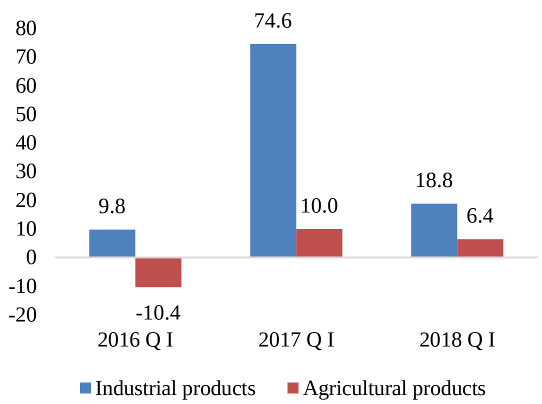
Expectations also contributed to swings in consumer prices. Overall heightened under certain cost factors, they were prone to lowering. Regular RSM by the CBA revealed that price expectations in trade fell in furniture and cars, and rose in home appliances for upcoming 3 months. Price expectations decreased across all areas of services, mainly in transportation, hotels and healthcare. In processing price expectations dropped in food and beverage, chemical, machinery and metallurgy segments, while they rose in construction materials, plastic mass, weaving and other non-metal mineral products. Price expectations jumped in construction.

Producer Price Index (PPI). According to the SSC, the GDP deflator, that measures price swings in all domestically produced goods and services, was 9.9%, mainly owing to rising global oil prices.

Having changed more on industrial products, the IPPI y/y increased by 18.8%, mostly due to price upswings in mining, and electricity, gas and steam generation (20.9% and 35.5% respectively).

Prices in processing rose by 14% - tobacco products (29.8%), polygraph activity (27.2%), oil processing (20%), and production of vehicles and towed vehicles (19%).

Graph 21.Annual average change in PPI, %



Source: SSC

The APPI increased by 6.4%, due to price hikes in plant growing products (6.6%) – prices for yearlings hiked by 9%. Prices for animal products increased by 6.2% – beef 8.4%, lamb 5.1%. Prices increased for forestry (1.5%), and fish and fishery products 7.9%.

Transportation tariffs decreased by 3.4%, attributable to 5% slide in cargo services. Whereas prices for passenger transportation increased by 6.8%, prices for communication and postal services decreased by 0.3%.

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 and 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 – the cash and cashless currency markets.

Cashless transactions amounted to $4.8 billion equivalent [2] (y/y up 11.2%) – 84% of which was USD denominated transactions and 16% other currencies. USD transactions y/y increased by 12.4%, while EUR transactions decreased by 12.1%.

29% of cashless operations was conducted in the Interbank, 71% in the Intrabank market.

Interbank market turnover y/y increased 13%. 54.3% of USD transactions is attributable to regulation of banks' liquidity position. Interbank market operations mainly are conducted over Bloomberg platform.

Intrabank currency operations amounted to $3.4 billion equivalent (y/y up 10%). Currency operations with legal entities account for 96% of total currency operations in the Intrabank market.

USD denominated operations account for 78% of Intrabank market turnover. Cashless purhases of the banks amounted to $1.1 billion, and sale to $1.6 billion worth of USD by internal conversion.

Table 3. Currency operations in the Intrabank FX market (currency unit)

	USD			EUR		
	Buy	*Sell*	*Net sell*	*Buy*	*Sell*	*Net sell*
2017 QI	1007	1350	343	281	304	23

[2] *Including transactions in the USD, the Euro, the English pound, the Russian ruble*

2018 QI	1090	1572	482	205	294	89

Source: CBA

Cash currency exchange operations by banks amounted to $1.4 billion USD equivalent (y/y up 80.3%). Commercial banks bought $594.2 mln and sold $517.8 mln worth of cash USD. Buy operations exceed sell operations by $76.4 million.

