# Table of Contents

Introduction ............................................................................................................... 3

I. Global economic processes and national economy ........................................... 3

1.1. World economy trends .................................................................................. 4

1.2. Macroeconomic processes in Azerbaijan ...................................................... 6

1.2.1. Foreign sector .......................................................................................... 6

1.2.2. Aggregate demand ................................................................................. 8

1.2.3. Aggregate supply .................................................................................... 9

1.2.4. Macroeconomic equilibrium ................................................................. 10

II. Money and exchange rate policies ................................................................. 11

2.1. Currency exchange market and exchange rate of manat ............................ 12

2.2. Monetary policy tools ................................................................................. 14

2.3. Money supply ............................................................................................ 15

Conclusions ........................................................................................................ 18
Introduction

Central Bank of the Azerbaijan Republic has carried out its policy under improving external economic conditions and continuing economic growth in the country in 1 quarter of the current year. Thus, unlike corresponding period of the last year, in 1 quarter of 2010 the global prices of Azerbaijan’s export products inclined to increase, and the chances of access by local banks to international money market has improved comparatively. Anti crisis measures taken in the country in 2009 caused the improvement of countrywide economic growth as well as improvement of external environmental conditions. According to the main directions of monetary policy declared for 2010 by Central Bank during the reported period it carried out policy of keeping the inflation rate low, preserving the exchange rate stability of manat, deepening the banking financial sector’s stability, meeting money demand of the economy. Despite improvement of global and domestic macroeconomic environment, neutralization of potential risks has always been in the focus of Central Bank.

I. Global economic processes and national economy

1.1. World economy trends

1 quarter of 2010 was characterized by strengthening of restoration trends in the global economy. As a result of measures taken against crisis by different governments in 2009, the rise has been observed in business confidence index\(^1\) in leading countries.

![Business Confidence Index in top 3 countries, compared to last month, %](image)

Source: [www.principalglobalindicators.org](http://www.principalglobalindicators.org)

\(^1\) Business Confidence Index is being calculated on the basis of systematizing, grouping of expectations like estimating social-economic conditions, macroeconomic indicators, recent and future sales, investments plans of business sector representatives.

In order to support aggregate demand, with the influence of fiscal stimulus measures, the economy growth trends in the USA have been stronger than in Eurozone and Japan. Since the beginning of the crisis in March of the current year, the prices for real estate increased in the USA for the first time, and 162 thousand new jobs have been created.

Despite the formation of positive expectations, high volatility are being observed in export the main leading factor of Japan's economy. Export has decreased 1.7% in February compared with the last month for the first time in the last 12 months.
Uncertainty in Eurozone is connected with the economic situation in Greece and Portugal.

Economic activity is rising in developed countries, as well as in developing countries. Especially, capital flows to the countries like China, India and Brazil accelerated within the quarter so that it gave impulses to activity in those countries. Economic growth rate was 11.9% in China, 9.2% in Taiwan, 13.1% in Singapore, 8.5% in India in 1 quarter of the year. Basic source of economic growth is the reviving of foreign investment demands in the South East Asian countries.

Revival observed in the global economy displays itself in the rise of fund indexes in financial markets. Thus, since the third quarter of 2008, Dow Jones Average index has approached the 11000 level for the first time. As compared with the beginning of the year, Dow Jones Average index has grown 3.1%, Nikkei 225 index 4.3%, and FTS Eurofirst 300 index 1.7% by the end of the quarter.

Support for total demand in the largest world economies has created favorable conditions for economic growth, and effects growing prices in global commodity markets.

"Commodity Price Index" calculated by the International Monetary Fund for the end of 1 quarter of 2010 has grown 5.3% compared with the end of the last year. Food Price Index has grown 0.3%. The growing prices of raw materials caused the rise in the prices. At the end of the quarter, price of aluminum has increased by 1.3%, price of gold by
1.3%, copper by 6.3% as compared with the end of the quarter of last year. The price of a barrel of Brent crude oil has increased by 2.7% since the beginning of the year and its average quarter indicator was about 76.7 USD.

Central Bank keeps the discount rates stable, some corrections were made to the terms of liquidity operations.

Taking into account recent positive trends, international financial institutions made optimistic corrections on economic forecasts for 2010-2011.

The last report by the International Monetary Fund on "Perspectives for World economy" of 21 April, 2010, economic growth rate of the world for the current year is forecasted on the 4.2% level. So, it is 0.3% higher than the forecasts given in January. At the same time, IMF’s anxieties connected with global imbalance still remains.

