

Currency market in Azerbaijan: Challenging environment for the national currency

by Mr. Rashad Hasanov

Senior Researcher

Center for Economic and Social Development (CESD)

Center for Economic and Social Development (CESD)

**Dilara Aliyeva 115,
Baku, Az1009,
AZERBAIJAN**

Phone; (99412) 4975684

Fax (99412) 4975684

Email; info@cesd.az

URL; www.cesd.az

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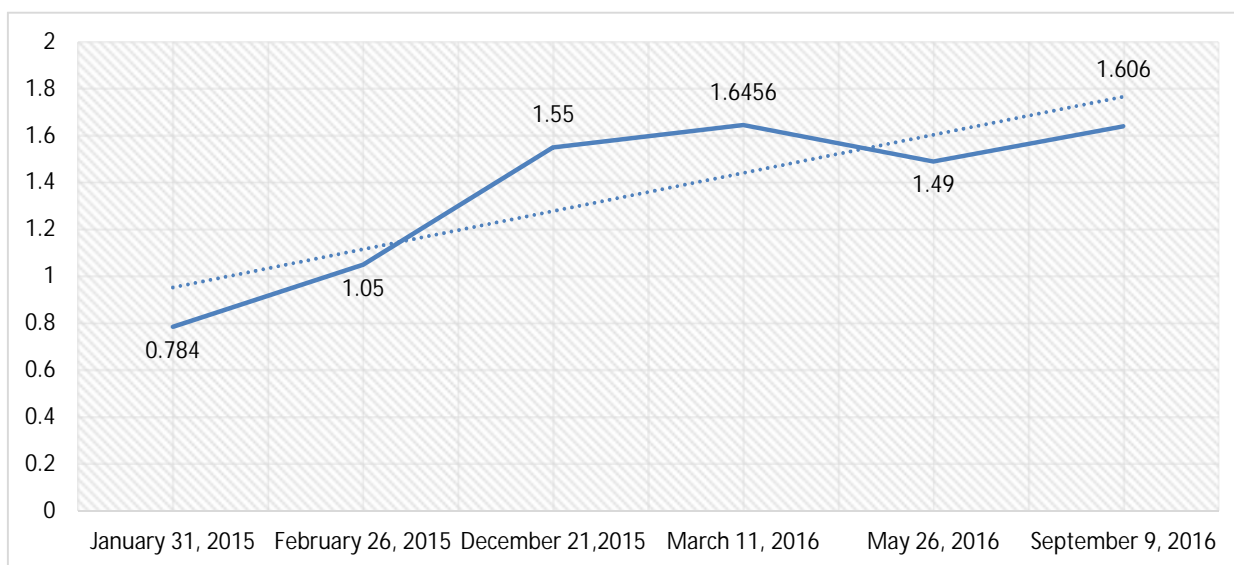
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Background

In August, the exchange rate of national currency of Azerbaijan-“Manat” beat all historical records. That is to say, the exchange rate was 1 USD= 1.61 Manat in previous month¹. It should be noted that, the exchange rate hit 1 USD= 1.6 Manat in March, 2016².

Since the second half of 2014, due to the fall of oil prices in the world markets there is a visible pressure on the national currency ‘Manat’. Overall, the Azerbaijani “Manat” lost 49.6% of its value in 2015 and in addition, a depreciation of more than 3% in the first 8 months of 2016, the losses could reach 52.2%. Although the occurring rapid dollarization and the observed stagnation in the business environment especially in imports in the first months of 2015 and 2016 resulted in short-term reduction in foreign exchange demand in the March-May period of this year and strengthening the exchange rate of USD/Manat at the level of 1.49, the process of depreciation proceeded again afterwards. As a result, the national currency increased its annual losses to the level of 5.5% in June-July, by depreciating 7% against the US dollar again.

Figure 1: USD/Manat



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

It should be noted that, the agitation observed in the currency markets since the beginning of August, has been accelerated at the beginning of September. The demand for foreign currency exceeded the currency supplied by the Central Bank by 12-14 times during currency auctions and banks used currency rates higher than auction rates during their foreign exchange purchases. These factors together with the restrictions applied to the currency sale and the afterwards suspension of currency sales led to a revival of illegal currency market, which set the actual

¹ Macroeconomic indicators on economic and social development in Azerbaijan during January-August, 2016, 16.09.2016

<http://stat.gov.az/news/?id=3347>

² Central Bank, Statistical Bulletin №197

http://www.cbar.az/assets/4217/STATISTIKA_BULLETEN_AZ_IYUL.pdf , 16.09.2016

exchange rate between 1.85 and 1.95 against USD. On September 8, the agitation in currency markets subsided for a short-term with the injection of USD 300 million by the State Oil Fund (USD 200 million³) and Central Bank (USD 100 million).

