

Summary on situation of the monetary policy on the first six months of 2004

1. Execution of the monetary policy

The National Bank conducted the monetary policy related to the maintenance of the acceptable level of inflation, the stability of the national currency rate, the currency reserves meeting international standards, strengthening of the national banking system and improvement of money supply in the economy during the first six months of 2004 as well and mostly achieved the targets. So, macroeconomic stability has been maintained and money supply in the economy has been improved. The ongoing economic processes inside and outside of the country significantly influenced the implementation of duties of the monetary policy.

Macroeconomic situation. The annual growth of the **GDP** as a main macroeconomic constituted 10.6% against to 10.1% of the same period of the previous year.

5.5% industrial product, 4.6% agricultural product, 61.3% capital construction and 12% commodities turnover growth rates were achieved as compared to the previous year.

The increase of the share of the **private sector** as an important term for the country with the market economy proceeded as well. Over 73% of the GDP, as well as 55.4% of industrial product, 99% of agricultural commodities, 93.3% of capital investment, 57% of freight forwarding, 69.1% of communication services were performed by the non-government sector during the first six months of 2004.

So, the **inflation level** remained at the acceptable level from the macroeconomic point of view, acceleration of its growth rate begun at the last months of 2003 persisted during the accounting period as well. Inflation's growth rate constituted 2.4% in June, 2004 as compared to December of the previous year.

Untraditional increase of the inflation rate was related to the expansion of the gross expenses (consumption, investment and government expenses) in the economy, mainly caused by ongoing utilisation of the oil incomes for socio-economic development, by the increase of government's financial support to the development of the private and non-oil sectors and by the realization of the large-scale social programmes. But, alongside with the economic growth processes the activation of the determinant institutional factors of inflation has been observed.

Inflation model shows that, **42% of inflation was related to the monetary factors** during the first six months. *27% of the monetary factors were related to the money supply, 3% to the exchange rate, and 12% to the inersion of the past year.* The **monetary inflation** influenced by the monetary factors constituted 1% ($2.4 \cdot 0.42$) during the period. **Influence of the non-monetary factors to the inflation constituted 18%**, 6% of this was related to the GDP and 12% to the expectations. **Seasonal factors effected the alteration of the prices 40%**, *17% of this was related to the fore-summer period increase, 22% to the seasonal decrease* in the months of May-June.

The amount of the capital **investment** as a main guarantee factor of the future economical development increased 61.3% constituting 11.6 trillion manats, since 9.8 trillion manats (1.9 billion USD) or 84.5% of this was constituted by foreign investment.

Positive declines observed in the **foreign trade balance** of Azerbaijan during the recent years persisted. The foreign trade turnover increased by 36.6% as compared to the same period of the previous year and reached 2346.5 million USD during the months of January –May of 2004. The export amounted to 1130.3 million USD and the import amounted to 1216.2 million USD. The appearance of the negative balance of approximately 85.9 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 445.8 thousand mantas (90.6 USD) and its real growth constituted 19.4%. 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. Revival declines were continued in the world economy during the first six months of 2004.

The economic growth in the **USA** – the locomotive of the global renaissance became sufficiently stable. Volume of the industrial production went up by 0.7% towards the end of February as compared to the same period of the previous year. Index of the productive capacity utilization reached 76.6% in February; this is the maximum level since June 2002. Activity index in the services sector rose up to 65.8 in March against 60.8 of February. Despite that, the growth rate of the GDP over the year was less than expected (5%) during the first quarter, it was sufficiently high and constituted 4.4% in May, according to the defined information. In general, positive declines were observed in the economy, in spite of separate indicators movement in different directions. Offers for long-term commodities decreased 3.2% in April and 1.6% in May. But new apartments' sale went up by the record level in May. The deficit of the trade balance constituted 48.1 billion USD in April and 46 billion USD in May. Consumer Confidence Index rose up from 93.2 to 101.9 in June. This is the highest indicator since June 2002. The positive balance of the federal budget constituted 19.1 billion USD, whereas it was expected to be around 16 billion USD. Productive capacity usage rate constituted 77.2% against the expected 77.7%. Simultaneously, the number of appealers for the unemployment compensation increased and reached 349 thousand. Scope of the retail sale decreased 1.1%. It should be reminded that the retail sale increased by 0.6% in the previous month.

