CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY REVIEW
January – June 2011

Baku - 2011
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SUMMARY

Notwithstanding the reduction in the rate of the world economic growth in the second quarter, in general, the first half of 2011 displayed certain increase. This also affected the world commodity price hike. The development processes of the Azerbaijani economy continued and macroeconomic stability was maintained against this background. In the condition of high net surplus of the balance of payments, the exchange rate of manat to USD remained unchanged and the foreign exchange market was operating in the self-regulation regime. The inflation remained on a single-digit level and was mainly affected by the food inflation.

The Central Bank, according to the previously declared key directions of the monetary policy, directed its activity at maintenance of the reasonable level of inflation, preserving exchange rate stability of the manat, providing stable growth and sustainability in the banking – financial sector. The Central Bank has provided crucial support to preserve macroeconomic and financial stability through making flexible corrections to its policy within the realization of these targets. The Central Bank, taking into account the hike in global food prices and expansion of aggregate demand, has pursued the anti-inflation monetary policy.
I. Global economic development and the national economy

1.1. Trends in the world economy

According to the initial assessments\(^\text{1}\), the global economic growth for the first half of 2011 was 2.6 percent. The economic growth for the first quarter was 4.3 percent. The tightening of the fiscal policy in Advanced Countries (ACs) to ensure sustainability adversely affected the economic growth in a short run. After the first quarter of 2011 the business confidence index in the leading ACs decreased and the employment level was still below the pre-crisis level. The instability of the global financial sector increased due to the budget problems in the Eurozone and the lower-than-expected level of economic activity in the USA.

Source: IMF

The global trade restored its growth rate in the second quarter. Following Emerging Countries (ECs) the ACs managed to increase the level of foreign trade above the pre-crisis level.

Source: IMF

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\(^{1}\) JPMorgan “Global Data Watch”, July 22, 2011
Slump in USD and stimulation of the export oriented sector triggered record highs for commodity and services export in April. The revival of internal demand accelerated import. However, the industry output growth rate has decreased since February which was paralleled with the 9.2 percent jump in the unemployment level in the last 3 months.

The business confidence index has dropped to its record lows since 2009 fuelled by 9.9 percent unemployment and 2.7 percent annual inflation. The ECB decision to tighten the monetary policy is expected to further weaken the economic activity.

The negative effect of the natural disaster in Japan on the aggregate output continued in the second quarter. However, acceleration of recovery is expected to positively contribute to future growth. The unemployment level dropped to 4.5 percent in May, which was the lowest indicator for the last two years. The high economic growth in ECs increased employment. Increase in food, energy prices, and salary accelerated inflation in these countries.

The global commodity price index, surging since the second half of the previous year went up by 11.7 percent.

**Chart 3. Global price indices, %**

Source: IMF

The high possibility of rich wheat crops had a downward effect on wheat prices in the international markets. In contrast, the sugar price gained 15 percent which is due to expectations of shrink in sugar production in one of the largest sugar manufacturers of the world – Brazil. While overall food price indices declined by 1.6 percent in the first quarter, they jumped by 5 percent in the first half of the year.

While the oil price approximated USD120 in April, it declined afterwards and stabilized around USD107. The current level of demand for and supply of oil in energy

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53
markets, above average indicators of oil resources and production potential against last five years, reduced the risk of further sharp price hikes. In general, increasing demand for oil in non-OECD countries, especially in China, India and other Asian countries is the main factor of oil price hikes in the world market. At the same time, the gradual refusal trends from nuclear power in ACs may, in future, factor in the price and share of oil in power sources.

**Box 1. Relations between oil price and its consumption**

Growth of oil consumption in the world, especially in ECs is the main reason for high oil prices in the medium term. According to BP calculations, there is high elasticity between the energy consumption and GDP. The elasticity ratio for ECs is 0.7. Therefore, in case of realization of expectations on economic growth in ECs, especially in China, India and other Asian countries will ensure high oil price in the world markets.

At present, according to BP estimations, oil prices sustained around USD100-120. Thus, USD100 balances the state budget of a number of oil exporters, especially Saudi Arabia, while USD120 is a “destroying price”, because in this case the fuel consumption in the USA and Eurozone decreases (economy and offset regime).

Moreover, increasing anti-nuclear movement in the world after the Fukushima Daiichi nuclear disaster in March can cause high oil prices in a long run. In this case, the share of oil in energy sources will increase and the prices will escalate as a result of increasing demand. Adoption by the Parliament of Germany of the decree to close down all nuclear power stations of the country by 2022, simulation tests performed in 143 nuclear power stations in the territory of the European Union are the real results of increasing anti-nuclear energy wave.

In general, despite slowdown in commodity price hike in the second quarter, prices are expected that to climb towards the yearend. Thus, according to forecasts of the US Department of Agriculture and the IMF, the food and oil prices are expected to increase by 15 and 30 percent respectively as of the yearend. The increase in commodity prices is explained with recent accelerated growth of commodity related financial tools. One of the reasons for this jump is the attempts of investors to diversify their portfolios. Some investors are interested in these increases because the commodities are becoming profitable derivatives due to rapidly increasing demands of ECs. In sum, current low interest rates surface profit searches as the key parts of commodity price increase trends.

