

Summary on situation of the monetary policy on the first nine months of 2004

1. Execution of the monetary policy

The National Bank conducted the monetary policy related to the maintenance of the stability of manat's rate and prices within its authority, the high international payment ability of the country and improvement of money supply in the economy during the first nine months of 2004 as well and mostly achieved the targets. So, macroeconomic stability has been maintained and money supply in the economy has been improved during nine months of 2004. The ongoing economic processes inside and outside of the country significantly influenced the implementation of duties of the monetary policy.

Macroeconomic situation. The growth rate of the **GDP** as a main macroeconomic indicator constituted 9.9%.

5.1% industrial product, 5.7% agricultural product, 45.3% capital construction and 12.5% commodities turnover growth rates were achieved as compared to the previous year.

The increase of the share of the **private sector** as an important term for the country with the market economy proceeded as well. Over 73% of the GDP, as well as 55.7% of industrial product, 99% of agricultural commodities, 92% of capital investment, 57.2% of freight forwarding, 70.6% of communication services were performed by the non-government sector during the first nine months of 2004.

Acceleration of **inflation's** growth rate continued till June, 2004, stopped and decreased during the months of June-August and in September it constituted 1.6% as compared to December of the previous year. Despite the inflation constituted 4.9% as compared to September of the previous year, "**basic inflation**" constituted 3.3%. It should be noted that, just the "**basic inflation**" expresses the exact macroeconomic efficacy of the monetary policy in the world practice.

Untraditional increase of the inflation rate was mostly related to the variety of new factors than to the fundamental economic factors. Especially, limitations in the border with Russia resulted in the appreciation of variety of food products. Simultaneously, the expiration of VAT relief system on the grain import and the intended appreciation of the energy carriers also slightly increased inflation expectations. But, alongside with these, non-official monopolists' reaction to the internal or external changes by the appreciation is also expected.

The amount of the capital **investment** as a main guarantee factor of the future economic development increased by 45.3% constituting 17.6 trillion manats, since 13.4 trillion manats (2.7 billion USD) or 76% of this was constituted by foreign investment.

Positive declines observed in the **foreign trade balance** of Azerbaijan during the recent years persisted. The foreign trade turnover increased by 36.9% as compared to the same period of the previous year and reached 4146.8 million USD during the months of January –August of 2004. The export amounted to 2037.2 million USD and the import amounted to 2106.6 million USD. The appearance of the negative balance of 72.4 million USD in the foreign trade was due to the import of the investment oriented products related to the realization of oil contracts.

The improvement of the **population's welfare** continued as well. The average salary reached 472.7 thousand mantas (96 USD) and its real growth rate constituted 25.2%. In its turn the increase of population's income became the guarantee factor of the real sector's development, enhancing the purchasing capacity.

Inclinations in the world economy. Revival declines persisted at the world economy during the first nine months of 2004.

The economic growth in the **USA** – locomotive of the global renaissance became sufficiently stable. In general, the growth rate of the GDP over the year constituted 4.5% during the first quarter and 3.3% by the end of the second quarter. Positive declines were observed in the economy during the third quarter, despite opposite changes of the separate indicators. Despite Consumer Confidence Index decreased to 96.8 in September from 98.2 of August, it was still

higher than (96.4) at the beginning of year. Unemployment rate constituted 5.4% according to the information in September. So, the scope of the retail sale decreased 0.2% in August, whereas it increased by 1.5% in September. The industrial production increased by 0.1% and the Index of the productive capacity utilization constituted 77.2% in September.

The committee of the FRS upon the open market issued a decree to increase the discount rate by 0.25% since July 1. It should be noted that market participants forecast monetary policy to become tougher.

During the accounting period, revival of the economy was observed in **Euro region**, too. The economic growth rate constituted 1.7% and 2.2% in Euro region and 1.5% and 2% in Germany – in the most enormous economy of Euro region, during the first and second quarters accordingly. Economic growth of Euro region was due to the increase of the export, corporative investment and government expenses. But consumer expenses still remain low. According to the opinion of the economists the economic growth rate couldn't be expected to be higher while consumer expenses are low. Industrial production decrease was observed in Germany (1%), in France (1.9%) and in Italy (0.8%). One of the main reasons of the moderate consumer demand is the great unemployment rate (9%) in the Euro region. But the European Central Bank doesn't hesitate to lower the discount rate. It remained at the stable 2% level during the first nine months of 2004.

