ICEG EUROPEAN CENTER

NEWS OF THE MONTH

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CONSIDERABLE ECONOMIC GROWTH WITH REGIONAL DIFFERENCES IN SLOVAKIA

The economic development in Slovakia has been remarkable in recent years, as economic growth rates have been above the EU-average. One can see however, that parallel with extreme growth performance regional differences remained considerable in the country, since the Bratislava Region is far above the other regions, and it is the only one of the four Slovak NUTS-2 regions, which doesn't have an Objective 1 status in the structural policy of the EU.[1]

TRADE-OFF THEORY

There exists a theory, which says if a national economy converges to the international average, divergence can be experienced between regions within the country. This means that the economic growth in the more developed regions will be faster, while less developed ones will lag behind. On the contrary, if convergence between the regions happens, the growth of the national economy is slow.

Since the EU supports the NUTS-2 regions to solve the structural problems and it helps them converge to the EU-average, this analysis is based on the NUTS-2 regions of Slovakia. The essay will investigate whether the theory mentioned above is true for Slovakia, i.e. how much the important imbalances between the regions contribute to the significant economic growth in the country.

ECONOMIC PERFORMANCE OF SLOVAKIA AS A WHOLE

The Slovak Republic belongs to the best performing new members of the EU, as its economic growth is considerable. The data concerning the change of the consumer prices also shows favourable changes (*Table 1*). Significant GDP growth is expected in the following two years; beside it, the consumer prices seem to be continuously decreasing, approaching the average inflation rate of the euro area.

Table 1. Outlook for the Slovak Economy, 2006-2008 (%)

Indicator	2006	2007	2008
Real GDP growth	8.3	8.0	7.5
Inflation	4.3	2.5	2.4
Private consumption	6.1	5.8	5.5
Public consumption	4.1	3.5	3.0
Growth of Exports	20.7	20.0	17.8
Growth of Imports	17.8	16.9	15.8
Current account balance (rate to GDP)	-8.3	-5.7	-4.8
Unemployment	12.3	11.3	10.0

Note: data for 2007 and 2008 are forecasts
Sources: ICEGEG

As Slovakia is an open country, the growth of exports and imports is important factor; because of the higher rate of the exports, the balance of payment is expected to decrease. The

[1] Regions have Objective 1 status if the regional GDP per capita does not reach the 75% of GDP of the EU-27.

employment has been increasing, in 2006 it reached the 59.4% (employed age between 15-64 years). It is also worth to note, while the unemployment rate seems to be decreasing, it is still high – the Slovak unemployment rate was above 12% in 2006, but further decrease is expected in the following years.

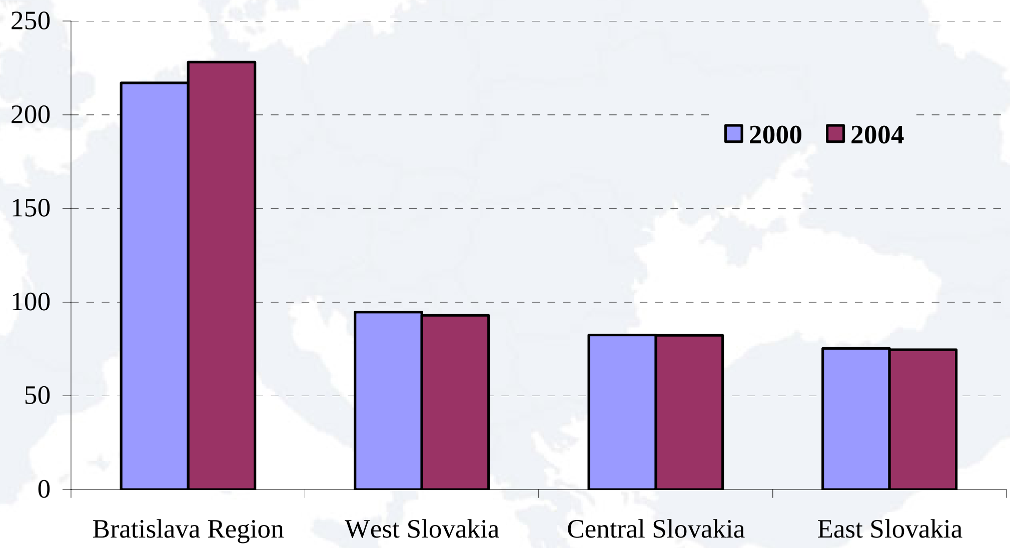
Although the Slovak economy performs very well, there are differences between its regions. Among the four NUTS-2 regions located in the Slovak Republic, one (Bratislava Region) prospers much better than the other areas.

INDICATORS OF THE SLOVAK REGIONS

The four NUTS-2 regions of Slovakia are the following: Bratislava Region, Western Slovakia, Central Slovakia and Eastern Slovakia. Comparing their GDP to the average of EU27 in 2004, we can state, that Bratislava Region (containing the capital of Slovakia) is far the best among the four regions (129.3%), then come West Slovakia (52.7%), Central Slovakia (46.7%) and East Slovakia (42.3%).

