

## *Summary on situation of the monetary policy on the first six months of 2005*

### *1. Execution of the monetary policy*

The National Bank conducted the monetary policy related to the maintenance of the acceptable level of the basic inflation as one of the main factors of the macroeconomic stability, and support of socio-economic development of the country during the first six months of 2005 as well and achieved the targets. The ongoing economic processes inside and outside of the country also influenced the implementation of duties of the monetary policy.

**Macroeconomic situation.** The growth rate of the **GDP** as a main macroeconomic indicator constituted 16.5%.

20.1% industrial product, 4.8% agricultural product and 12.2% commodities turnover growth rates were achieved as compared to the previous year.

The increase of the weight of the **private sector** as an important term for the country with the market economy proceeded as well. Over 74% of the GDP, as well as 65.7% of industrial product, 99% of agricultural commodities, 91.1% of capital investment, 57.3% of freight forwarding, 73.8% of communication services were carried out by the non-government sector during the first six months of 2005.

High growth rates of prices observed since the beginning of 2005 slowed down during the second quarter and were replaced by the deflation in the result of anti-inflationary measures taken by the National Bank alongside with government according to the Decree of the President of Azerbaijan Republic "About strengthening of anti-inflationary measures in the Republic of Azerbaijan" dated May 31, 2005. As a result, inflation constituted 4.8% in June 2005, as compared to December of the previous year and 13.1% to the same month of the previous year

Inflation model shows that, 30% of the inflation was related to the **monetary factors**. 20% of the monetary factors were related to the money supply (increasing) and 10% to the exchange rate (decreasing). Influence of the **non-monetary factors** to the inflation constituted 70% and 2% of this was related to the increase of the commodities supply in the market and 24% to the expectations. Seasonal factors increasingly (12%) influenced the prices during the winter and decreasingly (23%) in the summer. Appreciation of the water and natural gas increasingly influenced the inflation 5% and 4% accordingly.

**Basic inflation** computed according to the smoothed moving average method constituted -0.1% as compared to the previous month, 3% to December and 8.4% to the same month of the previous year. **The basic inflation** excluding officially regulated prices and seasonal hesitations constituted 0% as compared to the previous month, 2% to the beginning of year and 9.9% to the same month of the previous year.

The amount of the capital **investment** as a main guarantee factor of the future economic development increased 10.3% constituting 12.8 trillion manats, since 72% or 9.2 trillion manats of this was constituted by foreign investment.

Positive declines observed in the **foreign trade balance** of Azerbaijan during the recent years persisted. Foreign trade turnover reached 2822.3 million USD during the months of January – May. The export amounted to 1059 million USD and the import amounted to 1763.3 million USD. The gross volume of the foreign trade turnover went up by 20.4% as compared to the months of January – May of the previous year.

The improvement of the **population's welfare** continued as well. Thus, the average salary reached 561.2 thousand manats (119.4 USD) and its growth rate constituted 25.9%. 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 the first six months of 2005.

Positive declines were observed in the **USA** - locomotive of the global renaissance, despite opposite changes of separate indicators. The volume of the industrial production

increased by 0.3% in May and 0.9 in June, these are the highest indicators since February, 2004. Leading indicators' index went up by 0.9% in June; this is the maximum level since December 2003. In July the Consumer Confidence Index computed by the Michigan University went up to 96.5 from 96. Busyness activity index computed by the New-York Federal Reserve Bank increased to 23.9 from 10.5 in July. Unemployment rate constituted 5% in June of the current year.

The committee of the FRS on the open market increased the discount rate from 2.25% to 3.25% by changing it 4 times during the quarter. It should be noted that market participants forecast discount rate to be increased further.

During the accounting period, revival of the economy was persisted in **Euro region**, too. The Busyness activity index computed by the ZEW Institute increased to 37 from 19.5 in July in Germany, in the leading country of the Euro region and this is the highest value since September 2004. The unemployment rate still remained relatively high (8-9%) in the Euro region and constituted 11.7% in Germany during June of the current year. This is the highest level in the region.

The European Central Bank (ECB) remained the discount rate at the stable 2% level during the first six months of 2005, as well.

**In England** the unemployment rate was somewhat less than it was in the Euro Union countries and constituted 2.7%. Here the deficit of the state budget constituted 5.2 billion pound sterling in May and 12.3 billion in June. The Bank of England kept the discount rate at the stable 4.75% level during the accounting period. But, the increase of the percentage rates in the financial markets proceeded. Thus, a monthly LIBOR rate rose up to 3.34% by July 1, 2005 whereas it constituted 2.4% at the beginning of year.

Deflation processes proceeded in **Japan**. Despite that, positive payment balance was being increased. Here the volume of the industrial production decreased 2.8% in May. Housekeeping expenses decreased 2% as compared to the same period of the previous year. The unemployment constituted 4.7% in May. The Central Bank of Japan didn't change its main percentage rate and kept it at the level of 0.01% during the accounting period.