The business activity index has been exceeding 50 during the last months indicating the continuation of the economic progress in **England**. England Bank increased its discount rate from 4.25% to 4.5% in June and to 4.75% in August. This had a significant effect on the increase of the percentage rates in the financial markets. Thus, a monthly LIBOR rate rose up to 1.84% by October 1, whereas it constituted 1.12% at the beginning of year.

During the second quarter the economic growth rate slightly decreased constituting 0.4%, whereas it constituted 1.6% during the first quarter in **Japan**. Deflation processes still proceeded in the country. Unemployment decreased to 4.6% - the lowest level since 2000. Housekeeping expenses went up by 0.6% in August as compared to the same months of the previous year. Offers in machinery sphere increased by 3.1% and industrial production went up by 0.1% in August. The Central Bank of Japan didn't change its main percentage rate and kept it at the level of 0.01%.

The processes in the economy of the leading countries had effects on the rates of currencies and stock indexes of these countries.

Opposite changes on the **exchange rate of USD** against the other leading currencies of the world were observed. The rate of USD decreased 1% against English pound sterling and 0.1% against Russian ruble whereas it appreciated 2% against the euro, 1.5% against Swiss frank and 3.7% against Japanese yen.

Abrupt changes were not observed on the levels of main **stock indexes** during nine months. So the *Dow-Jones average* displaying the average price of 30 biggest industrial companies in the New-York Stock Exchange decreased 2.6%, the *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange increased by 0.5%. Abrupt hesitation of stock indexes was not observed in Europe, as well. So, the **FTSE Eurotop 100** calculated on the ground of stock prices of the 100 biggest companies of Europe increased by 1% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange decreased 2.4%.

The **average price of Brent oil** in the world market constituted 36 USD during the first nine months of 2004, which is 27% more than (28.3 USD) that of the same period of the previous year.

2. Development of the monetary management

Tools of monetary policy. For successful implementation of specified monetary policy the National Bank regulated the money-market by participation in credit auctions, securities and currency market, as well as by the obligatory reserve norms during the accounting period.

Actions for the realization of the strategy to set **open market operations** as a main tool of the monetary policy proceeded during the first nine months of 2004 as well. Within the framework of the sterilization policy, the National Bank issued **short-term bank-notes** to neutralize surplus liquidity in the banking system under the conditions of the limited scope of the **STSL** market. Money amounted to 64.1 billion manats has been sterilized by the short-term bank-notes to date.

Under the conditions of significant expansion of the money supply caused mainly by the foreign factors, the National Bank conducted less **refinance operations** than intended on the monetary program. Simultaneously, expansion of the employment of new financial tools in order to improve refinance mechanism and to conduct an effective and adequate monetary policy by the National Bank was ongoing. The **pawn-shop and overnight credit mechanisms** are examples of these tools. 10 **pawn-shop** credits amounted to 11.14 billion manats and 1 overnight credit amounted to 1 billion manats have been realized during the period.

Discount rate for the centralized credits remained at the stable level of 7% during the accounting period.

The **obligatory reserve norms** were 10% for the short-term deposits and at zero level for the long-term credits during the accounting period. The National Bank issued a decree allowing the operating banks in the country to use the obligatory reserve norms in manat for daily clearing, widely using opportunities of the interbank payment system of AZIPS. New system is applied to the chosen pilot banks by stages. The implementation of this measure is expected to positively influence the increase of trust towards the national currency, the development of the interbank money market and government securities market, expanding resource opportunities of the banks and obtaining a prompt reaction of banks to the demand of clients.

Exchange rate policy. The supply of foreign currency significantly exceeded the supply of manat as the world price of oil per barrel exceeded the intended price at the state budget - 20 USD, constituting 50 USD and as transfers to the state budget from the Oil Fund increased during the first nine months of 2004. As a result the official exchange rate of manat against USD strengthened by 15 manats or 0.31% during the months of January - September and by the end of the period constituted 4908 manats.