Table 4. Data on cash currency exchange by banks (mln. currency unit)

	USD			EUR		
	Buy	*Sell*	*Net sell*	*Buy*	*Sell*	*Net sell*
2017 QI	277	365	88	34	53	19
2018 QI	594	518	-76	43	147	104

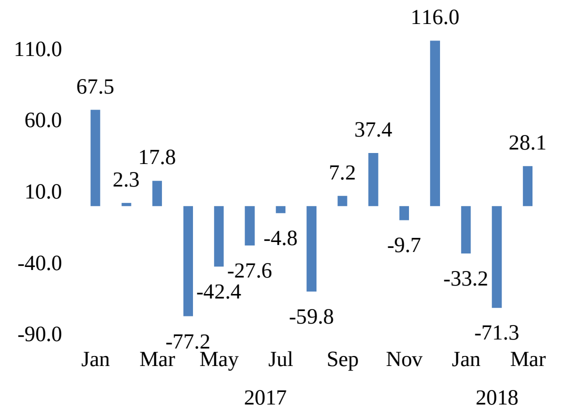
Source: CBA

Sell euro operations exceed buy euro operations by € 104 million.

Net cash bought by banks in other currencies (the English pound and the Russian ruble) amounted to $ 60.7 million equivalent and net cash sold amounted to $24.7 million.

Analysis of the dynamics of USD denominated operations of the banks in 2018 reveeals that the sale of banks exceeded their purchases in January and February, while the reverse was true for March.

Graph 22. Net sale of USD in cash, m. USD

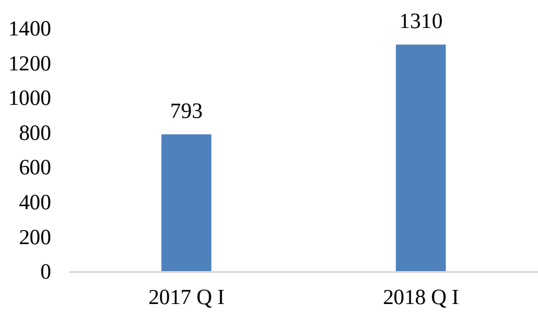


Source: CBA

CBA continued to hold currency auctions in the I quarter of 2018 to arrange sale of currency provided by State Oil Fund of Azerbaijan Republic (SOFAZ). Currency auctions are held twice a week and the market participants are informed about parameters of the auction through “Bloomberg” terminal prior to the auction.

The Bank held 23 foreign currency auctions, worth a total of $1310.2 (y/y up 65.2%).

Graph 23. SOFAZ currency sales, mln. USD



Source: CBA

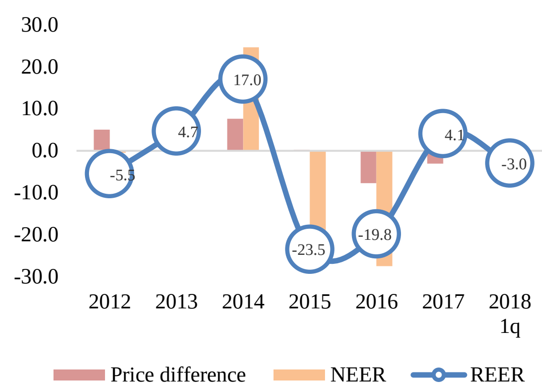
An official exchange rate of the manat was set on the basis of the average exchange rate on interbank transactions (both auction and non-auction).

The average daily official AZN/USD exchange rate was 1.7001 manat. Buy and sell currency exchange rates set by banks were close to the official rate. Commercial banks' average daily buy rate was 1.6955, while sell rate was 1.7022 manat. The difference between the official buy exchange rate and that of commercial banks was 0.3% (0.0046 manat), and sell rate was 0.1% (0.0021 manat).

AZN gained 0.01% against the USD, 4.16% against the Turkish lira, depreciated 2.45% against the euro, 3.78% against the pound, remaining unchanged against the Russian ruble.

The dynamics of bilateral exchange rates affected that of multilateral exchange rates. Total trade weighted non-oil REER appreciated 3%.

Graph 24. Dynamics of REER, % (2000=100)



Source: CBA

2% depreciation of the NEER and inflation differences in partner countries had a downward effect on the REER.