During the auction organized by State Oil Fund fairly over a half of the amount supplied was sold, i.e. USD 78 million USD⁴ out of USD 150 million, which signals for a serious impact of psychological factors in currency markets. It is necessary to mention that this factor has caused the reduction of actual demand in two subsequent auctions. Therefore, USD 72.4 million and USD 61.4 million have been purchased by the banks in auctions held on September, 20 and September, 22, 2016 respectively. Given that, as of September, 15, 2016, USD 478 million were converted by the Central Bank and State Oil Fund altogether, the currency purchase worth USD 611 million was carried out despite the fact that, only 4 days are left till the end of September. This amount is USD 167.3 million higher in comparison with August and USD 61.8 million higher in comparison with July 2016. This can be considered a high response of currency markets to the official position of monetary authorities. Hence, the official exchange rate of the manat has been appreciated starting from 15th of September.

At present, the official exchange rate is USD 1 = Manat 1.56292. However, commercial banks carry out the purchase of manat at Manat 1.63= USD 1 and the sale of manat at Manat 1.65 = USD 1, which is lower than 13% in comparison with the level observed in illegal markets 20 days ago. It is also important to note that the repeated appreciation of the manat and the determination of the interest rate ranges 12-15% in the auctions organized by the Central Bank in order to attract the deposits in manat currency, and it has led to the sharp increase for the demand in this direction. Thus, the Central Bank has succeeded to attract the deposits worth of 50 million manat at the amount first announced on September, 15, 2016. This has provided options for limiting the demand for currency by the means of crowding some amount of “manat” out of the circulation. Since September 15, 2016 the official exchange rate of manat has been “strengthened” because the fundamental factors are not in favor of the manat yet.

The dynamics of factors affecting the exchange rate of the national currency

Firstly, it should be underlined that, there is uncertainty concerning the exchange rate policy. That is to say, the Central Bank intervened at large-scale following a passive participation in currency markets during last 3 months, and was able to restore confidence for only a short-term period.

The foreign exchange demand for foreign currency markets was at minimum rate just 5 months ago. In auctions organized by the Central Bank, only 0.5 million US dollars were demanded

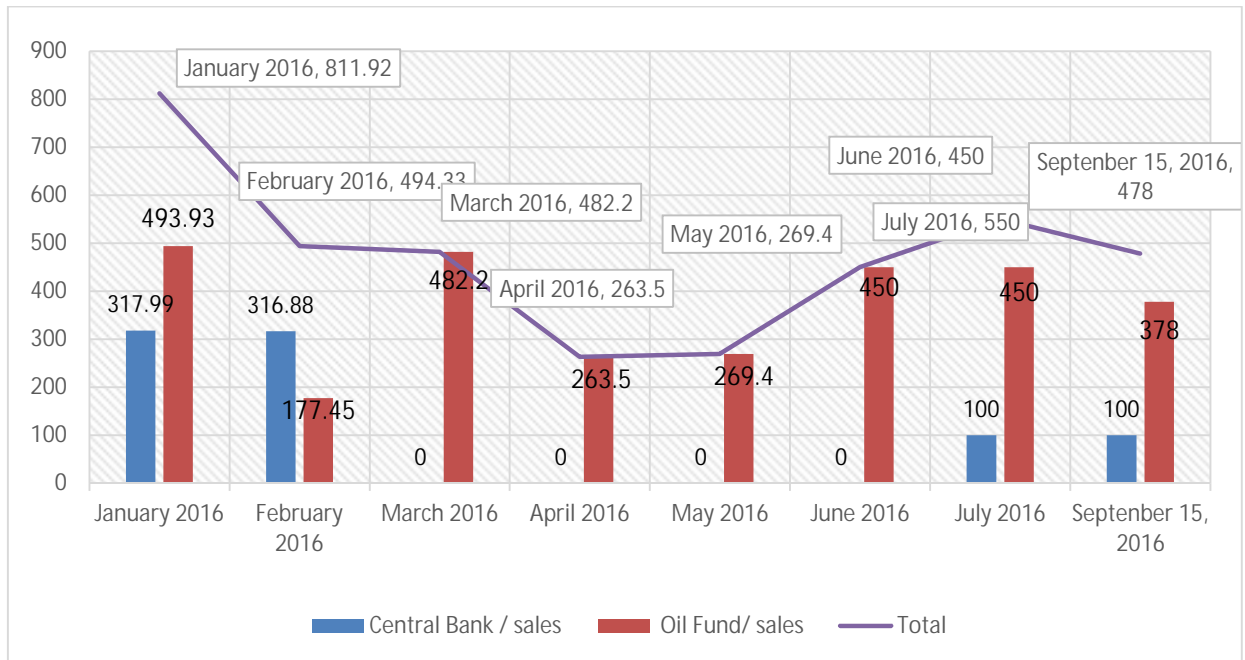
³ News Archives, Statement by the State Oil Fund of the Republic of Azerbaijan, 08.09.2016
http://www.oilfund.az/az_AZ/news/1185/100/Azerbaijan-Respublikasi-Doevlet-Neft-Fondunun-aciqlamasi.asp

⁴ News Archives, Statement by the State Oil Fund of the Republic of Azerbaijan, 14.09.2016
http://www.oilfund.az/az_AZ/news/1187/100/Azerbaijan-Respublikasi-Doevlet-Neft-Fondunun-aciqlamasi.asp

against the 200 million dollars supplied by the State Oil Fund of the Republic of Azerbaijan⁵, which constituted the 200-fold of the demanded dollar and thus, have played a prominent role of psychological factor in appreciation of national currency recently.