**Table 1. IMF forecasts on the world economy**

<table>
<thead>
<tr>
<th></th>
<th>Economic growth, %</th>
<th>Inflation, %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2010</td>
<td>2011</td>
</tr>
<tr>
<td>World</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Developed countries</td>
<td>2.3</td>
<td>2.4</td>
</tr>
<tr>
<td>USA</td>
<td>3.1</td>
<td>2.6</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Developing countries</td>
<td>6.3</td>
<td>6.5</td>
</tr>
<tr>
<td>China</td>
<td>10.0</td>
<td>9.9</td>
</tr>
<tr>
<td>Russia</td>
<td>4.0</td>
<td>3.3</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>2.4</td>
<td>4.2</td>
</tr>
</tbody>
</table>

**Source:** IMF

Economic situation worsened in Eurozone at the beginning of March, and the US dollar exchange rate grew in price. These factors caused a little decline in commodity prices, but the European Union's declaration of the Greek aid plans resulted in growing commodity prices again.

Taking into account restoration trends and increasing inflation pressures, liquidity support programs have been limited by several central banks of the world, even some of them began tightening their monetary policies. Norway, Israel, India, Singapore and Vietnam are examples of such countries. However, taking into account the need of supporting economic growth, central banks of some countries continued to soften monetary policies. Russia, Rumania, Hungary, Serbia, South African Republic and Kenya are among such countries. Although European
policies. Employment doesn’t react adequately to economic growth in some countries. Thus, according to the information by the International Labor Organization, unemployment rose in 38 of 43 countries in 1 quarter of the current year. Besides large budget deficits and government debts, the current account deficits and inflation pressures still remain as a source of concern.

1.2. Macroeconomic processes in Azerbaijan

The work on supporting aggregate demand done by the Government of Azerbaijan and the Central Bank in 2009 created conditions for continuing economic growth in the first quarter of the current year. Improving international situation and restoring external funding sources also provided additional impulses to domestic economic growth during this period.

1.2.1. Foreign sector

One could observe improvement of the country’s foreign positions under conditions of strengthening restoration trends in the global economy.

According to the State Statistics Committee data foreign trade turnover made up 3.2 bln. USD in January February of 2010, of which 3.2 bln. USD was exports’ share and 0.7 bln. USD – imports’.

2.2 times growth in exports and 24% fall in imports compared to the corresponding period of the previous year have resulted in 4.4 times growth in the trade balance surplus.

At the moment, the shares of export and import in GDP are 42% and 9% respectively. Raw oil, white sugar, tea and vegetable oils could serve as examples of products with rapidly growing export shares.

Wheat, raw sugar, tobacco, metal pipes, cement and motor cars were among the products with decreasing import shares.
Thus, during this period there was 2.5 bln. USD surplus in the foreign trade balance. Prices for Azerbaijan’s export products grow faster than for its imported products. Therefore, trade conditions index has increased 28% since December 2008.

The balance of payments surplus in I quarter has had positive impact on the country’s foreign exchange reserves. At the end of I quarter of 2010 the country’s strategic currency reserves made up about 22 bln. USD which makes it sufficient for 22 months imports of goods and services.

Central Bank’s foreign exchange reserves
have grown 6.5% in I quarter of the current year and exceeded 5.5 bln. USD level as of 01.04.2010, which makes it sufficient for 5.5 months imports of goods and services.

1.2.2. Aggregated demand

In I quarter of the current year all components of aggregate demand, including final consumption expenditures, investments and external demand have had a positive impact on economic growth.

1.2.2.1 Final consumption expenditures.

In I quarter of 2010 final consumption expenditures were among the main factors of economic growth.

Households' consumption. In I quarter of 2010 nominal money incomes of the population have grown 6.5% and 74.1% of them was the share of the final consumption.

The population final consumption expenditures in real terms have increased by more than 6% making up 3.7 bln. manats or 40% of GDP. Average monthly salary has increased throughout the country by 4.1% making up 304 manats, which also has contributed to keeping the high share of final consumption expenditures in GDP. As a result of this both retail trade turnover and paid services to population have grown compared to the corresponding period of the previous year 8.3% and 10.6% respectively.