The existing dynamics of the manat's rate maintained auspicious parity of manat against the currencies of the partner countries at the foreign trade. The **nominal effective exchange rate** of manat didn't change against the currencies of the main partner countries at the foreign trade in September, 2004 as compared to December 2003 and the import influenced rate cheapened 0.1%, whereas the export influenced rate strengthened 0.2%. During the investigation period the **real effective exchange rate** of manat on gross trade turnover decreased 1.4%, export influenced rate 5.6%, import influenced rate 2.7%. **The real effective exchange rate on the gross trade turnover** of the non-oil sector decreased 3.5%, whereas the export influenced rate decreased 5.1% and import influenced rate decreased 3.2% during the nine months of 2004.

The National Bank influenced the exchange rate of manat by the correlation of demand and supply in the currency market. The National Bank's interference to the currency market constituted 142.3 million USD and was purchase oriented during the accounting period. Purchase oriented interference of the National Bank in the currency market improved money supply in the economy and prevented "Dutch syndrome" and abrupt revaluation of exchange rate of the national currency.

The purchase oriented interferences also played an important part in the **increase of the currency reserves**. Scope of the currency reserves under the disposal of the National Bank increased by 11.83% as compared to the beginning of year (757.1 million USD) and reached 846.69 million USD by the end of the period. 48.74 million USD was spent on the repay of the

main and active debts on credits of IMF during the first nine months of 2004. Consequently, relative growth constituted 138 million USD.

Institutional development of the monetary management. The institutional development of the monetary management was also kept in the focus for the successful fulfillment of duties of the monetary policy.

Works on the extension of the **perfect research base** - one of the most important elements of the monetary management mechanism were ongoing.

Within the framework of the common economic problems' analysis the *regional economic development problems* were investigated in Azerbaijan. Part of the regions in the social economic development, the socio-economic indicators of separate regions, the realization of poverty reduction strategy in the regions and problems of the proprietary development were also analyzed. Proposals on the conducted government policy aiming to accelerate the regional development were put forward on the base of these analysis.

The scale of foreign investment in Azerbaijan and evaluation of its macroeconomic efficacy were studied as well. Thus, the dynamics of direct foreign investment to the Azerbaijan economy and the influencing factors were fully analyzed. Proposals and recommendations on the principal directions to increase the macroeconomic efficacy of the foreign investment were put forward on the ground of these analysis.

A research on *contemporary financial crises in the world economy, its appearance forms and early caution systems* was carried out. The essence of the financial crises, its causing factors, types of the crises and appropriate caution systems preventing theses problems were analyzed during the investigation process.

Within the framework of analysis in the monetary sphere, the *measures on the improvement of the money turnover and on the decrease of the dollarisation level* in Azerbaijan were evaluated. The existing situation of the money turnover and dollarisation were analyzed and summary on the conducted measures in this sphere were estimated. As a result, variety of new proposals on the improvement of the money turnover and on the decrease of dollarisation level were put forward.

Simultaneously, *problems on the improvement of the correlation mechanism of monetary and fiscal policies in Azerbaijan* were investigated. Thus, the theoretic basis of the correlation of the monetary and fiscal policies were investigated, the development of the relations between the monetary and fiscal policies in Azerbaijan were analyzed by stage and principal directions of the development of coordination between the monetary and fiscal policies were determined.

Construction and improvement of the monetary development models were kept in the centre of attraction. Usage of the correlation models of the inflation and money market, as well as the econometric model of the exchange rate of manat was proceeded in practical implementation of the monetary policy.

Simultaneously, the establishment of the *econometric model of the real sector* started in Azerbaijan. Problems of the existing statistical database were evaluated from the standpoint of qualitative construction of the model. Within the scope of construction of the productive function in the real sector the initial evaluation of the implementation opportunities of the CES and Cobb–Douglas models was performed. Processing of the information base of the GDP on the economic activity fields was started, influencing factors of the productive processes on these fields determined and grouped, methodological apparatus of the evaluation of the multi-factor regression of the economic growth was constructed. Construction of the productivity function of the oil and non-oil sectors of the GDP was started. Natural unemployment and potential level of production were evaluated within the model's scope. Direct foreign investments appearance as a main factor in the production innovation was proved empirically. Investigation of the relations among the import, inflation processes and the difference between gross demand and gross supply has been completed.

