

On the situation of monetary policy implementation on the final of 9 months of 2006

1. Macroeconomic situation and global economic processes

Within 9 months of 2006, the National Bank of the Azerbaijan Republic has pursued the monetary policy directed to the maintenance of the macroeconomic stability and one-digit inflation, and supporting the socio-economic development programs of the country, also in the first quarter of 2006. The domestic and external economic processes happening have also influenced the fulfilment of the monetary policy goals.

Macroeconomic situation. The economic growth rate in the country has furtherly sped up in 2006. 34% increase in the key macroeconomic indicator of economy, GDP, has happened in 9 months. The increase has been attained in the production of industrial goods (39.2%) and the freight transportation (9.4%), in communications services (22.7%), and in the commodity turnover (12.6%).

The role of the private sector in the economy, which is a necessary condition for the country with the market economy, is also increasing. The non-state sector has accrued over 75% of GDP, 75.8% of industrial products, 99% of agricultural products, 77.3% of capital investments, 55% of the freight transportation, and 72.4% of communications services.

The **inflation** has constituted 6.2% in September 2006, compared with the beginning of the year, and 10.3%, compared to the same month of the previous year. The *base inflation*, which undergoes the seasonal fluctuations and computed through the subtraction of the administratively regulated prices, has been 6%, compared with the beginning of the year, and 8,2%, compared to the same month of the previous year.

The inflation model indicates, 39.1% of the inflation during 9 months, have related with the **monetary factors**. Besides the traditional factors such as the money supply, nominal effective exchange rate, diesel price rise, and season, non-traditional factors such as sugar price rise in the world market, have influenced the price change.

As the key factor ensuring the future development of economy, the volume of the capital **investment** has went up by 16.4% and amounted AZN 4.2 bln, compared with the previous year, and the foreign investments have constituted 60.3% or AZN 2.6 bln of this. The domestic investments have increased by 52,8%, compared to the same period of the previous year. 39.6% of investments to the economy have been directed to the non-oil sector.

The positive tendencies observed in the balance of foreign trade of Azerbaijan in recent years, have kept on also in the current year. The high price rise still alive in the world market has also contributed also for the further improvement of the country's foreign balance. In January – August, the balance of foreign trade has amounted \$7003.4 mln, of which \$3658.15 mln are accrued by

export, and \$3345.3 mln by import. The total volume of the foreign trade turnover has increased by 38.2% and the import by 14.5%, compared to January – August 2005.

The betterment of the social condition of the population has also endured, so that the average monthly wage has amounted to AZN 129.7 manats, and its growth rate has constituted 20.3%. The increase in the population's income causing a raise in the purchasing ability, has been a factor paving the way for the development of the real sector.

The inclinations in the world financial and commodity markets.

The processes happening in the economy of the leading countries have reflected themselves in the indicators of their financial markets.

The exchange rate of the USD has changed in the diverse directions, against the leading currencies of the world, in the report period. While the exchange rate of the USD depreciated by 4.8% against euro, 6.9% against the Russian rouble, 2.6% against the Swiss franc, 6.4% against the English pound sterling, and by 4.9% against the Kazakh tenge, it has strengthened by 12.8% against the Turkish lira and 1.4% against the Japanese yen.

It should be noted that the increase in the deficit in the foreign trade balance of the USA has had a reducing effect in the exchange rate of dollar, and raising of the accounting degree by the Federal Reserve System (the FRS accounting degree having being changed by 4 times during the period, raised from 4.25% to 5.25%) has had a raising effect.

The increasing of **main stock indices** level both in the USA, Europe and Japan during the report period, has been observed. The Do Cons index, which reflects the average price of the 30 largest industrial companies auctioned in the New York Stock Exchange, has increased by 7.7%, and the Nasdaq index, computed basing on the shares of the 100 largest high technological companies of the USA, has increased by 0.3%. The Nikkey index, computed on the base of the prices of shares of 225 largest companies auctioned in the Tokio Stock Exchange, has decreased by 2.1%, the FTSE Eurptop 100 index, computed on the base of the prices of 100 largest European companies' shares has increased by 5.2%, and the *DAX index* – the average price of the shares of 100 largest companies auctioned in the German Stock Exchange has went up by 8.4%.

The **average Brent oil price** in 9 months of 2006 has constituted 68.5 mln USD. It has been 25.5% more than that of 9 months of 2005 (\$54.6). The factors such as the agiotage emerged over the Iranian nuclear program, speculations upon the possibility of an oil production volume diminution during the second quarter of 2006, and non-stable political situation in Nigeria have influenced the oil price rise.

