

Summary on situation of the monetary policy on the first quarter of 2005

1. Execution of the monetary policy

The National Bank conducted monetary and exchange policy related to the maintenance of the acceptable level of basic inflation as one of the main factors of macroeconomic stability, acceleration of economic re-monetization, stable equilibrium in payment balance, international competitive ability of non-oil sector and support of socio-economic development of the country during the first quarter of 2005 as well. The ongoing economic processes inside and outside of the country significantly influenced the implementation of duties of the monetary policy.

Macroeconomic situation. The growth rate of the **GDP** as a main macroeconomic indicator constituted 10.8%.

10.3% industrial product, 4.8% agricultural product and 12% commodities turnover growth rates were achieved as compared to the previous year.

The increase of the share of **private sector** as an important term for the country with the market economy proceeded as well. About 74% of the GDP, as well as 60.4% of industrial product, 99% of agricultural commodities, 92.1% of capital investment, 55.9% of freight forwarding, 73.6% of communication services were performed by the non-government sector during the first quarter of 2005.

The inflation constituted 2.9% in March 2005, as compared to the previous months, 7.6% to December of the previous year and 15.2% to the relevant period of the previous year in the country under the influence of high macroeconomic dynamics, continuation of the significant use of oil incomes, significant increase of gross demand and delay of the adaptation of gross supply to this demand, non-monetary factors and increase of producers' prices.

The inflation model shows that, 21.7% of the inflation was related to the **monetary factors**. 20.6% of monetary factors are related to the money supply (increasing) and 1.1% to the exchange rate (decreasing). Influence of **non-monetary factors** to the inflation constituted 78.3%. 2.3% of this was related to the GDP (decreasing) and 18.4% to the expectations (increasing). Seasonal factors increasingly (24.5) influenced the prices. Appreciation of water and natural gas increasingly influenced the inflation 25.7% and 7.4% accordingly.

Basic inflation excluding abrupt changes of regulated prices and prices of fruit and vegetables constituted 2.6% during the quarter, which was less than the gross inflation by more than 2 times. It should be noted that, just this parameter characterizes the result of the monetary policy in the world practice.

Activation of **demand factors**, as well as increase of the population's income by 24.1% and increase of the average salary by 22.8%, resulted in the increase of retail commodities turnover by 12.7% and played an important part in the increase of the inflation. The growth indicators of demand, i.e. every element of gross expenses were expressed in two figures, whereas the growth indicators of production (supply) were expressed in one figure. Generally, the growth of the demand exceeded the growth of the supply at least 2-3 times.

Expenditure factors were sufficiently active during the period, as well. The price index of the industrial commodities producers went up by 23.6% in March as compared to the same period of the previous year. The liberalization of fuel prices also influenced consumer prices as an important factor of the expenditure inflation. The increase in some import commodities influenced the inflation, too.

The amount of growth indicators of the capital **investment** as a main guarantee factor of the future economic development constituted 5.4 trillion manats, and 76.3% or 4.1 trillion manats of this was constituted by foreign investment.

Positive declines observed in the **foreign trade balance** of Azerbaijan during the recent years persisted. The foreign trade turnover increased by 1.7 times as compared to the same period of the previous year and reached 1111.8 million USD during the months of January –

February. The export amounted to 263.8 million USD and the import amounted to 848 million USD.

The improvement of the **population's welfare** continued as well. The average salary reached 539 thousand manats (110.2 USD) and its growth rate constituted 22.8%. In its turn the increase of population's income became the guarantee factor of the real sector's development, enhancing the purchasing capacity.

Inclinations in the world economy. Development declines persisted at the world economy during the first quarter of 2005.

Positive declines were observed in the **USA** - locomotive of the global renaissance, despite opposite changes of separate indicators. In March the Consumer Confidence Index slightly exceeded the value of December (102.3) of the previous year and constituted 102.4. It should be noted that this was less than in January (105) and February (104.4). Unemployment rate constituted 5.4% according to the information in February. The production offers increased by 0.2% in February and offers for long-term commodities increased by 0.3%. Retail sale volume increased by 0.3% and 0.1% excluding the automobiles in March.

The committee of the FRS on the open market increased the discount rate from 2.25% to 2.75% by changing it twice during the quarter. It should be noted that market participants forecast discount rate to be increased further.

During the accounting period, revival of the economy was observed in **Euro region**, too. Industrial production increased by 2.8% in January and decreased 1.4% in February in Germany – the leading country of Euro region. Despite that, the DIW institute of Germany increased its forecast from 0.5% to 0.7% on the growth rate of the GDP during the first quarter. Industrial production decrease about 0.5% has been observed in France in February, too. According to the estimations of the EUROSTAT retail turnover increased by 0.5% in January and 0.4% in February in Euro region. The unemployment rate still remained relatively high (9%) and constituted 8.9% in the Euro region by the end of February.