The committee of FRS upon the open market issued a decree to increase the discount rate by 0.25% since July 1. It should be noted that market participants forecasted the monetary policy to become tougher.

During the accounting period, revival of the economy was observed in **Euro region**, too. The economic growth of Euro region is due to the increase of the export, corporative investment and government expenses. 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. One of the main reasons of the consumer demand is the great unemployment rate (9%) in the Euro region. But the European Central Bank doesn't hesitate to lower the discount rate. It remains at the stable 2% level during the first six months of 2004.

The fact that business activity index has exceeded 50 during the last months, indicates the continuation of the economic progress in **England**. England Bank increased its discount rate from 4.25% to 4.5% in June. This had a significant effect on the increase of the percentage rates in the financial markets. Thus, a monthly LIBOR rate rose up to 1.37% by July 1, whereas it constituted 1.12% at the beginning of year.

In February of 2004 the positive balance of the foreign trade reached highest level during the last 5 years in **Japan**. Simultaneously consumer expenses of housekeeping increased by 4.2% in January and 2.5% in February. Retail sale went up by 4.5% in January and by 1.7% in February. Besides, the business activity index went up by 2.6% in January as compared to February. Economists associate the increase of the business activity index with the revival of the stock market, decrease of unemployment and increase of consumer optimism. The foreign trade balance increased by 35.5% in May as compared to the same period of the previous year. Deflation processes still continued in the country. Consumer Price Index decreased 0.3% in May as compared to the same period of the previous year. The retail sale decreased 1.2% in May as compared to April and 2.5% as compared to the same period of the previous year. Unemployment decreased to the lowest level (-4.6%) since 2000.

Changes on the **exchange rate** of USD against the other leading currencies of the world were in different directions. The rate of USD decreased 1.5% against English pound sterling and 0.7% against Russian ruble whereas it appreciated 3.9% against the euro, 1.9% against Swiss frank and 1.5% against Japanese yen.

The processes in the economy of the leading countries had effects on the **stock indexes** of these countries. Abrupt changes were not observed on the levels of main stock indexes during the period. So the *Dow-Jones average* displaying the average price of 30 biggest industrial

companies in the New-York Stock Exchange almost not changed, the *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange increased by 9.6%.

Abrupt hesitation of stock indexes was not 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 2.3% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange decreased 1.3%.

The average price of Brent **oil** in the world market constituted 33.4 USD during the first six months of 2004, which is 18% more than the same period of the previous year (28.3 USD).

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.

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. 10 **pawn-shop** credits amounted to 1 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 banks operating in the country to use the obligatory reserve norms on manat for daily clearing, using opportunities of the interbank payment system of AZIPS widely. New system is applied to the selected pilot banks by stages. The implementation of this measure is expected to influence positively the increase of trust towards the national currency, 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.

Actions for the realization of the strategy to set **open market operations** as a main tool of the monetary policy proceeded during the first six months of 2004 as well. Participation of the National Bank in the market of the STSL (short-term state loans) aimed to regulate short-term liquidity in the banking system. Simultaneously, the practice of using government securities from the portfolio of the National Bank at the open market has been proceeded. Thus, the long-term securities sold to the banks at the end of 2003 were directly purchased again at the beginning of 2004.

Exchange rate policy. The supply of foreign currency significantly exceeded the supply of manat as the world price of one barrel of oil had considerably exceeded the intended price at the state budget and the transfers to the state budget from the Oil Fund had increased during the first six months of 2004. As a result, the official exchange rate of manat against USD strengthened by 18 manats or 0.37% and by the end of the period constituted 4905 manats.

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 75.2 million USD and was purchase oriented. 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. But, unlimited sterilization interferences of the National Bank to the currency market is impossible and thus the determination of the optimal structure of utilization of oil dollars should be kept in the focus of attention.

