

Currency market in Azerbaijan: Why the national currency is losing its value?

by Center for Economic and Social Development (CESD)

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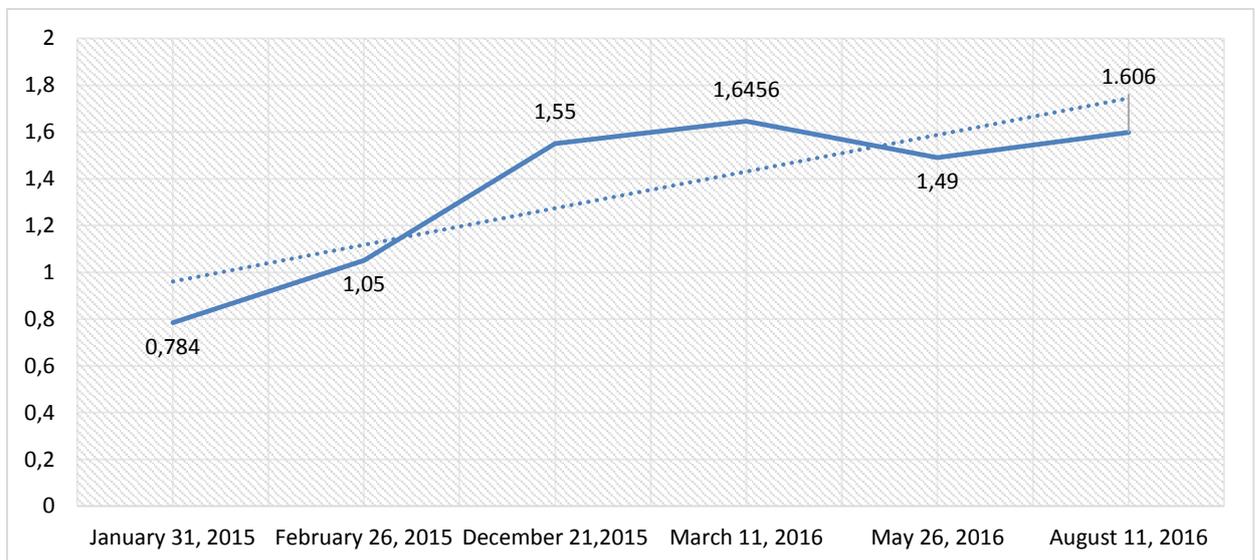
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Background

It has already been three months since the national currency of the Republic of Azerbaijan continuously loses its value.

Since the second half of 2014, due to the fall in oil prices on the world markets, the resulting pressure on the national currency – ‘Manat’ is ongoing nowadays. Overall, Manat lost 49.6% of its value in 2015 and in addition, with more 3% depreciation in the first 7 months of 2016, the losses could reach 52.6%. 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 March-May period of this year and strengthening the exchange rate of USD/AZN 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 3% in June-July, by depreciating 7% against the US dollar again.

Figure 1: USD/AZN



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

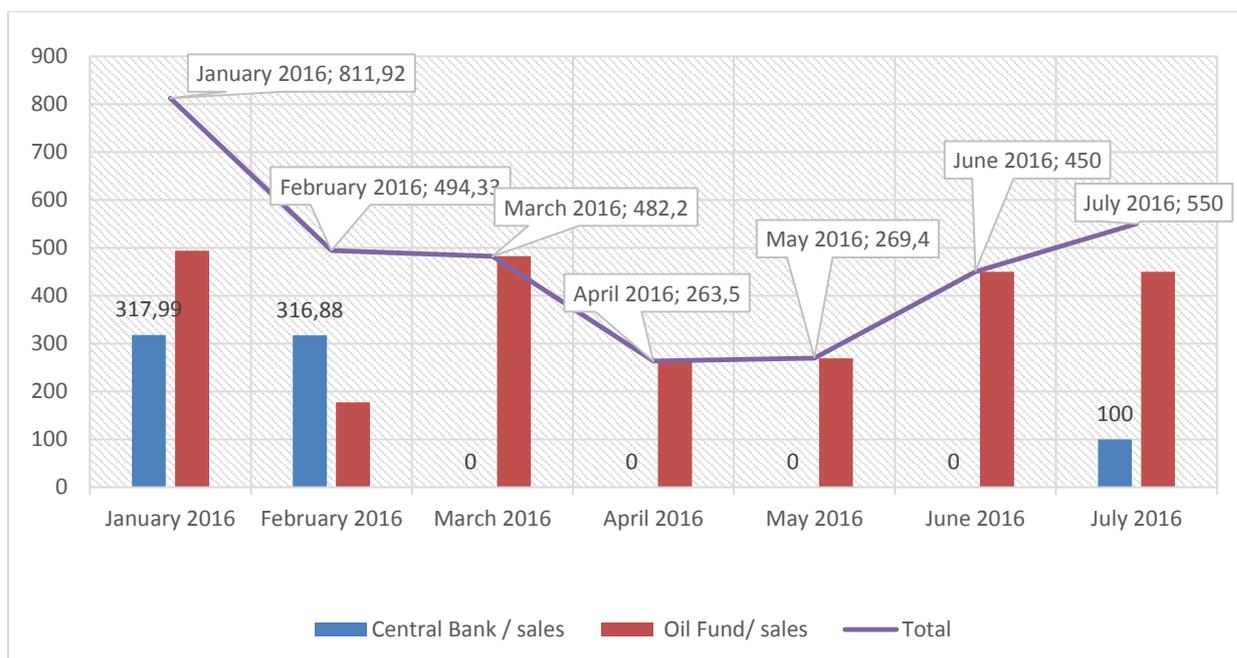
Why Does the Devaluation of Manat Sustain?

