

# **National currency rate in Azerbaijan: is the stability sustainable?**

Brief analytical review by

Center for Economic and Social Development (CESD)

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## **National currency rate in Azerbaijan: is the stability sustainable?**

Plummeting oil prices since the third quarter of 2014 have shaped new market conditions for the national currency of Azerbaijan. For the first time after the global financial crisis of 2008, the national currency has encountered serious challenges. The Central Bank attempted to preserve the stability of manat exchange rate at the expense of spending currency reserves. Although intervention operations have been initiated since August 2014, only 0.2 billion US dollars in total were spent in September, October and November for this purpose. However, intervention spending has rapidly increased reaching 1.2 billion US dollars in December 2014. During the following 2 months, the Central Bank was forced to take intervention measures of 1.08 and 1.68 billion US dollars respectively. As a result, currency reserves decreased to 11 billion dollars accounting for a 26.6% reduction within 3 months. One of the reasons for large-scale interventions was the society's perception that devaluation was unavoidable, which thus increased the demand for foreign currency.

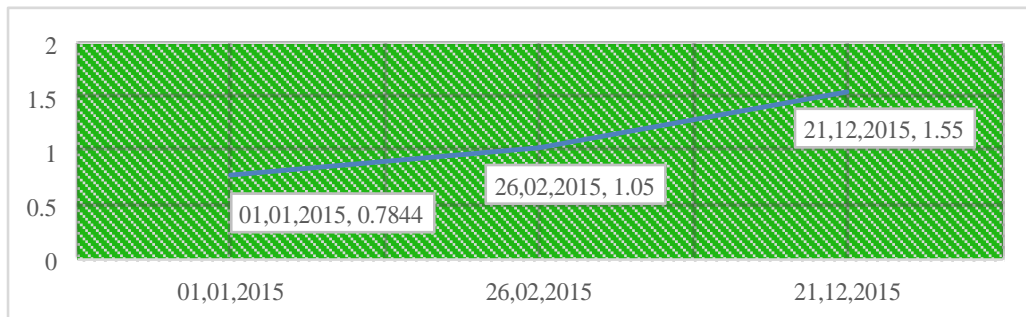
In order to carry out a floating exchange rate policy and to prevent the sharp reduction of currency reserves, the Central Bank shifted to the bi-currency basket represented by euro and US dollar. Applying this measure, the Central Bank aimed to maneuver between Euro-US dollar currency fluctuations in international currency markets on the one hand and to pursue a more flexible currency policy through the regulation of the currency basket structure in accordance with country balance of payments on the other hand. However, the shift to the bi-currency basket has strengthened the perception of devaluation for market participants, and as a result, the Central Bank had to make 0.5 billion US dollars injections to currency markets on a daily basis after the adoption of this decision. Eventually, after 4 days, on February 21, the Central Bank decided to devalue manat by 25.1% and determined an exchange rate at  $1 \text{ USD} = 1.05 \text{ AZN}$ .

During the months following the February devaluation, the continual reduction of oil prices, the inability of handling intervention costs as well as the initiation of expansive monetary policy by US Federal Reserve, limited the maneuvering options of the government. Thus, by emphasizing the uncontrollability of the situation that had emerged, the Central Bank decided to shift to a floating exchange rate regime on December 21. This same day, the Central Bank has announced  $1 \text{ USD} = 1.55 \text{ AZN}$  official rate, which amounted to approximately 49.4% devaluation of the national currency within a year (see: diagram 1).

At first, the shift to a floating exchange rate regime, in conjunction with the second devaluation, caused serious fluctuations in financial markets. The Central Bank's decision to adopt

sharp devaluation in fact aimed to complete the process of dollarization in a shorter period and with lowers costs by facilitating the public anxiety. Thereafter, the Central Bank imposed limitations on currency exchange outflow and currency exchange offices were briefly closed.

