

## ENTREPRENEURSHIP DEVELOPMENT FOUNDATION

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**OIL REVENUES: CHALLENGES FOR AZERBAIJAN**  
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## THE MONETARY ASPECTS OF OIL REVENUES AND INFLATION

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Another round table discussion on the project was held on May 3, 2007. The subject of the round table was the following: "The monetary aspects of oil revenues' impact on the economy and inflation" The director of Economic Research Center Dr. Gubad Bayramov and

the representative of the International Monetary Fund in Azerbaijan, Basil Zavoico, made reports at the round table.

The round table was attended by: Dr.Gubad Bayramov (The director of Economic Research Center); Dr.Basil Zavoico (International Monetary Fund); Dr.Sabit Bagirov (Entrepreneurship Development Foundation); Dr.Inqilab Ahmadov (PFMC); Eyub Huseynov (UFC); Namik Azizov (Association of managers); Dr.Sanan Alizade (SGS); Dr.Ruslan Sadirxanov (Azerbaijan Bank Association); Dr. Anar Ahmadov (Caucasus Research and Resource Center); Mahammad Talibli (Center for Economic Innovations); Chingiz Mammadov (Counterpart-International); Nariman Agayev (Center for Research of Sustainable Development); Zohrab Ismayilov (National Budget Group); Suheyly Jafarova (Eurasia Foundation); Aydin Nizamov (EITI NGO coalition); Nigar Ibadgizi (APA Information Agency); Rauf Aliyev (Novosti - Azerbaijan); Irada Eyvazova (Center for Economic and Political Research); Alovzat Bayramov (Entrepreneurship Development Foundation); Elnur Guliyev (ANS TV); Babalı Hafız (Turan Information Agency); Seymur Aliyev (Trend Information Agency); Parvin Abbasov ("Xalq Cəbhəsi" newspaper); Yashar Ahmedov (the student of State Economic University)



**The International Monetary Fund predicts that the inflation rate will reach 20% in Azerbaijan for 2007, said the IMF Officer in Azerbaijan.**

He added that the IMF has prepared a report on South Caucasus which will be posted on the official website next week.

"The IMF predicts the inflation rate to be around 20% for this year, but the figure can be above or below depending on Azerbaijan's reaction to the economic processes. Of course, we would like to see low inflation rate here," he noted.

The inflation rate averaged to 16.5% for January-April of 2007 in Azerbaijan while it was 9.6% for the full year of 2006. The government hopes to rein and slow the inflation to single-figures this year. /APA-Economics/

<http://economics.apa.az/en/news.php?id=24480>

04 June 2007

# The monetary aspects of oil revenues' impact on the economy and inflation

***Qubad Ibadoglu***

*Chairman of the board of the Center for Economic Research*



The inflow of oil revenues into the country and the developments going on under their influence are one of the issues that alarm not only politicians, but also researchers, regardless of their status and position. If politicians are wondering how and how much of these funds should be spent, researchers are interested in tendencies that will form in this case and in various aspects of its influence on the economy. At this moment, there is a problem of the same level for both groups, which is effective and transparent use of oil revenues. No matter how far discussions in these directions are from politicians' interests, there is no doubt that this subject will remain in the sphere of economists' interests for a long time. However, we should not forget that even among economists there are various approaches to the issue, which causes a divide of opinion among them sometimes. This is natural because the impact of oil revenues on the economy can be evaluated from various viewpoints. From this point of view, the article we present draws attention to the monetary aspects oil revenues and inflation.

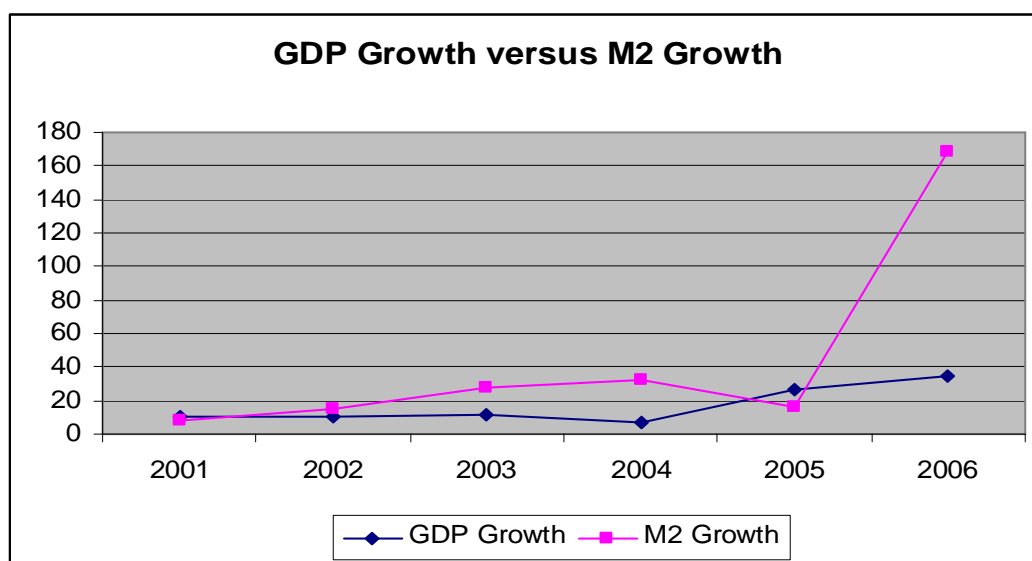
When we take a look at the history of these problems, we notice the developments that happened in Western Europe and Japan under the influence of the oil crisis observed in world experience in the 1970s. It was at that time that monetary methods of the money credit policy were used as a way out of the crisis. However, despite all that, this problem, which was regarded as being typical of the countries where a sharp increase was observed in export due to the growing output of extractive industries, is still topical. Although the central bank solved one problem to encourage the strengthening of national currency in order to prevent an imbalance on the domestic market because of the increasing inflow of currency due to increasing exports, this created a favorable environment for a new problem. In this environment, against the background of the increasing amount of money in circulation dominating the increase in all macroeconomic indicators, factors that create inflation become very active and new problems emerge in the economy.

