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Devaluation of Azerbaijani National Currency; Causes and Consequences

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Starting on February 21st, 2015 the official exchange rate of the dollar to the manat, the Azerbaijani national currency, has been set at 1.05 manat, which is 33.86 percent higher than the exchange rate set prior to the beginning of the exchange rate weakening process. The Azerbaijani national currency has been depreciated against US dollar for the first time since 2006.

Since the sharp drop of crude oil prices in the world market in the fall of 2014, the Central Bank of Azerbaijan has faced the dilemma of either a sharp depreciation or a gradual devaluation of the manat. In fact, the Central Bank has announced that a sharp depreciation would not be in the government's agenda in the near future. But, just two days after the Central Bank's governor's official declaration on not having a sharp depreciation, the national currency of Azerbaijan has lost its value against major foreign currencies by 33.86 %. The Manat's rate dropped to 1.05 from 0.78 against to US dollar.

Indeed, the sharp devaluation of the manat on February 21st, 2015 was broadly in line with movements in other emerging economies. As it is, the sudden fall in the currency has undermined the credibility of the Central Bank and the banking system —counteracting the government's avowed aim of boosting growth by improving external competitiveness.

The question here is why sharp depreciation rather than gradual depreciation, as the Central Bank has promised before, has happened. And again, why a 34 % devaluation and not the 12-15 % depreciation, which had been promised by the Central Bank?

The Government of Azerbaijan promised gradual devaluation; in effect slow depreciation would be a supportive tool to reach goals the government has laid out. Gradual depreciation would increase Central Bank's intervention cost; in addition it would increase budget revenues in manat terms. A devaluation of less than 30.0 % would not be enough to cover the state budget's current and potential deficits as long as the price of crude oil in the world market is low. Therefore, the Central Bank has taken the drastic step to have a sharp and deep devaluation of the national currency.

According to the CESD assessment, the main reason for the sharp and deep depreciation of the manat are as follows:

- 1. Fiscal reason.** Due to the sharp decline of oil prices, the current revenue flow to the state budget has started declining. The State Oil Fund of Azerbaijan Republic (SOFAZ) will generate 53.4%, or 10.3 billion manat, of the state budget. According to the 2015 state budget law, non-oil sector's contribution to the state budget will be 35.0 % of total revenues. The remaining 11.6 % of the budget's revenue will be directly generate through oil and oil product exports. This means that 65.0% of the state budget's revenues in 2015 will be generated through oil money.

Although Azeri monthly oil exports have not exaggeratedly declined, income from exporting crude oil has dramatically decreased due to dropping oil prices. Azerbaijan exported 2,122 million tones of oil in total in January 2015. Average price for Azerlight, Azerbaijani oil, was \$ 49.53 US per barrel last month. After the sudden decline in oil prices in the world market in 2014, Azerbaijan oil exports declined by 326 thousand tones or 13.4 % in January 2015 compared to the previous month.

As an oil exporting country, Azerbaijan started feeling the effects of a sharp fall in oil revenues after oil prices declined in the world market, owing to a decline of the country's oil income. In spite of the fact that Azerbaijan was able to reduce the share of the oil industry both in public revenues and in the country's Gross Domestic Product (GDP), Azerbaijan is still heavily dependent on oil and natural gas export revenues.

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Oil income in January 2015 declined by 35.0 % compared to the previous month, although the export volume dropped by only 13.4 % in the indicated period. In January 2015 Azerbaijan exported almost the same volume of oil as in June 2014, but the country received only \$760 million US in January 2015, compared to \$1.76 billion US in June 2015. It confirms that the drop in oil prices in the world market has dramatically decreased Azerbaijan's revenues, in spite of the fact that the same amount of oil was exported in January 2015 as in June 2014. This amounts to 2.31 times less income in January 2015 than in June 2014 (Note that gross income implies the currency entering the country from the sale of oil is included with AIOC oil revenues. Profit after deducting costs from revenues defines the value of oil. This is in accordance with the sharing of production funds between the Government of Azerbaijan and AIOC).

The oil price in the 2015 state budget is \$90 US per barrel, but the average price for January was less than \$50 US per barrel and the average price for the first 2 months is expected to be around \$56 US per barrel.

Meanwhile, direct oil contribution to the state budget is 2.27 billion manat. With the previous exchange rate, the government of Azerbaijan had to transfer \$2.91 billion US in oil money to the state budget, but after the devaluation only \$2.15 billion US in oil money is needed. This means that the depreciation of the national currency will help to save \$760 million US in oil money, just from direct oil income contributions.

The above-mentioned facts show that there is a deficit in monthly state budget lines. Forecasts of both oil prices and oil revenues are not optimistic. Devaluation is a tool for the government to cover the manat deficit in the state budget.

- 2. Saving SOFAZ's money.** The manat's depreciation against the dollar will aid SOFAZ, to some extent, to save its reserves. SOFAZ's 2015 income will be \$13,136 billion US if the average crude oil price in the world market is \$90 US per barrel during year. Meanwhile, expenditures will be 11,814 billion manat (\$15,146 billion US at the previous exchange rate of the manat and \$11,251 billion US at new exchange rate) in 2015 according to the official law on the State Oil Fund. The very important fact is that SOFAZ's revenue is in US dollars but its expenditure is in Azerbaijani manat. This means the manat's devaluation will help the Oil Fund save \$3,895 billion US in oil money (\$15,146 billion US - \$11,251 billion US) in 2015 alone.