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. The rate of USD strengthened 12.3% against the euro, 11.8% against Swiss frank, 7.2% against Japanese Yen 5.6% against English pound sterling and 3.2% against Russian ruble. It should be noted that the appreciation of USD against the euro was definitely influenced by the disloyalty of the French and Dutch voters during the referendums on common constitution of Europe.

Abrupt changes were not observed on the levels of main **stock indexes** during the accounting period. So, the *Dow-Jones average* displaying the average price of 30 biggest industrial companies in the New-York Stock Exchange decreased 3%, the *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange decreased 0.03%. Abrupt hesitation of stock indexes was not observed in Europe, as well. The **FTSE Eurotop 100** calculated on the ground of stock prices of the 100 biggest companies of Europe increased by 8.7% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange increased by 6.2%.

The **average price of Brent oil** in the world market constituted 51.3 USD during the first six months of 2005, which is 55% more than (33.1 USD) that of the first six months of 2004.

## 2. *Development of the monetary management*

**Tools of monetary policy.** *For the implementation of the intended monetary policy the National Bank used such tools as open-market operations, credit auctions, percentage rates, as well as obligatory reserve norms.*

**Use of open market operations** for the sterilization purposes proceeded during the first six months of 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 constituted 43.6 billion manats by the end of the first half of the year.

**The discount rate was** changed twice during the accounting period; firstly it was increased from 7% to 7.5%, then it was increased again up to 8%. 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 the 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. 4 **pawn-shop** credits amounted to 5.5 billion manats and 2 overnight credits amounted to 10 billion manats have been realized during the 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. Total transition to the classic average principle of the obligatory reserves since June 1, established an auspicious conditions to manage the liquidity more promptly and significantly increase the monetary multiplier.

**Exchange rate policy.** The supply of foreign currency significantly exceeded the supply of manat in the currency market of the country 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 196 manats, i.e. 4% during the first six months of 2005 and by the end of the period it constituted 4707 manats.

The **nominal effective exchange** rate of manat against the currencies of the main trade partner countries on the gross trade strengthened by 8.9%, the import influenced rate 6.7%, whereas the export influenced rate strengthened by 10.9% during the months of January – June of 2005. As a result, the alteration of the exchange rate had a decreasing influence on the inflation in the first six months of year. The econometric model on the inflation displayed that, every strengthening percent of the nominal exchange rate of manat had 0.6-0.7% decreasing influence on the inflation, after a definite time interval. Hence, during the forthcoming months, the decreasing influence of the rate on the inflation is expected to strengthen further.

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 11%, whereas the export influenced rate increased by 13.7% and the import influenced rate by 7.9% during first six months of 2005. **The real effective exchange rate** on the gross trade turnover increased by 9.4%, whereas the export influenced rate increased by 11.1% and the import influenced rate by 7.3% as compared to the same period of the previous year. **The real effective exchange rate** on the gross trade turnover of the non-oil sector increased by 7.2%, whereas the export influenced rate increased by 4.2% and the import influenced rate by 8.4% during the months of January-June, 2005. **The real effective exchange rate** of the non-oil sector increased by 7.3%, 2.7% and 8.3% accordingly, as compared to the same period of the previous year.

The National Bank influenced the exchange rate of manat by the correlation of demand and supply in the currency market. Despite the National Bank's purchase oriented (36.9 million USD) interference to the currency market, it decreased 51% as compared to the previous year.

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 exchanges were performed in a correlative manner. Large-scale interferences during the last years mainly appeared at the end of the quarter, resulted in abrupt increase of money supply.

Scope of the currency reserves under the disposal of the National Bank increased by 12.73% as compared to the beginning of year (876.86 million USD) and constituted 988.46 million USD by the end of the first six months of 2005. 26.77 million USD was spent on the repay of the main and active debts on credits of IMF during the period. Consequently, **relative growth** exceeded 138.37 million USD. Growth of reserves was mainly due to non-emission channels.

**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 2006-2009<sup>th</sup> years, to elaborate macroeconomic scenarios suitable to the target economic growth and the stability parameter for 2006-2009<sup>th</sup> 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 are being 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 summerized 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 trancient economy have been studied and the existing situation on the exchange rate selection in Azerbaijan have been estimated. Meanwhile, results and proposals are being formed.

**Improvement of the monetary development models** were kept in the centre of attraction, as well. Usage of the equilibrium model of the money market, the inflation model, the econometric models of the exchange rate of manat, real sector and the assessment of the currency risks was proceeded in the practical implementation of the monetary policy.

*Improvement of theoretical and methodological basis of real inflation in Azerbaijan* was investigated within the framework of **improvement of the monetary policy**. 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.

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

Variety of researches has been carried out to create modeled criterions and variants for the **choice of appropriate tools of the monetary regulation corresponding to the economic situation** according to the development declines of the financial markets. Moreover the base of the information and forecasts processing of short- and long-term monetary indicators has been improved in the **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 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 situation of financial markets*

**Situation of the money supply in the economy.** Under the terms of economic growth's acceleration and strengthening of the anti-inflationary measures, increase of money supply correlative to demand for money gained new qualitative features in the first six months of 2005. Thus, broad monetary aggregate in manat increased mainly due to the strengthening of money multiplying process in the first six months of 2005 unlike the same period of the previous year, when it increased owing to the growth of the monetary base by the National Bank. Minimization of the National Bank's interference to the currency market and almost blocking of manat's emission from the treasury resulted in the stability of the emission channels that forced the banks to accelerate turnover of the surplus amount in their correspondent accounts in order to satisfy the demand for manat.