According to the latest researches, the interest of financial investors in commodities results in short-time price changes in commodity markets. This indicates both the sensibility of investors to data and information, and their significant share in commodity trade. The significant deviation of oil prices in the world market from balanced ones is a strong empiric evidence of impact of financial investments on prices. However, there are very few empiric evidences that could prove such a strong relation for non-oil commodities. Here the prices mainly benefit from demand and supply factors.
Box 2. Relations between oil and food prices

The World Bank experts studied the historical dependence between oil and world food prices. It became obvious that each annual 10% increase in the world oil price causes 2-3% increase in food prices. In general, this relation is due to bigger share of oil and oil products as cost items in the net cost of agricultural products as compared to industrial products. To compare, we must note that the share of oil and oil products in net cost of industrial products is 2.5%, while this share approaches 11% in agriculture.

The definition of such a relation is very important from the country viewpoint. Thus, Azerbaijan is an oil exporter on the one hand (oil price increase in the world market brings additional profit or vice-versa), on the other hand, growing oil prices causes jump in the world food prices, including imported food. At the same time, there is a close correlation between the world food prices and internal food prices. The CBA and IMF calculations indicate that the elasticity ratio here is 0.8. In other words, 1% jump in the world food prices results in 0.8% inflation in the internal market. Given the estimations of the World Bank and the share of the food in the consumer basket of the country we can say that each 10% growth in the world oil prices can cause 1.5-2% inflation in the country.


The global financial markets became more volatile from May of the current year. This was primarily related to uncertainties in the markets resulting from the existing situation in the Euro Zone, contraction in the US real estate market.

Source: Reuters Information agency
Despite the tight monetary trends in ACs, still low interest rates increase the risk “appetite” of investors which is accelerating large capital flows from ACs to ECs. Accelerated capital inflows to ECs result in “bubbles” in the prices for assets and escalated financial stability risks by overheating the exchange rate in these countries.

The International Monetary Fund in its World Economic Outlook released in June maintained the forecast for the global economy for 2011 unchanged. Thus, the global economic growth for ACs was downgraded by 0.2 basis points while being upgraded by 0.1 basis points for ECs.

Table 1. IMF forecast on the world economy

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011(f)</th>
<th>2012(f)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic growth, over the previous year, by %</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World</td>
<td>5.1</td>
<td>4.3</td>
<td>4.5</td>
</tr>
<tr>
<td>Advanced economies</td>
<td>3.0</td>
<td>2.2 ↓</td>
<td>2.6</td>
</tr>
<tr>
<td>USA</td>
<td>2.9</td>
<td>2.5 ↓</td>
<td>2.7 ↓</td>
</tr>
<tr>
<td>Euro Zone</td>
<td>1.8</td>
<td>2.0 ↑</td>
<td>1.7 ↓</td>
</tr>
<tr>
<td>Emerging economies</td>
<td>7.4</td>
<td>6.6 ↑</td>
<td>6.4 ↓</td>
</tr>
<tr>
<td>China</td>
<td>10.3</td>
<td>9.6</td>
<td>9.5</td>
</tr>
<tr>
<td>CIS</td>
<td>4.6</td>
<td>5.1 ↑</td>
<td>4.7</td>
</tr>
<tr>
<td><strong>Export, over the previous year, by %</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advanced economies</td>
<td>12.3</td>
<td>6.8</td>
<td>6.1 ↑</td>
</tr>
<tr>
<td>Emerging economies</td>
<td>12.8</td>
<td>11.2 ↑</td>
<td>8.3 ↓</td>
</tr>
<tr>
<td><strong>Consumer prices, over the previous year, by %</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advanced economies</td>
<td>1.6</td>
<td>2.6 ↑</td>
<td>1.7</td>
</tr>
<tr>
<td>Emerging economies</td>
<td>6.1</td>
<td>6.9</td>
<td>5.6 ↑</td>
</tr>
</tbody>
</table>

Source: IMF, World Economic Outlook Report, July 2011

In total, the period was fuelled by fiscal consolidations and tight monetary policy in most countries. This monetary tightening is expected to continue till the end of the year amid inflation threats. At the same time, there is consensus on more pragmatic use of macro-prudential tools against the financial stability risks and acceleration of capital inflows to ACs. However, the results of financial consolidation initiatives are not satisfactory and public debt crisis potential is growing.
Thus, the second quarter witnessed elevated uncertainty in the global economy, ongoing uneven geographical economic growth and relative slack of overall activity as compared to the previous one. Whereas the economic activity is high in some ECs the risks for recovery of the global economy are still lingering. In general, these risks include: i) jumped “risk appetite” of investors due to low interest rates; ii) default threats in ACs; iii) high dirty\(^2\) global demand (China, India, Asia) for oil; iv) downgrade of credit ratings of the USA and other leading countries.

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\(^2\) Increased energy-consuming production
Sustainable financial sector, fiscal consolidation, tight monetary policy in ECc, structural policy and control, global macroeconomic coordination are the key policy challenges of the current period.

1.2. Macroeconomic processes in Azerbaijan

The country economy kept growing amid favourable external position and reviving internal demand in the first half of 2011. The public support for the economic activity, crucial structural and institutional changes also positively affected the dynamics of the economy. Despite certain threats from the global environment, the macroeconomic stability was maintained during this period.
1.2.1. External sector

In the first half of 2011 the external position of the country continued to improve in the environment of economical revival and rise in energy prices. Thus, high economic growth and overheating in emerging countries resulted in increased demand for oil and additional demand for non-oil expert.

According to the State Statistical Committee (SSC) in January-June 2011 the foreign trade turnover was USD 17.4 billion, of which export was USD13.1 billion and import USD4.3 billion.

![Chart 6. Trade balance, mln $](chart)

Source: SSC

In the first half of 2011, the export and import increased 27.8, and 49.6 percent respectively, comparing to the same period of previous year. Foreign trade surplus was USD8.7 billion which was USD 1.4billion or 19 percent higher than first half of 2010.
Pipe, tobacco, polyethylene, potato and white sugar are taking rapid upward trend in exports.

