Baku Research Institute

MACROECONOMIC ANALYSIS OF THE 2023 (January-September)

ECONOMIC BULLETIN

BAKU – 2023

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Introduction

We are in the final days of 2023. The year is ending, yet year-end economic data will only be revealed in a few months. Therefore, the macroeconomic analysis of 2023 in the Bulletin presented below is based on January-September figures.

It consists of 3 main sections.

The *first section* provides an overview of 2023 state budget revenues and expenditures, looking at key tendencies observed in the macroeconomic situation as well as changes in revenues and expenditures of the consolidated government budget that include both state budget and extra-budgetary funds.

The *second section* focuses on the ongoing monetary policy pursued by the government to control inflation. Imported inflation in our country amid a rally in global prices has led to general increases in the prices of goods and services, and the Central Bank of Azerbaijan (CBA) has focused on measures to combat inflation and tightened monetary policy in the last two years. To that end, the CBA followed a phased response to adjusting interest-rate benchmarks, introducing monetary policy instruments in a new configuration, and pushing an increase and differentiation of required reserve ratios. Beyond that, the CBA for the first time launched a policy of sharing responsibility with the country's banks. This section also reviews preliminary results of the impact of these measures on the banking system.

The *third section* analyses foreign economic relations, detailing the main trends observed there. The focus here is an assessment of the impact on the balance of payments of a significant decrease in revenues from oil and gas exports because of the decline in international energy prices, and a reduction in net capital outflows from Azerbaijan through various channels.

Income and Expenses of the 2023 State Budget

Macroeconomic situation: major trends

The State Statistical Committee data show the gross domestic product (GDP) of Azerbaijan in January-September 2023 amounted to 90 812,2 million AZN, registering a 0,8% real annual growth rate and only 0,2% real per capita GDP growth as compared to the same period last year.

For comparison, real GDP increased at an annual rate of 5,6% in the third quarter of 2022, totaling 98 193,8 million. [1] GDP deflator growth rates over the period January-September 2023 and 2022 were 91,7% and 145,4%,[2] respectively, i.e., there was a decrease in the overall price growth of the current year's GDP composition compared to the previous year (see Table 1).

Table 1: Comparison of Macroeconomic Indicators for January-September 2023 and 2022

	January-September 2023	January-September 2022
Amount of GDP, mln AZN	90812,5	98193,8
Real growth rates (compared to the same period of the previous year), %	100,8	1005,6
GDP deflator, %	91,7	145,4
Oil and gas GDP, million AZN	34647,5	47868,5
Real GDP growth rate in the oil and gas sector (compared to the previous year), %	98,5	97,5
Non-oil and gas GDP, million AZN	56165,0	50325,3
Real GDP growth rate in the non-oil and gas sector (compared to the previous year), %	103,0	110,1

(Table has been prepared on the basis of data provided by the SSC and CBA)

During this period, oil and gas generated a revenue of 34 647,5 million AZN, which made up 38,2% of the country's GDP, while non-oil and gas generated 56 165,0 million AZN (61,8%). The oil and gas sector recorded a 1,5% decrease in production in physical terms compared to the previous year, with a 27,6% decrease in value expression (i.e. nominal GDP) due to lower crude oil and natural gas prices in the world markets in the first 9 months of this year compared with the same period last year.

Unlike the oil and gas sector, nominal non-oil -and -gas GDP surged by 111,6%, with the real growth being 103,0%. Based on calculations, in the non-oil and gas sector GDP deflator for 9 months of the current year was 108,4%, i.e., rising prices in this sector will continue. As can be seen from the table, the real growth rate in the non-oil sector for 9 months has eased off compared to the same period of the last year and decreased by 7,1 pp.

[1] https://www.stat.gov.az/news/source/2022_09ay.zip
[2] https://uploads.cbar.az/assets/09b4f707806fa2f47d4af81b8.xlsx

In the first 9 months of 2023, the mining industry accounted for 34,7% of GDP (or 31 550,0 million AZN), trade and repair of vehicles 9,5% (8 622,9 million AZN), agriculture 6,4% (5 800,6 million AZN), transport and storage 6,0% (5 469,1 million AZN), manufacturing 5,6% (5 095,6 billion AZN), construction 5,0% (4,5 billion AZN), accommodation and food service activities 2,3% (2,1 billion AZN), information and communication 1,7% (1,5 billion AZN), and other 18,0% (16,4 billion AZN). Net of tax to products was 9,5% of GDP, or 8,6 billion AZN (*see Figure 1*).

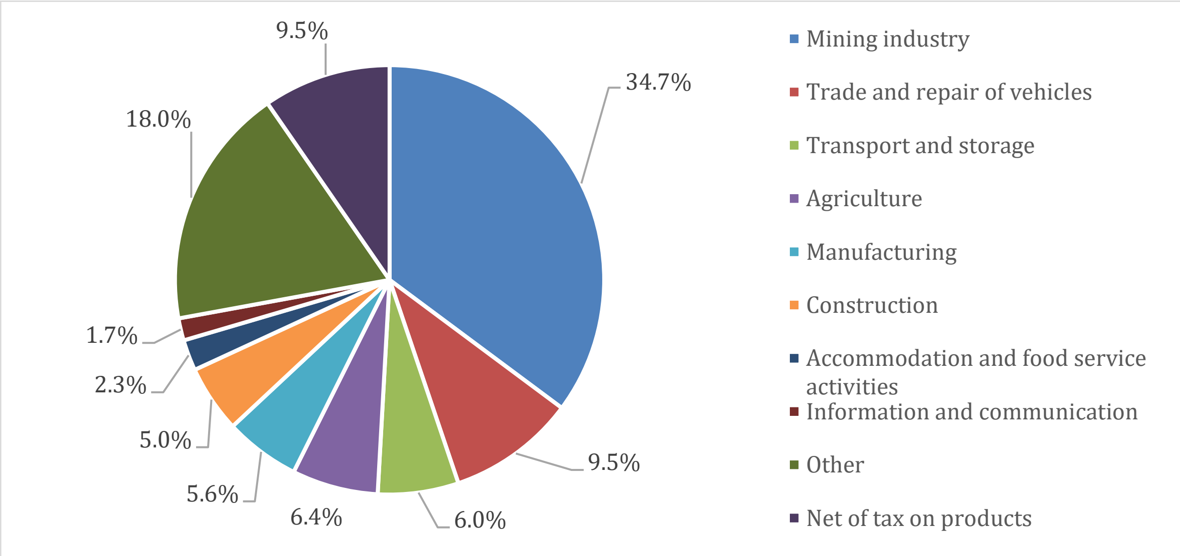

Figure 1. GDP Structure for January-September 2023, as Percent to Total (%)

Between January and September 2023, real growth in the mining sector fell by 0,7 pp, from -1,8% to -2,5% in annual terms. When comparing the same periods, the sharp slowdown in the accommodation and food service sector, which has seen a recovery in the post-pandemic period, is striking. The GDP growth rate in the first 9 months of last year was 74,0%, and fell to 26,0% in the first 9 months of this year (-48 pp). Thus, the partial reopening of the borders closed due to the pandemic in 2021 caused a significant growth in this sector last year, yet the closure of the country's land borders as well as rising prices last year played a role in limiting the growth of the tourist flow and catering sector in the first 9 months of this year.

Another sector that recorded a sharp slowdown in real growth rates compared to the same period last year is the transport and storage industry in which the GDP real growth rate in the first nine months of 2022 was 27,2%, compared to 11,8% in the same period this year, in other words, a decline of 39,0 pp.

Statistical data show that in the first nine months of 2023, the GDP of the country's manufacturing industry grew by 9,4 % in annual real terms, up 5,6 pp compared with the same period last year. Notably, manufacturing accounted for 5,6% of the country's GDP in the first 9 months of 2023, one-third of which was comes from the refining and petrochemical industries.

Compared to the first 9 months of last year, there was a slowdown of 0,8 pp in the GDP growth rate formed in the construction sector.

Over this period, 12 728,9 million AZN were allocated to fixed capital from the country’s total financial sources, up 21,3% versus the same period last year. 34,5% (4,4 billion AZN) of the total capital investment was invested in the oil and gas sector, and 65,5% (8,3 billion AZN) in the non-oil and gas sector. Compared to the same period last year, the amount of investment directed to fixed capital in the oil and gas and non-oil and gas sectors increased by 18,1% and 23,2%, respectively.

77,3% or 9,8 billion AZN of capital investment in the country's economy for 9 months were attracted from domestic sources, and 22,7% or 2,9 billion AZN from foreign sources, with 2,4 billion AZN (83,3%) being invested in the oil and gas sector.

