

Summary on the situation of the monetary policy on 2005

1. Macroeconomic situation and global economic processes

The National Bank conducted monetary policy directed to the maintenance of the macroeconomic stability and one-figure inflation, support of socio-economic development of the country during 2005. Ongoing economic processes inside and outside of the country significantly influenced the implementation of duties of the monetary policy.

Macroeconomic situation. Economic growth rate has significantly accelerated in the country in 2005. The growth rate of the **GDP** as a main macroeconomic indicator constituted 26.4%. As a result of this dynamic growth physical volume of the GDP not only reached the level of 1990, but also exceeded it in 2005. The GDP per capita constituted 1509.7 USD. 33.5% industrial product, 7.5% agricultural product and 13.2% commodities turnover growth rates were achieved as compared to the previous year.

The increase of the share of **private sector** as an important term for the country with the market economy proceeded as well. 76% of the GDP, as well as 69.2% of industrial product, 99% of agricultural commodities, 84.6% of capital investment, 56.6% of freight forwarding, 75.8% of communication services were performed by the non-government sector during 2005.

The anti-inflationary measures taken by the National Bank alongside with government were intensified according to the Decree of the President of Azerbaijan Republic "About the strengthening of anti-inflationary measures in Azerbaijan Republic" dated May 31, 2005. As a result, inflation constituted 5.4% in 2005, against 10.4% of the previous year. Base inflation constituted 3.9%.

Inflation model shows that, 36.5% of the inflation was related to the **monetary factors**. Firm monetary policy played a significant part in the decrease of inflation, despite the weak influence of monetary factors on the inflation.

The amount of the capital **investment** as a main guarantee factor of the future economic development increased 12.7% constituting 5.4 million AZN, and 67.2% or 3.3 million AZN of this was constituted by foreign investment.

Positive declines observed in the **foreign trade balance** of Azerbaijan during the recent years persisted during this year, as well. The foreign trade turnover increased by 28.8% as compared to the same period of the previous year and reached 7940 million USD during the months of January – August. The export amounted to 4138.9 million USD and the import amounted to 3801.1 million USD.

The improvement of the **population's welfare** continued as well. So, average salary reached 117.9 AZN and its growth rate constituted 21.9%. In its turn the increase of population's income became the guarantee factor of the real sector's development, enhancing the purchasing capacity.

Inclinations in the world economy. Development declines persisted at the world economy during 2005.

Basically, positive declines were observed in the **USA** – the locomotive of the global renaissance, despite the opposite changes of separate indicators. According to the last estimations the GDP increased by 4.1% in USA in the third quarter, which was more than forecasted. This indicator constituted 1.1% against forecasted 2.8%, according to primary figures. Acceleration of the economic growth was mainly related to the increase of the consumer expenses. Retail sale amount increased by 0.2% in September after 1.9% decrease of August. Despite industrial production volume increased by 0.3% in May and 0.9% in June, its decrease by 1.3% was fixed in September. Volume of orders for long-term products went up by 1.3% in December. Despite that, leading indicators' index displayed the maximum value in June since December 2003; it had negative value during the following months. Unemployment rate constituted 4.9% in December of the current year.

The committee of the FRS on the open market increased the discount rate from 2.25% to 4.25% by changing it 8 times during the accounting period. It should be noted that market participants forecast discount rate to be increased further.

During the accounting period, revival of the economy was observed in **Euro region**, too. Inflation constituted 2.2% in Euro region in 2005. Industrial production increased by 2.8% in November as compared to the same period of the previous year and this was more than forecasted. But, unemployment rate still remained relatively high (8-9%) in Euro region. It constituted 9.3% in Germany in November of the current year. This was the highest level in the region.

The European Central Bank (ECB) changed the discount rate once and raised it to 2.25 from 2% in 2005.

In England the unemployment rate was somewhere less than it was in the Euro Union countries (4.6%). According to the precisely defined information the GDP increased by 1.1% during the third quarter, which exceeded (0.3%) the estimation of the analysts. The England Bank changed its discount rate once during the accounting period and knocked it down to 4.5% from 4.75%. But growing of the percentage rates continued in financial markets. Thus, a monthly LIBOR rate rose up to 4.4% in December, whereas it constituted only 2.6% in January.

