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The Currency Market in Azerbaijan: Realities, Volatility and Perspectives

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Introduction

The dollar /manat (AZN) spot exchange rate specifies how much one currency, the US dollar (USD), is currently worth in terms of the other, the manat . On the first of February 2017, the exchange rate of the national currency of Azerbaijan, the manat, hit a new record low; namely, 1 USD was exchanged for 1.92 AZN. Illegal black markets and psychological factors such as a lack of publicly available information and confidence about the real financial situation were the most severe underlying causes, coupled with the ineffectiveness of the implemented monetary, fiscal and exchange rate policies. Overall, the Monetary Authority of the Central Bank of the Republic of Azerbaijan (CBAR) lost its credibility abruptly in financial markets.

However, it is noteworthy that the national currency of Azerbaijan has been gaining weight in its value recently. An 11.4% increase against the US dollar¹ has been observed; that is to say, 1 USD now equals 1.70 AZN. A strict monetary policy on the part of the Central Bank of the Republic of Azerbaijan had an impact on market demand and led to an “Expensive Manat”. A shrinking of the manat base through deposits and bond auctions paved the way for less manat in circulation, which led to a decreased demand for foreign currency. An expansive monetary policy for foreign currencies and restrictions on cash payments for businesses were the main reasons for the manat’s consequent appreciation. As a result, the national currency of Azerbaijan, the manat, advanced against USD to the level of 11.4% in February-April 2017.

1. Assessment of Azerbaijan’s Monetary Policy

The Monetary Authority of the Republic of Azerbaijan has commenced to pursue a tighter monetary policy (constricting spending and curbing inflation) as a consequence of the slump in global oil prices. Since 2016, the Monetary Authority of Azerbaijan has followed the Taylor Rule², raising the interest rate in order to prevent the depreciation of the value of manat. Consequently, the interest rate of the manat has been increased from 3% to 15% during last year. In other words, the interest rate was raised 5 times during the last financial year in order to control inflation, which is the main responsibility of the CBAR.

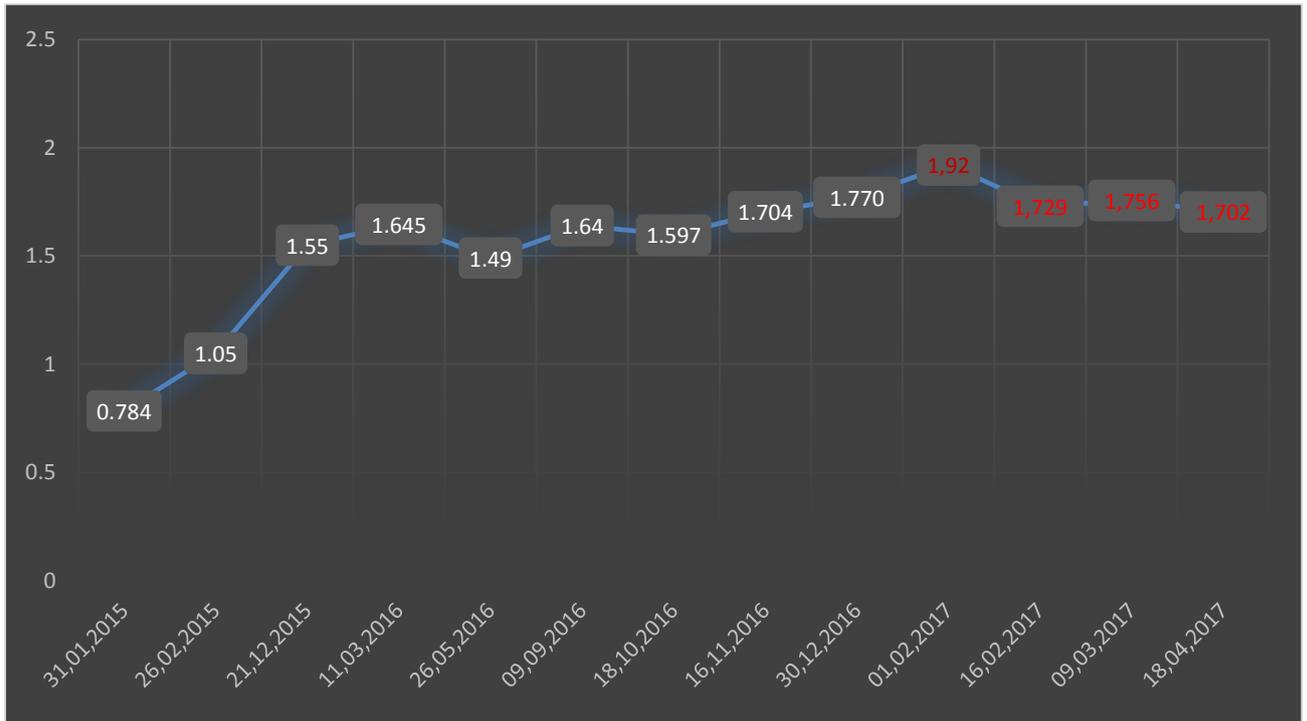
From the beginning of 2017, as a result of a rise in the price of oil in world stock markets, there has been an improvement in the value of the manat against foreign currencies. Overall, the manat gained value during the past three months by appreciating 11.4% against the US dollar in the international currency exchange market (see Figure 1).

