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The Moment of Truth of the Azerbaijani economy

Governor of the Central Bank of Azerbaijan shared his innermost opinions in an exclusive interview to I.Bayandurlu

Elman Rustamov is a governmental official who may boast that he created a really western management. He has a strong team, consisting of real strategists of macro economical idea. You will be sure though...

Mr.Rustamov, according to the latest statistical data the world economy is already starting to recover from recession. How could you assess the situation?

- According to the results of Q2 of the current year, Germany and France are demonstrating 0,3% growth, growth reductions slowed down in the USA (0.3% vs. 2.5% in Q1), in Euro zone (0.1% vs. 2.5% in Q1), in Great Britain (0.8% vs. 2.4% in Q1). Judging by this statistics, in principle we may say that the crisis already reached the bottom and the global economy is gradually starting to get out of it.

Meanwhile, growth rate of the global economy in 2009 will be negative and according to the forecast of IMF, slump will make 1.4%. It is expected that the world trade will reduce by more than 12% in the current year.

As for prospects, IMF revised up global forecast to 2.5% from 1.9% for 2010.

However, as for the IMF, despite all these positive shifts, the crisis may dwell, if the banking sector and financial markets do not pull themselves together and resume their functions of financial intermediary in full force.

And the situation with oil prices will be dictated, first of all, by the status of global demand. The higher oil consumption in the USA, in Euro zone, Japan, Great Britain, China and India (they make $\frac{2}{3}$ of the world economy), the higher oil price will be. According to the latest IMF forecast, average price for oil in 2010 will be USD 74.50 per barrel.

However, to forecast oil prices is the hardest task and no one has succeeded in this task up to now for 100%. We should note as well that there is a strong reverse dependency between oil price and exchange rate of the dollar against leading currencies. And this dependency is factored by a number of issues, not only by macro economical ones.

In total, we may say that the global economy is shifting to a new equilibrium with new structural balances and drifts, new power centers emerging in the world economy.

Why was the current crisis so deep, what is such duration of global recession due to?

- Indeed, since the Great depression the world has not encountered such large-scale recession and cyclic unemployment. Slump in the world industry started in Q4 of 2008 (by 21% as compared with the similar period of 2007) endured in Q1 of 2009 – in highly developed countries it made 17.3% as compared with Q1 of 2008. For the first time within the entire period of official statistics since 1947 the American economy reduces over a period of four quarters on end!!! Financial losses resulted from fall of prices for assets and bankruptcies of financial institutions exceeded USD 4 bln (5.8% of the world GDP), of which 60% of losses fall into the share of the banking sector. Subprime crisis in the USA was the catalyst of the current crisis. However, visible reasons for the crisis are as thus:

- Global imbalances of savings and expenses and as a result “overheat and overdose” of the global demand, especially in the leading countries of the world and in the USA in particular. Intense consumption, significant part of which was financed through bank loans was non-steady, since it was not supported by future real income. In this case economic boom caused assurance in future, artificially increased profitability at stock exchange and additionally stimulated growth of consumption.
- Globalization of financial markets that led to increase of potential “contamination” by financial crises, expansion of their reflexivity (reflexivity theory presented in G. Soros’s Alchemy of Finance) – this is the process at which prices for financial assets are primarily formed through conceptions of stock exchange participants about future tendency to their rise or fall, at that profitability level and size of assets do not virtually affect prices.
- Financial innovations, policy of deregulation of financial markets, increase of transactions with virtual money – derivatives, according to some calculations, volume of such tools 10 times as much exceeded the global GDP!! And as a result, informational asymmetry – non-transparency of financial tools and markets.
- Ineffective regulation of financial system – underestimation of risks by regulators and pro-cyclicality of their actions etc.