At the same time, the Central Bank preserved its status as an active participant in currency markets, in January and February of 2016. However, this participation led to the rapid depletion of reserves. Thus, during the abovementioned two months, the Central Bank sold USD 635 million in currency trading, as a result, the bank's foreign exchange reserves fell to the minimum level – USD 4,026 billion. Thereby, the Central Bank limited its participation to foreign exchange auctions and the gap was offset by the conversion of the SOFAZ. In March 2016, the SOFAZ proposed USD 482.2 billion dollars of foreign exchange that was approximately 3 times more in comparison with the previous month.

Figure2: The dynamics of currency sales in auctions held after second devaluation



Source: Prepared by CESD experts based on information of the Central Bank of RA and the State Oil Fund of RA

As can be seen, for the first time after 4 months, the Central Bank was forced to carry out an intervention worth USD 100 million in July. Afterwards, on September 8, the Bank injected USD 100 million once again, making the total intervention worth USD 200. Overall, the total of USD 4243.8 million (USD 834.87 million by the Central Bank and USD 3408.93 million by the State Oil Fund) has been sold in currency auctions as for September 15, 2016, which is equivalent to a monthly currency supply of USD 500 million. At the same time, it should be noted that for the first time in April 28, 2016, by entering the foreign exchange auctions as a recipient, the Central Bank was able to carry out the latest currency purchases in the amount of USD 10 million on 31.05.2016. In general, the Central Bank succeeded to carry out the purchase of USD 202 million from April 26 to May 31, 2016. In the following periods, the demand at

⁵ State Oil Fund, 28.03.2016

http://www.oilfund.az/az_AZ/news/1053/100/Azerbaijan-Respublikasi-Doevlet-Neft-Fondunun-aciqlamasi.asp

auctions exceeded the proposal continuously that this process has led to a depreciation of the national currency again.

It should be noted that, especially in these months, significant increases in oil prices are observed on world markets. Such that, Brent oil, the price of which has plummeted to its historical minimum in January - USD 27, increased by approximately 96% during 5 months and was traded with USD 53 in July 9. Then again, a fall in oil prices was observed. As a significant psychological factor in Azerbaijan's currency market, the rising oil price shapes a conviction in the community that the national currency will be stronger and citizens and business-based currency supply will increase. It should be noted that, in these days of the rapid appreciation of the national currency, the expert group of the Center for Economic and Social Development has forecasted the repeated devaluation based on the limited nature of protection opportunities of the exchange rate of the national currency by administrative tools and sustainable growth of balance of payments deficit.⁶ In addition, the chairman of the center - Vugar Bayramov pointed out to the local media that the strengthening of the national currency is just unattainable for a long time due to the current economic conditions⁷.

Although the intervention carried out several days ago helped to meet the demand to a certain extent and neutralize psychological factors, there are no economic grounds to claim that, the process is to be sustainable.

In reality, the situation is as following:

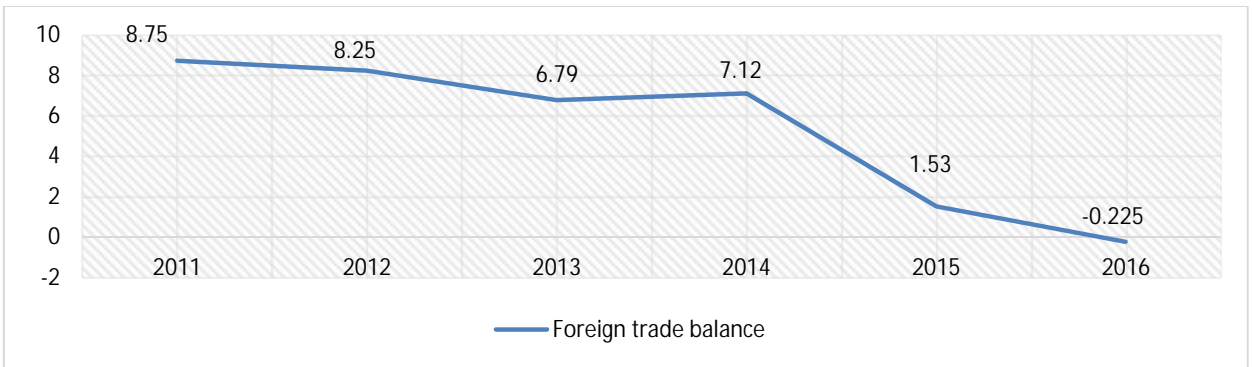
1. The decrease of currency reserves to a critical level has limited the intervention options of the Central Bank. As a result, the foreign currency demand has not been fully met, which has increased pressure on the national currency in last three months. During the period of March – September 2016, the Central Bank two times made an intervention of USD 100 million. During the year the overall intervention amounted to USD 835 million but the Central Bank conducted a currency sale of USD 8.4 billion in 2015.

2. There has been a serious decrease in the trade balance of Azerbaijan. That is to say, during the period of January-August, 2016 the trade balance recorded USD 250,3 million, being 9.2 times less (2015: USD 2284,8 million, SCCAR) than the corresponding period of the previous year and 38 times less (2014: USD 8 million, SCCAR) than the 2014 level. Additionally, the trade balance recorded a deficit of 225.8 million USD in the first half of the year (see; Diagram 3).