Besides, works on the *construction of the risk assesment of the econometric model in the banking system of Azerbaijan* were started. Experience of the developed countries on the risk

assessment models in the banking system has been studied, gathering and processing of the information on the factors potentially causing banking risks started. Implementation opportunities of the "Value at risk" method in Azerbaijan reality have been analyzed. This method is considered as the most effective tool of the risk assessment in the world practice. Construction works on the mathematic models enabling the maximum optimization of the assets and liabilities structure of the banking system were started. Specific models for investigation of the solvency (discriminant models, NEURON network and LOGIT type models) have been elaborated for Azerbaijan reality and partly completed.

Within the framework of the **improvement of the monetary policy** the *world practice on the averaging system of the obligatory reserves and implementation perspectives of this experience in Azerbaijan* were analyzed. World practice on the averaging system of the obligatory reserves has been looked through, features and stages of transition to the averaging system were investigated, positive and negative aspects of each stage were analyzed. On the ground of the studied world practice the implementation opportunities of the averaging system of the obligatory reserves were also evaluated.

Research and monitoring of the processes in the international markets, as well as development declines of the world economy under the terms of globalization process proceeded. This set a favorable condition for the detailed analysis of the influence channels of the world economy to the national economy and the macroeconomic aspects of integration of the republic economy to the global one.

Variety of researches has been carried out to create modeled criterions and variants for the **choice of appropriate tools of the monetary regulation corresponding to the economic situation** according to the development declines of the financial markets. Moreover the base of the information and forecasts processing of short- and long-term monetary indicators has been improved in the **monetary research and forecast sphere**.

Important steps were taken to create a **complete information database** to guarantee an effective monetary management. The statistical database on the processes in the world, the CIS region and the country economy and especially on the price changes has been enriched. Simultaneously, works on the automatic processing and round-up of the reports received from credit organizations, as well as on the improvement of the payment balance forming were intensified.

3. Monetary indicators and situation of financial markets

Situation of the money supply in the economy. Under the terms of economic growth's acceleration and increase of country's financial power, implementation of large-scale social programs and utilization of oil incomes for the development aims are increasing physical demand for money. In this connection, increasing declines of the money supply persisted during nine months of 2004, as well.

Monetary base of manat increased by 38.3% as compared to the same period of the previous year, 25.4% as compared to the beginning of year and constituted 2904.7 billion manats by October 1, 2004.

The **broad monetary aggregate (M-2)** increased by 30.9% as compared to the same period of the previous year, 17.4% in relation to the beginning of year and constituted 3044 billion manats. The real growth rate of money supply was higher, too. So the real growth rate of the money supply constituted 24.8% as compared to the same period of the previous year.

As a result, increase of the **monetisation** level proceeded further adequately to the economic growth. So, the share of the money supply in the GDP (upon the GDP of the non-oil sector) increased by 1% according to the summary of September, 2004 as compared to the same period of 2003. Simultaneously, the speed of the money turnover decreased 9.3%, which is a positive factor proving the improvement of money supply in the economy.

Positive changes occurred in the **structure of the money supply** in manat. So the part of the cash in the structure of the money supply decreased 6.7% as compared to the same period of the previous year. It is related to the increase of the non-cash amount by 67.9%, whereas the cash amount increased only by 19.4%. Rapid development of banking system, especially implementation of the progressive payment systems, establishment of the interbank electron payment system on small and large payments and expansion of the plastic card turnover presented additional stimuli to the increase of the non-cash amount.

Dollarisation level of the economy decreased during the accounting period. Thus, the share of deposits and savings in foreign currency in the total amount of savings decreased 2% as compared to the same period of the previous year. This establishes a favorable base for the strengthening of manat's part in the economic turnover.

Deposit market. The scope of savings and deposits increased by 68.5% constituting 4634.3 billion manats, and the deposits of legal persons increased by 68.2% constituting 2855.4 billion manats.