6 recessions have occurred in the world countries since 1960, the largest of which was the recession in Finland (60s). Various factors may cause recessions: financial, fiscal, monetary, external. From standpoint of deepness and duration the severest was the recession resulted from financial crisis. Recent researches by IMF show that the way out of such a recession lasts a bit longer. Thus, after the first year upon the completion of financial crisis cumulative growth of GDP is on average 2.5% lower as

compared with processes of recovery in other crisis types. Thus, speed of the way out of the recession will depend on speed of improvement of the situation in financial sector. What inspires is that due to mass support of financial sector (liquidity injection, state guarantees, recapitalization etc) index of financial stress in developed and developing countries decreased as compared with the year launch. Though, according to the latest data, in the USA the number of officially registered troubled financial institutions sharply moved from 305 to 416 in Q2 of the current year. Meanwhile, every fourth American bank was unprofitable.

Mr. Governor, how we are getting out of the crisis, did the global crisis in general affect our economy? What does Azerbaijan look like amidst all happenings?

- At one of the recent meetings Mr. President characterized impact of the global crisis on our country as thus: "Some countries of the region cannot cope with the economic crisis. The crisis showed who is who. Azerbaijan is the least affected country by the crisis." Indeed, many countries may envy safety factor of our country. This is, first of all, the merit of Mr. President, result of his well thought out economical policy. Even the countries of Eastern Europe and Baltic countries that until recently were considered to be pioneers of liberal market economy with vigorous macro economical institutions failed to withstand the first kicks of the global recession. Their budgets and foreign positions scattered from the first days of the crisis.

Accelerated recent economic growth in Azerbaijan, creation of large size foreign exchange reserves against the economy size and reserved debt policy became the guarantors of financial strength of economy, as a result of which the country was reliably prepared for the global crisis. This saved both economy and the banking sector.

As for impact of the crisis, fall of the price for oil from the beginning of the second half of the last year through the beginning of the current year was the key channel of the global transmission. All this, certainly, definitely affected dynamics of oil revenues. On the other hand, reduction of world prices for output of metallurgy and chemistry at the end of the previous and beginning of the current year affected export of these fields. Besides, external refinancing of banks reduced, the sum of external loans repaid by banks within eight months of the current year made USD 880 mln, that naturally told on growth rate of loan portfolio.

The Global crisis as well accelerated impact of psychological factors on the state of economy, in the first place, foreign exchange market and banking sector – in Q1 of the current year after series of devaluations in neighboring countries we observed sharp increase of demand for cash dollars, decrease of growth rate of deposits and money supply.

However, starting with Q2 of the current year the situation not only stabilized, but also changed for the better. In the first place, it should be noted that, balance of payments and strategic reserves look encouraging – the country owns sufficient “safety cushion” to support macroeconomic stability. Strategic foreign exchange reserves of the country as of 1 September 2009 made USD 17.9 bln, nearly the level of the beginning of the year. This is sufficient to finance import of goods within 24 months, the internationally established norm being 3 months. The foreign exchange market is currently in equilibrium, demand for currency stabilized, and intervention of the Central Bank in August was even positive. Current account surplus of the balance of payments in Q2 of the current year 1.5 times as much increased as compared with Q1 of the current year and fully covered deficit of the account of capital movement.

Economic growth in the country is enduring – growth rates of GDP according to the results of 7 months made 2.7%, including 3.6% of non-oil sector of the economy. To compare, I would like to note that GDP slump in Russia according to the results of half year, made 13.4%, in Ukraine – 20.3%, in Kazakhstan – 4.1%, in Armenia – 16.3%.

Business activity index considered by the Central Bank has been demonstrating growth for recent two months. For economy it means restoration of increase of sales of long-term goods, reduction of accumulated warehouse reserves of unrealized production as a result of demand revival, resume of growth of production in a number of non-oil export oriented fields, increase of optimism among producers and vendors.

In Q2 money supply, one of the key factors to support demand and economic growth, started to grow anew. Just in July gain of money aggregate M2 made 4.5%. Money supply growth being restored, average interest rates on loans in manat decreased from 17.1% to 15.3% in July.

In July deflation was followed by inflation (0.8%), base inflation left negative zone for positive one, which is an indicator of revival of demand in economy. At that, average annual inflation is still low (only 3.1%). I would note as well that real effective exchange rate of manat depreciated within 7 months by 2.3% which is primarily due to high inflation in trade partner countries. In other words, inflation in these countries made their economy more expensive, and consequently, not competitive.