Figure 3: The dynamics of the foreign trade balance in the 1st half of year, in billion manat

⁶ CESD, “National currency rate in Azerbaijan is the stability sustainable?”, 16.05.2016
http://cesd.az/new/wp-content/uploads/2016/05/CESD_Paper_National_Currency_Azerbaijan_2016.pdf

⁷ Azerbaijan Transparency International Project, “Manat: reasons of temporary stability”, 31.05.2016
<http://transparency.az/cnews/manat-muv%C9%99qq%C9%99ti-sabitliyini-s%C9%99b%C9%99bl%C9%99ri/>

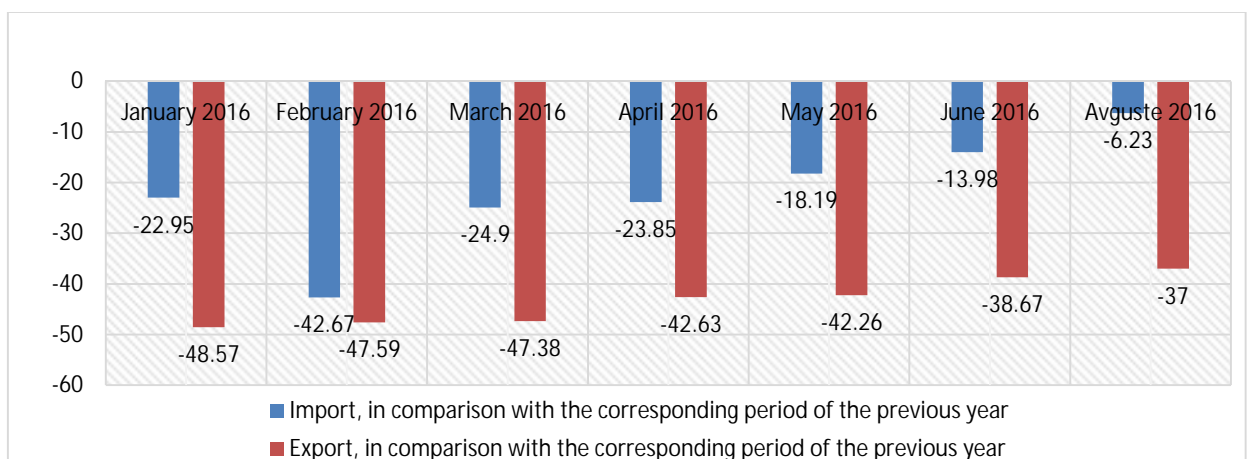


Source: State Customs Committee of the Azerbaijan Republic, 2016

At the same time, it should be noted that, the observed sharp recession in the volume of imports at the beginning of the year has gradually decreased in the following few months [see: Figure 4]. However, the level of stagnation observed in exports remains high, which also raises the possibility of the increase of the negative balance. In other words, imports declined by 6.23% during January-August, 2016, while exports fell by 37% compared to the corresponding period of the previous year. The underlying reason for a positive trade balance can be considered the increases observed in agricultural exports due to seasonal factors, which was 2 times higher (equivalent to USD 600 million) compared with an average recorded in previous months.

According to the CESD experts, the foreign trade balance is projected to follow a negative trajectory due to decreasing agricultural exports in the following months, and low oil prices as it is unlikely that the OPEC meeting in September will decide on freezing production or setting a quota.

Figure 4: Import and export operations, compared to the previous year, in percentage

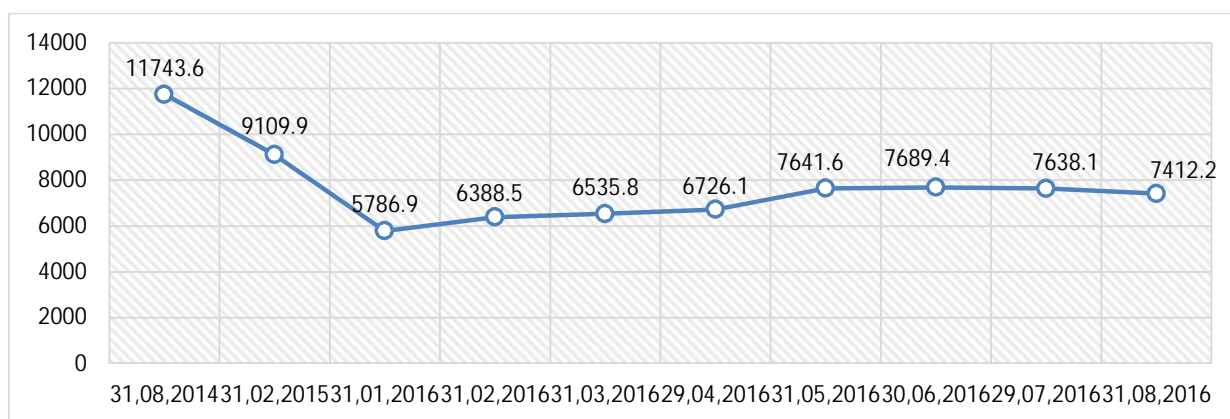


Source: State Customs Committee of the Republic of Azerbaijan, 2016

The reason for the observed lagged impact of the trade deficit on the demand for currency can be attributed to the dramatic dollarization observed in business assets and imports under credit conditions in first months of 2015 and 2016.

