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FED's interest rate: Causes and Implications for Azerbaijan

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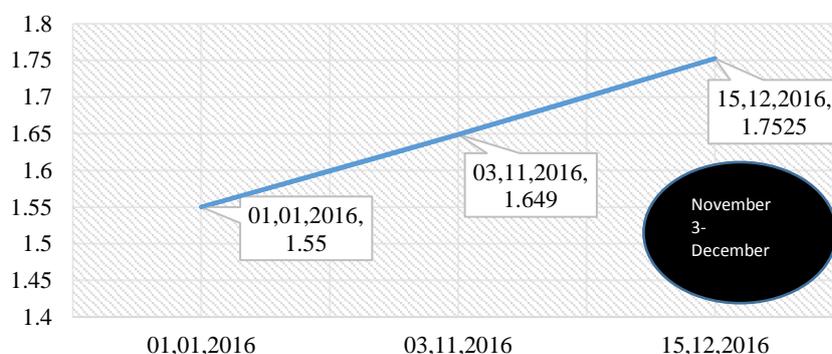
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The decision of FED and Azerbaijani national currency

The decision of the Federal Reserve System (FED) of the USA has been among the most important economic news during the previous week. That is to say, following the long-term expectations, FED raised interest rates by 0.25 percentage points (making it 0.75%)¹.

The decision of FED, which is to pose a serious impact on the future exchange rate of dollar, has been long waited in Azerbaijan as well. In particular, the participants of currency market were trying to predict the trends to be arisen following this decision and position themselves accordingly.

Diagram 1: Dynamics of USD/manat exchange rate



Source: Central Bank of the Republic of Azerbaijan, 2016

As a result, in the context of expectations for raised interest rates, manat, the national currency of Azerbaijan, lost its value by 5.9% during the months of November-December 2016, increasing annual depreciation to 8.9% [see: **diagram 1**]. Moreover, during the same period similar depreciation of 5.47% was observed in the exchange rate of EUR/USD [03.11.2016, EUR/USD=1.114, 15.12.2016, EUR/USD= 1.053].

It should be noted that, the December 13-14 decision of FED was forecasted to increase the interest rates by 100 %. That is why, after the decision, sharp volatility in the currency markets is expected only for a short-term period. Later, the attention of market participants will be switched into the political manipulations on the legitimacy of the newly elected president of the USA, Donald Trump and his decisions to be made on the first 100 days of office.

¹ Transcript of Chair Yellen's Press Conference December 14, 2016
<https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20161214.pdf>

Currency markets before the decision

Oil market

The currency market participants and generally the society in Azerbaijan are waiting for the outcomes of the OPEC meeting held on November 30 before the decision of the FED. Since the existing economic structure in the country proved ineffective in terms of non-oil revenues falling short to balance the BOP in short and medium term, even the country officials acknowledge this. After a long period, officials once again commenced their talks on expensive oil. In these circumstances, all stakeholders in Azerbaijan are closely following the OPEC meeting in Vienna. Azerbaijan even expressed its willingness for cutting production.

Notwithstanding some reservations, the Vienna meeting ended with optimistic statements, overall the production level was decided to be cut by 1.8 million barrel. This agreement led to 20% increase in oil prices. Thus, the price of crude oil sold by Azerbaijan in world markets, "Azeri LT CIF", rose to 57 USD. It should be noted that, the price of oil is considered an important psychological factor in currency markets of Azerbaijan. However, the change in price of oil does not mean an increased currency supply in the short term. Based on the oil factor estimations, local currency market participants opted for possibilities of appreciation of manat. Consequently, during the beginning of December, manat appreciated against dollar in black market by approximately 2.2% [see: **diagram 2**]. Yet, the concerns over the compliance of both OPEC and non-OPEC countries with the agreement, as well as, the expected last and critical meeting of the FED in 2016, elevate the pressures on the exchange rate of manat.