C*hart 1* also describes that Bratislava Region is more developed than the other areas, this area owns more than 220 % of the national GDP per capita, while each of the other NUTS-2 areas perform under the national level, especially East Slovakia with its 74.65%. During four years significant changes had not happened, the differences between Bratislava Region and the other areas remained, even it seemed to grow, as Bratislava was the only region, which could improve its indicator compared to the national level.

Chart 1. GDP Per Capita in 2000 and 2004 (National GDP=100, %)

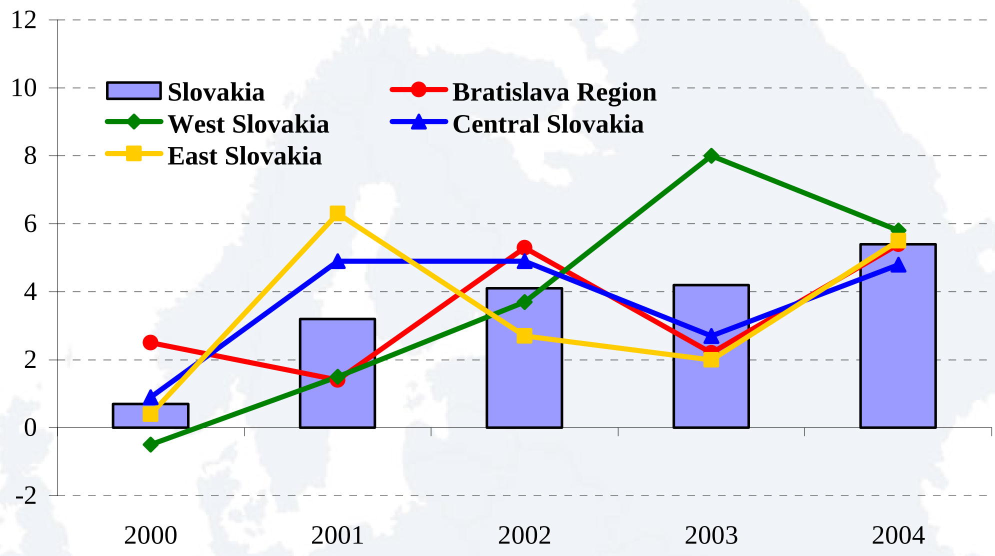


Source: Eurostat, own calculations

The imbalance between the capital region and the others is more apparent, if we compare the regions' performance to that of Bratislava Region. In this case, the best performing region, West Slovakia exceeds the 40%, while the other two are below it. What's more, the gap between the capital and the remaining regions had become wider during four years, e.g. in 2004 East Slovakia (the worst performing region) hardly reached the 30% of the capital region's achievement.

Though Bratislava Region performs better than the other regions regarding the GDP compared to the national level, there are no such imbalances between the investigated areas if we have a look on the real GDP growth in the different regions (*Chart 2*). All the regions did show hectic growth – slowdown could be experienced everywhere during the four years; meanwhile the Slovak economy had been continuously growing. In 2004, the growth of both the regional and national economy approached each other, reaching near 5.5%, only Central Slovakia performs worse in relation with the other regions with its 4.8%. Since the regions possess almost the same achievements, there is no chance that the imbalances between them will decrease.

Chart 2. Annual Real GDP Growth, 2000-2004 (%)



Source: Eurostat

The employment and unemployment rate in the regions show further differences (*Table 2*). The Bratislava Region again possessed the most favourable indicators – there could be found the highest employment rate and the lowest unemployment rate, what 's more, they exceeded the EU-average, as well. The imbalances between the regions can be regarded much better – especially as for unemployment rates. Central Slovakia and East Slovakia having the two lowest employment rate, possesses the two highest unemployment rate nearing (or exceeding) the 20%.

Table 2. Employment and Unemployment Rate in 2000 and 2004 (%)

Region	**Employment rate**		**Unemployment rate**	
	2000	**2004**	**2000**	**2004**
Bratislava Region	70.0	67.7	7.3	8.3
West Slovakia	56.7	59.9	17.7	14.2
Central Slovakia	55.5	53.8	20.4	22.1
East Slovakia	52.3	51.8	24.0	24.2

Source: Eurostat

One reason for it is the large Roma communities living in these two regions. It is also worth mentioning that the difference between the best (Bratislava Region) and the worst performing region (East Slovakia) reaches an extremely high value: 16.7 percentage points in 2000 and 15.9 percentage point in 2004 in case of the unemployment, but the employment rate also shows similar differences.

It is also important to investigate, which sector employs the most workers. In the capital region the services sector is the most important one in the economy (regarding the rate of employed) – 75.7% of the employed works here, while in case of the other areas this indicator is only around 60%, and the national level is also 60%. While in the agriculture in Bratislava Region less than 2% of the employed works, in the other areas it is above 4.5%.

The research and development has great impact on the economic performance – the better technology results more effective production, which leads to higher GDP and higher economic growth. Therefore, it is necessary to mention how much was spent on R&D in the Slovak regions. The total cost of research and development (relative to GDP) in the year of 2003[2] is the highest in Bratislava Region (1.12%) and it extremely exceeds the national level (0.58%), as well. In the other three regions, this indicator is around 0.3% – except West Slovakia nearing the national level (0.5%).

