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**Book**

## The effect of oil price fluctuations on the exchange rate of the national currency of Azerbaijan : assessment of the years 2014-2017

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**The Effect of Oil Price Fluctuations on the Exchange Rate  
of the National Currency of Azerbaijan:  
Assessment of the years 2014-2017**

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## 1. Introduction

Throughout the 21<sup>st</sup> century, the dynamics of oil prices have been among the most followed trends in the world economy. During the years 2000-2008, unprecedented increases in oil prices, mainly caused by a boom in demand and stagnation of production, were observed.<sup>1</sup> However, in the end of 2008, the price of oil dropped rapidly, falling to its lowest level around USD 34 per barrel (/bbl), before soaring back to high levels again in 2014 and subsequently precipitating a new, steep fall.<sup>2</sup> Decreasing global demand for oil, changes of the Organization of the Petroleum Exporting Countries' (OPEC) policies and the appreciation of the US dollar were key factors which brought about the post-2014 dramatic drop in prices.<sup>3</sup> Consequently, the world economy has been negatively affected by depressed oil prices since.

Since the year 2014, falling oil prices continued. In the beginning of 2016, oil prices bottomed at about USD 29 /bbl, but a gradual increase was recorded towards the end of the year. During 2016, an upward trend in oil prices was obvious, despite market interventions and the lower than average annual price of oil (USD 43.55 /bbl) compared to 2015.<sup>4</sup> Currently, a gradually increasing trend for oil prices is being recorded for 2017 and there have not yet been any significant fluctuations observed.

Throughout the years 2014-2017, the repercussions of dropping oil prices on the exchange rate of the national currency of Azerbaijan, the manat (AZN), have been easy to follow. During this period, oil price fluctuations have affected the Azerbaijani economy through the depreciation of the manat. As a substantial part of the country's revenue is obtained from the sale of oil and gas, in times of high oil prices the country has experienced resource windfalls and consequent problems of economic diversification, leading to economic problems in times of low oil prices. In fact, falling oil prices in the global market directly impact the exchange rate of the manat, since this process creates a deficit in the balance of payments (BOP) of Azerbaijan, which in turn leads to a decrease in the foreign exchange reserves of the country.

The exchange rate of the Azerbaijani manat increased sharply in February and December of 2015, the result of two harsh devaluations. The manat lost almost half of its value due to the devaluations, leading it to become the worst performing currency of that year. Towards the end of 2016, the exchange rate of the manat continued to increase, resulting in a rate of 1.92 against the US dollar in February 2017. Nevertheless, in the following months, decreasing dynamics were recorded in the manat's rate, leading to its current stabilized rate of 1.70 against the US dollar.<sup>5</sup>

The Central Bank of the Republic of Azerbaijan's (CBAR) policy change of shifting from a fixed exchange rate to a floating one had a significant effect on the stabilization of the manat. Additionally, several bodies, such as CBAR and the State Oil Fund of the Republic of Azerbaijan (SOFAZ), became involved in foreign exchange auctions in order to prevent the further depreciation of the Azerbaijani manat. Importantly,

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<sup>1</sup> James D. Hamilton, "Causes and Consequences of the Oil Shock of 2007–08", *Brookings Papers on Economic Activity* (2009), University of California, San Diego

[https://www.brookings.edu/wp-content/uploads/2016/07/2009a\\_bpea\\_hamilton-1.pdf](https://www.brookings.edu/wp-content/uploads/2016/07/2009a_bpea_hamilton-1.pdf)

<sup>2</sup> Macrotrends, Brent Crude Oil Prices - 10 Year Daily Chart,

<http://www.macrotrends.net/2480/brent-crude-oil-prices-10-year-daily-chart>

<sup>3</sup> John Baffes, M. Ayhan Kose, Franziska Ohnsorge, and Marc Stocker, "The Great Plunge in Oil Prices: Causes, Consequences, and Policy Responses", *Policy Research Note* (2015), World Bank Group, 4

<http://pubdocs.worldbank.org/en/339801451407117632/PRN01Mar2015OilPrices.pdf>

<sup>4</sup> The State Oil Fund of the Republic of Azerbaijan, 2016 Annual Report, 34.

[http://www.oilfund.az/uploads/Annual\\_Report\\_2016\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2016_ENG.pdf)

<sup>5</sup> The Central Bank of the Republic of Azerbaijan, AZN Rates, 2017

<https://en.cbar.az/other/azn-rates>

psychological factors played a major role in adding to the high volatility of the currency market and limiting the effects of CBAR interventions; citizens watched exchange rate fluctuations and widely participated in the sale and purchase of foreign currency during manat's appreciation and depreciation periods

In this research paper, the dynamics of the oil price's effect on the manat's rate during the last four years, 2014-2017, will be analyzed. The research will be based on the question, "How do oil price fluctuations affect the exchange rate of the national currency of Azerbaijan?". The main reasons behind the depreciation of the manat will be investigated. Measures taken by major players in the field, such as the CBAR and SOFAZ, to address the problem will be examined. The paper will also provide an overview of oil price forecasts, as well as of the rate of the Azerbaijani manat, based on international and domestic sources.

## **2. The impact of global oil prices on the national currency of Azerbaijan – reasons and outcomes**

The price of oil in the world market has a very big influence on the exchange rate of the manat and, generally, on the Azerbaijani economy. If we consider that substantial parts of the exports and revenues of the country are obtained from the sale of oil and gas, the relationship between the price of oil and the rate of the manat becomes clear. A decline in oil prices has an inverse effect on the balance of payments of the country which, in turn, decreases the trade balance. Therefore, a deficit in the balance of payments leads to a rise in the exchange rate. As a result, the main suppliers of foreign exchange currency, such as CBAR and SOFAZ, start to sell their currency reserves in auctions in order to prevent further depreciation of the manat. Consequently, it leads to the rapid depletion of the country's strategic currency reserves, leading to economic hardship.

### **2.1. The impact of oil prices on the rate of the manat – Dynamics for the years 2014-2017**

According to figure 1, the highest price of Brent crude oil in 2014 was USD 114.25 /bbl, after which it fell sharply towards the end of the year. The price stood at USD 45.13 /bbl by the middle of January 2015. As it is a long term process, the impact of the fall in oil prices on the manat was observed only after February 2015.

Generally, in the years 2015 and 2016, fluctuations were observed in the price of oil, which was then followed by a significant drop in 2016. On March 16<sup>th</sup> 2015, the price of oil was USD 52 /bbl and it rose over USD 64.93 within two months before decreasing sharply again in the end of the year. As a result, the exchange rate of the manat rocketed to 1.55 USD/manat, when on the 21<sup>st</sup> of February it had been 1.05 USD/manat (figures 1 and 2).

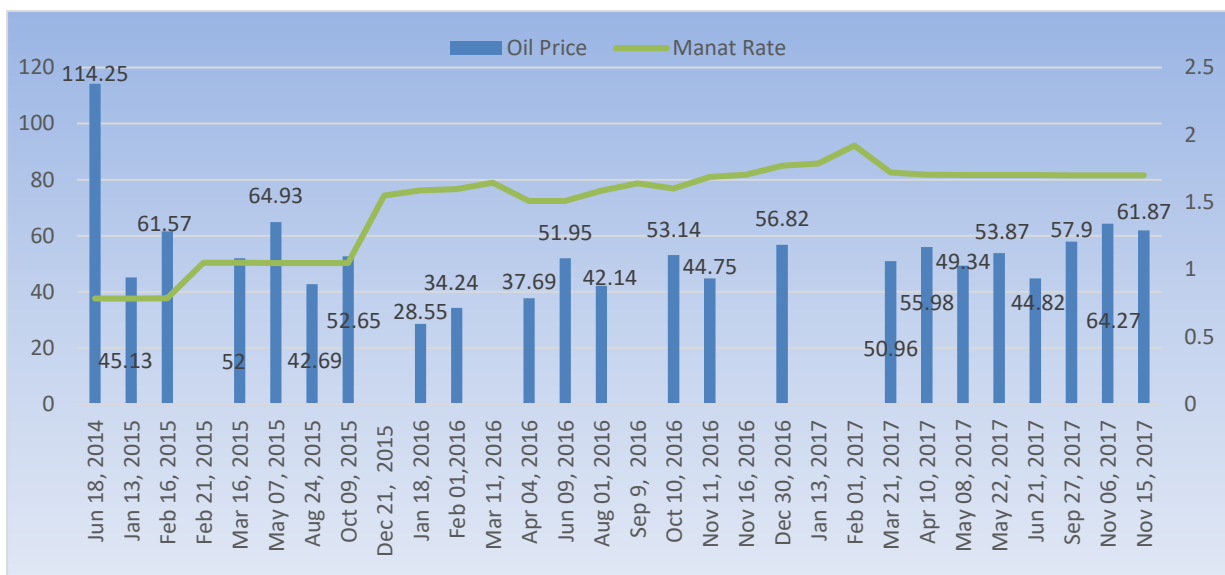
These fluctuations were even sharper in 2016. In the beginning of the year, the price of oil decreased to its lowest level – USD 28.55/bbl on 18 January, 2016 – while in the last month of the year, it increased twofold, reaching USD 56.82/bbl. Importantly, there was a 16% decrease in oil prices in 2016, compared to 2015, due to the higher supply of and lower demand for oil. In 2016, the average Brent oil price was USD 43.73 /bbl, which was the lowest annual price from the year 2014.<sup>6</sup> As a result, the manat faced difficulties in the global market; however, starting from the last three months of 2016, the rate of the manat started to decrease, reaching 1.7707 against the US dollar in the end of the year (figures 1 and 2).