Out of 9,8 billion AZN invested in fixed capital from domestic sources, 2,0 billion AZN (20,2%) went to the oil and gas sector and 7,8 billion AZN (79,8%) to the non-oil and gas sector. More than half of the total amount directed to fixed capital from internal sources – 52,4% or 5,2 billion AZN – came from the state budget. These funds are mainly directed to projects intended to restore and revitalize the liberated territories. In addition to budgetary funds, enterprises and organizations allocated about 3 billion AZN to finance fixed capital (of which 2 billion AZN went to the oil and gas sector) and 793,6 million AZN were provided through personal funds of the population. There is a tendency for the amount channeled from the personal funds of the population to fixed capital to decrease year over year.

Our calculations based on SSC data show that 75% of 8,3 billion AZN channeled into fixed capital in the non-oil and gas sector in January-September 2023 came from two sectors: 43,2 % (3,6 billion AZN) of the total amount from the transport sector and 31,3% (2,6 billion AZN) from the construction sector.

The funds invested in fixed capital in the field of agriculture, forestry and fishery totaled 445,1 million AZN, which is 5,3% of the total volume into the non-oil and gas sector. The capital investment into the country's non-oil and gas processing industry during this period amounted to 211,6 million AZN, which comprises 2,5% of the total amount in the non-oil and gas sector (*See Figure 2*).

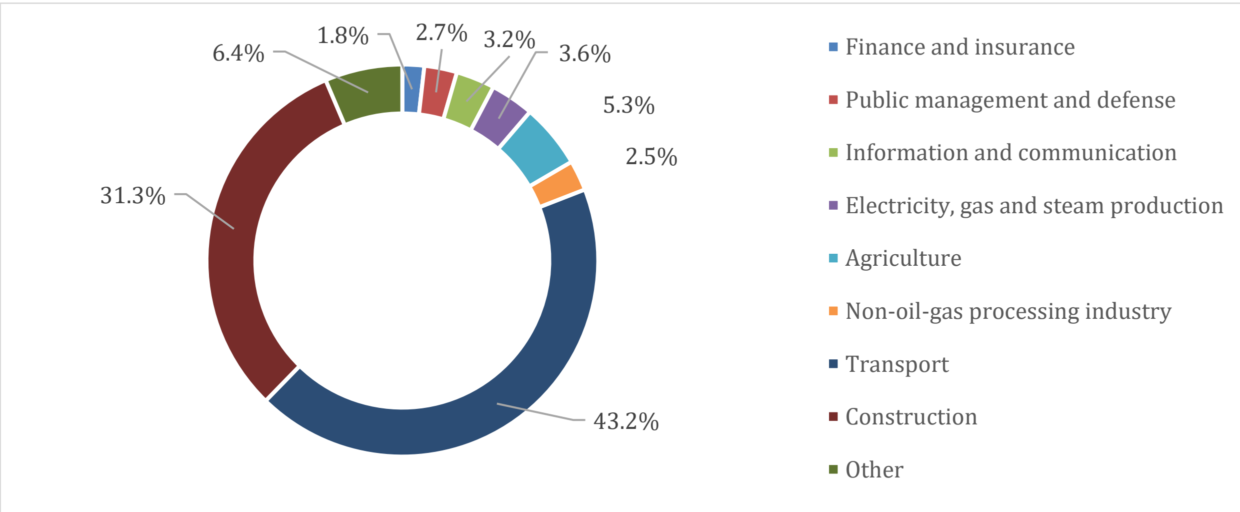

Figure 2. Compositional Structure of Funds Directed to Fixed Capital in the Non-Oil and Gas Sector in January-September 2023, as Percentage of the Total (%)

According to the SSC, the amount of funds allocated for fixed capital decreased by 27,6% in the non-oil and gas industry, 30,3% in manufacturing, 52,8% in non-oil and gas processing, while financial and insurance activities increased two-fold, agriculture by 70,8%, information and communication by 55%, construction by 33% and transport by 31,4%.

Consolidated budget revenues and expenditures

Data from the Ministry of Finance of the Republic of Azerbaijan[3] shows that January-September consolidated budget revenues and expenditures amounted to 36 889,4 million AZN and 25 898,4 million AZN, respectively, with a surplus of 10 991,0 million AZN. During January-September 2022, consolidated budget revenues increased by 7 169,6 million AZN or 24,1%, expenditures by 3 328,8 million AZN (14,7%) and surplus by 3 840,8 million AZN (53,7%). In January-September 2023, the deficit of the consolidated budget excluding State Oil Fund revenues stood at 3 877,6 million AZN, which is 332,2 million AZN (7,9%) less than the same period last year (4 209,8 million AZN).

Unlike previous years, the Ministry of Finance has taken into account revenues and expenditures of the Compulsory Health Insurance Fund in the consolidated budget revenues and expenditures.

The composition of the consolidated budget revenues and expenditures for 9 months of 2023 is shown below (*see Table 2*).

Table 2: Composition of Jan-Sep 2023 Consolidated Budget Revenues and Expenditures, (million AZN)

	Revenues	Expenditures	Surplus (+) or deficit (-)
Consolidated budget, total	36889,4	25898,40	10991,0
State budget	22077,0	23214,50	-1137,5
Nakhchivan AR's budget	383,5	354,6	28,9
State Social Protection Fund's budget	4875,0	4535,40	339,6
Unemployment Insurance Fund's budget	144,2	145,2	-1,0
Compulsory Health Insurance Fund's budget	1681,8	1222,50	459,3
SOFAZ budget	14868,6	3566,90	11301,7
Interbudgetary transfers	(7140,7)	(7140,7)	
Consolidated budget deficit excluding SOFAZ revenues	**-3 877,6**		

(Source: Ministry of Finance, https://www.maliyye.gov.az/static-page/periodic-reports)

In January-September 2023, 7 140,7 million AZN was covered by interbudgetary transfers within the consolidated budget. Of these, 3 550,0 million AZN are transfers from the State Oil Fund to the state budget, and the remaining 3 590,7 million AZN are transfers from the state budget to other budgets. During this period, 2 236,0 million AZN was transferred from the state budget to the

[3] https://www.maliyye.gov.az/static-page/periodic-reports

budget of the State Social Protection Fund (including 1,1 billion AZN for balancing the Fund's budget and 1 135,2 million AZN for social insurance contributions), 1 082,8 million AZN to the budget of the Compulsory Health Insurance Fund (including 980,3 million AZN to cover general compulsory insurance of the population and 102,5 million AZN to cover compulsory insurance of employees of budget-funded organizations), 255 million AZN to the budget of the Nakhchivan Autonomous Republic and 16,9 million AZN to the budget of the Unemployment Insurance Fund.

Key Tendencies in State Budget Revenues and Expenditures

According to operational data from the Ministry of Finance[4], January-September state budget revenues and expenditures totaled 22 076,9 million AZN and 23 214,5 million AZN, respectively, with a deficit amounting to 1 137,6 million AZN. State budget revenues decreased by 1,4% (324,5 million AZN), but expenditures rose by 13,4% (2 743,8 million AZN).

According to the Ministry of Finance, state budget revenues for the first 9 months of this year are down 12,6% (3 172.0 million AZN) from the 25 248,9 million AZN forecasted for the corresponding period. This is due to the fact that transfers by SOFAZ are 2 992 million AZN less than the forecasted figure for the period.

Nine-month state budget revenues received from taxes were up from the forecasted figures by 723,5 million AZN (6%), from customs and import taxes by 313,8 million AZN (7,1%) and from revenues in connection with the leasing of state property by 3,6 million AZN (17,3%), while chargeable services of budget organizations were down by 1,6 million AZN (0,3%).

The Ministry of Finance reports that January-September State budget revenues from taxes surged by 2 359,3 million AZN (22,6%), from customs and import taxes by 479,1 million AZN (11,3%), from incomes in connection with chargeable services of budget organizations by 1,6 million AZN (11,3%) and from incomes in connection with state property rent by 4,7 million AZN (23,9%) versus the same period of 2022.

Structure of state budget revenues. Nine-month state budget revenues received 12 810,7 million AZN (58%) from taxes, 4 706,6 million AZN (21,3%) from customs and import taxes, 3,550 billion (16,1%) from SOFAZ, 582,2 million AZN (2,7%) from incomes in connection with chargeable services of budget organizations, 24,4 million AZN (0,1%) from state property rent and 403 million AZN (1,8%) from other sources (*see Figure 3*).

