

On the situation of the implementatin of the monetary policy on the final of the first quarter of 2006

1. Macroeconomic situation and global economic processes

The National Bank of the Azerbaijan Republic has pursued the monetary policy directed to the maintenance of the macroeconomic stability and one-digit inflation, and supporting the socio-economic development programs of the country, also in the first quarter of 2006. The domestic and external economic processes happening have also influenced the fulfilment of the monetary policy goals.

Macroeconomic situation. The economic growth rate in the country has furtherly sped up in 2006. 39.5% increase in the key macroeconomic indicator of economy, GDP, has happened. The increase has been attained in the production of industrial goods (47.4%) and agricultural goods (2.5%), in the freight transportation (10.7%), in communications services (28.8%), and in the commodity turnover (11.9%).

The role of the private sector in the economy, which is a necessary condition for the country with the market economy, is also increasing. The non-state sector has accrued over 75% of GDP, 72.2% of industrial products, 99% of agricultural products, 87.9% of capital investments, 52.6% of the freight transportation, and 75% of communications services.

The **inflation** constituted 4.6% in March 2006, compared with the beginning of the year, and 5%, compared to the corresponding month of the previous year. The base inflation, which undergoes the seasonal fluctuations and computed through the subtraction of the administratively regulated prices, has been 2,5%, compared with the beginning of the year, and 4,1%, compared to the corresponding month of the previous year.

The inflation model indicates, 19.3% of the inflation during the quarter, has related with the **monetary factors**. Besides the traditional factors such as the money supply, nominal effective exchange rate, diesel price rise, and season, non-traditional factors such as sugar price rise in the world market, have influenced the price change. The money supply has had a significant role in the decline of inflation, though the monetary factors have had a low influence on inflation.

As the key factor ensuring the future development of economy, the volume of the capital **investment** has went up by 6.9% and amounted AZN 1.1 bln manats, compared with the last year, and the foreign investments have constituted 67.1% or AZN 0.7 bln manats of this.

The positive inclinations observed in the balance of foreign trade of Azerbaijan in recent years, have kept on also in the current year. In the months of January – February, the balance of foreign trade has amounted \$1037.3 mln, of which \$497.1 mln is accrued by export, and \$540.2 mln by import. The total volume of the foreign trade turnover has increased by 6.7%, compared to January – February 2005.

The betterment of the social condition of the population has also endured, so that the average monthly wage has amounted to AZN 129.7 manats, and its growth rate has constituted 20.3%. The increase in the population's income causing a raise in the purchasing ability, has been a factor paving the way for the development of the real sector.

The inclinations in the world financial and commodity markets.

The processes happening in the economy of the leading countries have reflected in the indicators of their financial markets. The exchange rate of the USD has changed in the diverse directions, against the leading currencies of the world, in the report period. While the exchange rate of the USD depreciated by 0.5% against euro, and by 3.7% against the Russian ruble, has strengthened 1.4% against the Swedish franc, 1.1% against the Japanese yen, 0.6% against the British pound, and 1.2% against the Turkish lira.

It should be noted that the increase in the deficit in the USA balance of foreign trade has had a reducing effect in the exchange rate of dollar, and raising of the accounting degree by the Federal Reserve System (the FRS accounting degree having being changed twice during the first quarter, raised from 4.25% to 4.75%) has had a raising effect.

The increasing of **main stock indices** level, both in the USA, Europe and Japan during the report period, has been observed. The Do Cons index, which reflects the average price of the 30 largest industrial companies auctioned in the New York Stock Exchange, has increased by 2.1%, and the Nasdaq index, computed basing on the shares of the 100 largest high technological companies of the USA, has increased by 3.4%. The Nikkey index, computed on the base of the prices of shares of 225 largest companies auctioned in the Tokio Stock Exchange, has risen by 4.3%, the FTSE Eurptop 100 index, computed on the base of the prices of 100 largest European companies' shares by 3.5%, and the DAX index – the average price of the share of 100 largest companies auctioned in the German Stock Exchange has went up by 8.1%.

