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Azerbaijani National Currency: Is the Current Status Quo Sustainable?

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Abstract

Currently, in Azerbaijan and the Caucasus, the situation in the economies of the region is quite variable. On the other side of the ocean, the US Federal Reserve System has been continuously raising the key interest rate. In Russia, the ruble depreciated due to existing and probable sanctions, in Turkey, economic and political circumstances have led to the 40% loss of the lira's value (and this figure is expected to further increase by the end of the year), and the withdrawal of the US from the Iran Nuclear Deal with replaced sanctions has caused more aggravation to the socio-economic situation and rapid depreciation of the Iranian rial in the southern neighbor of Azerbaijan. The so-called trade wars and new processes led by the current US government form serious risks for globalization and liberal trade.

At the moment, the most thought-provoking issues for ordinary Azerbaijani citizens are the questions: with a view to the above-listed developments, what awaits the manat now and what is the level of risk for the exchange rate? Although at first glance there is an impression that Azerbaijan's currency exchange rate takes shape independent of these processes described above, on deeper exploration it is apparent that this is not the truth. For this reason, this topic has been widely and constantly discussed.

Thereby, this article's subject covers what the present conditions for the Azerbaijani manat in reality are. In order to find answers for these questions, this article will analyze internal and external factors affecting the national exchange rate, new challenges emerging from current economic changes and both negative and positive aspects of the current exchange rate policy. Lastly, recommendations are made in order to ensure the flexibility of exchange policy and increase the sustainability of the economy against foreign fluctuations.

National Currency Exchange Rate - the Evolution of the Current Situation

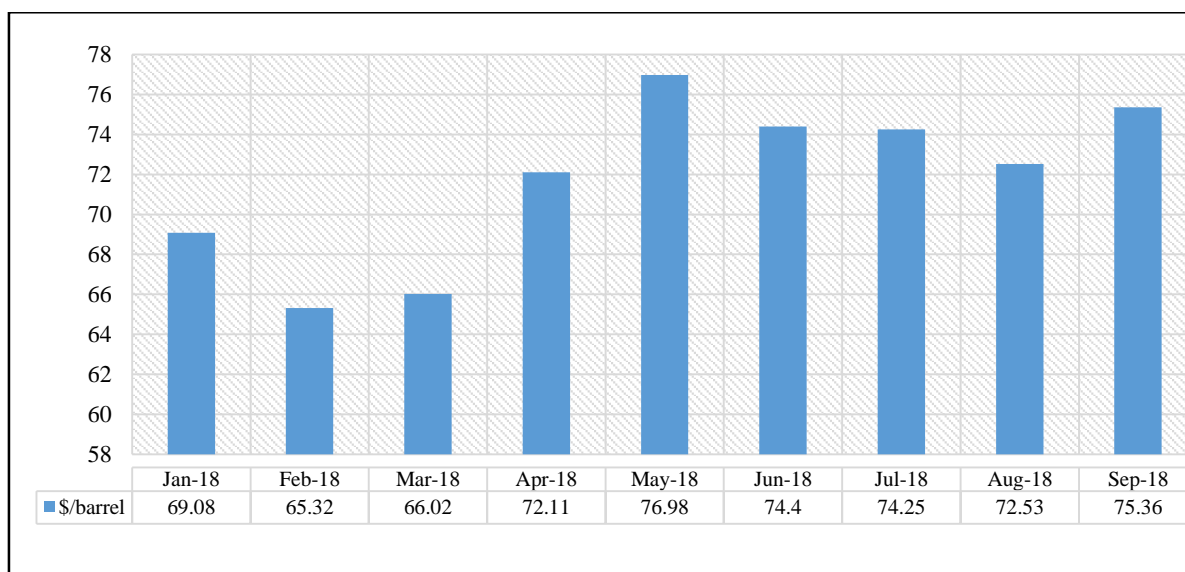
In comparison with the years 2014-2017, one wouldn't be mistaken to say that this year presented more favorable conditions for Azerbaijan's economy and economic policy. One of the factors that directly affect the economy, the price of oil in world markets, is above even the most positive predictions. The impact of this factor has been intensified in the government's current economic policy. This is clearly displayed in both fiscal (return to expansion after the last efforts at consolidation) and exchange rate policy (transition from floating exchange rate regime to fully regulated, fixed exchange rate). For the short-term period, fiscal expansion and the fixed-rate policy may be in line with interests of citizen and businesses. Azerbaijan's long pursued social-economic policy during 2005-2015 has weakened the operational ability of key economic stakeholders under variable conditions; economic growth has largely been driven by budget expenditure.