40,6% (8 946,1 million AZN) of the funds received by the January-September state budget were revenues from the oil and gas sector, down 30,5% (3 919,7 million AZN) from the forecast for the period and down 17,2% (1 855,6 million AZN) from the corresponding period of 2022.

[4] https://www.maliyye.gov.az/uploads/static-pages/files/6529485aa5f7b.pdf

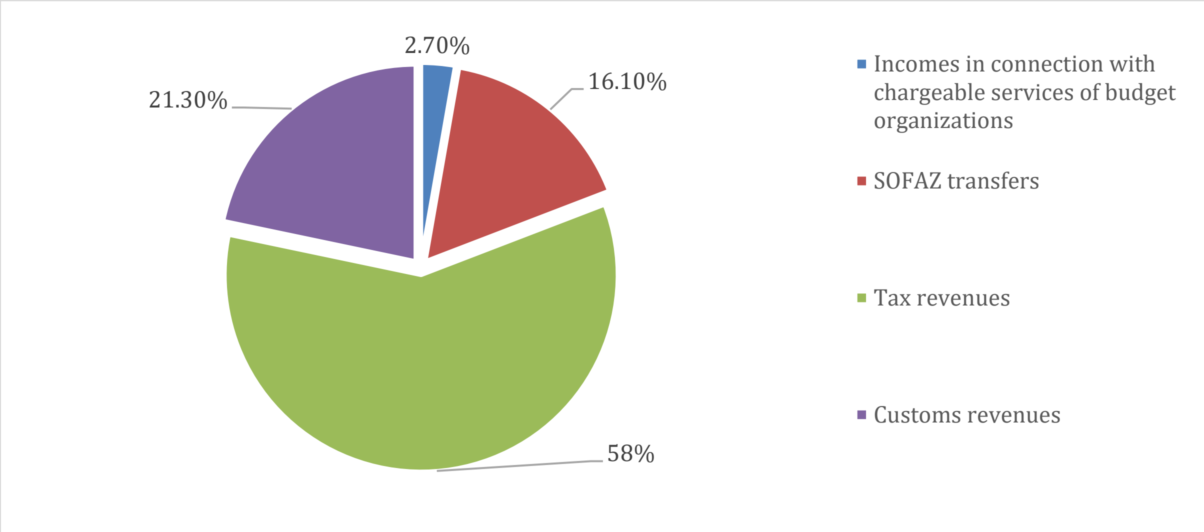

Figure 3. Structure of State Budget Revenues for January-September 2023, as Percentage of the Total (%)

Some 39,7% (3 550,0 million AZN) of state budget revenues received from the oil and gas sector are SOFAZ transfers, and the remaining 60,3% (5 396,1 million AZN) are tax revenues. Out of the total tax revenues received from the oil and gas sector, 3 377,9 million AZN (62,6%) are profit tax from incomes within the Shah Deniz PSA, 1 494,4 million AZN (27,7%) taxes paid by the State Oil Company (SOCAR) and 523,8 million AZN (9,7%) profit tax from incomes within ACG PSA.

59,5 % (13 130,8 million AZN) of state budget revenues are non-oil and gas revenues, up 747,7 million AZN (6%) from the forecast for the period and 1 531,0 million AZN (13,2%) from the actual execution of the corresponding period of 2022, according to the Ministry of Finance.

56,5% (7 414,6 million AZN) of non-oil/gas sector revenues in the state budget revenues for the mentioned period were tax revenues and 35,8% (4 706,6 million AZN) customs and import taxes.

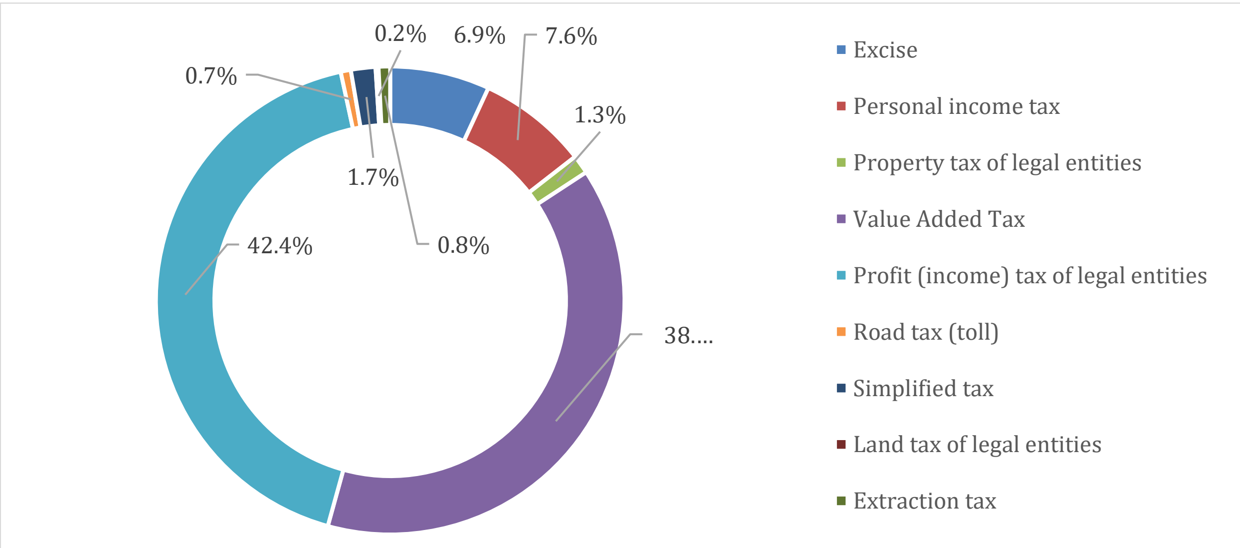

Figure 4. Structure of State Budget Revenues from Taxes for January-September 2023, as Percentage of the Total (%)

January-September budget revenues from taxes totaled 15 855,8 million AZN. Of these, 6,7 billion AZN (42,4%) came from the profit tax of legal entities, 6,1 billion AZN (38,6%) from VAT, 1,2 billion (7,6%) from personal income tax, 1,1 billion (6,9%) from excise tax and the remaining 4,5 % from other taxes (*see Figure 4*).

State budget expenditures. During January-September 2023, state budget expenditures amounted to 23 214,5 million AZN. The amount of 14 118,4 million AZN or 60,8% of state budget expenditures were spent on current expenditures, 8 382,4 million AZN or 36,1% on on capital expenditures and 713,7 million AZN or 3,1% on public debt service charges and liabilities.

According to the functional classification of the state budget from January through September 2023, expenditure on economic activities amounted to 6 431,5 million AZN (27,7%), on defense and national security expenditure 3 468,9 million AZN (14,9%), on social protection and social security expenditure 3 214,1 million AZN (13,8%), on expenditures on education 2 709,1 million AZN (11,7%), on expenditures on general public services 2 486,3 AZN (10,7%), on expenditures on the maintenance of judicial, law enforcement and prosecution systems 1 753,0 million AZN (7,6%), on healthcare costs 1 214,0 million AZN (5,2%), on agricultural costs 676,9 million AZN (2,9%), on expenditures on culture, arts, information, physical education, youth policy and other activities 305,3 million AZN (1,3%), on environmental protection costs 202,4 million AZN (0,9%), on housing and communal services costs 181,7 million AZN (0,78%) and on service charges not related to the main categories 571,3 million AZN (2,5%).

In 9 months of this year, 3 741,0 million AZN was spent from the state budget to finance projects of restoration, reconstruction and revitalization of the territories liberated from occupation, which was 1,7 times more than the corresponding expenditures in the same period of the last year.

Public debt and public debt service. According to the Ministry of Finance, by the end of September 2023, the total amount of state debt (external and internal) of the Republic of Azerbaijan amounted to 17 203,3 million AZN, which is 14,4% of the projected GDP for 2023. During this period, the amount of external public debt was 11 109,5 million AZN (equivalent to 6 535,0 million US dollars). This is 9,3% of the projected GDP for the respective period. The amount of 6 093,8 million AZN (35,4%) of the public debt is internal public debt (up to 5,1% of projected GDP).

In January-September 2023, public debt service charges amounted to 713,7 million AZN. Of these expenditures, 591,9 million AZN fell on the external public debt and 121,8 million AZN on the internal public debt service charges.

State Oil Fund Revenues and Expenditures

According to the State Oil Fund of the Republic of Azerbaijan (SOFAZ)[5], during January-September 2023, SOFAZ's budget revenues amounted to 14 878,3 million AZN and budget

[5] https://oilfund.az/fund/press-room/news-archive/1610

expenditures to 3 587,0 million AZN. Compared to the same period last year, its budget revenues increased by 3,5 billion AZN, but expenditures decreased by 3 billion AZN.