Positive balance on principal items of the payment had been increasing despite the persistence of the deflation processes in **Japan**. Retail sale amount increased by 1.5% in August and 0.1% in September as compared to the same period of the previous year. Unemployment rate constituted 4.6% in November of the current year. The Central Bank of Japan didn't change its main percentage rate and kept it on stable level of 0.01%.

The processes in the economy of the leading countries had effects on the rates of currencies and stock indexes of these countries. **Exchange rate of USD** appreciated against the other leading currencies of the world during the accounting period. So, the rate of USD strengthened 14% against the euro, 14.4% against Swiss frank, 14.1% against Japanese Yen, 11.1% against English pound sterling and 3.9% against Russian ruble.

Despite the stability of the main stock indexes in the USA, they underwent some hesitations in Europe and Japan during the accounting period. So, the *Dow-Jones average* displaying the average price of 30 biggest industrial companies in the New-York Stock Exchange increased by 0.5%, the *NASDAQ index* calculated on the base of the stocks of the top 100 high technology companies increased by 3.1%. The *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange increased by 41.9%. The **FTSE Eurotop 100** calculated on the base of stock prices of the 100 biggest companies of Europe increased by 21.9% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange increased by 27.2%.

The **average price of Brent oil** in the world market constituted 55.4 USD in 2005, which was 34.1% more than (41.3 USD) that of 2004.

2. Monetary policy

Targets and implementation of monetary policy. *For the achievement of the intended one-figure inflation the National Bank used tools like open-market operations, credit auctions, percentage rates, as well as obligatory reserve norms in order to influence money supply.*

Use of **open market operations** for the sterilization purposes proceeded during 2005 as well. The National Bank continued to use **short-term bank-notes** to neutralize the surplus liquidity in the banking system. The amount of the bank-notes in the turnover increased by 58.1% during year and constituted 31.3 million AZN to the end of year. Average measured profitableness of the bank-notes went up to 11.7% in December from 4.36% in January. The National Bank actively used REPO operations to regulate short-term liquidity of the banking system.

The discount rate was changed thrice during the accounting period; firstly it was increased from 7% to 7.5%, then to 8% and then to 9% again. This had the aim to appreciate the cost of money by creating a definite signal effect and by this approach, to direct the spare cash from the consumption sphere with inflationary potential to the accumulation means.

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. The pawn-shop credits amounted to 3.1 million AZN and the overnight credits amounted to 3 million AZN have been realized during the period.

The **obligatory reserve norms** were at 10% rate during the accounting period. Total transition to the classic average principle of the obligatory reserves since June 1, established an auspicious conditions to manage the liquidity more promptly, to increase the monetary multiplier significantly and had a stimulating influence on the development of the inter-bank market.

Exchange rate. The supply of foreign currency significantly exceeded the supply of manat under the conditions of oil prices' being over 50 USD, abrupt increase of the foreign investment and extensive use of the oil incomes. Under these conditions, the National Bank conducted the softening policy of the resistance to the strengthening of manat's rate in order to intensify the struggle against the inflation, taking into consideration the guaranteed international competitiveness of the economy, especially non-oil sector by significant reserves. As a result, the official exchange rate of manat against USD strengthened by 6.3% in 2005.

The **nominal effective exchange rate** of manat against the currencies of the main trade partner countries on the gross trade strengthened by 14.5%, the import influenced rate 11.9%, and the export influenced rate strengthened by 13.6% during 2005.

The existing dynamics of the nominal exchange rate of manat resulted in the effective exchange indexes to start changing towards the required level by the internal and external stability. **The real effective exchange rate** of manat on the gross trade turnover increased by 15.3%, whereas the import influenced rate increased by 11.4% and the export influenced rate by 18.6% during 2005. **The real effective exchange rate** on the gross trade turnover of the **non-oil sector** increased by 12.2%, whereas the import influenced rate increased by 13.7% and the export influenced rate by 5.9% during 2005.

But, international competitive ability of the country for a long period is still advantageous. Thus, real effective exchange rate of manat upon non-oil sector cheapened by 4.5% in December 2005 as compared to December 2000. As a result, the strengthening during the current year won't have strong influence on the international competitiveness of non-oil export.

