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Introduction

Central Bank of the Republic of Azerbaijan has pursued its policy in the environment of sluggish and non-equal recovery of the global economy, high volatility on international financial – foreign exchange markets, favorable climate on the world oil market, moderate and stable growth dynamics of the country economy in H1 of 2010. Within the period world prices of Azerbaijani export products followed an upward trend, access of domestic banks to international money markets was relatively improved. Domestic economic growth sourced from the anti-crisis measures taken in the course of 2009 along with positive effect of the external environment.

According to the Statement of the Central Bank on Key Directions of Monetary Policy for 2010 it pursued the policy oriented at maintaining optimum inflation level, defending exchange rate of manat and stability of the banking – financial sector, at the same time, satisfying demand for money of the economy. Notwithstanding improvement of the global and internal macroeconomic environment the Central Bank is permanently focused on neutralization of potential risks in preventive mode.

I. Global economic processes and national economy

1.1 World economy trends

As was expected, recovery trends were observed in the world economy in H1 of the current year. According to initial estimations of the International Monetary Fund (IMF) global economic growth made 5%.
Economic activity recovery within H1 was due to growth within the first four months. Thus, despite high economic growth within the first 4 months, observed was recession of the global economic activity in May and June. This recession in global economic activity is primarily due to the processes taking place in the countries of South-Eastern Asia and Latin America. Decrease in foreign demand resulted in decrease of economic growth rate in these countries. The current situation in the USA is still vulnerable with the likelihood of deterioration of business confidence expectations and the budget shortfall in 2010 to exceed 10% of GDP. While business confidence index is increasing in Europe and Japan as compared with the previous months, it decreased in the USA and South-Eastern Asian countries that are driving forces of the global recovery in June–July. Despite the debt crisis in Greece, persistence of growth in Eurozone was provided through expanding German economy. Increase of demand for Japanese products on international markets triggered economic growth in this country.

Source: WTO, Market Economics and IMF

Economic recovery in different countries is diversely reflected in employment indicators. Thus, according to the International Labor Organisation, despite unemployment decrease in 82 countries in Q2 of the current year it increased in 29 countries as compared with the
previous quarter. For instance, employment went up in Eurozone and Japan, but decreased in the USA. Non-reflection of the recovery on labour market in most countries is put down to economic growth through labour productivity.

Uncertainty of economic growth perspectives displays itself in the dynamics of fund indices. Thus, growth in Q1 was followed by decrease of fund indices in Q2 which resulted in decrease of Dow Jones by 6.4%, Nasdaq by 6.6%, FTSE Eurofirst 300 by 11.4%.

Volatility was observed on the global commodity markets along with economic activity indicators and fund indices within the reporting period. Commodity Price Index calculated by IMF on 48 commodities decreased by 2.3%, including decrease of food price index by 2.9% as compared with the year launch. Financial shocks occurred in May and early in June had a downward effect on prices of most commodities. While certain price rise is observed in agricultural raw materials, metals and majority of foodstuffs fell in price.
Low prices on commodity markets displayed themselves in prices for energy carriers as well. Thus, oil became 1.3% cheaper compared to the beginning of the current year. At the end of the first half of the year primary reasons for decline in oil prices were put down to increase of risks in the financial sector, demand stagnation in Europe, price hike of the US dollar against leading currencies and statements of OPEC countries on increase of daily oil production.

Source: US Energy Information Administration
Despite this, the US Department of Energy forecasts oil price to be USD 79 by the end of the current year and USD 82 – 83 for the following year.

Given the processes in H1 International Monetary Fund has changed its forecast regarding the world economy for the year of 2010 for the better.