¹ $(1.7026-1.92)/1.92*100=11.4\%$ (percentage change)

² Taylor rule: $\Delta i \geq \Delta \pi$ (change in the interest rate should be higher an equal than change in the inflation rate)

Since September 2016, the Monetary Authority and State Oil Fund of the Republic of Azerbaijan (SOFAZ) has committed to a policy of not sharing in advance the amount of US dollars which will be offered during its auctions. The main reason for this policy is to prevent markets from making any speculations, which end up artificially exaggerating rates, bringing instability and leading demand to exceed supply.

Figure 1: USD/AZN Exchange Rate



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

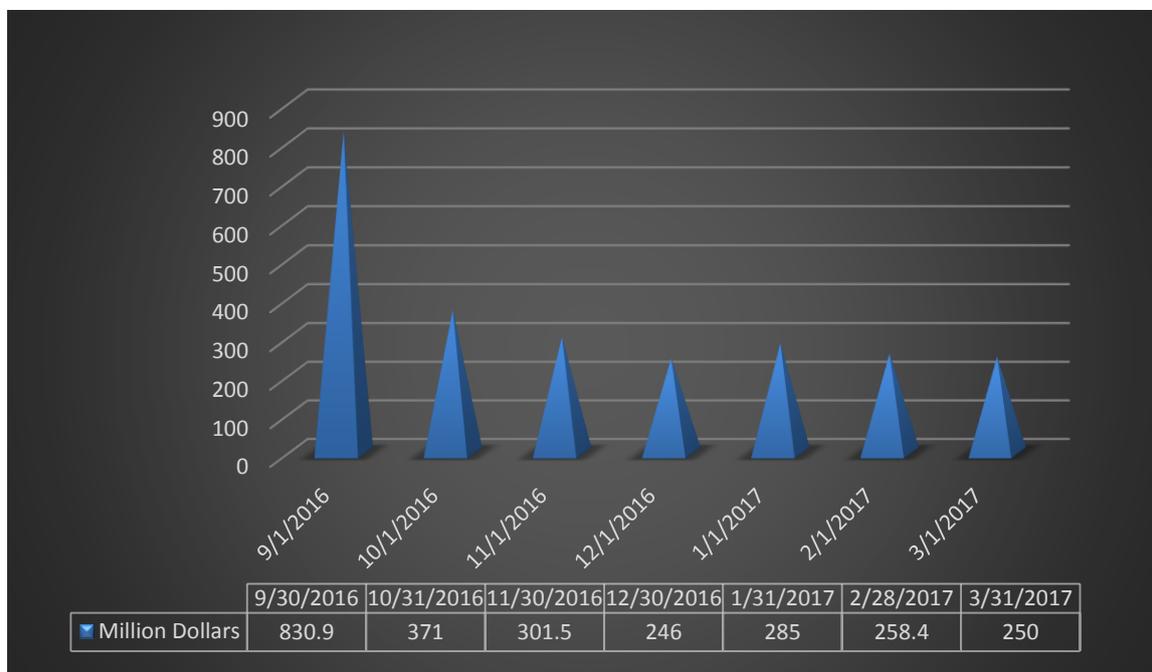
Concurrently, because of the shutting down of many exchange bureaus and resulting liquidity issues with foreign greenbacks, the foreign exchange currency market of Azerbaijan has been confronted with an illegal black currency market. The appropriate agencies of the Republic of Azerbaijan, the Central Bank, the State Security Service and the Financial Market Supervisory Authority of the Republic of Azerbaijan, have all striven to follow strict protocol to prevent unofficial currency trading and the implementation of illegal transactions³.

