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The exchange rate outlook in Azerbaijan in 2018: Expectations and Challenges

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CESD PRESS

Baku

December, 2017

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Abstract

The exchange rate of the national currency of Azerbaijan, the manat, will remain the main focus of socio-economic policy in 2018. During the course of the year, factors that will have a positive effect on the exchange rate of the manat – *the price of oil, balance of payments, fiscal policy, monetary policy, political environment, etc.* – will be stronger. In the course of this forecast's preparation, risks of change in the current exchange rate policy were taken into account in light of important political factors which may emerge during the first 11 months of the year. As a result of the analysis, while there will not be a sharp drop in oil prices in the January - November 2018 period, there is a **high probability** that the national currency will remain steady, the probability of the manat strengthening with low interest rates will be **low-middle** and the probability of the manat cheapening is projected to be **low**. The influence of political factors on the determination of the manat's exchange rate will weaken for the next period, while the price of oil will be an important indicator and the Central Bank will play a key role.

Introduction

After 2014, as a result of global economic fluctuations, the national currency of the Republic of Azerbaijan, the manat, faced a severe devaluation: the currency lost 53.9% of its value, compared to the end of 2014. As a result, all stakeholders including business owners, citizens of the country, state-owned enterprises and international financial institutions, faced serious financial losses. Despite the fact that starting from February 2017, the official exchange rate of the manat has stabilized against the US dollar (USD), the concerns of society have not been completely eliminated. One of the factors that raises these concerns is the weak reputation of the institutions responsible for exchange rate policy in the country (namely, the Central Bank of Azerbaijan [CBAR]) and the failure of these institutions to forecast a medium- and long-term rate for the manat. At the same time, there are serious concerns about the claim that the manat's rate is determined by the real market, while there persists the feeling that the float continues to be managed. As such, although there were considerable variations observed in some fundamental factors that should have affected the exchange rate of the manat in February and November 2017 – oil prices dropped from \$55 to \$45, then rose to \$67, and the weakening of USD position in global currency markets by more than 12% – the inadequacy of the national currency's reaction to these stimuli raises more doubts.

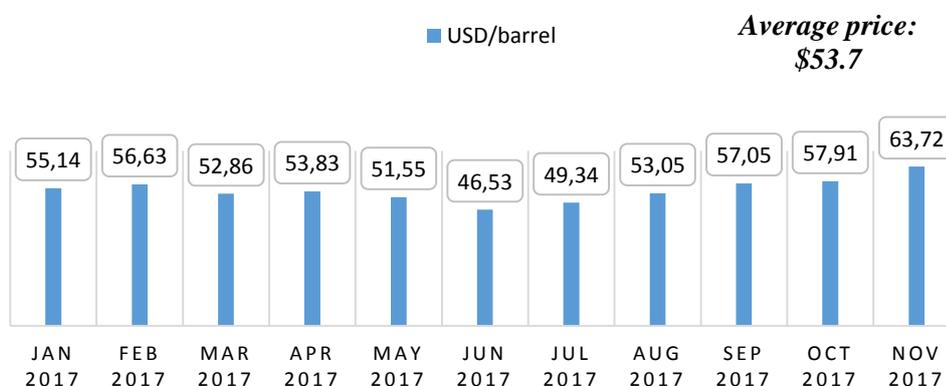
Taking into account the sensitivity of the topic, this research will explore the factors that determine the manat's exchange rate and their possible developments in the year 2018.

1. Assessment of the current situation

1.1. The current state of global markets

The current global market environment is positive when the country's fiscal revenues and the national currency are taken into account. This can be stated, firstly, when considering global oil markets. Compared with the previous year – the average annual price of “Azeri Light” oil in 2016 was \$43.7 USD per barrel – the price of oil during this year was 22.9% higher on average, which supported the macro-stability of the country. Decreases in oil prices occurred in February and June; however, overall, rising oil prices were observed due to factors such as: OPEC and non-OPEC countries’ decision to extend the duration of their production regulation by March 2018,¹ global decline in commercial oil reserves – for the first time in the last 3 years, the volume of daily oil consumption exceeded production by 0.35 million barrels / day worldwide² – and the weakening of the US dollar. At present, \$66.5 USD is offered per barrel of “Azeri Light” oil in commodity markets.³

Diagram 1: Price dynamics of “Azeri Light” oil in 2017, by month



Source: State Oil Company of the Azerbaijan Republic and Azertac, 2017

Global GDP for 2017 is projected at 3.6%, which represents a 0.4% increase from 2016 – the corresponding figure for 2015 and 2016 has been 3.2%. A major part of the growth of the world economy is due to the emerging economies of India and China, yet, countries such as the United States, the United Kingdom, Japan, and Italy have also seen significant increases in their economies, compared to last year.