Table 1. IMF forecasts on the world economy

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010 (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic growth, in %</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World</td>
<td>3.0</td>
<td>-0.6</td>
<td>4.6↑</td>
</tr>
<tr>
<td>Developed countries</td>
<td>0.5</td>
<td>-3.2</td>
<td>2.6↑</td>
</tr>
<tr>
<td>USA</td>
<td>0.4</td>
<td>-2.4</td>
<td>3.3↑</td>
</tr>
<tr>
<td>Eurozone</td>
<td>0.6</td>
<td>-4.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Developing countries</td>
<td>6.1</td>
<td>2.5</td>
<td>6.8↑</td>
</tr>
<tr>
<td>China</td>
<td>9.6</td>
<td>9.1</td>
<td>10.5↑</td>
</tr>
<tr>
<td>CIS</td>
<td>5.5</td>
<td>-6.6</td>
<td>4.3↑</td>
</tr>
<tr>
<td><strong>Export, in %</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World</td>
<td>2.8</td>
<td>-11.3</td>
<td>9.0↑</td>
</tr>
<tr>
<td>Developed countries</td>
<td>1.8</td>
<td>-12.6</td>
<td>8.2↑</td>
</tr>
<tr>
<td>Developing countries</td>
<td>4.5</td>
<td>-8.5</td>
<td>10.5↑</td>
</tr>
<tr>
<td><strong>Consumer prices, i in %</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Developed countries</td>
<td>3.4</td>
<td>0.1</td>
<td>1.4↓</td>
</tr>
<tr>
<td>Developing countries</td>
<td>9.3</td>
<td>5.2</td>
<td>6.3↑</td>
</tr>
<tr>
<td>Oil, 1 barrel</td>
<td>$97</td>
<td>$62</td>
<td>$75</td>
</tr>
</tbody>
</table>

IMF taking into account challenges in financial sector has not graded up its expectations regarding economic growth in Eurozone. The recovery trends here depend on regulatory measures directed at protection of financial stability and
restoration of confidence in the banking sector. Budget consolidations provided in most European countries are expected to decrease economic growth in short run.

Intensive economic recovery in Asian countries in H1 of 2010 is expected to endure in H2 as well.

Global economic growth is expected to be 4.6% which is higher than the average indicator of the last 30 years. Thus, average economic growth on 1980 – 2009 constituted 3.2%, in pre-crisis periods 4%, in the first year of post-crisis period 3.4%. According to analyses, despite the existing global crisis was the deepest one of the last periods, restoration as compared with other crises was fast. However, the Fund issues thoughts on annual economic growth connection with the achievements of H1 and it is non-exceptional that by the yearend growth rate will recess.

Uncertainty of economic recovery trends displays itself in inflation expectations as well. Thus, expectations were reduced in developed countries and increased in developing countries.

Thus, overall upward growth rate prevailed in the global economy within the period, but there occurred uncertainties within the last months which had affected various segments of financial markets. While economic growth prevailed expectations in Q1 of H1, it lagged behind expectations in Q2.

1.2. Macroeconomic processes in Azerbaijan

During the period economic activity in the country was affected by measures taken by the Government, on the one hand, on support for aggregate demand, on the other hand, on creation of favorable environment to increase aggregate supply. Improvement of international environment and restoration of external financing sources additionally impulsed economic growth within the period.
1.2.1. External sector

Observed were improvement trends in foreign position of the country within the reporting period (January – May 2010).

According to the State Statistics Committee, foreign trade turnover in January – May 2010 constituted USD 10,6 bln, export share being USD 8,2 bln and import - USD 2,4.

![Chart 5. External trade, mln.$](image)

**Source:** State Statistics Committee

As compared with the same period of the previous year, import increased by 6%, export by 78%, foreign trade balance profit 2,6 times as much. Crucial role in growth of export volume belongs to 49% increase of world market price for oil (average price since the year launch USD 78) as compared with the similar period of the previous year (USD 52). Currently, (January – May) the share of export and import in GDP is respectively 40% and 12%.

Raw oil, white sugar, tea and vegetable oils could serve as examples of products with rapidly growing export share.
Source: State Statistics Committee

Raw sugar and surfactants prevail in import.

Source: State Statistics Committee

Proficic in foreign trade balance amounted to USD 5,8 bln within the reporting period.
Prices for Azerbaijani export products grew faster than for its imported products in the current year. Thus, trade conditions index increased by 5.4% within the reporting period.

This displays increase in opportunities to import more commodities and services through less export within the reporting period.

Within the reporting period wire transfers and foreign borrowings dynamics had a rising effect on currency inflows to the country.

According to preliminary assessments, the volume of inflown wire transfers in H1 of the current year increased by 18% as compared with the similar period of the previous year.
The balance of payments surplus in H1 secured growth of strategic foreign exchange reserves of the country. As of the end of H1 of 2010 strategic foreign exchange reserves of the country constituted USD 23,8 bln which is sufficient for 35 month-goods-services-import.
Foreign exchange reserves of the Central Bank exceeded USD 5.4 bln as of 01.07.2010 having increased by 6% within 6 months of the current year sufficient to finance 8 month-goods-services-import.

