

Summary on situation of the monetary policy on 2004

1. Execution of the monetary policy

The National Bank conducted the monetary and exchange policy related to the support of the economic growth, maintenance of the acceptable level of the basic inflation as one of the main factors of the macroeconomic stability, competitive ability of the non-oil sector and improvement of money supply in the economy during 2004 as well and mostly achieved the targets. 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 10.2%.

5.7% industrial product, 4.6% agricultural product, 36.1% capital construction and 13% commodities turnover growth rates were achieved as compared to the previous year.

The economic growth rate of the oil sector constituted 2.5%, whereas it constituted 13.4% upon the non-oil sector.

The increase of the share of the **private sector** as an important term for the country with the market economy proceeded as well. 73.5% of the GDP, as well as 57% of industrial product, 99% of agricultural commodities, 91.2% of capital investment, 57.8% of freight forwarding, 71.3% of communication services were performed by the non-government sector during 2004.

The **inflation** rate constituted 10.4% in 2004. 13.7% food products and 4.9% non-food products and services appreciated. Analysis of the consumer price basket showed that, basic inflation constituted 6.8%, this is 3.6% less than common inflation rate. It should be noted that, the basic inflation is the main parameter expressing the macroeconomic effect of the monetary policy in the world practice.

The activation of **demand factors**, as well as the increase of population's income by 20.7% and growth of the investment in the economy played an important part in increase of the inflation. **Expenditure factors** were sufficiently active during the period, as well. The price index of the industrial commodities producers went up by 21.9% during the past year. Liberalization of the fuel prices also influenced the consumer prices as an important factor of the expenditure inflation. The foreign factors of the inflation were the increase of production expenses in partner countries in foreign trade, due to the appreciation of the world oil prices and the appreciation of imported commodities from the Euro region related to the strengthening of the euro. Alongside with these, limitations in the border with Russia during the months of September – October and the expiration of VAT relief system on the grain import also increased the inflation.

The amount of the capital **investment** as a main guarantee factor of the future economic development went up by 36.1% constituting 24.2 trillion manats. According to the initial information on the payment balance, foreign capital flow into the country increased by 30% and reached 4.4 billion USD in 2004. It was a positive case that, the foreign capital flow attracted as a direct investment, exceeded the indicator of the previous year by 1.1 billion USD and constituted 4.1 billion USD.

Positive declines observed in the **foreign trade balance** of Azerbaijan during the recent years persisted. According to the initial information on the payment balance, gross amount of the exported commodities increased by 900 million USD and reached 3.5 billion USD, the amount of the import increased by 700 million USD and reached 3.4 million USD. Positive balance of 80 million USD was appeared in the foreign trade.

The improvement of the **population's welfare** continued as well. The average salary reached 483.4 thousand mantas (98.3 USD) and its real growth rate constituted 26.2%. In its turn the increase of population's income became the guarantee factor of the real sector's development, enhancing the purchasing capacity.

Inclinations in the world economy. Development declines persisted at the world economy in 2004.

The economic growth in the **USA** – locomotive of the global renaissance became sufficiently stable. In general, the growth rate of the GDP over the year constituted 4.5% during the first quarter, 3.3% in the second quarter and 4% in the third quarter. Positive declines were observed in the economy during the fourth quarter, despite the opposite changes of separate indicators. In December the Consumer Confidence Index exceeded the value (96.4) of the beginning of year and constituted 102.3. Unemployment rate constituted 5.4% according to the information in December. The industrial production increased by 0.8% in December.

The committee of the FRS upon the open market increased the discount rate from 1% to 2.25% by changing 5 times. 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. The economic growth rate constituted 1.9%, 2.4% and 1.7% in Euro region and 1.5%, 2% and 1.3% in Germany – in the most enormous economy of Euro region, during the first, second and third quarters accordingly. Economic growth of Euro region was due to the increase of the export, corporative investment and government expenses. But consumer expenses still remain low. According to the opinion of the economists the economic growth rate couldn't be expected to be higher while consumer expenses are low. Industrial production decrease was observed in Germany (1%), in France (1.9%) and in Italy (0.8%). One of the main reasons of the moderate consumer demand is the great unemployment rate (9%) in the Euro region. Industrial production decreased 0.6% in October and consequently additional 0.3% decrease was observed in November in the Euro region. But the European Central Bank doesn't hesitate to lower the discount rate. It remained at the stable 2% level during 2004.