![Figure 13. Retail trade turnover and paid services dynamics, corresponding period of the previous year, %](image)

Source: State Statistics Committee

Government and social organizations. Government's consumer expenditures have been formed mainly at the expense of spendings on commodity and services from the state budget. During this period wages, pensions and allowances made up 38.8% of the budget expenditures, which is 10.6% points more than the previous year's level.²

² *Note: in January-February period*
1.2.2.2 Investment expenditures. In 1 quarter of 2010 the level of economy’s capitalization has continued growing. Thus, investments into the economy have grown 4.9% as compared to the 64.5% of the investments channeled into fixed capital was the share of non oil sector. Agriculture, chemicals, trade and healthcare have been among most rapidly developing sectors. Banking loans alongside with public investments have also played an important role in promoting capital investments in the nonoil sector. Thus, investment banking loans have grown 24.6%.

1.2.3. Aggregate supply
During the reported period the growth rate in the country was 5.4%, including oil sector growth rate of 6.9% and non oil sector growth rate of 4.3%. Supporting necessary financial sources of economic growth during the last year has positive effect economic growth in 1 quarter of the current year. In the reported period nominal GDP per capita has increased 38% compared to the corresponding period of the previous year reaching 1340 USD level.

Positive economic growth rate also revealed itself in other indicators of business activity, namely in growing number of economic subjects. Thus, in the current quarter a number of legal persons among the statistical units under the state registration has increased by 3.9% up to 91015, while the number of physical persons operating without establishing a legal
entity has increased by 1.3% up to 281351.

** Tradable sector.** GDP growth has been primarily influenced by growing activity of tradable sector. Thus, 60.6% of GDP was the share of tradable sectors and these sectors contributed 2.7% points to the overall growth. The tradable sector’s growth was conditioned mainly by the growth in industrial sector during this period. Thus, 5.9% points of trade sector’s 6% growth was the industry’s share. In its turn oil gas sector played a crucial role in industrial growth. In I quarter of the current year raw oil production has grown 6.4%, while natural gas production has grown 9.6%.

![Figure 16. Sectoral growth in I quarter, %](image1)

**Source:** State Statistics Committee

**Non-tradable sectors.** During the quarter there was growth on all fields of non tradable sector, including the most growing among the non tradable fields services field (transportation, communications, trade, hotel, social services). Preserving the consumer demand as well as expanding services fields has conditioned this sector’s impetus for GDP growth. Thus, services fields made up 77.6% of nontradable GDP and 25.7% of total GDP.

1.2.4. **Macroeconomic equilibrium**

1.2.4.1. **Consumer price index.** During the quarter the annual inflation was 3.8%, which was affected by growing prices on international commodity markets as well as seasonal factors. Calculations made by econometric methods show that 2.2% points of average annual 3.8% growth were result of the seasonal factors, while 1.7% foreign CPI.

![Figure 17. Inflation structure, % points](image2)

**Source:** Central Bank of Azerbaijan

---

4 Tradable sector includes agriculture and industry.

5 Non-tradable sector includes construction, transportation, communications, public catering, hotel services, etc.
Calculations made by Central Bank using traditional, new and hybrid Phillips Curve also showed that inflation in Azerbaijan is a result of the foreign factors.

**Phillips curve.** Central Bank assessed inflation using traditional, new and hybrid Phillips curve. It was found out that correlation between dependent variable consumer price index and independent variables inflation of previous period and anticipation of inflation is statistically important, but correlation between the total output deficit, employment level, labor cost per product unit are not statistically important. It should be noted that Phillips curve was proposed by the New Zealand economist A.V. Phillips to define correlation between wage inflation (cost inflation) and unemployment. On the basis of analysis of 100 year unemployment and inflation indices Phillips explored that there was inverse relationship between unemployment and inflation growth. At present, in parallel with traditional version of Phillips curve new hybrid versions are used too. In contrast to traditional version of Phillips curve in new and hybrid Phillips curves the total output deficit, anticipation of inflation and labor cost per product unit are also assumed as variables.

**Figure 18.** Monthly inflation in 2010, % (scenario-based average)

Source: Central Bank of Azerbaijan

1.2.4.2. Industrial production price index. 
**During the quarter average industrial production price index (IPPI) in industrial sectors** has grown 71.9%. Average annual IPPI's significant change of this kind is related to 70% increase of oil prices in the international markets last year. In the reported period oil industry's average annual IPPI has grown 75.6%, but non oil industry's IPPI has decreased by 0.6%.

**Figure 19.** Average annual IPPI and APPI, %

Source: State Statistics Committee

1.2.4.3. **Agricultural production price index (APPI).** In the reported period average annual APPI has been noted for its 2.1% decrease. Livestock products have had 7.7% decrease, plant growing products have had 1% growth.

