

On the situation of implementation 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 provision of the macroeconomic stability and one-digit inflation, and supporting the socio-economic development programs of the country, 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 sped up more in 2006. 36.3% increase in the key macroeconomic indicator of economy, GDP, has happened. The increase has been attained in the production of industrial goods (41.1%) and agricultural goods (4.5%), in the freight transportation (9.2%), in communications services (27.1%), and in the commodity turnover (12.1%).

The role of the private sector in the economy, which is a necessary condition for the country with a market economy, is also increasing. The non-state sector has accrued over 75% of GDP, 73.4% of industrial products, 99% of agricultural products, 84.5% of capital investments, 55% of the freight transportation, and 70.7% of communications services, in the first quarter of 2006.

The **inflation** constituted 5.6% in June 2006, compared with the beginning of the year, and 8.1%, 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 4.3%, compared with the beginning of the year, and 6.5%, compared to the same month of the previous year.

The inflation model indicates, 22.5% of the inflation during the half-year, have 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 also influenced the price change.

As the key factor ensuring the future development of economy, the volume of the capital **investment** has went up by 7.9% and amounted AZN 2.6 bln manats, compared with the previous year, and the foreign investments have constituted 60.3% or AZN 1.5 bln manats of this. The domestic investments have increased by 45.3%, compared to the same period of the previous year. 38.4% of the investments to the economy have been directed to the non-oil sector.

The positive inclinations observed in the **foreign trade balance** of Azerbaijan in recent years, have kept on also in the current year. 20% increase in

the oil price a barrel has caused a more favourable situation for the country's foreign balance. In January – May, the balance of foreign trade has amounted \$4138.6 mln, of which \$2472.5 mln are accrued by export, and \$1666.1 mln by import. The total volume of the foreign trade turnover has increased by 46.4%, compared to January – May 2005.

The betterment of the **social condition of the population** has also endured, so that the average monthly wage has amounted to AZN 135.1 manats, and its growth rate has constituted 20.4%. 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 themselves 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 has depreciated by 4.8% against euro, 5.9% against the Russian rouble, 3.6% against the Swiss franc, 4.1% against the English pound sterling, and by 11.4% against the Kazakh tenge, has strengthened by 19.1% against the Turkish lira.

It should be noted that the increase in the deficit in the foreign trade balance of the USA has had a reducing effect in the rate of dollar, and the raising of the discount degree by the Federal Reserve System (the FRS discount degree being changed for 4 times during the first quarter, have been raised from 4.25% to 5.25%) has had a raising effect.

Significant changes did not occur in the **main stock indices** level, during the report period. 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 2.9%, and the *Nasdaq index*, computed basing on the shares of the 100 largest high technological companies of the USA, has increased by 3.9%. The *Nikkei index*, computed on the base of the prices of shares of 225 largest companies auctioned in the Tokio Stock Exchange, has decreased by 7.6%, the *FTSE Eurptop 100 index*, computed on the base of the prices of 100 largest European companies' shares decreased by 1.6%, and the *DAX index* – the average price of the share of 100 largest companies auctioned in the German Stock Exchange has went up by 1.1%.

The **average brent oil price** in the first quarter of 2006 has constituted 67.1 USD. It has been 32.6% (\$50.6) 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 rise.

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 constituted 517 USD on January 1, it has amounted to 597 USD, by the end of the report period, increasing by 15,5% (or 80 US 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 in order to attain the one-digit inflation , through utilizing the instruments such as open market transactions, interest rates, and reserve requirements.*

26 auctions have been held by the National Bank, upon the deployment of **notes**. The total emission volume has amounted AZN 279,0 mln, and the deployed volume AZN 255,2 mln. The average weighted yield on the short-term notes of the National Bank have increased from 11,29% in the first auction to 12,07% in the last auction. 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 average weighted yield in 4 auctions held between March 22 – April 12, 2006, has declined to 4,90% level.

The volume (for 1 day) of the Reverse REPO transactions has amounted AZN 13,7 mln, which have been conducted during the report period to provide the banks' short-term demand for liquid assets, and to ensure the in due time fulfillment of their duties, has amounted AZN 14,6 mln. The average interest rate on the Reverse REPO transactions has been in the 13% level. The volume of REPO transactions (for 1,3 – 7 days) has constituted AZN 32,9 mln. The average interest rate on REPO transactions has been in 4-8% range.