Import goods with upward trend include reinforcement bars, fertilizers, rice, cement and passenger cars.

Source: SSC

In general, both the quantity and amount of the import and export goods have increased. According to estimations, 1/3 of the increased amount of the non-oil export and 1/4 of the increased amount of import was related to the price factor.
According to the SSC, prices for Azerbaijani export commodities grow prevailed over import commodity prices. Thus, if to compare with the relevant period of the previous year, in January-May of 2011 the prices for export goods went up by 24 percent, and import goods by 7 percent.

**Box 5: Price for Azeri Light oil**

According to the SOCAR, the average price for "BTC FOB Ceyhan" Azerbaijani oil is USD 113.5. During this period the highest price was observed in April (126.2) and the lowest – in January (97.7). The average annual price for the first half of the current year was the record high in the history of the country. If to compare with the depth of the crisis, the oil price in Azerbaijan increased by more than 2.2 times. At the same time, as per the IMF forecasts, the oil price is expected to approximate to USD 106 by the end of the current year.

![Average monthly price of Azeri Light oil, $](chart.png)

*Source: [www.socar.az](http://www.socar.az) and IMF*

This displays increase in opportunities to import more commodities and services through less export, in other words, improvement of trade conditions during the reporting period.

Remittances, and capital flows had a significant role in FX inflows to the country besides export. The scope of remittances in January–June of 2011 increased by 47 percent compared to the same period of the previous year.
According to the SSC, foreign investments to the economy of the country in 6 months of 2011 amounted to AZN 1.2 billion, having increased by 51 percent.

In 6 months of 2011 strategic foreign exchange reserves (FR) of the country increased by 27 percent and amounted to USD 37.4 billion which is sufficient for four year goods and services import.

Source: CBA

Foreign exchange reserves of the CBA have increased by 8 percent in 6 months of 2011 and reached USD 7, which covers financing of 9 month-goods-and-services-import.

Source: CBA
At present the foreign exchange reserves to the GDP ratio is about 65 percent which is expected to be 75 percent as of the end of the year. In general, high growth rate of strategic foreign exchange reserves is the factor reducing the sensitivity of the country economy to the possible external crisis impacts.

1.2.2. Aggregate demand

During the first half of the current year all components of aggregate demand, including final consumption expenditures, investments and external demand had a positive effect on the economic growth. Increase in income of the population and internal investments in the economy as well as the favourable global environment facilitated revival in demand components of the GDP.

1.2.2.1 Final consumption expenditures. Final consumption expenditures were one of the key determinants of the economic growth in 6 months of 2011.

Household’s consumption. During the reporting period, nominal income of the population increased by 15.5 percent as compared to the relevant period of 2010 and reached AZN 1495.8 per capita or on average AZN 249.3 per month. The population directed about 67.5 percent of the income to final consumption and spent on purchase of goods and services. Final consumption expenditures of the population increased by 13.7

Source: CBA
percent in nominal terms and equalled to AZN 9.1 billion or 40.4 percent of the GDP as compared to the similar period of the previous year.

**Source: SSC**

Average monthly salary across the country increased by 10.7 percent and made AZN 351.3 that contributed to maintenance of high share of final consumption in the GDP.

**Source: SSC**

Parallel increase of credits to households had a positive effect on the demand as well. Thus, in 6 months of 2011 credits to households (granted by banks and non-bank credit institutions) increased by 17.5 percent.
Demand growth displays itself in increase of retail trade turnover and paid services to the population.

In 6 months of 2011 the retail trade turnover increased by 9.5 percent, including 28 percent increase in retail trade turnover on non-food products, while the retail paid services to households increased by 7.9 percent.
According to the SSC, reserves of goods in industry and trade are decreasing amid growing economic activity. The Real Sector Monitoring performed by the Central Bank indicates climbed demand throughout the country. Thus, according to the findings of the monitoring, actual sales of durables (cars, furniture, etc.) and industrial sales are growing, while the reserves of the goods are decreasing. The similar tendency is being observed in the services sector. Thus, during the period average demand for services almost doubled as compared to the previous year.

Government and public organizations. Government’s consumption expenditures have been primarily shaped through spending on commodity and services from the state budget. In January – May of the reporting year salaries, pensions and allowances of the population made up 41.2 percent of the budget expenditures.

1.2.2.2 Investment expenditures. Investment in the economy from all sources in 6 month of 2011 increased by 17.8 percent and made up AZN 4.5 billion, which equals to 20 percent of the GDP, of which 72.8 percent of all funds directed to fixed capital consist of domestic investments and 27.7 percent – foreign investments.

![Chart 16. Investment, mln.manats](chart)

Source: SSC

71.1 percent of investments were channelled to the non-oil sector. In total, investments in the non-oil sector exceed the previous year level by 24 percent. Out of the non-oil sector, the growth rate of investments to machinery and equipment manufacturing, communication and chemistry prevail.
Bank loans played an important role in investment activity of the non-oil sector along with public investments.

The assigned banks of the National Fund for Entrepreneurial Assistance granted about AZN 72 million worth loans to entrepreneurs. These loans facilitated to finance 823 projects and in general, about 3500 new job places are expected to be created (www.anfes.gov.az).

1.2.3. Aggregate supply

In the first half of 2011 GDP increased by 0.9 percent in real terms and made up AZN 22 billion. During the reporting period the oil and gas sector shrank by 5.1 percent paralleled by the 7.2 percent growth in the non-oil sector. 66 percent of total value added comes from production and 34 percent from services.