It should be noted that the International Monetary Fund (IMF) predicts a 2.1% growth for the CIS countries this year, which is 1.5% more than the corresponding figure in 2016 – GDP increased by 0.4% in CIS countries in 2016.⁴ In Russia – which is considered the main foreign trade partner of Azerbaijan – GDP growth is projected at 1.8%, in Turkey by 5.1% and in Iran by 3.5%,⁵ which creates a favorable environment for the Azerbaijani economy by raising economic activity in the region and increasing aggregate demand.

¹ OPEC, “JMMC reports highest ever conformity level”, accessed: 22.12.2017

http://www.opec.org/opec_web/en/press_room/4535.htm

² U.S Energy Information Administration, accessed: 22.12.2017

https://www.eia.gov/outlooks/steo/report/global_oil.cfm

³ Azertac.az, “Oil prices drop on world markets”, 22.12.2017

https://azertag.az/en/xeber/Oil_prices_drop_on_world_markets-1123226

⁴ The Chamber of Accounts of the Republic of Azerbaijan, Opinion on draft budget for 2018, p.6 http://sai.gov.az/upload/files/REY_Layihe2018_27oktyabr_F.pdf

⁵ International Monetary Fund, accessed: 22.12.2017

http://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

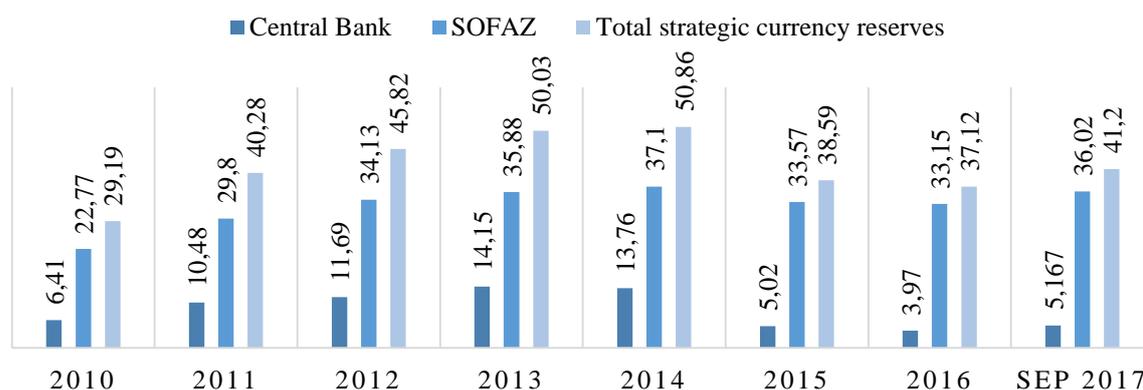
1.2. Azerbaijan's economy in 2017: the current situation

2017 can be characterized as a year of stabilization for the Azerbaijani economy. Although there was a 3.1% decline in the country's economy in 2016,⁶ the corresponding figure for 11 months of the current year is only -0.2%.⁷ According to the latest forecast of the Azerbaijani government, GDP will grow by 0.3% in the whole of 2017.⁸ The non-oil sector of the economy experienced greater growth, rising 2.4% throughout January - November.⁹

The first half of 2017 ended with surplus in the balance of payments of \$1.4 billion USD.¹⁰ The positive surplus of the balance of payments took place on the bases of relatively more expensive oil prices in global markets (21.2% higher on average compared to the previous year),¹¹ the increase in non-oil exports by 22% compared to the previous year¹² and an 18% decrease in imports in real terms.¹³ During this period, a positive balance of \$4.71 billion USD was generated in the foreign trade balance of Azerbaijan.¹⁴

Both a positive balance in the balance of payments and concurrent fiscal consolidation measures led to an increase in the country's strategic currency reserves. As a result, in September 2017, the volume of Azerbaijan's strategic currency reserves increased to \$41.2 billion USD, which is 11% more than in the beginning of the year [see: Diagram 2].

