

Summary on situation of the monetary policy on the first quarter 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 quarter 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 7.9% of the same period of the previous year.

6.1% industrial product, 5.6% agricultural product, 71.3% capital construction and 11.4% commodities turnover growth rates were achieved.

The increase of the share of the **private sector** as an important term for the country with the market economy proceeded as well. Over 73% of the GDP, as well as 56% of industrial product, 99% of agricultural commodities, 94.4% of capital investment, 54.2% of freight forwarding, two third of the communication services were performed by the non-government sector during the first quarter of 2004.

The average annual **inflation rate** was 3.1% in the first quarter of 2004 which is due to 5.1% appreciation of the food products. Non-food products cheapened 0.4% and services went up only by 0.1% during the period.

The *researches carried out according to the inflation model* prove that the price change of food products 96.8%, non-food products 2.7% and services 0.5% influenced the alteration of prices.

Results of the calculations made by the econometric models also show that, 26% of inflation was related to the monetary factors during the first quarter of 2004. Hence the **pure inflaton** influenced only by the monetary factors related to the monetary policy constituted 0.8% ($3.1 \cdot 0.26$) during the quarter. Remaining 2.3% inflation was related to the factors beyond the monetary policy.

The amount of the capital **investment** as a main guarantee factor of the future economical development increased 71.3% constituting 5.4 trillion manats, since 4.8 trillion manats (980 million USD) or 88.8% 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 33.4% as compared to the same period of the previous year and reached 678.5 million USD during the months of January –February of 2004. The export amounted to 252.8 million USD and the import amounted to 425.7 million USD. The appearance of the negative balance of approximately 100.1 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 439 thousand mantas (89 USD) and its real growth constituted 19.5%. 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 quarter 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 was the maximum level since June 2002. Activity

index in services sector rose up to 65.8 in March against 60.8 of February. But a faint development of the labor market created a base for some disappointment. Thus, employment was down by 2.3 million during the months of January-February. But employment was up by 308 thousand in March. This is the highest indicator during the last four years. Queries show that increase of the employment at the second quarter could be forecasted. Thus, number of companies intending to create new vacancies increased by 8%, whereas number of companies intending to reduce the staff decreased 7%. Unemployment rate was 5.7% in the USA by the end of March.

The European Commission forecasted the acceleration of the stability processes in the **Euro region** economy during the first six months of the current year and economic growth rate at the interval of 0.3% - 0.7% during the first quarter of the year. Revival of the economy 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 huge while the consumer expenses are slight. One of the main reasons of the consumer demand is the high unemployment rate in the Euro region. The discount rate is expected to be lowered by the European Central Bank in order to accelerate the economic growth.

In **England** the business activity index in the production decreased to 53.2 in February against 56 of January. But, this pointer exceeding 50 during the last eight months indicates the continuation of the economic progress in Great Britain. Retail sale amount was much more than forecasted during the first two months of the year. Despite that, scope of the industrial production decreased 0.6% in March as compared to February and 1.2% as compared to the same period of the previous year.

In February 2004 the positive balance of foreign trade reached the highest level during the last 5 years in **Japan**. Simultaneously, consumer expenses of the 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 business activity index with the revival of the stock market, decrease of unemployment and increase of consumer optimism.

Changes on the **exchange rate** of USD against the other leading currencies of the world were in different directions. The rate of USD decreased 2.8% against English pound sterling, 2.2% against Japanese yen, and 2.5% against Russian ruble whereas it appreciated 2.6% against the euro and Swiss frank.

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 quarter. So the *Dow-Jones average* displaying the average price of 30 biggest industrial companies in the New-York Stock Exchange decreased 0.3%, the *Nikkei index* determined on the ground of the stocks of the top 225 biggest companies in the Tokyo Stock Exchange increased by 7.5%. 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 0.6% and the *DAX 100 index* - the average of the stocks of the 100 biggest companies in the German Stock Exchange decreased 3.6%.

The **average price of Brent oil** in the world market constituted 31.2 USD during the first quarter of 2004.

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.

The National Bank performed refinance of commercial banks on the ground of auctions on the **centralized credits** during the accounting period as well. 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. 6 **pawn-shop** credits and 1 overnight credit amounted to 6.8 billion manats have been realized during the quarter.

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

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 quarter 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 banking system.

Exchange rate policy. The official exchange rate of manat against USD changed only 2 manats or 0.04% and by the end of the quarter constituted 4925 manats.

The nominal exchange rate of manat created a base for the further improvement of the international competitive ability of the country supporting the favorable dynamics of the real effective exchange rate index. Real effective exchange rate index decreased 2.2% in February 2004 as compared to December 2003.

Commercial relations with Euro region 0.68%, Russia 0.54%, Great Britain 0.31%, Turkey 0.51%, Kazakhstan 0.13% negatively and USA 0.05% positively influenced the alteration of the real effective exchange rate during the first two months of 2004. The greater influence of the Euro region to the real effective exchange rate is related to the major part of these countries in the foreign trade.