Economic growth in the first half-year. The GDP growth was mainly affected by the activity in the non-oil sector. Thus, about 50 percent of GDP is the share of non-oil sector and these sectors made 3.6 basis points contribution to total growth.
All non-oil sectors enjoyed growth during past 6 months. The highest growth was observed in hotels and restaurants, communications and trade. The economic growth mainly benefited from food, metallurgy, machinery and chemistry. The high growth observed in the agriculture sourced from both crop production and livestock sector.

Source: SSC

During the reporting period crude oil production declined by 5.6 percent, and natural gas production went down by 2.1 percent. During the past period of the current year approximately 1 ton gold was produced from gold mines.
**Economic growth expectations.** In the nearest horizon the economic growth in the country is expected to continue according to forecasts of the Government, Central Bank as well as international institutions. The IMF in the latest disclosed regional economic outlook mentioned endurance of economic growth by Azerbaijan in the following year. The Fund predicts around 2.8 and 2.5 percent growth of the economy in the country for 2011 and 2012 respectively\(^3\). Moreover, the IMF forecasts 6 percent growth in GDP of Azerbaijan in the non-oil sector.

![Chart 20. Crude oil and natural gas extraction](chart)

Source: SSC

\(^3\)Source: IMF, [www.imf.org](http://www.imf.org) / World Economic Outlook
The Real Sector Monitoring preformed by the Central Bank also shows optimistic forecasts on the economic activity. Thus, according to the RSM findings, industry production expectations and trade sale expectations tend to be growing from the beginning of the year. Positive expectations were particularly observed in chemical, construction materials production and textile subsections, whereas positive expectations in trade were observed in segments of sale of furniture and household appliances.

### Box 6. Impact of oil prices on economic growth

The specialists of the World Bank simulated possible impact of 50% oil price increase on the actual global economic growth within the following one year starting from the second half of 2011. The simulation tests identified that the increase in oil price by $50 will reduce the global economic growth by 0.5 percent in 2011 and by 1% and 0.4% respectively in the following years. Whereas the price increase will positively contribute to the economic growth in oil exporting countries, the oil importing countries will be adversely affected.

<table>
<thead>
<tr>
<th></th>
<th>Real GDP change, %</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil exporters</td>
<td>0.0</td>
<td>-0.5</td>
<td>-1.0</td>
<td>-0.4</td>
<td></td>
</tr>
<tr>
<td>Oil importers</td>
<td>0.0</td>
<td>0.2</td>
<td>0.5</td>
<td>0.9</td>
<td></td>
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<tr>
<td>Advanced economies</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Oil exporters</td>
<td>0.0</td>
<td>-0.6</td>
<td>-1.2</td>
<td>-0.6</td>
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</tr>
<tr>
<td>Oil importers</td>
<td>0.0</td>
<td>0.0</td>
<td>0.6</td>
<td>0.3</td>
<td></td>
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<tr>
<td>Emerging countries</td>
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<tr>
<td>Oil exporters</td>
<td>0.0</td>
<td>-0.1</td>
<td>-0.4</td>
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<tr>
<td>Oil importers</td>
<td>0.0</td>
<td>-0.6</td>
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<tr>
<td>Medium-income countries</td>
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<td>Oil exporters</td>
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<tr>
<td>Oil importers</td>
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<td>0.6</td>
<td>0.8</td>
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<td>Europe and Central Asia</td>
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<td>-0.2</td>
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<td>Oil importers</td>
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<td>Near East and North Africa</td>
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<td>1.1</td>
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<td>Oil importers</td>
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<td>Sub-Saharan Africa</td>
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<td>1.7</td>
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<td>Oil importers</td>
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</table>

The noted changes in the global oil prices are most favourable for Sub-Saharan African countries (real economic increase in 2012 will be 6.6 percent), and the least favourable for Near East and North African countries (-2.3 percent in 2012).

Service sector shows similar trends. The highest positive expectations belong to communication and hotel subsectors. Such positive expectations manifested themselves in decrease of excessive unrealised stocks in industry and trade.

In general, findings of the RSM conducted by the CBA demonstrate increase in a number of enterprises with incremental production, and risen turnover during last months and indicate the stability of such an increase.

The CBA estimations show that the output gap (difference between potential and actual levels of GDP) shifted from -5.2 percent in 2009 to -4 percent in 2010 as a result of recovery in economic activity.
The output gap already approached to a neutral level in the first half of 2011. Amid high state demand, the output gap is expected to enter the positive zone as from the 4th quarter.

### 1.2.4. Macroeconomic equilibrium

Macroeconomic stability is maintained in the country against the accelerated inflation trends in the world economy and revival of aggregate demand. The inflation during the period was mainly affected by external factors.

#### 1.2.4.1. Consumer Price Index (CPI):

In June of the current year the inflation made 2.5 percent against the beginning of the year and 8.3 percent as compared to the relevant period of the previous year. This was mainly affected by the increase of prices in the world commodity markets, especially food prices.

6.7 basis points of average annual inflation were due to rise in food prices, 0.8 basis points – non-food products and 1.3 basis points – price hike in services. Average annual inflation of food products equalled to 12.4 percent.

![Chart 23. Average annual CPI, %](chart)

Source: SSC

Average annual inflation of non-food products was 2.9 percent, which is 0.2 percent falls below the beginning of the year. Prices for services went up by 4.4 percent against the beginning of the year, and average annual equalled to 4.3 percent.
Thus, the analysis of decomposition of inflation shows that prices mainly rose through price dynamics of food products in the first 6 months of 2011. Food inflation accounts for ¾ of total inflation. The key factor for price rise of food products was the increase in prices for grain crops in the world market.