To answer the article's question, before beginning to analyze internal and external factors, we would like to point out that current circumstances encourage the government to maintain a stable exchange rate policy.

World Oil Prices

One of the indisputable facts of 2018 is that it is fitting to become the most successful years for oil markets and oil-producing countries in the last period – after 2014's sharp decline. That is, despite beginning the year at 66.87 \$/barrel, BRENT oil is sold at 85 \$/barrel¹ at the time of this paper.

Figure 1: Average monthly price of BRENT oil



Source: US Energy Information Agency², 2018

In general, the average market price for BRENT crude oil has been 71.77\$/barrel for the past 9 months of 2018, which is 30.5% higher than the government's forecast during its fiscal planning. Considering, at the beginning of the year, the price of one barrel was expected

¹ Bloomberg

<https://www.bloomberg.com/quote/CO1:COM>

² ABŞ Enerji İnformasiya Administrasiyası, baxış tarixi: 28.09.2018

<https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RB RTE&f=M>

at 45\$ in the state budget³; however, this indicator was revised in June and changed to 55\$ during budget changes⁴. Taking into account that Azerbaijan on average exports 600 thousand barrels per day⁵, revenues from crude oil exports have exceeded the expected revenue by 2.3 billion US dollars over the past eight months. This is reflected in the positive trends seen in the trade balance, balance of payments and strategic currency reserves.

It should be noted that the main factor influencing the manat's rate is the price of oil, as this product makes up about 90% of the country's export revenues. The positive predictions for oil prices promise an even more favorable environment for the Azerbaijani manat.

Foreign Trade Balance and Import Growth

According to the State Customs Committee, Azerbaijan's foreign trade turnover was 19.7 billion US dollars for January-August 2018, of which 65.2%, or 12.9 billion US dollars, was made up of exports.⁶ Please note that the value of contracted crude oil and natural gas is not taken into account when computing these numbers. In comparison with the corresponding period of the previous year, there has been a 57% increase in foreign trade, 79% increase in exports and 30% increase in imports⁷. Naturally, the oil sector played a primary role in the growth of exports. For example, crude oil exports increased by 78% nominally.

The observed growth in imports is one of the main factors for increased demand for foreign exchange. Factors such as the suspension of import restrictions by state funds at the beginning of 2018, an increase in budget expenditures, a 33.7% growth in consumption, in comparison to 2017, and the manat's exchange rate stabilization have together lead to increased imports. Additionally, Azerbaijan's import potential from major foreign trade partner countries such as Russia, Turkey and Iran was strengthened due to the loss in value of their national currencies. For example, in 2018, there has been a 19.6% increase in imports from Turkey, Russia and Iran.

³ Azərbaycan Respublikasının Maliyyə Nazirliyi, "2018-ci ilin dövlət və icmal büdcələri üzrə layihələrin təqdimatı", baxış tarixi: 28.09.2018, səh: 10

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

⁴ Azərbaycan Respublikası Hesablama Palatası, "Azərbaycan Respublikasının 2018-ci il dövlət büdcəsi haqqında" Azərbaycan Respublikası Qanununda dəyişikliklər edilməsi barədə" Azərbaycan Respublikasının Qanun layihəsinə Azərbaycan Respublikası Hesablama Palatasının Rəyi, baxış tarixi: 28.09.2018, səh: 16
<http://sai.gov.az/upload/files/2018-DURUSTLESME-REY-FINAL.pdf>

⁵ Azərbaycan Dövlət İnformasiya Agentliyi (Azertac), "Azərbaycan bu il 20 milyon tonadək neft və neft məhsulları ixrac edib", 12.09.2018

<https://azertag.az/xeber/Azerbaycan-bu-il-20-milyon-tonadek-neft-ve-neft-mehsullari-ixrac-edib-1193690>