The purchase oriented interference also played an important part in the **increase of the currency reserves**. The scope of the currency reserves under the disposal of the National Bank overstepped the limit of 800 million USD and reached 808.37 million USD. Growth of reserves constituted 6.77% as compared to the beginning of year (757.1 million USD). 35.36 million USD was spent for the repay of the main and active debts on credits of IMF during the first six months of 2004. Consequently relative growth constituted 86.0 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 economic research base** - one of the most important elements of the monetary management mechanism were proceeded.

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, socio-economic indicators of the separate regions, process of realization of the 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 ground of these analysis.

Simultaneously, the *scale of foreign investment and evaluation of its macroeconomic efficacy in Azerbaijan* has been studied. Thus, the dynamics of the direct foreign investment to the economy of Azerbaijan and the influencing factors were thoroughly analyzed. Proposals and recommendations on the principal directions to increase the macroeconomic efficacy of foreign investment were put forward on the base of these analysis.

Within the scope of analysis in the monetary sphere the *measures on 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. As a result, variety of new proposals on the improvement of the money turnover and on the decrease of the dollarisation level were put forward.

Simultaneously, *problems on the improvement of the correlation mechanism of the monetary and fiscal policies in Azerbaijan* were investigated. Thus, theoretic basis of the correlation of the monetary and fiscal policies were investigated, the development of 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 limelight. Use of correlation models of the inflation and money market, as well as econometric model of the exchange rate of manat was proceeded in the practical implementation of the monetary policy.

Simultaneously, establishment of the *econometric model of real sector* started in Azerbaijan. Problems of the existing statistical database were evaluated from the standpoint of qualitative construction of the model. Within the framework of construction of productive function in the real sector the initial evaluation of the implementation opportunities of the CES and Cobb–Douglas models. Processing of the information base of the GDP on economic activity fields was started, influencing factors of the productive processes on these fields were determined and grouped, methodological apparatus of evaluation of the multi-factor regression of economic growth was constructed. Construction of the productivity function of oil and non-oil sectors of the GDP was started.

Besides, works on construction of *econometric model of risk assesment in the banking system of Azerbaijan* were started. Experience of the developed countries on risk assesment models in the banking system were studied, collection and processing of the information on the factors potentially causing banking risks were started. Implementation opportunities of the “Value at risk” method in Azerbaijan reality were analyzed. This method is considered as the

most effective tool of risk assessment in the world practice. Construction works on mathematic models enabling maximum optimization of the assets and liabilities structure of the banking system were started.

Within the framework of the **monetary policy improvement**, the *world practice on averaging system of obligatory reserves and implementation perspectives of this experience in Azerbaijan* were analyzed. World practice on the averaging system of 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 base of the studied world practice the implementation opportunities of the averaging system of obligatory reserves 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 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 and especially on the price changes has been enriched. Simultaneously, works on automatic processing and round-up of the reports received from credit organizations, as well as on improvement of the payment balance forming were intensified.

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 38.8% as compared to the same period of the previous year, 19.2% as compared to the beginning of year and constituted 2760.8 billion manats by July 1, 2004.

The **broad monetary aggregate (M-2)** increased by 30% as compared to the same period of the previous year, 10.8% as compared to the beginning of year and constituted 2871.5 billion manats. The real growth rate of the money supply was higher, too. So the real growth rate of the money supply constituted 23.2%.

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 1.3% according to the summary of June 2004 as compared to the same period of 2004. Simultaneously, the speed of the money turnover decreased 13%, which is a positive factor proving the improvement of money supply in the economy.

Positive changes appeared in the **structure of the money supply** on manat. So the special share of the cash in the structure of the money supply decreased 6.1% as compared to the same period of the previous year. It is related to the increase of the non-cash amount by 63.3%, whereas the cash amount increased only by 19.6%.

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 2.4%. This established a favorable base for the strengthening of manat's part in economic turnover.

Deposit market. The scope of savings and deposits increased by 46.6% constituting 3688.6 billion manats, deposits of legal persons as well increased by 35.9% constituting 2109.3 billion manats.