The European Central Bank (ECB) remained the discount rate at the stable 2% level during the first quarter of 2005.

In England the unemployment was a little bit less than it was in the Euro Union countries and constituted 4.7%. The average salary went up 4.7% in March as compared to the same period of the previous year. England Bank kept the discount rate at the stable 4.75% level during the accounting period. But, increase of the percentage rates in the financial markets proceeded. Thus, a monthly LIBOR rate rose up to 2.87% by April 1, 2005 whereas it constituted 2.4% at the beginning of year.

Deflation processes still proceeded in **Japan**. Thus, the Consumer Prices Index decreased 0.5% in January and 0.2% in February. The unemployment increased to 4.7% from 4.5% of February. The retail sale amount decreased 2.8% and industrial production 2.1% in February. But, offers on machinery and equipment increased by 4.9% in February after 2-months' decrease. The Central Bank of Japan didn't change its main percentage rate and kept it at the level of 0.01%.

The processes in the economy of the leading countries had effects on the rates of currencies and stock indexes of these countries. **Exchange rate of USD** appreciated against the other leading currencies of the world during the accounting period. The rate of USD strengthened 2.2% against English pound sterling, 0.5% against Russian ruble, 4.8% against the euro, 4.6% against Swiss frank and 4.4% against Japanese yen.

Abrupt changes were not observed on the levels of main **stock indexes** during the accounting period. So, the *Dow-Jones average* displaying the average price of 30 biggest industrial companies in the New-York Stock Exchange decreased 1.8%, the *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange increased by 0.4%. Abrupt hesitation of stock indexes was not observed in Europe, as well. The **FTSE Eurotop 100** calculated on the ground of stock prices of the 100 biggest

companies of Europe increased by 3.3% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange increased by 1.3%.

The **average price of Brent oil** in the world market constituted 49.3 USD during the first quarter of 2005, which was 58% more than (31.2 USD) that of the first quarter of 2004.

2. *Development of the monetary management*

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

Actions for the realization of the strategy to set **open market operations** as a main tool of the monetary policy proceeded during the first quarter of 2005 as well. The National Bank continued to use **short-term bank-notes** to neutralize the surplus liquidity in the banking system. Generally, money amounted to 357 billion manats has been sterilized by the short-term bank-notes to date. The amount of the bank-notes in the turnover constituted 139.2 billion manats by the end of year.

Under the conditions of significant expansion of the money supply caused mainly by the foreign factors, the National Bank conducted less **refinance operations** than intended on the monetary program. Simultaneously, expansion of the employment of new financial tools in order to improve refinance mechanism and to conduct an effective and adequate monetary policy by the National Bank was ongoing. The **pawn-shop and overnight credit mechanisms** are examples of these tools. The **pawn-shop** credits amounted to 1.5 billion manats and the overnight credits amounted to 5 billion manats have been realized during the period.

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

The **obligatory reserve norms** were 10% for the short-term deposits and at zero level for the long-term credits during the accounting period. The National Bank issued a decree allowing the operating banks in the country to use the obligatory reserve norms in manat for daily clearing, widely using opportunities of the interbank payment system of AZIPS. The implementation of this measure is expected to influence positively the maintenance of the prompt reaction of banks to the demand of clients by expanding resource opportunities of the banks.

Exchange rate policy. The supply of foreign currency significantly exceeded the supply of manat in the currency market of the country under the conditions of oil prices' being over 50 USD, abrupt increase of the foreign investment and increase of the transfers to the state budget from the Oil Fund of the Azerbaijan Republic. Under these conditions, the National Bank conducted the softening policy of the resistance to the strengthening of manat's rate in order to intensify the struggle against the inflation, taking into consideration the guaranteed international competitiveness of the economy, especially non-oil sector by significant reserves. As a result, the official exchange rate of manat against USD strengthened by 51 manats or 1% during the first quarter of 2005 and by the end of the period it constituted 4852 manats.

As a result, the alteration of the exchange rate had a decreasing influence on the inflation in the first quarter of the year being opposite to the same period of the previous year. The econometric model on the inflation displayed that, the inflation decreased 0.5% per strengthening percent of the nominal exchange rate of manat after a definite time interval. Hence, decreasing influence of the rate on the inflation is expected to strengthen during the forthcoming months.

The existing dynamics of the nominal exchange rate of manat resulted in the effective exchange indexes to start changing towards the required level by the internal and external stability. The **nominal effective exchange** rate of manat on gross turnover strengthened by 0.9% against the currencies of the main partner countries at the foreign trade during the months of

January-March of 2005 and the import influenced rate strengthened by 0.3%, whereas the export influenced rate strengthened by 1.4%. The **nominal effective exchange** rate of manat on the gross turnover decreased 3.7%, whereas the import influenced rate decreased 2.5% and the export influenced rate decreased 4.7% as compared to the same period of the previous year.

