FOR AGENDA

SM/06/109
Correction 1

March 24, 2006

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Azerbaijan—Selected Issues**

The attached corrections to SM/06/109 (3/14/06) have been provided by the staff.

Changes in formatting:

Page 5, Figure I.1: three figures in the lower panel are corrected to reflect missing dates.

Factual corrections:

Page 7, line 1: for "from 18½ percent of non-oil GDP in 2002 to 48½ percent of non-oil GDP in 2004"
read "from 35 percent of non-oil GDP in 2002 to almost 70 percent of non-oil GDP IN 2004"

Questions may be referred to Mr. Kramarenko (ext. 34357) and Ms. Zermeno (ext. 37540) in MCD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

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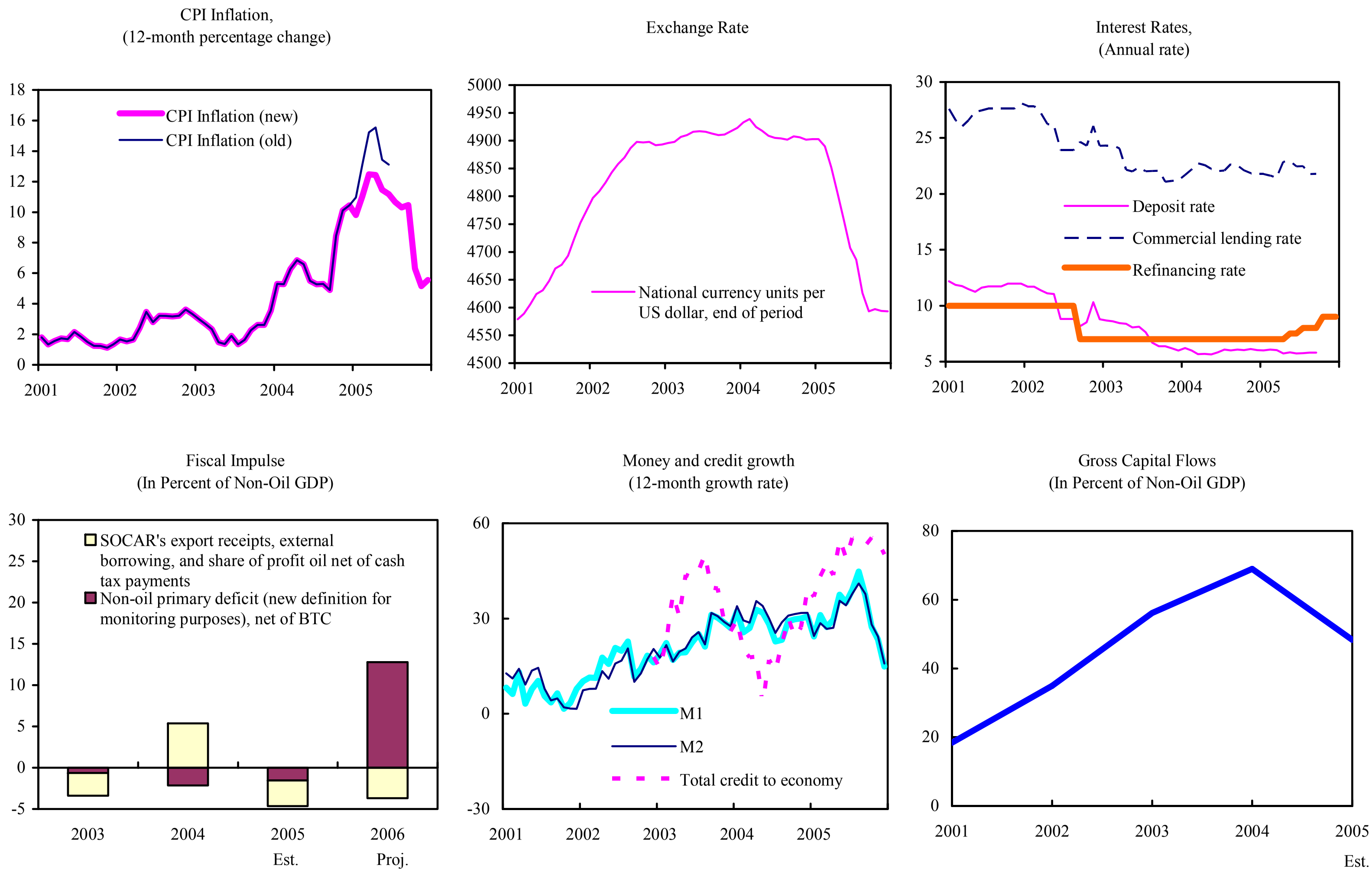
Figure I.1. Azerbaijan: Selected economic indicators, 2001–06