Diagram 2: Strategic currency reserves of the Republic of Azerbaijan



Source: The Central Bank of the Republic of Azerbaijan and the State Oil Fund of the Republic of Azerbaijan, 2017

⁶ The State Statistical Committee of the Republic of Azerbaijan, "Growth indices of gross domestic product, in percent", accessed: 26.12.2017 https://www.stat.gov.az/source/system_nat_accounts/en/028en.xls

⁷ The State Statistical Committee of the Republic of Azerbaijan, "Macro-economic indicators (January-November, 2017)", 14.12.2017 <https://www.stat.gov.az/news/macroecconomy.php?page=1&lang=en>

⁸ Modern.az, "2017-ci il Azərbaycanda kadr dəyişikliyilə yadda qaldı", 26.12.2017

<http://modern.az/az/news/152648#gsc.tab=0>

⁹ The State Statistical Committee of the Republic of Azerbaijan, "Macro-economic indicators (January-November, 2017)", 14.12.2017 <https://www.stat.gov.az/news/macroecconomy.php?page=1&lang=en>

¹⁰ CBAR, "Statistic Bulletin 2017", accessed: 26.12.2017

https://en.cbar.az/assets/4412/STATISTIC_BULLETIN_2017_AUGUST.pdf

¹¹ Statista, "Average annual Brent crude oil price from 1976 to 2017 (in U.S. dollars per barrel)", accessed: 26.12.2017 <https://www.statista.com/statistics/262860/uk-brent-crude-oil-price-changes-since-1976/>

¹² Economic Reform Analysis and Communication Center, Export Overview 2017 / December, accessed: 26.12.2017

http://iqtisadiislahat.org/store//media/documents/ixrac_icmali/dekabr/ExportReview_2017_9.pdf

¹³ The State Statistical Committee of the Republic of Azerbaijan, "Foreign trade relations", 19.12.2017 <https://www.stat.gov.az/news/index.php?id=3707?lang=az>

¹⁴ The State Customs Committee of the Republic of Azerbaijan, "Customs Statistics of Foreign Trade of the Republic of Azerbaijan", accessed: 26.12.2017

http://customs.gov.az/modules/pdf/pdffolder/56/FILE_8F9400-7C98F3-266905-7D703B-C8CE7E-A5FE09.pdf

As of the end of November, the Central Bank's reserves grew by 32.2%, compared to the start of the year, reaching \$5.3 billion USD.¹⁵ The assets of SOFAZ also increased, reaching \$36.02 billion in September, a 8.7% increase compared to the beginning of the year.

Starting from February 2017, the volatility of the national currency in financial markets declined and, since March, a stable exchange rate has been observed.¹⁶ It should be noted that during the period of March-December of the current year, the manat's rate did not react to foreign economic fluctuations. The dynamics of macroeconomic indicators and the surplus of the balance of payments have had a significant impact on exchange rate stability, however, the Central Bank has also played a major role by actively using financial instruments to apply a managed exchange rate regime.

Stabilization of the manat's exchange rate supported the de-dollarization process seen in the country to some degree. As a result, the share of deposits and savings in manat increased by 3.4% in November, reaching a 25.5% increase as compared to January.¹⁷

2. Macroeconomic forecast - 2018

According to the macroeconomic forecast prepared by the Ministry of Economy of the Republic of Azerbaijan, real GDP growth is expected to be 1.5% in 2018. Non-oil sector growth will be 2.9%, which will exceed the overall growth rate of the country. The real growth rate of the population's income is projected at 0.5%.¹⁸ According to government forecasts, inflation in Azerbaijan will be single-digit (6.1%) in the next year.¹⁹

It should be noted that the dynamics of the Azerbaijani economy for 2018 are projected as follows:

- The World Bank: 0.6% GDP growth²⁰,
- The International Monetary Fund: 1.3%,²¹
- Asian Development Bank: 1%.²²

In comparison with 2017, the revenues and expenses of the state budget in 2018 have been projected to be 20% and 17.3% higher, respectively. The budget deficit is expected to be 920 million manat. The volume of transfers from the State Oil Fund to the state budget is to increase by 51.1% compared to 2017, reaching

¹⁵ CBAR, "Official available currency", accessed: 26.12.2017

https://en.cbar.az/infoblocks/money_reserve_usd

¹⁶ CBAR, "AZN Rates", 26.12.2017

<https://en.cbar.az/other/azn-rates?act=betweenForm&from%5Bday%5D=1&from%5Bmonth%5D=1&from%5Byear%5D=2017&to%5Bday%5D=26&to%5Bmonth%5D=12&to%5Byear%5D=2017&rateID=usd>