Conclusion

All the investigated indicators refer to the fact that the economic development of the Slovak Republic between 2000 and 2004 was maybe the result of the dynamic growth of Bratislava Region. The other three regions stand much behind this one. Bratislava Region seems to fulfil (or in some cases exceed) the EU-averages, while the other areas are much below the average EU-performance. Furthermore, as far the high rate of the R&D, we could assume that there are high-skilled employees in large number in the capital region. This fact also makes the economic environment in the region more favourable not only for domestic producers but also for foreign ones.

This analysis described that the Bratislava Region has meant the motor of development for the national economy, so far. Furthermore, it also showed that the regional differences seemed to be not eliminated yet: Bratislava Region belongs to the relative developed regions in the EU, while the other areas stand far behind it. Although it can be accepted that there are significant regional imbalances in the Slovak Republic, the theory mentioned in the introduction can't be proven yet, because it assumes that the more developed region grows more quickly (as the national economy) – and we didn't experience it.

However, one should take into consideration, that according to the expectations, the development of the Slovak economy will be much more significant in the following years, the economic growth tends to exceed the 8% (i.e. the current 5.4%) – it will be far the best in the EU. Since there are no available regional (NUTS-2) economic forecasts for the following years (2006-2008), the theory mentioned in the introduction cannot be still proven.

The main aim of the cohesion policy of the EU is to decrease the regional differences within the Union. As it is the NUTS-2 regions, which are the beneficiaries of the support coming from the EU structural policy, it is worth analysing the regions' situation in a few years, investigating whether the EU-funds helped to solve the imbalances between the Slovak regions, and what would be the consequence of the regional cohesion for the country. If the

[2] Newer data are unavailable on Eurostat.

trade-off theory is true, significant changes might not be expected to happen, as an extremely high economic development is forecasted in the Slovak Republic.

UZBEKISTAN AND ITS GROWTH PUZZLE

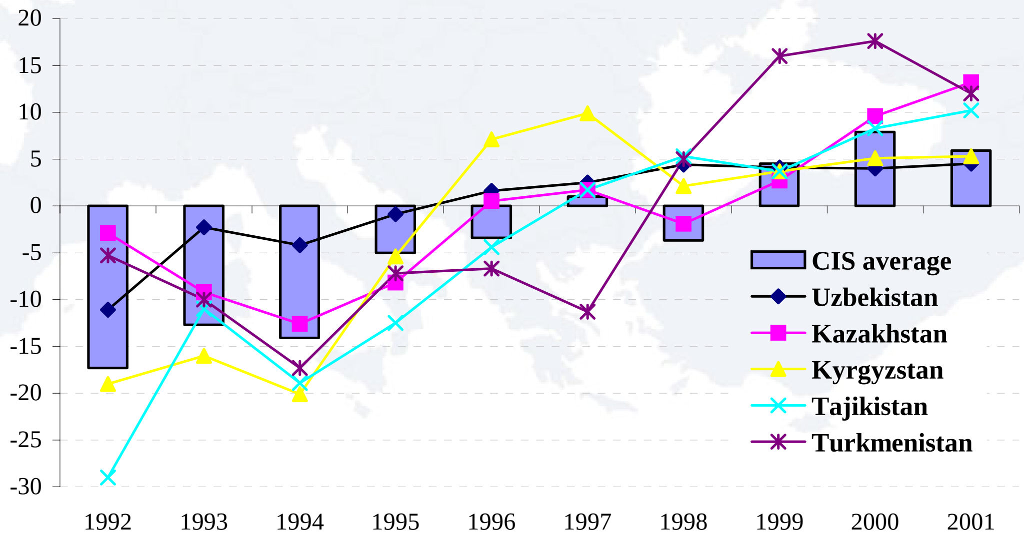
This analysis deals with the recent history of the Uzbek economy that tries to explain the peculiarities of the country's development. Since the set up of the Commonwealth of Independent States (CIS), Uzbekistan has used several, conflicting tools to boost economic growth. The recent policy of the Uzbek government is set against the recommendations of International Monetary Fund (IMF).

1ST STAGE: FOLLOWING THE COLLAPSE OF THE SOVIET UNION

As the Soviet Union ended in 1991 and almost parallel the CIS was established the countries of the block started to follow the principles of the "Washington Consensus". They opened the economy for foreign countries, lifted price controls, abolished state control on enterprises etc. At the same time, Uzbekistan took another way of economic development. Tashkent sustained state control on some areas (agriculture, industry), state spending remained high level and privatisation materialised only partially. Foreign trade was also kept in control.

The economic policy attempted to avoid decline in consumption and production capacity as well as intended to defend home-market against foreign goods. These measurements worked on the separation of the country from the world economy. In several segments of the economy they became self-sufficient and after the deep decline period of 1992 the country started to be off the downturn – alleged with the tool of not to be liberalised. Fiscal deficit began equalizing, current account balance turned to be positive, but inflation remained very high. We can obtain that Uzbekistan performed better (the decline was less dramatic) than other CIS states in Central Asia regarding to GDP-growth in this period (*Chart 3*). At first sight, we could draw the conclusion that Uzbekistan's "second best" solution with not following the rules of liberalisation pulled off the country, but the IMF formulated its queries.