1.2.2. Aggregate demand

All components of aggregate demand, including final consumption expenditures, investments and external demand had a rising effect on economic growth within 6 months of the current year.

1.2.2.1 Final consumption expenditures. Final consumption expenditures were one of the key factors of economic growth within 6 months of 2010.

Households consumption. Nominal money income of the population having increased by 9.7% approached AZN 1,290 per capita level or on average AZN 215 per month within the past half year.

**Chart 11: Distribution of population income, bln manats**

<table>
<thead>
<tr>
<th>Year</th>
<th>Consumption</th>
<th>Taxes, social insurance and etc.</th>
<th>Saving and capital growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>8.1</td>
<td>0.2 (70.3%)</td>
<td>2.0 (24.6%)</td>
</tr>
<tr>
<td>2006</td>
<td>10.2</td>
<td>2.0 (19.3%)</td>
<td>1.2 (11.8%)</td>
</tr>
<tr>
<td>2007</td>
<td>14.3</td>
<td>3.5 (24.4%)</td>
<td>1.5 (10.1%)</td>
</tr>
<tr>
<td>2008</td>
<td>20.7</td>
<td>4.9 (23.7%)</td>
<td>2.1 (10.2%)</td>
</tr>
<tr>
<td>2009</td>
<td>22.4</td>
<td>4.8 (21.6%)</td>
<td>2.4 (10.6%)</td>
</tr>
<tr>
<td>2010-M6</td>
<td>11.5</td>
<td>2.1 (18.6%)</td>
<td>1.1 (9.7%)</td>
</tr>
</tbody>
</table>

Source: State Statistics Committee

The population having directed about 70% of income to consumption spent it on purchase of goods and services. Final consumption expenditures of the population
having increased by more than 13% in nominal expression equaled to AZN 8 bln or 41% of GDP as compared with the similar period of the previous year. Average monthly salary throughout the country having increased by 5% made AZN 315 that contributed to maintenance of high share of final consumption in GDP.

Chart 12: Change of monthly average salary and final consumption, as compared with the similar period of previous year, in %

Source: State Statistics Committee

Salary income of hired labor within the period equaled to 22% of total income of the population.

Along with increase of the population income, increase of credit exposures within the period had a rising effect on the demand. As of 01.07.2010 credit portfolio constituted AZN 8840.7 mln, of which AZN 2507.8 mln. falls into the share of households. Since the beginning of the year credit exposures have increased by 5,2% and consumer loans by 7,7%.
Demand enduring its growth displays itself in increase of retail trade turnover and paid services to the population. In H1 retail trade turnover increased by 9.7%, including 11% retail trade turnover on non-food products as compared with the similar period of the previous year. Paid services to population increased by 11.1% within the period.

Government and public organisations. Government’s consumer expenditures have been primarily shaped through spendings on commodity and services from the state
budget. In January – May of the current year salaries, pensions and allowances of the population made up 33.8% of the budget expenditures that 2.9 basis points exceed the previous year level.

1.2.2.2 Investment expenditures. Investment to the economy in January – June of the current year having increased by 10.9% made up AZN 3.8 bln as compared with the same period of the previous year.

![Chart 15: Investments, mln manat](chart)

Source: Stat Statistics Committee

67.6% of investments channelled into fixed assets fell into the share of non-oil sector and by 4.7% exceeded the previous year level. Of non-oil sectors, growth rate of investments to construction, agriculture, trade and processing industries was particularly high.

16
Bank loans shared a crucial role in promotion of non-oil sector along with public investments. Thus, according to State Statistics Committee, investment bank loans increased by 19.8% as compared with the similar period of the previous year.

1.2.2.3. External demand:¹. Within the reporting period 1.3 basis points of real economic growth rate were affected by net growing exports.

1.2.3. Aggregate supply

Within H1 of the current year nominal GDP increased by 3.7%. Value added through comparative prices within the period having increased by AZN 561.4 mln made up AZN 19.7 bln. Nominal economic growth constituted 2.4% in oil-gas, 4.7% in non-oil sector within the reporting period.

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¹ Initial data on half year
67.5% of created additional value fell into the share of production, 32.5% - services.