3. The monetary base of the manat is growing. Since the end of 2014, the government pursues the regulation of the foreign currency demand by reducing the volume of manats in circulation in order to minimize the pressure on the national currency. Thus, in January 2016, the monetary base has constituted 5.78 billion manat falling by 5 billion manat during the 5 months.

Figure 5: Dynamics of Manat Liquidity (in millions)



Source: Central Bank of the Republic of Azerbaijan, 2016

However, considering the negative economic influence of continuous reduction in money supply, it can be seen that, the continuation of the current situation was impossible for a long time. Money supply increased by 22% (equivalent to 1625.3 million manat) as for August 31, compared with the January level which is considered as a factor that raises the demand in currency markets. At the same time, in February 2016 - the increase of social spending during the amendments to the state budget has led to repeated growth of money supply. Such that, although only 2.5 billion manat was spent from the state budget⁸ in the first quarter this amount increased by 41% and reached the level of 4.3 billion⁹ manat in the second quarter. During July-August state budget expenditures constituted 2.54 billion USD¹⁰.

⁸ Ministry of Finance of the Republic of Azerbaijan, “Information (operative) on the execution of the state budget for the first quarter of 2016”, 05.04.2016

<http://www.maliyye.gov.az/en/node/1926>

⁹ Ministry of Finance of the Republic of Azerbaijan, “Information (operative) on the execution of the state budget for six months of 2016”, 18.07.2016

<http://www.maliyye.gov.az/en/node/1950>

¹⁰ Macro-economic indicators (August , 2016), 19.09.2016

<http://www.stat.gov.az/macroeconomy/indexen.php>

Therefore, the state budget expenditures in the second quarter played a crucial role in growth of the manat liquidity. Considering the projected expenditures of 18.5 billion manat of the state budget¹¹, only 50.5% of this commitment has been implemented in the eight months of the year.

Though the CESD experts state that, the budget projections are unlikely to be realized and especially the expenditure part is to record a deficit with an increasing expenditures in the following 4 months. Consequently, the increase of the currency markets demand is predictable in the following months.

Starting from 9 June 2016, the Central Bank has initiated the attraction of deposits in manat in order to strengthen the confidence in national currency and control manat volume. Nevertheless, neither the deposits attraction of the Central Bank in manat, nor the emission of bonds in manat by the Ministry of Finance was effective enough to ensure the stability of the exchange rate.

4. The shift of the Central Bank to a floating exchange rate regime has caused the transformation of country population into participants of currency markets. As a result, new trend has emerged in currency markets. Thus, the population of the country and business entities pursue to gain profit from changes in exchange rate. Therefore, the sale of foreign currency during the appreciation of the national currency and purchase of it during the depreciation period by these groups is observed. This causes the increase in volatility of currency markets and the restriction of regulation opportunities of the Central Bank. Under current circumstances, the demand for currency by population and businesses increase continuously. As a result, the demand in recent currency auctions has reached USD 600 million¹². This amount exceeds the bid by 12 times. Nonetheless, the auction held in September 8, will result in an increasing currency supply by households and business for a short-term period. Increasing supply will be replaced by an increasing demand in medium- and long-term period; thereby currency sales will be replaced by currency purchases.

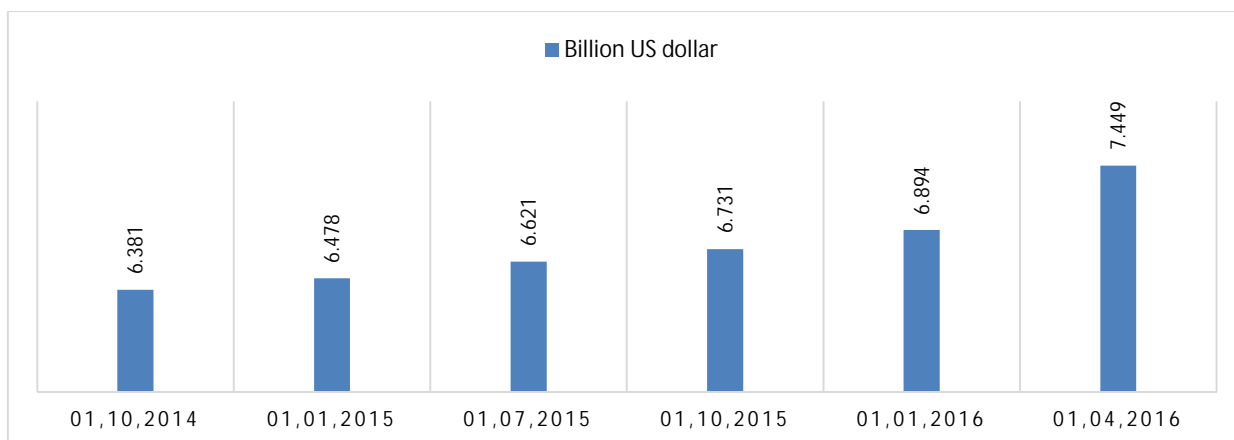
5. The external debt growth of the Republic of Azerbaijan will increase the expenditures on debt service in next years, which, in turn, leads to an increase of state-based demand in currency markets. [See; figure 6]. Such that, the external state debt peaked at USD 7.45 billion in March 2016, increasing by 14.3% in comparison with October, 2014.¹³