**II. Money and exchange rate policy**

In I quarter Central Bank in accordance with the declared main directions of its monetary policy for 2010 pursued the maintenance of acceptable level of inflation, stability of exchange rate, strengthening of the stability in the banking-financial sector, satisfaction of the demand of the economy for money, and has achieved assigned task. So inflation was on the targeted level, the
exchange rate was constant, the financial sector was stable, and the money supply has been changing adequately to the economic growth.

2.1. Foreign exchange manat and rate of manat

In contrast to the corresponding period of the previous year in I quarter of this year Central Bank has conducted exchange rate policy under conditions of expanding the supply channels in the currency exchange market. Exactly as a result of it, if in I quarter of the previous year Central Bank conducted sale interventions on foreign currency exchange, in I quarter of the current year it has conducted sterilization equal to 476 mln. USD.

![Figure 20. Currency interventions by Central Bank, mln. USD](image)

Source: Central Bank of Azerbaijan

Reduction in the demand for foreign currency in the currency exchange market in comparison with the same period of previous year is shown also from foreign exchange brought to the country by banks and volume of cash currency sold to people. So during this period the volume of net foreign currency brought to the country by banks and net exchange operations with cash foreign currency in comparison with I quarter of 2009 fell 2.5 and 1.9 times, respectively.

![Figure 21. Cash foreign currency brought by banks and operations with cash foreign currency (net), mln. USD](image)

Source: Central Bank of Azerbaijan

In I quarter of 2010 exchange rate of manat to USD has depreciated only by 0.04%.

During the quarter stability of manat’s exchange rate created favorable conditions for preventing the rise of inflation, foreign debt and dollarization and for improvement of social conditions of the people. At the same time the exchange rate stability of manat to USD in recent years did not have negative impact on international competitiveness of the country.
Although in the current quarter nominal exchange rate of manat to currency of some partner countries has decreased, it has strengthened against the currencies of other countries. Changes in bilateral nominal exchange rate of manat affected also bilateral real exchange rates. During the quarter both nominal and real exchange rate of manat to currencies of some countries (Russia, Ukraine, Kazakhstan, China) weakened.

Table 2. Indices of nominal and real exchange rate of manat against the currencies of main trade partner countries in I quarter of 2010, %

<table>
<thead>
<tr>
<th></th>
<th>According to the December of 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nominal exchange rate index*</td>
</tr>
<tr>
<td></td>
<td>Real exchange rate index</td>
</tr>
<tr>
<td>USA</td>
<td>100,0</td>
</tr>
<tr>
<td>Eurozone</td>
<td>107,2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>107,4</td>
</tr>
<tr>
<td>Turkey</td>
<td>101,6</td>
</tr>
<tr>
<td>Russia</td>
<td>98,4</td>
</tr>
<tr>
<td>Ukraine</td>
<td>99,8</td>
</tr>
<tr>
<td>Georgia</td>
<td>102,8</td>
</tr>
<tr>
<td>Iran</td>
<td>99,8</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>98,9</td>
</tr>
<tr>
<td>Japan</td>
<td>100,7</td>
</tr>
<tr>
<td>China</td>
<td>99,9</td>
</tr>
<tr>
<td>Belarus</td>
<td>104,0</td>
</tr>
</tbody>
</table>

*Average monthly change of exchange rate of manat to currencies of partner countries.

In the reported period of the quarter nominal effective exchange rate on non oil sector (on total trade turnover) has strengthened 1.2%, and real effective exchange rate has strengthened 1.7%.

In comparison with the corresponding period of the previous year nominal effective exchange rate on non oil sector has weakened 7.9%, real effective exchange rate 7.8%.

Both nominal exchange rates (NER) and prices changes had an upward influence on real effective exchange rate (RER) on non oil sector.

In I quarter real effective exchange rate has strengthened 6.8% mainly with regard to distant countries (US,
Eurozone, United Kingdom, Japan, and China). In the near abroad (Turkey, Russia, Georgia, Iran, Ukraine, Kazakhstan, Belarus) where big part of the non oil export of Azerbaijan goes to, real effective exchange rate has weakened 0.7%. So in I quarter of the current year there was an equilibrium at the exchange market and exchange rate stability of manat, while international competitiveness of the country generally has been preserved.

2.2. Monetary policy tools
In order to achieve the monetary policy goals Central Bank in I quarter of 2010 has not changed parameters of its interest rate corridor, refinancing rate was preserved at the level of 2%, corridor floor at the level of 1%, corridor ceiling at the level of 7%.

