

Summary on situation of the monetary policy on 2003

1. Execution of the monetary policy

The National Bank conducted the monetary policy related to the maintenance of the acceptable level of the inflation, the stability of the national currency rate, the currency reserves meeting international standards, strengthening of the national banking system during 2003 and improvement of money supply in the economy and achieved the targets. So, macroeconomic stability has been maintained, acceptable level of change of the inflation and exchange rate has been retained and money supply in the economy has been improved. Economic processes ongoing inside and outside of the country significantly influenced implementation of the duties of the monetary policy.

Macroeconomic situation. The annual growth of the **GDP** as a main macroeconomic constituted 11.2% against to 10.6% of the previous year.

6.1% industrial and 5.6% agricultural product growth rates were achieved.

The increase of the share of the private sector as an important term for the country with the market economy proceeded as well. 73.3% of the GDP, as well as 53.4% of industrial product, 99% of agricultural commodities, 88.7% of capital investment, 68.9% the communication services, 56.3% of freight forwarding were performed by the non-government sector during 2003.

The average annual **inflation rate** was 2.2% in 2003 which is 0.6% less than in 2002.

The *researches carried out according to the inflation model* prove that the price change of food products 92.6%, the price changes of non-food products 6.1% and the price change of services 1.3% influenced the alteration of prices.

The alteration of prices was related **67% to the monetary factors, 10% to the non-monetary factors and 23% to the seasonal factors.**

The amount of the capital **investment** as a main guarantee factor of the future economical development increased 71.2% constituting 17.8 trillion manats, since 14.3 trillion manats (2.9 billion USD) or 80.5% of this was constituted by foreign investment.

Observation of positive inclinations in the **foreign trade balance** of Azerbaijan during the recent years proceeded. The foreign trade turnover increased by 36.7% as compared to the same period of the previous year and reached 4479.3 million USD during the months of January – November of 2003. The export amounted to 2162.5 million USD and the import amounted to 2316.8 million USD. The appearance of the negative balance of approximately 154.3 million USD in the foreign trade was due to the import of the investment oriented products related to the realization of oil contracts.

The improvement of the **population's welfare** continued as well. The average salary reached 383.1 thousand manats (78 USD) and its real growth constituted 17.2%. In its turn the increase of population's income was the guarantee factor of the real sector's development, enhancing the purchasing capacity.

Inclinations in the world economy. Year 2003 was memorable due to the end of the diminishing processes begun in 1999 and replacement of this by the revival in the world economy. The World Bank estimates the growth rate of global economy to be 2%.

The main factor giving a push to the economic growth in the USA – a locomotive of the global renaissance was the elimination of uncertainty after the Iraq War, as well as the increase of the gross consumption and investment caused by the digression of taxes and the increase of government expenses. According to the summary on 2003 the financial deficit of the government of the USA constituted 6% of GDP; this is one of the highest figures among the developed countries.

Alongside with fiscal policy the monetary policy was softened as well. The FRS decreased the discount rate from 1.25% to 1% in order to augment economic activity in the

country by the end of June. Softening of fiscal and monetary policy was expressed in the increase of stock prices, in the decrease of percentage rates, as well as in the fall of USD rate.

The growth rate of GDP is expected to be 3.1% in 2003. Such a great growth of GDP is mainly due to the increase of the personal consumer expenses (especially on commodities of long-term utilisation) and increase of the volume of capital investment. Increase of pure export also gave a push to the increase of the GDP under the low USD rates condition against other currencies. Inflation rate was 2.1% and unemployment was 5.9% during the year in the USA. Alongside with fixed positive macroeconomic indicators, there are several problems existing in the USA economy. So despite the sharp devaluation of the USD, the deficit of the foreign trade balance still remains at high level.

As to the forecasts of the European Commission, the growth rate of the GDP will constitute 0.4% in Euro region in 2003. The inflation rate was about 2% while the unemployment was about 9%. Despite a slight increase of the production activity index in the beginning of the accounting period, it is annoying that the index is still below 50. A higher appreciation of the euro against USD is supposed to pose a threat for the export oriented economy of Europe.

For the stimulation of the economic growth in **England** the **England Bank** decreased the discount rate from 4% to 3.75% at the beginning of February. This is the lowest level during the last 48 years.

Government tries to prevent the deflation pressure by implementing structural reforms and re-constructing the banking system in **Japan**. Cooperative and financial patterns need tough reforms here. But taking into account the improvement of the foreign trade situation and increase of stocks recently, the economical growth rate is estimated to be at a significant level.

Processes in the economy of the leading countries have an effect on their financial and commodity markets.

Changes on the **exchange rate of USD** against the other leading currencies of the world were downtrend. The rate of USD decreased 16.8% against Euro, 9.7% against English pound sterling, 10.1% against Japanese yen, 10.6% against Swiss frank and 8.4% against Russian ruble.