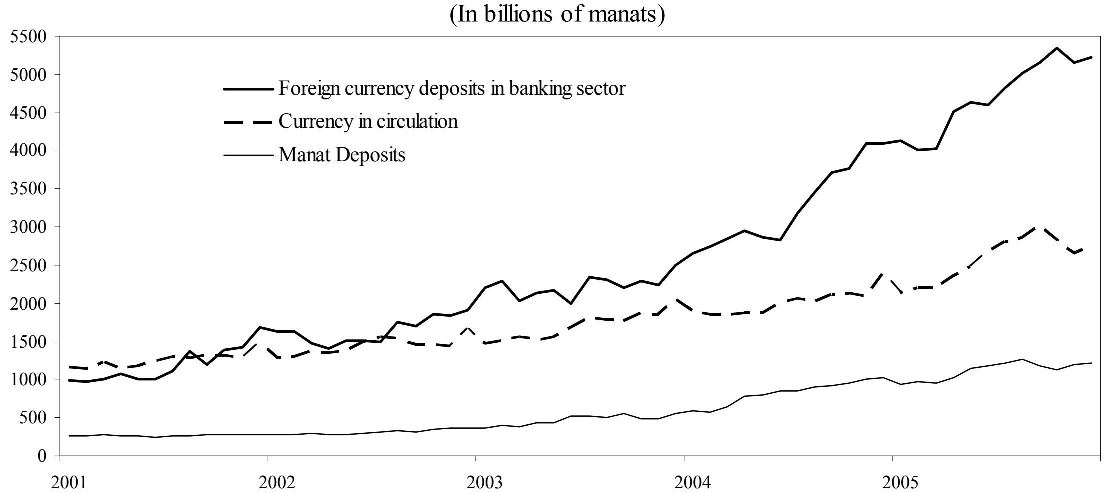
Sources: Azeri authorities; and Fund staff estimates.

September 2005. Third, since mid-September 2005 a de facto peg to the dollar has been reinstated mainly for political reasons, reducing again the ANB's flexibility in monetary policy implementation.

Fixed peg: mid-2002–early 2005

1. **The peg served Azerbaijan well from mid-2002 to early 2004.** In the absence of major foreign exchange market pressures, the fixed peg was effective in containing inflation: the 12-month CPI inflation rate fluctuated within a narrow range of 2 to 4 percent during the period (Figure I.1). The peg also reduced the incentives to develop and use indirect instruments of monetary policy: the ANB's interest rates remained broadly unchanged, sterilization operations were negligible, and the stock of government securities was reduced significantly. Nevertheless, despite low inflation and exchange rate stability, dollarization persisted with foreign exchange deposits reaching about 49 percent of broad money by end-2003 (Figure I.2). The hysteresis of dollarization in Azerbaijan is similar to the experience of other developing countries with a long track record of macroeconomic stability.[1]

Figure I.2. Azerbaijan: Currency in Circulation, Manat Deposits and Foreign Currency Deposits, 2001–05
(In billions of manats)



Sources: Azeri authorities; and Fund staff estimates.

2. **When tension between the peg and the inflation objective arose in 2004, the exit from the peg was delayed.** Real appreciation pressures spilled into higher inflation in the context of the fixed peg: the 12-month CPI inflation rate increased from 3.6 percent in December 2003 to 10.4 in December 2004. These pressures emanated from large capital inflows and expansionary fiscal policy. Capital inflows, mainly in the oil sector, increased

[1] For a recent discussion on the causes of persistent dollarization and related policy options see Ize and Levy (2005).

from 35 percent of non-oil GDP in 2002 to almost 70 percent of non-oil GDP in 2004, and the fiscal stimulus originated from increased spending by the State Oil Company of Azerbaijan Republic (SOCAR). At the same time, the ANB accommodated the rising supply of foreign exchange, and cash in circulation increased rapidly.[2] The attendant rapid growth in money and credit (Figure I.1) was initially interpreted as a sign of remonetization, and rising inflation was ascribed to one-off supply shocks. This assessment, together with concerns about the political repercussions of greater exchange rate flexibility, delayed the exit from the peg.

7. **The strong political opposition to greater exchange rate flexibility is rooted in widespread dollarization and to some extent in concerns about competitiveness.** Nominal exchange rate appreciation reduces the purchasing power of foreign currency-denominated assets and streams of incomes of large groups of the population, in terms of non-traded goods and services and food.[3] The corporate financial and nonfinancial sectors also have large open positions in foreign exchange and earn substantial foreign currency incomes. The two largest players in Azerbaijan's foreign exchange market—the International Bank of Azerbaijan (IBA) and SOCAR[4]—would incur large valuation and income losses from nominal appreciation. In addition, the widespread belief that nominal appreciation will lead to faster real appreciation and to a loss of competitiveness[5] contributed to the authorities' hesitation to allow greater nominal exchange rate flexibility.