When we look at the anatomy of this problem which has emerged in the Azerbaijani economy, we find out that there are changes in two directions at the moment: first, a swift increase in consumption and investments under the influence of total expenses, including fiscal factors, and second, an increase in the surplus of the payment balance and the transformation of this factor into the main source of increasing demand for money.

The swift growth in total expenses (investment expenses and individual consumption) over the last two years has formed demand for a high amount. Although total supply is increasing at a two-digit pace, total demand has considerably exceeded the parameters of increasing supply and has created a shock of demand in the country. Statistical information shows that the end consumption expenses which were the main channel of total demand totaled 85 per cent of the non-oil gross domestic product. It is no accident that 70 per cent of money incomes were spent on consumption at the time and about one fourth of consumption expenses were financed by consumption credits. In the volume of investments financed from domestic sources, which is another channel of total demand, the growth accounted for 47.6 per cent last year and its share in investments increased only to 37.9 per cent. The share of investments financed with banking credits accounted for 15 per cent in domestic investments.

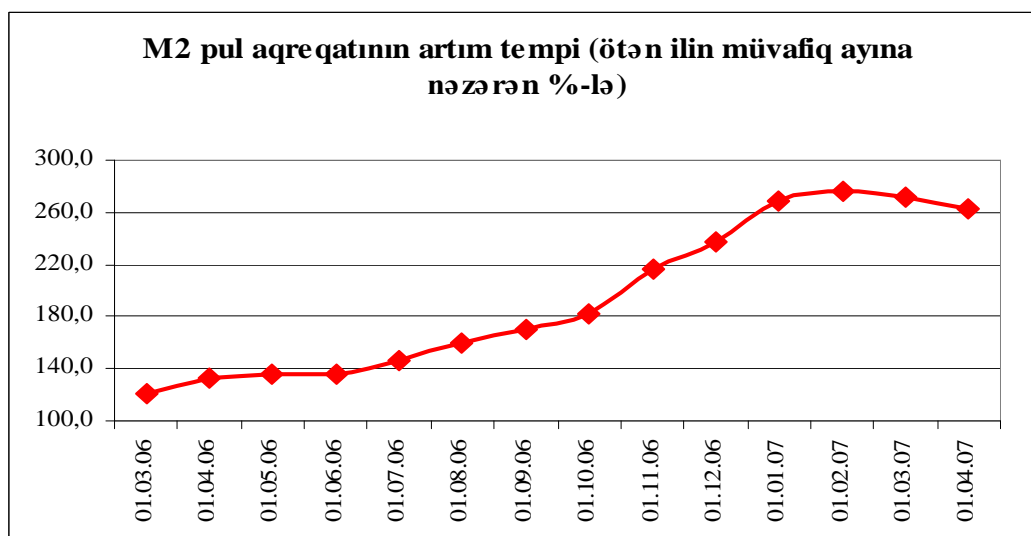
The pace of growth in the state budget has been an important factor in the expansion of total demand and in the acceleration of economic growth. For example, in 2006 budget expenditure increased by 88.9 per cent compared to the previous year and 42.6 per cent of this growth was due to construction expenses. The speedy increase in investments in the construction sphere in last year's budget has become an important factor that affects investment activity in the country. For example, as a result of domestic investments financed from the state budget increasing by 4.4 times last year, the share of these investments in the total volume increased from 11 to 31 per cent. At the same time, the implementation of social expenditure from the state budget during this period played an important role in increasing the population's money income and expanding individual consumption. The high economic growth and business activity based on increasing state expenditure increased the demand for credits in the economy and in line with the increasing demand, the banking system expanded the offer of credit resources.

The unusual increase in business activity in the Azerbaijani economy in recent years is related mainly to the continuing use of oil revenues for socioeconomic development purposes, increasing financial support from the state for the development of the private sector and non-oil sector and the expansion of total expenses (consumption, investment and state expenses) in the economy as a result of the implementation of large-scale social programs. All this significantly increased demand for money. As a result, the pace of growth in the M2 aggregate exceeded the pace of growth in the gross domestic product several times over. In order to follow this process, we can address the following table.