¹¹ The Ministry of Finance, “On 2016 State Budget of the Republic of Azerbaijan”, 23.02.2016
<http://www.maliyye.gov.az/sites/default/files/qanun%20budca.pdf>

¹² New Musavat, “Demand for dollar hit the record level”, 11.08.2016
http://musavat.com/news/valyuta-herracinda-dollar-telebat-rekord-hedde-chatib_369685.html

¹³ Note: Official information on state foreign debt was announced on 01.04.2016 latest. The Ministry of Finance of the Republic of Azerbaijan, “On state foreign debt due 01 April 2016”, 14.06.2016.
<http://www.maliyye.gov.az/node/1939>

Figure 6: The external debt of the Republic of Azerbaijan

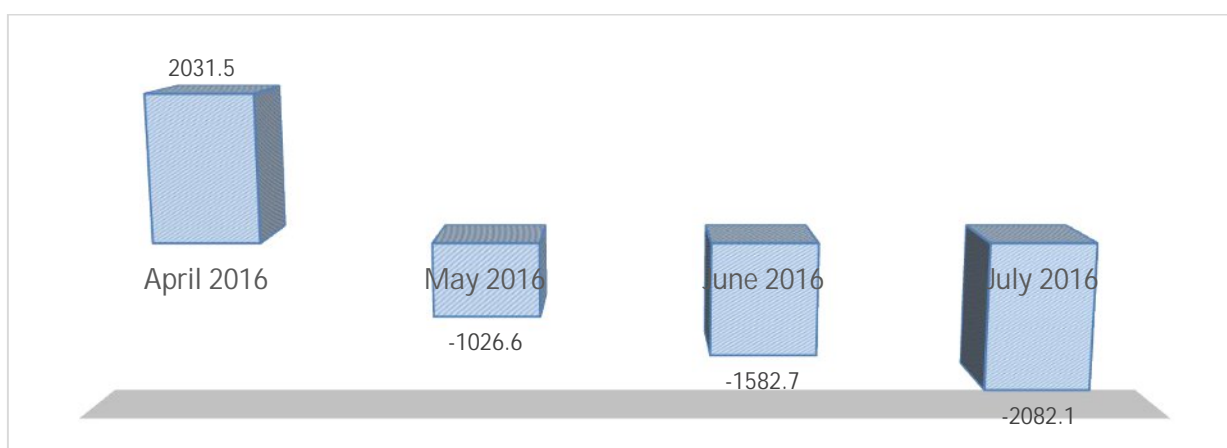


Source: Ministry of Finance of the Republic of Azerbaijan, 2016

Although the latest official statement on the foreign debt covers the period till April, the debt volume has increased more in next 4 months.

6. Starting from May, an increase in net foreign liabilities of commercial banks has been recorded. There is no official data for August, but net foreign assets of banks increased during April-July.

Diagram 7: Net foreign liabilities of commercial banks

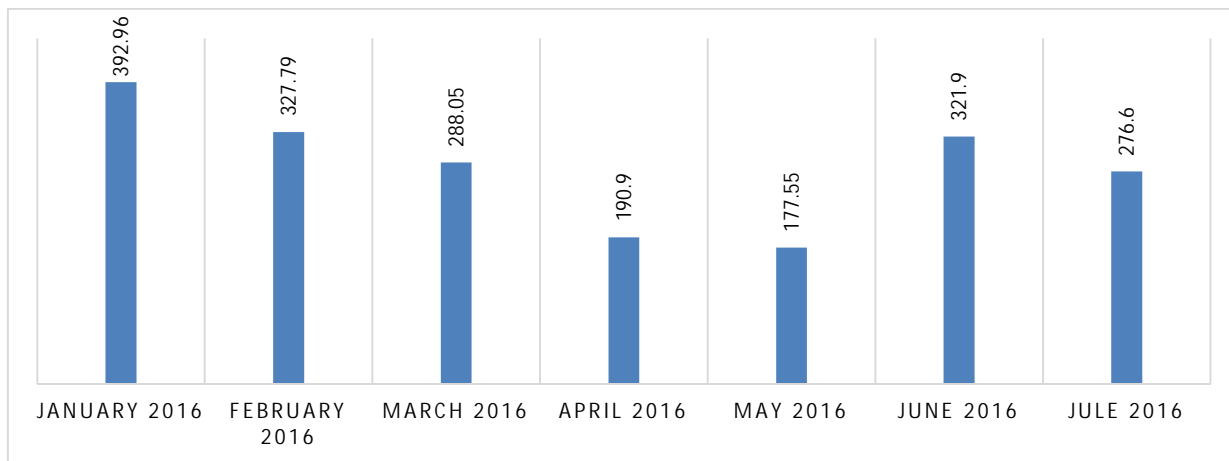


Source: The Central Bank of the Republic of Azerbaijan, 17.09.201

As can be observed, foreign debt burden of commercial banks has been increasing during last 4 months, which is going to raise demand for foreign currency by banks to meet their liabilities.