If to sum, economic diagnosis of the results of 7 months of the current year is as thus: macroeconomic stability in the country is rather high – it is first of all supported by solid foreign exchange reserves, namely these reserves guaranteed safety of the state budget and partially compensated reduction of external sources of liquidity in economy, economic growth and

employment as a whole were protected from fatal impact of the global crisis, and within recent two months demand has been reviving in economy, balance of payments is increasing again, foreign exchange market and channels of money supply are being stabilized under influence of anti-recession monetary policy.

Landslide of prices for oil from the fall of last year through the beginning of the current year and devaluation of currencies in most CIS countries caused lots of disputes and speculations on appropriateness of maintenance of stable exchange rate of manat against USD. Opponents of this policy point to loss of foreign exchange reserves as the price for exchange rate stability. What about of your opinion?

-Yes, we promised that we will not allow destabilization of foreign exchange rate and kept our word. Mr. President supported us in this issue as well. Temporary decrease of foreign exchange reserves – this is just the price for exchange rate maintenance, this is the price for macro economical and financial stability. Under growth of oil revenues the Central Bank has been purchasing foreign exchange at the market for several years and this is the key source of increase of its reserves. And now we have sold portion of these reserves to maintain stability in economy. I think, it is a normal macroeconomic response under the global crisis. Before proceeding to analysis of this question, I want to note that both in majority of transition countries with developing financial markets and specific structural features of economy, and in Azerbaijan exchange rate of manat against USD is a key so-called “nominal anchor” of maintaining macroeconomic stability. In other words, among all interim monetary indicators exchange rate of manat is controllable and predictable benchmark to achieve final targets of monetary policy – price stability and financial system.

In total, it is considered that one of the following three indicators may be chosen as conductors of monetary policy – exchange rate, money supply and interest rate. All these three indicators cannot be targeted simultaneously (“impossible trio”). Taking the specifics of the country into account de-facto we are pursuing exchange rate policy through dollar peg.

And now, what our arguments were when we set up exchange rate policy with the world economy crisis aggravation. Decision on maintaining exchange rate stability was built on analysis of set of macroeconomic factors. Considered were the following arguments for and against maintaining exchange rate stability:

- **Arguments against**

- 1) Exchange rate stability does not promote export growth and encourages import;
- 2) Exchange rate stability leads to loss of reserves due to de-facto fixed exchange rate;
- 3) Exchange rate stability deprives exporters of additional manat liquidity, that would be possible in case of devaluation;
- 4) Devaluation should not lead to price hike for imported goods, brought in from the countries that carried out large-scale devaluation and share of which in total import is high (e.g from Russia). And subsequently, devaluation may just constraint the level of cost reduction of foreign products in the worst case and not to make it expensive.

- **Arguments for**

- 1) Devaluation will not lead to increase of export due to slump of the global demand and shrinkage of external markets, as for “encouraging import”, according to the balance of payments, in H1 of the current year total volume of non-oil sector import did not increase, and even somehow decreased;

- 2) Devaluation will not promote instant replacement of import due to scarcity of surplus productive capacities to increase production of import replacing goods;
- 3) Availability of high specific weight of imported accessories and semi-finished products in production of local products (according to some researches from 40 to 60%, depending on fields of industry) that may sharply go up in case of manat devaluation (e.g. closure of some plants in Russia resulted namely from price rise of imported accessories);
- 4) Formation of a portion of internal consumption market through import products – under such circumstances devaluation could lead to growth of inflation and as a result to decrease of real value of assets and savings, impoverishment of population.
- 5) Balance of payments – key monetary basis for exchange rate stability in Azerbaijan is still favorable and does not cause devaluation. Foreign exchange reserves fully cover money supply in manat. The countries that encounter increasing deficit of balance of payments and danger of full loss of foreign exchange reserves resort to devaluation.
- 6) Under the current scale of loan dollarization (46%) $\frac{2}{3}$ of dollar loans are issued to those sectors of economy whose income is not generated in foreign currency, and consequently, devaluation would affect financial standing of these sectors very hard causing sharp deterioration of their creditability before banks.
- 7) Panic among the population – one-off devaluation could cause sharp withdrawal of resources from banks that could lead to aggravation of liquidity and smooth devaluation could not lead to anything good – uncertainty would intensify, that would trigger dollarization and further pressure on foreign exchange reserves;