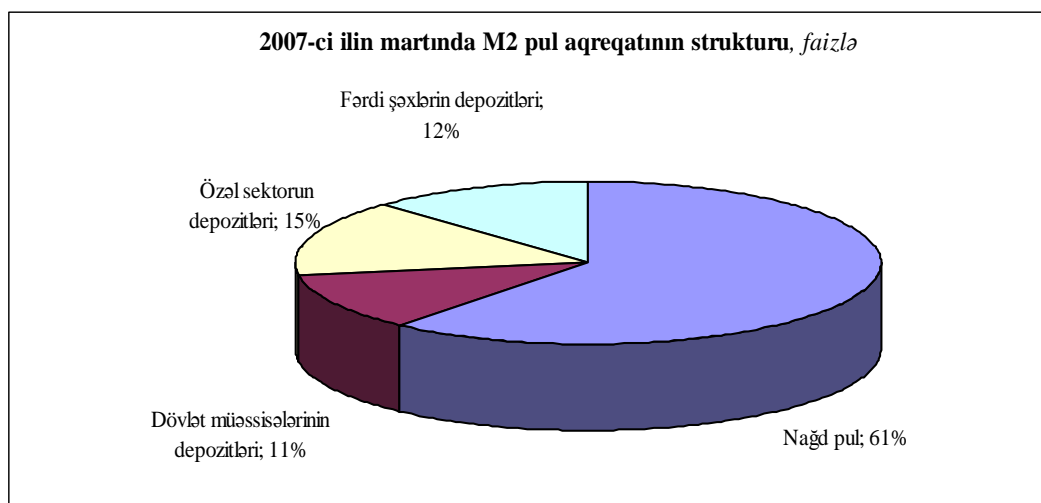
**Source:** The State Statistics Committee and National Bank of Azerbaijan

As we can see from the table, the M2 money aggregate, which indicates the demand for money, increased by 2.6 times over the past year, while the pace of growth in GDP accounted for 34.5 per cent. The average pace of growth in money supply in this period was 58.6 per cent. Money supply in manats (M2) also continued this year. This indicator increased by 6.6 per cent in March compared to the previous month and by 2.9 times in comparison with March last year. As a result, the level of monetization in the non-oil economy increased by 10 points (per cent) in comparison with the previous year and reached 21 per cent. In order to observe this change, we can have a look at the following table.



**Source:** The National Bank of the Azerbaijan Republic

One of the most alarming problems at the moment is the dominance of cash (M0) in the total money supply. According to the latest information from the National Bank, the relevant indicator in March this year accounted for 61 per cent. Let's describe the current situation with the help of the diagram below.

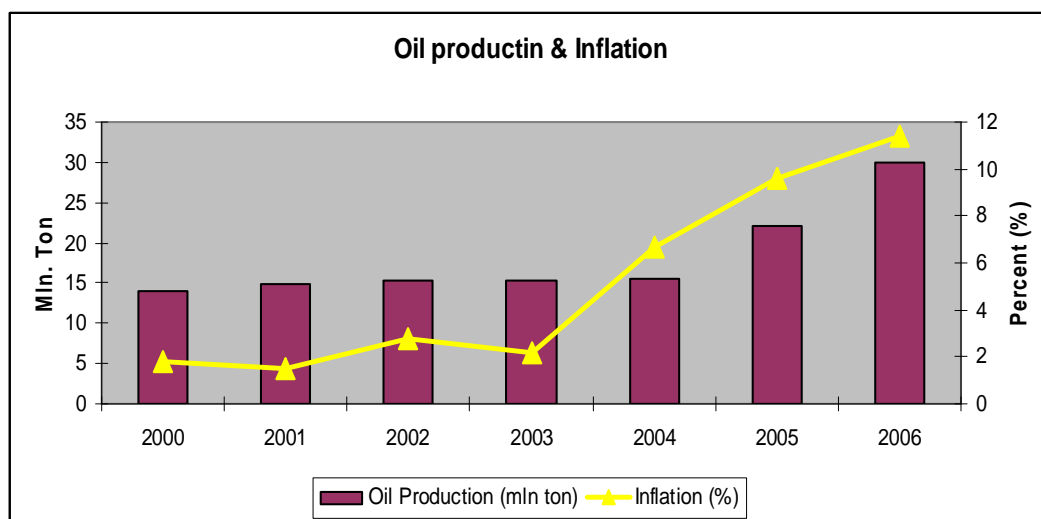


**Source:** The National Bank of the Azerbaijan Republic

According to the National Bank, though the number of fixed term manat deposits increased by 5.3 times, including long-term manat deposits by four times, in March this year in comparison with the same period of the previous year, the volume of manat cash (M0) increased by 2.6 times. Though official circles present this tendency as a certain quality change in the structure of the M2 money aggregate, in any case, the growth in the mass of cash certainly brings about the expansion of secret money flows and activity of inflation-creating factors. This situation also manifests itself in the change of the influence of the

monetary and non-monetary factors that affect inflation. For example, according to National Bank calculations, in 2006 77.2 per cent of inflation formed under the influence of monetary factors and 22.8 per cent - non-monetary factors. For comparison, the share of monetary factors in 2005 accounted for only 36.5 per cent in inflation. The increasing share of monetary factors can be regarded as an indicator of a significant increase in the fiscal demand for money. According to forecasts, demand for money is expected to increase by 2.3 times in 2007 and reach 9 billion dollars following a 50-60-per-cent increase in demand for money and in the surplus of the current account of the payment balance following the expansion of non-oil sector exports.

