Mendel University in Brno
Faculty of Business and Economics

Institutional Reforms of Monetary Policy in Azerbaijan

Bachelor Thesis

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Brno 2017

Acknowledgement
I would like to thank my thesis supervisor, Ing. Aleš Franc, Ph.D., for his willingness to help, valuable advices and comments and friendly approach during this work. Also, I would like to thank Daria Fokina and my parents for their support.

Statutory Declaration

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Abstract

Guliyev, F. Institutional Reforms of Monetary Policy in Azerbaijan. Bachelor thesis. Brno: Mendel University, 2017.
Bachelor thesis engages in the institutional reforms of monetary policy in Azerbaijan. The aim of this paper is to describe the institutional reform of the monetary policy of the country and to assess the economic impact of these reforms. Thesis is focused on outstanding situation in country's economy and monetary institution building after collapse of the United Socialist Soviet Republics. Author studies transition period of economy from central planned system to free market system, building of monetary authority, independence of central bank and monetary policy's performance. In practical part author evaluates the changes in institutional reforms of monetary policy for three different periods of time. The institutional reforms of monetary policy were evaluated by effect on main economic indicators. Based on the data, it is possible to say that reforms had a positive impact on first two analysed periods, however recent reforms did not have expected positive influence.

Keywords

Monetary policy, transition economies, Azerbaijan, central bank, institutional reforms, independence of central bank, Central Bank of Azerbaijan.

Abstrakt

Guliyev, F. Institucionální reforma měnové politiky v Ázerbájdžánu. Bakalářská práce. Brno: Mendelova univerzita v Brně, 2017
Bakalářská práce se zabývá institucionálními reformy měnové politiky v Ázerbájdžánu. Cílem této práci je popsat institucionální reformy měnové politiky země a posoudit ekonomicky dopad těchto reforem. Práce je zaměřena na výchozí situaci v hospodářství zemi a budování centrální měnové instituce po rozpadu Svazu Sovětských Socialistických Republik. Práce zahrnuje období transformace hospodářství od centrálně plánované ekonomiky do volného tržního systému, nezávislosti měnové centrální banky a výkonu měnové politiky. V praktické části autor hodnotí změny v institucionálních reformách měnové politiky pro tři různá časová období. Byl hodnocen vliv institucionálních reforem monetární politiky na hlavní ekonomické ukazatele. Na základě těchto údajů je možné říci, že dopad reforem na první dvě analyzovaná období byl pozitivní, nicméně nedávné reformy očekávaný pozitivní vliv neměly.

Klíčová slova

Měnová politika, tranzitivní ekonomiky, Ázerbájdžán, centrální banka, institucionální reformy, nezávislost centrální banky, Centrální banka Ázerbájdžánu.

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1 Introduction

After the breakdown of the United Socialist Soviet Republics (USSR) in 1991, on the political map of our world was created fifteen new independent states (www.soviethistory.msu.edu, 2016). After the collapse of the socialist regime all these states had a common economic goal and that goal was a successful transformation of the entire economic system from a central planned to a market economy. Planned economy was the only economic system in these countries over the past sixty-nine years. Certainly, for such a transformation of the economy was needed to carry out reforms of various institutions of government. One of those institutions, which has an enormous responsibility in the transformation of the economy on its shoulders, is the central bank and its monetary policy.

Monetary policy is a key point for the conduction of economic policy in any country in the world. The reason of its significance lies in the possibility to impact monetary base and interest rates, which in many cases have an influence on the value of real aggregate indicators and thus the whole economy. In the past, monetary policy experienced ious changes and turnabouts that were not only caused by various economic theories, as well as by particular aspects of political systems. These aspects contain characteristics of legal system, traditions, customs and institutions that represent a specific country. Other important impact has been performed by political ideologies (Goodman, 1992).

In Soviet Union monetary policy was authorized by Gosbank (National Bank). Gosbank was one of three economic authorities in Soviet system with Gosplan (National plan committee) and Gossnab (National supply committee). Because of different economical system in USSR, money had a different function as well. Economy in USSR worked only on planned supply of goods and services with a strict price so that came into of lost of measure of value function of money.

Money under communism passively accommodated the financing needs of the central plan, which underlined production in the real sectors. As is well known, central plans set production targets specified in physical units in every sector to guarantee a target growth rate for the economy. The emphasis on growth, given labour force and technology, required new investment; and planners decided the level of sectorial investment using investment coefficients derived from detailed input-output studies. An investment plan was then created by aggregating the sectorial investment needs (Martha De Melo, Cevdet Denizer, Alan Gelb, 1996).

The part of the financial sector was to fill the investment plan as well as other financing requirements of the state enterprises and the government budget. All these were included in the credit plan. Planners set targets in real sectors and financial flows were adjusted to accomplish them. The central credit plan worked like a global coordinated credit plan; interest rates were nota factor in the mobilization and allocation of assets, much less in managing aggregate demand. Money was not a policy instrument, and therefore most instruments of monetary policy found in market economies were not used in central planned economies (Martha De Melo, Cevdet Denizer, Alan Gelb, 1996).

However, this did not mean money and credit were insignificant. For price stability, planners had to guarantee a equality between money supply and output. To accomplish this balance, the system was split into cash and non-cash sectors. Non-cash exchanges between enterprises were accounting entries within the financial system and had no effect on the money supply. Cash transactions were undertaken by households, who received their wages in real money. The balance between the wage bill and consumption goods valued at administratively settled prices was a key condition for the equilibrium of the system. To the extent that wages paid by the authorities exceeded expenditures on goods sold by state-owned enterprises regularly in short supply money would be printed to finance the gap, creating inflationary pressures (Martha De Melo, Cevdet Denizer, Alan Gelb, 1996).

In sum, the financial institutions that actualized the Gosbank's credit plan were passive. They had no role in credit allocation, and the basic legal, accounting, and regulatory systems found in market economies. Knowledge of enterprises accounts and investment projects was ordinarily situated in the central planning agency, not in the banks. With this set of initial conditions, it is not surprising that improvements in resource allocation from financial intermediation have been slow in transition economies (Martha De Melo, Cevdet Denizer, Alan Gelb, 1996).

All the mentioned has explained us why monetary policy is such an important economic policy and why it differs across countries. This sovereignty is sometimes called as the political and legal sovereignty in monetary issues.

1.1 Purpose and Methodology

The aim of the thesis is to describe the institutional reform of monetary policy in Azerbaijan and assess its economic impact. In my thesis I will analyse, how successfully was managed implementation of institutional reforms in the monetary policy of the Central Bank of Azerbaijan Republic.

Thesis will contain both theoretical and practical parts. In theoretical part I will describe the outstanding situation of bank system after Soviet Union collapse, the very first steps that were taken by government in monetary policy, the structure of bank system, I will highlight its specificity compared with other transition countries.

In the next chapter, we are interested in the formation of independent Azerbaijan banking sector during the transitive period. As the author of the work will analyse the institutional reform of monetary policy focused mainly on central bank independence. I will focus on achieving the objectives of this thesis by studying specialized foreign literature, comparing to other transitive economies and analysing macroeconomic data. Especially, I will target institutional reforms if monetary policy, instruments and tools used by monetary authorities and specific ways of their use, conduction of monetary policy and indicators used for its assessment.

As follows, a comparison will summarize the facts described previously and point out the most important differences. In practical part I will spotlight monetary policy evaluation. In this thesis I would like to study monetary policy regime which was practiced by authorities. The policies will be sorted chronologically, described and their impacts analysed using a variety of financial, monetary and aggregate indicators, such as interest rates, exchange rate, gross domestic product (GDP) growth, inflation, government reserves, money supply etc. As a logical ending will be a comparison which will summarize the information provided in the previous description. This comparison will connect the practical differences with the theoretical ones.

2 Establishment of monetary policy in Azerbaijan Republic

The national banking system today is one of the most important and inseparable structures of a market economy in the Republic of Azerbaijan. After independence, the State developed a two-step market-oriented banking system, which is represented mainly by the Central Bank and commercial bank institutions. The system provides an uninterrupted communication between government, banks and people, redistribution of temporary free funds and performs other banking functions, including constant cooperation in the market. These components form an integrated system designed by common functions and purposes of the banking system. This is also confirmed by the presence of a common regulatory framework for banking legislation, which defines the legal status and rules governing the interaction of basic units of the banking system and regulates the most robust types of relationships between them.

Among the credit institutions in the country leading role belongs to commercial banks, whose number at the end of 2015 stood at 43, of which 2 were public administration and 41 private, including 21 banks with foreign capital. The prevailing model is a universal bank that offers a full range of banking services, including electronic communication channels (www.cbar.az, 2016).

2.1 Transitive period

At the start of transition period, the former socialist countries were commonly oriented toward industry. As you can see from Figure 1 the structure of transition economies was various. Central and Eastern Europe countries had distinguished service sectors, however in the Former Soviet Union (FSU) countries services did not exceed.