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<sup>6</sup> British Petroleum, Statistical Review of World Energy, 2016

<https://www.bp.com/en/global/corporate/energy-economics/statistical-review-of-world-energy.html>

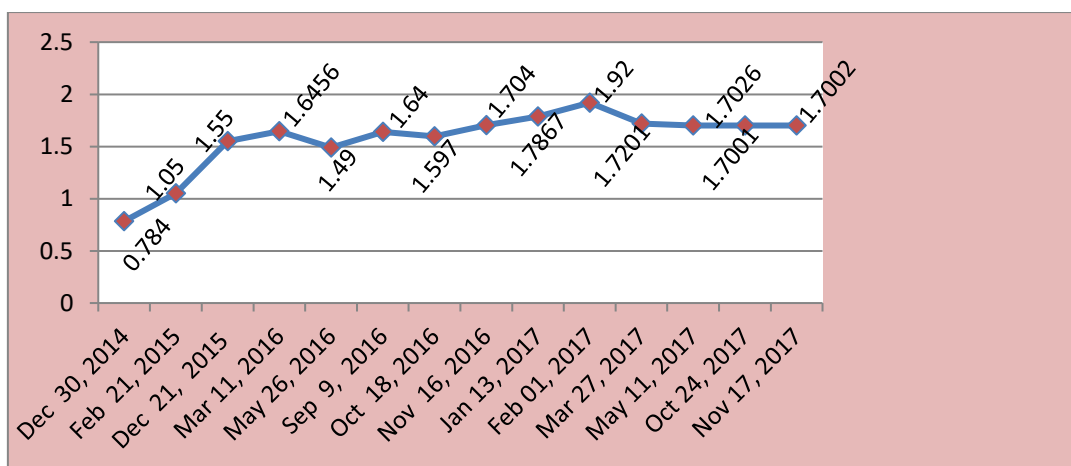
**Figure 1. The effect of Oil Prices (Brent, USD/bbl) on the national currency of Azerbaijan (USD/manat)<sup>7</sup>**



Source: Macrotrends and the Central Bank of the Republic of Azerbaijan, 2017

In 2017, there were no significant oil price fluctuations in the world market. The trend seen is one mainly increasing, peaking at USD 64.27 /bbl on November 6, 2017. Until November, the lowest price of oil was recorded in June, amounting to USD 44.82/bbl. The general depression of oil prices in 2016 affected the manat's rate in the beginning of 2017, particularly in February the manat saw its highest exchange rate, soaring up to 1.92 USD/manat. However, afterwards, the manat stabilized at the exchange rate of 1.70 against the dollar (figures 1 and 2).

**Figure 2. Dynamics of rate of the Azerbaijani manat, USD/manat<sup>8</sup>**



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

<sup>7</sup> Macrotrends, Brent Crude Oil Prices - 10 Year Daily Chart, 2017  
<http://www.macrotrends.net/2480/brent-crude-oil-prices-10-year-daily-chart>

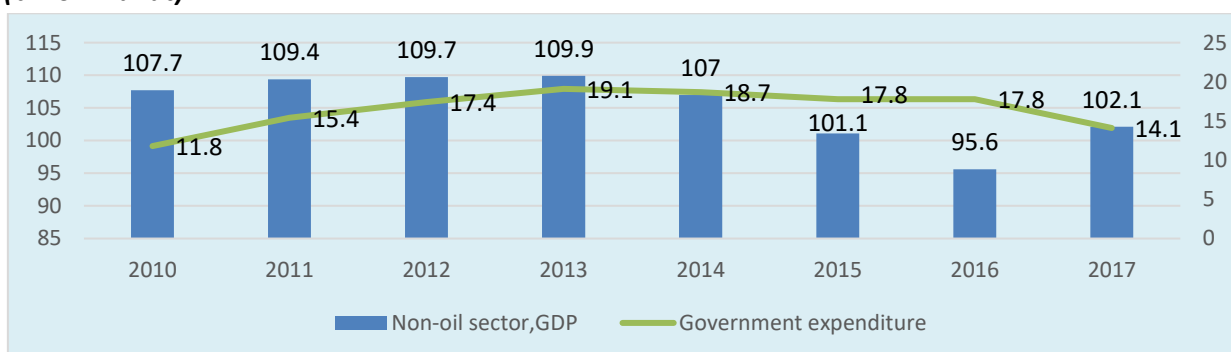
<sup>8</sup> The Central Bank of the Republic of Azerbaijan, AZN Rates, 2017  
<https://en.cbar.az/other/azn-rates>

## 2.2. Resource windfalls and the challenge of diversification in the Azerbaijani economy

The “resource curse” is a very problematic issue for many oil-rich countries, in that they focus only on the further development of their resource’s sector, while ignoring other sectors of the economy.<sup>9</sup> Azerbaijan is one such country, which suffered from resource windfalls. The country stood out for its medium-level economic diversification based on the Herfindahl-Hirshman Index (measurement for economic diversification), during the period 2005-2015.<sup>10</sup>

Why is the Azerbaijani economy vulnerable to oil price shocks? Key factors are the weak diversification of the country in terms of economy and export. In fact, an abundance of natural resources caused an increase of the general earnings of the country’s population, as well as public expenditures, particularly in the period of rising oil prices. As a result, when oil prices started to fall, the country lacked the ability to maintain the same level of economic growth and expenditures. As many sectors of the economy depended on public spending, the country faced difficulties in providing support for the subsidized economic spheres, which were established and maintained based on government payments. The revenues obtained from resources were directed to the economic sectors which are non-tradable, thereby making them highly sensitive to the steep fall of oil prices.<sup>11</sup>

**Figure 3. The relationship between the non-oil sector GDP (change in %) and government expenditure (billion manat)<sup>12</sup>**



Source: The State Statistical Committee of the Republic of Azerbaijan, 2016 and 2017

<sup>9</sup> Thorvaldur Gylfason, Tryggvi Thor Herbertsson and Gylfi Zoega “A Mixed Blessing, Natural Resources, and Economic Growth”, *Macroeconomic Dynamics*(1999), 3: 211

<https://notendur.hi.is/gylfason/borders/pdf/mixedblessing.pdf>

<sup>10</sup> Vugar Bayramov and Laman Orujova, “Volatility, Diversification and Oil Shock in Resource-Rich Turkic Countries: Avenues for Recovery”, *Bilig*, no. 83 (2017): 311, accessed November 20, 2017

<http://bilig.yesevi.edu.tr/yonetim/icerik/makaleler/2080-published.pdf>

<sup>11</sup> Vugar Bayramov and Laman Orujova, “Volatility, Diversification and Oil Shock in Resource-Rich Turkic Countries: Avenues for Recovery”, *Bilig*, no. 83 (2017): 304, accessed November 20, 2017

<http://bilig.yesevi.edu.tr/yonetim/icerik/makaleler/2080-published.pdf>

<sup>12</sup> The State Statistical Committee of the Republic of Azerbaijan, GDP production in the section of oil and non-oil of economy, 2016 [https://www.stat.gov.az/source/system\\_nat\\_accounts/en/007\\_1en.xls](https://www.stat.gov.az/source/system_nat_accounts/en/007_1en.xls)

Revenues and Expenditures of the state budget, 2016

<https://www.stat.gov.az/source/finance/en/006en.xls>

Macro-economic indicators (January-October, 2017)