* Tradable sectors*². GDP growth primarily sourced from activity in the tradable sector. Thus, 60.6% of GDP was the share of tradable sectors that contributed 2.7 basis points to the overall growth.

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² Tradable sector incorporates agriculture and industry.
Growth in industry triggered growth in the tradable sector. Oil-gas industry was the key player in industrial growth. Crude oil production increased by 2.1%, natural gas production by 9.9% as compared with the similar period within the reporting period.

Source: State Statistics Committee

*Non-tradable sectors*³. Growth was observed in all areas of non-trade sector within January – June of the current year, of which the highest growth rate was noted in services of non-tradable sectors (transportation, communication, trade, hotel, social services). This sector especially contributed to GDP growth within the reporting period.

³ Non-tradable sector incorporates construction, transport, communication, public catering, hotel services etc.
Source: State Statistics Committee

Thus, of total GDP 26% goes to the non-tradable, 79% to the service sector.

**Box 1. Indicators of economic cycles.** The Central Bank has reviewed correlation between total non-oil output deficit and sectoral cycle. To note, economic cycle characterizes deviation of non-oil economy from long-term equilibrium. In order to define scope of deviation, sectoral cycles of non-oil economy were measured.

Correlation of sectoral cycles with non-oil cycle (total output deficit) enables to answer questions on the status of economy. For instance, in the table below evaluated is correlation between total output deficit and sectoral cycles and identified are warning economic sectors.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Growth rate</th>
<th>Share of non-oil in GDP (2003-2009), %</th>
<th>Current correlation of sectoral cycles with non-oil total output deficit</th>
<th>Period</th>
<th>Periodic correlation with non-oil total output deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service</td>
<td>3</td>
<td>22.8</td>
<td>0.76</td>
<td>3 months before</td>
<td>0.20</td>
</tr>
<tr>
<td>Construction</td>
<td>6.2</td>
<td>18.7</td>
<td>0.68</td>
<td>1 month before</td>
<td>0.20</td>
</tr>
<tr>
<td>Trade</td>
<td>4.8</td>
<td>13.3</td>
<td>0.45</td>
<td>1 month before</td>
<td>0.16</td>
</tr>
<tr>
<td>Transport</td>
<td>3.1</td>
<td>12.7</td>
<td>0.30</td>
<td></td>
<td>0.12</td>
</tr>
</tbody>
</table>

According to the results, correlation ratio of service sector is considered to be the highest in the current period. Thus, service sector having early warning effect enables to issue opinions on the status of non-oil sector three months before.
1.2.4. Macroeconomic equilibrium
Adequate economic policy pursued by the Government and the Central Bank secured macroeconomic equilibrium in the country within the period. Macroeconomic equilibrium indicators were affected by inflation in partner countries and exchange rate changes along with internal processes.

1.2.4.1. Consumer Price Index: In June of the current year inflation made 2,1% compared to December of the previous year, and 6,1% compared to the similar period of the previous year. Seasonal deflation was observed in the last two months of the half year.

Source: CBA calculations on the basis of SSC data

Average annual inflation made 4,9%, 2,6 basis points of which is due to price rise of food products.
1.4 basis point price rise of non-food products, 0.9 basis point price rise of services had a rising effect on average annual inflation.

Econometric calculations made at the CBA identified that 43.3% of average annual inflation observed within H1 was formed under the influence of foreign factors, 27.4% - nominal effective exchange rate, 29.0% - M1 money supply, 0.3% - seasonal factors.
So

In similar month of the previous year. Average annual inflation within H1 of 2010 made 2.4%.

Source: CBA calculations on the basis of SSC data

In June base inflation was 0.8% compared to the year launch, 3.4% compared to the

1.2.4.2. Industrial production price index (IPPI): Within H1 of 2010 average annual
industrial production price index increased by 56.6%. High level of average annual
indicators on IPPI change is primarily due to significant increase of oil price on the
world markets compared to the similar period of the previous year.

Source: State Statistics Committee
Non-oil IPPI of H1 of 2010 on annual average increased by 1%. In June non-oil IPPI increased by 0.9% compared to the beginning of the year.

Industrial production price index changed with various rates in separate sectors of industry. For instance, average annual increase of production prices was 23.3% on metallurgy, 9.1% on chemical industry.
1.2.4.3. **Agricultural production price index (APPI):** APPI increased by 1,5% compared to the same period of the previous year within the reporting period. In June APPI increased by 3,3% compared to the year launch.