7. The sale of cash foreign currency decreases in foreign exchange markets [see; figure 8]. The reduction in consumption activity, low level of confidence in national currency and unpredictability of the economic dynamics for the future can be considered as main factors.

Figure 8: Dynamics of US dollar in exchange transactions with cash foreign currency, in millions



Source: Central Bank of the Republic of Azerbaijan, 2016

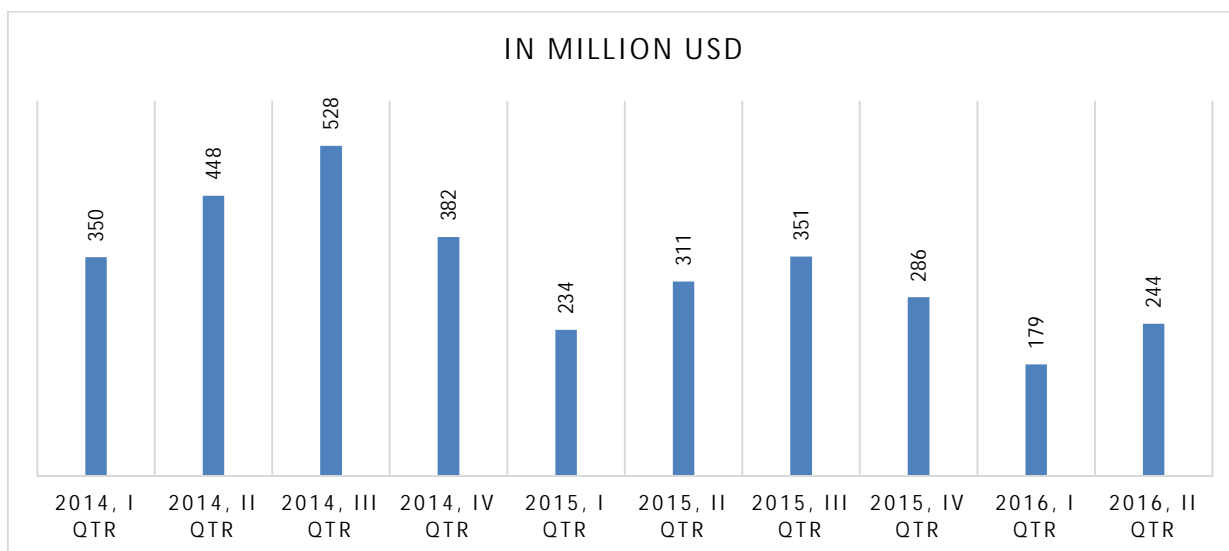
As seen, the sale of cash US dollars in the currency markets has decreased to the level of 276.6 million, declining by 29.6% in May in comparison with January. The CESD experts forecast the continuation of a downward trend in the following months. This is one of the factors keeping the national currency under the pressure by forming the supply deficit in currency markets.

8. The recession observed in real estate and automobile markets, where currency circulation is more widespread, is one of the crucial factors of the reduction in foreign currency turnover. Therefore, the stagnation observed in these markets and the dynamics of declining prices reduces the speed of circulation by increasing the amount of foreign currency liabilities collected in citizens and business, which, in turn, paves the road for the difficulties in meeting the existing demand.

9. Currently, the tendency to return foreign currency deposits and savings in manat is observed in commercial banks, which are being closed or taken under the state control. This situation, in turn, affects the formation of the excess demand in currency markets.

10. The remittances continue to decline due to the ongoing economic recession in the countries of destination of Azerbaijani migrants, e.g. Russia, Ukraine and Kazakhstan.