The main **stock indexes** went up during the year. So the *Dow-Jones average* displaying the average price of 30 biggest industrial companies in the New-York Stock Exchange increased by 25%, the *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange increased by 24.5%. Rise of stock indexes was observed in Europe, as well. So the **FTSE Eurotop 100** calculated on the ground of stock prices of the 100 biggest companies of Europe increased by 11.2% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange increased by 37.1%.

The average price of Brent oil in the world market was 28.5 USD during 2003. In defiance of the expected, the price of oil in the world market declined downtrend after the beginning of military operations in Iraq. Despite that it went up again.

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 report period.

The National Bank improved refinance mechanism during the report period. Expansion of the employment of **new financial tools** 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. 10 **pawn-shop** credits amounted to 8.1 billion manats and 6 overnight credits amounted to 6.1 billion manats have been realized.

Discount rate for the centralized credits remained stable - 7% during 2003.

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 investigations show that after the issue of the decree on zero level obligatory reserve norms for long term credits, the growth rate of the long-term credits accelerated. So the long-term credits increased by 3.2 times whereas the short-term credits increased only by 11% during the past period.

In addition the practice allowing the purchase of the STSL using the obligatory reserves was stopped by May 1, 2003 according to the decree of the Management Staff of the National Bank dated February 27, 2003. This aimed to accelerate the development of the STSL market and to establish conditions for the settlement of the real market percentage rates. The issued decree justified itself and the volume of the useful STSL for the turnover significantly went up in the **second-hand** market.

Actions for the realization of the strategy to set **open market operations** as a main tool of the monetary policy proceeded during the nine months of 2003 as well. Participation of the National Bank in the market of the STSL (short-term state loans) aimed to regulate short-term liquidity in banking system. During the year the National Bank performed the **REPO** and the **reverse REPO** operations depending on the liquidity of the banking system.

Use of the open market operations for the **sterilisation** actualized under the terms of the high growth rate of the money supply. For this purpose operations were carried out with the long-term securities at the disposal of the National Bank, issued by the Ministry of Finance. During 2003 the securities amounted to 61.2 billion manats were sold to the banks and the REPO operations were carried out amounted to 51.4 billion manats. So the volume of the surplus liquidity attracted by the National Bank from the commercial banks by the use of open market operations amounted to 112.6 billion manats.

Exchange rate policy. The official exchange rate of manat against USD changed only 0.6% or 30 manats and by the end of the year constituted 4923 manats. For comparison it should be noted that, this figure constituted 210 manats (4.6%) in 2001 and 118 manats (2.5%) in 2002.

The nominal exchange rate of manat created a base for the further improvement of the international competitive ability of the country supporting the favorable dynamics of the real effective exchange rate index. Real effective exchange rate index decreased 17.8% during the 11 months of 2003 as compared to December 2001.

The National Bank influenced the exchange rate of manat by regulating the demand and supply. The National Bank's interference to the currency market constituted 3.5% of total turnover and was purchase oriented (122.4 million USD). Purchase oriented interference of the National Bank in the currency market improved money supply in the economy, prevented "Dutch syndrome" and revaluation of exchange rate of the national currency.

The purchase oriented interference also played an important part in the increase of the currency reserves. Scope of the currency reserves under the disposal of the National Bank increased 11.32% (680 million USD) constituting 757 million USD by the end of 2003 as compared to the beginning of the year. This is sufficient for 5-month import of commodities and services excluding the oil sector. 82.7 million USD was spent for the repay of the main and active debts on credits of IMF during 2003 and 65.4 million USD was transferred to the State Oil Fund related to the construction of the Baku-Tbilisi-Ceyhan oil pipeline. In 2003 the National Bank performed diversification of reserves taking into account observed tendencies in the world economy and financial market.

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.

Much was done to form a **perfect research base** - one of the most important elements of the monetary management mechanism. The use of equilibrium models of the inflation and money market in practical implementation of the monetary policy was continued. Consequently, econometric model of the exchange rate of manat has been established. This model is the first model (upon macroeconomic importance and specification) of the econometric analysis

established in Azerbaijan which allows complex investigations of the factors influencing the long-term dynamics of manat's rate. Simultaneously, the establishment of real sector's model started and construction of its gross expense component completed.

Researches on **inflation aiming**, analysis of percentage rates in the money market of the country, improvement matters of the non-oil sector, monetary aspects of the nonpayment problem in energetic sphere, factors influencing the cash turnover, monetary and macroeconomic aspects of non-official economic activity and assessment of the strategic and tactical targets on the ground of the economic models have been completed.

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 influence channels of the world economy to the national economy and macroeconomic aspects of integration of the republic economy to the global one.

Variety of researches has been carried out to create a modeled criterions and variants for the **choice of appropriate tools of the monetary regulation corresponding to the economical situation** according to the development declines of the financial markets. Moreover the base of information and forecasts processing of short- and long-term monetary indicators has been improved in **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 has been enriched. The Automated Bank Statistical Accounts Systems began functioning.

3. Monetary indicators and situation of the financial markets

Situation of the money supply in the economy. According to the main directions of the monetary policy, goals on the rate of inflation and exchange-value of manat against foreign convertible currencies were achieved due to chasing of amounts of the monetary program parameters.