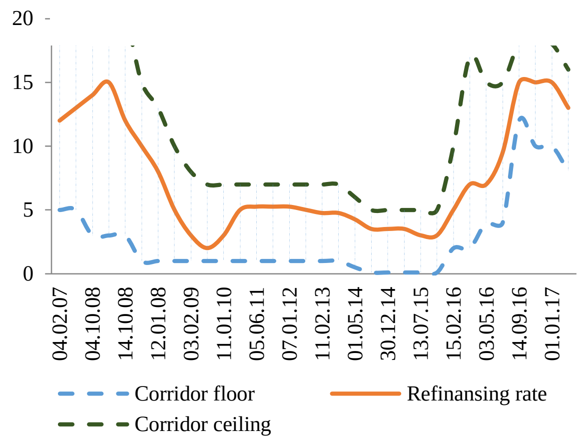
3.2. Monetary policy tools

Monetary policy tools were employed in light of developments in macroeconomic arena and financial markets, recent forecasts, and monetary policy pass through characteristics.

Improved external sector indicators and single-digit inflation paved the way to gradual normalization of the monetary policy. Given the stronger macroeconomic stability and recent macroeconomic forecasts the CBA made critical corrections to its interest rate corridor parameters on its liquidity operations. On 12 February 2018 the CBA Management Board decided to move down the refinancing rate to 13% from 15%, the ceiling of the interest rate corridor to 16% from 18%, and the floor to 8% from 10%.

The Bank kept various term (up to 7 days, 14 and 28 day) standing facilities and open market operations active to meet economy's demand for money and effectively manage liquidity. CBA's sterilization tools were in higher demand on the backdrop of accumulated excess liquidity due to lingering weak financial intermediation in the economy.

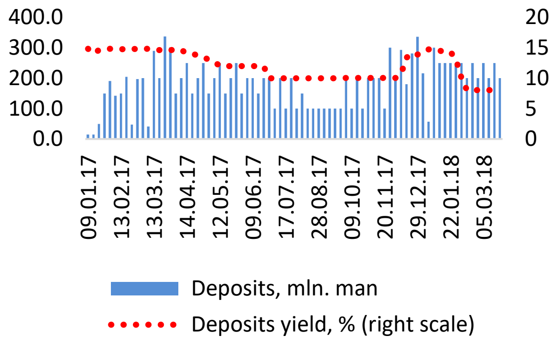
Graph 25. Parameters of interest rate corridor



Source: CBA

The Bank held 15 deposit auctions on attraction of available funds in the national currency and 12 auctions on placement of notes. Maturity of deposit operations was 14 days, while notes were placed for 28 days. Total outstanding amount of funds attracted at deposit auctions and placed notes made up AZN 1.3 billion.

Graph 26.Volume and yield of Central Bank's deposits

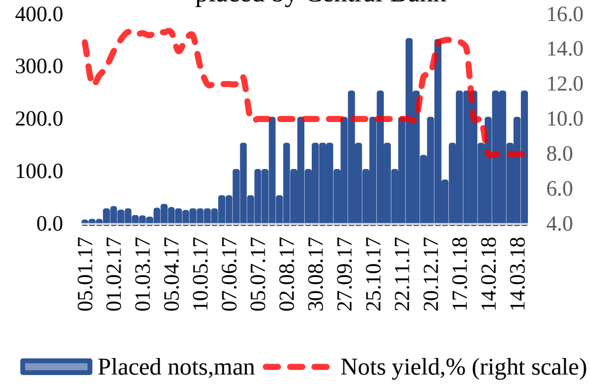


Source: CBA

AZN 700 million worth of funds were attracted at deposit auctions, while AZN 600 million via placement of notes. Outstanding amount of funds attracted by deposit auctions and placement of notes was down by 16%.

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 3 times at deposit auctions and by 2.7 times at auctions on placement of notes.

Graph 27.Volume and yield of nots placed by Central Bank



Source: CBA

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

Deposits are attracted and notes are placed at interest rates fluctuating between the floor of the interest rate corridor and the refinancing rate (currently 8%-13%) – deposits were attracted at 8.01% -14.79%, while notes were placed at 8.01%-14.52%.