**Monetary base of manat** increased by 21.5% to the end of June 2005, as compared to the same period of the previous year and 4.8% as compared to the beginning of year, and constituted 3354.8 billion manats.

**Broad monetary aggregate (M-2)** increased by 34.1% and constituted 3851.3 billion manats in July 1, 2005 as compared to July 1, 2004. Money supply increased by 12.7% as compared to the beginning of year.

**Positive qualitative changes persisted in the structure of money supply.** The weight of the cash in the structure of the money supply in manat decreased 0.7% as compared to the same period of the previous year. It was related to the increase of the non-cash amount by 37.3%, whereas the cash amount increased by 32.8%. Rapid development of banking system, 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.

Further improvement of the indicators characterizing the ability of the banking system to create money was observed. Thus, **monetary multiplier** (ratio of the broad money supply in manat over monetary base in manat) increased by 10.6% as compared to the same period of the previous year and reached the highest level of the last six years.

**Dollarization 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 0.4%.

**Deposit market.** The scope of savings and deposits increased by 56.3% and reached 5766.4 billion manats in the first six months of 2005 as compared to the same period of the previous year, and the **deposits of legal persons** increased by 71.3% constituting 3613.9 billion manats.

The growth rate of **savings of natural persons** was also high. So, the savings of the natural persons went up by 36.3% constituting 2152.5 billion manats. 51.6% of savings attracted by the banks were accrued by private banks.

Short-term savings of natural persons (deposits in foreign currency were also included) went up by 31.3% and long-term ones went up by 41.3%. 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 55.2% to July 1, 2005 as compared to the same date 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 by 32.4%, whereas in manat they increased by 83.7%. This factor establishes a favorable base for the strengthening of manat's part in the economic turnover improving the structure of money supply.

**Percentage rates of savings and deposits** almost remained stable during the last year. So, the average percentage rate of deposits in manat rose up to 7.52% in June, 2005 against 6.75% of the same month of the previous year and the average percentage rate of deposits in foreign currency fell down to 9.99% against 10.45%.

**Credit investments.** The scope of credit investments went up by 41.8% constituting 5341.5 billion manats by the end of the first six months of 2005 as compared to the same period of the previous year. **Net growth** of the credit investment constituted 394.2 billion manats (8%) as compared to the beginning of year.

Weight of the credit investment in the GDP increased by 2.5% as compared to the same period of the previous year.

**Newly given credits'** amounts increased by 35.1% during the months of January-June of 2005 as compared to the same period of the previous year.

Credit investment increased by 63.4% to the industry, 67.1% to the construction and property, 94.6% to the agriculture, 15% to the transport and communication and 69.2% to the physical persons as compared to the same period of the previous year.

**Short-term credit investments** increased by 22.6% and long-term ones increased by 92.1%. Ratio of the long-term credits over total credits went up to 32.6% according to the summary on the first six months of 2005 against 27.6% of the same period of the previous year.

97.2% of credit investments were accrued by banks and 2.8% of this was accrued by non-bank credit organizations. The **weight of private banks** in the structure of the credits given by the banks reached 53%.

Credits given to the private sector increased by 49.5% and the **share of private sector in credit investment** rose up to 85.3, whereas credits to the state sector decreased 9%.

**Credit investments in manat** increased by 64.6%, in foreign currency 30.5% during the last year. As a result, weight of the credits given in foreign currency in the total credits reached 61.6% to the end of the period, which was 5.3% less than it constituted in the same period of the previous year.

**No significant changes on average nominal percentage rates of credits** were observed during the last year. The percentage rate of credits in manat constituted 16.3% in June, 2005, this is 2% more than that of the same month (14.3) of the previous year. But, taking into consideration the inflation rate of last 12 months, decrease of the real percentage rate could be defined. The percentage rate of credits in foreign currency constituted 18.3% in June, this is 0.9% less than that of the same period of the previous year.

**State Loans market.** Operations in the **State Loans** market have been restored during the first six months of 2005. During the accounting period 3 auctions were conducted by the Ministry of Finance on the placement of the **State Loans**. The gross size of the emission constituted 55 billion manats in these auctions and volume of the replaced **State Loans** constituted 37.99 billion manats. Measured average profitability constituted 10.53% in the first auction and it increased to 10.96% in the second auction.

**Currency market.** The gross volume of the currency market increased by 38.1% and constituted 4.2 billion USD in the first six months of 2005 as compared to the same period of the previous year. 87.2% of currency exchange operations were performed by USD, 7.2% by the euro, 4.43% by Russian ruble and 1.07% by other currencies. The currency market operated in the self-regulating mode and there wasn't observed any tension during the period, as well.

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