The growth rate of **savings of natural persons** was relatively higher. So, the savings of natural persons went up by 63.9% constituting 1579.3 billion manats. 43% of the savings attracted by the banks were accrued by private banks. Short-term savings of population went up by 39.4% and long-term ones went up by 98.4%. 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. The savings and deposits in foreign currency increased by 42.2%, whereas the **savings and deposits in manat** increased by 63.3%. This factor establishes a favorable base to strengthen the part of manat in the economic turnover improving the structure of money supply.

The increase of the trust towards the national currency and banking system set favorable conditions for the decrease of the percentage rates of deposits on manat. So, the average percentage rates of deposits on manat constituted 6.75% in June, 2004 against 7.13% of the same period of the previous year.

Credit investments. The scope of the credit investments went up by 28.5% constituting 3748.6 billion manats in the first six months of 2004 as compared to the same period of the previous year.

Credit investment increased by 2.4 times to the industry, 43.8% to the construction and property, 29.3% to the agriculture, 35.4% to the transport and communication and 55.3% to the physical persons during the period.

Short-term credit investment increased by 24.1% and long-term ones increased by 41.8% as compared to the same period of the previous year. Part of the long-term credits in total credits reached 27.7%.

89.5% of the credit investment was accrued by banks and 10.5% 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 51 %.

Credits given to the private sector increased by 44.7% and the **share of the private sector in credit investment** rose up to 81%, whereas the credits for the state sector increased only by 12.2%.

The **credit investment on manat** increased by 34.4% and on foreign currency it increased by 25.8%. The share of the credit investment on foreign currency in the total credit investment decreased 1.5% as compared to the same period of the previous year.

Improvement of money supply in the economy, decrease of the percentage rates of the deposits and financial support of the government by the **National Fund on Ownership Assistance** influenced the dynamics of the **percentage rates of credits**, as well. So, average percentage rates of credits on the national currency constituted 14.34% in June which is 1.3% less than that of (15.64%) the same period of the previous year.

State securities market. During the accounting period 3 auctions were conducted by the Ministry of Finance on the placement of the **State Loans** (it should be added for comparison that, 7 auctions were carried out during the same period of the previous year). The gross size of the emission constituted 60 billion manats in these auctions and this is 220.0 billion manats (or 79%) less than that of the first six months of the previous year. As a result, the amount of the State Loans in the turnover decreased from 105 billion manats to 20 billion manats during the period.

In the auctions on the initial placement of the State Loans the demand of market participants constituted 180% of emission or 71.94 billion manats during the first quarter (this indicator constituted 111.5% at the first quarter of 2003) and 260% or 52.01 billion manats at the second quarter (this indicator constituted 77% at the second quarter of 2003). Significant limitation of the **State Loans'** amount issued by the Ministry of Finance resulted in the

downtrend of the profitability of the **State Loans**. Thus, by the end of the first six months of 2004 profitability of the **State Loans** decreased to around 4.29%.

The scope scaling down of the securities market naturally produces some problems for the retention of the agility of the money-and-credit policy from the standpoint of the maintenance of macroeconomic stability. Taking into consideration these problems, the National Bank takes steps to increase the sterilization opportunities of the money-and-credit policy together with the appropriate state structures.

Currency market. The gross volume of the internal currency market increased by 675.6 million USD or 30.9% constituting 2.86 billion USD during the first six months of 2004 as compared to the same period of the previous year.

The currency market operated in the self-regulating mode and there has not been observed any tension during the period.

7.1% of the currency exchange operations fell to the lot of the Baku Interbank Currency Stock (BISC), 20.1% of the Open Interbank Currency Stock (OISC), 61.1% of the Intra-bank exchange operations (IBEO) during the period.

Trade in the Stock Electronic System (TSES) - the new segment of the currency market became more activated and volume of the operations carried out through TSES significantly increased. 11.7% of the exchange operations was accrued by the TSES. New financial tools implemented by the National Bank has given an additional stimulus to the development of this segment. So, the National Bank conducted the finite currency operations during the past period of 2004 as well.

Thus, generally macroeconomic and monetary situation was auspicious and new qualitative declines were observed in the economic growth processes in the country during the first six months of 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.