During the period, the inflation in partner countries, changes in money supply and nominal effective exchange rate had an upward effect on the prices, while the seasonal factors shaded the prices.

---

**Box 7. Possible change scenario for the global prices of agricultural products**

The specialists of the World Bank performed a simulation test of possible price changes in a number of agricultural products as of the end of the year. The simulation tests included 3 scenarios: i) base scenario; ii) 5% reduction of the production, iii) 5% reduction of the production and 50% increase in the world market prices of oil. It was defined that the prices for all products will increase in all 3 scenarios. The highest price hike occurs in the third scenario. Thus, if this scenario is realized, wheat, corn and rice prices will increase by 50%, 58% and 17% respectively as of the end of the year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Wheat, ton/USD</th>
<th>Corn, ton/USD</th>
<th>Rice, ton/USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>326</td>
<td>223</td>
<td>650</td>
</tr>
<tr>
<td>2009</td>
<td>224</td>
<td>166</td>
<td>555</td>
</tr>
<tr>
<td>2010</td>
<td>224</td>
<td>186</td>
<td>489</td>
</tr>
<tr>
<td>2011</td>
<td>300</td>
<td>270</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>Base scenario</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>306</td>
<td>279</td>
<td>518</td>
</tr>
<tr>
<td></td>
<td>Scenario considering 5% increase in production</td>
<td>336</td>
<td>294</td>
</tr>
<tr>
<td></td>
<td>Scenario considering 5% increase in production + 50% increase in the world market price for oil</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The downward affect of the seasonal factors started from the second quarter of the current year and as a result, the consumer prices reduced by 1.7 percent in April-June.

Source: CBA estimations based on SSC data

Average annual inflation and core inflation against the same period of the previous year (June/June)\(^4\) was 6.1 percent and 5.8 percent respectively. Consumer prices (core) have increased by 0.6 percent since the beginning of the year.

\(^4\) Core inflation is defined as inflation adjusted from changes in administrative prices regulated by the government and seasonal factors.
Source: SSC

Low core inflation once more emphasizes that the share of external factors is high in consumer price rise.

Source: SSC

In 6 months of the current year the inflation in partner countries was 1.8 percentage point higher than in Azerbaijan. According to the IMF forecasts, the CIS countries are expected to face 9.6 percent average annual inflation.

1.2.4.2. Industrial Production Price Index (IPPI): The average annual industrial production price index increased by 26.2 percent. IPPI went up by 11.5 percent for the last one year. High increase of IPPI is primarily due to significant climb in oil prices in the world markets.
PPI varied across sectors of the industry. For instance, average annual increase of production prices was 30.6 percent on mining, 22.1 percent on textile industry, 21.5 percent on chemical industry, 19.6 percent on food industry and 13 percent on metallurgy, whereas it decreased by 2 percent in pharmacological production.

1.2.4.3. Agricultural production price index (APPI): APPI increased on average annual by 13.1 percent. Price dynamics equalled to 21.2 percent on perennials and 12 percent on livestock and livestock products.

1.2.4.4. Real estate prices: According to "MBA LTD" Appraisal and Consulting Company, in first 6 months of 2011 no significant changes were observed in dynamics of prices on segments of the real estate market (primary and secondary housing markets, land market, cottages, non-residential objects) and rent fees. During this period the prices increased by 0.2 percent in secondary markets, while the reduction in primary markets was 3.3 percent. Residential rent fees went down by 2.8 percent, and rent fee for commercial objects decreased by 9.2 percent. At the same time, the price for expensive apartments reduced by 4.4 percent during the period, although the prices for cheaper apartments increased by 1.8 percent. In June the supply of expensive apartments increased by 0.7 percent as compared to May and constituted approximately 40 percent of total apartment supply. Mortgage lending was the main reason for stabilization of prices for cheap apartments.
Continued mortgage lending was the main reason for increasing activity in the real estate market, especially in the secondary market. In the first 6 months of 2011 assigned credit institutions issued AZN 46 million worth mortgage loans up to 1250 persons.

**Box 8. Condition of the property market in the world countries**

Activity in property markets of most countries was low in the first quarter of 2011. However, the price for real estate is increasing in some countries and declining in others. As compared to the relevant period of the previous year (12 months) the highest price reduction was registered in Ireland (11.1%), and the highest price hike was in Hong-Kong (23.5%).
1.2.4.5. **Inflation forecast.** According to forecasts of international financial institutions, single-digit inflation is predicted for 2011. For instance, the latest report of the Asian Development Bank predicts 7.5 percent average annual inflation in Azerbaijan in 2011.

According to the findings of the Real Sector Monitoring performed by the CBA, there are no significant ups in price rise expectations in the economy.

![Chart 30. Price expectations (3 months moving average)](chart)

Source: CBA

Price expectations in trade sector are in a negative zone, but industry and service sectors expectations are in a positive zone. Index on the construction sector is close to a neutral point.

1.2.4.6. **Employment.** During the reporting period economically active population was 4593.4 thousand, of which 4338.2 thousand are engaged in the economy and various sectors of the social area. According to the SSC, the number of hired labour has been increasing in recent months.

The survey conducted by the CBA within the real sector monitoring project in up to 300 enterprises also demonstrates increase in employment. Thus, in monitored enterprises the number of staff increased by 5 percent during the reporting period.
According to the CBA monitoring, the expectations on employment in trade and services sector are in a positive zone. While the employment expectation index in industrial sector is in a negative zone, it has shown an upward trend during the period.