The business activity index has been exceeding 50 during the last months indicating the continuation of the economic progress **in England**. England Bank increased its discount rate from 4.25% to 4.5% in June and to 4.75% in August. This had a significant effect on the increase of the percentage rates in the financial markets. Thus, a monthly LIBOR rate rose up to 2.42% by January 1, 2005 whereas it constituted 1.12% at the beginning of year. In England the industrial production decreased 0.9%, whereas the unemployment reduced by 6400 in December.

During the second quarter the economic growth rate slightly decreased constituting 0.4%, whereas it constituted 1.6% during the first quarter in **Japan**. Deflation processes still proceeded in the country. Unemployment decreased to 4.6% - the lowest level since 2000. Housekeeping expenses went up by 0.6% in August as compared to the same month of the previous year. Offers in machinery sphere increased by 3.1% and industrial production went up by 0.1% in August. These declines persisted during the next months. Thus, the industrial production increased by 1.7% and offers on machinery and equipment increased by 19.9% in November. The Central Bank of Japan didn't change its main percentage rate and kept it at the level of 0.01%.

Exchange rate of USD against the other leading currencies of the world decreased during the accounting period. The rate of USD decreased 7.2% against English pound sterling, 4.7% against Russian ruble, 7.8% against the euro, 8.8% against Swiss frank and 3% against Japanese yen.

The processes in the economy of the leading countries had effects on the rates of currencies and stock indexes of these countries. 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 increased by 4%, the *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange increased by 6.1%. The **FTSE Eurotop 100** calculated on the ground of stock prices of the 100 biggest companies of Europe increased by 5.4% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange increased by 5.7%.

The **average price of Brent oil** in the world market constituted 37.9 USD during 2004, which is 33% more than (28.5 USD) that of 2003.

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 2004 as well. Within the framework of the sterilization policy, the National Bank issued **short-term bank-notes** to neutralize surplus liquidity in the banking system under the conditions of the limited scope of the **STSL** market. Money amounted to 182.2 billion manats has been sterilized by the short-term bank-notes in 2004. The amount of the bank-notes in turnover constituted 99.6 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. 12 **pawn-shop** credits amounted to 126 billion manats and 1 overnight credit amounted to 1 billion manats have been realized during the period.

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

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

Exchange rate policy. The supply of foreign currency significantly exceeded the supply of manat in the currency market of the country under the conditions of abrupt increase of world price of oil per barrel and increase of foreign currency import. As a result, the official exchange rate of manat against USD strengthened by 20 manats or 0.43% during 2004 and by the end of year it constituted 4903 manats.

The existing dynamics of the manat's rate maintained auspicious parity of manat against the currencies of the partner countries at the foreign trade. The **nominal effective exchange** rate of manat cheapened 6.5% against the currencies of the main partner countries at the foreign trade in 2004 and the import influenced rate cheapened 5%, whereas the export influenced rate cheapened 7.4%. During the investigation period the **real effective exchange rate** of manat on gross trade turnover decreased 1.5%, export influenced rate 1.2%, import influenced rate 1.9%. **The real effective exchange rate on the gross trade** turnover of the non-oil sector decreased 2.9%, whereas the export influenced rate decreased 2.7% and import influenced rate decreased 3.9% during 2004.

The National Bank influenced the exchange rate of manat by the correlation of demand and supply in the currency market. The National Bank's interference to the currency market constituted 518.7 million USD and was purchase oriented during the accounting period. Purchase oriented interference of the National Bank in the currency market improved money supply in the economy and prevented "Dutch syndrome" and abrupt revaluation of exchange rate of the national currency.

The purchase oriented interferences also played an important part in the **increase of currency reserves**. Scope of the currency reserves under the disposal of the National Bank increased by 15.82% as compared to the beginning of year (757.1 million USD) and reached 876.86 million USD by the end of 2004. 62.6 million USD directly from the reserves of the National Bank was spent on the repay of the main and active debts on the credits of IMF during 2004. Consequently, the relative growth exceeded 182 million USD.