In January-September 2023, SOFAZ revenues related to the implementation of oil and gas agreements amounted to 12 227,2 million AZN, of which 11 422,1 million AZN were revenues obtained from the sale of oil and gas, 800,7 million AZN from bonus payments, 0,8 million AZN from transit revenues and 3,6 million AZN from acreage fees. During those 9 months, 2 651,1 million AZN was earned from managing the fund's resources.

During the reporting period, 3 550,0 million AZN were transferred from SOFAZ's budget to the state budget, 10,8 million AZN were allocated to finance the “State Program on Increasing the International Competitiveness of the Higher Education System in the Republic of Azerbaijan for 2019-2023,” and 6,1 million AZN were allocated to finance the “State Program for the Education of Young People at Prestigious Higher Education Institutions of Foreign Countries for 2022-2026”. During this period, the expenses related to the management of SOFAZ amounted to 20,1 million AZN.

As of 30 September 2023, SOFAZ's assets amounted to 55 524,0 million US dollars. The fund's currency assets increased by 13% compared with the beginning of 2023 (49 033,6 million US dollars).

2. MONETARY POLICY: Tightening the Tourniquet on Inflation

Over the past two years, the Central Bank of the Republic of Azerbaijan (CBA) has singled out price stability as the primary objective of monetary policy for the next year in combatting inflation. In its *Statement on main directions of the monetary policy for 2023*, the CBA's main objective is to ensure price stability, yet it points out that monetary policy decisions will depend on the behavior of annual inflation indicators and deviation of updated forecasts from the target band. The statement also signals an easing of the policy, emphasizing that in the event of a decrease in actual and forecast indicators of annual inflation, the CBA will consider a pause on monetary policy tightening to be followed by the possibility of a decrease.

According to the statement, high uncertainties related to the external environment make it difficult to forecast inflation for the next year, and commodity prices in the world market and inflation in partners and transportation costs will influence inflation in the country in 2023 as well. The CBA assumes that inflation is forecasted to move gradually to the target band due to slowdown of external factors of inflation in the medium term, and as inflation will decrease gradually given the inertia of growing inflationary pressures, the process may last longer than expected.

The global environment in 2022 was characterized by rising geopolitical and geo-economic tensions, increasing inflationary pressures, economic stagnation in most of the world's leading economies and monetary tightening in many countries. Faced with high inflationary pressures, the monetary policy of central banks began to show a trend towards tightening. The years 2022-2023 in Azerbaijan were also marked by a tightening of monetary policy. According to a press release by the CBA, inflationary pressures persist in Azerbaijan too, and actual inflation is driven by inflation in main trade partners and cost factors of foreign origin. The CBA therefore decided to tighten monetary policy, i.e., increase the refinancing rate and the floor of the interest rate corridor in order to avoid excess expansion of aggregate demand and to support savings in the national currency on the backdrop of rising inflationary pressures over recent months.

The Management Board of the Central Bank decided to gradually adjust interest rate corridor parameters, increasing the refinancing rate to 8,5% from 7,5%, the floor of the interest rate corridor to 9,5% from 9% and the ceiling of the interest rate corridor to 7% from 6%. The decision to actively increase interest rates mainly extends to 2022 and the first half of 2023. A measure has been taken to decrease the interest rate corridor amid a decrease in the annual rate of inflation since November of this year.

The CBA's *Monetary Policy Review* notes that annual inflation will enter the target band in September 2023. The reasons cited are global economic processes and the country's anti-inflationary measures. Statical data shows that average annual inflation stood at 10,9% from January to September 2023—the lowest figure since 2021.

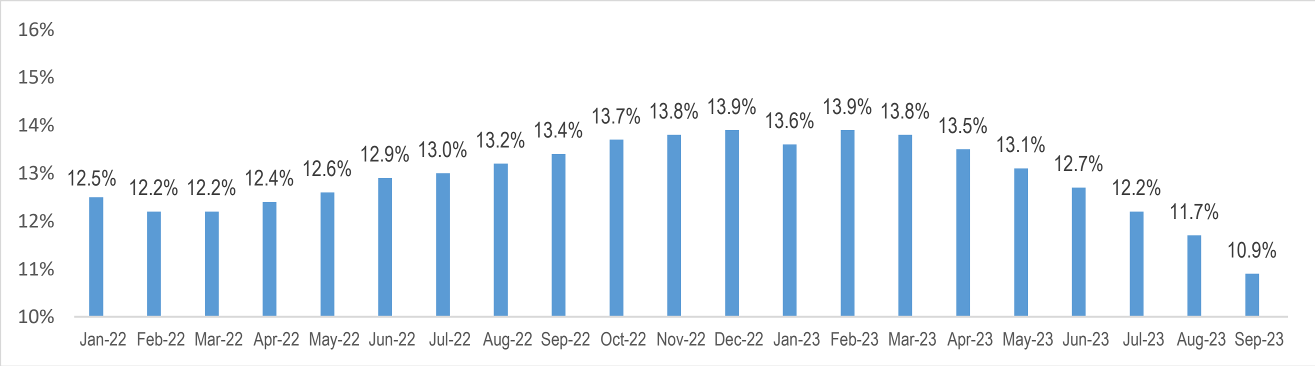

Chart 1. Consumer Price Index, 2022-2023 (January – September)

Price changes in food had the biggest effect on the dynamics of the overall inflation level. Annual inflation in food prices in September was 4,5%, with food average annual inflation standing at 12,4%. Non-food prices rose 5,9% year-on-year and 10,1% on an average annual basis in September. Services increased in cost by 5,4% over the past year, with average annual inflation in services amounting to 9,6%.

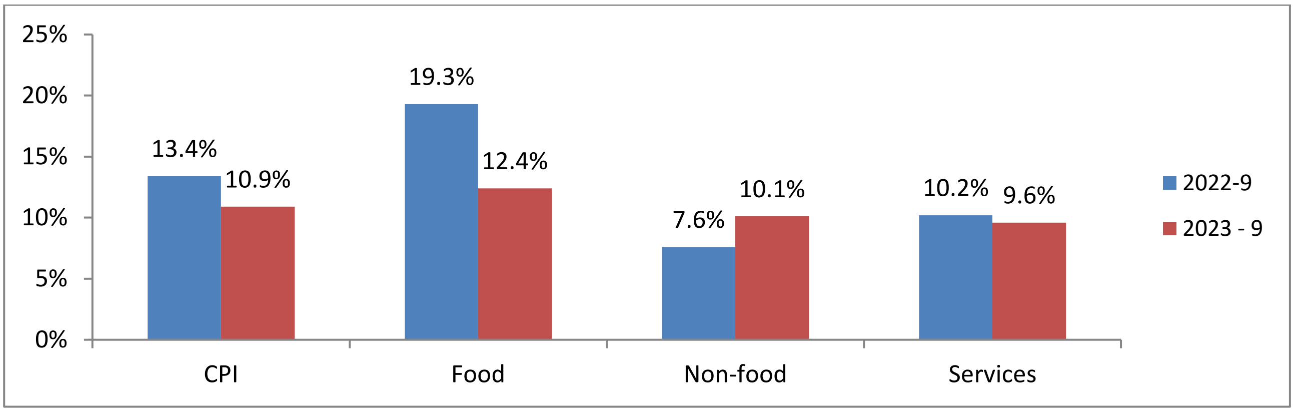

***Chart* 2. Dynamics of consumer prices for food, non-food products and services, %**
Source: Central Bank of Azerbaijan

In September 2023, annual inflation stood at 5,1% compared to the same month in 2022, thereby falling within the target band (4%±2%) set by the CBA. In September, food made 2 pp, non-food 1,4 pp, and services 1,7 pp contribution to annual inflation. As a result, the Central Bank at its meeting on 20 September kept the parameters of the interest rate corridor unchanged. Due to a slight decrease (by 10,2%) in average annual inflation in October 2023, the CBA decided to reduce all parameters of the interest rate corridor by 0,5% in November. According to the forecast of the CBA, annual inflation is predicted to be within its target bands (4%±2%) by the end of 2023 and for 2024. Thus, annual inflation is forecast at 4,3% by the end of 2023, 5,3% in 2024 and 3,4% in 2025.