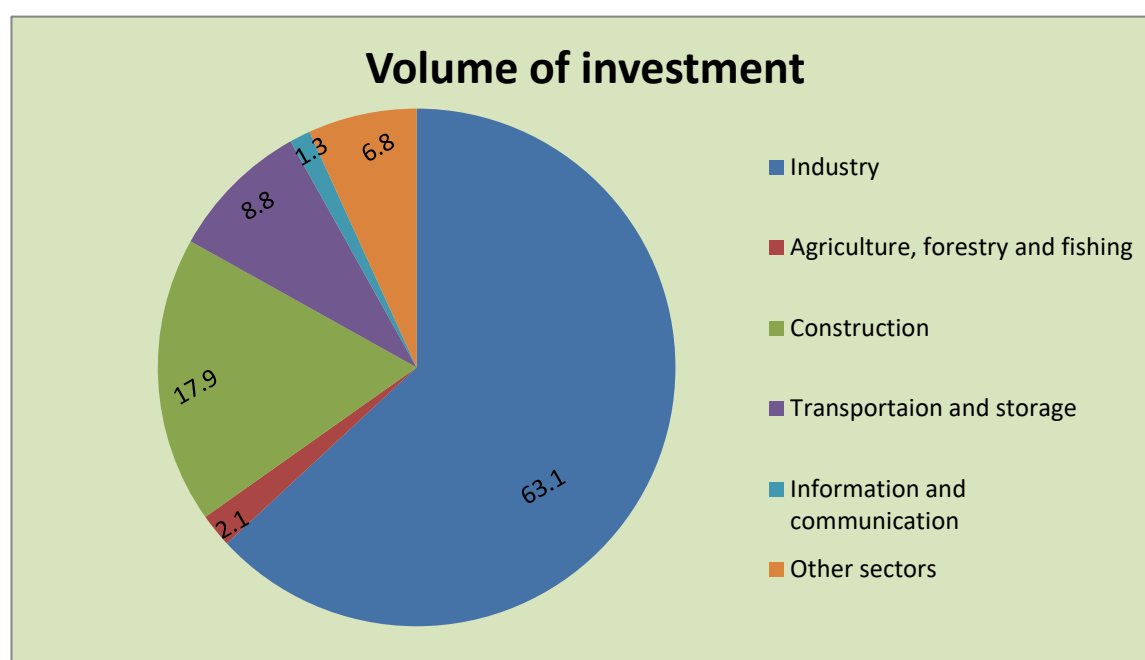
<https://www.stat.gov.az/news/macroeconomy.php?page=1&lang=en>

There is a clear causal relationship between oil prices and the non-oil sector in Azerbaijan, since non-resource sectors followed the same dynamics as oil prices, meaning decreasing prices have affected not only the oil-sector, but also non-oil sectors simultaneously.<sup>13</sup>

The dependence of state-spending and the non-resource GDP of the country on oil revenues is evident when considering that it was the government's fiscal expansion, due to rising oil incomes, which increased the non-oil GDP, as seen in figure 3. The opposite situation was observed in the case of decreasing oil revenues, seen especially in 2014 (figure 3).<sup>14</sup>

Total investments also increased when oil revenues grew and declined with falling oil incomes. In fact, in 2015 around 50% of total investments were made solely to the oil and gas sector. Only moderate investment was directed to the manufacturing (2.6%) and agriculture (2.3%) sectors, which are tradable sectors of the economy that are important in terms of value-added and employment generation. In contrast, large amounts of investment were oriented to sectors such as construction and transportation, which are not tradable and, therefore, less productive – they are unable to generate economic growth for the long-term. These sectors can be commendable in many aspects; however, in reality, they are in a supplementary position to the main driving forces of economic expansion.<sup>15</sup> In 2016, the share of the agriculture and manufacturing sectors saw slight increases (2.1% and 2.7%, respectively), while 17.9% of total investment was made to the construction sector, increasing by 5% compared to the previous year. By contrast, investment to the transportation and storage sector decreased to 8.8% (figure 4).<sup>16</sup>

**Figure 4. Volume of investment (%) in fixed by sectors of the Azerbaijani economy in 2016**



Source: The State Statistical Committee of the Republic of Azerbaijan, 2016

<sup>14</sup> Vugar Bayramov and Gulnara Abbas, "Oil shock in the Caspian Basin: Diversification policy and subsidized economies", *Elsevier, Resources Policy* 54 (2017) :154, accessed November 20, 2017 <https://doi.org/10.1016/j.resourpol.2017.10.006>

<sup>15</sup> Vugar Bayramov and Laman Orujova, "Volatility, Diversification and Oil Shock in Resource-Rich Turkic Countries: Avenues for Recovery", *Bilig*, no. 83 (2017): 318, accessed November 20, 2017 <http://bilig.yesevi.edu.tr/yonetim/icerik/makaleler/2080-published.pdf>

<sup>16</sup> The State Statistical Committee of the Republic of Azerbaijan, General, Volume of investment in fixed by sectors of economy, 2016 <https://www.stat.gov.az/source/agriculture/az/1.6.xls>



In fact, in 2016, 1.755 billion manat out of the 2.599 billion manat allocated to the industrial sector was domestically invested only in the oil and gas industry. By comparison, the figure for the manufacturing industry was a mere 424.3 million manat.<sup>17</sup> These numbers indicate that the government still invests a huge amount of money in the mining sector, particularly in the extraction of oil and gas, which limits the share of investment in other sectors of the economy.

The establishment of an effective government mechanism for market regulation and the implementation of the rule of law, the improvement of human capital, and the easing of access to finance for SMEs in non-oil sectors – to encourage their activity in tradable sectors – are all important activities which will act to attract investment and stimulate the diversification of the Azerbaijani economy.<sup>18</sup>

### **2.3. The manat's loss of value and measures taken by CBAR and SOFAZ**

As it was mentioned earlier, starting from the year 2014, there was a pressure on the manat due to decreasing oil prices in the global market. In 2015, the manat lost 49.6% of its total value. Temporary decreases in demand for foreign currencies during the months of March-May of 2016 were recorded due to the slowing pace of the rapid dollarization which occurred just before, as well as stagnation in business activities, particularly in imports, in the beginning of the years 2015 and 2016. These developments made the manat stronger (1.49 USD/manat), however the depreciation process continued thereafter.<sup>19</sup>

#### **Strategic currency reserves and sales**

SOFAZ has been the main player in the currency auctions of CBAR, since it is the principal supplier of foreign currencies. As it can be observed from figure 5, there has been a downward trend in the total strategic foreign currency reserves of the country (the combination of CBAR's and SOFAZ's reserves) since the year 2014, due to the measures taken by CBAR and SOFAZ for preventing the manat's further depreciation. In the year 2014, total currency reserves of SOFAZ and CBAR were USD 50.86 billion, which decreased to USD 38.59 billion in the next year.

In 2016, the total assets of SOFAZ were USD 33.15 billion, while CBAR's currency reserves equaled USD 3.974 billion, representing a 20.8% decrease. In general, the strategic foreign currency reserves of Azerbaijan amounted to USD 37.121 billion in 2016.

As a part of "The Strategic Roadmap of the Republic of Azerbaijan on National Economy Perspectives," which was adopted on 6 December 2016, the floating exchange rate was implemented.<sup>20</sup> Afterwards, SOFAZ's expansive quantitative easing policy was pursued, through which SOFAZ supplied commercial banks with foreign currency in currency auctions twice a week.

As it can be observed from figure 5, in 2017, the reserves of both institutions increased in the period from January-September. However, a huge gap existed between the volumes of reserves of the two institutions, where the higher volume belonged to SOFAZ, increasing from approximately USD 33 billion

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<sup>17</sup> The State Statistical Committee of the Republic of Azerbaijan, Industry, Investments directed to the main capital of industry, 2016 <https://www.stat.gov.az/source/industry/?lang=en#>