It should be noted that, starting from January 2017, SOFAZ has offered monthly auctions of nearly 250 million US dollars, which have met market requirements and led to the stabilization of the manat (see Figure 2). Moreover, a rise in global oil prices with barrels over 50 US dollars have

³ <http://www.azernews.az/business/106384.html>

been highlighted during this period. Both of the above mentioned reasons coincided and led to the manat's observed appreciation.

Figure 2: Dynamics of USD Sold by SOFAZ



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

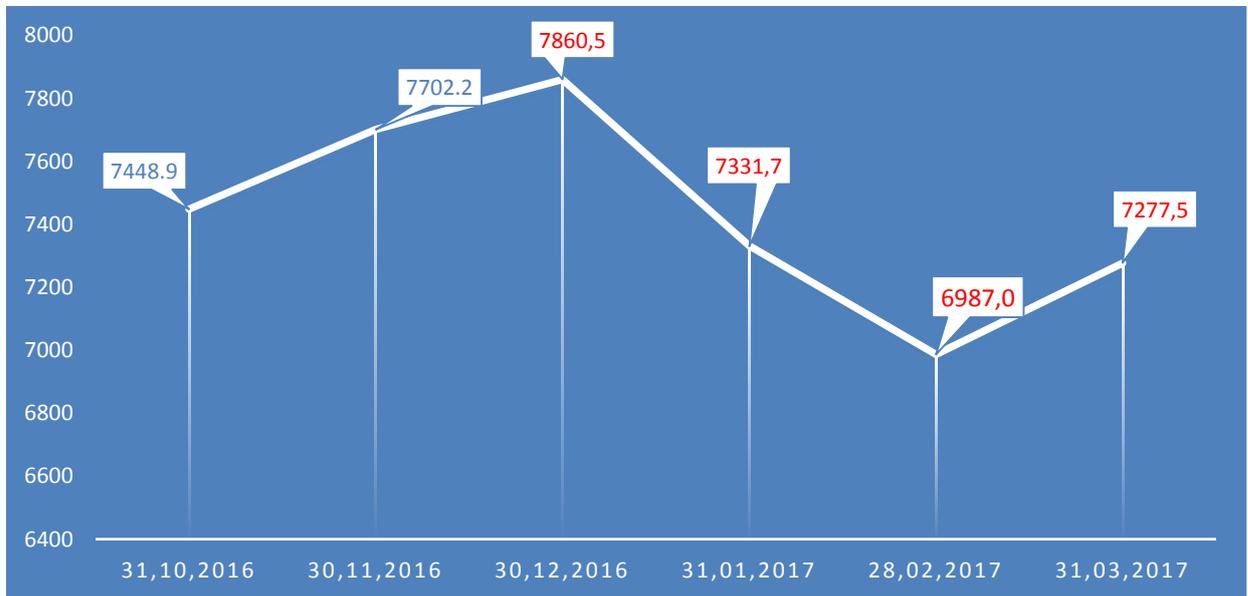
2. Underlying Reasons for the Appreciation of the National Currency

2.1. Contraction of the Manat Base and Quantitative Easing

Oil revenues are a crucial factor for the economy of Azerbaijan. As a consequence of the prolonged slump in oil prices, national oil windfalls were reduced. Due to its high level of reliance on oil rents, the Azerbaijani economy performed badly during this time. As a result, the Monetary Authority had to control macro-economic stability through the use of several tools. That is to say, the CBAR has pursued a strict monetary policy through raising the interest rate of the manat from 9.5% to 15% (on 14 September 2016) and minimizing the manat base by around 600 million manats in the first quarter of 2017 (see Figure 3).

The CBAR's key objectives in raising interest rates of the national currency were to curb inflation rates, increase the rates applied to deposits and bonds in markets (to extract manats from exchange markets and limit demand for foreign greenbacks) and to enhance confidence in the national currency.

Figure 3: Dynamics of Manat by CBAR (in Millions of Manat)



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

Additionally, deposit auctions have been held by the CBAR to attract deposits in manat and to remove more of the national currency from circulation. Thus, the Central Bank has achieved the following objectives through deposit auctions⁴:

- i) reducing the volume of manat in circulation;
- ii) increasing confidence in the manat by ensuring the profitability of the manat;
- iii) regaining control over deposits withdrawn from banks due to decreased confidence in the banking sector.