![Figure 24. Interest corridor parameters](image)

**Source: Central Bank of Azerbaijan**

<table>
<thead>
<tr>
<th>Tools of liquidity granting*</th>
<th>1 January 2010</th>
<th>1 April 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tools of attraction of liquidity **</td>
<td>29.5</td>
<td>35.5</td>
</tr>
<tr>
<td>Liquidity balance</td>
<td>1454</td>
<td>1422.1</td>
</tr>
</tbody>
</table>

*Loans of CBA to banks, SWAP operations etc.
**Notes portfolio, REPO operations, required reserve norms in manat and foreign exchange.

Balance on Central Bank operations fell from 1454 mln. manats at the beginning

---

6 This indicator expresses the difference between the remainder on the tools of offering of liquidity and the remainder on the operations of attraction of liquidity of Central Bank.
of the year to 1422.1 mln. manats at the end of I quarter of the current year. Diminishing of the positive balance on operations is explained by the fact that due to restoration of banks’ other resources, the need for liquidity support of Central Bank was low.

During I quarter of 2010 Central Bank held 12 auctions on placement of notes. Total volume of emission was 60 mln. manats, but volume of placed notes was 45,6 mln. manats (76% of emission). Weighted average yield of short term notes of Central Bank during the period remained stable at the level of 1%.

At the end of the quarter turnover of CBA notes was 12 mln. manats and it is 50% more in comparison with the beginning of the year.

2.3. Money supply

In I quarter of the current year money supply has changed adequately to the demand of the economy. A monetary base in comparison with the beginning of the year has increased by 1% and reached 4902 mln. manats.

During the period there was sudden volatility in the dynamics of monetary base. It is seen also from the standard deviation of the monetary base index during last 1 year?

Reports show that at the end of I quarter seasonally adjusted monetary base in comparison with the beginning of the year increased by 7.9%, in comparison with relevant period of previous year it increased by 32%.
The growth of monetary base in manat was mainly due to sterilization operations of Central Bank.

Money multiplier showing the bank’s ability to generate money during the period didn’t suddenly change and at the end of the quarter it was 1.26. Estimates show that the increase of commercial banks’ correspondent accounts with Central Bank had a downward effect on money multiplier.

Quantity parameters of the influence effect on the multiplier are shown in the following Figure:

During the quarter broad money supply also increased.

Broad money supply in manat (M2) in comparison with the beginning of the year has increased by 0.2% and at the end of the period reached 6182.6 mln. manats, and M3 aggregate has increased by 2.4% reaching 8673.4 mln. manats.
Generally during the quarter all money aggregates increased.

Table 3. Volume of money aggregates (mln. manats)

<table>
<thead>
<tr>
<th></th>
<th>01.01</th>
<th>01.02</th>
<th>01.03</th>
<th>01.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>M0</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
<td>4.10</td>
</tr>
<tr>
<td>M1</td>
<td>174.8</td>
<td>972.8</td>
<td>083.9</td>
<td>312.1</td>
</tr>
<tr>
<td>M2</td>
<td>239.8</td>
<td>857.2</td>
<td>982.5</td>
<td>190.7</td>
</tr>
<tr>
<td>M3</td>
<td>169.2</td>
<td>837.7</td>
<td>853.1</td>
<td>182.6</td>
</tr>
</tbody>
</table>

Continuing of soft monetary policy by Central Bank and restoration of money supply affected interest rates dynamics in the first quarter of 2010 too. In general, during the period nominal interest rates on financial instruments fell. An average interest rate on manat loans during the period fell 1.9% and in 01.04.10 was 13.99%. An average interest rate on loans to legal persons fell 2.5% and was 11.6%, on loans to physical persons fell 0.61% and was 19.93%.
Conclusions

Thus, Azerbaijan’s economy in I quarter of 2010 has managed to preserve its economic growth rate. Central Bank has been successful in achieving its monetary policy goals. The main target of the monetary policy – inflation, has been kept on one digit level in I quarter and has been mainly affected by developments on the foreign markets and inflation in the trading partner countries. Manat’s exchange rate against USD has remained stable under conditions of the balance of payments surplus, while Central Bank has increased its foreign currency reserved for implementation of sterilization measures on the currency exchange market. Huge surplus in the balance of payments is forecasted for the end of the year. During this period Central Bank continued its soft monetary policy and money supply in this situation increased adequately to the economic growth, while interest rates inclined downwards.

Central Bank will continue, in accordance with the country’s sustainable economic development, priorities to maintain manat’s exchange rate stability and low inflation as well as preserve stability and sustainability of the financial sector, support economic growth and employment for the rest of the current year.