¹⁷ CBAR, Statistic Bulletin 2017/October, accessed: 26.12.2017

https://en.cbar.az/assets/4456/STATISTIK_BULLETIN_2017_OCTOBER.pdf

¹⁸ The Ministry of Finance of the Republic of Azerbaijan, "Presentation of projects on state and consolidated budget of the Republic of Azerbaijan for 2018", 26.12.2017, p.6

<http://www.maliyye.gov.az/sites/default/files/Budce-19.10.2017.pdf>

¹⁹ The Chamber of Accounts of the Republic of Azerbaijan, Opinion on draft budget for 2018, 26.12.2017, p.18

http://sai.gov.az/upload/files/REY_Layih2018_27oktyabr_F.pdf

²⁰ World Bank, "Global Economic Prospects-June 2017", accessed: 26.12.2017

<https://openknowledge.worldbank.org/bitstream/handle/10986/26800/9781464810244.pdf>

²¹ International Monetary Fund, "World Economic Outlook, October 2017 Seeking Sustainable Growth: Short-Term Recovery, Long-Term Challenges – October/2017", accessed: 26.12.2017

<http://www.imf.org/~media/Files/Publications/WEO/2017/October/pdf/main-chapter/text.ashx?la=en>

²² Asian Development Bank, "Azerbaijan: Economy", accessed: 26.12.2017

<https://www.adb.org/countries/azerbaijan/economy>

9.216 billion manat.²³ In general, the share of oil revenues in the state budget is projected to increase 39.7% compared to the current year, or by 3.2 billion manat. In the state and consolidated budgets for 2018, the price of one barrel of oil is predicted at \$45, which can be considered a cautious approach in view of current market forecasts.²⁴

3. National currency exchange rate – 2018

It is projected that the manat's exchange rate in 2018 will be shaped by the effects of temporary and fundamental factors based on the following global and domestic economic developments:

3.1. Fundamental factors

- I. The price of oil** - analysis of global energy markets suggests that the price of oil in 2018 will be higher than the level expected by the Azerbaijani government in next year's state budget (\$45 USD/barrel). Global oil prices in 2018 will be formed in light of the consequences of important conditions: OPEC and non-OPEC countries' agreement on production regulations, a significant reduction in global commercial oil reserves and increasing demand due to expanded economic activity, all of which will contribute to minimizing the gap between demand and supply. These developments are already reflected in the reports of several global financial institutions. OPEC estimates that by 2021, average oil prices will increase by \$5 / bbl per year.²⁵ The Economic Forecast Agency predicts that the maximum price of oil will be \$87 / bbl in June and \$75 / bbl by the end of 2018.²⁶ The forecast of the World Bank is \$60 / bbl,²⁷ while the corresponding figure for the International Monetary Fund is \$50.2 / bbl.²⁸ It should also be noted that in December, the US Energy Information Administration raised the forecast of Brent oil prices for 2018 to \$57 / bbl.²⁹

It is clear that the oil price forecast for 2018 is positive. This trend promises financial stability by reducing the likelihood of the Azerbaijani economy facing serious upheavals.

- II. Balance of Payments** - considering the fact that export of oil and oil products has a considerable share in Azerbaijan's exports– the share of hydrocarbon products in exports was 90% in the January

²³ Azertac, The Law of the Republic of Azerbaijan "On the State Budget of the Republic of Azerbaijan for 2018", accessed: 26.12.2017

https://azertag.az/store/files/news/Qanun_budce_2018.pdf

²⁴The Ministry of Finance of the Republic of Azerbaijan, "Presentation of projects on state and consolidated budget of the Republic of Azerbaijan for 2018", accessed: 26.12.2017, p.10

<http://www.maliyye.gov.az/sites/default/files/Budce-19.10.2017.pdf>

²⁵ OPEC, World Oil Outlook 2016, accessed: 26.12.2017, p.60

http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO%202016.pdf

²⁶ The Economy Forecast Agency, accessed: 26.12.2017

<https://longforecast.com/oil-price-today-forecast-2017-2018-2019-2020-2021-brent-wti>

²⁷ World Bank, "World Bank Commodities Price Forecast", accessed: 26.12.2017, p.1

<http://pubdocs.worldbank.org/en/662641493046964412/CMO-April-2017-Forecasts.pdf>