- Main macro-economic indicators are also in favor of the manat:

According to the State Statistical Committee of the Republic of Azerbaijan, first quarter data presents that gross-domestic products, including non-oil GDP and GDP per capita, have exceeded their counterparts from the same period last year (see Figure 4)⁵. Since 2016, the appropriate agencies have led deep investigations to be able to greater diversify the economy and reduce the level of reliance on oil rents. Consequently, after conducting comprehensive research on future perspectives of the non-oil sector in Azerbaijan, appropriate actions have been begun. On 6 December 2016, the President of the Republic of Azerbaijan, Mr. Ilham Aliyev signed “The

⁴ http://cesd.az/new/wp-content/uploads/2017/01/CESD_Paper_National_Currency_Azerbaijan.pdf

⁵ <http://www.stat.gov.az/macroeconomy/indexen.php>

Strategic Roadmap of the Republic of Azerbaijan on National Economy Perspectives”⁶, in order to greater diversify and foster the economy of Azerbaijan. As a result of the abovementioned legal and administrative improvements, investigations and investments, GDP growth has improved this year as compared to the same period last year.

Figure 4: Macro-economic indicators (January – March 2017)

| | January-March 2017, actual million manats | January-March 2017 compared to January-March 2016 | January-March 2016, actual million manats | January-March 2016 compared to January-March 2015 |
|---|---|---|---|---|
| Gross domestic products, million manat | 15 229,7 | 99,1% | 11 897,6 | 96,5% |
| Including: | | | | |
| Non-Oil GDP | 8 566,3 | 102,4% | 7593,4 | 94,3% |
| GDP per capita, manat | 1 570,0 | 98,0% | 1311,6 | 95,3% |

Source: The State Statistical Committee of the Republic of Azerbaijan, 2017

- An additional reason for the appreciation of the manat is the restriction on cash payments for businesses, namely a 15,000 manats reduction per month for tax payers and 30,000 manats for VAT payers.

The Parliament, Executive and appropriate agencies of the Republic of Azerbaijan have prioritized collecting more money for the state budget to obtain greater financial stability; that is to say, they have decided to clean up banks’ balance sheets. As a consequence, they signed several documents to collect more money from banks through non-cash payments.

- Last but not least, another cause of the appreciation of the manat is the high level of dollarization of the economy, such that 80% of deposits and 90% of cash savings are in US dollars.

⁶Official website of the President of the Republic of Azerbaijan-president.az, “Strategic Roadmap of the Republic of Azerbaijan on national economy perspectives”, 21.01.2017

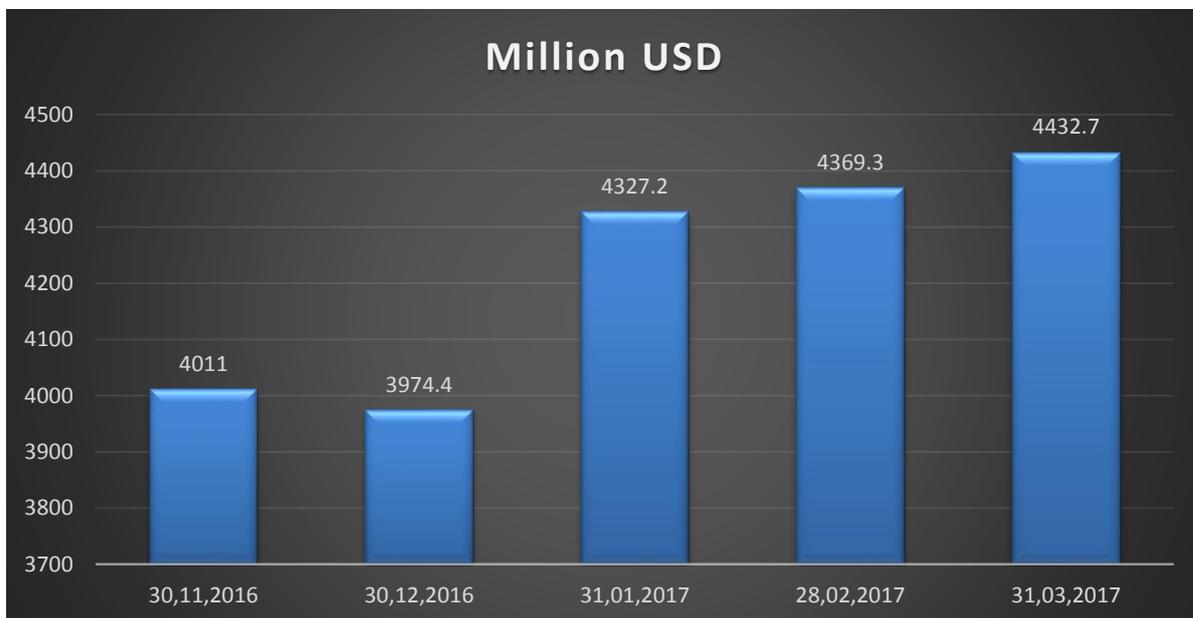
After two sharp devaluations, currency market players and the population of Azerbaijan started to accumulate a higher percentage of their savings in USD. Consequently, they accumulated a large enough amount of dollars during this period, leading to a lower demand for USD and a more stable and powerful manat in terms of foreign currencies.