- 8) Exporters received urgent financial assistance, as a result of which necessity for “devaluational liquidity” seceded.
- 9) Devaluation could lead to additional expenditures on servicing gross foreign exchange debt and growth of debt burden (especially of banks).

In any case, the standing of economies of the countries that announced devaluation does not arise any desire to imitate them:

- Neither on inflation, nor on growth of export and economy no positive results were achieved, but in lieu they received strong financial destabilization, high “stagflation” (simultaneous growth of inflation and unemployment) and worsening of social indicators.
- Even China that is a highly export oriented country did not announce devaluation, but preferred partial re-orientation of economy to domestic demand. The Chinese as well considered high specific weight of imported accessories in local production, that could sharply rise in price in case of devaluation, thereby weakening competitiveness of the country.

As for foreign exchange reserves, as I have already noted, volume of strategic foreign exchange reserves nearly has not altered since the beginning of the year. To compare: from August of last year through July of the current year Russia lost $\frac{1}{3}$ of strategic reserves, as well as the Central Bank lost about half of its reserves. Many central banks incurred serious financial losses on management of financial reserves. Thus, losses of the Central Bank of Norway made nearly USD 8 bln in 2008 an average profitability level being 17.5%. To compare: average profitability on management of foreign exchange reserves of the Central Bank of Azerbaijan made 3.22% in 2008.

Foreign exchange reserves of the Central Bank of Azerbaijan are starting to resume through growth of surplus of balance of payments. As for the reserves the Central Bank sold within Q1 of the current year, analyses show that their significant portion was primarily connected with migration of the part of manat assets of the population and companies to USD. In other words, these sales are in no way connected with the standing of the balance of payments, majority of these funds remained in the economy.

What did the Central Bank concretely do to counteract impact of the global crisis? What was the goal of recent amendments to the Law on the Central Bank?

-First of all, I want to mention that the current period is not the first test for strength – up to the recent crisis I personally witnessed two more macro economical crises (1992 – 1993, - local financial crisis, 1997 – 1998, - impact of the crisis in South-Eastern Asia on Russia). These crises taught us a lot, and evidently, anti-crisis experience somehow proved useful to us in elaboration of correct response. However, no secret that scale and specifics of the current global crisis required non-standard decisions that was done by us.

Therefore I will start from the second part of the question. Amendments to the Law on the Central Bank quite corresponded to the spirit of recent global tendencies in legislations of central banks. According to the adopted amendments, the Central Bank enjoys the right to issue loans to banks as the lender of last resort for longer period and in various currencies. In order to capitalize creditability of banks experiencing temporary challenges the Central Bank is entitled to grant subordinated loans to banks.

The CBA as a mega regulator responded to the global crisis, I would say, in a real time mode – decisions were taken on a weekly basis. Monetary Policy and Financial Stability Committee took the promptest decisions at the height of the global crisis. For prompt response information was collected and analyzed more thoroughly at a micro level, up to direct contact with real sector entities.

Starting with the yearend of 2008 the Central Bank 6 times changed refinancing rate and corridor limits on open market transactions in a declining manner. As a result, refinancing rate was decreased from 15% in October 2008 to 2% today, corridor ceiling accordingly from 20% to 7%, balance requirements of the CBA to banks since the beginning of the year increased 20 times as much. Mandatory reserve norms on domestic sources of funds attraction were decreased from 12% to 0.5%, and on external sources of funds attraction they were annulled at all. Along with this, in order to reduce the burden of maintaining mandatory reserves, the reporting period of averaging on mandatory reserves was extended from 15 days to a month.