The average brent oil price in the first quarter of 2006 has constituted 62.5 mln USD. It has been 29.9% (\$48.1) more than that of the first quarter of 2005. The factors such as the agiotage emerged over the Iranian nuclear program, speculations upon the possibility of an oil production volume diminution during the second quarter of 2006, and non-stable political situation in Nigeria have influenced the oil price raise.

A sharp gold price increase in the world markets has been observed during the report period. While the spot gold price (1 troy ounce = 31,1 g) in the international interbank markets consituted 517 USD on January 1, it has amounted to 583,2 USD, by the end of the report period, increasing by 12,8% (or 66,2 bln dollars). The main reason for the oil price rise in the world market has been that investors has increasingly been interested on gold, the confident investment object, deriving from an uncertainty, existent over the Iranian nuclear program.

2. Monetary policy

Monetary policy goals and instruments. *The National Bank has influenced the money supply, through utilizing the instruments such as open market transactions, credit auctions, interest rates, and required reserve requirements.*

13 auctions have been held by the National Bank, upon the deployment of notes. The total emission volume has amounted AZN 115 mln, and the deployed volume AZN 112,1 mln. Despite no evident changes registered in the balance on correspondent accounts, an increase has been observed in this balance and it has influenced the volume of orders on notes and average weighted yield. The volume of orders in January, having increased by 61,7% and 71,5% from the amount of AZN 34,16 mln, has respectively amounted AZN 55,3 mln and AZN 58,6 mln in February and March. The averagely measured profitability on short – term notes, decreasing, has declined from 11,3% in the first auction held in the beginning of the period to 4,9% in the last auction. The volume of notes in circulation has amounted to AZN 36 mln, to the end of the period.

The National Bank has actively utilized the REPO and Reverse REPO transactions in order to regulate the banking system liquidity. The volume (for 1 day) of the Reverse REPO transactions, which have been conducted to provide the banks' short-term need for liquid resources, and to ensure the in due time fulfillment of their duties, has amounted AZN 13,7 mln. The average interest rate on the Reverse REPO transactions has been in the 13% level. The volume of REPO transactions (for 1 – 7 days) consisted AZN 0,86 mln. The average interest rate on REPO transactions on 1 day has constituted 7%, and 4% on 7-day transactions.

The National Bank has conducted **refinancing** operations in the less volume than that considered in the monetary program, as a result of an evident extension of the money supply entailed by external factors. The National Bank has continued the broadening of the application of new crediting instruments in order to pursue an effective and adequate monetary policy. For instance, lombard and **overnight** crediting mechanisms are such instruments. Lombard credits in the amount of AZN 1,7 mln have been granted during the period.

As for as February 2006, the Management Board of the National Bank has adopted a decision on the restoration of the practice of attracting the deposits over a year , into the reserve requirements. It should be recollected that the reserve requirements on deposits over a year have been determined in 0% level, since 2003. Here the main aim has been the financial sources broadening of the provision of long-term credits to the economy. The application of this procedure has had a certain stimulus in the increase of the long-term credits, as the analyses of the last 2 years have indicated. But the growth rate of the provision of long-term credits has declined at the expense of exemptions from the reserve requirements in

the condition of a significant raise of the coefficient of inclination to collection, and of broadening of the other alternative financial sources. Besides this, the economic growth's significant speeding up in the country, especially a leap in oil revenues' increase and an extensive usage of these revenues will lead to furtherly extend long-term financial sources in the economy. Taking these factors into consideration, the National Bank has adopted a decision upon reserve requirements, and this decision has corroborated itself, so that attraction of long-term deposits to reserve requirements again, has caused a serious sterilization effect.

Exchange rate. Also in the report period, the foreign currency supply has prevailed the manat supply, in the condition of the world price of a barrel of oil remaining high, foreign investments proceeding to increase in a high rate, and the extensive usage of oil revenues. Consequently, the official exchange rate of manat has strengthened by 1% against the US dollar, in the previous period of 2006.