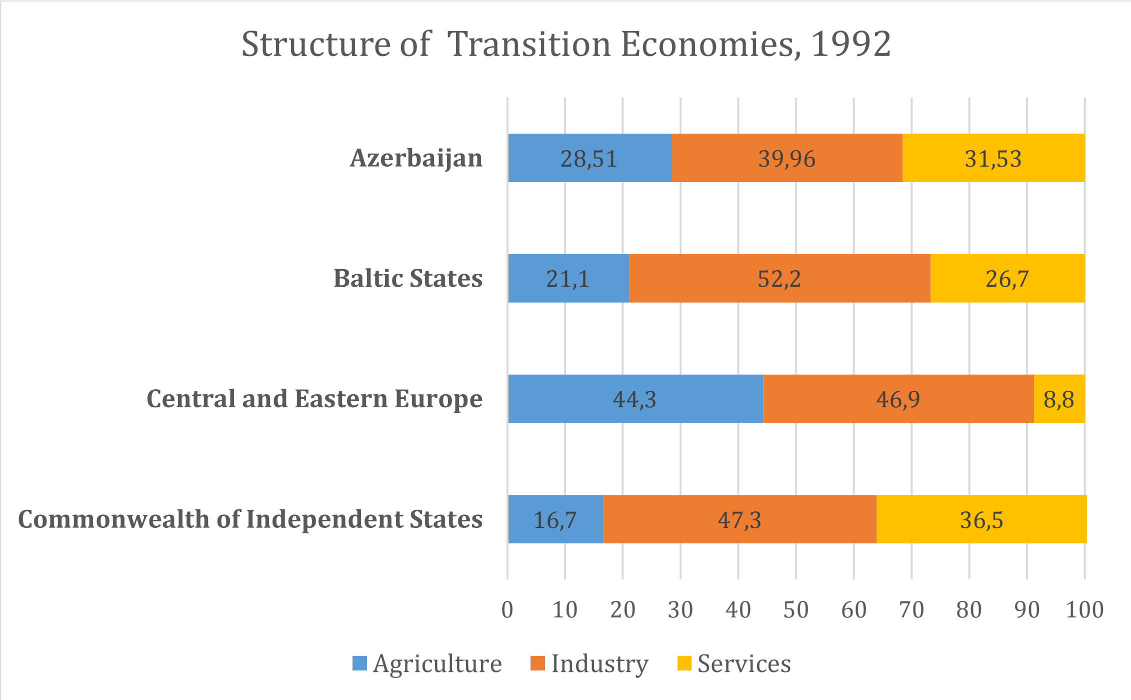

Figure 1. Structure of Transition Economies in 1992[1].
Source: Khaled Sherif et al. 's (2003), p. 8

According to Khaled Sherif et al. 's (2003) in this kind of economic structure, banks were geared to financing industry. When market opened, these banks financially supported the export of goods for currency. This kind of support of export by financing had already happened in post-socialist countries like Yugoslavia, Hungary and Romania, which had helped to these economies to open their free markets regimes many times before the collapse of the Soviet Union. However, we know some cases when functions of financial support of export put their focus on agriculture or commodities for example, natural gas in Turkmenistan, oil in Kazakhstan and Azerbaijan and cotton in Uzbekistan and Tajikistan.

In order to understand the current situation in most of the transitive countries, it is really important to have a look on their first steps in early independent years. Transitive period did not pass the same way for all post-socialist countries. The banking sector of the Azerbaijan has overcome structural and institutional transformation that were corresponding to the amendments, carried out by other transitive countries, during the transitive period after collapse of socialist regime. Banking system reform in post socialist countries has shown common features yet produced comprehensively unique results. All transition economies have presented two-tier banking systems as socialism and its one bank (one tier) system collapsed around late 80's and early 90's. These amendments built up the general basis for normal banking functions by a second tier of commercial banking and gave

[1] Data for Azerbaijan was retrieved from World Bank.

the monetary policy and its execution in the hands of the central bank system. Before transition period these functions had all been a piece of one unique bank system in socialist countries. Thus, simply creating the institutions of financial intermediation represented a big test to transition countries. It included characterizing new parts and responsibilities for the new system. Investment, and trade were in a condition of emancipation and even collapse.

As a main face of the reconstruction, central banking systems were commonly authorized with banking supervision over other banks, because of their monetary policy part in system. As an original step, fundamental reasonable standards and original measures to create supervisory oversight over the banks were introduced. However, the reasonable requirements have ended up to be insufficient. Observational power was undermined by wretched accounting and financial data in the banks, fragile off-site supervision capacity, and lack of experience with onsite inspection as it is portrayed in Khaled Sherif et al (2003). At the same time by majority of the economics laws for both the new central banking system and the second-tier commercial banks, were additionally introduced. These primarily managed with capital, ownership, reporting requirements, lending exposures and other common constituent elements of banking legislation and regulation.

After a primary period of experimentation with initiation to liberalize the licensing operations for new commercial banks and low minimum capital requirements, majority transition economies have experienced extreme precariousness in their banking sectors mirroring macroeconomic problem like as for instance the serious depression in the purchasing power of enterprises and individuals, exchange rate unsteadiness, hyperinflation and the breakdown of traditional trade models and distribution channels. Deficit also has become to be more common spread issue, notably in the Commonwealth of Independent States (CIS) countries, where fiscal accounts, power companies, unemployment compensation, wage earners, health, and other social funds efficiently turned out to be net creditors to the economy (Khaled Sherif et al., 2003).

In table 1 you will see list of specialized state banks such as industrial investment and foreign trade, savings, agricultural banks, that were a complement to the central bank, in many countries. While this system may show up to imitate the two-tier system that were created later later, these banks functioned more like departments of a single bank than as separate, autonomous commercial banks.

By 1992 the medium for the 26 post-socialist transition economies countries was about seven major state controlled banks and majority of transition economies had at least three specialized state controlled banks. However, the major part of transition economies had state controlled banks that particularized by function, with crossbred functions in some occasions (Khaled Sherif et al., 2003).

Tab. 1 Profile of specialized state banks in selected[2] transition economies

Country	Industrial	Agriculture	Saving	Foreign Trade	Other
Azerbaijan	✓	✓	✓	✓	×
Armenia	✓	✓	✓	✓	×
Czech Republic	✓	×	✓	✓	✓
Georgia	✓	✓	✓	×	✓
Hungary	✓	✓	✓	✓	×
Kazakhstan	✓	✓	✓	✓	✓
Latvia	✓	✓	×	✓	×
Lithuania	×	✓	✓	×	×
Turkmenistan	✓	✓	✓	✓	✓

Source: Khaled Sherif, Michael Borish, and Alexandra Gross, 2003, p.17

According to the research of Thorsten Beck and Luc Laeven (2005), resource entrenchment and endowments of the post-socialist countries affected the political pattern of transformation at the start of transition. Transition economies with elites that were less closed and economies less dependent on natural resources had less stimulus to secure to authority and were thus more likely to permit an authorization and competitive political structure in the country.

This ingenious political system, on the other hand, had decisive chain replication for the type of property rights that arised in the middle of the transition period, and particularly the level of opposition to the appearance of rule of law and public property rights. Beck and Laeven (2005) are suggesting that the two influences of natural resource entrenchment and funds on primary political framework and institutional progress around each other out. As an illustration Thorsten Beck and Luc Laeven (2005) circumscribe the situation whilst there is little diversity in the level of political trench throughout Former Soviet Union (FSU) countries there is a large modification in natural resources within FSU countries. Afterwards, even within the group of FSU countries there is a broad diapason of change in the behaviour of the political elite of the country and the level of institution creating within the transition period of economy is different for each post-socialist country. While both the availability of considerable natural resource endowments and a trenched political elite turned out to be harmful to the appearance of healthy property rights and rule of law, the effect was intensified by the presence of both[3].

[2] I have selected for comparison two countries from the South Caucasian region (Armenia and Georgia), two countries from Central Europe (Czech Republic and Hungary), two Baltics countries (Latvia and Lithuania) and two countries from Central Asia (Kazakhstan and Turkmenistan).

[3] For example, Azerbaijan and Armenia. Armenia is a country with few natural resources. Countries have a contradiction with each other over the disputed territory Nagorno-Karabakh after gaining the independence. In spite of a great socialist tradition Armenia had a strong right-wing nationalist

On the one hand, we have countries like Czech Republic, Hungary and Slovakia that possess with a few natural resources and have spent less time under socialist rule (see Table 2). Not unexpectedly, these three countries have quickly built up their market-based institutions, judging by Thorsten Beck and Laeven's indicator. On the other hand, Azerbaijan, Turkmenistan and Kazakhstan have both large amount of natural resources and highly trenched socialist elites. These three countries have among the lowest weight for Thorsten Beck and Luc Laeven's model of institutional development.

Tab. 2 Institutional development across selected transition economies.

Country	Institutional development	Communist share	Years under socialism
Azerbaijan	-0.87	100	71
Armenia	-0.37	0	71
Czech Republic	0.78	16	42
Georgia	-0.71	25.6	70
Hungary	0.64	8.4	40
Kazakhstan	-0.59	100	71
Latvia	0.20	29.4	51
Lithuania	0.23	3.5	51
Turkmenistan	-1.22	100	71

Source: Thorsten Beck and Luc Laeven, 2005

Different hallmark which is really significant for us to understand the outstanding context in Azerbaijan is institutional development. Institutional Development is the average of six primary constituent element indicators: government effectiveness, regulatory quality, political stability, rule of law, absence of corruption, and voice and accountability. Azerbaijan hit the point -0,87 which is the third

movement under the governance of Levon Petrosian. However, in Azerbaijan the socialists had political power greater than in average FSU country. A crucial distinction between the two countries is the amount of natural resources, Armenia has relatively few natural resources and Azerbaijan has significant oil reserves and rich mineral deposits. According to Beck and Laeven's hypothesis is that the degree of natural resources is a crucial aspect in explaining why the right-wing nationalists of Armenia did devoted market-based reforms, while the socialist of Azerbaijan have shown a very little interest in moving country to a market economy (Thorsten Beck and Luc Laeven, 2005).

lowest score from all post socialist countries (Thorsten Beck and Luc Laeven, 2005).

On a third column of Table 2 you will see Beck and Laeven's second index of the primary political structure, which is the share of seats in Parliament of the former communist party that had control in the first held election after transition period. This ranges from zero in Armenia and 29,4 in Latvia. Five countries from twenty-six[4] that did not hold free elections after transition are coded with 100%: Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan and Turkmenistan. That means that communist share of the Parliament in these countries remained 100% after the collapse of the regime. It allows us to day that communist regime in these countries did not that much collapsed as in other countries as an aftermath of USSR fall.

Figure 2 shows the inequality in institution building throughout the selected transition economies in our instance. I use an indicator compiled by European Bank for Reconstruction and Development (EBRD). This particular index is index of banking sector reform. Index is provided for financial sector reforms, which contains data series like Number of foreign-owned banks, asset share of state-owned banks (%), asset share of foreign-owned banks (%), non-performing loans (% total loans), domestic credit to private sector (% GDP), domestic credit to households (% GDP), mortgage lending (% GDP), stock market capitalisation (% GDP), stock trading volume (% market capitalisation). EBRD as itself have another indexes for transition economies as for example, enterprise reforms, competition policy, banking sector reform and reform of non-banking financial institutions, with values between one and four[5]. While not a detector of institution development, this variable determines some of the legislative and regulatory inputs into institution building. While some countries, most notably Hungary started earlier and thus with more reformed institutions in 1991, the gap between these early reformers and

[4] In early 90's of 20th century 26 countries experienced transition in their economies.