A sharp **gold price** rise in the world markets has been observed during the report period. While the spot gold price in the international interbank markets has constituted 517 USD on January 1, it has amounted to 602.4 USD, by the end of the report period, increasing by 16,5% (or 85.4 USD). The main reason for the oil

price rise in the world market has been that investors has increasingly been interested on gold, the reliable investment object, deriving from an uncertainty, existent over the Iranian nuclear program.

2. Monetary policy

Monetary policy goals and instruments. *The National Bank has influenced the money supply, through utilizing the instruments such as open market transactions, credit auctions, interest rates, and required reserve requirements, to accomplish one – digit inflation.*

39 auctions have been held by the National Bank, on the deployment of **notes**. The total emission volume has amounted AZN 714 mln, and the deployed notes' volume constituted AZN 506,4 mln. The average weighted yield on short – term notes of the National Bank, has risen from 11,29% in the first auction held in the beginning of the period to 15,,9% in the last auction. The volume of notes in circulation has amounted to AZN 73,4 mln, to the end of the period.

The National Bank has actively utilized the REPO and Reverse REPO transactions in order to regulate the banking system liquidity. The volume (for 1 day) of the Reverse REPO transactions, which have been conducted to provide the banks' short-term need for liquid resources and to ensure the in due time fulfillment of their duties, has amounted AZN 47,7 mln. The average interest rate on the REPO transactions has been in the 4-8% range. The volume of the Reverse REPO transactions (for 1 day) has consituted AZN 30,4 mln. The average interest rate on the Reverse REPO transactions has constituted 16%.

The accounting degree has been changed for once, and it has risen from 9% to 9.5%, on June 3.

Rate. Also in the report period, the foreign currency supply has prevailed the manat supply, in the condition of the world price of a barrel of oil remaining high, foreign investments proceeding to increase in a high rate, and the extensive usage of oil revenues. Consequently, the official exchange rate of manat has strengthened by 4.6% against the US dollar, in 9 months of 2006.

Despite the strengthening of the nominal bilateral exchange rate of manat against dollar, its nominal effective exchange rate, which characterizes the average change of manat, compared to the currencies of the key trading partner countries, has been stable, during 9 months of 2006. This indicator has fallen back by 0.4% on the total trade weight, 1.1% on the export weight, and risen by 0.5% on the export weight.

The **real effective exchange rate** of manat has increased by 2.3% on the total trade turnover, 2.4% on the import weight and 2.2% on the export weight, in 9 months of 2006. **The real effective exchange rate on the non-oil sector** has increased by 3.3% on the total trade turnover, 3.4% on the import weight, and 1.2% on the export weight.

But the international competition capability of the country in the long-term period remains favourable. The real effective exchange rate of manat on the non-oil sector in September 2006 has cheapened by 7,7%, compared to December 2005, thus a strengthening during the report period will not have a serious influence in the international competitiveness of the non-oil export.

The National Bank has influenced the exchange rate of manat via regulating the demand and supply in the currency market. The National Bank **interference in the currency market** during 9 months has been purchase directed, and amounted \$540.3 mln.

The volume of currency reserves at the disposal of the National Bank, has amounted to 1522,3 mln USD, increasing by 58,3% or 560.6 mln USD on the final 9 months of 2006, compared with the beginning of the year (961,71 mln USD).

Institutional development of the monetary management. The institutional development of the monetary management has been kept as the focus of attention in the report period, in order to achieve the goals set by the monetary policy.

The works directed to intensification of the perfect **economic research base**, one of the most important elements of the monetary management mechanism, have been continued.

A research on the evaluation of the financial system and features of the monetary policy transmission mechanism, with the aim of establishing the monetary policy mechanism, which could efficiently target the base inflation and stimulate the financial stability, has been conducted. In the research work, the traditional transmission channels of the monetary policy and explanation of the ideas existent in this sphere have been given, and summaries of the conducted researches associated with the monetary policy transmission, and their generalized results have been presented, based on the experience of other countries. At the same time, the impacts of the policy instruments or operational targets on the financial sector indicators and through this the real sector indicators have been evaluated from the period and quantity viewpoints. This evaluation has been performed on different transmission channels, depending on the policy operations. In the research, the issues of the dependence of inflation - the ultimate target of the monetary policy, on the monetary indicators and quantitative evaluation of this dependence have been expounded. The differentiation of the inflationary processes to the monetary indicators in the short and long term periods, and transitive, shock impacts on inflation are analyzed.