Export influenced real effective exchange rate 1.7%, import influenced one 2.8% cheapened during the first two months of 2004.

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 1.7% of total turnover and was purchase oriented (16.3 million USD). Purchase oriented interference of the National Bank in the currency market improved money supply in the economy and prevented "Dutch syndrome" and revaluation of exchange rate of the national currency.

The purchase oriented interference also played an important part in the **increase of the currency reserves**. Scope of the currency reserves under the disposal of the National Bank increased by 0.88% and reached a record level for Azerbaijan constituting 763.8 million USD by the end of the first quarter of 2004 as compared to the beginning of year (757.1 million USD). This is sufficient for 4.3-month import of commodities and services excluding the oil sector. 22.6 million USD was spent for the repay of the main and active debts on credits of IMF during the first quarter of 2004. Consequently relative growth constituted 30.0 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.

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.

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 the 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 assesment 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 the 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 36% and constituted 2456.1 billion manats by April 1, 2004.

The **broad monetary aggregate (M-2)** increased by 28.7% constituting 2504.4 billion manats. The real growth rate of the money supply was higher, too. So the real growth rate of the money supply constituted 24.8%.

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% according to the summary of March 2004 as compared to the same period of 2004. Simultaneously, the speed of the money turnover decreased 11.7%, 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 cash in the structure of the money supply decreased 5.9%. It is related to the increase of non-cash amount by 66.9%, whereas the cash amount increased only by 19.1%.

Dollarisation level of the economy decreased during the accounting period. The share of deposits and savings in foreign currency in the total amount of savings decreased 2.5%. This established a favorable base for the strengthening of manat's share in the economic turnover.

Deposit market. The scope of savings and deposits increased by 44.1% constituting 3488.8 billion manats, deposits of legal persons as well increased by 36.3% constituting 2078.4 billion manats.

The growth rate of **savings of natural persons** was relatively higher. So the savings of natural persons went up by 57.4% constituting 1410.4 billion manats. 41.6% of the savings attracted by the banks were accrued by private banks. Short-term savings of population went up by 22% and long-term ones went up by 2.1 times. It indicates the further increase of the population's trust towards the banks.

It should be noted that the analysis of the structure of savings against the currencies show the increase of the population's trust towards manat. The savings and deposits in foreign currency increased by 39.8%, whereas the **savings and deposits in manat** increased by 66.8%. 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 decreased to 6.69% by the end of March, 2004 against 8.03% of the same period of the previous year.

Credit investments. The scope of the **credit investments** went up by 30.4% constituting 3575.4 billion manats according to the summary on the first quarter of 2004.

Short-term credit investment increased by 21.7% and long-term ones increased by 55.1%. Part of the long-term credits in total credits reached 31%.

89.6% of the credit investment was accrued by banks and 10.4% 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 51.2% by the end of the first quarter against 46.6% at the same period of the previous year.

Credits given to the private sector increased by 40.7% and the **share of the private sector in credit investment** rose up to 75.4%, whereas the credits for the state sector increased only by 6.7%.

Credit investment to the industry increased by 2.4 times, to the construction and property 2.1 times, to the agriculture 35%, to the transport and communication 48% and to the physical persons 54.1% 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 the credits on the national currency constituted 15.2% in March which is less than that of (15.7%) the same period of the previous year.

State securities market. During the accounting period 2 auctions were conducted by the Ministry of Finance on the placement of the **State Loans** (it should be added for comparison that, 4 auctions were carried out during the same period of the previous year). The gross size of the emission constituted 40 billion manats in these auctions and this is 120.0 billion manats (or 75%) less than that of the first quarter of the previous year.

As a result, **amount of the State Loans** in the turnover decreased from 105 billion manats to 40 billion manats during the period. The cause of this decrease is repayment of the **State Loans** and taking them out of the turnover in the amount of 65 billion manats.

The scope of the **operations held in the second-hand market by the State Loans** was around 6 billion manats.

Decrease of the **profitableness of the State Loans** proceeded while demand significantly exceeded supply in the first quarter of 2004. By the end of the quarter profitableness of the **State Loans** decreased to around 4.84%.

The structure of the **State Loans**' holders insignificantly changed during the first three months of the current year as compared to the first quarter of 2003. Accordingly, during the accounting period, the share of the banks in the State Loans oriented investment increased by 2% constituting 82%. Share of the other investors constituted 18%.

Currency market. The gross volume of the internal currency market increased by 281.4 million USD or 44% constituting 923.4 million USD during the first quarter of 2004 as compared to the same period of the previous year. Currency market operated in the self-regulating mode and there has not been observed any tension.

4.4% of the currency exchange operations fell to the lot of the Baku Interbank Currency Stock (BISC), 17.4% of the Open Interbank Currency Stock (OISC), 53.5% of the Intrabank exchange operations (IBEO) during the quarter.

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 increased by 13.8 times as compared to the same period of the previous year. 24.6% 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 has started finite currency operations starting the current year.