[5] In case of bank reforms EBRD methodology is the next:

- 1 Little progress beyond establishment of a two-tier system.
- 2 Significant liberalization of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
- 3 Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalization with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
- 4 Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
- 4+ Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

others has widened, with Belarus, Tajikistan and Turkmenistan having undertaken little reforms according the research of EBRD.

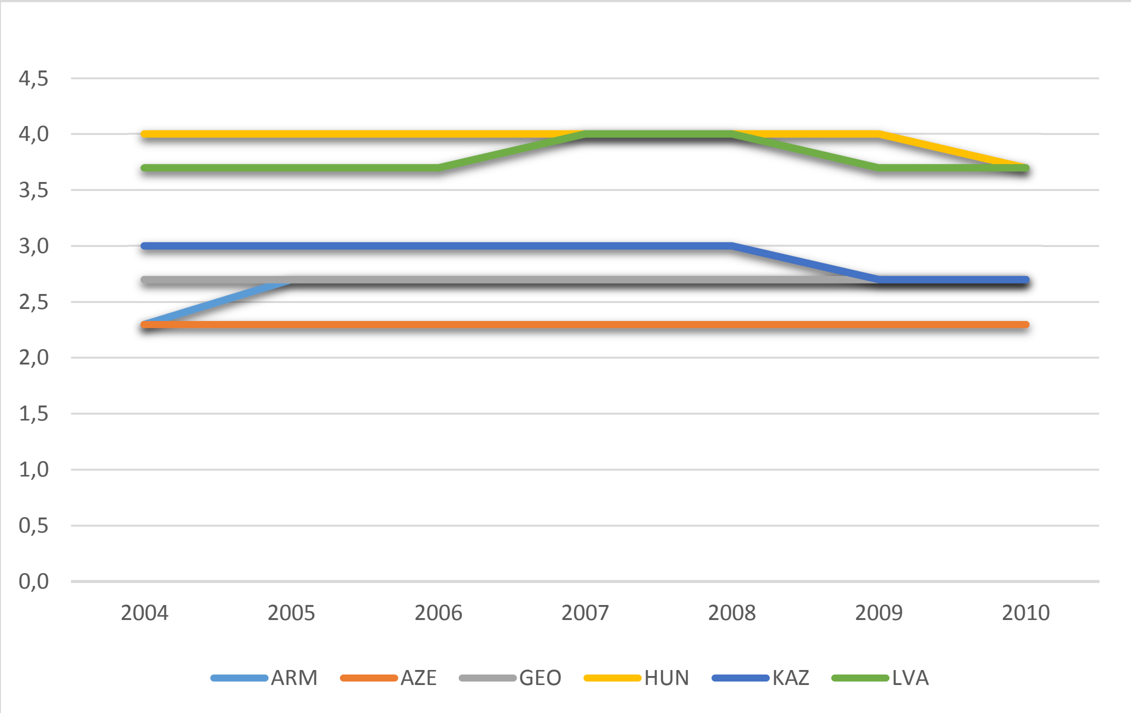

Figure 2. EBRD index of bank sector reform for selected Transition Economies
Source: EBRD (2016)

Index provided us by research of EBRD is really helps us to understand overall situation in bank system and willingness of government to execute reforms.

3 Central Bank of Azerbaijan Republic

The central bank has been described as "the lender of last resort", which means that it is responsible for providing its economy with funds when commercial banks cannot cover a supply shortage. In other words, the central bank prevents the country's banking system from failing. However, the primary goal of central banks is to provide their countries' currencies with price stability by controlling inflation. A central bank also acts as the regulatory authority of a country's monetary policy and is the sole provider and printer of notes and coins in circulation. Time has proved that the central bank can best function in these capacities by remaining independent from government fiscal policy and therefore uninfluenced by the political concerns of any regime. The central bank should also be completely divested of any commercial banking interests.

Twenty-five years ago political map of world has changed and 15 new independent countries appeared after Gorbachev’s announcement of the dissolution of the Soviet Union and his resignation as its president. These developing economies are confronted with issues such as the move from managed to free market economies. The primary concern in that kind of situation is often controlling inflation. This can prompt the formation of an independent central bank however can take some time, given that many developing nations maintain control over their economies in an effort to retain control of their power. Unfortunately, many developing nations are faced with civil disorder or war, which can force a government to redirect funds away from the development of the economy as a whole. Nonetheless, one factor that seems to be confirmed is that, for a market economy to develop, a stable currency (whether achieved through a fixed or floating exchange rate) is required.

Governments generally have some level of impact over even "independent" central banks; the aim of independence is primarily to prevent short-term interference. For instance, the Board of Governors of the U.S. Federal Reserve are nominated by the President of the U.S. and confirmed by the Senate, publishes verbatim transcripts, and balance sheets are audited by the Government Accountability Office (www.federalreserve.gov, 2016)

The literature on central bank independence has characterized a number of types of independence. The most common are following three

- Legal independence
- Goal independence
- Political independence

Legal independence is the autonomy of the central bank that is stored in law. This type of autonomy is limited in a democratic country; majority cases the central bank is accountable, at some degree, to government officials, either via a government minister or immediately to a legislature. Even describing the legal independence has vindicated to be a challenge since legal system typically provides only a scope within which the government and the central banking system work out their relationship by itself (Carl E. Walsh, 2005).

When we say goal autonomy we imagine that the central bank has the prerogative to set its own policy goals, whether control of the money supply, inflation targeting or maintaining a fixed exchange rate. While this type of independence is more common, majority of central banks prefer to declare their policy goals in collaboration with the appropriate government branches or departments. This enlargement the transparency of the policy installation process and therefore increases the credibility of the goals selected by providing confidence that they will not be changed without notification. Besides, the setting of collective goals by the central banking system and the administration helps to avoid situations where fiscal and monetary policies are in contradiction; a policy conjunction that is clearly optimum (Carl E. Walsh, 2005).

By central bank political autonomy, we understand the liberty of monetary policymakers from straight political or governmental impact in the management of policy (Carl E. Walsh, 2005).

3.1 History of Central Bank of Azerbaijan Republic

On October 18, 1991, Azerbaijan established its state independence. However, the legal basis for foundation of banking system and the National Bank of the Azerbaijan Republic, was formed before. Legal basis for establishment of independent banking system and economic independence of the Republic of Azerbaijan was created on May 25, 1991, by Article 14 of the Constitution Act called "Banking System and Money Turnover". This article covered topics like, the status and authorities of the National Bank of Azerbaijan alongside with turnover of national monetary unit of Azerbaijan and conditions for legal basis of independent banking system. Beside these lines, the National Bank was declared as a supreme institute of emission that followed the state policy in the sphere of money turnover, settlements, credit and foreign exchange relations, and also as an authority that regulates overall activity of the banking system as a one unit and fills functions and obligations of reserve bank of state (www.cbar.az, 2016).

On October 8, 1991, by means of the Decrees of the President of the Republic of Azerbaijan in correspondence with the Law of the Republic of Azerbaijan on Extra Measures on Stabilizing Economic and Socio-Political Life of the Republic, establishment and liquidation of central state executive authorities as well as regulation of budgeting and financial system were precisely defined and let the country towards foundation of Independent Monetary Institute. Dated February 1992, the National Bank of the Republic of Azerbaijan was finally established as an independent governmental institute on the basis of the State Bank, the former USSR Industrial-Construction Bank and Azerbaijani branch of Agro-Industrial Bank of the USSR (www.cbar.az, 2016).

Skipping the next chronological order of reforms, acts and laws, it is necessary to mention that on March 18, 2009, after the Referendum Act of the Azerbaijan Republic called "Additions and amendments to the Constitution of the Republic of

Azerbaijan" where majority of the voters choose to change the name of "The National Bank of the Republic of Azerbaijan" to "The Central Bank of Azerbaijan Republic" (CBAR) (www.cbar.az, 2016).

The Central Bank of Azerbaijan Republic is managed by the Executive Board with the Governor at the head and owned by the Republic of Azerbaijan. The Board is in charge of the supervising the administration and activities of the bank and for other institutionalized tasks. The structure of Executive Board is composed of the Governor, who is the chairman and 4 members appointed. All members of the Executive Board are appointed for 5 years in double process by President and the Milli Mejlis (National Assembly). (www.cbar.az, 2016).

The very first governor that was appointed is Qalib Aghayev. His first term started 12th of February 1992 and was not long due to overall political situation in country (Nurmammadov, 2015). On August 7, 1992, alongside with the Law of Azerbaijan Republic on Banks and Banking Activity in the Azerbaijan Republic, there was adopted the Law on the National Bank of Azerbaijan. On August 15 of the same year the national currency of the Azerbaijan Republic manat was put into circulation in parallel with soviet rouble (www.cbar.az, 2016).

Later on, 20th of November the same year governor Qalib Aghayev was replaced by Cavanshir Abdullayev who also did not serve long as a governor of Central Bank (Nurmammadov, 2015).

On December 1,1992, the National Assembly of the Azerbaijan Republic ratified the Resolution on Approval of the Charter of the National Bank of the Azerbaijan Republic. These kinds of legislative acts were vital for banking activity and played the key role in the foundation of the national banking law and facilitated further adaptation of banking activity to new socio-economic conditions. The stated legislative act determined the National Bank as the central bank of the state, gave the authority of regulatory and supervisory institute over the banking system, also granted the exclusive rights of issuing the of national currency and fulfils the function of reserve system (www.cbar.az, 2016). As we can see the Resolution founded the central bank as a monetary policy institute of the country which is very important point in establishment of any independent country.

Qalib Aghayev was appointed back as governor after almost one year his first appointment. However political regime again changed in country and in 1994 dated 29th of June by President and national Assembly Elman Rustamov started fulfilling the position of the governor of CBAR. Since then Elman Rustamov has not left his post as a head of the Executive board (www.cbar.az, 2016).

Effective January 1, 1994 manat was proclaimed the only payment facility of the country. On June 10, 1996, the Laws on the National Bank of the Republic of Azerbaijan on Banks and Banking Activity empowered the banking system to further approach towards the international practices and assisted in the process establish reliable credit institutions (www.cbar.az, 2016).