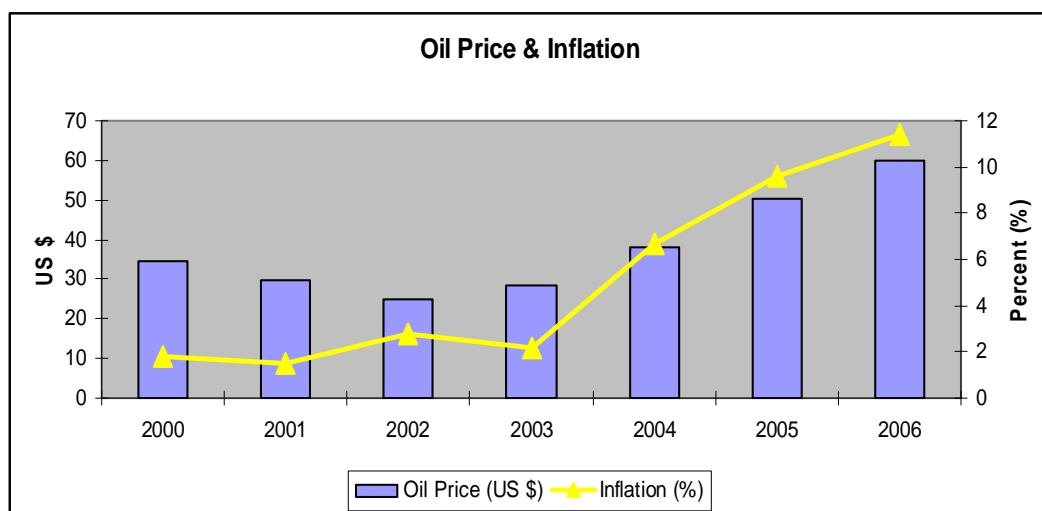
In order to observe the relationship between increasing oil revenues and inflation, we can address the following table.



**Source:** The State Statistics Committee of the Azerbaijan Republic

As can be seen from the table, oil extraction did not really change in 2000-2003, while the level of inflation in that period was about 5 per cent. However, inflation has been increasing since 2004. In 2005-2006, there was a direct correlation between the growth in oil extraction and increasing inflation in the economy and this correlation was linked to oil prices on the world market. Therefore, let's take a look at the following table to find out the correlation between oil prices on the world market and the level of inflation in Azerbaijan.

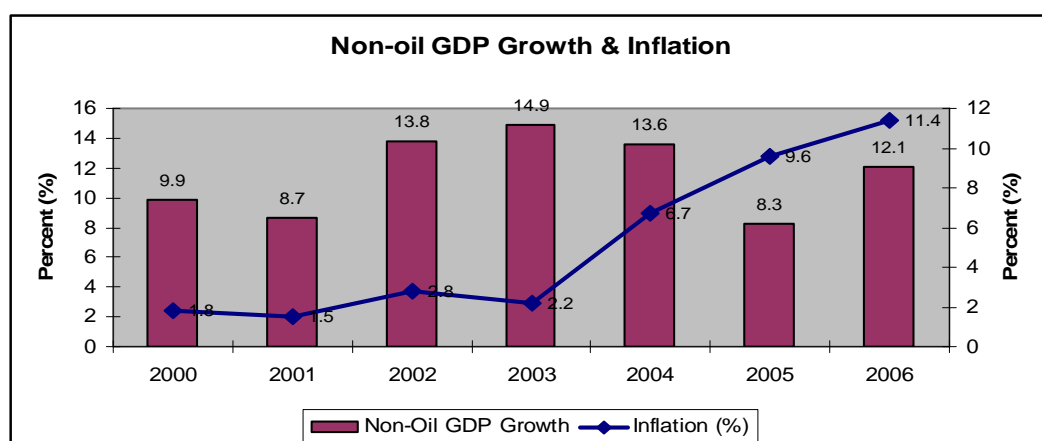




**Source:** The State Statistics Committee of the Azerbaijan Republic and Forex Agency

Thus, the increase in the rate of the national currency, the increase in state expenditure and two-digit inflation are having a negative impact, above all, on the development of the not-oil sector. For this reason, one of the most important tasks facing the Azerbaijani economy is to determine the optimal level of the growth in these indicators in the long and medium-term and to establish an appropriate state policy. The only survey existing in this sphere (SOFAR-Oxford model) shows that in the short-term, the seven or eight-per-cent level of inflation, a 23-25-per-cent increase in state expenditure and the five or six-per-cent strengthening of the nominal rate of the manat for the US dollar can secure a growth of seven or eight per cent in the non-oil sector.

If we take into account that state expenses have doubled over the last two years and the strengthening of the rate of the manat for the dollar has been five or six per cent, the level of inflation and the pace of growth in the non-oil sector in this period will be of interest. Taking this into account, let us present you with a table on this dependence.



**Source:** The State Statistics Committee of the Azerbaijan Republic

As we can see from the table, the level of inflation over the last two years has been higher than the pace of growth in the non-oil sector. If we take into account that this



dependence in the proportional form will be even more noticeable this year, then this problem should prompt the government to think about it more and the National Bank to intensify sterilization operations.

