

Optimal Monetary Policy Strategy During the Huge Foreign Exchange Inflows

This article studies the questions of determining monetary policy strategy during foreign exchange inflows. International experience shows that a huge surplus in a country's balance of payments puts the central bank in dilemma, whether to target inflation or exchange rate. Targeting inflation could cause sharp appreciation of exchange rate and adversely affect the country's economic competitiveness. While targeting exchange rate could trigger inflation and adversely affect the social life. This article particularly studies Azerbaijani experience in response to foreign exchange inflows. The article draws with a conclusion that combination of both inflation and foreign exchange targeting with exchange rate priority is optimal monetary policy strategy for a country in transition with huge foreign exchange inflows. After achieving financial markets development and solving other institutional problems, the main objective of monetary policy could shift from exchange rate to inflation targeting. Prioritizing exchange rate stability to price stability may have temporary significance.

Foreign exchange inflow to a country with high degree of economic growth has been one of the important tendencies in global economic processes during the last 5 years. If capital outflow originates threat for currency depreciation, the capital inflow entails diametrically adverse problems. The inflow of foreign exchange reserves causes national currency to strengthen, increase in foreign reserves, hinders inflation to be stable and increases risks for financial system stability. Various central banks react capital inflows differently. Generally, in response to capital inflow central banks prevent accelerated currency appreciation. For this purpose, central banks purchase excess foreign exchange from markets. This is the main reason why foreign reserves of developing countries have been doubled within the next three years. Some countries (such as Thailand, Columbia) apply restrictions for capital inflows while other countries (India, South Korea) liberalize capital outflow. Countries in transition also faced with the same problem.

Determination of optimal monetary policy strategy under condition of balance of payments surplus is the main problem of central banks in transitional economies where institutional problems have not been completely solved. During capital inflow, a central bank may choose one of the following monetary policy strategies:

- **Exchange rate targeting or nominal exchange rate stabilizing.** Under this policy central bank should purchase excess supply in the foreign exchange markets. As a result, monetary base will rapidly increase and push up inflation which is undesirable from the social point of view.
- **Inflation targeting or prices stabilizing.** In this case, the central bank shouldn't worry about exchange rate appreciation and purchase excess reserves from the foreign exchange markets. Sharp appreciation of national currency could have negative affect on financial system stability of a country with high degree of dollarization. In such a way, if the share of foreign currency in banking deposits and credits is high, sudden fluctuations in exchange rate will incur big losses for financial sector. Moreover, appreciation of national currency weakens the country's competitiveness.
- **Simultaneous stabilization of nominal exchange rate and prices.** In this case, the central bank should purchase excess supply of foreign currency and then sterilize excess monetary base in national currency. As a result, domestic interest rates will increase and this will attract specula-

¹ Deputy Director of Monetary Policy Department, National Bank of Azerbaijan Republic. Master in Economic Science.

tive capital inflows which spill-overly lead to inflation. Inflow of hot money will increase financial system sensitivity to international crisis.

Selecting monetary policy strategy depends on a country's specific features.

Azerbaijan has also experienced huge capital inflows during the last 5 years. Mainly, it is related to rapid extraction of oil production and oil export as well as increase of oil prices in the world markets. As a result, current account balance surplus amounted 30% of GDP in 2007. Present and future oil inflows create condition for international capital flows to the non-oil sector of the economy. Consequently, international capital inflow to non-oil sector of Azerbaijan is growing rapidly. Rapid increase in foreign liabilities of domestic banks should be especially noted. Only in 2007 foreign liabilities of domestic banking system have grown up by 2,2 times.

National Bank of Azerbaijan (NBA) responds to foreign exchange inflows by pursuing combinatory policy, simultaneous targeting of inflation and exchange rate. Considering high dollarization in the economy, NBA sees its main responsibility to keep stability of the national currency against the USD. The national currency appreciated by 6,3%, 5,1%, 3% in 2005, 2006 and 2007 respectively. To keep exchange rate stability, NBA purchases excess foreign exchange from the foreign exchange markets. Estimations show that without NBA intervention in the foreign exchange market the national currency would be appreciated at least 20% in 2007. This would negatively affect the financial position of the banking system since, more than half of financial system assets are made up in foreign currency. Since 2002 NBA foreign reserves have grown up 4,8 times. Monetary base also grows rapidly which is reflected in price movement. Monetary base in national currency increased 17%, 2,8 times and 77% in 2005, 2006, and 2007 respectively. Annual inflation (CPI) increased from 3–4% in 2002–2003 to 16–17% in 2007.

Why NBA prioritize exchange rate stability to price stability?

As is well known, there are criteria's to determine degree of flexibility of exchange rate regime for countries. These criterias are determined base on the comprehensive analysis of international experience. For determining exchange rate regime we may analyze these criterias from the case of Azerbaijan.

1. Size of economy. In general, countries with large economies may select more flexible exchange rate regime since, these countries are less subject to external factors. In this case, floating exchange rate regime positively affects the external equilibrium. Azerbaijan is a small country and the share of its economy is miserable in the global economy. Currently, GDP of the country amounts 0,02% of the world GDP. Therefore, we can predetermine that for Azerbaijan fixed exchange regime is more appropriate.