3.2 Independence of Central Bank

3.2.1 Measurements of Central Bank Independence

There is various irresistible measure of central bank independence due to its multi-dimensional nature. Also, this indicates that there is a number of techniques to measure central bank autonomy. Particularly, there are several indexes that aimed at quantifying the degree of various models of central bank independence that had my interest and I would like to mention in this paper.

Robin Bade and Michael Parkin (1978) are the first in the history of modern economics to construct a model that quantifies central bank independence. In their paper "Central banks Laws and Monetary Policy" dated 1980 it was firstly mentioned. In their research, they have measured political autonomy of central banking systems for twelve countries. The main point for definition of political independence for Bade and Parkin is the ability of the central bank to implement the monetary policy without government control.

Grilli, Masciandro and Tabellini in their work "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries" quantifies the political and economic autonomy of the bank and invented Grilli-Masciandro-Tabellini (GMT) index.

As I have noticed above and brought couple of examples, in economic theory there is no single value that can measure central bank independence and list of examples can be longer. However, I would like to focus only on one of them now. According to Elkin Nurmammadov the most comprehensive index is the one constructed in Alex Cukierman's work dated 1992 "Central Bank Strategy, credibility and Autonomy". In this paper Cukierman was working on the Legal Variables Weighted (LVAW) model. It is a uniquely legal index which enormously focused on the precise research of various central bank charters, acts and laws. It gives us a precise quantitative illustration of central banks' legal autonomy by setting numerical values to each question of the model.

The Cukierman's model consists of 16 variables that are organized into the following four groups:

1) The status of the CEO or the head of the executive board, which includes the questions: what are terms of office, appointment and dismissal policies from legislation perspective and incompatibility conditions;

2) The policy formulation, which includes the questions: regulations on the expertise to formulate monetary policy, the central bank's potential involvement in the budget process and regulations on possible conflicts between the central bank monetary policy and the government institutions;

3) The central bank goals and target policies set by legislation;

4) regulations on restrictions of lending in the form of advances or purchases of government securities as well as time limits of lending, circle of potential borrowers, limits on direct credit to the government and its maximum maturity, level of interest rates and lending in the primary market.

Obviously, legal independence of institution is the most essential component of actual autonomy. The research made by Nurmammadov highlights two significant models of measuring the actual of central bank independence in practice. Both methods are introduced in Cukierman's work (1992). First method, the turnover rate of governors of the central bank or in our case the head of Executive Board, is used as a proxy of actual independence. The turnover rate (TOR) is defined as the annual average number of turnovers of the Head of central Bank. Particularly, a higher turnover rate represents that average timescales in office of the governor is less than that of the average for government, which bypasses the central bank from taking a long-haul perspective of monetary policy. The weak point of this particular indicator lies in the probability that a low turnover of governors may be mistakenly recognized as an attribute of autonomy in the case of a central bank that is partially controlled by the executive branch of government. Nevertheless, according to the Nurmammadov's research, TOR is a useful index of central bank independence in developed economies taking in mind the hypothesis that, at least above a certain level, a more rapid turnover rate points out a lower level of central banking system independence.

3.2.2 Independence of Central Bank of Azerbaijan Republic

Article 6 of the latest Law on the CBAR defines the independence of the Bank as follows:
"Central Bank shall be independent in charge of its responsibilities and exercise of its authorities prescribed by the Constitution and laws of the Republic of Azerbaijan, and no state authority or self-administration body, physical person or legal entity may directly or indirectly by any reason, illegally influence or interfere with its activities. In case of any restrictions of the CBAR's activity, interference with the affairs of the Central Bank or any influence on the CBAR senior management, the Chairman shall inform the President of the Azerbaijan Republic. Central Bank shall report only to the President of the Republic of Azerbaijan." (www.cbar.az, 2016).

Taking into consideration the different facets of the theory behind central bank autonomy and provided common information on the history, I would like to focus on the level of independence of the CBAR. Elkin Nurmammadov in his paper evaluates the Bank's independence according to various criteria introduced earlier.

Legal and Actual Independence of the CBAR

I would like to start with the Cukierman's LVAW model focused on the legal independence of the CBAR. As I have noticed previously, this model is based on calculated aggregate of 16 variable characteristics of central bank legal acts that include the distribution of authority over monetary policy, limits of lending to government by the central bank, procedures for solution of conflicts between the central bank institute and government, the relative significance of price stability goal as stated in the law, protocols of appointment and dismissal of the central bank's head and etc.

Please take into consideration that the LVAW index, just as other central bank independence models, can be reviewed subjective in its explanation of laws and model is helpful for comparability purposes with other researches. In this paper, I would like to particularly focus on research that was done by Elkin Nurmammadov (2015) of the LVAW index. It is important to know that the LVAW index does not determine the independence in order to do anything that satisfies the central bank. Rather it estimates the ability of the central bank to seek the objective of price stability even at the cost of another short-term real objectives.

Table 3 shows us index values for CBAR from 1992 till 2008. Time period was grouped in three parts. The values range from 0 to 1 and higher index value then the stronger degree of autonomy was indicated. If we will take a look to the research provided by Cukierman et al. (2002) the index based on the charters of the CBAR for the first column that represent years 1992-1996 score is 0.22, whereas the index based on the charters for the second column representing years 1996-2004 scored 0.24, which is the lowest score of the research from the 26 former socialist countries. In a time period from 2004 till 2008 values were calculated by Nurmammadov (2015) and in his work, he calculates the LVAW index based on examining the National Bank Law from 2004. According to Nurmammadov's calculations and evaluations, the LVAW index based on National Bank Law from 2004 scores a total of 0.61, which shows an enormous improvement over the 1992 and 1996 score when it comes to the legal basis of CBAR independence.

Tab. 3 Legal Independence (LVAW) Index[6]

Criteria	Year		
	1992-1996	1996-2004	2004-2008
Central Bank CEO	0.05	0.08	0.13
1. Term of office of CEO	N/A	0.5	0.5
2. Who appoints the CEO	0.5	0.00	0.25
3. Provisions for dismissal of CEO	0.33	0.17	0.83
4. CEO allowed to hold another in the government	0.00	1.00	1.00
Central Bank Objectives	**0.09**	**0.06**	**0.09**
5. Central Bank objectives	0.6	0.4	0.6
6. Policy formulation	0.02	0.05	0.08
7. Who formulates monetary policy	0.33	0.67	1.00
8. Government directives and resolution of conflicts	N/A	N/A	N/A
9. Central Bank given active role in formulation of government's budget	0.00	0.00	0.00
Central Bank lending	**0.06**	**0.07**	**0.31**
10. Limitation on advances	0.00	0.00	0.66
Limitation on securitized lending	N/A	N/A	N/A
11. Who decides control of terms of lending to government	0.00	0.33	0.66
12. Beneficiaries of Central Bank lending	N/A	0.33	0.33
13. Types of limits when they exist	N/A	N/A	0.66
14. Maturity of loans	1.00	0.00	1.00
15. Restrictions on interest rates	0.25	0.25	0.25
16. Prohibition on Central Bank lending in primary market to Government	0.00	0.00	1.00
Total	**0.22**	**0.26**	**0.61**

Source: Elkin Nurmammadov, 2015, p. 66

Interestingly, Cukierman et al's (2002) calculations shows that in comparisons the National Bank Laws of 1992 and 1996 there had not been a notable improvement of legal independence based on the interpretation of two laws by researcher and moreover indicates that of the Central Bank was rather limited than independent. And this has occurred in spite of observation by researchers, that the

[6] Indexes for year 1992-1996 and 1996-2004 were calculated by Cukierman, table was expanded by calculations of Nurmammadov for year 2004-2008.

latecomers to the executives of central bank reformers usually tend to adopt laws with higher level of autonomy.

A reason for this decrease might be changes of the political regime in Azerbaijan in 1993. The changes in the legal status of the Central Bank institution were made after the political transformations happened in Azerbaijan, however in contrast with other transition countries which had ratified central bank reforms within the one political regime. The changes in the political scene of the country changed Azerbaijan into a country with more centralized ruling government. The Central Bank did not end with less independence even though it could have ended due to Azerbaijan's strong need of external aid and help from the International Monetary Fund (IMF), at the time.

Quite the opposite situation happens, according to Nurmammadov's (2015) LVAW index calculations based on the Law of 2004. The index reaches remarkably higher values when compared to the early scores by Cukierman et al.'s (2002). Numerically, the Nurmammadov's LVAW value doubles from the results of study for years 1996 to 2004 – with a significant increase by more than 130%, as noticed in Table 3. This is a plain proof for the supporters of the argument legislators meant to grant higher level of legal independence to the Central Bank in Azerbaijan. Nurmammadov (2015) believes that this should not come as a wonder and the principal reason for the enhancement has nothing to do with the fact that the amendments have happened with the same political power on the rule. Azerbaijani policymakers and legislators are well informed of the importance of having a trustworthy monetary authority. As Cukierman et al.'s (2002) points out, an independent central bank has become a face of economic respectability for the developing countries, not to mention that one of the demands to join the European Union (which is an ultimate goal of Azerbaijani government) is an establishment of the independent central bank. Additionally, central bank autonomy alongside with transparency and reliability are substantial prerequisites of enacting the inflation targeting policy regime.

As reported in Table 3, all four aggregated clusters in Nurmammadov's calculations had a quantitative rise in indexes. Nonetheless, the greatest advance in the Central Bank's legal independence index originates from the much stricter position in opposition lending to the government. With the passed new law, index of the weighted central bank lending elaborated from 0.07 for the time period1996-2004 to 0.31 in 2004-2008. By Article 16 of the Law direct loans from CBAR to the government are now heavily prohibited. Only in a context of a short-haul liquidity gap in the state budget could let the Central Bank buys government securities in the secondary market and Article 16 of the Law purely determines the limit of the loan and the repayment conditions for the loan (Nurmammadov 2015).

If we will have a look at the sub-index number 3 which evaluates the time limits of office, appointment and dismissal method of procedure of the governor and Executive Board, its value has also registered increase over time. The legislation from 2004 makes it nearly impossible to discharge the governor before his term in office comes to end, especially on political motives (Nurmammadov 2015).