At present, citizens of Azerbaijan are more curious about this question, while the foreign exchange demand in foreign currency markets was at minimum rate just 4 months ago. In auctions organized by the Central Bank, only 0.5 million US dollars were demanded against the 200 million dollars

supplied by the State Oil Fund of the Republic of Azerbaijan, 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 \$ 635 million in currency trading, as a result, the bank's foreign exchange reserves fell to the minimum level - 4,026 billion US dollars. Thereby, the Central Bank limited the participation in foreign exchange auctions and the gap was offset by the conversion of the SOFAZ. In March 2016, the SOFAZ proposed 482.2 billion US 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 \$100 billion in July. 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 \$10 million on 31.05.2016. In general, the Central Bank succeeded to carry out the purchase of 202 million US dollars from April 26 to May 31, 2016. In the following periods, the demand at 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 - \$ 27, increased by approximately 96% during 5 months and was traded with \$ 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.¹ In addition, the chairman of the center - Vugar Bayramov pointed out to the local media that strengthening of the national currency is just unattainable for a long time due to the current economic conditions².

Since June, the main causes of the currency depreciation can be listed as follows:

1. The decrease of currency reserves to a critical level has limited the intervention options of the Central Bank. As a result, foreign currency demand is not fully met, which causes the increasing pressure on the national currency in last two months. During the March – July 2016, the Central Bank has made intervention for \$ 100 million only once.

2. A deficit was observed in Azerbaijan's foreign trade balance since March, and as a result, a trade deficit worth \$ 225.8 million³ occurred in the first half of the year. However, for the same period in the previous years, the foreign trade balance was a constant positive [see: Figure 3]. Thus, it is clear that the trade balance, which has declined by 4.6 times in 2015, is already sustained at negative value in 2016. Nonetheless, the amount of positive balance exceeded the volume of imports for the respective period during 2011-2014 years.

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



Source: State Customs Committee of the Azerbaijan Republic, 2016

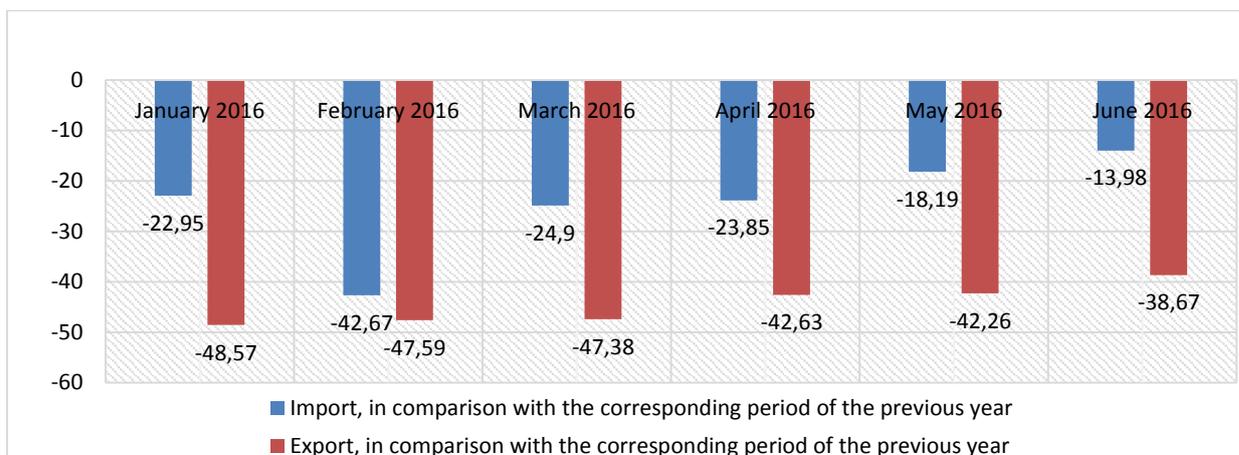
At the same time, it should be noted that, the observed sharp recession in the volume of imports at the beginning of the year has gradually decreased in the following few months [see: Figure 4]. However, the level of stagnation observed in exports remains high, which also raises the possibility of the increase of the negative balance.