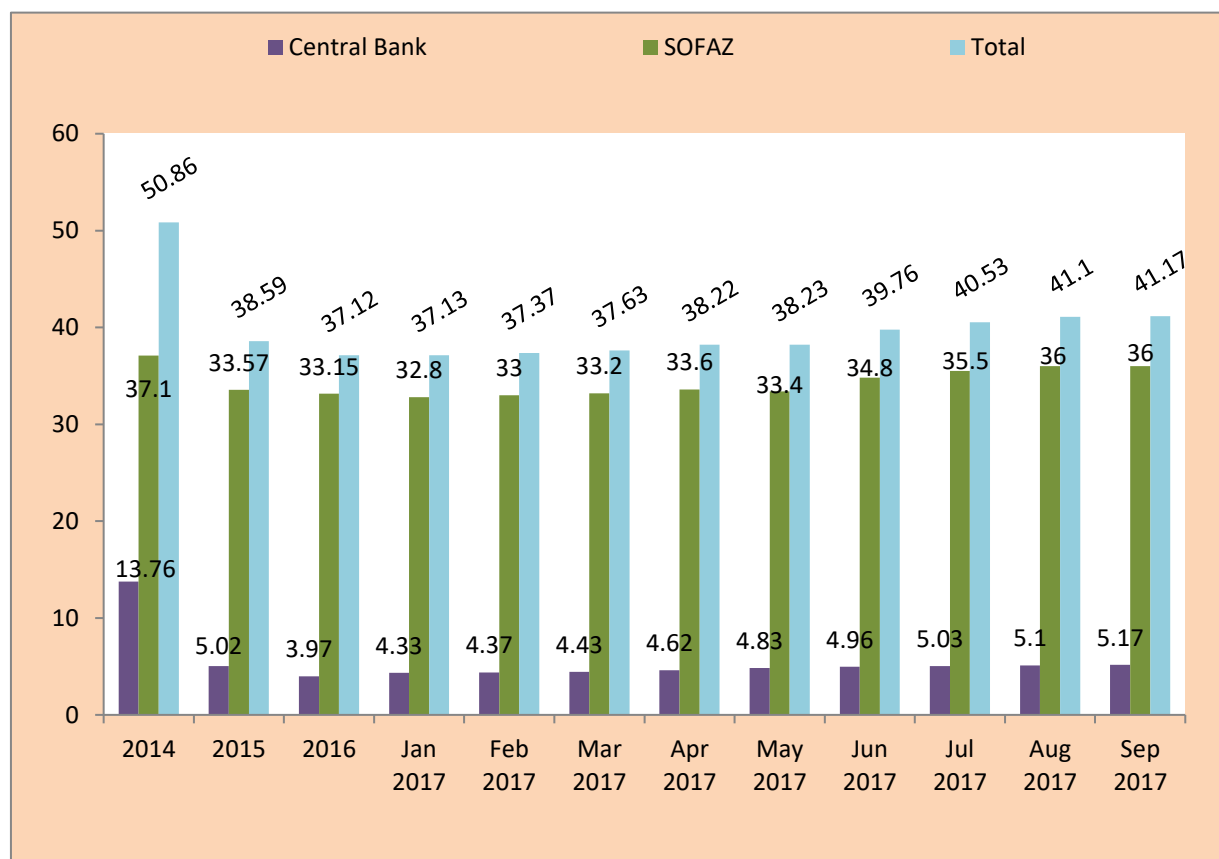
<sup>18</sup> Vugar Bayramov and Laman Orujova, "Volatility, Diversification and Oil Shock in Resource-Rich Turkic Countries: Avenues for Recovery", *Bilig*, no. 83 (2017): 325, accessed November 20, 2017 <http://bilig.yesevi.edu.tr/yonetim/icerik/makaleler/2080-published.pdf>

<sup>19</sup> CESD, "Currency market in Azerbaijan: Why the national currency is losing its value?", 12.08.2016, 3 [http://cesd.az/new/wp-content/uploads/2016/08/CESD\\_Paper\\_Currency\\_Depreciation-1.pdf](http://cesd.az/new/wp-content/uploads/2016/08/CESD_Paper_Currency_Depreciation-1.pdf)

<sup>20</sup> Official 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

to 36 billion. SOFAZ's transfers of foreign exchange currencies to CBAR and also a liberal exchange rate strategy helped the bank to replenish its reserves. The reserves of CBAR were increasing gradually throughout 2017, reaching around USD 5.2 billion in September. During the first three quarters of the year, total foreign exchange reserves of the country increased by approximately USD 4 billion.

**Figure 5. Foreign exchange reserves, USD billion<sup>21</sup>**



**Source: SOFAZ and CBAR, 2016 and 2017**

According to figure 6, in the first two months of 2016, CBAR was actively involved in currency markets, selling around USD 635 million, which led to the speedy exhaustion of its foreign exchange reserves. Consequently, currency reserves of the bank decreased to their minimum – USD 4.026 billion. Thus, CBAR substituted its active role in currency sales with SOFAZ, which offered about USD 482 million in March, 2016.

It is clear from figure 6 that CBAR intervened in the currency market at a total amount of USD 100 million after a four-month suspension interval in July 2016. Unmet demand for foreign currency, which increased pressure on the manat, was the main reason for CBAR's action. It should also be mentioned that the bank, as a recipient buyer in the auctions, purchased USD 202 million during one month (26 April - 31 May,

<sup>21</sup> The State Oil Fund of the Republic of Azerbaijan, 2016 Annual Report, 28

[http://www.oilfund.az/uploads/Annual\\_Report\\_2016\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2016_ENG.pdf)

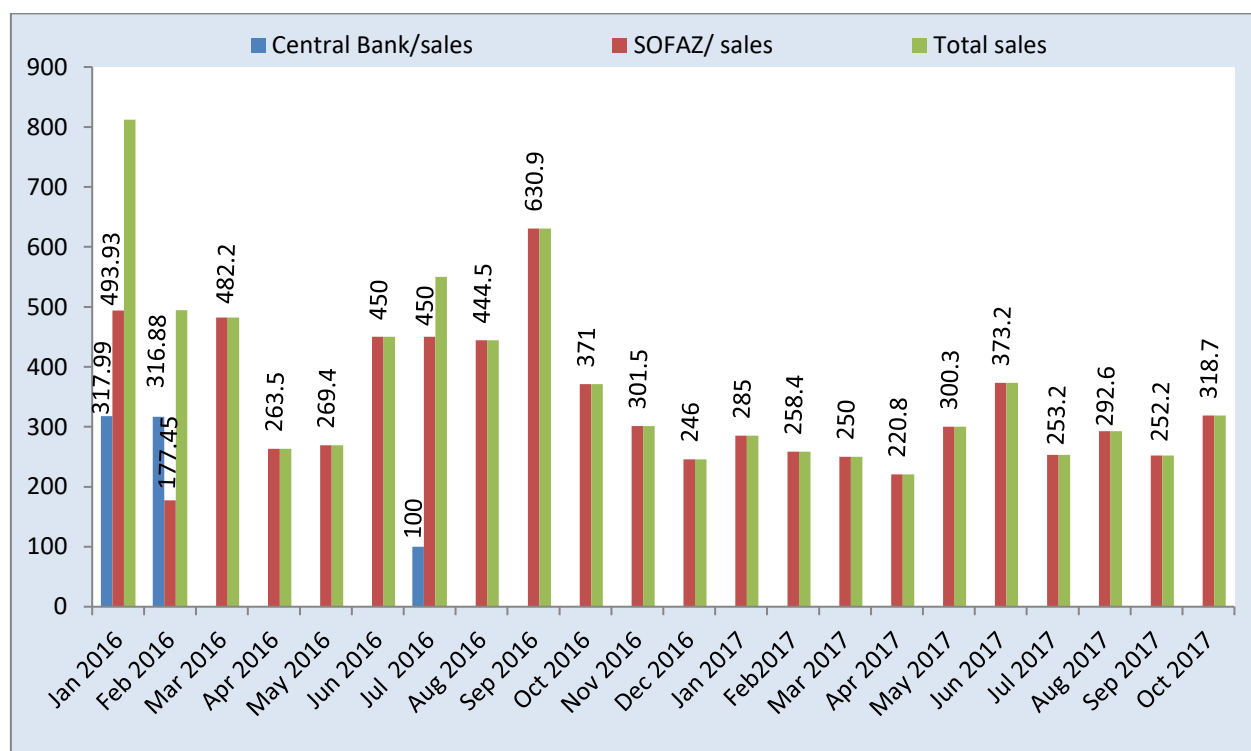
The State Oil Fund of the Republic of Azerbaijan, Investment results for the 9 MONTHS of 2017, Monthly change in SOFAZ's Currency Assets in 2017 (USD), [file:///C:/Users/USER/Desktop/ENGLISHVERSIONQ3\\_2017.pdf](file:///C:/Users/USER/Desktop/ENGLISHVERSIONQ3_2017.pdf)

The Central Bank of the Republic of Azerbaijan, Official FX reserves 2017

[https://en.cbar.az/infoblocks/money\\_reserve\\_usd](https://en.cbar.az/infoblocks/money_reserve_usd)

2016). In the following periods, excess demand was followed by the manat's depreciation. In 2016, the overall amount of USD that SOFAZ sold at the auctions was USD 4.88 billion; however, this figure represents a 37.5% drop compared to the previous year.<sup>22</sup>

**Figure 6. Post-devaluation (second) currency sale dynamics, USD million<sup>23</sup>**



**Source: Center for Economic and Social Development, 2016**  
**The State Oil Fund of the Republic of Azerbaijan, 2016 and 2017**

SOFAZ became the only seller of foreign exchange reserves after July 2016. Since then, the highest amount of USD sold by SOFAZ was recorded in September 2016, at about USD 631 million, while the lowest figure amounted to around USD 221 million in April 2017. In October 2017, SOFAZ conducted a sale of USD 318.7 million (figure 6).