Another aggregated variable that significantly enhances since 1996-2004 period is the one on the Central Bank objectives called “policy formulation.”. In fact, there is a progressive betterment on this particular point of legal autonomy from the 1992 Law till today. The executive branch of the government is now legally ties to advise with the Central Bank prior to taking decisions on monetary policies that in some degree related to the Central Bank. Nonetheless, the legislation still does not appoint the Central Bank an active role in the organization of the government’s budget.

Due to the absence of legislative specification on the issues and their resolution of different conflicts between Central Bank and other government institutions, index for the criteria number 8 has been marked as “NA” in Table 3 for both Nurmammadov and Cukierman’s calculations. Even though Central Bank is independent institution, and formally none of the state organs has the right to intervene to its policy decisions and activities. But in a case of possible conflicts concerning the objectives of the policies to be implemented by the Central Bank, the executive branch of the government in face of the President has an advantage over the Central Bank, as it can dismiss the Executive Board of CBAR and appoint new candidates. Thus, these particular criteria would not reach very high score anyway. In the Azerbaijani legislation, it is not determined that the CBAR has to follow the exchange policy formulated by the government. Legally speaking, it can mean that the CBAR is independent to carry out the exchange rate policy that it takes into account as a relevant but also must report to the President about it.

When it comes to central bank objectives sub index, the score of the Law from 2004-2008 equals the unweight value of 0.60, as back in 1992-1996. Interestingly, in years between these two time periods the Law from 1996 does not distinguish the price stability as a primary goal of the monetary policy; consequently, the sub-index value drops to 0.40 between years 1996 and 2004. The Law from 2004 recognize a distinction between the primary and second objectives of the central bank. Though price stability is not explicitly determined as the primary goal, the primary goal of currency stability can be interpreted as an engagement to stable prices. In fact, on the webpage of the CBAR price stability is referred as its primary objective.

Structure and size of a central bank administration board is one of the vital factors of central bank autonomy. Blinder (2004) believes that one of the noticeable characteristics of the transformation in central banking system has been a motion in direction of decision making by a committee rather than by the authoritative central bank governor. He additionally highlights that “in many countries a movement from an individual central banker to a committee went hand-in-glove with granting independence to the central bank.” (Blinder, p. 37, 2004). Lybek and Morris, in an extensive study of one-hundred one central bank legislation, emphasize that the “size of a board should strike a balance between having a sufficient number of members to ensure an informed, balanced and professional view, while at the same time limiting the number so that the board remains effective and avoids a dilution of individual responsibilities.” (Lybek and Morris, p.25, 2004)

Looking at the numbers, researches believe that the format of a monetary policy department of the central bank should alter from 7 to 9. Authors as well suppose that the separate responsibility by all board members is a vital element of an independent and liable central bank.

According to the bank legislation, there should be two outside members of the Executive Board who are not employees of the CBAR. However, these two members are not responsible to the president or National Assembly, but to the governor. Thereby, this situation, aimed to create an outside inspection of the CBAR, actually does not practise such functions. Virtually decisions can be made without two outside members of the Board, since votes of simple majority of the Executive Board members present at the appointment are sufficient for a quorum.

Having considered the advancement in the legal autonomy of the National Bank, Nurmammadov (2015) takes an effort to measure the valid practice of the law. First, Nurmammadov studies the turnover index of the governors. De facto, given the short range of the CBAR's history, the list of governors, their corresponding office terms and the rates of turnover was summarized in Table 4 by Nurmammadov (2015). One may notice a stable decrease in the TOR index, which equals 0.8 in 1997, 0.4 in 2002 and 0.25 in 2009 as shown in Table 4. When it comes to the meaning of the numbers, the TOR index of 0.8 in 1997 indicates that for the appropriate period under review the average term of office of the head of the Executive Board is 15 months, while in 2009 it lifts to the whole 4 years. As you see, Azerbaijan has improved its TOR index a lot since 1995. De facto, there has been no new governor since 1994 as Elman Rustamov has been re-appointed five times, lastly appointed in 2015 for five-year term. If we compare these results with researches for Central European countries that passed transformation period too for years 1992-2000 in (Dvorsky, p. 19, 2000), we see that the governor turnover values in these countries are lower, although not much when compared to the value from 2009 for the CBAR, e.g. the highest score for Poland 0.35, 0.23 for Hungary, 0.26 for Slovakia, 0.11 for Slovenia and 0.13 for Czech Republic. However, the shortness of periods under review raise questions about the trustworthiness of the calculated outcomes and conclusions. besides, it can be debated that turnover rates do not truly represent the status of practical central bank autonomy. If government has the ability to participate in the appointment process, it may use it to cause political tension on the central bank.

Tab. 4 Governor Turnover Index (TOR)

Governors	Qalib Aghayev 02.12.1992-11.20.1992	Cavanshir Abdullayev 11.20.1992-09.02.1993	Qalib Aghayev 09.02.1993-04.20.1994	Elman Rustamov 06.29.94-present
Period of reference	From February 1992 to February 2009			
Turnover rate in 2009	0.25			
Turnover rate in 2002	0.4			
Turnover rate in 1997	0.8			

Source: Elkin Nurmammadov, 2015, p.72

The personal factors, namely personal characteristics of the Head of the Executive Board and his connections with the regent elite, are also decisive in evaluation the real central bank independence. For instance, in Azerbaijan Qalib Aghayev had to step down from his post of the governor of the Board due to of his disagreement with the government on questions of borrowing money from the IMF. However, a new Chairman, Elman Rustamov, has no record of confronting any decisions made by the executive branch of the government, and it may be one of the interpretations for his standing position. This fact can endorse the statement that a low turnover rate does not involve a high level of real central bank autonomy. Besides, in countries like Azerbaijan, where the political authority and decision-making are concentrated within one figure, it could be the other way around: low turnover can involve a lower level of actual independence (Nurmammadov, 2015).

Nurmammadov (p.59, 2015) states that "actual central bank independence must be viewed in the context of the political system of a given country. It is hard to speak of a strong level of actual central bank independence in Azerbaijan, as well as in other countries with strong central political authority".

Goal versus Instrument Independence of the CBAR

Analysing the legislation on the CBAR, one can clearly see that it is by all means an instrument of an independent institution. Independence of CBAR legislatively is fixed in Article 5 of Law on the Bank from 2004, which states that the Central Bank has the authority to define and execute monetary policy, as well designate and proclaim the official exchange rate of the manat.

Interestingly, according to the legislation, the CBAR's goal independence is undetermined. It has to give the Head of State general guidelines of the monetary policy for the oncoming year time-limit to August 1st. This document includes analysis of the macroeconomic and financial situation, and represents primary directions of the monetary policy and banking sector further development as well as the specification of objectives and tasks of the monetary policy for the oncoming year and methods to accomplish those. However, it does not necessarily mean that the President should approve this document. Since the Head of State is accountable for implementing the macroeconomic policy of the country and has its own targets, therefore the President can require the Bank to change its policy, if necessary. The CBAR administration takes into consideration these suggestions, in a different situation the President may nominate other people to the National Assembly for appointment the new Executive Board of CBAR. Considering the structure of the Assembly (where president party representatives are traditionally an overwhelming majority of the Assembly) there is almost no hesitation about the way they will make their choice (Nurmammadov, 2015).

Political vs. Economic Independence of the CBAR

To measure the political and economic autonomy of the Central Bank, I would like to have a look at previously mentioned the GMT model as characterized in Grilli et al.'s (1991). Calculations of this model seem to support the results of the Cukierman (2002) value. The general index in 2004 has remarkably enlarged compared to that based on the 1996 legislation.

Table 5 represents the calculations of GMT index. In comparison with another transition economies, the economic autonomy of the CBAR in 1996 was particularly low, while the political autonomy of the institution was more or less at the same level. For instance, we can have a look at results from Dvorsky (p. 15, 2000) in different transition economies, in Poland overall independence was the highest 16 (PI – 9 and EI – 7), then Hungary – 15 (7 and 8), Czech Republic - 13 (9 and 4), Slovenia – 12 (8 and 4) and in Slovakia – 11 (6 and 5). However, mostly due to of the amendments to legislation in relation on the Central Bank's loans to the government, the economic freedom of institution in 2004 more than doubled.

Tab. 5 GMT index of Political and Economic Independence[7]

Criteria	Year 1996	Year 2004
Political independence		
Governor		
Governor not appointed by the government (1) and not by the parliament only (2)	2	2
Board		
Provisions for governor's dismissal non-political only		**1**
Relation with government		
No mandatory government representative on the board	1	1
Government/parliamentary approval of monetary policy is not required	1	1
Constitution		
Statutory responsibility to pursue monetary policy	1	1
Total PI	**5**	**6**
Economic Independence		
Direct credit to the government		
Direct Credit facility is not automatic	0	1
Direct credit facility is temporary	1	1
Direct credit facility is of limited amount	0	1
CB does not participate in the primary market for public debt	0	1
Monetary Instruments		
The discount rate is set by CB	1	1
Total EI	**2**	**5**
Overall Index	**7**	**11**

Source: Elkin Nurmammadov, 2015, p.72

Nurmammadov believes that the fact that the institutional differentiation of banking oversight from monetary policy in the GMT index is counted as contributory to the higher degree of central bank autonomy. It can be debated that a combination of these functions could create more powerful and weighty central bank, and thereby facilitates to its higher autonomy. However, this problem is too complicated to be applied in common to any country without approaching to point of particularity of each state together with country's political system and "culture of politics".

[7] Indexes for year 1996 were calculated by Cukierman, table was expanded by calculations of Nurmammadov for year 2004.

Example of Azerbaijan, where, the generally speaking, system of public administration is highly centralized, it is difficult to forecast whether there will be opportunity and grounds for such an institutional segregation. According to Nurmammadov, it should stay integrated as it is, given the domestic particularity that the efficiency of institutions is inversely connected to the number of institutions. When every institution and the Head of institution tries to be “more superior,” it is hard to coordinate policies when needed. This may outcome as an unhealthy power fight. Conjunction of the monetary and supervisory official duties within the CBAR at least assists policy coordination.