The **discount degree** has not been changed during the report period and has been kept in 9% level. As of July 3, the discount degree has been risen to 9.5%.

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 2.5% against the US dollar, in the half 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 1.5% in the total trade weight, 0.7% in the import weight and 2% in the export weight. It is mainly related with the depreciation of dollar against euro, Russia rouble, and the Kazakh tenge.

The **real effective exchange rate** of manat has increased by 1% on the total trade turnover, 1.3% on the import weight and 0.8% on the export weight, in the first quarter of 2006. The **real effective exchange rate on the non-oil sector** has

increased by 2.2% on the total trade turnover, 2% on the import weight, and 1.5% on the export weight.

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 June 2006 has cheapened by 13,3% against December 2000, thus, a strengthening during the report period will not have a serious influence in the international competitiveness of the 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 half year has been with a tendency to purchase, and amounted \$161. mln.

The volume of reserves at the disposal of the National Bank, has amounted to 1444,6 mln USD, increasing by 50,2% or 483 mln USD on the final of the first quarter of 2006, compared with the beginning of the year (961,71 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.

A research on the subject of *evaluation of properties of financial system and monetary policy transmission mechanism in Azerbaijan* has been conducted, with the aim of establishing the monetary policy mechanism, which could efficiently target the base inflation and stimulate the financial stability. Here have been given the traditional transmission channels of the monetary policy and the explanation of theoretical ideas in this sphere, and presented the summary of researches related with the monetary policy transmission and conducted on the base of the other countries' practice, and their summarized results. Here the effects of the policy instruments and operation targets on the financial sector indicators and via this, on real sector indicators, have been evaluated from the viewpoint of time and quantity. This evaluation has been implemented on different transmission channels, depending on the policy operations. The issues of inflation dependence on the monetary indicators and quantitative evaluation of this dependence have been interpreted in the research. Differentiation of the inflation processes reaction against the monetary indicators in the short and long-term periods, and temporary and shock effects on inflation are analysed.

An international experience upon the monetary policy regimes set on targeting the quantity and value parameters has been attained. 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 prospective 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.

A research on the subject of *reserve requirement effect on the monetary indicators* has been conducted. In the research work, in this sphere, the experience of a group of leading central banks of the world has been attained, the money multiplier that is one of the monetary policy transmission channels, and its probable effects on the monetary sector by means of the credit supply and interest rates, and monetary indicators reaction against the reserve requirement have been explored. Finally, relevant suggestions have been proposed, considering particular aspects of the economy.

It has been started to *prepare suggestions upon the arrangement of the macroeconomic management in the institutional and normativ-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 (MTES) lies on the base of the most effective arrangement mechanism of the macroeconomic management. It determines the fiscal circle within the mid-term period. Practical matters of the MTES on the countries such as Albania, the Czech Republic, South Korea, Pakistan, India, Sweden, Finland, Georgia, Norway and Finland have been explored.

Also the preliminary project of the *methodological guidance upon compiling the financial program* has already been prepared. For the formation of the financial program as a system, requisite actions plan have been prepared, and considering the features of the economy of the country, methodology of the oil and non-oil spheres separation has been determined, for the formation of the financial program as a system,

3. Monetary indicators and financial markets

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

Money base in manats on the final of June has grown by 43.5% and amounted AZN 963.1 mln, compared to the same period of the previous year. The broad money supply in manats (M-2), has amounted to AZN 1132.1 mln, growing by 47% in the last one year.

An improvement in the indicators characterizing the banking system's capacity of money creation, has been observed. The **money multiplier** (ratio of the broad money supply in manats to the money base in manats) has grown by 4.3% in the June 2006, compared to the same month of previous year. 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 June 2006 has amounted to AZN 1625.4 mln, increasing by 40.9%, compared to the same month of the previous year. The **juridical persons'** deposits has amounted AZN 1010.8 mln, growing by 39.8%.

The growth of **physical persons' deposits** has also went on. Physical persons' savings have grown by 42.8% in the last one year and amounted AZN 614.6 mln. The private banks have accrued 58.7% of savings and deposits attracted by banks, for the end of the report period.

It should be noted that, besides residents, savings deposit by non-residential physical persons are growing in a high rate. Non-resident physical persons' savings have increased by 43.8% for July 1, 2006, compared to the same period of the previous year.