Chart 3. Real GDP Growth of Central Asian countries and the CIS



Source: Center for Economic Research, Uzbekistan

According to the opinion of the IMF, extended protection of the economy and state-monitored investment strategies led to weaker development. Although some parts of the economy were well organised by the state (grain, oil), other areas underperformed. Additionally the government introduced an import-substituting system in the end of the period: they obstructed free trade by building up quantitative barriers and customs.

2ND STAGE: THE WAY OF IMF

A slight turn of the governmental policy was observable by the end of 1994 and the economy started opening towards IMF recommendations. Even though a number of experts claimed, the country was able to do on the development without following the advices of IMF. They based on the facts that Uzbekistan began reducing the fiscal deficit, and the decline in GDP growth rate was better than in other CIS countries. Nevertheless the country reached self-sufficiency in oil (previously the Soviet import was inevitable).

Following the stabilisation program of the IMF, some trade liberalisation began and current account convertibility was aimed to reach until the end of 1996. The price liberalisation was accomplished by 1995. EBRD, World Bank and Asian Development Bank disbursed large amount of loans to Tashkent. Indeed, the approach to the tools of 'Washington Consensus' was short.

As the market opened up, price of the Uzbek cotton was well above the price on the world market – as the country was in autarchy stage before. Cotton exports represented approximately 50% of total export; following the opening up of the market painful decline was experienced.

The Uzbek government introduced a multiple exchange rate system in the beginning of 1997 in order to protect those sectors, which were sensitive to the effects of liberalisation. Multiple exchange rate system means that a country has more than one exchange rate. Fixed and floating exchange rates parallel exist. Fixed rate is applied for certain segments of the economy. It is used mainly for those products, which are essential for the country. The compound currency regime combined with broad state regulations on some sectors of trade aimed at diversifying the economy. In Uzbekistan, the main objective was to save cotton producing. Certain sectors were protected from foreign competition. Additionally the Uzbek Central Bank granted allowance for sensitive areas through state-controlled commercial banks.

IMF stopped disbursing its supporting credits after this divergence from the objectives of liberalisation.

3RD STAGE: 'UZBEK GROWTH PUZZLE'

Uzbekistan built up a slightly developing economy. There were movements towards privatisation, the ownership of the state in the agriculture reduced from 75% to 30% by 1997 and Tashkent encouraged foreign investments in defined segments of the economy (cars, electronics, textiles, etc.). The proportion of private sector in the country's GDP grew up to 72% in 1997. Although all the mentioned factors tended to show that liberalisation grained ground, the state still had a bunch of tools to control even the private sector. A parallel existing private sector and state-regulated economic strategy were observable. The so-called 'Uzbek growth puzzle' included a turn back to a state-controlled economy.

Main components of the 'growth puzzle'[3] were multiple exchange rate and controlled access to foreign exchange (it helped to defend the most important export-sectors – e. g. cotton), trade regime with high tariff and non-tariff obstacles, financial system based on a state-run central bank, strong state interference in the decision-making of enterprises, privileged sectors is defined and supported by state money and finally import substitution.

The boost included the high growth level of internal savings and real wages. Real incomes also rose rapidly in the last years of the 20th century – in 2000, the real average wage exceeds the 160% of the real wage in 1991. Beside the strong state, extended social and educational systems were maintained. The data of fiscal balance shows almost all the time hardly negative values. The slight attendance of privatisation and liberalisation helped the growth of trade and service sectors. Nevertheless, inflation remained very high (27.4%). The 1/4 of the population lived under the poverty level. The informal market was extended in the country – the black economy contributed estimated 30-35% to the total GDP.

4TH STAGE: IMF AGAIN

There were two sensitive areas where the lack of liberalisation hindered development. The lack of independent, private bank sector and the multiple exchange rate system. According to the experts of the IMF, banking sector was dependent on foreign loans. Additionally, the administrative controls and import substitution tools were altogether factors of high inflation rate. Besides, the multiple exchange rate system transferred 16% of the GDP from exporters to importers and affected a welfare loss of 2-8% of GDP on import market and 15% on export market.

Since 2000, Tashkent has introduced a convertible exchange rate system (abolishing the second rate), the government allowed the improvement of business area, built down the barriers in front of the export goods.

The main argument of the IMF is that the Uzbek economy had wider opportunities based on raw material stocks, which had big demand on the world market. By state controlled economy, these opportunities were not exploited appropriately.