4 Monetary Policy in Azerbaijan

In this chapter I would like to take a deeper look and analyse monetary policy that was held by Central Bank of Azerbaijan starting the date of independent Azerbaijan Republic. To make it more structuralized I will divide chapter in three parts, each representing certain time period. I will start with the last decade of 20th century and then would like to move to time period during the financial crisis and have a look on recent monetary policy.

Central Bank of Azerbaijan Republic has a special committee of Monetary Policy and Financial Stability. The Monetary Policy and Financial Stability Committee of the CBAR is an advisory body created to set and execute different benchmarks for both the exchange rate and monetary policies, additionally maintain financial stability. The Committee gives recommendations for Management Board on amendments to parameters of the exchange rate policy, also to monetary policy tools. The Committee is supervised by Governor of the Central Bank. The Committee representatives involves heads of the structural departments directly engaged in organizing and further realization of exchange rate and the monetary policies of the CBAR, as well as maintaining financial stability. The Committee discusses the policies in meetings which they hold at least once in a month (www.cbar.az, 2016).

4.1 Monetary Policy in 1990's

In the mean time, the CIS nations confronted the enormous difficulties of hyperinflation and weak fiscal base. By all measures the CIS countries had failed to accomplish the macroeconomic stability needed to accommodate structural change. As a result, the CIS countries have found it much more difficult to recover from central planning than any other transition economies (Khaled Sherif, Michael Borish, and Alexandra Gross, 2003).

This trouble was evidenced first by the uncommonly high inflation, with top rates averaging almost 5,000 percent. This high inflation prompted the presentation of new currencies in CIS countries, including Russia, which presented a new ruble on January 1, 1998. Even by 1995 the CIS countries still confronted fundamentally higher inflation than the Central and Eastern Europe (CEE) and Baltic countries, with few remaining at hyperinflationary levels (Khaled Sherif et al., 2003).

At the same time CIS fiscal shortages were about twice those of the CEE and Baltic states, averaging more than 6 percent of GDP. The huge deficits related in part to the breakdown of the industrial sector, as enterprise sales had generated much of the earlier fiscal income stream in the form of turnover taxes. With sales now plummeting and often unrecorded (to stay away from tax payments), government incomes declined. Corruption also had impact, with taxes being paid but not making their way into national treasury accounts. This made for a very unstable environment for normal banking operations (Khaled Sherif et al., 2003).

CIS countries were caught in the troublesome circumstance of seeking to maintain or revive production to preserve jobs and reactivate the fiscal base. In a tight money regime this prompted budgetary subsidies and transfers, concessionary rollovers from the banking system, and loans to enterprises, social funds, workers, and fiscal authorities. Interestingly, the CIS countries demonstrated a state bank share of assets about half that registered in the CEE countries. This demonstrates that "private" banks in the CIS were greatly used as financing vehicles for their enterprise owners and other related parties rather than as channels of financial discipline. These "privatized" practices reflect weaknesses in the banking sector framework and incentive structure in the CIS countries and inherent flaws in proprietorship change (Khaled Sherif et al., 2003).

Table 6 lists the 8 countries in central Europe and the Former Soviet Union for which I have found comprehensive data for the period 1989-1994 from Stanley Fischer, Ratha Sahay and Carlos A. Végh work "Stabilization and Growth in Transition Economies: The Early Experience". According to authors of mentioned work "In the judgment of the IMF economists working on those countries, stabilization plans have been executed in 25 of the 26 transition economies, with Turkmenistan being the exception". Also, in Table 6 we can see list of the dates on which the stabilization program was implemented for selected countries in the second column of Table 6. The date given is the starting date of a country's inflation stabilization program that I would like to analyse more later in this chapter. The third column of Table 6 indicates the exchange rate regime adopted during the stabilization program. Countries that announced an exchange rate peg, including a crawling peg, are classified as having a fixed rate regime. Interestingly, even though in particular Azerbaijan is listed as having adopted a flexible exchange rate, authorities have often intervened in foreign exchange markets to stabilize the exchange rate (Stanley Fischer, Ratha Sahay and Carlos A. Végh, 1996).

Tab. 6 Initial Conditions and Stabilization Programs in selected Transition Economies

Country	Stabilization program date	Exchange regime adopted
Azerbaijan	January 1995	Flexible
Armenia	December 1994	Flexible
Czech Republic	January 1991	Fixed
Georgia	September 1994	Flexible
Hungary	March 1990	Fixed
Kazakhstan	January 1994	Flexible
Kyrgyz Republic	May 1993	Flexible
Latvia	June 1992	Flexible/Fixed[8]
Lithuania	June 1992	Flexible/Fixed[9]

Source: Stanley Fischer, Ratha Sahay and Carlos A. Végh, 1996, p. 6

Table 7 provides information on inflation in eight economies during 1989-94 that I found in Stanley Fischer, Ratha Sahay and Carlos A. Végh work. In table 7 inflation is reported as an average measures, since it is most common way and as these are more useful in studying and comparing the evolution of inflation over time (Stanley Fischer et al., 1996).

[8] The Latvian currency was pegged to the Special Drawing Rights (SDR) in February 1994.

[9] Lithuania adopted a currency board in April 1994. Both countries had flexible exchange rate regimes prior to these dates.

Tab. 7 Inflation rate in selected Transition Economies

Country	Year in which inflation was highest	Maximum annual inflation
Azerbaijan	1994	1788.0
Armenia	1993	10896.2
Czech Republic	1991	52.1
Georgia	1994	8273.5
Hungary	1990	34.6
Kazakhstan	1992	2566.6
Latvia	1992	958.2
Lithuania	1992	1162.6
Turkmenistan	1993	9743

Source: Stanley Fischer, Ratha Sahay and Carlos A. Végh, 1996, p. 8

According to Stanley Fischer, Ratha Sahay and Carlos A. Végh the maximum inflation rate was typically for twenty-six transition economies recorded toward the begin of the transition process, when costs and, in most cases, trade controls were lifted. As we can see from previous two tables, countries which have adopted fixed exchange regime had smaller numbers in maximum annual inflation. However, FSU countries that have chosen only flexible regime experienced a hyperinflation.

In Azerbaijan early 90s are characterized by ensuring macroeconomic stability and holding tight monetary policy. As I have mentioned previously the world practice shows that the transition from a centrally planned system to a market economy in the period of the restructuring of the national economy is accompanied by the sharp rise in inflation and according to Eyubov (2012) deterioration of the performance indicators, accelerated depreciation of the national currency and the deteriorating social situation. In post-Soviet countries, this process is even more aggravated due to the gap formed over decades of economic ties. This situation was typical for Azerbaijan in the early 1990s, when the tension in this area has reached a critical point. Average annual rate of inflation was 1000-1800% in the country, the state budget deficit grew by 10%, while the national currency against the US dollar has depreciated several times (Eyubov, 2012). I believe that high inflation has been associated with both monetary and non-monetary factors. The main monetary factor was that the government deficit was covered entirely by loans of the Central Bank, and what is more the commercial banks were able to get credit resources to a greater extent than was necessary for the balanced growth of the national economy. As a result, the scale of speculation in the foreign exchange and money market increased. Unjustified increase in the money supply did not correspond to the actual economic situation and the demand for money led, ultimately, to the collapse of the financial system and strengthened inflationary expectations in the domestic economy. Together with the reduction of quantitative indicators of the state of the financial system there was a serious imbalance in the quality of its structure, the level of development of the national economy during the period of structural adjustment was very low. Accepted July 1st, 1992 Russian decision to stop granting loans from the Bank of Russia to central banks of other countries led to the actual disintegration of the ruble zone and the appearance of their currencies in the other republics of the former Soviet Union. As I have previously noticed in chapter 3 August 15, 1992 Azerbaijani manat was put into circulation and used in parallel with the Russian ruble, and since the beginning of 1994, it became the only legal means of payment in the country.

During the research I have found that the strong demand for cash in the context of high inflation and insufficient emission, share of rubles per manat accounted for more than half of the money in circulation[10] for Azerbaijan Republic in March 1993. Although the issue of the accelerated pace of emission of manat in the first half of 1993 partly compensated for the lack of ruble banknotes, however, the lack of cash was felt throughout the year. By the end of 1993, the country has accumulated arrears of wages of about 7.3 billion manat, despite the considerable supply of banknotes manufactured in France (www.cbar.az, 2016). Lack of cash flow dramatically reduced the liquidity of bank deposits, which in turn has led to the interest of the population and enterprises in the accumulation of funds in bank accounts fall. Thus, until the end of 1993, the total share of deposits in broad money supply fell from 75% to 55%, while the share of household deposits from 16% to 8% (Ismailov, 2008). These factors partly reflect a shift and the private banking operations of the informal financial market. In 1993 there was a rapid increase in the volume of operations, carried out in foreign currency banks of Azerbaijan.

Since 1994 after breaking the record of highest inflation rate in history, the government and the Central Bank started the taking drastic measures to ensure macroeconomic stability. With the assistance of the IMF and World Bank (WB) new program activities of monetary policy have been developed. Their implementation began with the adoption of the Special Presidential Decree of June 15, 1994 " Effort to strengthen the social position of the population and the stabilization of the financial condition of the country." However, implementation of this stabilization program has started in 1995. The main objective of this legal instrument - a decrease in the rate of inflation and stabilization of manat through flexible monetary policy, and the establishment on this basis of a favourable macroeconomic environment for economic growth. And this goal was accomplished successfully. In 1995 annual inflation rate according to WB was 411.8%. And as it shown in Figure 3 following years' rate reached two digit numbers and in 1998 economy experienced a deflation.

[10] In other words we can say that for every manat in circulation there were two rubles.