Despite the strengthening of the nominal bilateral exchange rate of manat against dollar, its nominal effective exchange rate, which characterizes the average change of manat, compared to the currencies of the key trading partner countries, has depreciated by 0.4% in the trade weight, 0.5% in the import weight and 0.3% in the export weight.

The real effective exchange rate of manat has increased by 2.6% on the total trade turnover, 2% on the import weight and 3.1% on the export weight, in the first quarter of 2006. The real effective exchange rate on the non-oil sector has increased by 2.1% on the total trade turnover, 2.3% on the import weight, and 0.2% on the export share.

But the international competition capability of the country in the long-term period remains favourable. The real effective exchange rate of manat on the non-oil sector in March 2006 has cheapened by 9.7%, thus, a strengthening during the report period will not have a serious influence in the international competitiveness of non-oil export.

The National Bank has influenced the exchange rate of manat via regulating the demand and supply in the currency market. The National Bank interference in the currency market during the quarter has been with a tendency to purchase, and amounted \$16.7 mln.

The volume of reserves at the disposal of the National Bank, increasing by 6,74% (961,71 mln USD) on the sum of the first quarter of 2006, compared with the beginning of the year, has amounted to 1 026,56 mln USD. An amount of 15,04 mln USD has been spent for the main debts repayment and payment of interest on the IMF credits, during the period So, the relative increase has amounted 79,89 mln USD.

Institutional development of the monetary management. The institutional development of the monetary management has been kept as the focus of attention in the report period, in order to achieve the goals set by the monetary policy.

The works directed to intensification of the perfect economic research base, one of the most important elements of the monetary management mechanism, have been continued.

“Research methodology of monetary policy transmission mechanism” has been prepared within the exploration of transmission channels with the aim of establishing the monetary policy mechanism, which could efficiently target the base inflation and stimulate the financial stability. Here have been reflected the evaluation methods of transmission channels, with the aim of determining the role of monetary transactions in economy, transmission mechanism structure of the monetary policy, and to explore the influence of the changes in these indicators, in the real sector, especially, inflation and the general product output. At the same time, some models have been primarily set and the influence possibilities of transmission channels have been evaluated basing on this.

Attainment and application of international experience on the computation of official exchange rate has been analysed, at the same time. It has been defined that the exchange rate of the national currency against the other currencies are determined basing on the regime of the currency exchange rate. Determining the exchange rate of the national currency has comprehensively been learned in the “floating” and intermediate currency exchange rate regimes defined and existent in the theory, taking into consideration their characteristic features. An international experience upon the computation of the national currency official exchange rate has also been attained, current situation in this sphere in Azerbaijan has been evaluated, and appropriate recommendations have been given, in the event.

An international experience upon the monetary policy regimes set on targeting the quantity and value parameters has been attained, besides. Various strategies in contemporary central banks’ experience used while the implementation of the monetary policy, have been explored. Setting of the monetary policy tactic on different operative targets and selection of the key criterias for this, and positive and negative features of the targets selected have been explored, and it was determined that the regime of targeting quantity parameters is preferred in developing and transition countries. But as a perspective strategy of the monetary policy, most transition countries have set the transition to the regime of targeting value parameters a goal, taking into account also the increasing role of the financial mediation in the monetary policy transmission.

Monetar idarəetmə mexanizminin digər elementi olan pul siyasətinin işlənməsinin təkmilləşdirilməsi istiqamətində də işlər davam etdirilmişdir.

The works directed to improving the working out of the monetary policy, another element of the monetary management mechanism, have been continued. The research topic in the sphere of the ***preparation of a methodological standard for the working out of the main monetary policy directions***, has begun to be worked out. The international experience in this sphere has been explored, and it has been determined that the preparation process of decisions in this sphere covers a certain period, and adoption of decisions during this period passes through a few stages. The preliminary stages are usually the discussion of international economic

scenarios, computation of inflation forecast via the models, revision of the inflation forecast basing on the results obtained from different models, and determination of the final consensus forecast.