Within the reporting period price hike of plant-growing products was 3,5%, livestock products had 2,5% price fall compared to the similar period of the previous year.
1.2.4.4. **Inflation forecast.** According to the CBA forecast, annual average inflation is expected to be one-digit as of the yearend of 2010. This forecast is based upon analysis of the processes occurred in H1 of 2010 as well as expected global and domestic environment.

*CBA builds several econometric models in a number of specifications for inflation forecast. Forecasts issued on the basis of econometric models are incorporated in one chart and it reflects potential growth dynamics of possible scenarios by the yearend. Stripes in the chart changing from dark to light the most probable scenario is replaced with the least probable one.*

**Source:** CBA calculations on the basis of SSC data

In the event of inflation processes activization, the Central Bank will take necessary anti-inflation measures within its authorities.

1.2.4.5. **Employment.** Employment level in the country is still high. As of July 1 of the current year the number of economically active population was 4337.4 thousand, of them 4078.1 thousand fall into the share of the population engaged in diverse areas of the economy and social sector. Within the past half year the number of employed population increased by 0,2% by the economy.
The number of persons with official unemployment status issued by employment agencies throughout the country within January – June of the current year was 40 thousand persons. Average allowance for unemployment within the period was AZN 153.

II. Monetary and exchange rate policies

According to key directions of monetary policy declared by 2010 within H1 of the current year, the Central Bank targeted its performance at maintaining acceptable level of inflation, protection of exchange rate stability, more enhancement of stability of banking – financial sector, coverage demand for money of the economy and achieved its targets. Thus, level of inflation was within the target, exchange rate of manat was stable, stability of the financial sector was protected, money supply kept pace with economic growth.
2.1. Foreign exchange market and exchange rate of manat

Within H1 of the current year the Central Bank provided its exchange rate policy in the environment of supply channels expansion on the currency market. While the Central Bank provided sale oriented interventions within H1 of the previous year, it sterilized currency amounting to USD 598.5 mln. within H1 of the current year.

Source: Central Bank of Azerbaijan

Decrease in demand for foreign currency on the currency market compared to the similar period of the previous year, is tracked in the volume of cash foreign currency brought in by banks and cash currency sold to the population. Thus, within the period the volume of net cash foreign currency brought in by banks and net cash exchange operations lessened respectively by 18% and 21.3% compared to H1 of 2009.
In January – June of 2010 exchange rate of manat to USD depreciated only by 0.04%.

Stability of manat within half year created favorable condition for stopping inflation processes, foreign lending and dollarization and for overall support for improvement of social welfare of the population.

Within the half year, while nominal exchange rate of manat depreciated against currencies of some partnering countries, it hardened against currencies of others. Dynamics of bilateral exchange rate of manat caused changes in real bilateral exchange rates. In January – June manat depreciated both from nominal and real standpoint against currencies of some countries (Ukraine, Uzbekistan).
Table 2. In January – June of 2010 bilateral nominal and real exchange rates of manat against currencies of partnering countries, in %

<table>
<thead>
<tr>
<th></th>
<th>Against December of 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nominal bilateral exchange rate index*</td>
</tr>
<tr>
<td>USA</td>
<td>99.9</td>
</tr>
<tr>
<td>Eurozone</td>
<td>119.4</td>
</tr>
<tr>
<td>Great Britain</td>
<td>110.1</td>
</tr>
<tr>
<td>Turkey</td>
<td>104.5</td>
</tr>
<tr>
<td>Russia</td>
<td>104.0</td>
</tr>
<tr>
<td>Ukraine</td>
<td>99.1</td>
</tr>
<tr>
<td>Georgia</td>
<td>110.2</td>
</tr>
<tr>
<td>Iran</td>
<td>101.0</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>98.8</td>
</tr>
<tr>
<td>Japan</td>
<td>101.4</td>
</tr>
<tr>
<td>Israel</td>
<td>101.6</td>
</tr>
<tr>
<td>China</td>
<td>99.8</td>
</tr>
<tr>
<td>Belorussia</td>
<td>106.0</td>
</tr>
</tbody>
</table>

*average monthly change of exchange rates of manat against currencies of partnering countries.