¹ 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

² Azerbaijan Transparency International Project, “Manat: müvəqqəti sabitliyin səbəbləri”, 31.05.2016
<http://transparency.az/cnews/manat-muv%C9%99qq%C9%99ti-sabitliyin-s%C9%99b%C9%99bl%C9%99ri/>

³ Azerbaijan State Customs Committee, “Azərbaycan Respublikası Xarici Ticarətinin Gömrük Statistikası 01.01.2016-30.06.2016 hesabat dövrü”, Baxış tarixi: 06.08.2016
<http://customs.gov.az/files/arayis20160106.pdf>

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

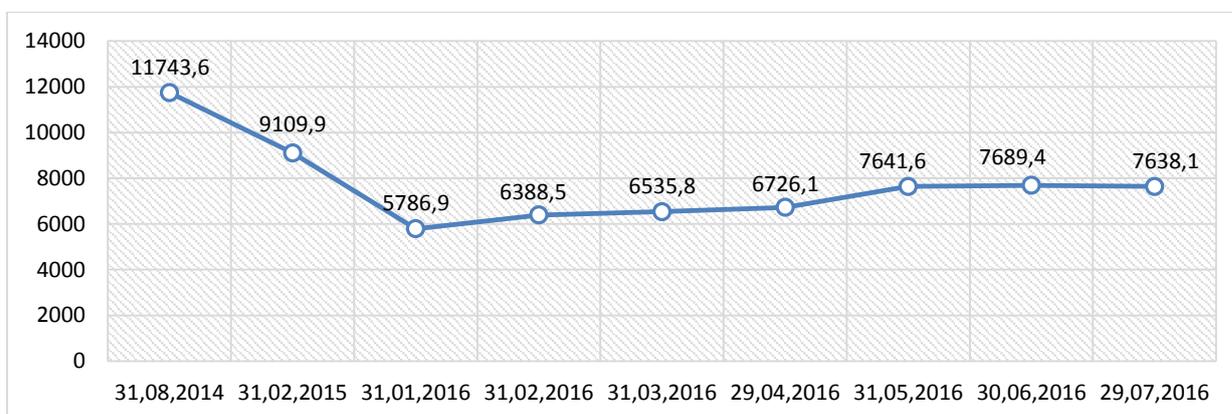


Source: State Customs Committee of the Republic of Azerbaijan, 2016

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 Manat is growing. Since the end of 2014, the government pursues the regulation of the foreign currency demand by reducing the volume of Manat in circulation in order to minimize the pressure on the national currency. Thus, in January 2016, the monetary base has constituted 5.78 billion Manats falling by 5 billion Manats 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. The total amount of Manat increased by 1.85 billion or 24% on July 29 in comparison with January, 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 Manats was spent from

the state budget⁴ in the first quarter this amount increased by 41% and reached the level of 4.3 billion Manats⁵ in the second quarter.

In other words, 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 Manats of the state budget, only 36.7% of this commitment has been implemented in the first quarter.⁶ This raised the possibility of growth in the amount of budget expenditures in the second half of the year. 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 600 million dollars. This amount exceeds the bid by 12 times.

5. The external debt growth of the Republic of Azerbaijan increases 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 \$ 7.45 billion in March 2016, increasing by 14.3% in comparison with October, 2014.⁷

⁴ 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>

⁵ 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>

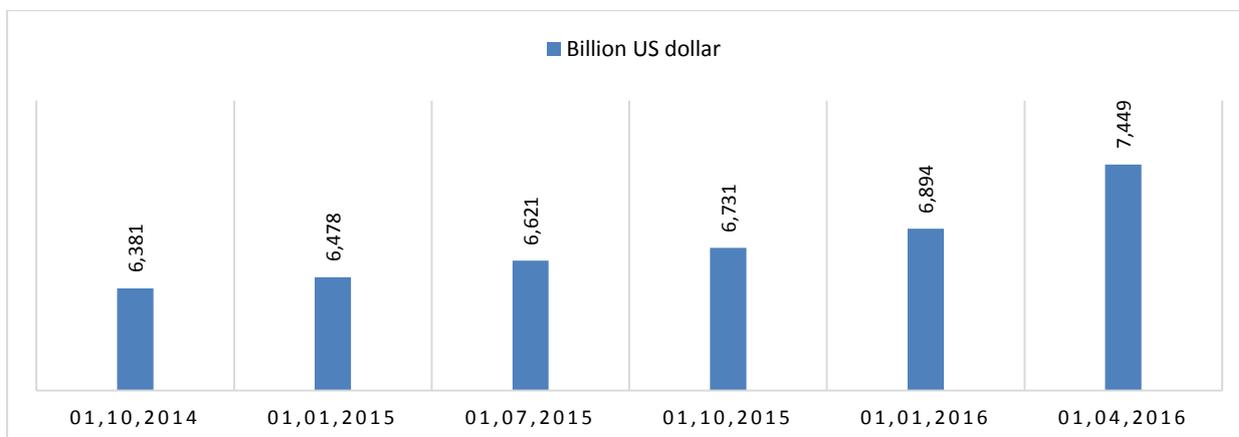
⁶ Azerbaijan Republic Ministry of Finance, “Azərbaycan Respublikasının 2016-cı il dövlət büdcəsi haqqında” Azərbaycan Respublikasının Qanununda dəyişikliklər edilməsi barədə Azərbaycan Respublikasının Qanunu, 23.02.2016