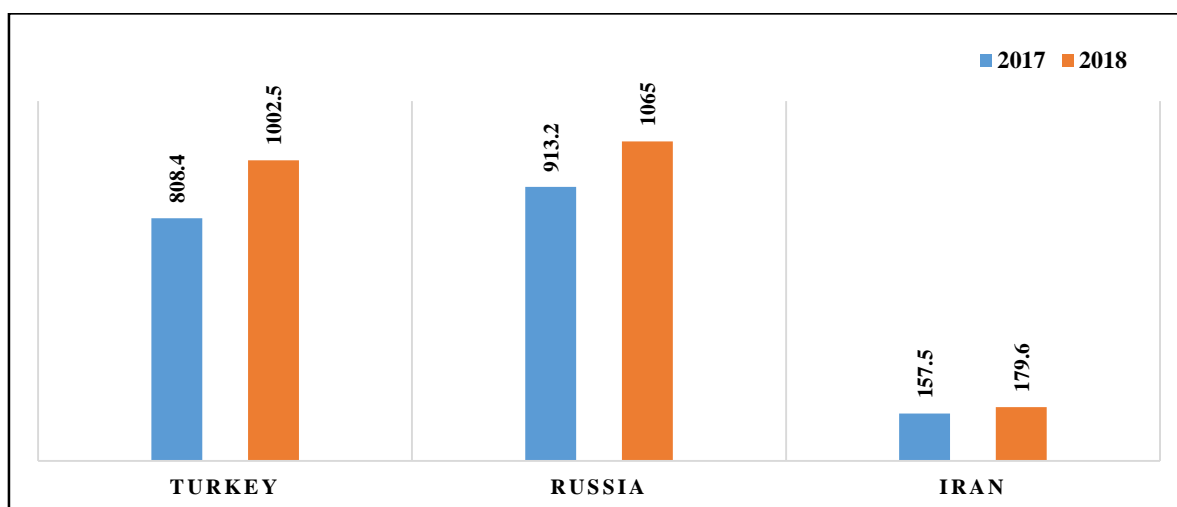
⁶ Azərbaycan Respublikasının Dövlət Gömrük Komitəsi, "Azərbaycan Respublikası Xarici Ticarətinin Gömrük Statistika, hesabat dövrü: 01.01.2018-31.08.2018", baxış tarixi: 28.09.2018, səh: 2

http://customs.gov.az/modules/pdf/pdf folder/71/FILE_E8AB16-42D726-02E2C6-806EB5-989034-C41732.pdf

⁷ Azərbaycan Respublikasının Dövlət Gömrük Komitəsi, "Azərbaycan Respublikası Xarici Ticarətinin Gömrük Statistika, hesabat dövrü: 01.01.2018-31.08.2017", baxış tarixi: 28.09.2018

http://customs.gov.az/modules/pdf/pdf folder/56/FILE_35F2F6-CFE233-FA3240-E69F49-9CB570-E2E119.pdf

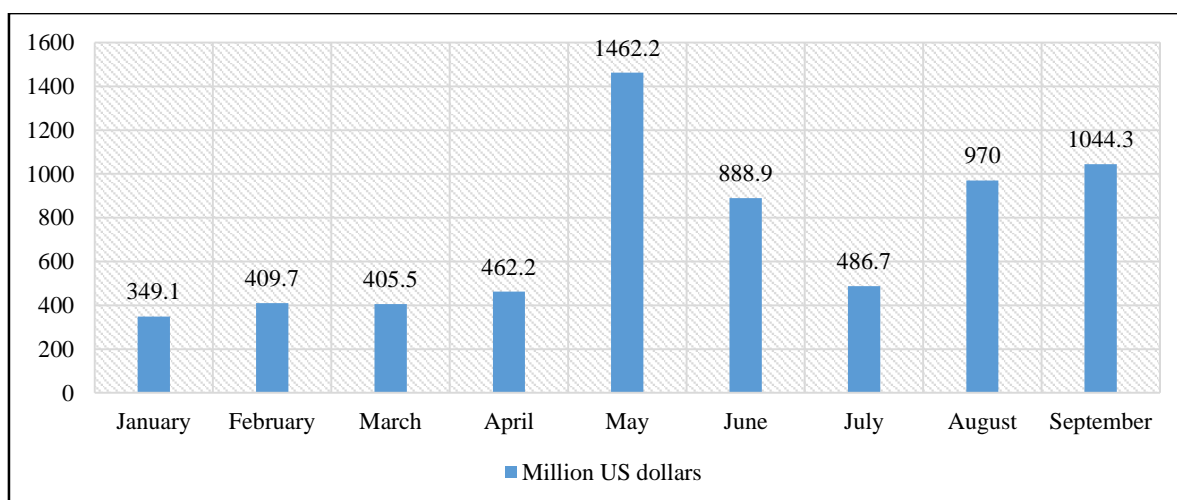
Figure 2: Trends of imports from leading countries of the region, comparison of January – August period, million US dollars