A new tendency emerged: as the CBAR shifted from a fixed to floating exchange rate, so the population transformed into participants of foreign currency markets. The citizens of the country began to follow the tendency to benefit from exchange rate changes in terms of selling foreign currency in manat's appreciation period and purchasing it in depreciatory periods. As a result, volatility of the currency market grew, restricting the control of the Central Bank over the manat's rate.<sup>24</sup>

There is a common view among the Azerbaijani community that, shaped by rising oil prices, the manat will be stronger and the currency supply of ordinary citizens and businesses will rise. This is the current

<sup>22</sup> The State Oil Fund of the Republic of Azerbaijan, 2016 Annual Report, 28  
[http://www.oilfund.az/uploads/Annual\\_Report\\_2016\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2016_ENG.pdf)

<sup>23</sup> CESD, "Currency market in Azerbaijan: Why the national currency is losing its value?", 12.08.2016  
[http://cesd.az/new/wp-content/uploads/2016/08/CESD\\_Paper\\_Currency\\_Depreciation-1.pdf](http://cesd.az/new/wp-content/uploads/2016/08/CESD_Paper_Currency_Depreciation-1.pdf)  
 The State Oil Fund of the republic of Azerbaijan, News archive, Statements on foreign exchange sales, 2016 and 2017 [http://www.oilfund.az/en\\_US/news/1323/100/Statement-on-foreign-exchange-sales.asp](http://www.oilfund.az/en_US/news/1323/100/Statement-on-foreign-exchange-sales.asp)

<sup>24</sup> CESD, "Currency market in Azerbaijan: Why the national currency is losing its value?", 12.08.2016, 7  
[http://cesd.az/new/wp-content/uploads/2016/08/CESD\\_Paper\\_Currency\\_Depreciation-1.pdf](http://cesd.az/new/wp-content/uploads/2016/08/CESD_Paper_Currency_Depreciation-1.pdf)

state of psychology in the country's currency market, often said to play a prominent role in foreign exchange markets. Despite this, the main reasons behind the devaluations of the manat were: the limited measures taken by the administration to balance the exchange rate of the manat and ongoing increases in the deficit in the BOP.<sup>25</sup>

#### The year 2017 - current developments of the Azerbaijani manat

There are several reasons behind the manat's drop to its record low of 1.92 against the dollar on February 1<sup>st</sup> 2017. On the one hand there existed psychological reasons, such as a lack of confidence and lack of readily available information for the public. On the other hand, inefficiencies in monetary and fiscal policies arose, as well as the widespread use of illicit black markets.<sup>26</sup> However, once the CBAR strengthened its monetary policy, deposits and bond auctions decreased the manat in circulation in the market, making it more expensive, which led to a decline in foreign currency demand. As a result, the manat appreciated against the dollar. The slowing rate of previous rapid dollarization and the limitation of cash payments in manat were other reasons for its appreciation. The Azerbaijani people had already saved huge amount of dollars as a result of the two sharp devaluations, which decreased demand for the US Dollar, leading to the stronger manat.<sup>27</sup>

During this year, the national currency of Azerbaijan gained in value against USD because of the increase in oil prices in the world market. The monetary authorities of the country conducted a policy of not revealing the total quantity of USD available in auctions beforehand, as it would bring wrong assumptions, overstating exchange rates that would lead to greater instability in the market.<sup>28</sup>

In the first three months of 2017, CBAR followed a policy of increasing interest rates, as well as the reduction of the manat's monetary base. The main objectives of CBAR included diminishing the total quantity of manat in circulation and strengthening confidence in it.<sup>29</sup>

#### 2.4. The BOP of the Republic of Azerbaijan for the period 2014-2017

As indicated by figure 7, it is clear that starting from the fourth quarter of the year 2014, a substantial deficit appeared in the BOP of Azerbaijan, due to cheapening oil prices in the world market.

In the first quarter of 2015, the BOP deficit increased to its highest level, reaching USD 4.590 billion. Consequently, CBAR adopted harsh devaluation policies in order to remedy the situation which, in turn, led to the devaluation of the manat by almost half over the course of the year. Fluctuations were observed in the BOP, ending the year with a fourth quarter USD 2.188 billion deficit. In total, the year saw a deficit amounting to USD 11.329 billion (figure 7).

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<sup>25</sup> 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](http://cesd.az/new/wp-content/uploads/2016/05/CESD_Paper_National_Currency_Azerbaijan_2016.pdf)

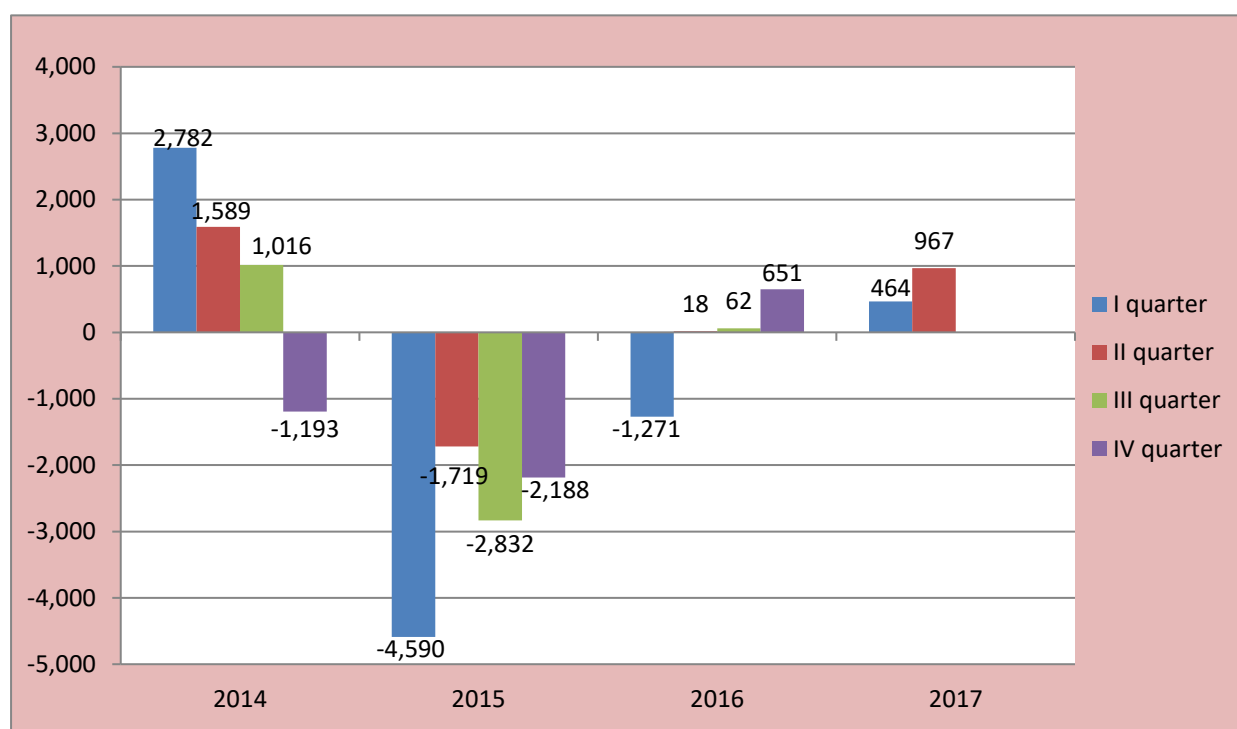
<sup>26</sup> CESD, "The Currency Market in Azerbaijan: Realities, Volatility and Perspectives.", 08.05.2017  
[http://cesd.az/new/wp-content/uploads/2017/05/CESD\\_Paper\\_Currency\\_Market\\_Azerbaijan\\_2017.pdf](http://cesd.az/new/wp-content/uploads/2017/05/CESD_Paper_Currency_Market_Azerbaijan_2017.pdf)

<sup>27</sup> Ibid.

<sup>28</sup> Ibid.