<http://www.maliyye.gov.az/sites/default/files/qanun%20budca.pdf>

⁷ 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



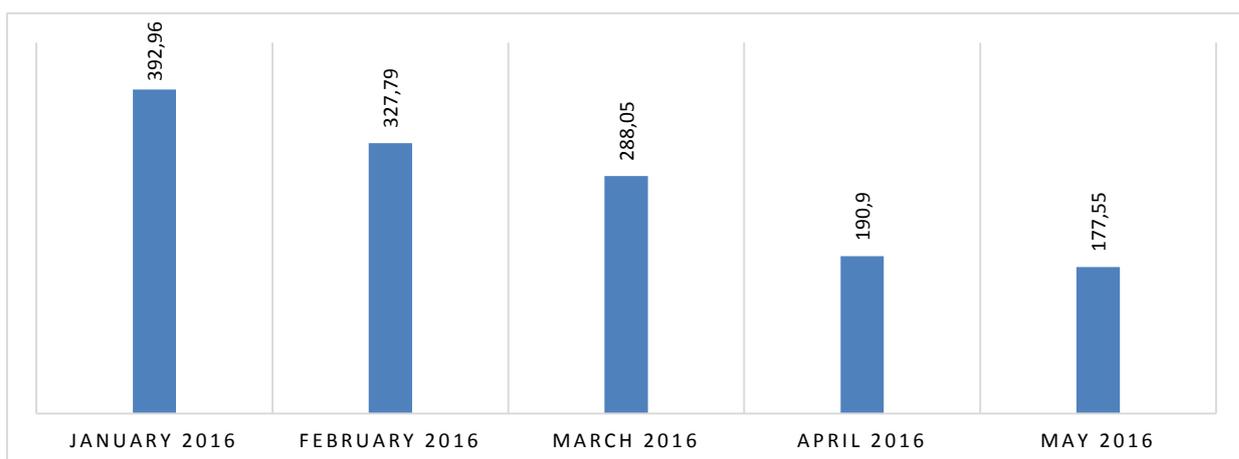
Source: Ministry of Finance of the Republic of Azerbaijan, 2016

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. An increase is observed in net foreign liabilities of commercial banks. So that, despite the corresponding index of 151.6 million Manats in the beginning of the year, the index has reached 1 billion 26 million Manats⁸ by rising 7 times at the end of May. It should be noted, that this growth would increase the currency demand which formed by commercial banks in following periods.

7. The sale of cash foreign currency decreases in foreign exchange markets [see; figure 7]. 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 7: Dynamics of US dollar in exchange transactions with cash foreign currency, in millions



Source: Central Bank of the Republic of Azerbaijan, 2016

⁸ The Central Bank of the Republic of Azerbaijan, “Analytical balance of commercial banks (end of period)”, 08.07.2016
http://www.cbar.az/assets/3573/Bulleten-2016_may_sayt_1_.pdf

As seen, the sale of cash US dollars in the currency markets has decreased to the level of 177.5 million, declining by 55% in May in comparison with January. The CESD experts forecast the continuation of downward trend in 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. So that, 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.

It should be noted, that the influence opportunities of the Central Bank in the currency market is currently limited. So that, the depletion of the currency reserves to the critical level reduced the possibility of intervention. The Central Bank raised the discount rate to 9.5, by increasing 2.5 percentage points for the purpose of adjusting the level of inflation and exchange rate in the first week of August. However, considering the small volume of centralized loans, it is possible to predict in advance that an increase in the refinancing rate will not influence appreciation of the national currency strictly.

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 AZN 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, considering the abovementioned, 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 the 2016 and 2017 years, unless there are any force majeure cases; the latter strengthens the conviction that medium-term increases will take place for USD/AZN couple.

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