On the other hand CESD's latest assessment shows that SOFAZ will earn \$4.5 billion US less if crude oil's average price is \$60 US per barrel in 2015. Then, the oil fund's total income will be \$8.636 billion US instead of \$13,136 billion US in 2015. In this case, SOFAZ's income in local currency will be \$9,067 billion manat. It means that SOFAZ will be able to reach its 2015 fiscal targets through the devaluation. The Government of Azerbaijan will also manage to slightly reduce the declining ratio of its currency and state reserves.

- 3. Decreasing the decline of the Central Bank's reserves.** The fall of the world prices for oil, the main export product and main source of income for Azerbaijan, has cost the CBAR, which was forced to sell currency to maintain the exchange rate of the manat. This has been quite expensive. From August to December 2014 alone, the gold and foreign currency reserves of the Central Bank decreased by \$1,435 billion US – \$15,193 billion US to \$13,758 billion US. In January 2015, the CBA spent another \$1,077 billion US on maintaining the exchange rate of the manat, bringing its reserves to their lowest levels since the spring of 2013. The Central Bank's currency reserves have declined to \$12.681 billion US in early February 2015 since the drop in the world oil price. Due to the intervention costs, CBAR lost 8.0 % of its currency reserves in January, the first month of 2015.

Indeed, the demand for US dollars in the country has dramatically increased after the Central Bank's announcement in the middle of February 2015 about the manat's future devaluation. The resulting panic among lenders led to a large withdrawal of deposits from banks, causing a credit crunch. \$3 billion US has been purchased during the last week due to the depreciation. Daily dollar demand has reached \$500 million US in certain days during the second week of February 2015. Share of manat deposits in the total deposits has decreased to 45.0 % from 63.0 % during this period. The result of postponing the devaluation decision could have meant losing all of the Central Bank's reserves within a few months.

- 4. Promoting non-oil export capacity.** Indeed, from 2006 up to the Central Bank's February devaluation, the Azerbaijani national currency had appreciated against the dollar. However, Azerbaijan's main trade partners' national currencies have depreciated against to dollar. Turkey's national currency depreciated 30.0 %, increasing to 2.50 per dollar from 1.75 in the last 2 years. Russia's ruble depreciated against dollar more than 2 times in this period increasing to 63 per dollar from 30, Georgia's national currency lost its value by 41.0 % and it increased to 2.3 per dollar from 1.6 in the same period. Ukraine faced a very dramatic currency tragedy in last 2 years; national currency depreciated against to the dollar almost 6 times.

Devaluation in national currencies of Azerbaijan's major trade partners makes local exporting products much more expensive in dollar terms. More challenges have been observed, particularly after ruble's depreciation against dollar since the northern neighbor is the main market for Azeri's non-oil products. By depreciating the manat against dollar the Government of Azerbaijan targets the promotion of non-oil sector export capacity. In fact, 95.3 % of total Azerbaijani exports are oil and oil products.

The share of non-oil products in total exports is less than 5.0 %. Therefore, economic diversification should be the main priority of the Government of Azerbaijan. Nevertheless, promoting non-oil export capacity in Azerbaijan is not a short-term target; it is more of a long-term goal. Consequently, we do not expect sharp increases in non-oil exports in the short-term period even though the manat's rate has been sharply depreciated.

- 5. Increasing of Azerbaijani GDP in manat terms.** Azerbaijan's nominal GDP in the first month of 2015 fell by 30.6% against December 2014 and by 17.9% against January 2014. The State Statistics Committee reports that in January 2015 Azerbaijan's GDP totaled AZN 3.631 billion (\$ 4.629 billion), which in comparable prices is 4.4% more than the GDP for January 2014 (AZN 4.423 billion); that is, nominal GDP fell by 17.9%. In fact, the State Committee has reported real GDP growth in the first month of 2015, but according to the State Statistics Committee, GDP was 4.4 billion manat in January 2014. The Committee also reported that GDP was 3.631 billion manat in the first months of 2015. The official figures confirm that there was an 18.0 % decline (3.631/4.4) last month compared to the same month in 2014.

The manat's depreciation will increase GDP in manat terms but GDP in dollar terms will decline in upcoming months. "Azerbaijan will suffer from a sharp fall in oil prices, because of its high dependence on exports of hydrocarbons. Currency reserves accumulated by the Central Bank and the Oil Fund of the country (the State oil Fund of the Republic of Azerbaijan, SOFAZ. – RBC), will cushion the impact of external threats, however, growth in only one of the non-oil sectors of the economy is unlikely to achieve a sustained increase in General", – stated in the report of the EBRD. The level of GDP growth in Azerbaijan in 2015 in the updated forecast by the EBRD was reduced compared with September's report, by 1.5 percentage points (PP) from 3% to 1.5%. CESD, temporarily, does not forecast real economic growth for 2015 in the case of oil prices not increasing.

- 6. Boosting of the inflation rate.** The correction in the value of the manat will cause import prices to rise, leading to a sharp increase in inflation. Given the high base year for household consumption—it is officially estimated to have risen by 8.0 % year on year in 2015—there is likely to be a sharp retrenchment in private consumption expenditure in 2015. The Central Bank has been pushing the inflation rate to promote local and foreign investments to the country's economy. Taking into consideration the level of devaluation, CESD forecasts a 14.0% inflation rate for 2015.

There are other reasons, such as the increasing of cost of imported goods and targeting of further liberalization of the domestic market, why sharp and deep devaluation has taken place in Azerbaijan. Nonetheless, there is one major question; will Azerbaijan further devalue the national currency in 2015?

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