In 2022, Azerbaijan embraced a monetary policy as part of the "Formulation of the basic conditions for the transition to the inflation targeting regime" envisaged in the Action Plan of the *"Socio-economic Development Strategy of the Republic of Azerbaijan in 2022-2026."* The CBA believes that diversifying supply channels in the foreign exchange market, enhancing the financial sector's depth, limiting the monetary shadow economy and strengthening the efficiency of macroeconomic coordination in the country will create conditions for the transition to an inflation-targeting regime. The Central Bank started to apply monetary policy tools in a new configuration beginning on 1 September 2022 with a view to strengthening the transmission of the interest rate corridor to inflation. The new configuration provides for the launch of *standing facilities* (*liquidity providing and absorbing) initiated by banks and for enlarging the range of open market operations (liquidity providing and absorbing initiated by the CBA)*. The institution started to use one-day deposit for liquidity absorption and one-day reverse repo operations for liquidity provision as a standing facility. According to a statistical bulletin released by the CBA, the residual value of one-day deposits attracted in banks was 424,7 million AZN at end of September 2022, 483,3 million AZN at end of October, 486,8 million AZN at end of November, and 476,5 million AZN at end of December. Deposit operations continued in 2023, and growth in the volume of attracted funds is increasing. The residual value of attracted deposits increased to 1,5 billion AZN at the end of September 2023 and 1,9 billion AZN at the end of October. In September-December, the average volume of one-day deposit transactions totaled 464,3 million AZN. The annual interest rate on one-day deposits fluctuated within the range of 4% -7,5% in accordance with the lower threshold of the interest rate corridor. The increase in the lower limit of the interest corridor increased the attractiveness of one-day deposits for banks and, as a consequence, increased the activity of banks in the process. An important factor in the growth of activity was that the Central Bank increased the quota for one-day deposits beginning 27 February 2023, and completely eliminated the quota for 35 million AZN from 15 August. It is no coincidence that after the decision to abolish the limit, there was a sharp increase in one-day deposit volumes. The deposit balance was 655 million AZN at the end of July, 940,4 million AZN at the end of August, 1,5 billion AZN at the end of September, and 1,9 billion AZN at the end of October. The banks are currently attracting one-day deposits at 7% per annum.

The CBA failed to disclose information on one-day reverse repo operations for liquidity injection during the period.

Along with 1, 3, 6 and 9-month notes, the bank found seven-day repo and reverse repo auctions expedient, to improve open market operations for sterilization purposes. As part of the new operations, AZN 2,5M worth of 7-day repo operation was conducted over the year for sterilization purposes. AZN 302,5M worth of 7-day operations (repo and one-week note auctions) were conducted in January-September 2023 for sterilization purposes.

The activity in the placement of 1, 3, 6 and 9-month banknotes increased. The CBA conducted a total of 90 auctions of banknotes of different durations in 2022 and 102 auctions in the first 9 months of 2023. While the CBA preferred 28-day banknotes before the new rule, from September 2022 onwards it started to increase the issuance of 84, 168 and 252-day banknotes compared to previous years. Consequently, by the end of 2021 the volume of notes in circulation was 200 million AZN, by the end of 2022 1,3 billion AZN, touching 1,6 billion AZN by the end of September 2023. The main reason for the increase is the annual interest rate growth of notes against the background of increasing interest corridors. At the same time, after the decision to expand the investor base on Central Bank notes, eligible non-bank legal entities have also been allowed to participate in auctions along with banks. At present, over 7% of Central Bank notes in circulation are owned by non-bank legal entities.

As part of the tightening of monetary policy, reserve requirements were increased and differentiated. According to the Resolution of the Central Bank dated 1 August 2022, the ratio of required reserves for attracted funds of both legal entities and individuals was increased from 0,5% to 4% in national currency and from 1% to 5% in foreign currency. And in 2023, the CBA started to apply a new differentiation to the ratio of required reserves in order to limit liquidity constraints in the banking system, as well as stimulate the de-dollarization trend. Based on the changes made in December 2022 to the "Regulations on the ratio, calculation and maintenance of required reserves," the required reserve ratios were slightly increased, and the level of this increase was differentiated according to the volume of deposits attracted. The new change was implemented in two stages.

At the initial phase (dated from 01.01.2023 to 30.06.2023) for deposits in national currency attracted from legal entities, the ratio of reserve requirements is set at 5% on deposits with a total amount up to 1 billion AZN and 10% on deposits with a total amount over 1 billion AZN. 6% is set on deposits in foreign currency with a total amount up to 750 million AZN, while 12% on deposits in foreign currency with a total amount over 750 million AZN. During this period, the ratio of reserve requirement for deposits attracted from individuals were raised from 4% to 5% in national currency and from 5% to 6% in foreign currency.

In the second phase (dated from 01.07.2023) the norms applicable to deposits in both national and foreign currencies attracted from legal entities also started to apply to deposits of individuals.

As a result of these changes, the volume of required reserves increased sharply. According to the CBA, the volume of required reserves increased 8 times by the end of 2022, compared to 2021 and stood at 1,4 billion AZN, hitting 2,8 billion AZN through the end of October 2023.

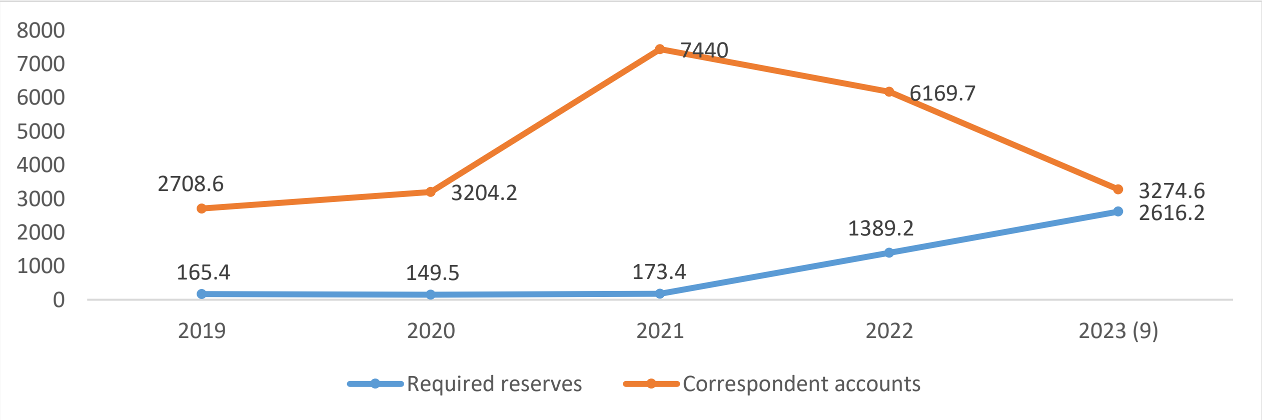

Chart 3. Correspondent accounts and dynamics of required reserves by year, millons of AZN
Source: Central Bank of Azerbaijan

According to the Resolution of the CBA dated 1.11.2023, new differentiation criteria were entered into the ratio of required reserves, effective beginning 15 December. The new ratio of required reserves introduced a differentiated mechanism on legal entities' deposits in the national currency depending on the share of related deposits and deposits of individuals belonging to the bank in the total amount of deposits. Overall, since the new monetary policy framework came into effect (early September 2022), the CBA's sterilization portfolio (including required reserves in manat and the sterilization-oriented standing facilities instrument) has increased to 6,4 billon AZN from 3,9 billion AZN.

According to the Resolution dated 15 February 2023, the CBA approved the Sustainable Finance Roadmap 2023-2026 to ensure the financial sector's successful transition to sustainable finance. The ultimate objective of this roadmap is to promote the emergence of sustainable finance, which takes into account climate-related and environmental risks, as well as social and governance factors and to ensure financial stability. The roadmap contains four strategic pillars: 1) Capacity building in sustainable finance; 2) Enabling an environment for sustainable finance flows, 3) Integrating climate-related and ESG factors into risk management; 4) Ensuring market transparency and discipline in financial markets.

Starting May 2023, the Central Bank began to publish daily on its official website the AZIR (Azerbaijan Interbank Rate) indexes for various periods, reflecting the average weighted interest rate on transactions concluded in the national currency between banks in the unsecured market. These indexes are calculated in accordance with the "Regulations on Calculation and Publication of Benchmark Rate (AZIR – Azerbaijan Interbank Rate) in the Unsecured Interbank Money Market" approved by the Management Board of the Central Bank. When calculating AZIR indexes, transactions concluded in the national currency between commercial banks operating in the Republic of Azerbaijan through the Bloomberg trading platform are used. Along with the percentage indicators, the amount and number of eligible transactions will be announced on the website of the Central Bank.