Source: Azerbaijan Republic State Customs Committee, 2018

As seen in Figure 2, there was an evident increase in imports from all three countries, where the value of the partners' local currency declined sharply. Despite this, the trade surplus for the relevant period is shown below.

Figure 3: Dynamics of foreign trade balance by month, 2018



Source: Azerbaijan Republic State Customs Committee, 2018

In general, the foreign trade balance has been 6 billion US dollars for the past 8 months, which is 3.1 times larger than the corresponding period in the previous year. Growth in the trade balance has affected the balance of payments positively as well.

Surplus of Balance of Payments

According to the Central Bank, the surplus of the balance of payments was 2.4 billion US dollars for January-June, which represents a 70% increase from last year⁸ - the surplus

⁸ARMB, 2018-ci ilin yanvar-iyun ayları üçün Azərbaycan Respublikasının tədiyə balansı, baxış tarixi: 28.09.2018

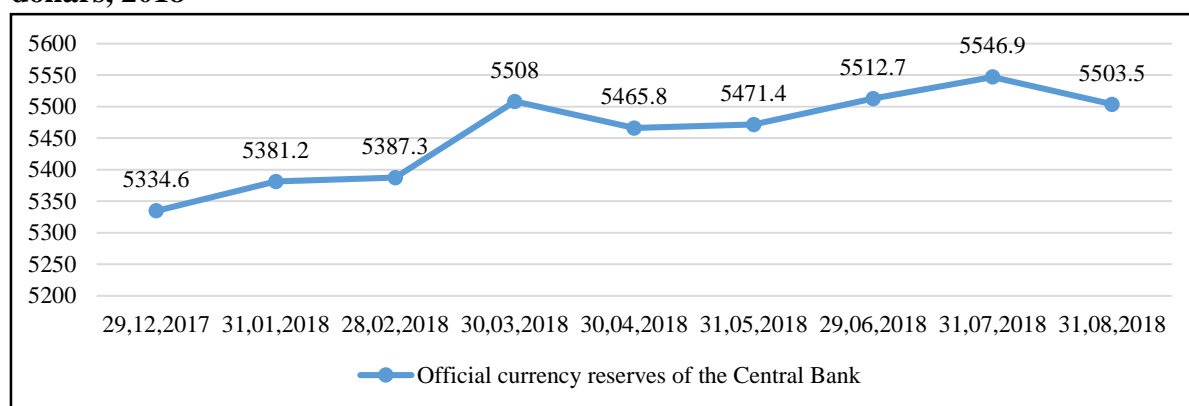
<https://www.cbar.az/assets/4729/1TB6M18s.xls>

balance of payment for last year's relevant period was 1.4 billion US dollars⁹. Even though the main element supporting the surplus in the balance of payments in 2018 is the positive foreign trade balance, the service balance deficit was also reduced by 53%. These developments together have made the environment more suitable for the national currency. The Central Bank believes that the balance of payments will be able to maintain its surplus until end of the year¹⁰. Over the course of the year, the factors listed above have contributed to the increase of Azerbaijan's strategic currency reserves and strengthened the financial stability of the country.

Strategic Currency Reserves

Despite minor declines, the Central Bank's official currency reserves have increased by 3.1% and reached 5.5 billion US dollars by the end of August, comparing to the beginning of the year [see: figure 3]¹¹. We would like to point out that, after the 2014 crisis, the Bank's reserves had dropped to a minimum level (3.98 billion US dollars) in December 2016.