The real effective exchange rate of manat on the gross trade turnover increased by 6.9% in March 2005, as compared to December 2004, whereas the export influenced rate rose up by 7.9% and the import influenced rate by 5.8%. **The real effective exchange rate** on the gross trade turnover increased by 5.5%, whereas the export influenced rate increased by 5.6% and the import influenced rate by 5.2%, as compared to the same period of the previous year. **The real effective exchange rate** on the gross trade turnover of the non-oil sector increased by 5.8%, whereas the export influenced rate increased by 3.3% and the import influenced rate by 6.3% during the months of January-March, 2005. **The real effective exchange rate** of the non-oil sector increased by 6.2%, 2.4% and 6.6% accordingly, as compared to the same period of the previous year.

The National Bank influenced the exchange rate of manat by the correlation of demand and supply in the currency market. The National Bank's interference to the currency market constituted 29.1 million USD and was sale oriented during the accounting period. The sale oriented participation of the National Bank in the currency market limited the expansive increase of the money supply. It could be added for information that, this indicator constituted 16 million USD and was purchase oriented at the same period of the previous year.

Scope of the currency reserves under the disposal of the National Bank increased by 1.65% as compared to the beginning of year (876.86 million USD) and constituted 891.34 million USD by the end of the first quarter of 2005. 14.07 million USD was spent on the repay of the main and active debts on credits of IMF during the quarter. Consequently, **relative growth** exceeded 28 million USD.

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

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

Establishment of the macroeconomic prognosis model covering four sectors was started within the scope of the researches on common economic problems. Methodological actions were taken to integrate analytic systems with a huge information base on real, monetary, fiscal and foreign sectors for this purpose. Information base (the National Accounts System) was created and the world practice was studied in this area. Meanwhile activities are being conducted to correlate and evaluate the mutual resource flows in the economic sectors, to create common macroscheme and to integrate local econometric models to this scheme, to compose model financial program for 2006-2009th years, to elaborate macroeconomic scenarios suitable to the target economic growth and the stability parameter for 2006-2009th years.

A research was carried out on the structural improvement of the monetary aggregates under the terms of the financial markets' development within the framework of researches in the monetary sphere. The theoretical basis of the determination of the monetary aggregates' structure, items on broad monetary aggregate in the Magazine of Monetary and Financial Statistics (MMFS) of the IMF, experiences of leading countries and countries with transitional economy on the monetary aggregates, directions of the structural analysis and improvement of the monetary aggregates in Azerbaijan were covered in the research. The results were summarized and proposals were put forward in the end.

Improvement of the monetary development models were kept in the centre of attraction, as well. Usage of the equilibrium model of the money market, the inflation model, the econometric models of the exchange rate of manat, real sector and the assessment of the currency risks was proceeded in the practical implementation of the monetary policy.

Improvement of theoretical and methodological basis of real inflation in Azerbaijan was investigated within the framework of **improvement of the monetary policy**. Thus, the theoretical and methodological basis of the real inflation was investigated, the real inflation was estimated by using different methodics and comparison of the earned results was performed on the base of definite criterions. Practical proposals and recommendations were put forward as a result of the research.

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

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

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

3. Monetary indicators and situation of financial markets

Situation of the money supply in the economy. Under the terms of economic growth's acceleration and increase of country's financial power, implementation of large-scale social programs and utilization of oil incomes for the development aims were increasing physical demand for money. In this connection, increasing declines of the money supply persisted during the first quarter of 2005, as well.

Monetary base of manat increased by 14.4% in March 2005, as compared to the same period of the previous year and constituted 2809.5 billion manats. But, the monetary base decreased 12.2% as compared to the beginning of year and this was related to the actions of the National Bank to sterilize the money amount with the inflationary potential by the operations mostly on the currency and securities (short-term bank-notes of the National Bank) market. As a result, the weight of the monetary factors in the structure of the inflationary factors decreased more than 3 times in the first quarter of 2005 as compared to the same period of the previous year.

Broad monetary aggregate (M-2) increased by 26.8% and constituted 3174.5 billion manats in April 1, 2005 as compared to April 1, 2004. Money supply decreased 7.1% as compared to the beginning of year. It should be noted that, according to the econometric model upon the inflation, the change of inflation constitutes 0.2-0.3 per every percent of the change of money supply.

Monetisation level improved as compared to the same period of the previous year. So, the share of the money supply in the GDP (upon the GDP of the non-oil sector) increased by 0.82% in March, 2005. Simultaneously, the speed of the money turnover decreased 8.7%, which was a positive factor proving the improvement of money supply in the economy.