Monetary base of manat increased by 23.7% constituting 2316 billion manats by January 1, 2004. Caused by the increase of the banking system's ability to create money the increase of the monetary base established a basis for the higher growth rate of the money supply.

The monetary multiplier - the ability of banking system to create money increased by 3.7%. Reconstruction of banking system, development of banking infrastructure, and especially improvement of payment system resulted in positive dynamics of this indicator.

The **broad monetary aggregate (M-2)** increased by 28% constituting 2592.2 billion manats. The real growth rate of the money supply was higher, because this increase appeared under the conditions of the low level inflation. So the real growth rate of the money supply constituted 25.2% in 2003.

As a result, adequately to the economic growth monetisation level increased more. So the share of the money supply in the GDP (upon the GDP of the non-oil sector) increased by 1% in 2003. Simultaneously, the speed of the money turnover decreased 9.7%, which is a positive factor proving the improvement of money supply in the economy.

The special share of the cash in the **structure of the money supply** decreased 3.7%. It is related to the increase of the non-cash amount by 54.4%, whereas the cash amount increased only by 22.3%.

Dollarisation level of the economy decreased during the accounting period. The share of deposits and savings in foreign currency in the total amount of savings decreased 2.3%. This establishes a favorable base for the strengthening of manat's share in economic turnover.

Deposit market. The scope of savings and deposits increased by 35.3%, and the deposits of legal persons increased by 20.4% in 2003.

The growth rate of **savings of natural persons** was higher. So the savings of natural persons increased by 64.2% constituting 1259.7 billion manats. The 41.5% of the savings attracted by banks are shared by the private banks. Short-term savings of population went up by 11% and long-term ones went up by 3.2 times. 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 population's trust towards manat. **The savings and deposits in foreign currency** increased by 31.7%, whereas the savings and deposits in manat increased by 54.4%. This factor establishes a favorable base to strengthen the role of manat in the economical turnover improving the structure of money supply.

The increase of the trust towards the national currency and banking system set a favorable conditions for the decrease of the percentage rates of deposits. So, the average percentage rates of deposits in manat decreased to 6.5% by the end of the year against 8.3% at the beginning of the year.

Credit investments. The scope of the **credit investments** increased by 28.4% constituting 3339.1 billion manats in 2003. Growth rate of credits constituted 33.7%, excluding the credits of "Aqrarkredit" organization.

The share of the credit investment in the GDP increased by 1%, which displays the increase of the share of the banking system in the economy and strengthening of the transmission effectiveness of the monetary policy.

By the end of the year, 89% of the credit investment was accrued by banks and 11% of this was accrued by other non-bank credit organizations. The share of private banks in the structure of the credits given by the banks rose up to 51.1% by the end of the year, while it was 45% at the beginning of the year.

Credits given to the private sector increased by 45.1% and share of the private sector in the credit investment increased by 76%.

Improvement of the money supply in the economy and decrease of the percentage rates of the deposits influenced the **percentage rates of credits**, as well. So, average percentage rates of credits in the national currency decreased to 14.9% by the end of the year while it was 14.9% at the beginning of the year.

State securities market. The size of the **State Loans** market decreased 25.0% or 35.0 billion manats and decreased to 105.0 billion manats by the end of the year from 140.0 billion manats of the beginning of the year.

Growth of the investors' interest towards the **State Loans** has been proceeded due to attempts of the National Bank to revive the market of the **State Loans**. Thus, the volume of the auction offered by the investors constituted 118.1% of the advertised **State Loans** during the accounting period whereas this indicator constituted only 92.8% in 2002.

Profitableness of the **State Loans** decreased about 2 times as demand significantly exceeded supply in 2003. During accounting period the measured average profitableness of the **State Loans** decreased from 12.57% at the beginning of the year to 6.97% by the end of the period.

In 2003, 81.36% of the loans market belonged to the banks and 18.64% of it belonged to the non-bank organisations.

The scope of purchase and sale operations performed on **State-Loans** in the **second-hand** market increased by 2 times (or 20.8 billion manats) and constituted 29.8 billion manats during the accounting period as compared to 2002. Average volume of the operations held in the **second-hand** market rose up to 1753.6 million manats from 310.6 million manats in 2003 as compared to 2002. This is a clear proof of the liquidity increase of the **State-Loans** market.

Currency market. The gross volume of the internal currency market increased by 1.05 billion USD or 42.5% constituting 3.5 billion USD in 2003 in comparison with the previous year.

Currency market operated in the self-regulating mode and there has not been observed any tension.

5% of the currency exchange operations is shared by the Baku Interbank Currency Stock (BISC), 25% by the Open Interbank Currency Stock (OISC), 58% by the Intrabank exchange operations (IBEO) in 2003.

Trade in the Stock Electronic System (TSES) - the new segment of the currency market has activated. Thus 12% of the exchange operations are shared by the TSES. New financial tools implemented by the National Bank has given an additional stimulant to the development of this segment. So, the National Bank has started foreign currency operations starting with the current year.