As a result, from October of the previous year up today there was provided net injection to economy equal to about AZN 2 bln. Of this amount, just through reduction of mandatory reserves banks obtained liquidity totaling to more than USD 730 mln. I want to particularly note that by order of President of the country activation of discount window of the Central Bank primarily was oriented at support of liquidity of systemic entities (e.g. SOCAR) and banks (primarily for timely servicing of external debts).

The Mortgage Fund resumed its operations which instantly told on stabilization of prices at the real estate market and increase of activity at the market in question. Thus, within two months of Mortgage Fund

functioning prices for real estate at the secondary market stabilized and even increased by 1.3%. Prices stabilization is of key importance for financial standing of the banking sector. The fact is that about half of total loan portfolio of banks is collateralized through real estate. So, price fall for real estate means depreciation of collateral that requires creation of additional financial reserves from banks and reduces their income. For historical example I will note that one of the reasons for L-shaped recession in Japan that started in 90s of the last century and lasted for the whole decade (in Japan it is called “the period of lost decade”) was just collapse of prices at real estate market.

With mortgage revival the number of transactions at the market increased in July by 25% as compared with May. Amplification of activity of the real estate market also told on terms of sale and liquidity of real estate.

You stressed the role of mortgage program in revival of real estate market. Surprising is that namely subprime crisis was the catalyst of the global recession. In our case everything is vice versa – revival of mortgage stabilizes macro economy. How can it be explained?

-Yes, subprime crisis in the USA became the catalyst of the local financial crisis that later expanded to the global funding, banking and then economic and social crisis. It was, I will repeat, the catalyst, but not the reason. The crisis does in no way reduce importance of this tool in revival of housing market, construction sector of economy as a whole. It is calculated that on average every 1 dollar of a mortgage loan triggers effect of income growth in economy equivalent to 5 dollars.

The problem of the USA was that, first of all, they underestimated subprime credit risks. Non-credibility of people received mortgage loan eventually led to bankruptcy of large mortgage agencies, that

borrowed huge funds not only in the USA, but also far beyond it. It turned out that millions of mortgage loan receivers do not have stable income base to repay the loan. There were numerous cases of non-purposeful use of loans. All this tells about lack of proper oversight over credit risks.

Our approach to mortgage was from the very start conservative. Provisions of mortgage lending were formulated such that not to allow mass non-credibility of clients. That is why, today there have nearly been no cases of deterioration of banks portfolio on mortgage loans. But along with this, these provisions in no way hinder people to obtain loans to solve housing problems.

Mortgage loans are resumed in the country in the current year as the most important anti-crisis measure. From June 1 up today about 800 mortgage loans have been issued totaling to AZN 3.4 mln.

Was the banking sector ready to face impact of the global financial crisis? What did the Central Bank do to maintain stability of the sector, what about the current situation in the sector?

-First, till the crisis banks regulation was directed against extreme overheat of the sector. It is sufficient to remind establishment of mandatory reserve norms on external borrowings at the level of 5%. Capital adequacy till the crisis (launch of 2008) made 19.6% that was much higher than the above mentioned minimum norm (12%).

Second, till the crisis aggravation we thoroughly prepared banks for all possible shocks, carried out so called measures on additional "financial immunization" of the sector. Prudential normative was set such that to maintain enough liquidity and create additional provisioning on potentially trouble loans. Toughened were terms of assets classification, collateral value to loan amount ratio increased. In order to regulate

credit risks reconsidered and hardened were norms of risks per borrower, provisions of loan underwriting. Special attention was paid to minimization of currency risks, perceived by banks. At the same time, increased were requirements on the level of data disclosure and overcoming of informational asymmetry. At the height of the global crisis with the purpose of capitalization of banks and insurance organizations through internal resources a decision was taken to exempt portion of income directed at capitalization from taxation. In order to protect interests of depositors and stimulate deposit flow to the banking sector the maximum size of the deposit to be state insured was increased 5 times as much. There was simultaneous relaxation of provisions constraining deposit insurance.