The growth rate of **savings of natural persons** was relatively higher. So, the savings of the natural persons went up by 69% constituting 1778.8 billion manats. 44.2% of savings attracted by the banks were accrued by private banks. Short-term savings of population went up by 46.6% and long-term ones went up by 96.6%. It indicates the further increase of the population's trust towards the banks.

It should be noted that the analysis of the structure of savings against the currencies show the increase of the economic units' trust towards manat. **The savings and deposits in foreign currency** increased by 48.2%, whereas in manat they increased by 68.2%. This factor establishes a favorable base to strengthen the role of manat in the economic turnover improving the structure of money supply.

Percentage rates of savings and deposits either in manat or in foreign currency decreased in September, 2004 as compared to the same period of the previous year. So, the average percentage rates of deposits in manat constituted 6.9% in September, 2004 against 7.36% of the same period of the previous year and the average percentage rates of deposits in foreign currency constituted 6.44% against 9.92%.

Credit investments. The scope of credit investments increased by 40.3% constituting 4363.7 billion manats in the first nine months of 2004 as compared to the same period of the previous year.

Credit investment increased by 39% to the industry, 9.9% to the construction and property, 35% to the agriculture, 3 times to the transport and communication and 65.5% to the physical persons during the period.

Short-term credit investments increased by 33.9% and long-term ones increased by 59.3% as compared to the same period of the previous year. Part of the long-term credits in total credits reached 28.8%.

90.6% of credit investments were accrued by banks and 9.4% of this was accrued by non-bank credit organizations. The **part of private banks** in the structure of the credits given by the banks rose up to 51 %.

Credits given to the private sector increased by 40.4% and the **share of private sector in credit investment** rose up to 78.2%, whereas credits for the state sector increased only by 40.1%.

Abrupt changes weren't observed in the **average percentage rates of credits** in September, 2004 as compared to the same month of the previous year. The percentage rate of credits in manat constituted 14.84% in September, 2004, this is 0.2% more than the same month of the previous year. But, taking into consideration 4.9% inflation rate of last 12 months, 4.7% decrease of real percentage rate could be defined.

State securities market. During the accounting period 4 auctions were conducted by the Ministry of Finance on the placement of the **State Loans** (it should be added for comparison that, 11 auctions were carried out during the same period of the previous year). The gross size of the

emission constituted 80 billion manats in these auctions and this is 350 billion manats (or 5.4 times) less than (430 billion manats) the first nine months of 2003. The reason of this decrease is the withdrawal of the **State Loans** amounted to 85 billion manats from the turnover during the period.

In the auctions on the initial placement of the **State Loans** the demand of the market participants constituted 212% of emission or 169.4 billion manats during the nine months (this indicator constituted 104% during the nine months of 2003). Significant limitation of the **State Loans'** amount issued by the Ministry of Finance gave an additional push to the downtrend of the profitability of the **State Loans**. Thus, by the end of the first nine months of 2004 profitability of the **State Loans** decreased to around 3.92%.

Currency market. The gross volume of the internal currency market increased by 646.2 million USD or 17.8% constituting 4.27 billion USD during the first nine months of 2004 as compared to the same period of the previous year.

The currency market operated in the self-regulating mode and there wasn't observed any tension during the period.

6.6% of currency exchange operations fell to the lot of the Baku Interbank Currency Stock (BISC), 19.7% of the Open Interbank Currency Stock (OISC), 63.1% of the Intrabank exchange operations (IBEO) over the nine months.

Trade in the Stock Electronic System (TSES) - the new segment of the currency market became more activated and the volume of operations carried on the TSES significantly increased. 10.6% of the exchange operations is accrued by the TSES. New financial tools implemented by the National Bank have presented additional stimuli to the development of this segment. So, the National Bank conducted finite currency operations during the past period of 2004.

Thus, generally macroeconomic and monetary situation was auspicious and new qualitative declines were observed in the economic growth processes in the country during the first nine months of 2004. At the same time the problem of strengthening of the coordination mechanism of the macroeconomic policy is relevant for further strengthening of the achieved successes and especially for more effective control of the inflation processes under the terms of expanding use of oil incomes.