Figure 1: Dynamics of price of Brent crude oil



Source: Bloomberg, 2016

Changing the rules of currency auction

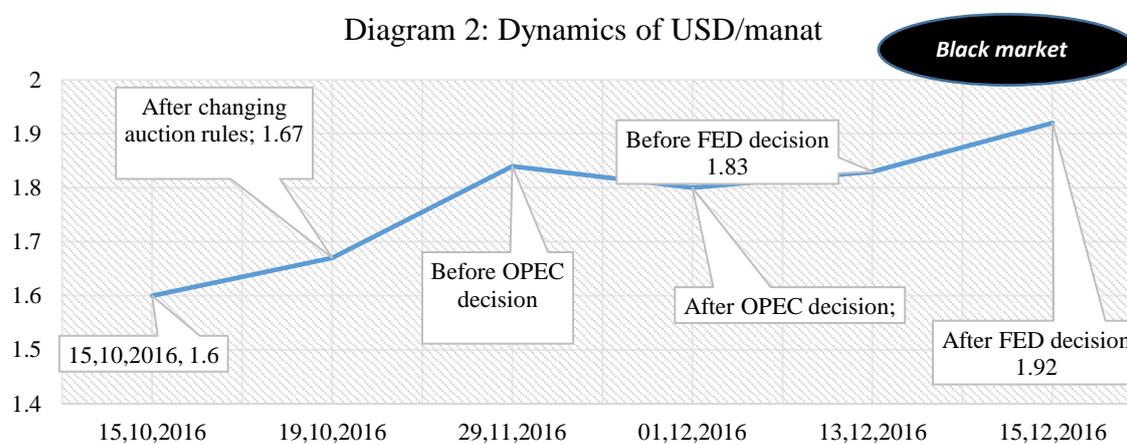
Alongside external factors, the adoption of new rules during previous 2 months in Azerbaijan is expected to affect the exchange rate of national currency, directly or indirectly. Firstly, it should be noted that, in October, the Central Bank of Azerbaijan has made amendments to the rules on currency auctions.² Thus, the commercial banks now have rights to participate as supplying parties in currency auctions, which led to more liberal conditions for auction rules and to increased participation of market members in the formulation of exchange rate. New rules are considered to contribute to the transition to the liberal exchange rate regime, according to currency market participants, and therefore the depreciation of manat has been accelerated [see: **diagram 2**].

Coping with illegal currency market

During the days of increased currency risks and unmet demand, the only private sector participants in currency auctions, that is to say, banks either applied limits to their currency sales or completely suspended the sales. This raised the concerns of people by leading to an extra demand for foreign currency, and thereby created a mass flow to the black market. As a result, accessibility to legal market entirely disappeared and there was a serious

² The Central Bank of the Republic of Azerbaijan , “On new auction mechanism of foreign exchange sale”, 05.10.2016
<http://en.cbar.az/releases/2016/10/05/on-new-auction-mechanism-of-foreign-exchange-sale/>

variance between a black market rate and official exchange rate. Since the end of November, the government started the process of elimination of black market and the punishment of participants. The exposure of the mechanism of banks, participating in currency auctions organized by the Central Bank of Azerbaijan, to direct the foreign currency to the black market resulted in enforcement of control mechanisms in this respect. This, in turn, led to disruption of currency accessibility in the country, since the beginning of December. In other words, the decrease in currency sources for black market participants and an increased risk brought about a further rise of margin. Subsequently, the difference between the exchange rate of USD and EUR in black markets and official exchange rates has risen to 5.0 %. Notwithstanding this difference, it has been almost impossible to obtain US dollar. Currently, in black markets USD/manat=1.92 [see: **diagram 2**].



The transition to a free floating exchange rate regime

“Strategic Road Map on the national economy perspective of the Republic of Azerbaijan” approved by the Presidential Decree dated December 6, 2016, once again confirmed the statements on the transition to a “free floating exchange rate regime”³ in 2017 (*Note that, until December 21, 2015 fixed exchange rate regime had been applied. The December devaluation was conducted in parallel with the decision of transition to managed floating exchange rate regime. Currently, the situation in the country proves the transition to a free floating exchange rate regime inevitable*). Consequently, the pressure is increased through the purchase of short-term savings formed by physical persons. On the other hand,

³ Azerbaijan State Information Agency, Decree of the President of the Republic of Azerbaijan dated December 6th, 2016, “Strategic Road Map on the perspective of national economy of the Republic of Azerbaijan”, http://azertag.az/store/files/untitled%20folder/_STRATEJI%20YOL%20XERITESI_.pdf

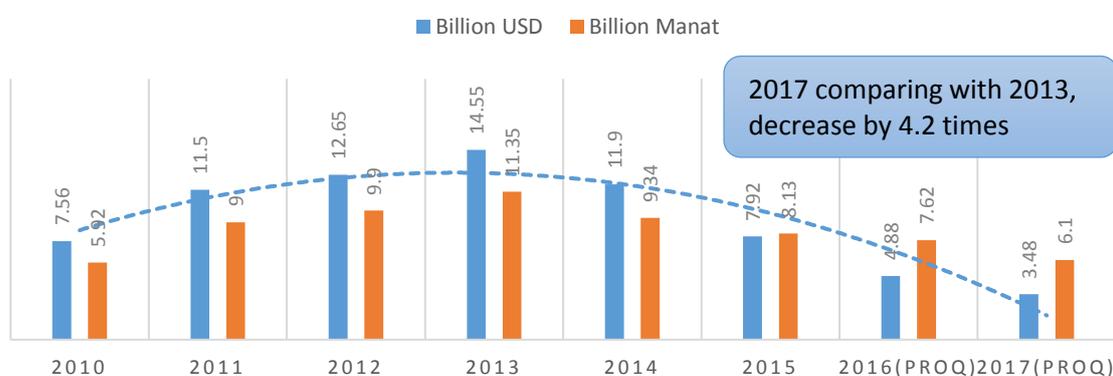
the government officials participating in the discussions of the budget express pessimist statements for 2017. For instance, the chairman of the Central Bank of Azerbaijan, Elman Rustamov stated that “*We are unsure about the exchange rate of manat if the control is taken*”⁴ which increased negative predictions for manat.