Figure 4: The dynamics of the Central Bank's official currency reserves, billion US dollars, 2018



Source: Central Bank of Azerbaijan Republic, 2018

Growth was also observed in the assets of the State Oil Fund of the Republic of Azerbaijan (SOFAZ). According to Fund's publicized information, the assets of the organization reached 38 billion US dollars in the first half of 2018¹², which is 2.2 billion US dollars, or 6.1%, more than at the beginning of the year. We would like to point out that at the end of 2017, SOFAZ's assets were 35.8 billion US dollars¹³. Currently, the country's strategic currency reserves total about 44 billion US dollars, which is approximately equivalent to Azerbaijan's imports for 57 months.

⁹ ARMB, 2017-ci ilin yanvar-iyun ayları üçün Azərbaycan Respublikasının tədiyə balansı, baxış tarixi: 28.09.2018

<https://www.cbar.az/assets/4404/1TB6M17s.xls>

¹⁰ ARMB, Faiz dəhlizinin parametrləri haqqında", 01.08.2018

<https://www.cbar.az/releases/2018/08/01/on-interest-rate-corridor-parameters-gh/>

¹¹ ARMB, Rəsmi valyuta ehtiyatları, baxış tarixi: 28.09.2018

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

¹² ARDNF, SON RƏQƏMLƏR: 2018-ci ilin 1 iyul tarixinə olan məlumat, baxış tarixi: 28.09.2018

http://www.oilfund.az/az_AZ/hesabatlar-ve-statistika/son-reqemler.asp

¹³ ARDNF, Azərbaycan Respublikası Dövlət Neft Fondunun 2017-ci il üzrə gəlir və xərclərinə dair məlumat, 08.02.2018

http://www.oilfund.az/az_AZ/news/1365/100/Azerbaycan-Respublikasi-Doevlet-Neft-Fondunun-2017-ci-il-uezre-gelir-ve-xerclerine-dair-melumat.asp

Along with these, factors such as an increase in exports by the non-oil sector, low interest rates offered on deposits placed in foreign currencies, restriction of saving opportunities due to depreciation of revenues, and the application of strict controls on currency flows from the country have formed optimal circumstances for the manat. However, despite all this, there are negative factors impacting the manat's exchange rate. These include factors such as depreciation in the country's major foreign trade partner's currencies, fiscal expansions and import growth.

Dynamics in the Currency Markets of Neighbouring Countries

We would not be mistaken if we call 2018 a "year of sanctions" for the countries of the region. In May of the current year, the US administration rejected the "nuclear deal" signed with Iran in 2015, which led to a wave of new sanctions on Azerbaijan's neighbor. It should be noted that there is less than a month until the US-determined deadline for companies to stop their cooperation with Iran in the fields of oil, information technologies, modern technologies, etc.

Naturally, global economic cooperation with Iran is at serious risk due to recent events, which has had a "nuclear effect" in its domestic currency markets. Throughout the year, the Iranian rial has lost about 75% of its value or, in other words, depreciated 4 times. While the official exchange rate of US dollar/rial stands at 42,000¹⁴, in the real market it is about 170,000¹⁵. It should be noted that the foreign trade turnover between Iran and Azerbaijan in 2017 was 257 million US dollars, of which 93% belongs to imports from Iran¹⁶. It is expected that imports from this country will further increase in 2018 as a result of rapid depreciation of rial.

The other country of the region that is subject to sanctions is the Russian Federation. The US government's repeated sanctions on Russia over the course of the year have weakened the idea that "Trump is a friend of Russia" and, as a result, risks to the country's investment environment have increased. As a result, the Russian ruble lost 12% of its value during the year¹⁷. At present, Russia can be considered to be in a more advantageous position than Iran. The rise in oil prices weakens the psychological pressure on foreign exchange markets in Russia, which reduces exchange rate losses. However, the sanctions imposed on oil exports of Iran have put the country's main source of foreign currency under risk, which contributes to its disadvantaged position.