II. Monetary and exchange rate policies

In the first half of 2011, the Central Bank, in accordance with its declared key directions of the monetary policy, targeted at maintenance of an acceptable level of inflation, prevention of volatility of the exchange rate of manat, preserving stability in the banking-financial sector.

2.1. Foreign exchange market and exchange rate of manat

In the first half of 2011 the CBA continued its exchange rate policy within the framework of new operation mechanisms and in the environment of expansion of supply channels in the foreign exchange market.

Thus, since the beginning of the year the CBA has been implementing its exchange rate policy within the corridor targeting bilateral USD/AZN exchange rate.

Performed analyses indicate that currently targeting bilateral US dollar/manat exchange rate is more reasonable than targeting double currency basket containing different currencies in Azerbaijan. This mechanism is both favourable from the communication point of view and, at the same time, it increases the opportunity of the Central Bank to transition to free floating exchange rate regime in the long run.
Box 9. Transition to flexible exchange regime

In the world practice the country abandons the fixed currency regime either in a planned manner or as a result of crisis. By colligating these practices the researchers concluded that the fixed exchange rate must be abandoned as per the following scheme:

Transfer to flexible rate regime can be performed in the following three stages:

- **Fixed regime → Limited flexibility of rate.** In this case one of the BBC (Band, Basket, Crawl) exchange rate regimes may be selected. In order to ensure the limited flexibility of the rate, it is important to i) ensure operative independence of central bank, ii) establish fiscal discipline, iii) ensure transparency and accountability of monetary policy, iv) establish information systems for exchange rate risk management.

- **Limited flexibility of rate → Significant flexibility of rate.** This stage shall include important reform directions like elimination of different rate adjustment types existing in currency market in order to ensure the wide floating range of the exchange rate, establishment of prudential supervision based on risk management, promotion of various financial tools in the foreign exchange market.

- **Significant flexibility of rate → Floating regime.** The Central Bank shall eliminate targets related to the exchange rates and define the ways of intervention to forex market after transition to floating regime.

Countries orderly transitioning from fixed exchange rates: e.g. Chile (1982-99), Israel (1985-2005) and Poland (1990-2000) had a number of similar characteristics:

- These countries had undeveloped foreign exchange and financial markets before transition to this regime;
- All 3 countries started with narrow channel that gradually broadened;
- Transition to floating exchange regime involved simultaneous development of foreign exchange market, intervention policy, liberalization of current account, stability of financial system, effective monetary policy and development of tools.

All three countries transitioned to the floating exchange rate regime within 10-20 years.

Source: Rupa Duttagupta, Gilda Fernandes, Cem Karacadag and N.Wastelius (2010)
In the first 6 months, the foreign exchange market was operating in the almost self-regulation regime and the Central Bank sterilized foreign currency amounting to USD 324 million.

Chart 32. CBA intervention, mln. $

Manat appreciated only 1.4 percent against USD in 6 months of 2011. The stability of the exchange rate of the national currency created favourable conditions for the stability of macroeconomic and financial sectors in the country.

Whereas the nominal exchange rate of manat depreciated against currencies of some trade partners, it appreciated against the currencies of other countries during the period. Dynamics of the nominal bilateral exchange rate of manat caused changes in real bilateral exchange rates. In January-June manat depreciated both in nominal and real terms against currencies of some countries (Euro Zone, Great Britain, Russia, Georgia, Japan, Israel, China, S. Korea). However, manat strengthened from real and nominal standpoint against currencies of some countries like the USA, Turkey and Belarus.
Table 2. Bilateral nominal and real exchange rate indices of manat against key trade partner-countries in six months, %

<table>
<thead>
<tr>
<th>Country</th>
<th>Nominal bilateral exchange rate index</th>
<th>Real bilateral exchange rate index</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>101.4</td>
<td>102.1</td>
</tr>
<tr>
<td>Eurozone</td>
<td>93.1</td>
<td>93.9</td>
</tr>
<tr>
<td>Great Britain</td>
<td>97.5</td>
<td>97.8</td>
</tr>
<tr>
<td>Turkey</td>
<td>106.7</td>
<td>105.7</td>
</tr>
<tr>
<td>Russia</td>
<td>92.0</td>
<td>89.9</td>
</tr>
<tr>
<td>Ukraine</td>
<td>101.6</td>
<td>98.3</td>
</tr>
<tr>
<td>Georgia</td>
<td>95.1</td>
<td>96.5</td>
</tr>
<tr>
<td>Iran</td>
<td>106.7</td>
<td>99.6</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>100.3</td>
<td>97.8</td>
</tr>
<tr>
<td>Japan</td>
<td>97.9</td>
<td>99.8</td>
</tr>
<tr>
<td>Israel</td>
<td>96.0</td>
<td>96.3</td>
</tr>
<tr>
<td>China</td>
<td>98.7</td>
<td>98.8</td>
</tr>
<tr>
<td>Belarus</td>
<td>167.5</td>
<td>126.1</td>
</tr>
<tr>
<td>S. Korea</td>
<td>95.5</td>
<td>95.6</td>
</tr>
</tbody>
</table>

*Average annual change of exchange rates of manat against currencies of partner-countries

Source: CBA

Nominal effective exchange rate on the non-oil sector (trade turnover weighted) went down by 1.7 percent during the period. The difference between the inflation in partner countries and in Azerbaijan depreciated the real effective exchange rate by 1.6 percent.
The real effective exchange rate of the non-oil sector went up by 0.8 percent during the period.

![Chart 34. REER decomposition, %](chart)

The real effective exchange rate of the non-oil sector depreciated by 3.1 percent against the near foreign countries, where over 80 percent of non-oil products is exported.