<sup>29</sup> CESD, "Assessment on Real Effective Exchange Rate in Azerbaijan: 2017 Outlook. January 2017"  
[http://cesd.az/new/wp-content/uploads/2017/01/CESD\\_Paper\\_National\\_Currency\\_Azerbaijan.pdf](http://cesd.az/new/wp-content/uploads/2017/01/CESD_Paper_National_Currency_Azerbaijan.pdf)

**Figure 7. The balance of payments (BOP) of the Republic of Azerbaijan for the years 2014-2017, USD million<sup>30</sup>**



Source: The Central Bank of the Republic of Azerbaijan, 2016 and 2017

However, compared to 2015, the year 2016 demonstrated more positive dynamics. Although the deficit stood at USD 1.271 billion in the first quarter, the rest of year was followed by a positive trend. In fact, there were surpluses recorded. The trend continued throughout 2017 as well, hitting over USD 967 million in the second quarter of the year.<sup>31</sup>

#### Foreign trade balance of the Republic of Azerbaijan during the years 2014-2017

The foreign trade balance decreased sharply during the year 2015 in comparison with the year 2014, as can be seen from the figure below. In 2014, the total trade balance was USD 18.928 billion, while in 2015 it declined to USD 5.812 billion. This was followed by a further decline in the next year, standing at USD 4.206 billion. In 2017, the total trade balance was USD 3.479 billion for the first and second quarters of the year.

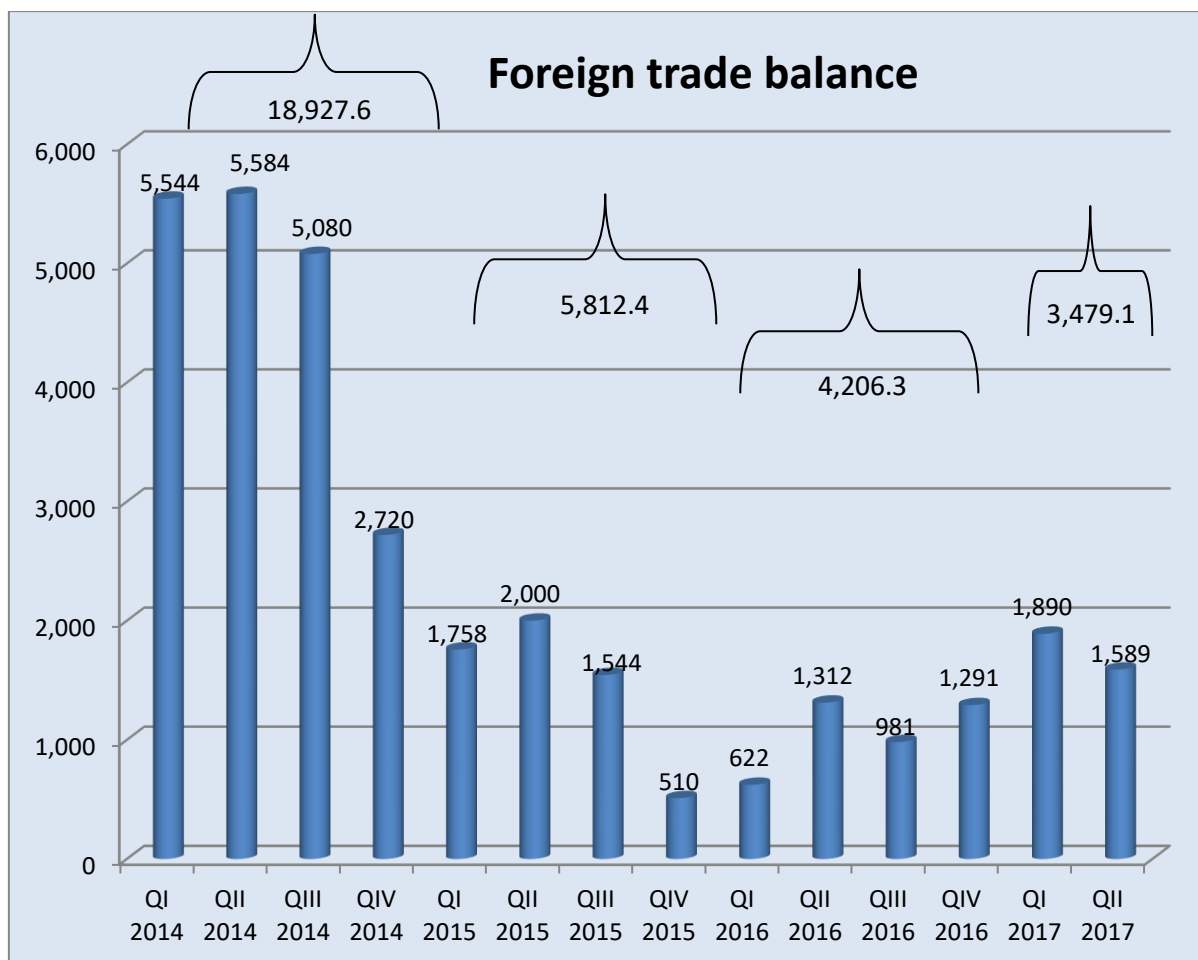
During these years, the highest trade balance was USD 5.584 billion, which was recorded during the April-June months of the year 2014. The lowest figure was noted in the last three months of 2015, amounting to USD 510 million.

<sup>30</sup> The Central Bank of the Republic of Azerbaijan, Statistical Bulletin 10/2016  
[https://en.cbar.az/assets/4246/YEKUN\\_STATISTIK\\_BULLETEN\\_ENG\\_2016\\_OKTYABR.pdf](https://en.cbar.az/assets/4246/YEKUN_STATISTIK_BULLETEN_ENG_2016_OKTYABR.pdf)

The Central Bank of the Republic of Azerbaijan, Statistical Bulletin 09/2017  
[https://en.cbar.az/assets/4429/STATISTICAL\\_BULLETIN\\_2017\\_SEPTEMBER\\_V3.pdf](https://en.cbar.az/assets/4429/STATISTICAL_BULLETIN_2017_SEPTEMBER_V3.pdf)

<sup>31</sup> The Central Bank of the Republic of Azerbaijan, Statistical Bulletin 08/2017  
[https://en.cbar.az/assets/4412/STATISTIC\\_BULLETIN\\_2017\\_AUGUST.pdf](https://en.cbar.az/assets/4412/STATISTIC_BULLETIN_2017_AUGUST.pdf)

**Figure 8. Foreign trade balance of the Republic of Azerbaijan during the years 2014-2017, USD million<sup>32</sup>**



**Source: The Central Bank of the Republic of Azerbaijan, 2016 and 2017**

### Balance of services of the Republic of Azerbaijan for the period of 2014-2017

Nevertheless, the foreign trade balance is not consistent with other sections of the BOP. Indeed, the decrease in the deficit of the balance of services portion of BOP is only gradually being remedied. The oil sector is the main barrier to the reduction of the deficit in the services balance. It was recorded that USD 1.96 billion of USD 2.27 billion, or 86%, of the balance of services' deficit was formed by the oil sector during the first three quarters of the year 2016.

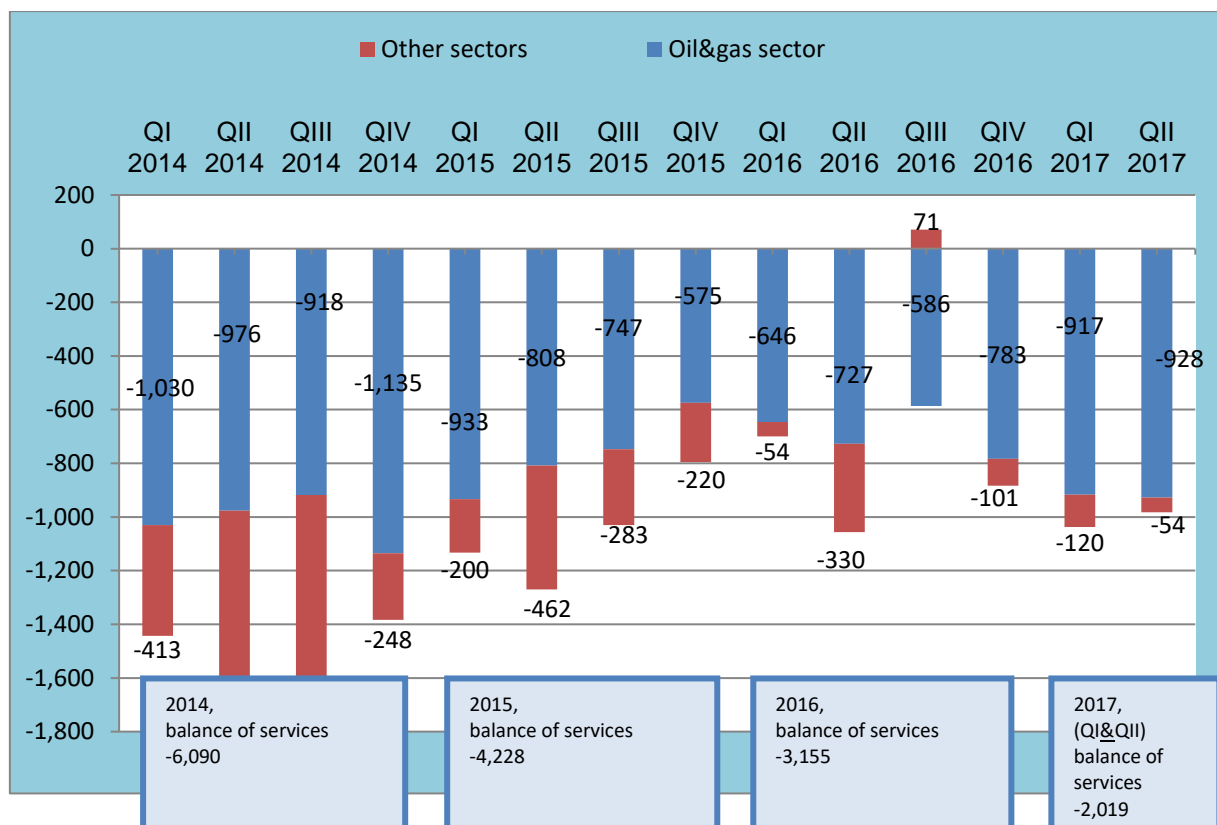
In the non-oil sector too persists a deficit despite increasing government control and regulation. The falling purchasing power of different sectors of society such as that of ordinary citizens, the private sector and government is the main reason for the profit decrease of this sector. However, the further development of the tourism sector had positive effects on the non-oil sector, bringing about USD 71 million in profit during the third quarter of 2016.<sup>33</sup>