¹⁴ Central Bank of the Islamic Republic of Iran, 01.10.2018

https://www.cbi.ir/ExRates/rates_en.aspx

¹⁵ Haber Türk, "İran riyali tarihin en düşük seviyesinde", 26.09.2018

<https://www.haberturk.com/iran-riyali-tarihin-en-dusuk-seviyesinde-2157397-ekonomi>

¹⁶ Azərbaycan Respublikası Dövlət Statistika Komitəsi, "Azərbaycanın xarici ticarət əlaqələri (yanvar – dekabr, 2017), baxış tarixi: 01.10.2018, səh: 894

https://www.stat.gov.az/source/trade/az/bulleten/2017/f_trade_IV_2017.zip

¹⁷ The Central Bank of the Russian Federation, "Dynamics of the official exchange rates", baxış tarixi: 01.10.2018

https://www.cbr.ru/eng/currency_base/dynamics/?UniDbQuery.Posted=True&UniDbQuery.mode=1&UniDbQuery.date_req1=&UniDbQuery.date_req2=&UniDbQuery.VAL_NM_RQ=R01235&UniDbQuery.FromDate=30%2F12%2F2017&UniDbQuery.ToDate=29%2F09%2F2018

Apart from being the third largest foreign trade partner of Azerbaijan, Russia ranks as #1 in import and #4 in export partners of Azerbaijan¹⁸. The foreign trade turnover between Azerbaijan and Russia in 2017 amounted to 2.14 billion US dollars. Azerbaijan imported goods and services worth of 1.55 billion US dollars from Russia. The volume of exports was 0.59 billion US dollars¹⁹, of which 0.55 billion US dollars, or 93.2%, fell to non-oil products. Let us note that this is 36% of Azerbaijan's total non-oil exports²⁰. In other words, Russia is currently the number one partner of Azerbaijan in the non-oil sector. Thus, when the Russian ruble loses value against the Azerbaijani manat, several risks appear. First, the depreciation of the ruble increases the attractiveness of imports from this country, resulting in acceleration of foreign currency outflows from Azerbaijan. Secondly, it creates a need to offer Azerbaijani products in the Russian markets at a higher price, which weakens their competitiveness. As a third reason, the decline in immigrant wages in terms of foreign currencies leads to a decrease of remittances to the country. Moreover, the potential flow of tourists from Russia weakens. In other words, what is happening now in the neighboring country has widespread negative effects on Azerbaijan.

The third country in the region to face the risk of serious foreign exchange rate fluctuations is Turkey. Since February, the Turkish lira has started to lose its value due to various effects of its economic environment. The belief that the elections in July will result in radical changes in management formed a cloud of political pressure on the lira. During a short period - about two weeks - the Turkish lira lost 33% of its value. In general, the national currency of this country has fallen by more than 37% during the past months of the current year²¹. Turkey is the 2nd largest foreign trade partner of Azerbaijan, both in exports and imports. The total trade turnover with this country was 2.7 billion US dollars in 2017²². In addition, Turkey is considered to be the second largest market for non-oil products of Azerbaijan²³. Thus, against the backdrop of the Turkish lira depreciation, there is now a risk of increase in imports and decrease in exports.

The above-mentioned countries are also considered as the main tourism partners of Azerbaijan. 51% of tourists arriving in Azerbaijan over January-August 2018 and 65% of Azerbaijani tourists going abroad belongs to these countries²⁴. The decline in national

¹⁸ Dövlət Gömrük Komitəsi, "Azərbaycan Respublikası Xarici Ticarətinin Gömrük Statistika", baxış tarixi: 01.10.2018, səh: 21 http://customs.gov.az/modules/pdf/pdfolder/56/FILE_AA28EF-712081-B355C1-37724A-E40246-2FAAF8.pdf

¹⁹ Azərbaycan Respublikası Dövlət Statistika Komitəsi, "Azərbaycanın xarici ticarət əlaqələri (yanvar – dekabr, 2017)", baxış tarixi: 01.10.2018, səh: 280 https://www.stat.gov.az/source/trade/az/bulleten/2017/f_trade_IV_2017.zip

²⁰ İqtisadi İslahatların Təhlili və Kommunikasiya Mərkəzi, "İxrac İcmalı/yanvar 2018", baxış tarixi: 01.10.2018, səh: 4 http://iqtisadiislahat.org/store//media/documents/ixrac_icmali/2018/yanvar/Export_Review_2018-1.pdf