It has been started *to prepare suggestions upon the arrangement of the macroeconomic management in the institutional and normative –legal levels*, within the coordination of the economic policy and figuring out of the macroeconomic management conception project. The practical experience of some states in this sphere has been attained. The preliminary analyses resultedly determined that the Medium-Term Expenditure Strategy lies on the base of the most effective arrangement mechanism of macroeconomic management. This determines the fiscal circle within the mid-term period.

The application issue of the MTES on the countries such as Albania, Czech Republic, South Korea, Pakistan, India, Sweeden, Finland, Georgia, Norway has been explored.

The works in the sphere of *establishing a methodological base on the financial program drafting* have also already been started, and some actions have concretely been implemented, within the coordination of the economic policy and figuring out of the macroeconomic management conception project. This actions include the latest situation of the financial program and discussion of the problems existent in its structure, preparation of necessary actions plan for the formation of financial program as a system, separation of the oil and non-oil sectors within macroeconomic accounts, taking into consideration the country economy features, drafting up of the instruction content on compiling the financial program and etc. Regular works directed to attaining the international experience in the preparation of instruction are done in the real time, the ICF and the other organizations' researches are revised, and an information base upon the preparation of such a document and its structure is created.

Significant works directed to the creation of substantial **information base** have also been done to ensure the efficient monetary management. The processes in the world economy, CIS space, and in the country economy, and especially, the statistical base on the change in prices have been furtherly enriched. At the same time, the works on automatically processing and summarizing statistical reports received by credit organizations, and on the improvement in the compiling of the balance of payment, have been intensified.

3. Monetary indicators and financial markets

Situation of maintenance of economy with money. The increase in the demand for money in accordance with the money supply in the first quarter of 2006, in the condition of the economic growth's speeding up, has been proceeded.

Money supply in manats on the sum of March has grown by 26.8% and amounted AZN 712 mln, compared to the corresponding period of the previous year. The broad money supply (M-2), growing by 32.6%, has amounted to AZN 842.1 mln.

An improvement in the indicators characterizing the banking system's capacity of money creation, has been observed. The **money multiplier** (rate of the broad money supply in manats, against the money supply in manats) has grown by 4.4% in the first quarter of 2006. The speedy development of the banking infrastructure in the country, especially, the application of progressive payment systems, creation of interbank electronic payments system on large and small payments, and broadening of the plastic cards turnover are giving an additional stimulus to the rise in the banking system's capacity of money creation.

The deposit market. The volume of savings and deposits in March 2006, increasing by 41.3%, amounted to AZN 1411 mln, compared to the corresponding month of the previous year. The **juridical persons'** deposits, increasing by 49.5%, amounted AZN 866 mln.

The increase of **physical persons' deposits** has also went on. Physical persons' savings has increased by 29.5% and amounted AZN 494.5 mln. The private banks has accrued 56.4% of savings and deposits attracted by banks, to the end of the report period.

It should be noted that, besides residents, savings deposit by non-residential physical persons are increasing in a high rate. Non-resident physical persons' savings have increased by 50.1%, compared to the corresponding period of the previous year, to April 1, 2006.

The analysis of savings' structure on currencies, reflects economic subjects' confidence has increased towards manat. While the population's savings in foreign currency increased by 22.9%, compared to the corresponding period of the previous year, **savings in manats** have increased by 2.1 times. This factor lays a favourable ground for manat to strengthen its role in the economic turnover, via improving the money supply structure.

A rise in the interest rates on deposits has been observed in the last one year. The average interest rate on deposits in manats in March 2006 went up from 6.9% in March 2005 to 10.5%, and the average interest rate on deposits in foreign currency went up from 9.9% to 11%. It should be noted that the highest increase has been observed in the interest rates on 1 month time deposits.

Credits . The percentage of credits in the GDP (GDP of the non-oil sector) has risen by 1.6 percentage points in the first quarter of 2006, compared to the corresponding period of the previous year.