<sup>32</sup> The Central Bank of the Republic of Azerbaijan, Statistical Bulletin 10/2016  
[https://en.cbar.az/assets/4246/YEKUN\\_STATISTIK\\_BULLETEN\\_ENG\\_2016\\_OKTYABR.pdf](https://en.cbar.az/assets/4246/YEKUN_STATISTIK_BULLETEN_ENG_2016_OKTYABR.pdf)

The Central Bank of the Republic of Azerbaijan, Statistical Bulletin 09/2017  
[https://en.cbar.az/assets/4429/STATISTICAL\\_BULLETIN\\_2017\\_SEPTEMBER\\_V3.pdf](https://en.cbar.az/assets/4429/STATISTICAL_BULLETIN_2017_SEPTEMBER_V3.pdf)

<sup>33</sup> CESD, "Assessment on Real Effective Exchange Rate in Azerbaijan: 2017 Outlook", January 2017, 14  
[http://cesd.az/new/wp-content/uploads/2017/01/CESD\\_Paper\\_National\\_Currency\\_Azerbaijan.pdf](http://cesd.az/new/wp-content/uploads/2017/01/CESD_Paper_National_Currency_Azerbaijan.pdf)

**Figure 9. Balance of services of the Republic of Azerbaijan during the years 2014-2017, USD million <sup>34</sup>**



**Source: The Central Bank of the Republic of Azerbaijan, 2016 and 2017**

In the first six months of 2017, the balance of services has been in deficit, totaling USD 2.019 Billion. Once again a major portion, or USD 1.845 billion, of this deficit falls to the share of the oil sector and USD 174 million to the non-oil one (figure 9).

## 2.5. The revenues and assets of SOFAZ along with transfers to the state budget

### Revenues and Assets

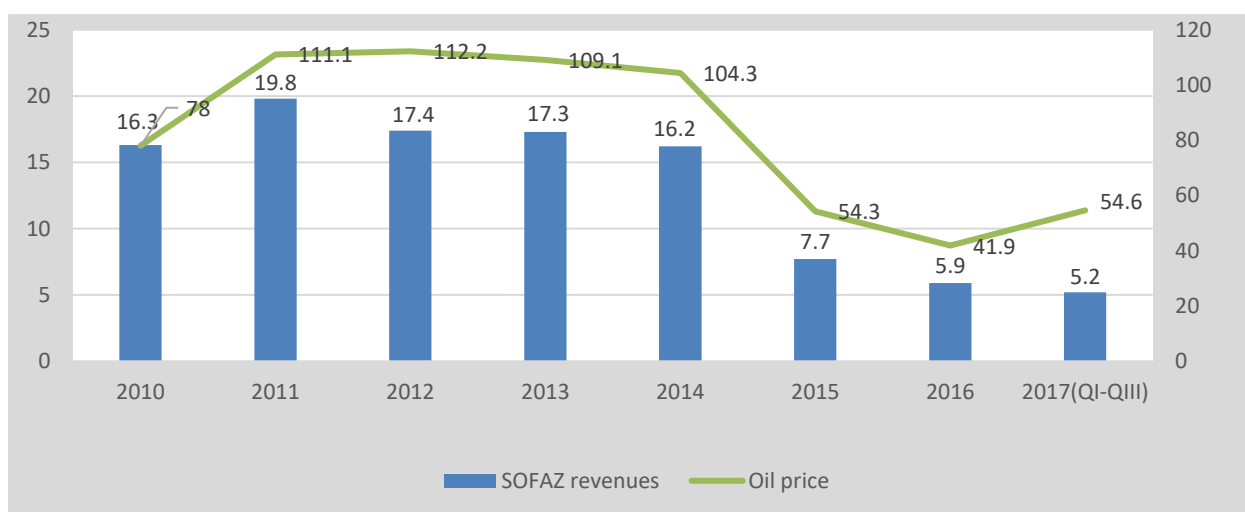
There was a substantial decline in SOFAZ's revenues after the fall of oil prices in global markets, starting from the year 2014. As a result, the revenues from the selling of oil and gas decreased significantly, by about 1/3 in 2016, compared to the year 2014 (figure 10).<sup>35</sup>

<sup>34</sup> The Central Bank of the Republic of Azerbaijan, Statistical Bulletin 10/2016  
[https://en.cbar.az/assets/4246/YEKUN\\_STATISTIK\\_BULLETEN\\_ENG\\_2016\\_OKTYABR.pdf](https://en.cbar.az/assets/4246/YEKUN_STATISTIK_BULLETEN_ENG_2016_OKTYABR.pdf)

The Central Bank of the Republic of Azerbaijan, Statistical Bulletin 09/2017  
[https://en.cbar.az/assets/4429/STATISTICAL\\_BULLETIN\\_2017\\_SEPTEMBER\\_V3.pdf](https://en.cbar.az/assets/4429/STATISTICAL_BULLETIN_2017_SEPTEMBER_V3.pdf)

<sup>35</sup> The State Oil Fund of the Republic of Azerbaijan, 2016 Annual Report, 33  
[http://www.oilfund.az/uploads/Annual\\_Report\\_2016\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2016_ENG.pdf)

**Figure 10. The dynamics of SOFAZ revenues (USD billion) and oil prices (USD) during the years 2010-2017(QI-QIII)**

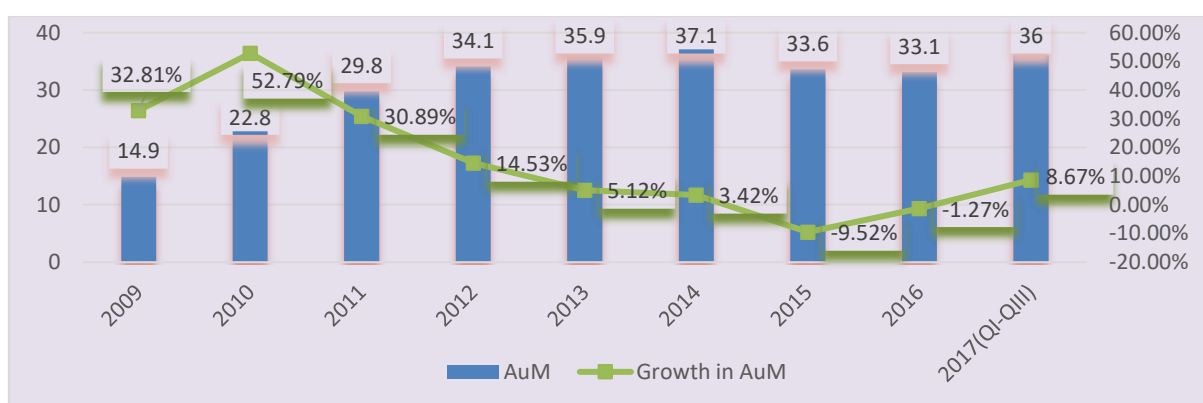


**Source: The State Oil Fund of the Republic of Azerbaijan, 2016 and 2017**

In the first three quarters of 2017, SOFAZ budget revenues were 8.793 billion manat, of which 7.958 million manat were gained from the sale of hydrocarbons and 816.7 million manat from asset management.<sup>36</sup>

According to figure 11, the value of SOFAZ's assets followed a decreasing trend during the years 2014-2016. In 2014, SOFAZ's assets stood at USD 37.1 billion, decreasing 9.52% in the next year and a further 1.27% in 2016. In the end of the third quarter of 2017, SOFAZ assets equaled USD 36.02 billion, an 8.67% increase from the beginning of the year. The main reasons for this increase were the growth of SOFAZ's budget revenues, assets management and investment exchange rate effect.<sup>37</sup>

**Figure 11. The growth of SOFAZ assets during the period 2009-2017(QI-QIII), USD billion<sup>38</sup>**



**Source: The State Oil Fund of the Republic of Azerbaijan, 2016 and 2017**

<sup>36</sup> The State Oil Fund of the Republic of Azerbaijan, Quarterly Statements (III), SOFAZ revenue and expenditure Statement for January-September 2017 [http://www.oilfund.az/index.php?page=hesabat-arxivi&hl=en\\_US](http://www.oilfund.az/index.php?page=hesabat-arxivi&hl=en_US)

<sup>37</sup> Ibid.