An international experience upon the monetary policy regimes set on targeting the quantity and value parameters has been attained, besides. Various strategies in contemporary central banks' experience used while the implementation of the monetary policy, have been explored. Setting of the monetary policy tactic on different operative targets and selection of the key criterias for this, and positive and negative features of the targets selected have been explored, and it was determined that the regime of targeting quantity parameters is preferred in developing and transition countries. But as a perspective strategy of the monetary policy, most transition countries have set the transition to

the regime of targeting value parameters a goal, taking into account also the increasing role of the financial mediation in the monetary policy transmission.

A research on the topic of *the impact of the reserve requirements on the monetary indicators* has been conducted. In the research work, the experience of the leading central banks in this sphere has been learned, the money multiplier that is one of the monetary policy transmission mechanism channels, its probable impacts on the monetary sector via the credit supply and interest rates mechanisms, and the monetary indicators' reaction on the reserve requirements have been researched. Finally, appropriate suggestions have been made, taking into consideration the specific features of the economy.

A conception project on the application of the Medium-Term Expenditure Strategy in Azerbaijan, within the coordination of the economic policy and arranging of the macroeconomic management conception project. Because analyses resultedly determined that the Medium-Term Expenditure Strategy lies on the base of the most effective arrangement mechanism of macroeconomic management. This determines the fiscal circle within the mid-term period. The issue of application of the MTES in the countries such as Albania, Czech Republic, South Korea, Pakistan, India, Sweden, Finland, Georgia, Norway, has been researched.

Within the coordination of the economic policy and arranging of the macroeconomic management conception project, *a methodological guidance on the compiling of the financial program* has been prepared. In order to form the financial program as a system, a plan of requisite actions has been prepared, and taking into consideration the features of the country's economy, the methodology of separation of the oil and non-oil sectors from each other, within macroeconomic accounts.

3. Monetary indicators and financial markets

Situation of supply of the economy with money. The increase in the money demand in accordance with the money supply in 9 months of 2006, in the condition of the further growth of the economy, has continued.

Money supply in manats on the final of September has increased by 62.6% and amounted AZN 1193.4 mln, compared to the same month of the previous year. The broad money supply (M-2) has amounted to AZN 1530.6 mln, increasing by 82.5%, in the last one year.

An improvement in the indicators characterizing the banking system's capacity of money creation, has been observed. The **money multiplier** (rate of the broad money supply in manats against the money supply in manats) has grown by 10.3% in September 2006, compared with the beginning of the year. The speedy development of the banking infrastructure in the country, especially, the

application of progressive payment systems, creation of interbank electronic payments system on large and small payments, and broadening of the plastic cards turnover are giving an additional stimulus to the rise in the banking system's capacity of money creation.

The deposit market. The volume of savings and deposits in September 2006 has amounted to AZN 1805.9 mln, increasing by 42.6%, compared to the same month of the previous year. The **juridical persons' deposits** have amounted AZN 1172.6 mln, increasing by 44.6%.

The increase of **physical persons' deposits** has also went on. Physical persons' savings have increased by 52.2% in the last one year and amounted AZN 633.3 mln. The private banks have accrued 60.6% of savings and deposits attracted by banks, to the end of the report period.

It should be noted that, besides residents, savings deposit by non-residential physical persons are increasing in a high rate. Non-residential physical persons' savings have increased by 46.8%, compared to the same period of the previous year, for October 1, 2006.

The analysis of savings' structure on currencies, reflects economic subjects' rely has increased towards manat. While the population's savings in foreign currency increased by 30%, compared to the same period of the previous year, **savings in manats** have increased by 3.2 times. This factor lays a favourable ground for manat to strengthen its role in the economic turnover, via improving the money supply structure.

A rise in the interest rates on deposits has been observed in the last one year. The average interest rate on deposits in manats in September 2006 has gone up from 8.1% in September 2005 to 10.7%, and the average interest rate on deposits in foreign currency gone up from 10.2% to 11.5%. It should be noted that the highest increase has been observed in the interest rates on 1 month term deposits.

Credit investments. The volume of credit investments has amounted AZN 2015.1 mln, increasing by 61.8%, in September 2006, compared to the same month of the previous year.

The percentage of credits in the GDP (GDP of the non-oil sector) has risen by 6.6% points in 9 months of 2006, compared to the same period of the previous year.