Thus, during 6 months the foreign exchange market was operating in almost self-regulation regime, no abrupt changes were observed in the bilateral exchange rate of manat, while the multilateral exchange rate changed towards improvement of the international competitiveness of the country.

2.2. Monetary policy instruments

During the first half of the current year expectations on jump in food prices in the global market, high foreign exchange income of the country, expansion of money supply sources due to growing public demand and accelerated growth in the non-oil sector brought the increased control over inflation factors and their regulation in the preventive regime into a new focus. The decisions regarding “neutrality” in the monetary policy instruments taken in the first half of 2011 also implied to preserve the price stability in the country.
The CBA, when taking a decision regarding parameters of the monetary policy instruments, considered analyses of up to 30 cyclical indicators. These include leading, coincidence and lagging cyclical indicators. Close to the end of the first half of the current year, the number of indicators for correction of the monetary policy among the continuously analyzed cyclical indicators started to prevail.

Source: CBA

In the view of these processes, as well as revival of aggregate demand, inflation factors, and forecasts of the balance of payments, the Central Bank made a decision to move the refinancing rate from 3 to 5 percent from 1st of March, and to 5.25 percent from 6th of May. This decision is also aimed at increase opportunities of the Central Bank to sterilize excessive money supply by ensuring appropriate conditions in financial markets.

Source: CBA
Box 10. Real interest rates

Slow and uneven global economic recovery, aided by lingering risks have triggered central banks of a number of countries to pursue soft monetary policy for a long time. Thus, the refinancing rate is negative in real terms at present in most countries. In 6 out of 10 emerging countries with strong impact on the world economy inflation is higher than refinancing rates and only in 4 of them the refinancing rate is higher. The difference between the refinancing rate and inflation in Saudi Arabia constitutes -4.3 basis points, while in Brazil the difference is +5.7 basis points. The highest inflation among the countries is observed in Russia (9.6%), and the lowest – in Mexico (3.3%). Brazil has the highest refinancing rate (12.25%), while in Saudi Arabia this rate is the lowest (0.25%).

<table>
<thead>
<tr>
<th>12 month inflation (May)</th>
<th>Refinancing rate</th>
<th>Actual refinancing rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>5.5</td>
<td>5.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>6.6</td>
<td>12.25</td>
</tr>
<tr>
<td>India</td>
<td>9.1</td>
<td>7.5</td>
</tr>
<tr>
<td>Russia</td>
<td>9.6</td>
<td>8.25</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.3</td>
<td>4.5</td>
</tr>
<tr>
<td>S. Korea</td>
<td>4.1</td>
<td>3.25</td>
</tr>
<tr>
<td>Turkey</td>
<td>7.2</td>
<td>6.25</td>
</tr>
<tr>
<td>Indonesia</td>
<td>6.0</td>
<td>6.75</td>
</tr>
<tr>
<td>Poland</td>
<td>5.0</td>
<td>4.5</td>
</tr>
<tr>
<td>S. Arabia</td>
<td>4.6</td>
<td>0.25</td>
</tr>
</tbody>
</table>


In order to regulate the growth rate of money supply, reserve requirements in the national and foreign currency has twice been corrected within 6 months. First the reserve norm was decided to be shifted from 0.5 to 2 percent (from 1 May 2011), followed by 3 percent rise (from 1 July 2011).

According to the specified direction of the monetary policy, the amount of issued notes to accelerate sterilization processes in first 6 months of 2011 equalled to AZN 772 million, of which AZN 504 million was taken to auctions all of which were sold. Average yield on notes at the last auction made 2.5 percent, while this number was 2.20 percent at the beginning of the year.
The volume of notes in circulation as of 01.07.11 was AZN 66.1 million.

2.3. Money supply

In the first half of 2011 money supply kept pace with the economic demand meanwhile being affected by seasonal factors.

The money base increased by 1.6 percent in 6 months.

As per estimations, seasonally adjusted money base rose by 14.5 percent against the beginning of the year.
Box 11. Seasonal factors in money base.

The dynamics of money base increases or decreases depending on seasons of the year (different months, quarters or seasons of the year). Therefore, the existing seasonal factors must be identified and adjusted in time series.

In modern practice the most common method used to extract the trend from a time series is the Hodrick Prescott (HP) filter. HP filter is selected due to very easy calculations and to obtain a smoothed non-linear representation of a time series. In general, this filter is calculated by minimization of the below formula:

$$\sum_{t=1}^{T} (y_t - \tau_t)^2 + \lambda \sum_{t=2}^{T-1} [(\tau_{t+1} - \tau_t) - (\tau_t - \tau_{t-1})]^2$$

where,

- $y_t$ – an indicator that must be seasonally adjusted
- $\tau_t$ – smoothed series
- $\lambda$ – smoothing coefficient

The below chart describes the actual and seasonally smoothed (using HP filter) series of money base of manat:

As we can see from the chart, the seasonally adjusted series is less volatile. HP filter extracts deviations existing and repeating in same months of several subsequent years by assessing them as seasonal factor.
During the period the broad money supply (M3) increased by 8.4 percent and reached AZN 11412.5 million, broad money supply in manat (M2) increased by 5.3 percent and made AZN 8735.4 million.

Chart 40. Dynamics of M3 money, %

These indicators increased by 25.7 and 31.8 percent respectively against the relevant period of the previous year.