We should point out that sterilization is one of the leading methods used in countries rich in mineral resources to reduce the monetary impact of currency extraction. The purpose in applying sterilization operations is not just to completely prevent the entry of currency into the market in order to neutralize its negative impact on the domestic market and neutralize in this way the liquidity that follows the withdrawal of foreign currency from circulation. The purpose should be to neutralize the influence of interventions in the exchange market in line with the country's monetary policy, using open market operations. According to research carried out by the US Treasury Department, some oil-rich countries are trying to direct their foreign currency reserves to the foreign market in the form of investments in order to reduce the inflation-creating impact of their funds. Along with that, unsuccessful attempts at sterilization can strengthen inflation-creating factors. However, even if sterilization is successfully implemented, problems are still possible: the inflow of a great number of bonds into the market might push up the degree of registration, which will increase the inflow of foreign capital and intensify inflation-creating factors.

For this reason, it is of special importance to choose sterilization forms correctly. Among these forms, open market operations, the regulation of compulsory reserve norms and state deposits are of special importance. The choice and intensiveness of these forms largely depends on the growth in world oil prices, the targets of the monetary credit policy pursued by the Central Bank and the scale of the current inflow in this period.

#### **Inflation in Kazakhstan will account for 7.3-8.3 per cent in 2007**

According to National Bank forecasts, inflation in Kazakhstan will total 7.3-8.3 per cent in 2007, the chairman of the National Bank, Anvar Saydenov, reported on 7 February this year. "According to all preliminary calculations, the second scenario seems more realistic. According to this scenario, the corridor of inflation is between 7.3 and 8.3 per cent," Saydenov said.

In 2006, annual inflation in Kazakhstan (from December 2005 to December 2006) accounted for 8.4 per cent (7.5 per cent in 2005). In January-December last year, inflation on all goods and services accounted for 8.6 per cent against January-December 2005.

In January 2007, inflation in the republic accounted for 1.1 per cent.

<http://www.zakon.kz/our/news/news.asp?id=30087798>

# DECLARATION<sup>1</sup> of the National Bank of Azerbaijan Republic about main directions of the monetary policy for 2007

The last 3 years in the history of Azerbaijan were characteristic with the beginning of a new development period. The new economic development doctrine advanced by the President of Azerbaijan Republic Ilham Aliyev aims to guarantee the stable social-economic development, to diversify the national economy and raise the standard of life of the population in so strategic period of the country.

With the beginning of the realization of new development priorities and under new dynamic economic growth conditions National Bank pursued a money-currency policy (in 2006) to defend the macroeconomic stability and competitiveness of the national economy and to support the realization of budget-investment policy.

High macroeconomic dynamics, significant increase in the currency income, largescaled investments by state budget and realization of the social programs during the current year were the main factors in the formation of the macroeconomic situation. Substantial development projects realized by means of high proficiency of the payment balance of the country and additional financial opportunities. This caused a significant increase of demand to money, goods and services in the economy.

## I. Economic Growth in 2006

**Economic Growth.** During 11 months of 2006 the GDP of Azerbaijan increased by 34.4%. Growth in oil sector was 64.8%. GDP per capita expectation for the end of the current year is 2400 USD (non-oil sector – 1150 USD). Growth in non-oil sector was 11.2% and production increased by 7.7%.

**Internal Balance.** Rapid increase in the volume of total expenses (investment expenses and personal consumption) formed high total demand in the economy. Increase in the total demand was a main factor in the acceleration of economic growth. Despite total supply increased by two-digit rate, total demand outstripped it substantially.

<sup>1</sup> [http://www.nba.az/download/Pul\\_siyaseti/istiqamet/statement\\_2007.pdf](http://www.nba.az/download/Pul_siyaseti/istiqamet/statement_2007.pdf)

Last consumption expenses (main channel of total demand) formed 85% of the non-oil sector GDP. Last consumption expenses and average monthly salary of the population increased respectively by 34.4% and 20%. 70% of total income was directed to expenses. Consumer loans financed approximately 25% of total consumption expense.

**Substantial channel of the total demand** – Growth in the internally financed investments made up 47.6% and its portion in the total investments increased to 42.7%. Portion of investments financed by bank loans reached 15% of total internal investments. Nearly 90% of all internal investments were directed to non-oil sector.

**Realization of State Budget** played substantial role in the increasing of total demand and acceleration of economic growth in current year. In comparison with the same period of the previous year, budget expenses increased by 67% during 11 months of 2006.

Rapid increase in the investment expenses of the budget became a substantial factor affecting the investment activity of the country. A 4.4 times growth in state financed internal investments increased their share in total investments from 11% to 31%.

On the other hand, realization of social expenses of state budget increased income of the population and played significant role in the growth of personal consumption.

A two-digit growth rate of total demand decreased the **unemployment rate in the economy**. Rapid increase in the personal consumption and investment expenses forms additional requirement to goods and services. Supply increases to meet these requirements. As a result new workplaces are created and economy gradually approaches to full employment rate. During the year 135 000 new workplaces were created in the country. 56% of these workplaces are permanent and 83% of all workplaces were created in the regions of the country.