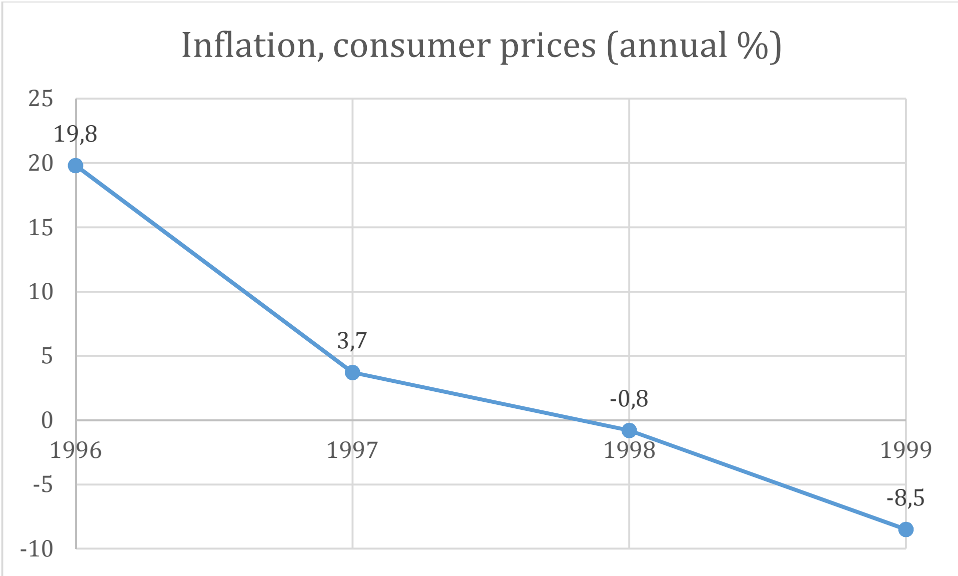

Figure 3. Annual inflation rates in % (CPI)
Source: World Bank, 2016

The primary anti-inflationary measures of the state stopped funding the budget deficit by the Central Bank loans. In order to smooth financing deficit and ensure the stability of national currency the amount of official foreign exchange reserves of the country was brought to the required level. All these measures led to the creation of a sustainable macroeconomic position and formed the primary basis for the beginning of sustainable economic growth. Thus, the Central Bank pursued a tight monetary policy in the period of restructuring the national economy will fully relieve the tension in the monetary sector, to stop hyperinflation and to create conditions for achieving macroeconomic stability of the country.

Next I would like to talk about years 1997-1998 characterized by softening some tough national monetary policy in accordance with the new period of institutional development of the market economy. The economic crisis that erupted in 1997 in Asia, thoroughly shook the national economy of Russia in August 1998. In turn, the 1998 crisis in Russia had a strong impact on the monetary system of many CIS countries. Given the sharp decline in international oil prices, the export of which is of strategic importance for the national economy, the country's leadership had to hold large-scale preventive measures in order to stop the proliferation of crisis.

Further analyses show that one of the main difficulties of the period was to ensure the stability of the budget system, as an essential part of the state budget revenue was formed mostly by oil export. In addition, an extremely unbalanced situation has arisen in the foreign exchange market, where there was an acute shortage of foreign currency supply, due to, on the one hand, the decline in export earnings from the oil industry, on the other - the massive import of Russian goods, cheapened as a result of devaluation of the ruble. In this situation, the Central Bank was able to maintain stability of the national currency against the dollar and avoid the crisis in the monetary sphere. By the end of 1998, it managed to maintain macroeconomic stability, support the ongoing dynamics of foreign capital inflows, even to achieve significant economic growth as we can see in Figure 4.

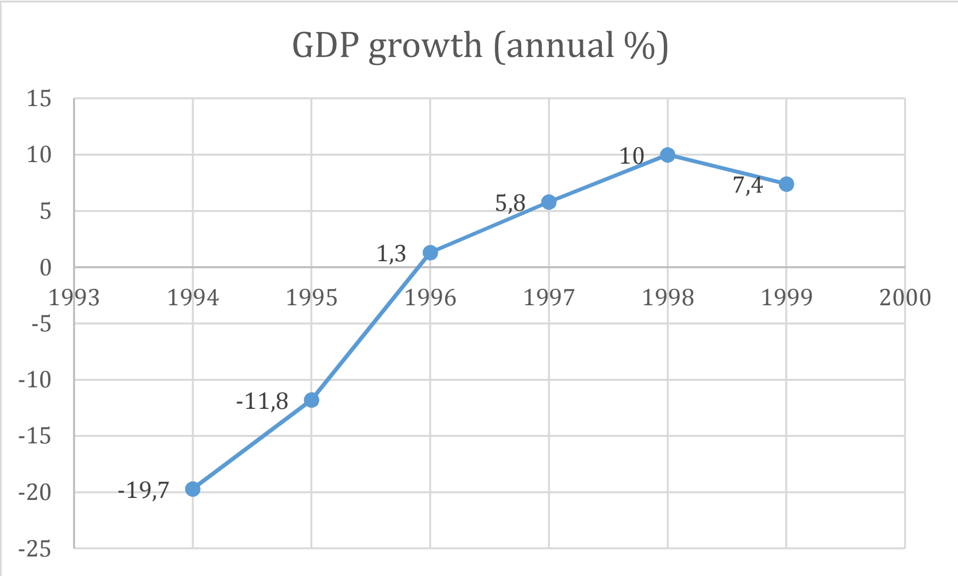

Figure 4. Annual GDP growth in %
Source: World Bank, 2016

Preserving macroeconomic stability was made possible by efforts to create a national economy with necessary correction of the currency market and the main macroeconomic indicators, which allowed for a number of years prior to the events of 1998 to accumulate foreign exchange reserves (see table 8).

Tab. 8 Reserves and related items (BoP, current US$)

Year	Reserves and related items (BoP, current US$)
1995	57,809,244
1996	-85,047,139
1997	139,165,532
1998	-59,239,193
1999	132,890,070

Source: World Bank, 2016

The costs of maintaining stability were relatively small: in 1998 the foreign exchange market has absorbed about 10% of foreign exchange reserves of the Republic, in the same year some of the other CIS countries have lost 30-50% of their foreign exchange reserves (Eyubov, 2012). The main factor contributing to the relatively low impact of the Russian financial crisis on the economy of the country, should be considered a flexible monetary policy and a balanced policy in the sphere of external debt. The degree of vulnerability of the restructuring of the national economy to external shocks can be estimated by the dynamics of macroeconomic indicators. By the beginning of 1998, the fiscal deficit to GDP ratio was 2.5% and in 1999 4.5%, while the share of gross external debt to GDP does not exceed 15.1% (Eyubov, 2012). A significant part of the external debt accounted for long-term loans from international financial organizations directly used to finance specific investment projects related to oil industry. For these reasons the financial market of Azerbaijan was protected from financial speculation in the market and mostly painlessly survived the impact of the Russian crisis. According to Eyubov (2012) economy has managed to maintain the volume of foreign exchange reserves in accordance with the standards adopted in the world (currency reserves covered the four-month import Difficulties that showed up in 1998 in the execution of the state budget related to the reduction in revenues from oil exports, was eliminated through the active use of non-inflationary methods of financing. Effective policy of external debt, designed primarily to fill up domestic financial resources for sustainable economic growth and the model of development which is based on the use of natural resources and their export. It allows us to say that those years in Azerbaijan had a solid economic basis. So, the first experience of prevention of the crisis on the monetary system of the republic gave a certain confidence that the national monetary policy in the period of structural adjustment can protect the emerging modern market economy of country from external financial shocks, and the preserved an internal macroeconomic stability.

According to Eyubov (2012) a new phase of monetary policy has started in Azerbaijan in 1999. After an economic growth in 1999, accompanied by a significant increase in the demand for money and the acceleration of structural reforms, the Central Bank has strengthened the process of "soft" monetary policy. As a result, we can see a decrease in real interest rates from 17% in 1999 to 6.4% in 2000 and the rate of manat in the managed floating exchange rate regime became more flexible to United States Dollar (USD) (see Figure 5).

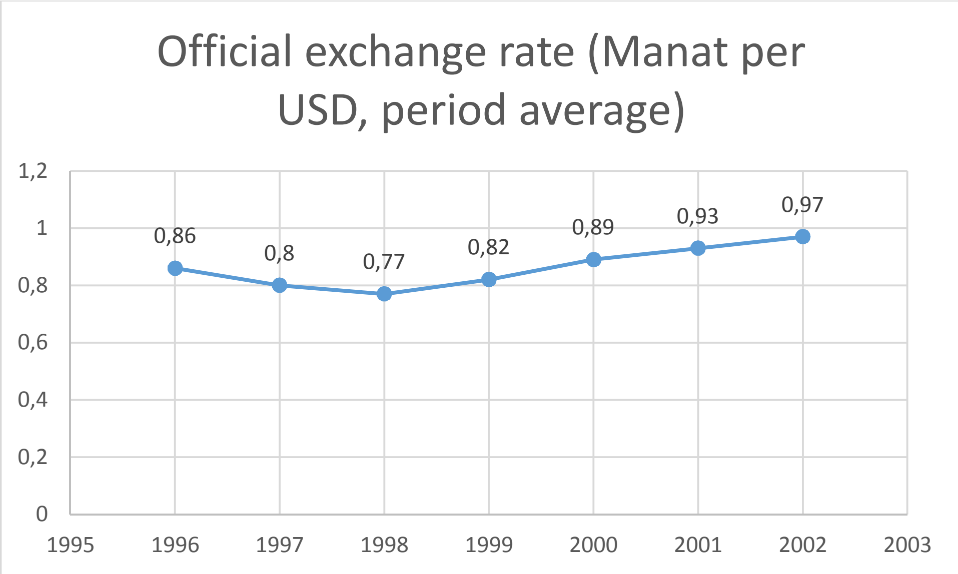

Figure 5. Official exchange rate (Manat per USD, period average)
Source: World Bank, 2016

This policy helped to avoid a serious negative impact on the restructuring of the national economy in spite of such factors as the decrease in world oil prices in 1998, and the impact of the Russian financial crisis.

From 1995 we can observe changes in exchange rate policy regime change from fixed to flexible and soft monetary policy regime implemented by central bank. These institutional reforms helped country's economy to grow and decrease the inflation rate. All together it led to macroeconomic stabilization. Since the government budget mostly was fulfilled by natural resources revenue central bank mostly implemented reforms in foreign exchange policy.

4.2 Monetary Policy in context of financial crisis

The Great Financial Crisis of 2007-2009 was the most severe economic crisis since the Great depression in 1930's. In this part of my work I would like to study monetary policy of CBAR in context of this crisis.