Table 3. Monetary aggregates, million manat

<table>
<thead>
<tr>
<th></th>
<th>01.01.11</th>
<th>01.04.11</th>
<th>01.07.11</th>
</tr>
</thead>
<tbody>
<tr>
<td>M0 (Cash)</td>
<td>5455.8</td>
<td>5427.1</td>
<td>5851.6</td>
</tr>
<tr>
<td>M1 (Cash, demand deposits and savings)</td>
<td>6718.9</td>
<td>6608.5</td>
<td>6972.4</td>
</tr>
<tr>
<td>M2 (Cash, demand and term deposits and savings, in manat)</td>
<td>8297.5</td>
<td>8115.5</td>
<td>8735.4</td>
</tr>
<tr>
<td>M3 (Cash, demand and term deposits and savings, in manat and FX)</td>
<td>10527.5</td>
<td>10757.4</td>
<td>11412.5</td>
</tr>
</tbody>
</table>

Source: CBA
Amid depreciation of the multi-lateral nominal exchange rate of manat, increase in the money supply during the period generally softened the “Monetary condition index”.

Chart 41. Monetary condition index

Source: CBA

Despite the CBA decisions to tighten the monetary policy parameters, in general the MCI is soft.

2.4. Institutional framework of the monetary policy

In the first half of 2011 the Central Bank continued to develop the institutional base of macroeconomic management and the monetary policy.

The activity of the Monetary Policy and Financial Stability Committee of the Central Bank (MPFSC) continued. The committee held 6 meetings during the first half of 2011 where the macroeconomic situation was promptly reviewed, internal and external factors were analyzed and appropriate policy statements were adopted. These statements mainly covered the parameters of exchange rate and monetary policy instruments, and key directions of the financial stability policy.

In the first half of 2011 the Central Bank kept bringing the monetary policy mechanisms in line with the requirements of the post-crisis challenges and international standardization. Integration of the monetary and financial stability policies were studied within the framework of establishment of counter-cyclic macro-prudential management in
Azerbaijan. This processes generated a draft version of the monetary and financial stability strategies of the Central Bank.

Box 12. Assessment of impact of macro-prudential instruments using Taylor rule

The International Monetary Fund (IMF) in its October 2009 issue of “World Economic Outlook” proposes to add usage of macro-prudential tools with regard to the macro-financial risks. It is specially noted that application of these tools (macro-prudential) is important for assurance of stable inflation and economic growth under shocking prices of financial assets. The review assesses importance of the macro-prudential policy from the econometric point of view by implementing the Taylor rule. The assessment tests the following regimes:

1. Standard Taylor Rule
2. Extended Taylor Rule – in addition to output gap and inflation, the volume of credit also affects the refinancing level
3. Macro-prudential Rule – the volume of loans affects macro-prudential tool (change in spread between loans and refinancing level).

The assessment confirmed that the macro-prudential policy is of great importance in drive against financial shocks. Moreover, it became obvious that macro-prudential tools are more important for the Central Bank in improvement of lending standards rather than the rise of the refinancing rate.

Table: Assessment as per various regimes

<table>
<thead>
<tr>
<th>Regimes</th>
<th>Inflation (standard deviation)</th>
<th>Output gap (standard deviation)</th>
<th>Loss $^x$</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard Taylor</td>
<td>0.512</td>
<td>0.624</td>
<td>0.652</td>
<td>4</td>
</tr>
<tr>
<td>Expanded Taylor</td>
<td>0.110</td>
<td>0.076</td>
<td>0.018</td>
<td>3</td>
</tr>
<tr>
<td>Expanded Taylor +</td>
<td>0.092</td>
<td>0.061</td>
<td>0.012</td>
<td>2</td>
</tr>
<tr>
<td>Macro-prudential</td>
<td>0.018</td>
<td>0.040</td>
<td>0.002</td>
<td>1</td>
</tr>
</tbody>
</table>

$x$ Summary of total output gap and inflation variations.

$^{xx}$ Share of interest rate is taken equal to 0.7; the share of other indicators – equal to 0.3

As we can see from the table, implementation of the Taylor rule is highly ranked among the regimes, which confirms once more the importance of macro-prudential tools in preserving of the macroeconomic stability.

Source: Lessons for Monetary Policy from Asset Price Fluctuations World Economic Outlook. – IMF, October 2009
Draft new regulations on required reserve norms were developed within the framework of the monetary policy improvement and the necessity to improve the interest corridor concept used by the Central Bank is being reviewed.

During the reporting period the Central Bank has taken certain steps to develop the survey base that ensures effectiveness of the monetary and financial stability policies.

To that end, identification, and management of risks were prioritized with an eye to increase the capacity of financial stability assessment and management. Stress tests and financial stability indicators helped identify strengths and weaknesses of the financial system, fuelled by periodic evaluation of sustainability and sensitivity of the banking sector.

Moreover, Dynamic Stochastic General Equilibrium model was econometrically estimated and improved on an ongoing basis. The Azerbaijan economy was simulated on the basis of mathematical-analytic specification of the model. At present the working paper of the model is being drafted given the country-specific micro and macroeconomic parameters.

In order to evaluate the response function of the Central Bank in Azerbaijan, analyses performed in various countries through application of the Taylor rule were reviewed which released the Azerbaijan specific methodology. The impact of the tools like money supply, exchange rate and oil price on total output gap, the difference between possible and actual inflation was assessed to that end.

At the same time, the critical level of inflation in Azerbaijan was evaluated, the assessment of panel VAR model for oil exporting countries started. For this purpose, the sources of economical fluctuations in oil exporting countries are being studied (Azerbaijan, Kazakhstan, Russia and Iran).

In 2011 the Central Bank also focused on further improvement of statistic dataware and its adjustment to international standards. Electronic Database and Analytical Reporting System (ESAS) reflecting multifunctional and efficient unified statistic database to be created at the Central Bank is under way.
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