²⁸ IMF, "World Economic Outlook, October 2017", accessed: 26.12.2017, p.256

<https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0ahUKEwjx8pmn-qfYAhXmPZoKHXdwBfwQFggyMAE&url=http%3A%2F%2Fwww.imf.org%2Fen%2FPublications%2FWEO%2FIssues%2F2017%2F09%2F19%2F~%2Fmedia%2FFiles%2FPublications%2FWEO%2F2017%2FOctober%2Fpdf%2Fmain-chapter%2Fc1.ashx&usq=AOvVaw0bBFmV1vq2YLPdD9uFngwP>

²⁹ U.S Energy Information Agency, "Short-Term Energy Outlook", 26.12.2016

https://www.eia.gov/outlooks/steo/report/global_oil.cfm

- October 2017 period – the rise of oil prices in the next year will increase oil revenues, which will compensate for the overall 8% reduction in foreign trade exports. It should be mentioned that as the Azerbaijani government estimates the price of oil at \$45 / bbl in the state budget, a decline in exports is forecasted due to the decrease in production of oil (on account of the lower price). As such, the average price of oil per barrel in 2018 is estimated to be more than \$60 USD by various international sources, which, in turn, will result in an additional unaccounted \$2 - \$2.5 billion USD in oil revenues for the country (calculating with an average daily volume of oil exports at 420,000 barrels). At the same time, the level of inflation in Azerbaijan is projected to be high in 2018 – the Asian Development Bank puts estimates at 10%³⁰ and the International Monetary Fund at 8%³¹ – which, in turn, gives grounds to predict that the present decline in imports will continue due to the further weakening purchasing power of the population. However, the government's forecasts a 0.5% increase in imports.³² This increase may be due to the significant risk that public funds will be used on imports. This observation is due to the fact the Decree of the President of the Republic of Azerbaijan "On Additional Measures to Increase the Efficiency of Procurement in the Activity of Executive Authorities and State Budget-Financed Organizations", which defines restrictions on imports with budgetary funds, will become invalid at the beginning of January 2018.³³ The termination of the decree can increase the purchase of goods and services from outside the budget, which can adversely affect the volume of trade balance by increasing the volume of imports.

However, we believe that the government will continue to control financial flows in 2018, which will reduce pressure on the national currency by supporting the surplus in the balance of payments.

III. Strategic currency reserves - The strategic currency reserves of the Republic of Azerbaijan are formed by two sources: 1) Reserves of the Central Bank of the Republic of Azerbaijan and 2) Assets of the State Oil Fund of the Republic of Azerbaijan. In 2017, growth in both sources has been observed. Compared with the beginning of the year, reserves of the Central Bank increased by 32.3% by the beginning of December³⁴ and reserves of the State Oil Fund increased by 8.7% by early October.

There exist psychological pressures on financial markets and the exchange rate, leading to short-term fluctuations in demand for foreign currencies. Strategic currency reserves strengthen the state's maneuverability by increasing its ability to overcome such fluctuations in demand.

³⁰ Asian Development Bank, "Economic forecasts for South Asian countries", accessed: 26.12.2017 <https://www.adb.org/countries/azerbaijan/economy#tabs-0-1>

³¹ IMF, "World Economic Outlook, October 2017", accessed: 26.12.2017, p.66 <https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0ahUKEwjx8pnm- qfYAhXmPZoKHXdwBfwQFggyMAE&url=http%3A%2F%2Fwww.imf.org%2Fen%2FPublications%2FWEO%2FIssues%2F2017%2F09%2F19%2F~%2Fmedia%2FFiles%2FPublications%2FWEO%2F2017%2FOctober%2Fpdf%2Fmain-chapter%2Fc1.ashx&usg=AOvVaw0bBFmV1vq2YLPdD9uFngwP>

³²The Chamber of Accounts of the Republic of Azerbaijan, Opinion on draft budget for 2018, 26.12.2017, p.19 http://sai.gov.az/upload/files/REY_Layih2018_27oktyabr_F.pdf

³³ President.az, "Decree of the President of the Republic of Azerbaijan on Additional Measures to Increase the Efficiency of Procurement in the Activity of the Executive Authorities and the Organizations Funded by the State Budget", 15.09.2016 <http://www.president.az/articles/21083>

³⁴ CBAR, Official available currency, 30.11.2017 https://en.cbar.az/infoblocks/money_reserve_usd