**Diagram 1: Exchange rate of national currency to US dollars**

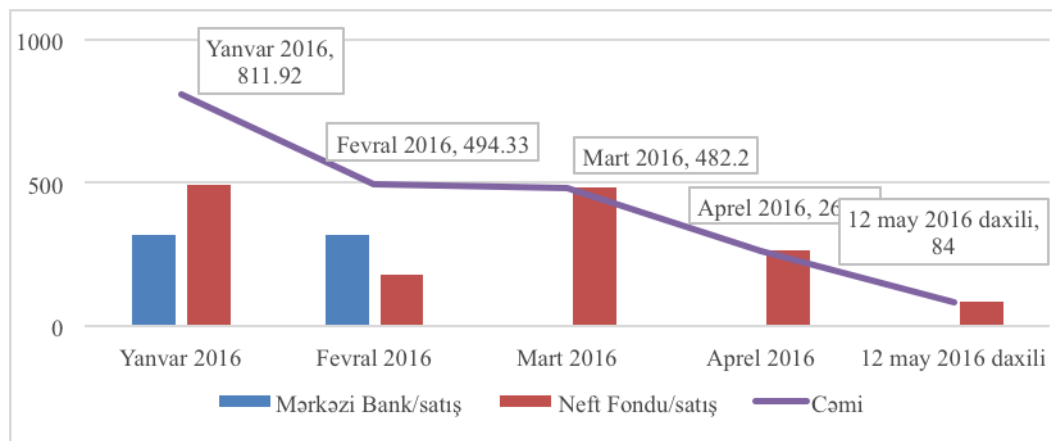


**Source: Central Bank of Azerbaijan Republic, 2016**

Those regulations and the limitations imposed on transactions exceeding 500 US dollars as well as the weak participation of commercial banks in the process of conversion have caused the expansion of illegal currency turnover in a short time. Hence, the exchange rate of US dollars has deviated substantially from official currency during this brief period and reached its historical maximum of 1.90 manats in illegal currency markets as a sole address of foreign currency purchase options. The difference between the illegal and official exchange rates accounted for 15%. Specifically, illegal currency exchange rates sharply increased during the holidays, that is, during the days when banks did not work.

The official exchange rate was determined in currency auctions organized by the Central Bank after the second devaluation. This period was accompanied by sharp reduction in foreign exchange reserves. On January 13, the State Oil Fund of the Republic of Azerbaijan joined the currency auctions. Nonetheless, the Central Bank continued the currency transactions (see: diagram 4). However, starting in March, the State Oil Fund became a sole seller party in currency auctions.

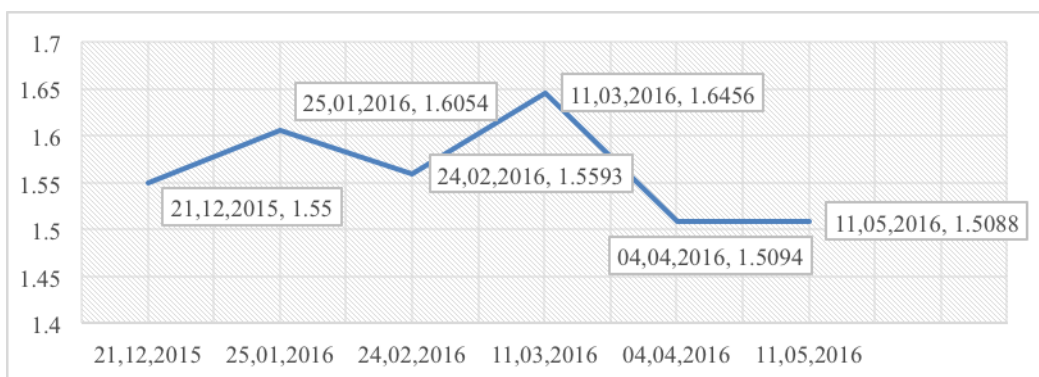
**Diagram 2: Dynamics of currency sales in auctions held after the 2nd devaluation**



**Source: Central Bank of AR and State Oil Fund of AR, 2016**

The Central Bank participated actively in currency auctions during January and March. On March 24, the dollar demand was satisfied only by 44.9%, which in turn led to the appreciation of the US dollar. The appreciation of dollar at record level in March was experienced once more. Nevertheless, the demand for currency began to decrease rapidly toward the end of March. Thus, only 0.5% of 100 million dollars for sale by the State Oil Fund were sold during the auctions held on March 28. Similarly, April showed a similar trend which resulted in manat appreciation at 1 USD= 1.5 AZN level. This process continued until February 26, when the Central Bank entered auctions as a buyer. CESD chairman Vugar Bayramov forecasted such developments regarding the dollar purchase of Central Bank in local media reports. Vugar Bayramov has substantiated his point of view that, if the State Oil Fund cannot purchase sufficient amounts of manat in auctions, it would not be able to perform its obligations towards the state budget. This, in turn, would result in the Central Bank’s intervention to the processes through dollar purchases. Hence, the Central Bank has prevented the sharp appreciation of national currency by carrying out the purchase of 140 million US dollars in currency auctions.