The volume of the **newly granted credits** has amounted AZN 2307.8 mln in January – September 2006, and this is 35.8% more than that of the same period of the previous year.

Radical changes have not been observed in the **sectoral breakdown of credits**, during the period analysed. The credit investments to the non-financial institutions - juridical persons has increased by 64.1%, compared to the same period of the previous year, and its percentage share in the total credit investment has constituted 68.2%. During the last one year, the amount of credits directed to

industry and production has amounted AZN 161.2 mln, increasing by 2.1 times, of credits directed to trade and services amounted AZN 567.3 mln, increasing by 80.9%, of credits to agriculture and processing amounted AZN 127.4 mln, increasing by 49.7%, and the amount of credits directed to transport and communication has amounted AZN 202.7 mln, increasing by 67.5%. The amount of credits directed to the construction and estate sector, which would stimulate the other sectors of economy, has amounted to AZN 137.6 mln, increasing by 2 times.

The amount of credits extended to physical persons amounted AZN 617.3 mln, increasing by 63.8 %, of which 3.6% are shared by the credits on plastic card operations.

Short-term credit investments have increased by 28.9%, and **long-term credit investments** by 2.2 times, compared to the same period of the previous year. The percentage share of long-term credits in credits has risen from 37.4% in the same period of the previous year, to 50.1% for the the final of the end of the report period. It should be noted that recently, start of the mortgage crediting mechanism is giving an additional stimuli to the growth of the long-term credit investments.

Banks and non-banking credit organizations relevantly accrue 97.1% and 2.9% of credit investments. The **share of the private banks** in the structure of credits granted by banks has constituted over 50%.

While the credits to the state sector have decreased by 7%, compared to the same period of the previous year, credits to the private sector have increased 76.8%, and the **share of the private sector in credit investments** has risen to 89.7%.

The strengthening of the exchange rate of manat against freely convertible currencies, has influenced also the currency structure of credits. **Credits in manats** in September 2006, have increased by 81.5%, compared to the same period of the previous year, and credits in foreign currency have increased by 49.2%. Credits in foreign currency have constituted 56.2% of credit investments, for the end of 9 months, and it is 4.8% less than it was in the previous year.

Radical changes have not been observed in the **nominal interest rates on credits**, in September 2006, compared to the same month of the previous year. The average interest rates on credits in the national currency have increased by 0.6%, compared to the same month of the previous year, and constituted 16.2% for 01.10.06. The average interest rates on juridical persons in manats, have constituted 14.8%, decreasing by 0.2%, compared to the same month of the previous year, and the average interest rates on physical persons have constituted 19.9%, increasing by 2.4%. The average interest rates on credits granted in foreign currency have constituted 17.2% against 17.5% in September of the previous year. In this period, the average interest rate on credits granted in foreign currency to juridical persons, has fallen back from 15.8% in September of the previous year, to 15% for the end of the report period, and the average interest rate on credits granted to physical persons has risen from 21.2% to 21.7%.

Organized Interbank Credit Market. The bargains in the Organized Interbank Credit Market have been concluded in manats and USD, during the report period. The total volume of bargains concluded in manats has amounted AZN 10,8 mln. The average annual interest rate on the concluded bargains has constituted 12,5%. The total volume of bargains concluded in a certain period in the US dollar has amounted USD 6,3 mln. The period of credits granted has been in the range of 2-183 days.

The state short-term bills market. 25 auctions on the placement of the State short-term bills have been conducted by the Ministry of Finance of the Azerbaijan Republic, during 9 months of 2006. The emission volume has amounted AZN 117 mln. The volume of the placed ST-bills has amounted AZN 61,1 mln. While the average weighted yield has constituted 12,4% in the first auction, it has risen to the 14,4% level at the time of the last auction. The cases such as the decline in the yield have also occurred during the period. In 3 auctions held in March and April of 2006, the average weighted yield on the State short-term bills has relevantly constituted 5,61%, 5,41% and 5,32%. For the end of the period, the volume of the ST-bills in the turnover has amounted AZN 28,1 mln.

Currency market. The volume of the currency market in 9 months of 2006 has amounted USD 7,1 bln, increasing by 7,2%. 86.7% of currency transactions have been conducted in USD, 10.9% in Euro, 2% in the Russian ruble, and 0.3% in the other currencies. A significant increase in the transactions in euro has been registered, compared to the same period of the previous year, so that the transactions in euro had constituted 7.1% of the total currency transactions in 9 months of the previous year.