The National Bank influenced the exchange rate of the manat by correlation of demand and supply in the currency market. Despite the **National Bank's purchase oriented (118.8 million USD) interference** to the currency market, it decreased 25.1% as compared to the previous year (158.7 million USD). Decrease of the purchase oriented participation of the National Bank in the currency market as compared to the previous year, significantly limited the expansive increase of the money supply. It should be noted that, currency interferences were correlated and performed in rhythmic manner.

Scope of the currency reserves under the disposal of the National Bank increased by 9.7% as compared to the previous year (876.86 million USD) and constituted 961.7 million USD in 2005. 50.54 million USD was spent on the repay of the main and active debts on credits of IMF during the period. Consequently, **relative growth** constituted 135.4 million USD.

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

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

Establishment of the macroeconomic (financial forecasting) model covering four sectors was started within the scope of the researches on common economic problems. Methodological actions were taken to integrate analytic systems with a huge information base on real, monetary, fiscal and foreign sectors for this purpose. Information base (the National Accounts System) was created and the world practice was studied in this area. Meanwhile activities are being conducted to correlate and evaluate the mutual resource flows in the economic sectors, to create common macroscheme and to integrate local econometric models to this scheme, to compose model financial program for 2006-2009th years, to elaborate macroeconomic scenarios suitable to the target economic growth and the stability parameter for 2006-2009th years.

Research on the *implementation of the early caution system on financial crisis in Azerbaijan* has started. Principal boundaries of the subject have been determined and relevant main conceptions have been elucidated. As well, the essence of the financial crisis, its character, causative factors, types of crisis and the essence of the appropriate caution systems have been investigated, in order to prevent such problems. Relevant aspects of the subject to the Azerbaijan economy were investigated in the second stage.

A research was carried out on the *structural improvement of the monetary aggregates under the terms of the financial markets' development* within the framework of researches in the monetary sphere. The theoretical basis of the determination of the monetary aggregates' structure, items on broad monetary aggregate in the Magazine of Monetary and Financial Statistics (MMFS) of the IMF, experiences of leading countries and countries with transitional economy on the monetary aggregates, directions of the structural analysis and improvement of the monetary aggregates in Azerbaijan were covered in the research. The results were summarized and proposals were put forward in the end.

The research on the *selection criterions of the exchange rate regime* has started. Firstly, information database was collected in this sphere, a plan of research and classification of the exchange rate regimes have been worked out. The selection criterions of the exchange rate regimes and important conditions of the selection based on these criterions have been determined, experience of the developed and developing countries, as well as countries with transition economy have been studied and the existing situation on the exchange rate selection in Azerbaijan have been estimated. Results and proposals have been formed.

In addition, a research on *development perspectives of operational procedures of the monetary policy in Azerbaijan* was carried out. A conceptual essence of operative procedure of monetary policy was thoroughly analyzed and functions of operative target were shown. International experience, as well as experience of leading countries on operative procedures of monetary policy was revised. Characteristics of operative procedure of implemented monetary policy in Azerbaijan were revised and evaluated. Considerations on improvement directions of operative procedure of the monetary policy in Azerbaijan were put forward. The results were summarized and proposals were put forward in the end.

Use of inflation model, equilibrium model of money market, econometric model of exchange rate of manat, econometric model of real sector and econometric model on currency risks' assessment was proceeded in practical implementation of monetary policy.

Improvement of theoretical and methodological basis of the base inflation in Azerbaijan was investigated. Thus, the theoretical and methodological basis of the real inflation was investigated, the real inflation was estimated by using different methodics and comparison of the earned results was performed on the base of definite criterions. Practical proposals and recommendations were put forward as a result of the research.

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

credit organizations, as well as on the improvement of the payment balance forming were intensified.

3. Monetary indicators and financial markets

Situation of the money supply in economy. Under the conditions of economic growth acceleration, the growth of money supply relevant to demand for money persisted in 2005. The expansion of the broad monetary aggregate was mainly due to the intensification of the monetary multiplication process than the increase of the monetary base by the National Bank and this was the principal characteristic of the period. Within the framework of anti-inflation policy, minimization of the National Banks' interference to the currency market has limited emission channels. This forced banks to accelerate turnover of surplus amount in their correspondent accounts in order to satisfy the demand for manat.

Monetary base of manat increased by 7.5% and constituted 687.8 million AZN in 2005. **Broad monetary aggregate (M-2)** increased by 15.8% and constituted 791.8 million AZN.