**External Balance.** Processes differing from the previous years' were seen in the payment balance during the 9 months of the current year. In the previous years the deficit of the current account were closed by means of the positive balance of the capital movement account. But in 2006 there was **a large proficiency in the current account**. By means of the proficiency formed as a result of rapid increasing oil export Azerbaijan economy started to return the liabilities on direct investments attracted to oil sector. According to the expectations these liabilities will be fully fulfilled in the nearest 1 or 2 years.

Proficiency of the current account of the payment balance reached 2 bln USD during the 9 months of the current year. Such a high positive balance was especially formed by means of increasing oil export. 2 times increase in oil and gas export formed a 5.4 mln USD positive balance.

Such a high proficiency formed in current account guaranteed significant increase of the strategic currency reserves of the country. As a result, **strategic currency reserves** of the country increased by 1.7 times and were more than 4 bln USD during 11 months of the current year.

**Pure creditor position of the country** on capital account movement became substantially stronger. Financial demand (assets) of the country on all capital inflows (before the external world) increased by 2.5 bln USD from the beginning of the year. Liabilities increased by only 0.7 bln USD.

**Capital Market.** High economic growth and business activity resulted with an increase in demand to loans. Banking system increased the supply of credit resources in accordance with growing demand. Average interest rate on loans stand stable without substantial change from the beginning of the year. Volume of loans increased by 65% from the beginning of the year.

Growing demand to long-run resources in loan market increased their supply by 2.3 times and their share in total loan portfolio increased by 14% items. More than half of the loans fell on the portion of long-run resources. **High growth rate of the long-run loans** shows the rapid transformation of oil income to the capitalization of non-oil sector.

High loan activities of the banks show increasing activity of banking system in the financing of total demand. This process occurs under the condition of increasing trust to banking system. **Stability in the sum of the income directed to the consumption under the condition of the stable two-digit increase in the income shows the growing saving orientation of the population.** Saving orientation in the usage of income structure of the population during 11 month of the current year is more that 18.3%. As a result, deposits of the population increased by 55.5%. Long-run deposits increased by 36.5%.

**Money multiplier**, being the main indicator of the development of financial mediator and characterizing the money creation ability of the banking system **increased by**

**12.2% and reached 1.3 in comparison with the beginning of the year.** Thus, banking system created 1.3 AZN against each 1 AZN created by the National Bank of Azerbaijan Republic.

**Sterilization operations realized by the National Bank** with the purpose of defense of the macroeconomic stability substantially affected the growth of the financial market. 67% of the total volume of the state securities market fall on the share of the notes of the National Bank. Volume of the circulating notes of the National Bank increased by more than 3 times in comparison with the beginning of the current year.

Stock market also affected by high economic activity. Number of stocks and corporate bonds issued in the primary stock market during 11 months of the current year increased by respectively 29% and 11 times in comparison with the previous year. 84% of the corporate bond emission fall on the commercial banks' share.

Level of demand in the real estate market was sufficiently high. Azeri-Rey<sup>2</sup> index, being the main indicator of the market increased by 3.3% during the year. Growth of the index (as an alternative collection form) shows the high level of demand to real estate. Employment of mortgage loan mechanism in 2006, stimulated increasing demand to real estate.

**Demand for Money.** Inflowing oil income actively used for development purposes and it caused a significant increase in demand to money. M2 money aggregate – the indicator of demand to money increased by 2.3 times during 11 month of the current year. Average annual growth rate of the money mass was 58.6%. As a result, monetarization level of non-oil economy increased by 10% items in comparison with the previous year and reached 21%.

## **II Monetary Policy and Macroeconomic Stability in 2006**

**Main purposes and results of the monetary policy.** National Bank meet below shown duties in 2006 under the condition of increasing money demand because of the high economic growth:

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<sup>2</sup> This indicator reflects the general change of prices in real estate market and calculates by the monitoring group of the social unity named as "The Participants of the Real Estate Market".

***Holding basis inflation in one-digit level.*** Inflation processes in the country during the current year were formed under the effect of the below shown factors:

- Rapid increase of consumption and investments that were significantly affected by fiscal factors;
- Total demand substantially exceeded total supply;
- Increase in the proficiency of the payment balance and this factor became the main source of the growth of demand to money;
- Industrial wholesale prices substantially increased and accelerated the consumer inflation;
- Inflation import from the partner countries.

The monetary policy applied during 2006 made it possible to hold inflation in one-digit level as the National Bank announced with the declaration about the main directions of the monetary policy. This opportunity was possible though, expansion of the demand was rapid, currency pressure, internal and external structural factors' increasing intensity.

**Average annual inflation rate** – main indicator of the rationality of the macroeconomic policy **was 8%** during 11 months of the current year. Growth rate of the income of the population exceeded average annual inflation rate by 2 times. Basis inflation – main target of the National Bank was only 7.5% in the beginning of the year.

***Defending favorable foreign trade condition of the country.*** Formation of high proficiency in the payment balance of the country resulted with the additional foreign currency supply of 1 bln USD in the currency market and this supply became the main factor effecting the exchange rate of AZN. Foreign currency supply exceeded demanded amount and this condition strengthened AZN against USD by 5.1%. **Currency market faced active interference of the National Bank and this process prevented the sharp strengthening of the exchange rate of AZN.**

Average interest rate of AZN changed against all currencies. Average inflation rate of partner countries exceeded the average inflation rate in Azerbaijan during the last 6 years and **it guaranteed the 22.8% cheapening of local products for foreign markets during this period.** Thus, the difference in both interest and inflation rates changed the parity

between internal and foreign prices in national consumers' fair. The non-oil export of the country increased by 44% during the 9 months of the current year.