**Diagram 3: USD/AZN after second devaluation**



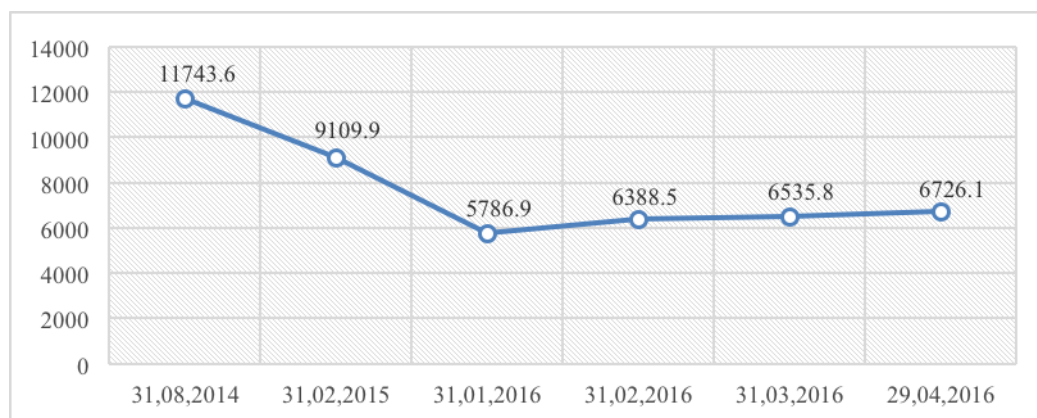
**Source: Central Bank of AR, 2016**

The December devaluation was followed by a continuous depreciation in the exchange rate of manat, though an improvement was recorded starting from January 25, 2016. During the next month, the appreciation of national currency continued. However, in March manat lost its value by hitting a new historical maximum. Trends in the past month mark the stabilization of the exchange rate of national currency. The revaluation process of manat, due to decreased demand for foreign exchange, was interrupted by purchases of the Central Bank in currency markets. The intervention of the Central Bank made it clear that, the government is not interested in further appreciation of the national currency beyond the rate 1 USD=1.5 AZN.

It should be noted that the current situation is favourable for increasing foreign exchange reserves of the Central Bank. However, the Central Bank demonstrates a cautious approach in this respect. Although a certain amount of the US dollars offered by the State Oil Fund in auctions are purchased by the Central bank and commercial banks, remaining part of dollars fail to find a buyer. According to experts, the Central Bank is continuing to limit the sterilization of manat.

Based on predictions of Fitch Ratings, the exchange rate of manat will be stable in 2016. Likewise, Elman Rustamov, the governor of the Central Bank made similar statements. He stated that, based on current situation, the exchange rate of manat is going to follow a stable track. The major reason for decreasing demand for foreign currency in exchange markets is the limited supply of manat. That is to say, the Central Bank has pursued a policy towards reducing manats in circulation since the end of 2014.

**Diagram 4. The dynamics of manat base (in millions)**



**Source: The Central Bank of the Republic of Azerbaijan, 2016**

The amount of manats in circulation fell by 43% in April 2016 compared to the level in

August, 2014. As of January, 2016 the value of manats in circulation is observed to decrease to its level in December 2010 (5605 million manats, 29.11.2010). According to the experts of the CESD, although the lower supply of manats in circulation can prevent the depreciation of national currency in the short run, this policy will leave an adverse impact on economic activity. In fact, the economy is facing a serious liquidity problem.

The arguments supporting a stable exchange rate of national currency are rooted in the end of dollarization the process and lower supply of manat. Nonetheless, the experts of the CESD consider this stability relative and state the status-quo could only be predicted for a short-term period. Considering that there are still factors shaping the negative and positive trends in the exchange rate of national currency, it is not reasonable to attempt predictions for the medium- and long-run. According to experts, the factors affecting the exchange rate of manat are as following:

Positive factors:

- a) The end of dollarization;
- b) The presence of administrative regulation;
- c) The lower supply of manats;
  - Decreases in budget spending,
  - Limited credits in manats.
- d) Decreased imports;
- e) Foreign borrowing opportunities;
- f) The psychological effect of rising oil prices;

Negative factors:

- a) Reduced value of exports;
- b) Lower foreign exchange reserves of the Central Bank;
- c) The limited participation of the State Oil Fund of the Republic of Azerbaijan in exchange markets
- d) Decrease in the value of remittances;
- e) Poor development of domestic production and dependence on raw materials:

Decreasing purchasing power and decreasing business activity are the main reasons for reduced demand for foreign currency. That is to say, imports fell by 24.9% in comparison with the first quarter of last year, which is equivalent to 0.6 billion USD. Moreover, an increasing price of oil during the last three months indirectly affected the exchange rate of manat, being a psychological

factor. In this case, citizens offer their dollars in currency markets anticipating appreciation of manat.

The reports of the State Customs Committee reveal that, a negative trade balance was recorded in the first quarter of 2016. Compared with the last year respectively, the value of exports fell by 47.4%, which is equivalent to 1 billion dollars. On the other hand, the experts of CESD predict that, the June meeting of oil producing countries will not bring about freezing production. Furthermore, following the end of summer tourism in August, the demand for oil will fall, which will result in decreasing oil prices. Therefore, the pressure on manat may increase starting from the second half of the year.

## **Conclusion**

Although the Central Bank adopted a flexible exchange rate regime, the observations show that, administrative adjustments are still applied. As mentioned above, the exchange rate of the national currency increasing from 1.05 to 1.55 was quite an alarming step, and the underlying motive was to complete dollarization process by ensuring the transition to de-dollarization. Furthermore, reducing monetary base and limiting the demand for foreign currency via administrative measures can negatively affect economic activity. The application of 4% upper and lower limits for currency exchange subjects can be considered an administrative measure as well. Consequently, the necessary conditions for national currency to reach its real value have not been formed during recent months. According to CESD experts, if administrative measures are removed, manat is likely to lose its value. That is why, it is complicated to predict the exchange rate of manat in the medium- and long-term. Moreover, poor development dynamics in terms of other sources of currency supply, the major factor to potentially influence the exchange rate of manat is considered to be the price of crude oil in world markets.

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