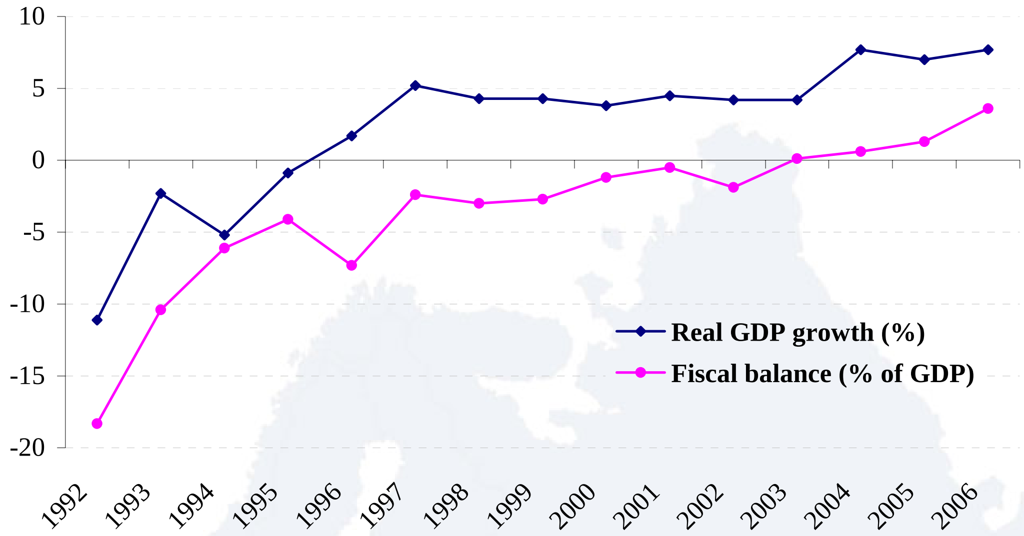
As consequence of broader liberalisation, Uzbekistan performed much better comparing to the previous period. The annual GDP growth increased from 4.2% (2003) to 7.7% (2004), performing a positive trend brake. The current account balance – as a percentage of GDP – was minus 0.5% in 2001. Until 2006, it grew up to plus 19.5%. The CPI based inflation rate reduced from the level of 27.4% (2001) to 6.5% (2005) moreover in 2004 the inflation reached its bottom at the annual average 1.7%.

Contradictory opinions were formulated about the conclusion that the results were impressive enough. The upholders of the 'Uzbek Growth Puzzle' always allude to the fact that Uzbekistan was the first country of the former Soviet Union where real GDP reached the level of development of 1989. At first sight we could allege Uzbekistan performed better than those countries which followed the program points of the 'Washington Consensus', but comparing the welfare with other CIS countries, the development is questionable. Although the GDP rate of Uzbekistan is 2nd among the CIS countries in Central Asia (1st: Kazakhstan), but the GDP per capita is all in all USD 2 283 (2005). Only Kyrgyzstan and Tajikistan present worse. As

[3] Source: Linking Macroeconomic Policy to Poverty Reduction in Usbekistan, CER, Tashkent 2005, p. 19.

the majority of the CIS countries followed the way of IMF, the results could decide the argument about ways of economic policies.

Chart 4. Development of Uzbek Real GDP and Fiscal Balance, 1992-2006 (%)



Source: Center for Economic Research; IMF

CONCLUSION

The opinions of the IMF and the Uzbek state-owned economy upholders were contradictory and exaggerated. IMF wanted all the time free liberalised economy while the opposition stands up for the necessity of state subsidised economic decisions. The former argues the success of the recent period; the latter emphasizes the hit of the late nineties.

The justice could be in the middle: state organised economy got the country through the painful transition period of the nineties – Uzbekistan performed better than the other CIS countries –, but liberalisation was needed to utilise the opportunities of the Uzbek economy and to attract foreign investors.

Delaying WTO Membership of Ukraine

According to the Institute for Economic Growth and Policy Consulting, Ukraine was originally supposed to become a member of the World Trade Organization (WTO) in 2006. Nevertheless, optimism was not enough for accession. The current situation shows that the membership became doubtful even in the year 2008.

Process of Winning WTO Membership

Accession to the WTO is essentially a process of negotiation. Any state or customs territory having full autonomy in the conduct of its trade may request for accession to the WTO. The request is considered by the General Council, which creates a Working Party that is open to all Members of the WTO. The task of the Working party is to examine the request and after sufficient progress on principles and policies, parallel bilateral talks begin between the applicant government and the individual members, covering tariff rates, market access commitments and other policies in goods and services. The applicant has to fulfil such basic principles as fair competition, trade without discrimination, transparency in the multilateral trading system and some other regulations and standards (e.g. concerning international food regulation, dumping, subsidies etc.). The results of the negotiations form part of the final "accession package" which finally has to be approved by the General Council. The two final documents are The Decision of the General Council and The Protocol of Accession, which the prospective new member is free to sign, once approved. Thirty days after the applicant ratifies the agreement, the government becomes a full Member of the WTO.

Ukraine applied for membership on 30 November 1993, and its Working Party was established on 17 December. The last revision of the country's draft Report of the Working Party was circulated in April 2007 while bilateral market access negotiations are still ongoing.

Towards the WTO

The year 2006 was an important one for Ukraine since many important steps were made towards the completion of WTO membership negotiations. Besides completing WTO talks with Armenia and Columbia, Ukraine signed the bilateral protocol of accession on markets of goods and services with the USA in March, with which the country committed to join zero binding tariffs sectoral initiatives concerning wood, metals, machinery products etc. The completion of negotiations with the USA had a positive affect on ongoing talks with Australia and other countries as well. By signing the bilateral protocol with Australia, Ukraine completed negotiations with the 45th out of 151 countries so far.