All these measures enhanced financial stability of the banking sector. Thus, today liquidity of the banking sector is very high, instant liquidity is 67% whereas established minimum norm is 30%. Long term liquidity is favorable as well – gap between assets and liabilities of banks from 180 to 365 days is positive and makes +2% of the assets volume. Capital adequacy is 19%, the norm being 12%. Share of overdue loans in loan portfolio is only 3.6%. To compare, in some countries of Eastern Europe this indicator is over 20%. At that banks provisioning takes 70% of the amount of overdue loans. In the course of the current year banks capital is stably increasing, from the launch of the year growth was 11%. Financial results of bank activities are positive as well – ROA made 3.2%, ROE – 22% according to the results of 7 months.

According to the results of stress-testing of the banking sector, even at the worst case scenarios of development of macroeconomic situation, the banking sector is capable to withstand the hardest shocks and absorb various losses to occur. It is due to the fact that most part of

potential risks has already been recognized by banks and adequate reserves have been created to neutralize them.

Presently, the situation in the banking sector is changing for the better by contrast to Q1. Deposits of the population not only resumed at the level of year launch, but also are demonstrating 4.6% growth according to the results of 7 months. Large (in Q2 increased by 19%) and time deposits (growth of time deposits for 7 months was by 12.2%) are increasing. Loan portfolio is also restoring growth, in April – July of the current year loan portfolio of banks increased by 5.6%, in total assets for this period increased by 9%. External financing of banks as well is being gradually resumed, for 7 months banks attracted external borrowings amounting to about USD 400 mln.

New qualitative tendency in the banking sector – is growth of micro lending. Its key advantages are high profitability, considerably less risks, expansion of economy coverage both from geographical standpoint and from the standpoint of small client base. Micro lending is as well of crucial macro economical importance causing self-employment of the population, particularly in rural areas.

Despite the global crisis, the Central Bank is continuing to realize large scale projects of national importance. Under the CBA initiative, a new phase of development of payment system that is unique both according to scales and economic importance is being realized in the country. In the nearest future the population will have an opportunity to pay for utilities through Internet sitting at home. Another not less ambitious project is launch of post-office – banking system infrastructure. 1500 post offices throughout the country will be rendering the population various financial services.

Active phase of the global fire is likely to have been extinguished, many have started talking about so called “exit strategies” – the idea

of this strategy is to discharge central banks from excessive macro economical responsibility. How do you imagine the model of the post-crisis future Central Bank and what are the priorities of the CBA for 2010?

-I will start from the fact that the global crisis was the key motive to change correlation of powers in opposition of diverse schools of the world economic thought. At the height of the crisis there was much more criticism of modern capitalism, frequent attempts of new Keynesians to prove “failure” of the idea of free market. Amidst all this the world witnessed enhancement of regulatory role of the state to combat the crisis, fiscal stimuli were expanded. Balances of central banks increased manifold, reaching historical maximum. Thus, from the beginning of the crisis through the end of Q1 of 2009 assets of Federal Reserve USA increased by 2.3 times as much, assets of ECB – nearly 2 times. Direct participation of central banks in financing of economy strengthened, that implies sanitation of the financial system through recapitalization of financial institutions, purchase of toxic assets and stimulation of consumer lending.

Some experts even think that according to their scales the realized plans of financial stimulation of the economy do in no way rebate to the Marshall Plan – that was adopted after completion of World War II to stimulate development of postwar Europe. Global coordination of economical policy has been strengthened. Washington and London summits G-20 are impressive events of supranational coordination of economical policy.

Assessing macroeconomic policy of the leading countries of the world under the global crisis we may come to the following conclusions:

- Discrete macroeconomic decisions proved out to be demanding. Growth of governmental expenditures was a more effective leverage

to smooth recession. It turned out that it is impossible to weaken recession without supporting governmental demand (expenditures). Under the crisis private consumption and investments directly depend on governmental expenditures. Therefore they cannot be self-contained stimulators of economic growth.