Strengthening of AZN's position creates condition for the growing of trust to the national currency. **Dollarization level of the country decreased** during the current year. Share of the foreign currency deposits in the sum of the total deposits decreased by 17.3% and share of the foreign currency loans in the sum of the total loans decreased by 7.2% during 11 months of the current year.

***Meeting the money requirements of the economy.*** Realization of the social-economic development programs, especially, increasing social and investment expenses of the state budget were the main factors of the increasing money demand. National Bank permanently guaranteed AZN cover of the government's currency income and sterilized the main part of the currency supply formed in the currency market to guarantee the continuous execution of the budget's cash-desk. During the current year, with this purpose National Bank bought more than 900 mln USD (belonging to the budget) from the currency market and it forms 100% of the general interference volume.

As a result of a wide interference, the foreign currency reserves of the National Bank increased by nearly 2 times and reached 2 bln USD during the current year.

***Defending financial stability in bank-finance system.*** High macroeconomic dynamics and jumps observed in the development of banking system increase the actuality of holding financial stability in the focus of attention. Money and exchange rate policy (directed to the holding of the basis inflation in one-digit level) of the National Bank helped to defend the financial stability of the country.

A serious turn in the regulatory frame concerning to the capitalization of banks and asset quality were substantial factors in the increasing financial forbearing of banks. At the same time, application of rational corporate management standards in the banks created favorable condition for the more effective risk management by system. Expansion of the geographical scope of the banking system and population's increasing trust in banking system created a condition for the growing of financial depth of the economy. Share of the bank assets in non-oil GDP increased by 7% and reached 39% during the current year.



Thus, the monetary policy applied by the National Bank gave an opportunity to hold the “basis inflation” in one-digit level, meeting money demand of the economy, to create favorable condition for the strategic foreign trade of the country and defending financial stability during the current year.

### III Purposes and directions of the monetary policy for 2007

2007 will be a significant stage in Azerbaijan economy in the application of the modernization doctrine of the President of Azerbaijan Republic. The main purpose of this doctrine is the transformation of the oil income (received from the realization of the oil strategy) to the stable development potential of the non-oil sector, formation of the competition-durable alternative economy and raising the life standard of the population. National Bank will support this purpose on the basis of defense of the macroeconomic stability during 2007.

**Macroeconomic and fiscal frame for 2007.** Government noted that the economic growth rate for 2007 will be 26%. Expectations for the economic growth rate in non-oil sector is 9%.

**Rapid growth in the total demand also expected** as in 2006. Internal investments, income of the population and average monthly salary expected to grow respectively by 33%, 25% and 25%.

**State budget will be the main factor in the growth of the total demand** in 2007. Increase of the budget expenses will be 42%. Correlation of the non-oil deficit of the review budget to the non-oil GDP will reach 37% which is more than the 34% of 2006.

In 2007 (as in 2006), growth rate of the demand to goods and services will be more than the growth rate of the goods and services supplied.

According to the forecasts, especially, growing export in the oil sector will increase the **proficiency of the current account of payment balance** by 2.3 times during 2007 and will reach 9 bln AZN.

Expected macro-fiscal frame in 2007 will increase the money demanded by nearly 50-60%.

International organizations and analytical centers make forecasts on some risk factors that can affect global economic stability in 2007. The below shown global risk factors affects the national economy and money-credit sphere under the condition of a substantial integration to the world economy and goods markets:

- Changeability of oil prices and exchange rates of currencies playing significant role in the world economy;
- Cost inflation as a result of a non-stable dynamics of the economic cycle and price increase in the energy carriers in the developed countries;
- Non-stability in the real estate markets of the leading countries, etc.
- Purposes of the monetary policy. Main purpose of the National Bank for 2007 (as in 2006) will be the holding of basis inflation in one-digit<sup>3</sup> level (8-9%).
- Beside the realization of this purpose, National Bank will support the purposes of defending strategic competitive advantages of the non-oil sector and continuous financial stability of the country.

Because of the forecasting high currency pressure condition in the currency market for 2007, National Bank will apply active sterilization strategy in the currency market to neutralize the negative effect that may occur with the exchange rate of AZN and foreign strategic trade condition of the country.

Realization of the duties occurring from the May 31, 2005 dated decree of the President of Azerbaijan Republic “About strengthening of anti-inflation measures in Azerbaijan Republic” will be a significant factor in the application of the monetary policy targets. Thus, the strengthening of the finance-fiscal discipline, improving the competitive condition in products market, significant growth in non-oil trade sector<sup>4</sup> and acceleration of development of the finance-capital market will be the significant factors defending macroeconomic stability.

Macroeconomic perspectives of 2007, makes it necessary to hold the financial stability in the focus of attention in the next year too. Continuing of the capital base strengthening, institutional base of the banking system, including corporate management system and

<sup>3</sup> Basis inflation – price index calculated by deducting administratively regulated prices (out of central bank’s supervision) and prices of seasonal products from the consumption basket.