Maintaining a stable exchange rate of the manat against the US dollar has also played an important role in curbing inflation. The Central Bank uses the AZIR indexes as one of the indicators to assess the effectiveness of monetary policy in achieving operational goals. Market participants can use the AZIR index as a reference interest rate when entering into various transactions on the financial market. Buy-sell exchange rates set by banks were close to the official one. Commercial banks' average buy/sell rate was 1,6946/1,7021.

The CBA held a total of 71 currency auctions auctions to arrange the sale of foreign currency provided by the State Oil Fund of the Azerbaijani Republic. During the reporting year, supply exceeded demand in 99% of currency auctions and CBA's intervention in the FX market was purchase-oriented.

The depreciation of national currencies of some trade partners of Azerbaijan in foreign trade, especially in imports, against the manat also became one of the factors in import inflation reduction. In the reporting period, the manat appreciated against the Turkish lira, the Kazakh tenge, the Russian ruble, the Japanese yen, and the Chinese yuan and depreciated against the euro, the British pound, the Swiss franc and the Georgian lari in nominal terms. However, the real effective exchange rate (REER) of the manat depreciated against the Turkish lira, the euro, the Iranian rial, and the US dollar. The REER of the manat appreciated against the Russian ruble, the Chinese yuan, the Japanese yen, the South Korean wan and the Israeli shekel across major trade partners, while depreciating against the currencies of several trade partners, including the Turkish lira, the euro, the US dollar, the Iranian rial and the British pound. In general, total trade-weighted non-oil nominal effective exchange rate (NEER) of the manat appreciated 19,3% and REER by 7,5%.

Since inflation in Azerbaijan is lower than the average inflation in partner countries, it had a reductive effect on the REER. A stronger NEER of the manat acted as one of the factors in containing the inflation import rate.

As a result of the CBA's measures aimed at reducing excess liquidity in banks, the activity of the foreign exchange market relatively weakened, and there was a decrease in the turnover of foreign exchange transactions. In 9 months of 2023, there was a decrease in the volume of transactions in both cash and non-cash segments of the FX market. The volume of cashless transactions in the FX market during January-September decreased by 6% yoy to the equivalent of $21 billion: 79% in the USD and 21% in other currencies. The Interbank FX market accounted for 20,1%, the Intrabank FX market for 79,9% of operations. During the reporting period, Interbank FX market operations yoy decreased by 36,4% ($4,2 billion), while the volume of transactions in the BDVB decreased by 7% to $15,7 billion.

20,1% of foreign exchange transactions were carried out in the interbank foreign exchange market and 79,9% in the intrabank foreign exchange market. During the reporting period, the volume of transactions in the BVB decreased by 36,4% year-on-year to $4,2 billion, while the volume of transactions in the BDVB decreased by 7% to $15,7 billion.

The volume of the Azerbaijani banks' cash foreign currency purchase and sale transactions went down by 29,2% from the same period of the previous year and totaled $2,8 billion. Of this, 83,6% were transactions in US dollars. The banks' foreign currency purchases have, for the first time, overtaken sales over the past nine months.

The Central Bank has initiated the process of delegating a number of business processes to commercial banks in order to optimize cash operations and to increase the effectiveness and efficiency of cash management. In this context, the CBA has started the implementation of the operator bank model and established the requirements for the operator banks selected from among the commercial banks. The Management Board of the Central Bank designated "ABB" OJSC and Kapital Bank OJSC as bank operators to provide cash services. In accordance with the relevant decision of the Management Board of the Central Bank on promoting the sale and repurchase of bullion coins, "Bank of Baku" OJSC and "TuranBank" OJSC, both of which applied to operate in this field and met the established requirements, have been selected as sales agents. The Central Bank, having chosen the sales agents, has stopped the direct sale and repurchase of bullion coins to the population and banks.

There was a decrease in the share of cash money supply. During the first 9 months of 2023, the volume of cash in circulation increased by 19,8% to 14,7 billion AZN, the highest figure since Azerbaijan gained independence. Since the beginning of the year, the volume of money supply (M2) in manats has grown by 12,2% to 33,2 billion AZN as of the end of September. Despite the growth in money supply, the share of money supply in manat (M2) fell from 45% to 44,4%. The growth level of money supply in banks and outside banks was different. Cash money supply outside the bank increased by 12,4%, while money in the bank grew by 5,2%.

The increase in money supply is regulated by the Central Bank by attracting one-day deposit, issuing notes and increasing reserve requirements. At the end of September 2023, the volume of attracted one-day deposit against the money supply of 33,2 billion AZN was 1,5 billion AZN, the volume of issued notes was 1,6 billion AZN, and the volume of the banks's required reserves with the Central Bank was 2,6 billion AZN.

Although the Central Bank has introduced new instruments to support banks, it has also taken steps to tighten requirements for them over the last two years. Examples may include changes to the *Norms of, Procedures for Calculating and Maintainence of Required Reserves*, the *Corporate Governance Standards in Banks*, *Rules of Credit Risk Management in Banks*, or *Regulation on Liquidity Risk Management in Banks*.

In accordance with the *Regulation on Liquidity Risk Management in Banks*, which came into force with the Resolution of the Central Bank dated 01.12.2023, a new monitoring tool (Herfindahl-Hirschman Index) regarding the concentration of sources of attracted funds has been introduced, the composition of the instant liquidity ratio improved. Moreover, the Regulation determines principles and requirements for daily liquidity management to allow the bank to make timely payments and settlements under normal and stress conditions. The *Regulations on the Buying and Selling of Foreign Currency between the Central Bank and Banks*, which came into force on 30.11.2022, define the methods, form, and conditions of the Central Bank's foreign currency operations with banks in accordance with the currently used practice. In addition to tools currently in use, the list of tools that the Central Bank can use in the domestic foreign exchange market includes other potential tools that may be used when needed, including forwards, swaps and options.

Overall, the processes that took place in the banking sector between September 2022 and September 2023 can be systematized as follows:

The trend of declining lending institutions, including banks, has continued. Between September 2022 and September 2023, three commercial banks and two non-bank credit organizations left the market. The CBA's Management Board, with its resolution dated 11 October 2022, revoked license No. 248 granted to the Baku Branch of the National Bank of Pakistan dated 30 June 2005. And the CBA's Management Board with its resolutions dated 16 May 2023 and dated 18 October 2023 revoked the licenses granted, respectively, to Günay Bank OJSC and Muğan Bank OJSC. The National Bank of Pakistan has submitted an appeal on the voluntary cancellation of the bank license of Baku Branch. The closure of the other two banks occurred because the amount of their total capital was less than the minimum amount prescribed for banks, their total capital adequacy ratio was less than 3%, and because the banks were not carrying on their current business in a sound and prudential manner.

The three banks accounted for about 2% of the whole banking sector. About 0,6% of all assets, 1% of the loan portfolio and 0,5% of the liabilities in Azerbaijan's banking sector were held at Günay Bank, while 1,4%, 2%, and 1,3%, respectively, were held at Muğan Bank.

With the closure of all three banks, the number of banks operating in the country has dropped to 23. Currently, 2 of the banks operating in the country are state-owned and 21 are private. And 9 of them are banks with foreign capital. As of 1 November 2023, banks in Azerbaijan have 471 branches, 86 sub-branches, and 23.292 employees.

The CBA's Management Board Central Bank, with its decision of 31 May 2023, revoked the license of the *Gold Finance Non-bank Credit Institution Limited Liability Company* and the *Visa Credit Non-bank Credit Institution Limited Liability Company*. The said institutions classified loans issued to customers as loss assets in full and violated capital requirements. Moreover, the above institutions have not carried out any lending activities in the past several years at all. As of the end ofSeptember 2023, the number of NBCIs decreased from 96 to 92 compared to the same period of the previous year. A total of 3.169 people are currently employed in 283 branches of 92 NBCIs.

Against the background of the stability of the national currency and the high annual interest rates offered for attracting manat deposits, the level of dollarization in the banking sector has decreased. The de-dollarization trend has been observed in deposits throughout the country. Deposits in the national currency during the reporting period were up 14.3% with total deposits growing by 0,8%. During this period, the volume of deposits in foreign currency decreased by 31,2%. As a result, the share of deposits placed in foreign currency in total deposits fell from 49,1% to 40,1%.

De-dollarization was observed in all types of deposits. The share of foreign currency in household savings decreased from 39,2% to 35,1%, deposits of financial organizations from 60,5% to 53,8%, and deposits of non-financial organizations from 53,2% to 41,9%.