The long-lasting negotiations were because of treading on delicate ground, as the cornerstone of negotiations was the agricultural policy, and Ukraine's most protected sector of the economy was the agro-food sector at that time. Inflation was above 10% year-on-year; ban of export of agricultural products was one of the only ways of reducing consumer prices. As a member of the WTO, Ukraine should definitely loosen protectionist policy in this sector, improving performance in the economy.

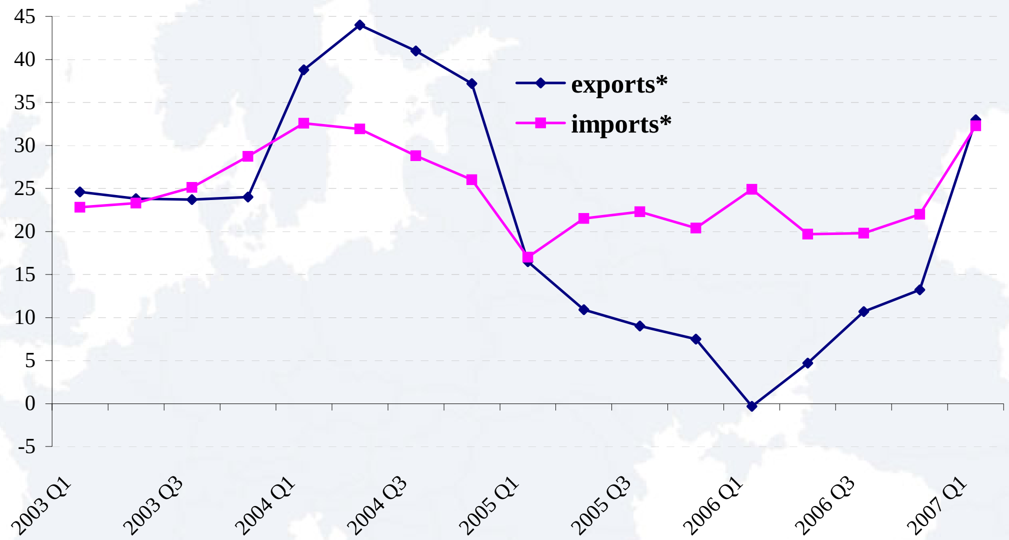
Apart from signing several bilateral protocols, Ukraine still had to amend some legislation concerning state support in agriculture, export tariffs and harmonisation of standards in line with the WTO regulations such as open market for branches of foreign banks. In addition, Ukraine had to complete the Final Report of the Working Party. Although President Viktor

Yushchenko and his government were optimistic and expected the country to become member of the WTO until the end of 2006, due to delays in amending the required legislation and ratification of the membership agreement in the Parliament, 2007 seemed to be a more realistic date.

SIX TO EIGHT: ACCESSION ONLY IN 2008

There are several reasons for the gradual delay of Ukraine's WTO membership. Although monthly exports grew by 11.4% year-on-year in May after six months of continuous decline and imports grew by 24.4% year-on-year, realizing a better trade balance, the Parliament's new fiscal policy contradicted the strategy of the WTO accession and even threatened the economic stability of the country. In July 2006, the Parliament voted to reckon with the Guidelines of the fiscal policy for 2007 prepared by the government. The deputies demanded the reincarnation of special economic zones and the increase of customs duties that were once reduced in the year of 2005. Even more, the government suggested increasing social expenditures, which as well as the rapid growth in utility tariffs contributed to the acceleration of inflation.

Chart 5. Trade in Goods and Services 2003-2007 (quarterly, y-o-y)



**growth rate in USD terms*
Source: State Statistics Committee of Ukraine

Another economically wrong decision of the government was the introduction of licensing and quotas on exports of wheat, barley, rye and corn in October 2006. The result was the stop of grain exports in the fourth quarter of the year. The decision was wrong in the sense that it hurt the international image of Ukraine as a reliable trading partner, damaging the investment prospects in the sector. Obviously, this affected bilateral talks with the individual members of the WTO, making negotiations even slower. Ukraine has not been able to reach agreement with Kyrgyzstan yet, - who also demanded the repayment of some earlier debts as a condition for signing the protocol – thus the likelihood that the negotiation will be concluded before the second half of 2007 has become low.

Despite the negative consequences of the quotas on grain exports, the Ukrainian government further restricted the quotas, - limiting grain export to 1.2 million tons - not taking into account the warnings of various local and international institutions. As a result, the half-year existence of the quotas significantly harmed investment climate and the confidence of Ukraine. Approximately USD 100 million direct, monthly losses were estimated due to the wrong economic decision.[4] In February, the government finally lifted export quotas for such types of grain as barley and corn, which shows how WTO accession may limit discretionary steps of the government in the near future. Since Ukraine could not reach agreement on the aggregate support measures in agriculture, an even worse fact had to be accepted: the WTO accession has become unlikely until 2008.

SYNCHRONIZED ACCESSION SETS BACK UKRAINE'S MEMBERSHIP IN THE WTO

From the end of 2006 constant successes characterised Ukraine concerning the number of laws passed, required for the complete harmonisation of Ukrainian legislation with the WTO rules. 15 out of 20 laws were passed in the first round, dealing with non-discriminatory regulation regime in selected services, improved protection of intellectual property rights and changes in agricultural policies. On May 31, Ukraine has made a significant step towards the completion of membership negotiations with the WTO; the parliament passed 11 more laws, which focused on VAT regime, genetically modified organisms, export tariffs and counterfactual products. These laws expedite Ukraine's accession to the WTO without doubt, however, the most recent foreign policies may jeopardize the country's membership even in the year of 2008.