Figure 9: Quarterly dynamics of remittances to Azerbaijan

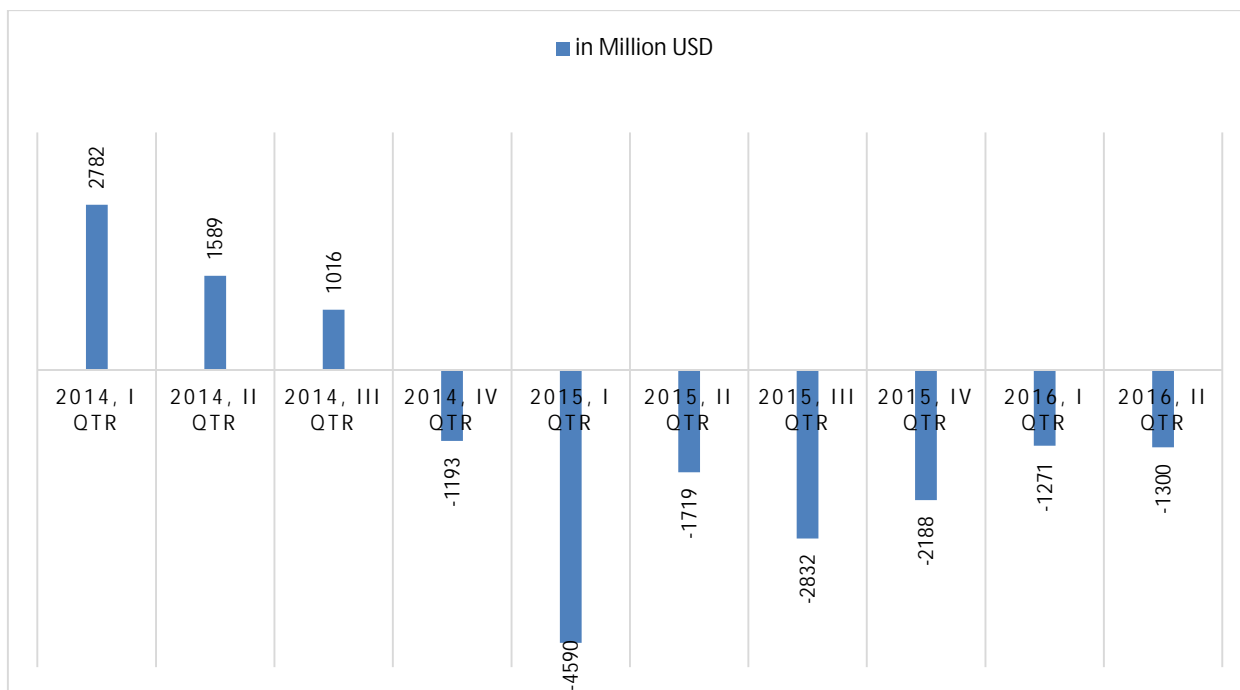


Source: Central Bank of the Republic of Azerbaijan, 18.09.2016

As seen from the Figure, Azerbaijani citizens residing abroad sent USD 799 million the first quarter of 2014, whereas this number declined to USD 545 million in 2015 and USD 423 million in 2016. Hence, the volume of remittances sent has plummeted by 47% and 22,4% in 2015 and 2016 respectively. Given that this trend is also attributed to remittances sent will illegal channels, the deterioration in the volume of sent remittances is expressed in large numbers.

11. The current account deficit observed since the fourth quarter of 2014 is ongoing. Such that, permanent deficit have occurred in the current account of the country throughout the cheap oil period. This suggest that the current account will be accompanied with deficit in the third quarter as well with no spurt in oil prices.

Figure 10: Current account of the Republic of Azerbaijan, quarterly



Source: Central Bank of the Republic of Azerbaijan, 18.09.2016

According to the calculations of CESD experts, within the current situation (the reduction of investment expenditure of government budget, lower purchasing power of population and etc.), the current account deficit can be covered in case of the average quarterly price of 1 barrel oil equals to USD 75, that is, 30 dollars higher than the current level.

As we have mentioned above, the Central Bank has created serious panic among citizens due to the inactive position in the currency markets until the early September. This is mostly explained by the limited reserves of the Central Bank and indecision regarding the currency policy of the government. However, the successive steps taken by the Central Bank and the government targets the short-term appreciation of manat. Such that, starting from 8th of September, the volume of currency supply in auctions have been constantly increased. The demand is practically satisfied. At the same time, the Central Bank raised the interest rate by 5.5 percentage points up to 15% on 14th of September motivating these steps as for the regulation of inflation and the strengthening the reliability of the national currency¹⁴. A decree of the President of the

¹⁴ Central Bank of the Republic of Azerbaijan “Information of the Central Bank”, 09.09.2016
<http://en.cbar.az/releases/2016/09/09/information-central-bank/>

Republic of Azerbaijan on “The auxiliary measures on the increase of the efficiency of purchases for the operation of executive power bodies and enterprises financed by the government budget” was signed on 15th of September.¹⁵ This decree aims to limit the currency outflow by the regulation of currency demand emanating from the budget expenditure. Starting from 16th of September, the ceiling for the annual interest rate for deposits in national currency was raised by 3% points reaching 15%.¹⁶ The goal is to restrict the withdrawal of savings deposited in national currency and to give an impetus for the process of attraction of deposits in national currency. A citizen reluctant in keeping the savings in national currency is interested in depositing in foreign currency, which is considered to be one of the main factors shaping the additional demand in currency markets.

Overall, taking into consideration the abovementioned factors the depreciation of Azerbaijani Manat will continue in the coming months with the exceptions for minor fluctuations. Although Azerbaijani Manat has not maintained its real rate within the liberal circumstances, CESD experts exclude the possibility of rapid devaluations of February 21, 2015 and December 21, 2016. At the same time, the exchange rate of the Azerbaijani Manat for the future will mainly depend on oil price, which is an external factor. Any significant increase is not predicted in oil prices for 2016 and 2017, unless there are any force majeure cases; the latter strengthens the conviction that medium-term increases will take place for USD/ Manat couple. On the other hand, CESD experts reckon there is a high probability that the government will decide upon the shift to floating exchange rate regime which can result in a 35% depreciation of the national currency once again.

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¹⁵ A decree of the President of the Republic of Azerbaijan on “The auxiliary measures on the increase of the efficiency of purchases for the operation of executive power bodies and enterprises financed by the government budget, 15.09.2016
<http://www.president.az/articles/21083>

¹⁶ Deposit Insurance Fund, “The ceiling for deposits in national currency was raised from 12% to 15%”, 16.09.2016
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