IV. External factors - forecast for USD is negative in 2018. The Economy Forecast Agency predicts the convergence level for the next EUR / USD pair at 1.338 USD at the end of 2018,³⁵ which represents a 12.4% weakening of USD compared to the current year. Scotiabank made a forecast of 1 EUR to 1.2 USD for the III and IV quarters of 2018, which represents a 1.7% decline in the dollar against the euro. Moreover, the organization estimates that in 2018 the value of the US dollar will decrease 1.7% against the Japanese yen and 2.2% against the British pound.³⁶ By revising its forecast for the US dollar in December 2017, Danske Bank concluded a total 5.7% decline in US dollar against the euro in 2018.³⁷

Table 1. EUR/USD prognosis of international institutions for 2018

| | I Q /2018 | II Q /2018 | III Q /2018 | IV Q /2018 |
|------------------------------|-----------|------------|-------------|------------|
| Barclays | 1.17 | 1.19 | 1.22 | 1.24 |
| Morgan Stanley | 1.2 | 1.23 | 1.18 | 1.17 |
| Danske Bank | 1.16 | 1.2 | 1.2 | 1.25 |
| The Economic Forecast Agency | 1.2 | 1.23 | 1.32 | 1.34 |
| Scotiabank | 1.18 | 1.18 | 1.2 | 1.2 |

Morgan Stanley estimates that the US dollar will weaken against the euro, Japanese yen and British pound in the first and second quarters of 2018; however, it will recover its value in the third and fourth quarters of the year. Nevertheless, the organization's forecast weakened the US dollar's exchange rate position in 2018 compared to the previous year.³⁸ According to Barclays' forecast, the US dollar will lose its value 4.8% against the euro, 7.4% against the Japanese yen, and 10.3% against the British pound in the next year.³⁹

As can be seen above, most international financial institutions have predicted that the position of the US dollar in global financial markets will weaken for the year 2018. This is due to factors such as a weak dollar policy supported by the US government in recent months, a declining demand on the backdrop of currency market participants' hesitation about the future of the US dollar and the likelihood of a change in the rate of USD by a person who will lead the FED in next year. Taking into account that Azerbaijani currency market participants prefer US dollars over manat – in January - September 2017, 83% of transactions in domestic currency markets were conducted in US dollars⁴⁰ – this USD exchange rate weakness can reduce domestic risks by supporting operations in manat.

V. Money supply - Since the end of 2014, the Central Bank of the Republic of Azerbaijan has begun to apply a more prudent monetary policy. The channels which increase the money base have been

³⁵ The Economy Forecast Agency, "Euro to Dollar (EUR USD) Forecast 2018, 2019, 2020 And 2021", accessed: 27.12.2017

<https://longforecast.com/euro-to-dollar-eur-usd-forecast-2017-2018-2019-2020>

³⁶ Scotiabank, "FOREIGN EXCHANGE OUTLOOK", 05.12.2017, p.2

http://www.gbm.scotiabank.com/English/bns_econ/fxout.pdf

³⁷ Danske Bank, "FX Forecast Update", 18.12.2017, p. 7

[http://danskeresearch.danskebank.com/abo/fxforecastupdate/\\$file/fxforecastupdate.pdf](http://danskeresearch.danskebank.com/abo/fxforecastupdate/$file/fxforecastupdate.pdf)

³⁸ "Morgan Stanley: Updated FX Forecasts for 2017/18", 28.11.2017

<https://www.poundsterlinglive.com/exchange-rate-forecasts/8086-morgan-stanley-updated-fx-forecasts-for-2017-18>

³⁹ "Barclays: FX Forecasts for 2018", 17.11.2017

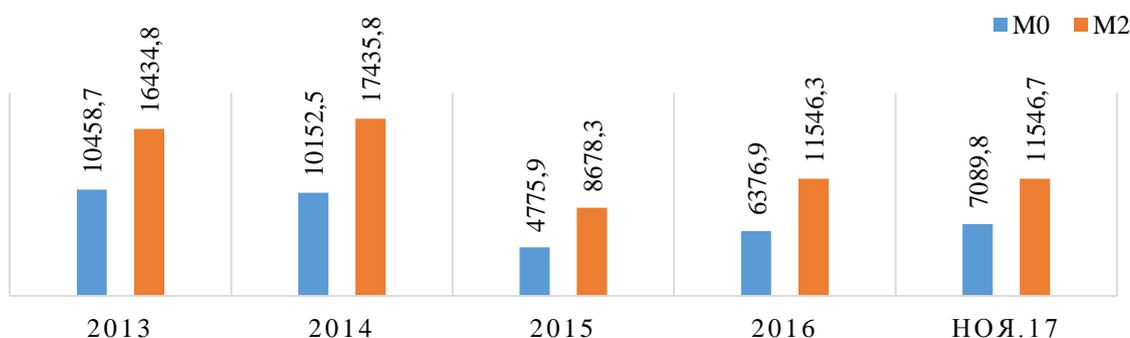
<https://www.poundsterlinglive.com/exchange-rate-forecasts/8013-barclays-releases-new-fx-forecasts-for-2018-year-ahead>