Within the reporting period nominal effective exchange rate on non-oil sector (on total trade turnover) went up by 5.9% which had a contractionary effect on inflation. Inflation in partnering countries prevailed over inflation in Azerbaijan and had 0.8 basis point decending effect on real effective exchange rate of manat. Within the period real effective exchange rate increased by 5.0%.

Source: Central Bank of Azerbaijan
As compared with the similar period of the previous year nominal and real effective exchange rates grew respectively by 3.8% and 4.9%.

Source: Central Bank of Azerbaijan

REER primarily has strengthened mainly with regard to distant countries (USA, Eurozone, Great Britain, Japan, Israel, China) (13.4%). REER strengthening on near foreign countries with most non-oil export (Turkey, Russia, Georgia, Iran, Ukraine, Kazakhstan, Belorussia) was about 1.2%.

Thus, in January – June of the current year supply channels on the foreign exchange markets of the country expanded, bilateral stability of exchange rate of manat protected.

### 2.2. Monetary policy tools

No significant change in monetary policy tools observed amid existing trends in economic cycle.

In order to support business activity and economic growth, the Central Bank did not change parameters of interest rate corridor, refinancing rate was maintained at the level of 2%, corridor floor – 1%, corridor ceiling – 7% within the reporting period.
Required reserve norms didn’t change and were maintained at 0,5% level within the period. Average term of required reserve norms on deposits both in manat and foreign currency was one month within the period which created favorable condition for banks to regulate liquidity in an optimum way.

**Table 3. Liquidity balance**

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2010</th>
<th>July 1, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tools of liquidity injection*</td>
<td>1483.5</td>
<td>1622</td>
</tr>
<tr>
<td>Tools of liquidity absorption**</td>
<td>29.5</td>
<td>48.1</td>
</tr>
<tr>
<td>Liquidity balance</td>
<td>1454</td>
<td>1574.8</td>
</tr>
</tbody>
</table>
During the period the Central Bank kept its liquidity window open, balance on operations\(^4\) moved from AZN 1454 mln at the year launch to AZN 1574.8 mln. as of the end of Q2.

Within H1 of 2010 the Central Bank held 25 auctions on placement of notes. Of state registered notes amounting to AZN 132 mln, AZN 111 mln was taken to auctions, the outstanding part was employed as frame tools of the Central Bank. Notes amounting to AZN 108,6 mln were placed in auctions and off-auctions within the period. Volume of bank orders at auctions made up AZN 622,57 mln. Weighted average yield on notes since the year launch has been 1%.

![Chart 37: Volume of CBA notes in circulation, mln.$](image-url)

**Source:** Central Bank of Azerbaijan

Volume of notes in circulation having increased by AZN 18 mln or 3,2 times as much compared to the year launch made AZN 26 mln. Within H1 of 2010 volume of operations on frame tools constituted AZN 343,05 mln.

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\(^4\) This indicator stands for difference between the balance of liquidity granting tools of the CBA and balance of liquidity attraction operations.
2.3. Money supply

Within H1 of the current year money supply kept pace with the demand of economy. Monetary base having increased by 5.3% against the year launch made AZN 5139.2 mln by the end of H1.

Source: Central Bank of Azerbaijan

No sharp volatility observed in dynamics of monetary base within the period. This is seen from standard deviation of the monetary base indicator on the past half year. 5

Source: Central Bank of Azerbaijan

5 Standard deviation characterizes deviation of any indicator on the period from average level.
Calculations show that, as of the end of H1 seasonally adjusted monetary base increased by 14 compared to the year launch and by 32 compared to the similar period of the previous year.

![Chart 40: Effect of seasonal factors on monetary base](chart)

Source: Central Bank of Azerbaijan

**Box 3. Seasonal adjustment** – is provided through removal of seasonal and cyclic factors from time rows in order to obtain clearer dynamics of indicators and smoother economic trends. Examples for seasonal factors are price hike of oil in September due to preparation for winter, landslide of prices for agricultural products in summer time that are periodic changes.

Growth of monetary base in manat was primarily achieved through sterilization operations of the Central Bank and liquidity injections.
Money multiplier showing the ability of the banking sector to generate money had no significant change within the reporting period and as of the end of June made 1.3. Upward trend of money multiplier within the last months is due to relative increase of banks credit activity.
Within the reporting period broad money supply in manat (M2) having increased by 7.5% constituted AZN 6629.4 mln by the end of H1, M3 aggregate having increased by 7.2% made AZN 9082.5 mln.