2. Degree of economic openness. Countries with high degree of economic openness should select more fixed exchange rate regime because, in such economies the impact of exchange rate on the macroeconomic processes is higher. In countries with high degree of economic openness flexible exchange rate regime is undesirable from the macroeconomic stability point of view. Economic openness of Azerbaijan increases each year. As a result of 9 months of 2007 the share of import amounted to 21,5% of GDP and share of export reached to 73,9% of GDP. However, considering Azerbaijan specification, it is expedient to evaluate economic openness by using share of non-oil import and export in non-oil GDP, since import and export operations in oil sector are not affected by changes in exchange rate. In 2007 share of non-oil import and export in non-oil GDP amounted to 16,5% and 4,2%, respectively. Therefore, Azerbaijan is not a country with high degree of economic openness and this gives possibility to select more flexible exchange rate regime.

3. Degree of economic diversification (particularly export). Countries with high degree of economic diversification (particularly export) may select more flexible exchange rate regime. Azerbaijan

economy is dominated by oil sector. The share of oil and gas sector is 50% and 80% in GDP and export, respectively. In the future, these ratios are expected to be increased. Considering low level of economic diversification, selecting fixed exchange rate regimes is more appropriate for Azerbaijan.

4. Level of economic and financial market development. Countries with developed economy and financial market may select more flexible exchange rate regime. According to universal indicators, Azerbaijan remains behind of industrial countries for GDP per head. Financial markets are also not well developed. In financial markets it is passively used such instruments as forward and futures albeit, high dynamism in foreign exchange market. This criterion let us conclude that, Azerbaijan should select fixed exchange rate regime.

5. Capital mobility. The more capital mobility the more flexible exchange rate should be selected. In Azerbaijan there is no any restriction on capital inflow. Capital outflow was liberalized in June, 2007. That means Azerbaijan can be characterized as a country with high level of capital mobility. According to this criterion, Azerbaijan may select free floating exchange rate regime.

6. Degree of dollarization. The more degree of dollarization the more fixed exchange rate should be applied. Despite people's confidence in national currency increases in Azerbaijan last years, degree of dollarization still remains high. Thus, the share of foreign currency deposits in total deposits is 50%, and the share of foreign currency deposits in M3 exceeds 29%. More than 45% bank credits are given in foreign currency. High degree of dollarization generates prerequisite for selecting fixed exchange rate regime.

7. Difference between domestic inflation and inflation in partner countries. The more the difference between inflation in domestic country and in partner countries the more fixed exchange rate is appropriate. Recently, it has been observed an increase difference between inflation in Azerbaijan and in partner countries that suggests selecting fixed exchange rate regime. In 2007 inflation in Azerbaijan contained 16%, where average weighted inflation in partner countries contained 9%.

So, 4 criteria from 7 suggest possibility of selecting more fixed exchange rate regime for Azerbaijan.

Along with the exchange rate targeting, NBA tries to intensify anti-inflationary effectiveness of the monetary policy. For this reason, NBA realizes several measures in various directions.

Considering limited scope of the government security market, since 2004 NBA has issued its own bills to limit monetary base growth. Through these bills NBA conducts outright transaction as well as REPO and reverse-REPO operations. Long-term liquidity shortage and surplus are regulated through outright transactions of NBA bills. Short term liquidity is regulated through REPO and reverse-REPO. The volume of NBA short-term note portfolios increased 58%, 3,6 times and 2 times in 2005, 2006 and 2007, respectively. However, the share of these bills in monetary base is 7–8% in all. NBA considers irrelevant sharp increase of its bills since, such increase could cause interest rates to be increased.

In order to cut down demand for credits and decrease monetary base, NBA increased its discount rate for 6 times within the last 3 years. Presently, interest rate on overnight credits of NBA is 19% that exceeds annual inflation.

Because of disequilibrium in foreign exchange market due to excess foreign exchange, at the beginning of June 2007 capital outflow was liberalized. Starting that time Azerbaijani resident can have direct or portfolio investment in abroad, purchase real estate in abroad, and keep their savings in foreign banks. Local banks were also given rights to lend to non-residents. To decrease resident's risks geographical limitation is applied on capital account liberalization. Thus, residents could export their capitals only to OECD countries and Russian Federation. Until June 2007 export of capital was possible only due to NBA permission.

Positive outcome of selected monetary policy strategy in Azerbaijan is protecting of the country's economic competitiveness. Real effective exchange rate has been appreciated only 10% within the last two years. If NBA don't not prevent national currency to be appreciated, real effective exchange rate will be further appreciated. Anti-inflationary effect of this policy could be small, since nominal exchange rate affects inflation indirectly while real effective exchange rate affects directly. Due to current exchange rate policy Azerbaijan was able to avoid so-called Dutch Disease¹. In Azerbaijan non-oil growth is more than 10 %. Furthermore, such policy enables to keep financial and banking system stability.

Thus, simultaneous inflation and exchange rate targeting with exchange rate priority is optimal monetary policy for a country in transition faced with huge foreign exchange inflows. By achieving financial markets development and solving other intuitional problems the main objective of monetary policy can be shifted from exchange rate to inflation targeting. Because effective central bank it's a bank that can provide low, stable and predictable rate of inflation. Priority exchange rate stability over price stability can bear only for short-term.

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¹ Deterioration of competitiveness in manufacturing industry against a background of sharp development of natural resource industry.