- Monetary policy is primarily a supportive element in stimulating economic growth/demand since it stimulates, first of all, aggregate supply. Partially, monetary expansion may stimulate consumption through consumer loans and micro lending. Key effect of monetary policy is addressed liquidity feed to financial institutions and systemic entities with the purpose of financial sanitation.

However, in my opinion, enhancement of dirigist tendencies is of temporary nature. It is the attempt to have a respite and reconsider values. I don't think that the ideology of "a big state" will root itself in a post-crisis period. So far there is not an exact answer to the question – did the crisis result from "market failure" or "state failure"? In any case, liberal capitalism has not been buried, the question is through which new institutional construction to make it steady. As for exit strategy, indeed, there is necessity in some "discharge" of macro economical policy. Under normal macro economical conditions an excessive issuance activity of the Central Bank could lead to high inflation, that confronts with its primary mandate – maintenance of price stability. Whole philosophy of packet of financial stimuli realized during crises is timely purchase of assets by the state. Upon completion of recession assets are sold and central bank returns to status quo. In post-crisis period state budget should be discharged as well. Governments cannot live within their means having high budget deficit. Though it is accepted that it does not concern the countries with initially low volumes of budget deficit and state debts against GDP.

The crisis as well showed that even till its commencement monetary policy apart from other measures may be too “blind” tool to restrain financial booms. Prudential and administrative measures may provide much better “addressed” regulation of economy overheat, if the state is eager to overcome deep recession. The point of the matter is that central banks set such a normative that restrain excessive expansion of banks during booms (movement against wind, the wind being vigorous growth of economy).

On the other hand, questions on replacement of classic mode of inflation targeting with the mode of targeting of overall level of prices (prices for goods + prices for assets) are discussed at central banks. According to the concept, it should help central banks clearly track the level of economy overheat and timely respond to manifestations of any kind of speculative financial boom.

As for Azerbaijan, I think, that the year of 2010 will be the year of restoration of economic growth speed. Maintenance of price stability within its authorities as well as provision of stability and development of the banking sector are our key priorities. Stability of exchange rate of manat, no doubt, will remain one of the key tasks of the Central Bank. I will mention once more that exchange rate stability under the conditions of Azerbaijan is an anchor of macro economical stability – and namely, the guarantor of low inflation, support for the level of real income of the population, financial stability. In 2010 efforts on enhancement of institutional base of introduction of mechanisms of targeting the level of prices in the economy will endure new realities being considered.

Full scale introduction of counter cyclic rules will be one of the key priorities of banking regulation. Presently we are actively studying so called Spanish model of counter cyclic regulation that is considered

successful in the world practice and recommended for central banks. Priorities on further deepening of financial intermediation of banks, their capitalization, consolidation and institutional development are still in force.

Which tasks of economic policy for 2010 are being discussed at the Government presently? Which priorities, according to you, should be accented at?

In total, if to look at 2010 from strategic horizon, I think it will be the year of elimination of effects of the global economic crisis. Natural that accents of macro economical policy may considerably change for this purpose.

I think, the crucial wing of macro economical policy - fiscal policy – in 2010 will be moderate. At that, probably, we will have to think of diversification of sources of coverage of non-oil fiscal deficit and further optimization of the structure of state expenditures. It is a core provision of maintenance of long term fiscal steadiness. Key element of the budget policy is tax optimization as well. Presently considered are options of partial switch of tax load from production to consumption (particularly “de luxe” consumption). Currently all these questions are being in-depth considered at the government.

Natural that at moderate fiscal policy private expenses (private investments and private consumption) should gradually crowd out state expenditures and become a core factor of maintaining aggregate demand and consequently economic growth and employment. For this, it will be necessary to entirely utilize potential of growth of non-oil economy.

Acceleration of economic growth in non-oil sector of the economy will require more significant efforts and resources through realization of new structural policy. In post-crisis period institutional environment of the economy should be more flexible so that to accelerate the process of diversification of the economy. For this purpose non-oil industry of the country and agricultural sector have sufficient comparative advantage. Entirely realizing these advantages we may not only effectively implement the policy of import replacement and absorb excessive labor resources but also go to export markets. Production potential of non-oil sector as compared with capacious domestic demand may prove to be too big to orient only at internal market.