The volume of the **newly granted credits** has amounted AZN 583.1 mln in the first quarter of 2006.

Radical changes have not been observed in the sectoral breakdown of credits, during the period analysed. The amount of credits directed to industry and production has amounted AZN 96.6 mln, increasing by 34.4%, of credits extended to physical persons amounted AZN 438.6 mln, increasing by 43.9 %, of credits directed to trade and services amounted AZN 390.6 mln, increasing by 41.8%, of credits to agriculture and processing amounted AZN 103 mln, increasing by 79.6%, and the amount of credits directed to transport and communication has amounted AZN 123.3 mln, decreasing by 5.6%, in the last one year.

Short-term credits have increased by 8.9%, and **long-term credits** by 73.9%, compared to the corresponding period of the previous year. The percentage of long-term credits in credits has risen to 43.3% on the sum of the end of the report period, from 32.3% in the corresponding period of the previous year.

Banks and non-banking credit organizations respectively accrue 96.5% and 3.5 of credits. The **share of the private banks** in the structure of credits granted by banks has constituted 52.2%.

While the credits to the state sector have decreased by 14.6%, compared to the corresponding period of the previous year, credits to the private sector have increased 38.4%, and the **share of the private sector in credits** has risen to 89.5%.

The strengthening of the exchange rate of manat against freely convertible currencies, has influenced also the currency structure of credits. **Credits in manats** in March 2006, have increased by 37.7%, compared to the corresponding period of the previous year, and credits in foreign currency by have increased by 25.1%. Credits in foreign currency have constituted 59.3% of credits, to the end of the quarter, and it is 2.3% less than it was in the previous year.

Radical changes have not been observed in the **nominal interest rates on credits**, in March 2006, compared to the corresponding month of the previous year. The average interest rates on credits in the national currency have increased by 0.1%, compared to the corresponding month of the previous year, and constituted 15.7% for 01.04.06. The average interest rates on juridical persons in manats, have constituted 14.7%, decreasing by 0.8%, compared to the corresponding period of the previous year, and the average interest rates on physical persons have constituted 18.5%, increasing by 2.3%. The average interest rates on credits granted in foreign currency have constituted 17.9% against 18.6% in March of the previous year. In this period, the average interest rate on credits granted in foreign currency to juridical persons, has fallen from 17.2% in March of the previous year, to 15.9% to the end of the report period, and the average interest rate on credits granted to physical persons has fallen from 21.9% to 21.7%.

Organized Interbank Credit Market. The bargains in the Organized Interbank Credit Market have been concluded in AZN and USD, during the report

period. The total volume of bargains concluded in manats has amounted AZN 4,3 mln. The period of credits granted in manats has been in the range of 7-90 days. The total volume of bargains concluded in the US dollar has amounted USD 4,7 mln. The period of credits granted in the US dollar has been in the range of 2-90 days.

The state short-term bills market. 6 auctions on the placement of the State short-term bills have been conducted by the Ministry of Finance of the Azerbaijan Republic, during the first quarter of 2006. The emission volume has amounted AZN 23 mln. The volume of the placed ST-bills has amounted AZN 18,54 mln. The average weighted yield in the first quarter of 2006 has fallen to the 5,61% level at the time of the last auction, from 12,44% in the first auction. The volume of the ST-bills in the turnover has amounted AZN 18,54 mln, to the end of the report period.

Currency market. The volume of the currency market in the first quarter of 2006 has amounted USD 2,2 bln, increasing by 10.4%. 86.8% of currency transactions have been conducted in the US dollar, 10.4% in Euro, 2.5% in the Russian ruble, and 0.3% in the other currencies. An significant increase in the transactions in euro has been registered, compared to the corresponding period of the previous year, so that the transactions in euro had constituted 5.7% of the total currency transactions in the first quarter of the previous year.

Thus the macroeconomic and monetary situation in the country has been favourable in the first quarter of 2006, positive quality changes in the economic growth have endured.