The analysis of savings' structure on currencies, reflects economic subjects' confidence has increased towards manat. While the population's savings in foreign currency have increased by 29.9% in June 2006, **savings in manats** increased by 2.6 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 June 2006 has gone up from 7.5% in June 2005 to 11.5%, and the average interest rate on deposits in foreign currency has gone up from 10% to 11%. It should be noted that the highest increase has been observed in the interest rates on deposits, of which term is up to 1 month.

Credits. The volume of the **newly granted credits** has amounted AZN 1660.5 mln, increasing by 53.8%, in June 2006.

The percentage of credits in the GDP (GDP of the non-oil sector) has risen by 2.7 percentage points in the first quarter of 2006, compared to the same period of the previous year.

The **newly granted credits** volume has constituted AZN 1366.8 mln, and this is 27.6% more than it was in the same period of the previous year.

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 122.7 mln, increasing by 44.1%, of credits extended to physical persons amounted AZN 519.5 mln, increasing by 53.1 %, of credits directed to trade and services amounted AZN 446.2 mln, increasing by 60%, of credits to agriculture and processing amounted AZN 113.5 mln, increasing by 89.7%, and the amount of credits directed to transport and communication has amounted AZN 160.1 mln, increasing by 38.3%, during the last one year.

Short-term credits have increased by 30.1%, and **long-term credits** by 93.3%, compared to the same period of the previous year. The percentage of long-

term credits in the credit investments has risen to 47.1% on the sum of the end of the report period, from 37.5% in the same period of the previous year. It should be noted that, the mortgage crediting mechanism, which has started to work, is giving an additional stimulus to the long-term credit investments.

Banks and non-banking credit organizations relevantly accrue 96.8% and 3.2% of credit investments. The **share of the private banks** in the structure of credits granted by banks has constituted 52.1%.

While the credits to the state sector have increased by 13%, compared to the corresponding period of the previous year, credits to the private sector have increased by 60.8%, and the **share of the private sector in the credit investments** has risen to 89.3%.

The strengthening of the exchange rate of manat against the freely convertible currencies, has influenced also the currency structure of credit investments. **Credit investments in manats** in June 2006, have increased by 64.1% and credit investments in foreign currency increased by 47.3%, compared to the same period of the previous year. They have increased by 25.1%. Credits in foreign currency have constituted 58.7% of credits, to the end of the half-year, and it is 2.6% less than it was in the previous year.

Radical changes have not happened in the **nominal interest rates on credits**, in June 2006, compared to the same month of the previous year. The average interest rates on credits in the national currency have decreased by 0.5%, compared to the same month of the previous year, and constituted 15.8% for 01.07.06. The average interest rates on juridical persons in manats, have constituted 14.5%, decreasing by 0.9%, compared to the corresponding period of the previous year, and the average interest rates on physical persons have constituted 19.5%, increasing by 0.9%. The average interest rates on credits granted in foreign currency have constituted 17.5% against 18.3% in June of the previous year. In this period, the average interest rate on credits granted in foreign currency to juridical persons, has fallen from 16.5% in May of the previous year, to 15.3% to the end of the report period, and the interest rate on credits granted to physical persons has fallen from 21.75% to 21.73%.

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 4,7 mln. The average annual interest rate on the bargains concluded has constituted 10,8%. The term of credits granted in manats during the relevant period has been in the range of 2-90 days. The volume of bargains concluded in the USD has constituted 5,8 mln USD. The period of credits granted in the US dollar has been in the range of 2-90 days. The average annual interest rate on the bargains concluded has constituted 11,8%. The term of credits granted in manats during the relevant period has been in the range of 2-183 days.

The state short-term bills market. 16 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 half of 2006. The emission volume has amounted AZN 69 mln. The volume of the placed ST-bills has amounted AZN 41,9 mln. The average weighted yield in the first quarter of 2006 has risen to the 13,9% level at the time of the last auction, from 12,44% in the first auction. The average weighted yield level on the State short-term bills in the auctions held in March and April 2006, has relevantly constituted 5,61%, 5,41% and 5,32%. The volume of the ST-bills in the turnover has amounted AZN 24,96 mln, to the end of the report period.

Currency market. The volume of the currency market in the first quarter of 2006 has amounted 5,3 bln USD, increasing by 27.8%. 85.5% of currency transactions have been conducted in the US dollar, 11.6% in Euro, 2.6% 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 same period of the previous year, so that the transactions in euro had constituted 7.4% of the total currency transactions in the first quarter of the previous year.