Over Quarter I the reserve requirement was left unchanged. 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%.

Table 5. Reserve requirement, %

	Foreign currency denominated liabilities	Liabilities in manat and precious metals	Funds attracted from n/resident financial sector
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

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

Monitoring findings display that banks' cumulative balances on correspondent accounts with the CBA considerably exceeded amounts to be maintained as required reserves over the reported period.

3.3. Money supply

Tailored money supply maintained the best possible balance between realization of macroeconomic stability targets and coverage of the economy with liquidity.

Money base in manat increased by 10.9% to AZN 9471 million as of the end-period. Higher money supply contributed to liquidity coverage of the economy and uninterrupted payments. Demand for money is still driven by demand of the fiscal sector and the banking system for liquidity.

Cash in circulation – the structural element of money base – decreased by 0.4%. On the other hand, balance of correspondent accounts in manat increased by 3.6 times.

Broad money supply in manat (M2) increased by 4.3% in I quarter and reached to AZN 13005.9 million as of the end-period.

Cash stock, savings of individuals and deposits of legal entities in the structure of money supply in manat (M2) performed differently: whereas cash stock decreased by 1.2%, savings of individuals in manat increased by 8.6%, and deposits of legal entities increased by 3.2%.

Table 6. Money aggregates, mln. manat

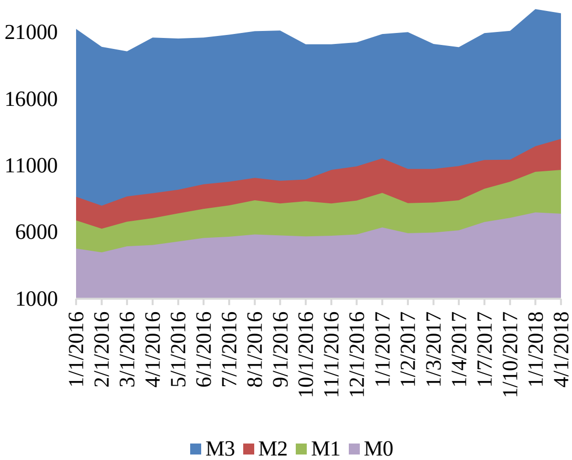
	01.04.17	01.01.18	01.04.18
M0	6145	7490	7404
M1	8411	10544	10692
M2	10982	12466	13005
M3	19903	22772	22459

Source: CBA

Term savings and deposits in manat increased by 20.4%, while demand deposits increased by 7.7%. Term deposits of individuals in manat increased by 16.2%.

Broad money supply (M3) decreased by 1.4% to AZN 22459 million as of the end-period.

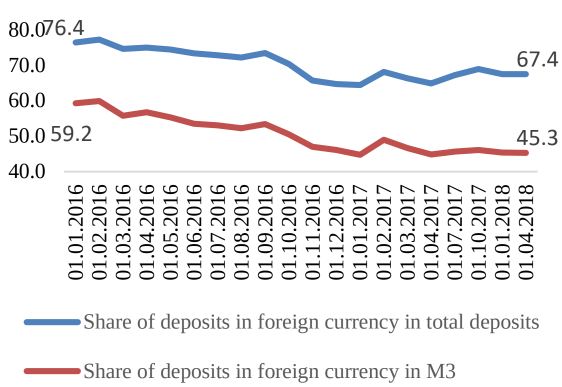
Graph 28. Dynamics of money aggregates, mln. manats



Source: CBA

Dollarization of bank deposits decreased – the share of foreign currency denominated savings and deposits in M3 money aggregate was 45.3% early the period, and 42.1% end period.

Graph 29. Dollarization, %



Source: CBA

Savings of individuals in manat increased by 8.6%, while their foreign currency denominated deposits decreased by 2.4%. As a result, dollarization of deposits of individuals dropped to 64.1% from 66.5% at the beginning of the year.

Graphs and tables

Graphs

Central Bank of the Republic of Azerbaijan

Tel.: (+99412) 493 11 22

http://www.cbar.az

Address: R.Behbudov Str. 90, AZ1014, Baku