In other words, these statements comprehended as “confession of the chairman of the Central Bank of Azerbaijan about experiencing difficulties in predicting the risks of the transition to a free floating exchange rate regime” by stakeholders. In general, all stakeholders in Azerbaijan agree that, manat has not found its real value. This, in turn, increases the risk of unmanaged regime.

Transfers from the Oil Fund to the State Budget

Alongside the factors discussed above, it was clear during the 2017 budget discussions that, the main participant of the currency markets, SOFAZ is willing to make a transfer amounted to only 6 billion during the next year. This means, in 2017 the currency supply will decrease to its minimum level over the course of recent years.

Diagram 3: Dynamics of transfers from SOFAZ to the state budget



Source: Calculated by the CESD based on the information provided by the SOFAZ⁵, 2016

During 2010-2017 there has been a decline in the transfers of SOFAZ to the state budget, both in terms of manat and USD. The maximum was recorded in 2013 with 14.55 billion USD. But, the oil price slump in 2014 led to reconsideration of the transfer policy.

⁴ Sputnik.az, “Senior Banker talked about the fate of manat: “We do not intervene the market”, 30.11.2016 <http://sputnik.az/economy/20161130/407917875/neftin-qiyemeti-elman-rustemov.html>

⁵ Note: transfer in 2017 by SOFAZ is calculated based on official exchange rate on 15.12.2016 by the Central Bank

Consequently, transfers have been decreased. Relatively lower projection of transfers is one of the factors weakening the currency accessibility in 2017, which led to the depreciation of national currency. Therefore, local market participants reduced their currency sales and increased their purchases. As a result, the gap between supply and demand is widening and foreign currency is getting expensive.

Strategic Road Map is publicized

Since December 6th 2016, short-, medium- and long-term strategic development plan and its integral components in different directions of the economy of Azerbaijan are being approved. It is to be noted that, although some groups of interest are optimistic in this regard, foreign currency markets assess the effectiveness of short-term outcomes as weak, which does not support the exchange rate of “manat”. At the same time, given the absence of any rigorous reforms oriented to the encouragement of foreign investment, the methods of attracting currency to the country in short-term period is very limited in the strategy. This, surely, weakens the forecast position for manat in 2017.

Current situation in currency markets

Overall, it is to be mentioned that, current economic situation does not envisage any positive dynamics for national currency. Among the above-mentioned factors, only the decision to freeze oil production by OPEC and non-OPEC countries is considered as a favourable factor for “manat”. However, it must also be taken into consideration that, the current and forecasted level of oil prices will not lead to significant changes in the current account balance of the country. At the same time, the foreign debt burden of state and non-state sectors in Azerbaijan rapidly increases, which complicates the appreciation of manat amidst the price surge. In other words, despite being a favourable factor, the increase in oil prices as such is not able to appreciate “manat” for medium and long term.

It is to be noted that, at present, currency markets in Azerbaijan are still assessing the decision of FED, political decisions regarding the informal markets, and the risks of floating exchange rate regime. Consider that, the expert group of the Center for Economic and Social Development (CESD) has assessed the impact capacity of the information on interest rate rise as weak even before the announcement of decision. Experts justified their approach by the preparedness of currency markets to the increase in interest rates.

At local level, participants in currency markets in Azerbaijan must track other changes carefully. The following can be shown as noteworthy information in recent days:

- Banks has halted the currency sale;
- Low level of activity is observed in informal market amidst the threats and pessimistic forecasts. Despite the high level of demand, the supply is almost negligible.
- Meantime, the volume of daily money transfers abroad for resident and non-resident physical persons has been restricted. This step is considered as an attempt to limit the capital outflow from the country.

Amidst the events taking place, it is also observed that, the Central Bank of Azerbaijan possesses low capacity of communication. The orientation by implementing the communication capabilities in foreign exchange markets is almost zero. At the same time, the mistrust of interested parties towards the Central Bank of Azerbaijan in this sphere is palpable.

Conclusion: USD/Manat pair in 2017

At present, one of the main questions concerning Azerbaijanis is the future fate of manat. In other words, observed economic stagnation is encountered at all stages of population's life in the form of the exchange rate of manat, debt burden widen (debt in foreign currency), import inflation accelerates, and nominal and real value of income shrinks day by day.

Before announcing the projections for the next year it must be mentioned that, experts of the Center of Economic and Social Development have forecasted the actual exchange rate as 1 USD = 1.93 manat towards the end of 2016. The processes at the moment allow us to say that, 2016 will be completed around the forecasted rate.

Given that, it is shifted to floating exchange rate regime, the Central Bank of Azerbaijan does not participate in foreign exchange markets, demand for manat by the Oil Fund is low, oil price is not expected to rise significantly, and rates of growth in the share of non-oil economy is low, CESD experts forecast USD/Manat rate at 2.2 – 2.5 level.

At global level, the attention of market agents will be oriented towards the political manipulations regarding the legitimacy of new USA president-elect Donald Trump and the decisions to be adopted in first 100 days of his presidency.

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