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

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

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

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

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

Within the framework of analysis in the monetary sphere, the *measures on the improvement of the money turnover and on the decrease of the dollarisation level* in Azerbaijan were evaluated. The existing situation of the money turnover and dollarisation were analyzed and summary on the conducted measures in this sphere were estimated.

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

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

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

among the import, inflation processes and the difference between gross demand and gross supply has been completed.

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

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

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

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

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

3. Monetary indicators and situation of financial markets

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

Monetary base of manat increased by 38.2% in 2004 and constituted 3200.2 billion manats.

The **broad monetary aggregate (M-2)** increased by 31.9% and constituted 3418 billion manats. The real growth rate of money supply was higher, too. So the real growth rate of the money supply constituted 19.5%.

As a result, increase of the **monetisation** level proceeded further adequately to the economic growth. So, the share of the money supply in the GDP (upon the GDP of the non-oil sector) increased by 1.04% according to the summary of 2004. Simultaneously, the speed of the

money turnover decreased 8.8%, which is a positive factor proving the improvement of money supply in the economy.

So the part of the cash in the structure of the money supply in manat decreased 8.8%. It was related to the increase of the non-cash amount by 86.6%, whereas the cash amount increased only by 17.1%. 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.

Dollarisation level of the economy decreased during the accounting period. Thus, the share of deposits and savings in foreign currency in the total amount of savings decreased 2%. 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 67.9% and reached 5126.2 billion manats, and the **deposits of legal persons** increased by 73.5% constituting 3110.6 billion manats.

The growth rate of **savings of natural persons** was also high. So, the savings of the natural persons went up by 60% constituting 2015.6 billion manats. 47.6% of savings attracted by the banks were accrued by private banks. Short-term savings of population went up by 53.5% and long-term ones went up by 66.5%. It indicates the further increase of the population's trust towards the banks.

It should be noted that the analysis of the structure of savings against the currencies show the increase of the economic units' trust towards manat. Thus, **the savings and deposits in foreign currency** increased by 63.8%, whereas in manat they increased by 86.6%.

Percentage rates of savings and deposits almost remained stable in 2004. So, the average percentage rates of deposits in manat rose up to 6.93% in December, 2004 against 6.5% of the same period of the previous year and the average percentage rates of deposits in foreign currency fell down to 9.43% against 10.08%.

Credit investments. The scope of credit investments went up by 47.4% constituting 4941 billion manats in 2004.

New credits amounted to 8.5 trillion manats were given in 2004. Taking into consideration the payments, a pure growth of the credit investment constituted 1589.5 billion manats, 1063.3 billion manats of this was constituted by short-term credits, 526.2 billion manats by long-term ones.

Credit investment increased by 50.7% to the industry, 53.5% to the construction and property, 55.2% to the agriculture, 2.2 times to the transport and communication and 81.7% to the physical persons during the year.

Short-term credit investments increased by 43.7% and long-term ones increased by 57.4%. Part of the long-term credits in total credits reached 29.2%.

91.5% of credit investments were accrued by banks and 8.5% of this was accrued by non-bank credit organizations. The **part of private banks** in the structure of the credits given by the banks rose up to 50%.

Credits given to the private sector increased by 54.3% and the **share of private sector in credit investment** rose up to 79.4%, whereas credits for the state sector increased only by 25.8%.

Credit investment in manat increased by 57%, in foreign currency 42.5%. 63.9% of the credit investment was given in foreign currency by the end of the period.

Average nominal percentage rates of credits increased in 2004. The percentage rate of credits in manat constituted 15.55% by the end of December, this is 0.64% more than (14.91) that of the end of the previous year. But, taking into consideration 10.4% inflation rate of last 12 months, 9.76% decrease of **real percentage rate** could be defined.

Currency market. The gross volume of the internal currency market increased by 1.1 billion USD or 22.4% constituting 6.21 billion USD in 2004. The currency market operated in the self-regulating mode and there wasn't observed any tension during the period.

14.4% of currency exchange operations fell to the lot of the Baku Interbank Currency Stock (BISC), 22.6% of the Open Interbank Currency Stock (OISC), 63% of the Intra-bank exchange operations (IBEO).

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