Central Bank of Azerbaijan held same monetary policy in 2007 and 2008. Goals of CBAR for those years was in relation with extremely high economical growth in country, which increased money demand. According to WB in 2007 annual GDP growth was 34.5 % and 25 % following year. These number were triggered by increasing oil export revenues. Central Bank tried to protect currency stability and meet needs of the economy to money, as well as protection of stability in banking-financial system. The most important priority of the CBAR was to prevent negative influence of highly increased oil incomes to currency stock markets, national currency and to financial system. Monetary and exchange rate policy of the CBAR directed to rate stability, rendered help for protection of financial stability in country.

In order to achieve defined goals, CBAR used such tools as open market operations, interest rates, as well as obligatory reserve norms. Real interest rate in Azerbaijan in 2007 was at level -1.5 % and -6.3% in 2008. Central Bank continued to use its short-term notes for sterilization of money stock that had inflation potential. Within reporting period, the CBAR has held 52 auctions on localization of notes. Emission's total figure constituted for 2650 million manat and sum of placed notes constituted for 1920 million manat which is 72.5% of total emission volume (www.cbar.az, 2016).

Central Bank of Azerbaijan started implementing anti-crisis policy in 2009. Firstly, CBAR brought the corrections to legislation of the Law on the Central Bank of Azerbaijan. According to the adopted amendments Central Bank of Azerbaijan has the right to grant loans to banks as a lender of last resort for longer periods and in foreign currencies. This was made for the purposes of capitalization solvency of banks experiencing difficulties. The main objectives of CBAR's policy during the crisis included the provisioning of financial liquidity of the system, support for aggregate demand and maintaining the stability of the financial system. For example, in February 2009, the interest rate has been reduced to 5%. The upper limit of the interest rate corridor was reduced to 10% and the rate of compulsory reserves on liabilities in national and foreign currencies decreased from 6 to 3%. Thus increased the liquidity of the banking sector assets by 135 millions manat. A month later the discount rate and the upper limit of the interest rate corridor lowered to 3, and 8%, respectively. Reserve requirements on liabilities in national and foreign currencies of reduced from 3 to 0.5% which again liquidity increased by 111 million manat (Elman Rustamov, 2010).

State Mortgage Fund launched its work, which immediately affected the market prices of real estate stabilization and increase in activity in this market. That helped real estate market within two months stabilize the prices. Price stabilization of this market is very important to the financial position of the banking sector, as it makes roughly half of the total loan portfolio of banks. Despite the crisis in the global foreign exchange market rate of manat to the US dollar stayed stable. According to WB official exchange rate in 2009 was 0.82 manat and the same rate was 0.8 in 2008.

Central Bank of Azerbaijan, conducting exchange rate policy in the fixed mode of the US dollar. However, the operational guide was a basket of currencies including of the USD and Euro. The central bank justified this by saying that in 2009 turned out to be the period when the excessive volatility of the manat could lead to a destabilization of the financial sector. And a standard use of the currency basket exchange rate reckons synchronized movement of the manat to the USD and the Euro with the movement of dollar cross-rate against the Euro.

Tab. 9 Economy indicators 2007-2010

Index	Year			
	2007	2008	2009	2010
Total reserves (includes gold, current US$)	4,273,114,894	6,467,239,212	5,363,850,274	5,363,850,274
GDP growth (annual %)	25.0	10.8	9.4	4.9
Inflation, consumer prices (annual %)	16.6	20.8	1.4	5.7
Unemployment, total (% of total labour force)	6.3	5.9	5.7	5.6

Source: World Bank, 2016

In conclusion we can say that macroeconomic stability in the country was kept on high level - it was fixed primarily by solid total reserves, although we can see a drop in number in Table 9. These reserves guaranteed the strength of the state budget and partially compensate the reduction of external sources of liquidity. Also we can see that national economy demonstrated a rise of GDP and employment in general, were protected from the harmful effects of the global crisis.

4.3 Recent monetary policy

National economy of Azerbaijan faced big challenges in 2015. That was caused because of worldwide oil prices dropped down. Like other energy exporting nations it significantly affected the revenue of the country. The price for Brent oil decreased 39.3% comparing the end 2015 versus the beginning of the year. This led to export decline for about 48% over the year, primarily on the oil and gas sector, to be more specific export dropped 34% on natural gas, 45% on oil products and 52% on crude oil (www.cbar.az , 2016).

Officially, according to policy review, CBAR set two main aim for 2015. First goal composed of international competitiveness of the national economy and maintain macroeconomic sustainability. And as a second goal stabilize foreign exchange supply channels and sharp rise in demand for foreign currency.

As I have mentioned above slump in oil prices, which is vital source of public expenditures triggered a rise in foreign exchange demand. It happened not only to Azerbaijan's national economy, however also to Russia and Kazakhstan. All three countries GPD is mainly submitted by energy export. Interestingly, Kazakhstani and Russian monetary authorities in 2015 choose the flexible exchange rate strategy. However, in February 21st the Management Board of the CBAR decided to devaluated national currency, CBAR set fixed exchange rate of USD against at 1.05 Azerbaijani manat which they have explained by pressure on foreign exchange market due to oil price drops. According to Fitch Ratings in Azerbaijan, the share of foreign-currency deposits reached more than 70 percent after the February devaluation, from 51 percent at the beginning of the year. Another slump on oil prices in the end of July pushed more pressure on national currency, however CBAR decided to keep exchanged rate fixed. On December 21st Board of Directors at CBAR in order to tailor the exchange rate of manat to new oil prices decided to move to a floating exchange rate regime. According to Bloomberg the very same day the national currency nosedived 32 percent to 1.5375 to the dollar. During the 2015 USD appreciated 98.8%, while euro appreciated 79% against manat. Central bank explained their decision stating that floating exchange rate allows absorbing the impacts of global shocks to the economy through exchange rate, especially in a time of descending oil prices. Other than that CBAR changed the reserve requirement to 0.5% from 2% in an effort to support economic growth by allowing drops in interest rates. Also currently, CBAR sells foreign exchange only through auctions. With no exchange rate related quantitative targets in mind CBAR only strives to smooth sharp exchange rate fluctuations.

In 2015 the exchange rate regime in country changed twice. It switched from flexible to fixed at the beginning of the year and close to the end of the year back to flexible. Here we can see a good example of institutional reform of monetary policy in 2015.

Over the reported year the base money in manat decreased 40.2%, Over the year, broad money supply in manat (M2) decreased 50.6% as of the end-period, primarily due to cash money supply. Liquidity injections and absorptions through the banking system were conducted within the interest rate corridor parameters. The CBAR shifted the refinancing rate to 3% from 3.5% from 13 July 2015 to ensure higher financial contribution to economic growth in the non-oil industry, stimulate investments by accelerating drops in interest rates on loans, and pave the monetary way to the optimization of SME financing and mortgage lending of the population given the acceptable rate of inflation. Other interest rate corridor parameters were left unchanged - the corridor ceiling remained 5% and the floor 0.1%.

At the end we can see say that Central Bank of Azerbaijan Republic did succeed in terms of achieving annual GDP growth (2 %) with money supply tools and macroeconomic sustainability by keeping annual average inflation rate at 4.2 %. However, close to the end year under the pressure of demand for foreign currency monetary policy authorities were not able to keep fixed exchange rate and changed it to flexible. It caused a big depreciation of national currency in a short time, nonetheless we do not possess with appropriate data to evaluate it.

5 Conclusion

The aim of the thesis was the evaluation of institutional reforms of monetary policy in Azerbaijan. I have look through the historical development of institution in Azerbaijan in context of Central bank of Azerbaijan. Azerbaijan gained its independence and started transformation to free market economy in 1991.

The transition period of national economy did not go smoothly. As we discovered for countries with rich natural resources they transformation process to market economy was slower. It was explained by political system in such countries. After Soviet Union collapse political instability came to country and conflict between Azerbaijan and Armenia did not let the country to build from the start of independence a proper monetary policy institution. First 3 years of central bank's existence governor has changed three times but, the governor of Central Bank has been unchanged from 1994 till 2016. The frequent change of the governor in early independence was also related to political disagreement with authority. That means that for 22 straight years the monetary policy was run by the same authority. At the same time the same political party stands in the rule of government in Azerbaijan from 1993. At the beginning of their rule the New Azerbaijan Party brought both the political and the economical stability in the country. When we had a look on independence of central bank we noticed that the indexes have risen in early and mid 2000's however were still in low level comparing to other post socialist republic.

National economy of Azerbaijan has faced a lot of challenges during the transition period. Country has recorded the highest inflation rate at the point of 1788% in 1994. Due to institutional reform in exchange rate policy that brought the stabilization this numbers were decreased. However even after that, the main goal of monetary policy authorities was the support of expanding fiscal policy. All the steps that were taken by Central Bank of Azerbaijan accomplished the national goal of Gross Domestic Product growth after 1995. The main field of Central Bank's reforms was in the exchange rate market, since the economy of Azerbaijan republic is mainly composed from oil and gas exports.

The financial crises of 2007 – 2008 did not hit the country's economy that hard. The monetary policy regime of the country remained the same, that means the support of fiscal policy and GDP growth. The central bank used such tools in their policy as open market operations, interest rates and obligatory reserve norms. All these had a positive impact of the country's economy and macroeconomic situation.

However, the second real challenge faced the authorities due to a gigantic drop of oil prices on markets in 2015. From the moment of achievement independence, the non-oil sector was not development well and all macroeconomic growth was achieved by oil sector export. It influenced the monetary policy in republic which decided to change the exchange rate regime from flexible to fixed and vice versa in the very same year. The economical shock that were originated by that decision had immediate results as the double depreciation of national currency to

United States Dollar. Unfortunately, we do not possess with more information to analyze the latest monetary policy regime change due to its implementation a few days before the end of 2015.

Overall, I would like to recommend a change in monetary policy authority in Azerbaijan, since I have mentioned above almost for more than 20 years the governor did not change. I believe that a new authority will be able to bring the new ideas to Central Bank of Azerbaijan. However also government should now focus on development of non-oil sector of economy, since the economy and especially state budget dependent on energy exports and price fluctuation on this particular market.

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