<sup>4</sup> Trade Sector – international trade sector object of the goods and services.

especially the risk management improvement will be guaranteed by the banks, with the purpose of the defending the financial stability of the banking system in the macroeconomic condition distinguishing with its dynamicity. The measures will be continued in the direction of the institutional development of the financial system, with the purpose of expansion of population's access opportunities to financial services. At the same time, the consulting processes related with the step by step transition to the new Basel-2 standards will be intensified.

Methods of the monetary policy introduction. National Bank will guarantee the growth of the notes (the main sterilization tool of the National Bank) to hold the growth rate of the money volume in the acceptable level. The expansion of the state securities market will be a main factor in the extend of the macroeconomic benefit of the National Bank's sterilization policy.

At the same time, step by step ease of capital export regime can play a significant role in the macroeconomic stability defense in the growing oil income condition.

In 2007, National Bank will supervise the improvement of the formation and realization mechanisms of the monetary policy corresponding to the international standards. Program measures will be introduced in the benefit increment direction from the organization of monetary management.

With the enlargement purpose of the item arsenal of the monetary policy the usage potential of non-custom sterilization items and necessity will be evaluated.

Economic analysis base of introduction of the monetary policy will be strengthened. Monitoring of the macro, micro and institutional environment and risk estimation system will be developed. Received results will be considered in the operative monetary management.

National Bank will closely participate in the coordination of the introduction work of the financial program in the related economic organs with the purpose of preparation of optimal macro-fiscal frame for middle-time period in the formation frame of middle-time monetary policy strategy.

Thus, the National Bank will apply the money-currency policy directed to hold the basis inflation in one-digit level and to defend the financial stability during 2007. National Bank will also actively participate in the coordination of the macroeconomic policy and support the realization of social-economic development programs.

# Information from the National Bank about the process of inflation in January-April 2007<sup>1</sup>

## 1. Inflation growth index:

- In April 2007, inflation accounted for 0.4 per cent against the previous month, 9.7 per cent against the beginning of the year, 16 per cent against the same month of the previous year and 16.5 per cent against the average annual rate. *If we do not take account of January, inflation accounted for 3.1 per cent against the beginning of the year, 9 per cent against the same month of the previous year and 9.3 per cent against the average annual indicator.*
- During the month, the price of food products increased by 0.5 per cent, non-food products by 0.4 per cent and services by 0.1 per cent.

## 2. The commodity composition of inflation:

- The share of food products in inflation in January-April 2007 accounted for 48.9 per cent, including bread, bread products and cereals – 5.2 per cent, the share of meat and meat products – 4.5 per cent, the share of fruit and vegetables – 35.7 per cent, oil and fat – 2.7 per cent, sugar and tea – 1.5 per cent, drinks and tobacco – 0.3 per cent and milk and eggs – 1.1 per cent.
- The share of non-food products totaled 15.6 per cent and services 35.4 per cent.

## 3. The sector structure of inflation:

- 0.4 per cent in comparison with the previous month and 14.1 per cent in comparison with the same month of the previous year in the trade sector;
- 0.2 per cent in comparison with the previous month and 20.4 per cent in comparison with the same month of the previous year in the non-trade sector.

## 4. The monetary and non-monetary factors of inflation:

- **Monetary factors** – Monetary factors in the formation of inflation accounted for 12.3 per cent. The lag effect of the 2.6-per-cent growth in M1 money supply in the first quarter of 2007 was 12.3 per cent. In the non-oil sector, import NEM did not change.

<sup>1</sup> [http://nba.az/download/Pul\\_siyaseti/inflyasiya/04\\_2007.pdf](http://nba.az/download/Pul_siyaseti/inflyasiya/04_2007.pdf)

- **Non-monetary factors** – Inflation formed mainly under the influence of non-monetary factors. For example, non-monetary factors accounted for 87.7 per cent, including the growth in offered goods and services had a 4-per-cent reducing effect, the growth in administrative prices accounted for 39.1 per cent directly and 26.1 per cent indirectly, while seasonal factors had an 18.5-per-cent increasing effect.

## 5. Inflation:

- Seasonal factors – prices increased by 1.8 per cent in the first four months.
- Non-seasonal factors – non-seasonal factors consisted mainly of the growth in consumers' demand caused by fiscal expansion and hikes in administrative prices.

## 6. Basic inflation:

- If we do not take account of prices regulated seasonally and administratively, basic inflation in April 2007 which is calculated by excluding prices that are affected by seasonal fluctuations and regulated administratively will account for 0.2 against the previous month, 3.4 per cent against the beginning of the year and 9.4 per cent against the same month of the previous year. *At the same time, basic inflation calculated only by excluding administrative prices accounted for 0.4 per cent against the previous year, 6.2 per cent against the beginning of the year, 12.8 per cent against the same month of the previous year and 13.3 per cent against the average annual indicator.*
- The smooth medium principle:<sup>2</sup> Basic inflation calculated on the basis of the smooth medium principle accounted for 0.2 per cent against the previous month, 3.8 per cent against the beginning of the year and 7.2 per cent against the same month of the previous year.



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<sup>2</sup> The smooth medium principle is calculated by deducting the 10 per cent lower and upper limit from changes in prices for individual products and types of services and is based on the average price change of remaining products