⁴⁰ CBAR, "Monetary policy review / January-September 2017", accessed: 27.12.2017, p.24

https://www.cbar.az/assets/4428/PS%C4%B0_2017_-_III_R%C3%BCb_-_final.pdf

taken under greater control.⁴¹ To this end, the policy of sterilization of surplus money supply was continued through 2017. The participation of banks in deposit auctions through the application of high interest rates [10% - 14.87%] was encouraged.⁴² It is projected that the current policy will continue in 2018 as well.

Diagram 3: The dynamics of manat supply (M2) including deposits in banks and outside bank (M0), in million manat



Source: The Central Bank of the Republic of Azerbaijan, 2017

At the end of 2014, while the manat base outside banks stood at \$13 billion, the corresponding figure fell to \$4.2 billion in November of the current year. Accordingly, the manat base including money deposits placed in banks (M2) decreased from \$22.2 billion to \$6.8 billion; however, no change occurred in the M2 aggregate in 2017. Despite the fact that an increase in cash in manat (M0) was noted, it was due to a decline in these deposits and, thus, was not reflected in the overall results.

All of these factors suggest that the current level of the manat base weakens the potential for the growth of foreign exchange demand for the long-term period, by reducing the effects of short-term and psychological pressures on foreign exchange bases.

VI. The exchange rate regime - despite the fact that in January 2017, the Central Bank announced a switch to a floating exchange rate regime and the process should have been completed by October of that year,⁴³ the public, including banking sector subjects, businesses, and industry experts, considers that the manat rate is still being managed. It should be noted that dynamics observed in the exchange rate further strengthen the aforementioned concern: in March - November 2017, changes observed in key factors that should have had a direct impact on the manat's exchange rate, have not affected the volatility of manat. This observation leads to the conclusion that the manat's exchange rate is not based on demand and supply, but rather is governed by responsible state institutions, including the Central Bank.

Thus, we believe that the volatility of currency markets in 2018 will be low and the effects of external factors will not be reflected in the manat's exchange rate.

⁴¹ CBAR, "Monetary policy review / January-September 2017", accessed: 27.12.2017, p.32 https://www.cbar.az/assets/4428/PS%C4%B0_2017_-_III_R%C3%BCb_-_final.pdf

⁴² CBAR, "Monetary policy review / January-September 2017", accessed: 27.12.2017, p.29 https://www.cbar.az/assets/4428/PS%C4%B0_2017_-_III_R%C3%BCb_-_final.pdf

⁴³ Report.az, "Central Bank: transition to floating exchange rate regime has already been ensured", 03.10.2017 <https://report.az/maliyye/merkezi-bank-tam-uzen-mezenne-rejimine-kecid-artiq-temin-olunub/>

3.2. Temporary factors

- I. Fiscal policy** – Expenditures of the state budget for the year 2018 have been increased by 3.1 billion manat, or 17.3%, which may increase the demand for currency to some extent. In parallel, the volume of transfers from the State Oil Fund to the state budget increased by 3.1 billion manat – accomplished through the conversion of assets to manat in order to meet budget commitments – suggesting that the Oil Fund will offer approximately \$1.8 billion USD in additional funds to foreign exchange markets in 2018, compared to the current year. The government’s foreign debt obligations have been increased due to the restructuring of the foreign debts of the International Bank of Azerbaijan (IBA) in 2017.⁴⁴ The government’s foreign debt payments from the state budget will be about \$1.3 billion – estimated based on the government’s 2.160 billion manat foreign debt obligation.⁴⁵ The increased foreign debt obligations will lead to an increased demand for foreign currencies on the part of the government. However, this increased demand on the part of the government will be neutralized by the decreased demand of the lessened activities of the IBA.

In other words, the foreign exchange demand arising from budget spending will be compensated by the Oil Fund's supply and will not be a serious source of risk.