According to the Ministry of Economy, Ukraine intends to coordinate its accession to the WTO together with Kazakhstan. To benefit from synchronization, the applying countries should fulfil several conditions. First, each country should be at the same, early stages of the negotiations since it makes coordination much easier already from the beginning. If one lags significantly behind the other, it will have to accept some of the other's accession conditions. This would happen in the case of Kazakhstan, as its Working Party was established three years later in February 1996, and has signed bilateral protocols with only 16 of 39 countries that are members of it. Unlike Ukraine, – who is in ongoing negotiations only with Kyrgyzstan - Kazakhstan is still in negotiations with such WTO members as Australia, Canada, the EU and the USA. Moreover, synchronizing the accession process makes sense rather for countries forming a customs union, as in this case the same rules would apply to all members of that union: open access to specific markets, lower their customs duties to the same level and negotiate the same transition periods.

However, Ukraine is not a member of any customs union and its foreign trade policies are different from the ones of the other candidates too. Furthermore, as mentioned before, Ukraine's accession process is almost complete, only some technical procedures are left before membership. As the conditions for effective synchronization do not apply to Ukraine, recent policies of the Ministry of Economy may endanger previously achieved successes and have negative consequences on accession. Moreover, the lack of internal political stability – due to the constantly ongoing conflict between President Viktor Yushchenko and Prime Minister Viktor Yanukovych – slows down the process of foreign policies, postponing Ukraine's membership in the World Trade Organization indefinitely.[5]

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[4] Unfortunately, the same decision was made in June 2007, when long-lasting drought and low grain harvest had to be compensated somehow.

[5] International Centre for Policy Studies (June 20, 2007): Synchronizing Ukraine's accession to the WTO with other countries makes little sense

DEVELOPMENT OF MONETARY PROCESSES IN AZERBAIJAN

After acquired independence on 18 October 1991, similar to other former socialist countries, Azerbaijan experienced hard times in the early nineties in the course of transition from the autocratic, planned economy regime to a new democratic, market economy formation. In this incalculable period, the downturn was observable almost in all economic indicators. The economic growth fell back enormously, the inflation reached extremely high levels (hyperinflation in 1994). The first signs of economic recovery were observed in 1996 with positive real GDP growth and moderating paces of inflation.

BRIEF HISTORY OF THE NATIONAL BANK

Alongside with the above-mentioned developments, the banking system, the status and authorities of the National Bank of Azerbaijan were declared in 1991. The National Bank was announced a supreme emission agency, which carries out state policy in the sphere of credit, money turnover, settlements and currency relations, regulates activity of banking system as a whole and fulfils duties of reserve bank.[6]

In 1992, the Law on the National Bank of Azerbaijan was accepted in which the National Bank - as the supreme state bank - was acquired the rights of issuing banknotes, fulfilling the function of reserve system, regulating and controlling authorities over the banking system. In the same year national currency, the rouble was replaced by real new Azeri one, manat that was declared as the only means of payment at 1 January 1994.

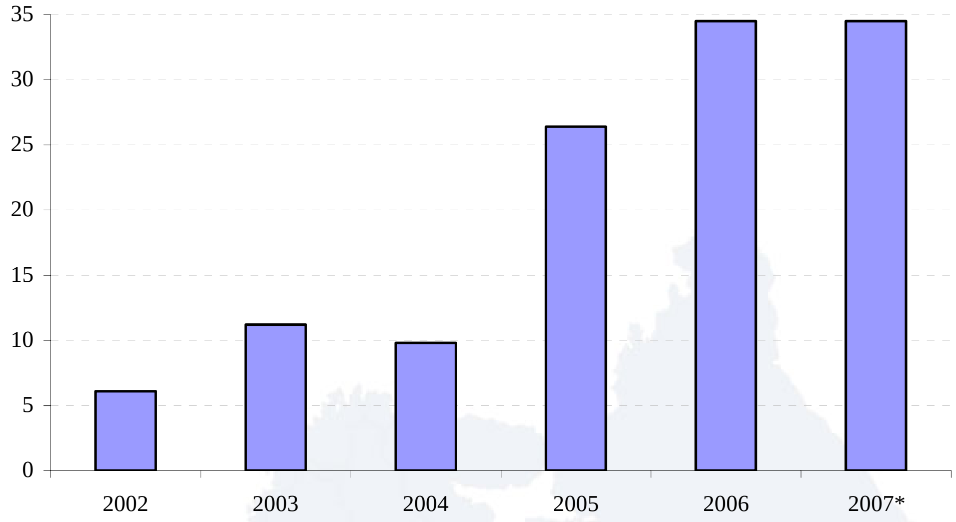
In 1996, the laws on the National Bank was created, which gave the monetary framework of the Azerbaijan Republic. The Bank was developed as a modern national bank with independence from the actual governance, but shall support the government's economic policy that corresponds to its objectives determined by the law. The board meetings shall be held not less than once a month, and the decision of the Board shall be adopted by a simple voting majority.