As of the end of September 2023, the volume of credit investments increased by 16,8% year-on-year and exceeded 23 billion AZN. Thus, the volume of credit investments of credit organizations reached a record level. During this time, the volume of loans issued in national currency increased by 21,5%, while loans in foreign currency increased by 0,04%. As a result, the level of dollarization of credit investments fell from 21,9% to 18,7%. The share of foreign exchange in the total liabilities of banks in the reporting period decreased from 45% to 36,1%.

In contrast to retail deposits, deposits of legal entities decreased. The increase in the total volume of deposits in the country was due to household savings. In the first nine months of 2023, household savings increased by 14,8% compared to the corresponding period of the previous year, while deposits of financial organizations and non-financial organizations decreased by 3,4% and 8,7%, respectively. The reason for the decrease in financial and non-financial organizations was due to a sharp decrease in foreign currency deposits, dropping by 23,8% and 24,6%, respectively.

There was a decrease in the banking sector during the concentration process. An analysis of statistical data of the Azerbaijan Banks Association on the financial condition of banks shows that in 2022 (September) - 2023 (September), the market share of 5 banks in terms of assets decreased from 73,1% to 72,4%. The deposit portfolio also declined during this time and the market share of 5 banks fell from 78,4% to 76,7%. Increased concentration was observed only in the credit market. The five banks' market share in the loan portfolio increased from 62,2% to 63,1%.

3. Analyzing foreign economic relations: main trends

In the first 9 months of 2023, there were significantly different trends in the dynamics of the country's foreign economic relations. Thus, on the one hand, there was a serious decrease in revenues from oil and gas exports to the country due to the decline in energy prices in international markets. On the other hand, the decrease in net capital outflow from the country through a variety of channels significantly increased the balance of payments surplus.

Analysis of foreign trade relations[6]

Exports over the first nine months of 2022 and 2023 saw a decrease of 10,3% or $3,032 billion compared to the same period of the previous year, totaling $26,489 billion, while imports rose by 22,5% ($2,321 billion) to $12,614 billion. As a result of the change in imports and exports, trade surplus fell to $13,875 billion from $19,228 billion.

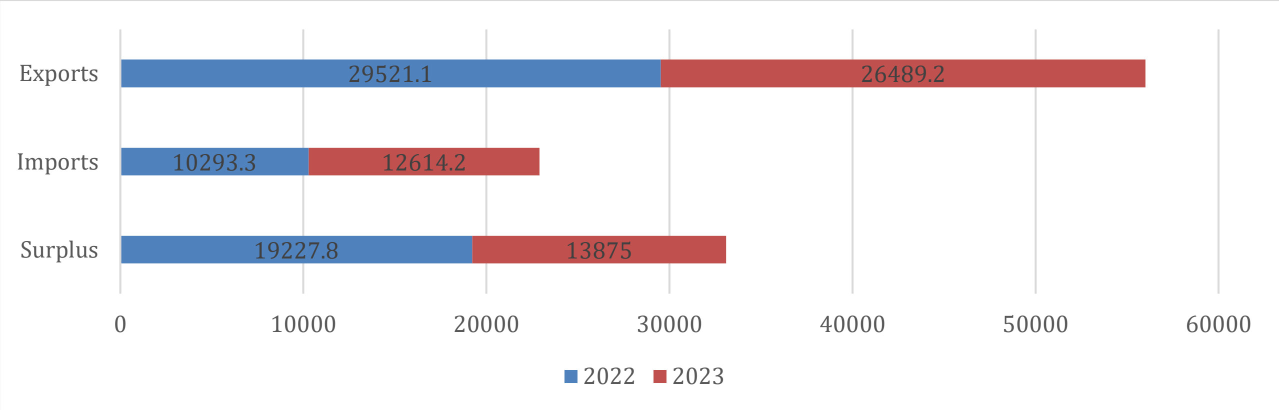

Chart 4. Overall foreign trade figures, first 9 months of 2022 and 2023

The decline in exports is associated with the oil and gas sector. Thus, oil and gas exports over the period fell by 12,2% ($3,350 billion), while non-oil and gas sector exports grew by 15% ($317,6 million) and totaled $2,434 billion. This sector accounted for 9,2% of exports (7,2% in the previous period).

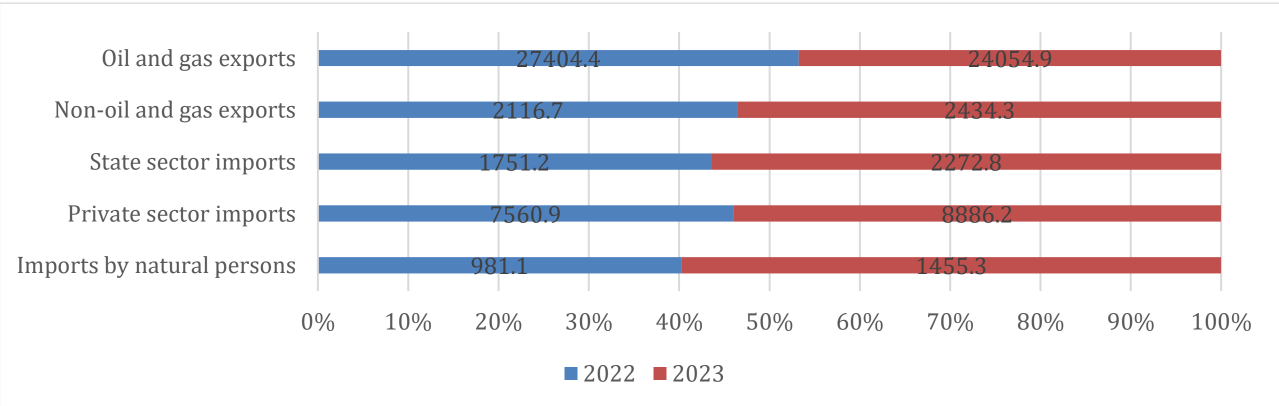

Chart 5. Indicators of export and import structure

[6] Foreign trade figures for the first 9 months of 2022 and 2023 are taken from the monthly bulletins of the State Statistics Committee (https://www.stat.gov.az/source/trade/) and the monthly export surveys of the Centre for Analysis and Communication of Economic Reforms (https://ereforms.gov.az/az/ixrac-icmali).

As for changes in the structure of imports, state sector imports increased by 30% ($522 million), accounting for 18% of total imports (compared with 20,6% in the previous year), private sector imports by 17,5% ($1,325 billion), while imports by natural persons by 48,3% ($474,2 million).

The geographical concentration of non-oil sector exports has significantly increased. Thus, in the first 9 months of 2022, 5 countries accounted for 80,4% of non-oil exports (the volume of exports to these countries was $1,459 billion), yet in the same period of this year, the geographical concentration ratio was 87,5% (exports $1,850 billion). Four countries on the list of the top-5 did not change (Russia, Türkiye, Switzerland and Georgia), but the USA was replaced by Kazakhstan. The overall growth of non-oil exports was observed in trade with these countries. Thus, the volume of exports by the first 5 countries increased by $391,6 million (+27%), while it decreased by $74 million (-11.2%) with the remaining countries. In turn, non-oil exports to Russia surged by $185 million (30%) to $787 million, to Türkiye by $120 million (+23,5%) to $631 million.