To realize this potential expansion of access of small and medium enterprises to financing is a very important condition. Expansion of financing should be, probably, accompanied by diversification of financial products (e.g. expansion of financial lease, factoring services, venture capital, development of export capital etc). Development of integrated production-sale chains both in industry and agriculture is an important condition of formation of a competitive economy.

The findings of the researches of the World Bank – Where is the Wealth of Nations? (World Bank 2006) show that in developed countries of the world primary portion of the national riches (over 75%) is made of so called “invisible capital” (human capital, quality of institutions, level of knowledge and sciences). Differences in the structure of national riches depending on level of income capture attention: in developed countries specific weight of natural capital declines (from 29% to 2%) through increase of the share of “invisible capital” (from 55% to 81%). If size of natural capital in rich counties is 4.6 times higher than in poor ones, then according to the size of “invisible” capital they differ nearly 90 times as much. The advanced data allow us to make a conclusion that the way to

be enlisted among more successful countries goes through accumulation of human and social capital as well as creation of qualitative institutions. The countries that succeed in it diversify production and leave resource dependency, the rest remain suppliers of initial resources at the world market.

Economic strategy of Mr. President is directed at realization of the first model – model of diversification built on accumulation of human and social capital. One simple sample of realization of this model is financing of the program of foreign education through funds of the Oil Fund. This is a good groundwork to transform oil riches to human capital.

I want to say thorough this that utilization of competitive advantages of the country that rely not only on field – economic opportunities of development, but also on cultural riches for formation of competitive economy will be of key importance. For instance, high inclination of the population to entrepreneurship in Azerbaijan, drive for education and high value of education are core elements of the national cultural capital. I think, they should be actively used to diversify economy and export.

Experience on fighting economic crises repeatedly prove that namely sound institutions with strong internal inertia of development are able to withstand the hardest situations and successfully resolve any challenges. We know that, the Central Bank of Azerbaijan is the entity where stimuli for improvement are always present. How do these stimuli help you realize the assignments?

First of all, I have to note that the Central Bank is the most important macro economical institution in the system of state management of the economy. This institution is functioning in conditions specific for

Azerbaijan – under the conditions of small open transformational economy with high growth potential, with not fully exposed opportunities for development and deepening of the capital market, dynamically developing macro economical environment, that was characterized with large scale inflow of oil dollars, economic boom in those sectors of the economy, that are pro-cyclical to dynamics of prices for oil and scales of fiscal policy.

Certainly all this presets specific tone to performance of the CBA, which, despite its relative youth as an institution of macroeconomic management, pretty well handles sometimes hardly compatible tasks.

Primary key of our success is introduction of the culture of strategic behavior and formation of human potential, that allows us to resolve various tasks whether tough or easy.

In recent years institutional strengthening of the CBA itself is a key chain in our strategic development plans. The CBA is one of the first state institutions in the country that has introduced modern western system of staff motivation. Budgeting and motivation according to the results of performance is the primary principle of our work.

All areas of the CBA activity are covered with large scale technical assistance and educational programs. Intense specialized external education is a mandatory element of our intellectual ration. Due to diverse educational and training programs we managed to create a strong research group, dealing with study of various macroeconomic problems and development issues. In the nearest future on the basis of this group we are planning to launch a centre of researches and development that will be specialized in not only fundamental researches of economy, but also in implementation of specific programs of economic education and enlightenment in the society.

Internally we regularly introduce corporate governance standards, typical for purely central banks. Special standards of corporate behavior and ethics have been adopted and are being implemented that is productively told on efficiency of the bank performance. Widely introduced are up to date information technologies, all activity spheres are automated. All development projects at the CBA were realized through direct support of the president of the country. I think, all this helps us carry out the tasks set. And it particularly helped us counteract the global crisis.