²¹ Türkiyə Cumhuriyyəti Mərkəz Bankası, Indicative Exchange Rates <http://www.tcmb.gov.tr/wps/wcm/connect/en/tcmb+en/main+menu/statistics/exchange+rates/indicative+exchange+rates>

²² Azərbaycan Respublikası Dövlət Statistika Komitəsi, "Azərbaycanın xarici ticarət əlaqələri (yanvar – dekabr, 2017)", baxış tarixi: 01.10.2018, səh: 1395 https://www.stat.gov.az/source/trade/az/bulleten/2017/f_trade_IV_2017.zip

²³ İqtisadi İslahatların Təhlili və Kommunikasiya Mərkəzi, "İxrac İcmalı/yanvar 2018", baxış tarixi: 01.10.2018, səh: 4 http://iqtisadiislahat.org/store//media/documents/ixrac_icmali/2018/yanvar/Export_Review_2018-1.pdf

²⁴ Azərbaycan Respublikası Dövlət Statistika Komitəsi, "Turizmin inkişafı haqqında", 18.09.2018 <https://www.stat.gov.az/news/index.php?id=3976>

currencies of these countries increases the attractiveness of their tourism sector and increases the number of people leaving Azerbaijan. On the other hand, the steady exchange rate in Azerbaijan has a negative impact on the number of tourist arrivals to the country. As a result, currency outflows increase while inflows shrink in the tourism sector.

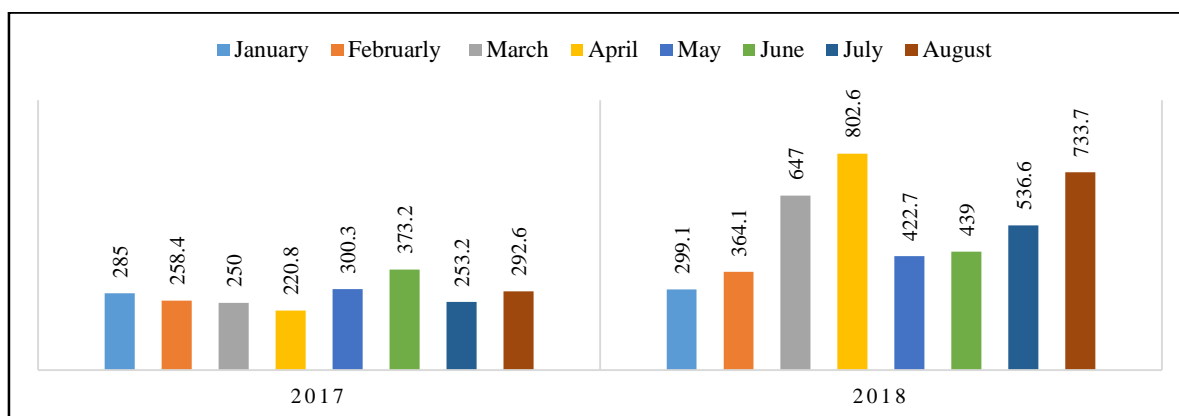
Another factor that poses a threat to Azerbaijan is the large scale of the illegal currency markets in these countries, especially in Iran. Because, in this case, the black market in these countries may become a serious threat for currency outflows.

Overall, the impact of national currency depreciations of the above mentioned countries to the economy of Azerbaijan can be grouped as following:

- *Stimulating imports,*
- *Weakening export opportunities,*
- *Decreased competitiveness of Azerbaijani exports in foreign markets and pressure from relatively cheaper imports even in domestic markets,*
- *Diminished attractiveness of the tourism sector,*
- *Increased attempts to illegally take currency out of the country, increased volume of illegal currency flows,*
- *Decrease in remittance revenues.*

It should be noted that the current stable exchange rate policy will further enhance the impact of each of the factors listed above. As a whole, the process puts pressure on the national currency. That is, demand in the domestic currency market of Azerbaijan in 2018 has grown substantially. The increase in demand was clearly reflected in the sale of foreign currencies by SOFAZ.