<sup>38</sup> The State Oil Fund of the Republic of Azerbaijan, 2016 Annual Report, 8 [http://www.oilfund.az/uploads/Annual\\_Report\\_2016\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2016_ENG.pdf)

The State Oil Fund of the Republic of Azerbaijan, Quarterly Statements (III), SOFAZ revenue and expenditure Statement for January-September 2017 [http://www.oilfund.az/index.php?page=hesabat-arxivi&hl=en\\_US](http://www.oilfund.az/index.php?page=hesabat-arxivi&hl=en_US)



## SOFAZ transfers to the state budget

Every year starting from the year 2003, SOFAZ has had the liability to transfer a predefined amount of money to the state budget. Throughout the period 2003-2016, SOFAZ transferred 71.5 billion manat to the state budget. During the years 2001-2016, 89.9% of the budget expenses of SOFAZ fell to the share of budget transfers. SOFAZ's policy of cutting the amount of transfers to the state budget is continuing in recent years, due to continuously low oil prices.<sup>39</sup>

**Figure 12. Transfers by the SOFAZ to the state budget by years, million manat**



Source: *The State Oil Fund of the Republic of Azerbaijan, 2016 and 2017*

In 2016, SOFAZ was accountable for transferring 7.615 billion manat to the state budget, which was 6.3%, or 515 million manat, less than the previous year.<sup>40</sup> In 2017, this liability was 6.1 billion manat.<sup>41</sup> During the period January-September of the current year, SOFAZ transferred 4.3 billion manat to the state budget.<sup>42</sup>

## 2.6. Forecasts for the price of oil and the rate of the manat

The future of the exchange rate of the manat is mainly dependent on the price of oil. For the years 2016 and 2017, no substantial rise in oil prices was observed; however, there was a gradual rise starting from June of 2017.

<sup>39</sup> The State Oil Fund of the Republic of Azerbaijan, 2016 Annual Report, 39  
[http://www.oilfund.az/uploads/Annual\\_Report\\_2016\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2016_ENG.pdf)

<sup>40</sup> The Finance Ministry of the Republic of Azerbaijan, "On the amendments to the 2016 state budget of the Republic of Azerbaijan", 23.02.2016 <http://www.maliyye.gov.az/sites/default/files/qanun%20budca.pdf>

<sup>41</sup> The Ministry of Finance of the Republic of Azerbaijan, "Law on the state budget of the Republic of Azerbaijan for 2017", 16.12.2016 [http://www.maliyye.gov.az/sites/default/files/State%20budget\\_2017.doc](http://www.maliyye.gov.az/sites/default/files/State%20budget_2017.doc)

<sup>42</sup> The State Oil Fund of the Republic of Azerbaijan, Quarterly Statements (III), SOFAZ revenue and expenditure Statement for January-September 2017 [http://www.oilfund.az/index.php?page=hesabat-arxivi&hl=en\\_US](http://www.oilfund.az/index.php?page=hesabat-arxivi&hl=en_US)

For 2017, Goldman Sachs predicted Brent oil prices at USD 59/bbl, if the OPEC agreement held. According to the International Monetary Fund's (IMF) and the World Bank's forecasts, oil prices per barrel would be USD 52 and USD 55, respectively. The International Energy Agency's projected fluctuations between USD 55-61 per barrel. However, there can be numerous risks which affect the price of oil, such as disputes over OPEC decisions on the extension of existing cuts of oil production,<sup>43</sup> ongoing decreases of Chinese demand, and USD appreciation, as well as the rising disputes between the members of OPEC.<sup>44</sup>

According to the projections made by the IMF, the average price of Brent crude oil for the year 2017 will be 50,2 USD per barrel and in the following two years the price is expected to rise to USD 50.1/bbl and a further USD 51.9 /bbl. For 2020, the forecasted figure is 53.5 USD per barrel.<sup>45</sup> These predictions, however, are subject to change based on the factors referred to above.

The exchange rate of the manat has also been predicted by many agencies. One such agency, Fitch, which is a well-known rating agency based in the UK and USA, estimated the USD/manat exchange rate to be between 1.55-1.7 throughout the years 2016-2018, meaning the manat will be stable until 2018.<sup>46</sup> Nonetheless, many factors can affect the rate of the manat, thereby changing these predictions.

### 3. Conclusion

Since 2014, sharply falling oil prices in the world market affected many economies and Azerbaijan was not excluded. As a result, the national currency of the country, the manat, depreciated against the dollar, leading to a huge loss in value. This process happened because the main revenues of Azerbaijan are earned from the sale of oil and gas; thereby, a decline in the price of oil caused a deficit in the balance of payments of the country, bringing the manat's rate down. In fact, the vulnerability of the Azerbaijani economy to external shocks, such a fall in oil prices, emphasized the economic diversification problems of the country, the so-called "resource curse".

During the period of 2014-2017, the manat saw two sharp depreciations, first in February and later in December 2015. Since it is a long-term process, the rapid fall of oil prices in 2014 didn't precipitate serious consequences until 2015, when it inversely affected the exchange rate of the manat and brought instability until 2017. Consequently, agencies such as CBAR and SOFAZ engaged in currency auctions and other policy measures in order to remedy the challenging situation, stabilizing the manat as well as bringing back its credibility this year.

The year 2017 is remarkable for the stabilization of the manat's rate. Although the currency has shifted to a floating exchange rate, authorities still hold power to regulate the currency market via SOFAZ, which exercises a monopoly over the market. The implementation of the liberal exchange rate brought back the

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<sup>43</sup> Ernest Scheyder, Ahmad Ghaddar and Vladimir Soldatkin, "UPDATE 6-OPEC, Russia head for oil cut extension but wary of overheating market", *CNBC*, 29.11.2017 <https://www.cnbc.com/2017/11/29/reuters-america-update-6-opec-russia-head-for-oil-cut-extension-but-wary-of-overheating-market.html>

<sup>44</sup> The State Oil Fund of the Republic of Azerbaijan, 2016 Annual Report, 35 [http://www.oilfund.az/uploads/Annual\\_Report\\_2016\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2016_ENG.pdf)

<sup>45</sup> "Crude Oil Price Forecast: 2017, 2018 and Long Term to 2030", IMF Brent Crude Oil Projections <https://knoema.ru/yxtpab/crude-oil-price-forecast-2017-2018-and-long-term-to-2030>

<sup>46</sup> APA, "Fitch announces forecasts on manat rate by 2018", 07.12.2016 <http://en.apa.az/azerbaijan-economy/finance-news/fitch-announces-forecasts-on-manat-rate-by-2018.html>

manat's stability, although it has not found its real value yet. Limited currency reserves of CBAR are also problematic for the manat's rate, while they contribute to the high volatility of the manat.

The root causes of the vulnerability of Azerbaijan's economy to fluctuating oil prices should be addressed. Firstly, diversifying the economy should be a main priority in order to prevent further over-dependence on oil revenues. This goal can be achieved through the creation of effective management systems, the application of relevant legislation, the development of human capital, the facilitation of access to finance for enterprises of non-resources sectors, and the stimulation of investment in tradable, non-oil sectors.

According to several international agencies, forecasts for oil prices during the next three years are around USD 50-53/bbl, which indicates that there will not be any significant decreases in oil prices. Despite those projections, oil prices are subject to change based on several factors such as declining demand for oil, implementation of OPEC's decisions and controversies among its member states, etc. Therefore, it is difficult to predict the long-term rate of the Azerbaijani manat; however, there is a possibility of further depreciation in the short-term period, as the manat finds its real market value.

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