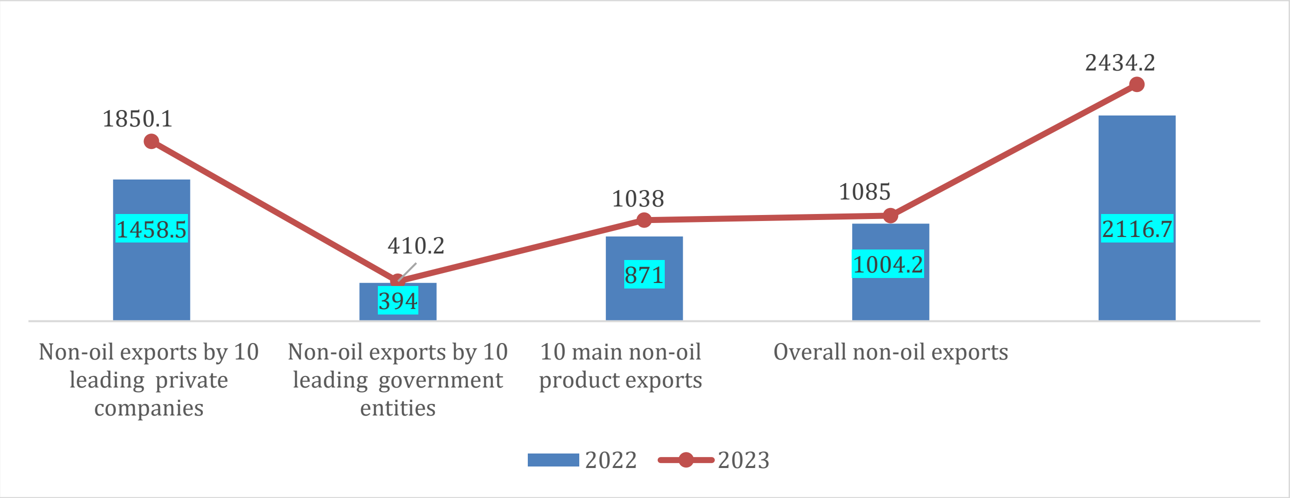

Chart 6. Main non-oil export figures

If we at concentration in terms of the number of exporting entities, the share of the top 10 state-owned enterprises in non-oil exports rose from 41,4% to 42,6%. In real terms, the exports of these companies went up from $871 million to $1,038 billion (+$167 million). However, although the share of the top 10 private companies in non-oil exports fell from 18,6% (an export value of $394 million) to 16,8% ($410,2 million), the value increased by $16,2 million in real terms. As a result, the share of the top 20 exporting entities in non-oil exports has essentially remained stable (60% of total non-oil exports) during the period under review. As for the diversification of non-oil exports in terms of the product ranges, the share of top 10 products was 44,6% ($1,085 billion) during the first 9 months of 2023 (47,4% or $1,004 billion in the same period last year).

Analysis of the balance of payments figures

Declining oil and gas revenues for the first 6 months of this year was also accompanied by a sharp decline in current account payments to the country, which plummeted by 15,8% ($3,7 billion) over the same period last year to $19,8 billion

Of these current account payments, 71,6%, or $14,2 billion, came from the oil and gas sector and 28,4%, or $5,6 billion from the non-oil sector. Compared with the first half of the previous year, oil and gas sector receipts plunged by 22%, or $4 billion, while non-oil sector revenues increased by $288,3 million (5,4%).

Current account payments for non-residents totalled $14,7 billion, up $1,5 billion (11%) over the same period of last year. Of these, $6 billion (+$336 million, or 5,9%) and $8,7 billion (+$1,1 billion, or 15%), respectively, came from the non-oil and gas and oil and gas sectors.

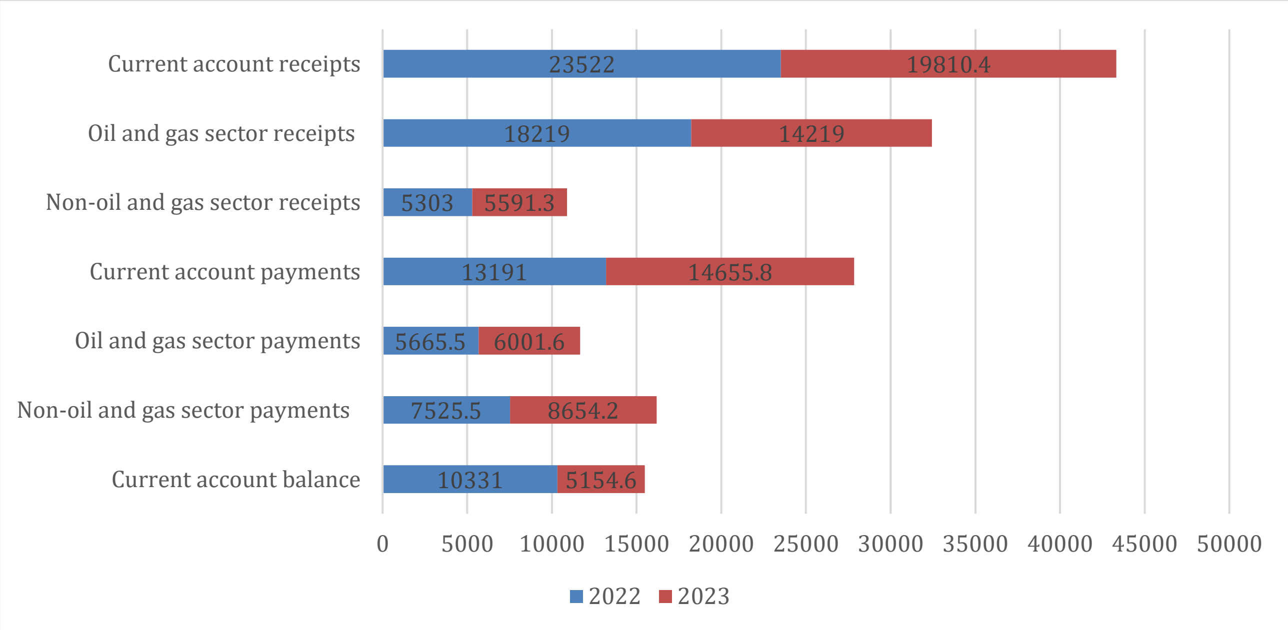

Chart 6. The performance of current account balance, in $ million (first 6 months of 2022 – 2023)

The current account surplus for the analyzed period was slightly more than $5,1 billion, which is half of that of the previous year. Out of the country's current account receipts, 76,5% ($15,2 billion) are constituted by goods exports, 14,5% ($2,9 billion) by services exports and 9% ($1,7 billion) by factor income (wages, profits and interest) and current transfer payments (primarily remittances).

About half of the revenues earned from the exports of services ($1,4 billion) was generated by transport, 20% ($589 million) by tourism and 25,5% ($740 million) by business services. The deficit in the balance of services in the first half of the year amounted to $1,1 billion (down $200 million compared to last year). In that same timeframe, about $4 billion was paid for various services to non-residents from different countries, including $1,6 billion for business, $835 million for transport, $697 million for construction, and $488 million for tourism services.

At the end of 2023, Azerbaijan recorded a deficit of $1,8 billion (including $837 million of receipts and $2,6 billion of payments) in the primary income, which is the main section of the current account. The bulk of payments ($2,3 billion) was related to the repatriation of income from oil and gas investments.

During the period under review, the country received $937 million in secondary income, including $39 million in humanitarian and technical assistance and $890 million in remitances sent to individuals. The assistance to households from abroad, by the way, decreased twice, which amounted to slightly more than $1,6 billion during the first half of last year.

In the first half of the year, there was a surplus of $509 million in the financial account ($5,3 billion in the same period last year). Below are sources of the surplus in the above amount:

- Net capital outflows from the country through direct investment channels reached $566 million (last year, net capital inflows totaled $2,1 billion). The CBA said in its report that during the period under review, the country attracted $3,2 billion in direct investment, down $241 million (7,5%) from last year. Of this, about $2,3 billion came from the oil and gas sector. Foreign oil and gas companies made $3,6 million in capital repatriations as part of direct investment (this figure was $5,6 million in the six months of last year). Five countries (the UK, Türkiye, Cyprus, Russia and Iran) accounted for 70% of foreign direct investment (FDI) flows to Azerbaijan. In turn, Azerbaijan invested $620 million abroad, up $100 million (19%) from the previous year, mostly directed to the United Arab Emirates ($132,6 million), Australia ($75,4 million), Türkiye ($60 million) and the United States ($32 million);
- $1,0835 billion was accounted for by net capital outflow mainly from the oil and gas sector at the expense of portfolio investments (last year net capital outflow totalled $127 million). A total of $1,5 billion was accounted for by net capital outflow from the country in the form of portfolio investment of this sector;
- As part of other investments, a net capital inflow of $1,707 billion was brought into the country (last year, the net capital outflow was $2,8 billion). Under this section, financial flows between residents and non-residents occur through three channels: deposits and cash flows in currency, obtaining and repaying loans and credits, receipts and payments on trade loans. During this period the country received deposits and cash flows in currency totalling $1,3 billion, net capital flows to the extent of $626 million in credits and loans and $977,5 million in trade loans;
- The Azerbaijani government received a one-off bonus of $450,2 million, with bonuses of $3,6 billion under oil agreements in 2018-2025.

As part of the "Net errors and omissions" section, $411,4 million in net capital outflow was taken out of the country ($399,2 million in the same period of the previous year). According to international methodology, this item reflects either capital flows into or out of the country through financial flows, which for various reasons cannot be accurately accounted for.

The overall balance of payments surplus reached $5,2 billion during the first half of the year, thus reflecting the extent of the increase in the country's reserve assets. In January-June 2022, the figure was $4,6 billion.