2.2. Reverse Scenario for USD

The Monetary Authority of the Central Bank of the Republic of Azerbaijan used to interfere in the financial market and had a preference for a pegged currency rate. The Monetary Authority managed to follow this policy during times of higher oil prices, which equaled larger oil windfalls. Since 2014, international stock markets have been confronted with a prolonged slump in oil prices. Consequently, oil producing countries, such as Azerbaijan, faced an unexpected or unplanned reduction in oil revenues and an aggravation of monetary and fiscal policies. As a requirement of the pegged exchange rate policy, the Monetary Authority had to interfere in currency market, which diminished the foreign exchange reserves of the Central Bank. Moreover, before the plunge in oil prices started, the CBAR had over 15 billion USD in reserves, while at the end of 2016, the CBAR possessed less than 4 billion USD in reserves and lost its supplier position in auctions to commercial banks.

After the implementation of the floating exchange rate policy through “The Strategic Roadmap of the Republic of Azerbaijan on National Economy Perspectives”, the Monetary Authority followed an Expansion Quantitative Easing (henceforth QE) policy for foreign currencies in order to obtain financial stability in the local economy and meet market requirements via the support of SOFAZ. Twice a week, SOFAZ provided foreign currency to commercial banks through auctions. In addition to the aforementioned policy, SOFAZ transferred 4.2 billion dollars to the CBAR to replenish the foreign exchange reserves of the Central Bank. As a consequence of the transfers and liberal exchange rate policy, the CBAR now possesses nearly 4.5 billion USD in reserves.

Figure 4: Foreign exchange reserves of the CBAR



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

3. Is the Current Stability of the Manat Sustainable?

Historically, the exchange rate of the manat has been pegged to USD by the Central Bank. Starting with the plunge in oil prices in international commodity markets, which resulted in less oil windfalls for oil producing countries, the Monetary Authorities of oil producing countries have been faced with difficulties regarding macro-economic and financial stability. International organizations, such as the International Monetary Fund (IMF) and World Bank, have commenced to investigate the economic and financial situation on the ground and have offered several tools, namely countercyclical macro-prudential policy tools, to help countries overcome several economic issues. One of the main suggestions for Azerbaijan regarded switching to a floating currency regime, through which the rate of the manat would be determined by demand on the forex market. Additionally, the Central Bank of Azerbaijan removed its 4% profit margin on currency exchange as a way to pursue a more liberal exchange rate regime⁷.

As a result, the current situation is as follows:

- 1) In spite of the Monetary Authority's official announcement regarding the floating exchange rate of the manat and the implementation of "The Strategic Roadmap of the Republic of Azerbaijan on National Economy Perspectives", the government still has an administrative power regarding financial markets. Namely, SOFAZ is a unique supplier of foreign currency during auctions, which somehow dictate the market;
- 2) According to the "unofficial" requirements of the CBAR, the International Bank of Azerbaijan (IBAR), the biggest player among commercial banks in the financial market, is not to take part in auctions, which has led to less demand for dollars in favor of the manat. Consequently, the CBAR will be a provider of foreign currency for the IBAR within limited currency reserves. Additionally, SOFAZ has a liability to the state budget; that is to say, SOFAZ will transfer 6.1 billion manats to the state budget over the course of 2017, which is considered a threat to the assets or reserves;
- 3) The rate of volatility is high. That is to say, the switch to a floating exchange rate regime affected people's desire to join the currency, or forex, market. Consequently, the population of the country and business entities now seek to gain profit from changes in the exchange rate. This development increases the volatility of currency markets and restricts the regulatory opportunities of the Central Bank. Under current circumstances, the demand of the population and businesses for currency is continuously increasing⁸;
- 4) The existence of illegal black currency markets is a bad signal for the national currency. The closure of exchange bureaus and the adoption of a +/- 4% profit margin quickly led to the emergence of a "black market". Despite official statements by regulatory organizations, the illegal black market has a considerably strong and negative impact on the manat;