Improvement of the indicators displaying the money creation ability of the banking system was observed. Thus, **monetary multiplier** (ratio of the broad monetary aggregate in manat over the monetary base in manat) increased by 7.5% in 2005. Rapid development of banking system in the country, especially implementation of the progressive payment systems, establishment of the interbank electron payment system on small and large payments and expansion of the plastic card turnover presented additional stimuli to the increase of the non-cash amount.

Deposit market. The scope of savings and deposits increased by 25.6% and reached 1288 million AZN in 2005 and the **deposits of legal persons** increased by 27.5% constituting 793.5 million AZN.

Growth of **savings of natural persons** also proceeded. So, the savings of the natural persons went up by 22.7% constituting 494.5 million AZN. 56.2% of savings attracted by the banks were accrued by private banks to the end of the accounting period.

Short-term savings of natural persons (deposits on foreign currency were also included) went up by 23.9% and long-term ones went up by 21.5%. It indicates the further increase of the population's trust towards the banks.

It should be noted that, savings of the **non-resident physical persons** also are growing up rapidly together with residents' ones. Thus, the savings of the non-resident physical persons went up by 40.4% to January 1, 2006 as compared to the same period of the previous year.

It should be noted that the analysis of the structure of savings against the currencies show the increase of the economic units' trust towards manat. Thus, **the savings and deposits in foreign currency** increased only by 17.6%, whereas in manat they increased by 85.3%. This factor establishes a favorable base for the strengthening of manat's part in the economic turnover improving the structure of money supply.

A slight increase of percentage rate of deposits was observed during 2005. So, the average percentage rate of deposits in manat rose up to 8.92% against 6.93% of the beginning of year and the average percentage rate of deposits in foreign currency went up to 10.19% from 9.43%.

Credit investments. The scope of credit investments went up by 45.6% constituting 1441 million AZN to the end of 2005.

Weight of the credit investment in the GDP (over the GDP of non-oil sector) increased by 3.9%.

Newly given credits' amounts increased by 33.4% during 2005 and constituted 2270.4 million AZN.

Credit investment increased by 26.3% to the industry, 77.3% to the construction and property, 73.2% to the agriculture and 44.2% to the physical persons.

Short-term credit investments increased by 30.3% and long-term ones increased by 82.8% as compared to the same period of the previous year. According to the summary on accounting year, ratio of the long-term credits over total credits went up to 36.6% against 29.2% of the previous year.

97.3% of credit investments were accrued by banks and 2.7% was accrued by non-bank credit organizations. The **weight of private banks** in the structure of the credits given by the banks approached 50%.

Credits given to the private sector increased by 46.5% and the **share of private sector in credit investment** rose up to 80.1, whereas credits to the state sector increased by 42.3%.

Strengthening of exchange rate of manat against free convertible currencies influenced the currency structure of credit investments as well. **Credit investments in manat** increased by 51.9% and in foreign currency 42.1% during 2005. As a result, weight of the credits given in foreign currency in the total credits reached 62.3% to the end of year, which was 6.6% less than it constituted in the previous year.

Decrease **on average nominal percentage rates** of credits were observed in 2005. The percentage rate of credits in manat constituted 15.14% to the end of 2005, this was 0.41% less than that of the beginning (15.55) of year. But, taking into consideration the inflation rate, the real percentage rate was decreased more, i.e. 5.8%. Average percentage rate of credits in foreign currency constituted 17.11% in December and this was 1.85% less than that of the beginning of the previous year.

Short-Term State Loans market. Operations in Short-Term State Loans market have been restored since the second quarter of 2005. During the accounting period 21 auctions were conducted by the Ministry of Finance on the placement of the Short-Term State Loans. The gross size of the emission constituted 97 million AZN in these auctions and volume of the replaced Short-Term State Loans constituted 53.1 million AZN. Thus, the amount of the Short-Term State Loans in the turnover constituted 27.9 million AZN as to the end of 2005. Measured average profitability constituted 10.53% in the first auction and it increased to 12.76% in the last auction.

Currency market. The gross volume of the currency market increased by 21.7% and reached 8.4 billion USD in 2005. 89.1% of currency exchange operations were performed by USD, 6.3% by the euro, 3.8% by Russian ruble and 0.8% by other currencies.

Thus, generally macroeconomic and monetary situation was auspicious and positive qualitative declines persisted in the economic growth processes in the country during 2005, as well.