Figure 5: Monthly dynamics of SOFAZ's currency sales



Source: SOFAZ, 2018

While the State Oil Fund of Azerbaijan sold foreign currencies amounting to 2.23 billion US dollars in January-August 2017, this figure was 4.25 billion US dollars in the corresponding period of 2018²⁵. In other words, in comparison with the previous year, the volume of the Oil Fund's currency sales increased by 90.1%. Specifically, sharp increases in currency sales have occurred in March, April and August of the current year. The main factor that increased demand for foreign exchange markets in March and April was the public

²⁵ Azərbaycan Respublikası Dövlət Neft Fondu
http://www.oilfund.az/?page=xeberler-arxivi&hl=az_AZ&date=2018

concern as a result of the presidential election in the country; however, in August it was directly influenced by external factors - those occurring in Turkey, Russia and Iranian currency markets. Despite all of this, a stable exchange rate policy continued in Azerbaijan.

Along with its positive impacts such as the effectiveness of social protection mechanisms, slowing import driven inflation, sustaining consumption and ensuring a secure environment for business planning, the fixed exchange rate also leads to certain problems with the sustainable development of the economy, resilience towards external fluctuations and adequate response to new challenges.

Exchange Rate of the Manat: Expectations

The exchange rate of the manat for the following months (until the end of the year) is forecasted as following:

- | | | |
|------|--|-------------------|
| I. | Continuation of the fixed rate policy: | high |
| II. | Slight weakening of Manat : | low-medium |
| III. | New devaluation risk: | low-medium |
| IV. | Sharp change in exchange rate policy: | low |

The forecast made above relies on the current exchange rate policy of the Central Bank aimed at maintaining the existing status quo in the short-run. However, it should be noted that the current situation has created several advantages for a fixed exchange rate policy. Although the ongoing economic conditions in regional countries have created an overall negative mood, the sale of oil at a higher-than-expected-price led to positive dynamics on a number of macro indicators such as trade balance, balance of payments, and strategic foreign reserves. These conditions allow for the contemporary exchange rate policy.

Conclusion

The conducted analyze has shown once again that the previous period of 2018 was vibrant from the context of the Azerbaijani manat's exchange rate. During this period, positive and negative trends were observed on various factors. While factors such as more expensive oil, rise in non-oil exports, reduction of deficit in services balance and increasing foreign reserves can be listed as positive factors, others such as higher volatility of the exchange markets in regional countries, sharp depreciations of national currencies of Iran, Turkey and Russia - who are important trade partners for Azerbaijan - and increasing imports can be treated as negative developments.

Throughout the year, a sharp increase was observed in demand for foreign currencies. That is, in January-August of 2018, the Oil Fund sold 90% more currency than the consequent period of the last year.

The weak elasticity of the exchange rate policy not only created difficulties for non-oil exports and tourism revenues, it also led to the risk of currency outflows towards the illegal foreign exchange markets in the region.

While higher oil prices create favorable conditions to control the risks on the exchange rate of the manat, it has also weakened the competitiveness of the national economy.

The continuation of the current exchange rate policy contributes to the formation of unfavorable conditions for the future of the country's tourism sector, non-oil production and exports when compared to the other countries of the region. However, despite all this, we predict the probability that the current status quo will continue is high, taking into account the priorities of the Central Bank and the government when it comes to exchange rate policy. In other words, the exchange rate of US dollar/manat = 1.7 will most probably be maintained during the next 3 months.

Suggestions

Adaptation of the exchange rate policy to the priorities of the country's sustainable development is of great importance in terms of reducing the impact of future risks and external fluctuations. For that purpose, it is recommended to take the following steps:

1. ***Implementation of elastic exchange rate policy within a predetermined interval*** – as a result, the Central Bank and the government will be able to use one of the strongest tools to reduce the negative effects of external factors on the domestic economy, which ultimately can make it possible to pursue a more flexible policy when adapting the country's economy to new challenges.
2. ***Using the "Factors Basket" for a more effective and flexible management of exchange rate policy*** – factors such as price of oil, balance of payments, foreign trade balance, as well as export and production environment in the non-oil sector, attractiveness of tourism and investment should be included in the basket.

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3. Bloomberg; <https://www.bloomberg.com/quote/CO1:COM>
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