Positive qualitative changes persisted in the structure of money supply. The weight of the cash in the structure of the money supply in manat decreased 4.5% as compared to the same period of the previous year. It was related to the increase of the non-cash amount by 48.6%, whereas the cash amount increased only by 19.1%. Rapid development of banking system, especially implementation of the progressive payment systems, establishment of the interbank

electron payment system on small and large payments and expansion of the plastic card turnover presented additional stimuli to the increase of the non-cash amount.

Further improvement of the indicators characterizing the ability of the banking system to create money was observed. Thus, **monetary multiplier** (ratio of the broad money supply in manat over monetary base in manat) increased by 10.8% as compared to the same period of the previous year. Simultaneously, ratio of the M-2 and M-1 aggregates over the cash amount went up by 6.4% and 6.8% accordingly.

Dollarisation level of the economy decreased during the accounting period. Thus, the share of deposits and savings in foreign currency in the total amount of savings decreased 0.7%. The weight of the deposits in foreign currency in the structure of the deposits of legal persons decreased 1.5% and the weight of the savings in foreign currency in the structure of the savings of physical persons decreased 0.3%. This establishes a favorable base for the strengthening of manat's part in the economic turnover.

Deposit market. The scope of savings and deposits increased by 43.2% and reached 4994.6 billion manats, and the **deposits of legal persons** increased by 39.4% constituting 2896.6 billion manats.

The growth rate of **savings of natural persons** was also high. So, the savings of the natural persons went up by 48.8% constituting 2098 billion manats. 49.9% of savings attracted by the banks were accrued by private banks.

Short-term savings of natural persons went up by 45.3% and long-term ones went up by 52.1%. It indicates the further increase of the population's trust towards the banks.

It should be noted that, savings of the non-resident physical persons also grew by fast rate together with residents' ones. Thus, the savings of the non-resident physical persons went up by 55.7%, as well as short-term ones by 40.6% and long-term ones by 80.4%.

It should be noted that the analysis of the structure of savings against the currencies show the increase of the economic units' trust towards manat. Thus, **the savings and deposits in foreign currency** increased by 41.9%, whereas in manat they increased by 48.6%. Population's savings in foreign currency increased by 48.2% and in manat 55.2%.

Percentage rates of savings and deposits almost remained stable during the last year. So, the average percentage rate of deposits in manat rose up to 9.9% in March, 2005 against 6.69% of the same period of the previous year and the average percentage rate of deposits in foreign currency fell down to 9.93% against 10.1%.

Credit investments. The scope of credit investments went up by 49.2% constituting 5363.6 billion manats by the end of the first quarter of 2005 as compared to the same period of the previous year. Net growth of the credit investment constituted 416.3 billion manats (8.4%).

Part of the credit investment in the GDP increased by 3.6% as compared to the same period of the previous year

Newly given credits' amount increased by 35.3% in the first quarter of 2005 as compared to the same period of the previous year and constituted 2851.9 billion manats.

Credit investment increased by 55.6 to the industry, 40.5% to the construction and property, 83.3% to the agriculture, 49% to the transport and communication, 2.2 times to the trade and services sector and 84% to the physical persons during the year.

Short-term credit investments increased by 46.2% and long-term ones increased by 55.7%. Ratio of the long-term credits over the total credits went up 1.4% and reached 32.6% as compared to the same period of the previous year.

92.1% of the credit investments were accrued by banks and 7.9% of this was accrued by non-bank credit organizations. The **part of private banks** in the structure of the credits given by the banks exceeded 50 %.

Credits given to the private sector increased by 65.9% and the **share of the private sector in the credit investment** rose up to 84%, whereas the credits to the state sector decreased 2.4%.

Credit investments in manat increased by 84.8%, in foreign currency 33.3%. As a result, the weight of the credits given by the foreign currency in the total credits decreased 7.3% as compared to the same period of the previous year.

No significant changes on the average nominal percentage rates of credits were observed during the last year.

Currency market. The gross volume of the internal currency market increased by 654.8 million USD or 45.2% constituting 2.1 billion USD in the first quarter of 2005 as compared to the same period of the previous year. The currency market operated in the self-regulating mode and there wasn't observed any tension during the period, as well.

88.9% of currency exchange operations were performed by USD, 5.7% by the euro, 4.1% by Russian ruble and 1.3% by other currencies.

Thus, generally macroeconomic and monetary situation was auspicious and positive qualitative declines persisted in the economic growth processes in the country during the first quarter of 2005. At the same time the problem of strengthening of the coordination mechanism of the macroeconomic policy is relevant for further strengthening of the achieved successes and especially for more effective control of the inflation processes under the terms of expanding use of oil incomes.