Growth of broad money supply (M3) resulted from increase both in cash in circulation and non-cash money supply within the period.
Persistent growth of savings and deposits within the reporting period is a manifestation of the population confidence in the banking sector. This growth majored from growth rate of deposits of individuals.

![Chart 45: Growth rate of deposits of individuals, %](chart)

Source: Central Bank of Azerbaijan

Thus, deposits of individuals having increased by 9.8% against the year launch made up AZN 2,562.8 mln as of 1 July 2010.

Table 4. Money aggregates, mln. manat

<table>
<thead>
<tr>
<th></th>
<th>01.01.10</th>
<th>01.04.10</th>
<th>01.07.10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>M0</strong> (Cash)</td>
<td>4,174.8</td>
<td>4,312.1</td>
<td>4,587.3</td>
</tr>
<tr>
<td><strong>M1</strong> (Cash, demand deposits and savings)</td>
<td>5,239.8</td>
<td>5,190.7</td>
<td>5,544.1</td>
</tr>
<tr>
<td><strong>M2</strong> (Cash, demand, term deposits and savings in manats)</td>
<td>6,169.2</td>
<td>6,182.6</td>
<td>6,629.4</td>
</tr>
<tr>
<td><strong>M3</strong> (Cash, term deposits and savings in foreign currency)</td>
<td>8,469.2</td>
<td>8,673.4</td>
<td>9,082.5</td>
</tr>
</tbody>
</table>

Source: Central Bank of Azerbaijan
Despite growth of money supply, slight strengthening of multilateral nominal exchange rate of manat Monetary Condition Index slightly toughened within 6 months.

Source: Central Bank of Azerbaijan

**Box 4. Monetary Condition Index (MCI)** – is an indicator characterizing weighted average change of money supply and multilateral exchange rate index. CBA referred to the methodology suggested by Ben Bernanke and Ilian Mihov to calculate MCI. Under the VAR model identified is that nominal exchange rate and M1 money supply more adequately reflect the situation in the country and that’s why may be employed as a monetary policy guide. The ratio of their impact on inflation is 60:40. Effect of nominal exchange rate on inflation is of statistic importance for 2-5 months, effect of money supply – 1-2 months. Researches revealed that monetary condition is primarily characterized with sharp or slight softening within the last years.

\[ M_{SI} = 60(N_c-N_b)+40(M1c-M1b)+100 \]

Here

\( N_c \) – NER in the current period
\( N_b \) – NER in base period
\( M1c \) – M1 money aggregate in the current period
\( M1b \) – M1 money aggregate in base period

Amidst persistence of soft monetary policy by the Central Bank restoration of money supply had a downward effect on interest rates in economy within H1 of 2010. Thus, interest rates on loans issued in manats decreased by 2,3 basis points within 6 months of
the current year. Policy of promotion of deposits interest rate decrease within the period endured. The Trustee Board of the Azerbaijan Deposits Insurance Fund through coordination with the Central Bank decreased the highest annual interest rate from 15% to 12% from 1 June 2010. This decision having an downward effect on interest rates of deposits caused decrease of interest rates on loans as well.

Thus, within the period volume of money supply kept pace with economic growth, sterilization and market operations of the Central Bank fully neutralised factors having a decending impact on money supply.

Conclusions

Azerbaijani economy preserved dynamics of economic growth in H1 of 2010, amid existing macroeconomic environment the Central Bank met its targets on monetary policy. Inflation targeted by monetary policy was on an one-digit level and was primarily affected by processes on foreign markets, inflation in trade partnering countries, and seasonal factors. The Central Bank endured its loose monetary policy, in such an environment money supply kept pace with economic growth rate.

Amidst proficit of the balance of payments exchange rate of manat against USD was stable, the Central Bank providing sterilization on foreign exchange markets increased its foreign exchange reserves more. Forecast is to have large volume proficit in the balance of payments as of the yearend.

The Central Bank being guided by sustainable economic growth priorities within the following period of the current year will continue its performance on securing exchange rate stability of manat and low level of inflation, as well as protecting stability and sustainability of the financial sector, supporting economic growth and employment.
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