⁷ APA Information Agency, "the margin of 4% is cancelled", 11.01.2017

<http://www.apa.az/iqtisadiyyat-xeberleri/birja-xeberleri/banklar-valyuta-mubadilesi-mezennesini-telebteklif-esasinda-mueyyenlesdirecek.html>

⁸ http://cesd.az/new/wp-content/uploads/2016/09/CESD_Research_Paper_Currency_Market.pdf

- 5) Psychological factors also play a crucial role. In particular, after two devaluations, the population and business entities do not believe official statements of the Monetary Authority relating to forecasts of the manat. In other words, the Monetary Authority of the Republic of Azerbaijan has lost its credibility. As a consequence, whenever people have money, they prefer to exchange it to US dollars;
- 6) The limited access to the real and publicly available data is a threat for national currency and also puts pressures on the manat. As a result, this weakens the level of confidence in the manat and raises uncertainty regarding future economic and financial circumstances of the Republic of Azerbaijan;
- 7) Financial instability is stressed through the shutting down of banks (the number of banks decreased from 42 to 32 and the process is still continuing), a higher rate of inflation (double-digit inflation rate), a negative trade balance and an increase in foreign debt commitments of banks, all of which negatively impact the manat;

2. Conclusion

The administration of “The Strategic Roadmap of the Republic of Azerbaijan on National Economy Perspectives” and the switch to a floating exchange rate regime have positively affected the population’s and business entities’ view of the manat. The Monetary Authority has utilized several policy tools in order to reduce instability in financial markets, achieve the stabilization of the manat and re-back its credibility. Particularly, it is noteworthy that, the appropriate agencies have started to fight against illegal currency circulation together. On 25 April 2017, the Parliament of the Republic of Azerbaijan voted in favor of opening currency exchange bureaus within new regulations; namely, a 500 manat state duty for licensing and the institution of deposit fees, in addition to being under the control of the Financial Markets Supervisory Authority⁹. Overall, these developments increase access to currency and raise competence among commercial banks, which results in fewer margins in currency exchange.

On the other hand, after the implementation of the liberal exchange rate regime, the performance of the national currency had been relatively smoother than expected. There has been a period of adaptation to new conditions, and even so, the manat has not yet found its real value and there is still room for the greater depreciation of the manat. Moreover, the Federal Open Market Committee (henceforth FOMC) has announced a tighter monetary policy for upcoming years (raising the interest rate of the US dollar more than twice during the course of a year), which has

⁹ <http://en.apa.az/azerbaijan-economy/finance-news/azerbaijan-to-relaunch-currency-exchange-offices.html>

introduced increased uncertainty. The limited foreign currency reserves of the Central Bank of the Republic of Azerbaijan are also negative signals for the exchange rate of the manat and results in its higher volatility.

According to the policies chosen by the government of the Republic of Azerbaijan, there are two different scenarios which could take place and have major effects on the exchange rate of the manat:

- 1) On the one hand, the government may decide to change its current policy and switch its position from saver to investor, in order to foster the economy and boost the real sectors. As a requirement of this policy, the Monetary Authority would conduct an expansionary policy for the manat, which could increase the rate of volatility and reduce the exchange rate of the manat against foreign currencies. In an attempt to offset such a sharp deterioration of the manat in the medium- and long-term, the Monetary Authority may choose to implement countercyclical macro-prudential policies;
- 2) On the other hand, if the government chooses to pursue the same policies as it does now; that is to say, if the Monetary Authority continues to diminish the manat base and support the national currency via the same tools, the level of investment and consumption would continue go down. Consequently, there would be no progress in the economy.

Overall, it can be concluded that, in the short-run, the appreciation of the manat could continue due to the abovementioned reasons, particularly with a view to the upcoming 4th Islamic Solidarity Games (12-22 May, 2017), which would lead to an increase in the supply of USD from tourist's consumption. However, in the medium- and long-term, further depreciation is quite feasible.

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