Gradual appreciation: February–September 2005

8. In **an effort to reduce inflation, the authorities moved away from the fixed peg and allowed the nominal rate to appreciate starting in early 2005**. A relatively strong and fast exchange rate pass-through to prices has been present in Azerbaijan over the last six years[6] (Figure I.3). Based on these findings, the ANB abandoned the fixed peg, and started to use an appreciating path for the nominal effective exchange rate (NEER) to guide its foreign exchange interventions. During February–July 2005, the NEER appreciated by about 8 percent, and the refinancing rate was increased by 100 basis points to 8 percent. The authorities also supported their monetary policy tightening with expenditure restraint and non-oil revenue mobilization. In late summer 2005, they gradually shifted the focus of their monetary policy operations from the exchange rate path to base money targets; allowed

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[2] Annex I.1 has identified cash in circulation as one of the main leading indicators of inflation.

[3] In Azerbaijan, food items could be imported to smooth out supply shocks. However, fito-sanitary and other non-tariff restrictions make them to a large extent non-traded goods.

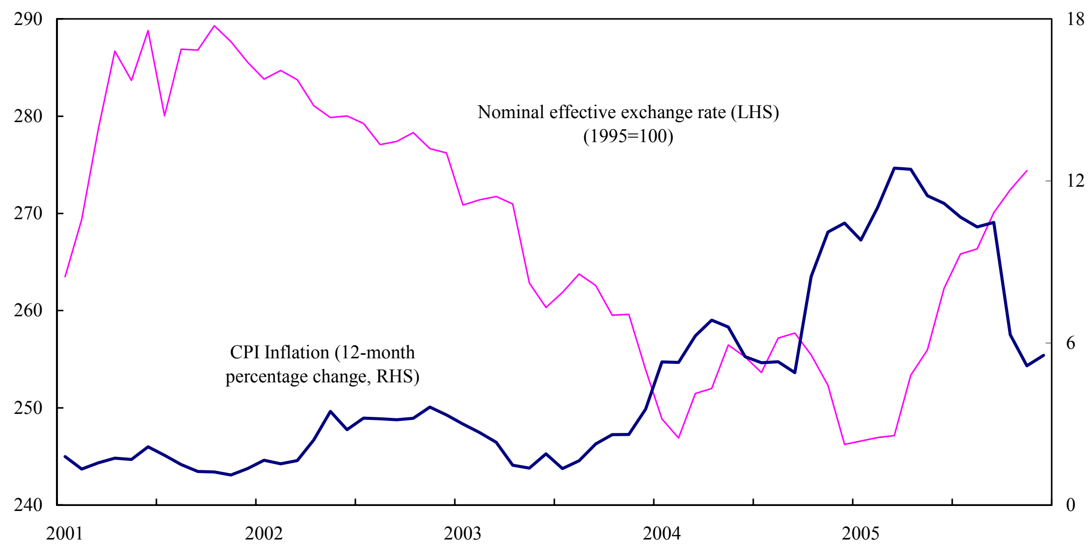
[4] The foreign exchange market is dominated by the treasury, SOCAR, and the IBA.

[5] Chapter IV discusses competitiveness trends and issues.

[6] See Annex I.1 for a discussion of econometric results.

greater exchange rate volatility; and increased interest rates by another 100 basis points to 9 percent. The impact of this monetary tightening and fiscal prudence on inflation was encouraging: the 12-month CPI inflation rate declined from 15.4 percent in April to about 10.5 percent in September 2005.[7]

Figure I.3. Azerbaijan: Nominal Effective Exchange Rate and CPI, 2001–05



Sources: Azeri authorities; and Fund staff estimates.

Peg reinstated: September 2005

9. **The experience with greater exchange rate flexibility was short-lived, as political pressures against nominal appreciation intensified in September 2005.** The return to the peg was triggered by a sudden appreciation of the manat in the cash market in mid-September. Although technical shortages of banknotes contributed to the sharp appreciation, the underlying reason was the on-going tightening of monetary policy amidst mounting real appreciation pressures. Capitalizing on public opinion against nominal appreciation and exchange rate volatility, vested interest groups exerted strong pressure on the government and the ANB to change their exchange rate policy. In response, the government publicly announced a new target range of 4,500 to 4,600 manats per U.S. dollar in mid-September, and the ANB confirmed this target range soon thereafter.

10. **In the fourth quarter of 2005, there was no apparent conflict between the fixed peg, base money targets, and the single-digit inflation objective.** The ANB reverted to

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[7] The CPI methodology was revised in 2005 as discussed in Box I.1.