- II. Credit Policy** – One of the factors that temporarily affect currency demand in the markets is the lending policy of banks. Loans offered in manat can raise the demand for the currency and put pressure on it. However, since 2014, alongside factors such as the weakening of the loan repayment capacity of the real sector, the increase in problem assets and the aggravation of the financial position of borrowers by increasing their debt burden due to the devaluation, a shrinking credit policy is being implemented by local banks. As a result, compared to December 2015, the credit investments of banks to the economy decreased by 44%, or by 9.6 billion manat, in November of the current year.⁴⁶ As a result, excess liquidity was observed in banks.⁴⁷ Nevertheless, banks are not interested in credit, despite the existing risks; the Central Bank's manat deposit auctions enable them to manage funds without risk. Moreover, giving loans in manat with higher interest rates is another factor that decreases demand.

Thus, the likelihood of an increase in manat lending in 2018 is low. It weakens the probability of pressure on the manat’s rate in the mentioned direction.

- III. The political conjuncture** – In October 2018, the presidential election is expected to be held in line with the Constitution of the Republic of Azerbaijan.⁴⁸ Traditionally, governments are more sensitive to socioeconomic problems in election years in order to maintain their popular support. This would necessitate avoiding further depreciation, so as to stave off such socioeconomic unrest.

⁴⁴ Report.az, “Debts restructuring plan for International Bank of Azerbaijan approved”, 13.07.2017

<https://report.az/en/finance/debts-restructuring-plan-for-international-bank-of-azerbaijan-approved/>

⁴⁵ Ministry of Finance of the Republic of Azerbaijan, "Presentation of projects on state and consolidated budget of the Republic of Azerbaijan for 2018", accessed: 27.12.2017, p.59

<http://www.maliyye.gov.az/sites/default/files/Budce-19.10.2017.pdf>

⁴⁶ CBAR, Statistic Bulletin 2017/October, accessed: 27.12.2017, p.16

https://en.cbar.az/assets/4456/STATISTIK_BULLETIN_2017_OCTOBER.pdf

⁴⁷ CBAR, "Monetary policy review / January-September 2017", accessed: 27.12.2017, p.32

https://www.cbar.az/assets/4428/PS%C4%B0_2017_-_III_R%C3%BCb_-_final.pdf

⁴⁸ The Ministry of Labor and Social Protection of Population of the Republic of Azerbaijan, "Production Schedule / 2018", accessed: 27.12.2017

<http://www.mlsp.gov.az/az/pages/4/769>

We believe that this factor will be reflected in the Government's exchange rate policy to a significant level in 2018. Thus, the likelihood of maintain the stability of the manat's rate increases. However, Azerbaijan's Finance Minister, Samir Sharifov's statement that, "there are pressures on the further strengthening of the manat's exchange rate"⁴⁹ because of political factors, does not exclude the possibility of the government's shift of the manat's policy for 2018. Thus, if the weight of political factors in the decision-making increases, the manat can be strengthened within a 3% interval for the short-term period.

Result

In 2018, the economic environment for Azerbaijan's national currency is assessed positively. Analysis of fundamental and temporary, domestic and foreign factors affecting the exchange rate of the manat in 2018 shows that factors that positively influence exchange markets during the year – oil price, balance of payments, fiscal policy, monetary policy, political environment, etc. – will be stronger. Under normal market conditions, this process should result in the appreciation of the manat's rate. However, depreciatory pressures do exist as well. As oil is expected to continue to be a key factor in the balance of payments, this necessitates a high level of dependence of domestic currency markets on foreign markets. This relationship means that domestic currency markets are highly susceptible to foreign fluctuations, a huge source of risk requiring the government to pursue a more prudent exchange rate policy. In this vein, maintaining the current manat exchange rate, without allowing significant appreciation, will be important in order to protect against external shocks.

Despite the fact that factors which strengthen the manat will be strong in 2018, the current exchange rate policy increases the possibility that an appreciation will be prevented. However, due to political factors in the next year, the likelihood of a change in this policy and the strengthening of the national currency in the range of 3% should not be ignored.

On the other hand, we believe that the administrative management of the manat's rate will continue in 2018, which is one of the major difficulties in forecasting its exchange rate.

Taking into account all of the factors mentioned, in the case of no sharp decline in oil prices in the January - November 2018 period, the probability that the national currency will remain stable will be high, the probability of manat strengthening with low interest rates will be low-medium, and the probability of the manat cheapening is projected to be low. The impact of political factors will weaken in the determination of the manat's exchange rate for the following period, whereas the price of oil will be an important indicator and the Central Bank will play a key role.

⁴⁹ Azeri Daily, "Samir Sharifov: Manat strengthens against dollar", 28.12.2018
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