STYLIZED FACTS

Nowadays, Azerbaijan performs the best in economic growth around the world. Having a look on the GDP growth, we can realize the enormous growth development from the year, 2003. The real GDP growth is expected to reach above 30% in 2007. (*Chart 6*) In the oil sector, the year on year growth was and expected to be much faster; as in the year 2006, the growth in the oil sector was 64.8%. Consumption expenses increased by around 35% (year-on year) in 2006, but the 25% of the total consumption expense is financed by consumer loans, thus it seems, that the consumption smoothing is working in Azerbaijan and has the possibility for that. State budget plays a substantial role in the increasing of demand and the two-digit economic growth rate. In 2006, the investment expenses of the budget was about 4.4 times higher than one year before; which leads the state financed internal investment share to enhanced from 11% to 31% in the total investment.

[6] From the website of the National Bank of Azerbaijan, www.nba.az

Chart 6. Real GDP Growth of Azerbaijan in 2002-2007 (%, y-o-y)



** July 2007*
Source: National Bank of Azerbaijan

The enormous economic growth rate has caused decreasing unemployment rate and has created new workplaces continuously. Higher economic growth and business activity resulted with an increase in demand on loans; for example deposits of the population increased by 55.5% in 2006.

Higher demand of the population for the banking operations on the market leads banks operating more and better; they supply higher portion of their resources and have to preserve their own liquidity in this changing period. On the other hand, growing loan-demand can make other banks enter the market, which could stimulate competition.

THE MONETARY SITUATION

Monetary and banking system has been going through a dynamic and dramatic change from the foundation of the National Bank of Azerbaijan through creating the laws on banking system until now. This analysis is going to make attempt to summarize the main effects of the structural change in the economic policy and the current processes.

As the economic growth generates higher demand, that increases the money demand as well. Consequently, monetary aggregates show continuous rise to be able to fulfil the demand-requirements. The growth of monetary base puts pressure on inflation.

The inflation trend seems to be shifted to a higher level from the mid of 2006 and had its three-year-peak in January 2007. (*Chart 7*) While in 2006, the average annual inflation rate was around 8% – although the National Bank has failed to hold inflation rate in one-digit level in the second half – in the first half of 2007 inflation reached 15%.

Chart 7. Inflation in Azerbaijan, 2005-2007 (%, monthly)

Source: National Bank of Azerbaijan

In December 2006, money multiplier - being the main indicator of the development of financial mediation and characterizing the money creation ability on the banking system - increased by 12.2% and reached the level of 1.3 in comparison with the beginning of the same year. It means that, creating 1 manat by the Nation Bank generates 1.3 manat by the banking system. This multiplier is around 2 in current year, thus the development seems to be extremely fast.

Because of increasing economic activity, the volume of circulating banknotes of the National Bank grew by more than three times in comparison with the beginning of the current year. The national currency has been strengthening with undiminished energy against the US dollar, which creates conditions for the growing trust to the national currency.

Naturally, the National Bank should answer for these considerable economic shocks, thus it is worth to have a look at the development of the main monetary policy instrument, the interest rate. (*Table 3*) In the mid of 2005, there was a trend change in the interest rate trajectory, as the National Bank decided to tight the monetary conditions by pushing the rate upward. Until now, the tightening-cycle has kept.

Table 3. Interest rate changes in Azerbaijan

Date of change	**Official interest rate**
04.01.1996	20.0
05.01.1996	20.0
06.01.1996	15.0
06.01.1998	15.0
07.01.1998	12.0
06.01.1999	12.0
07.01.1999	14.0
07.01.2000	14.0
08.01.2000	10.0
06.01.2002	10.0
07.01.2002	7.0
10.05.2005	7.0
11.05.2005	7.5
01.06.2005	7.5
02.06.2005	8.0
03.10.2005	8.0
04.10.2005	9.0
05.07.2006	9.0
06.07.2006	9.5
02.04.2007	9.5
03.04.2007	12.0
10.08.2007	12.0

Source: National Bank of Azerbaijan

WHAT IS EXPECTED?

The monetary system in Azerbaijan is on evolving way, the National Bank tries to acquire, how a modern economy works and what are the possibilities and answering mechanism of a monetary authority. In the next period, the Bank of Azerbaijan has big challenges to direct and keep monetary indicators accordingly the economic development. The main problem of the bank will be naturally the controlling of the home inflation.

Inflationary factors in the future: increasing home demand, raising ability for getting loans from the banks, the Balassa-Samuelson effect, growing demand for the Azerbaijani financial assets, which leads exchange rate to appreciate, where through the imported goods' prices grow

About the further course of proceedings, the National Bank has the following three options:

"Expected macro-fiscal frame in 2007 will increase the money demand by nearly fifty-sixty percent."

"Main purpose of the National Bank for 200 (as in 2006) will be the holding of basis inflation in one-digit level (8-9 percent)"

"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."[7]

As the developing economy of Azerbaijan keeps performing excellent, the trends realizing today can have long-lasting effects. Thus, inflation and money demand could grow more than expected. However, in such economies the uncertainty is high and the sustainability of economic indicators is questionable.

[7] Source: www.nba.az