Assessment on Real Effective Exchange Rate in
Azerbaijan: 2017 Outlook

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Introduction
The implementation of fixed exchange rate regime for 20 years (1994-2014) resulted in a formation of an insecure currency position for all interest groups, including the government and business. Although the pressures on manat have commenced to increase since the second half of 2014, the Central Bank and the government failed in comprehending the process. That is why, promising statements have been made to the general public. But the following events proved the underlying problem more severe and the implemented monetary, fiscal and exchange rate policies ineffective in the long-term. Business, citizens, as well as state-owned enterprises faced serious financial losses. The country experienced serious threats with regard to its financial sustainability.

The Central Bank promised that “stable exchange rate of manat is going to be among the important priorities” in its statement on the major directions of monetary and financial stability policies in 2015, nonetheless, only after two months a decision about the devaluation amounted to 25.7% of national currency has been adopted. The next devaluation of 32.3% on December 21, 2015 made manat the worst performing currency of the year. Thus, manat lost its value by 49.6%.

All interest groups are now seeking answers to their questions such as until when manat is going to depreciate, what to expect from the monetary policy of the Central Bank, what to expect from the liberal exchange rate regime. This report will try to provide answers to the aforementioned questions in the following chapters.

The performance of manat during the recent period
Manat has lost its value seriously on the background of slumping oil prices since the second half of 2014. That is to say, during February-December 2015, two sharp devaluations have been implemented and as a result manat lost its value by 49.6% during the year. As mentioned above,

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this happened during the year the Central Bank promised stable exchange rate regime and therefore, the Bank lost its credibility abruptly at financial markets. Thus, the agency responsible for monetary and exchange rate policies lost its ability to influence to financial markets due to poor communication skills.

Nevertheless, the process does not end here. Despite the Central Bank switched to a managed floating exchange rate regime with a statement made on December 21, 2015, huge administrative interventions still continued. Persistent low oil prices resulted in aggravation of the impact on monetary, fiscal and exchange rate policies of the government. Note that, since the first days of December, 2016, the next tension is being observed in the currency markets. Restrained currency access caused the national currency lost its value by 10.7% officially and 18% in real terms [see: graph 1]. With the strengthening of measures against illegal currency markets during the same period, the access level to currency subsided to minimum. In parallel, the exchange rate in this market increased and margin went up sharply.

**Graph 1: USD/ Manat**

![Graph 1: USD/ Manat](image)

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

As can be observed from the Graph 1, manat demonstrated appreciation during the first 4 months of 2016 and depreciation during the rest 8 months of the year. Thus, there have been 5 important turning points in the currency markets. The trend observed in the currency markets is characterised with its rigidity and led currency market participants to opt for a one-sided position—either “buy” or “sell”. Consequently, the impact of psychological factors has been felt relatively more during the year.
It should be noted that, the depreciation observed in the exchange rate of manat since the end of May, has intensified at the beginning of September. Subsequently, demand exceeded supply by 12-14 times in currency auctions organized by the Central Bank. At the same time, banks were setting exchange rates of foreign currency higher than auction prices, restraints were applied to the currency sale and the following suspension of the currency sale led to the revival of illegal currency market, making the actual USD/manat exchange rate around 1.85-1.95. Note that, it was the second time in 2016, manat hit this level (the first was observed in January, 2016).

On September 8, 2016 the State Oil Fund (200 million USD) and the Central Bank (100 million USD) together allocated 300 million USD for the currency auction, as a result, the tension in the currency markets subsided for the short-term period. After 6 days following the first sharp intervention, 78 million USD out of 150 million USD has been sold, which indicate vital role of psychological factors in the currency markets. It should be noted that, this factor was also responsible during the subsequent two auctions by decreasing demand. That is to say, banks purchased 72.4 million USD in the auction held on September 20 and 61.4 million USD on September 22. Aforementioned factor (predictability of exchange rate dynamics in the short-term) played an essential role in sharply reducing demand for currency. In parallel, this situation can be considered a sign of sensitivity of currency markets to the official position.

It should be noted that, the re-appreciation of manat and the interest rate of 12-15% in auction held to attract manat denominated deposits by the Central Bank brought about sharply increased demand in this regard. Consequently, the Central Bank was able to attract 50 million manat deposits as announced on September 15, 2016. This, in turn, serves the purpose of removing manat from circulation and limiting demand for foreign currency.

September intervention also demonstrated the tightening level of the currency markets. That is to say, in September State Oil Fund and the Central Bank sold respectively 631.1 million USD and 100 USD, a total of 731.1 million USD, which is only 286.7 million USD higher compared with August. In other words, the gap between demand and supply accumulated during June-August was compensated with 286.7 million USD. This is characterised with a serious decrease in the volume of currency markets compared to the first quarter of 2015 and 2016. The underlying reasons include rapid dollarization process and the tight monetary and credit policies.
of the Central Bank. The appreciation trend observed in the exchange rate of manat continued until the second half of October.

Starting from October 18, 2016, manat again demonstrates a depreciating trend. This depreciation commences with the impact of political factors. That is to say, the referendum on the amendment of constitution held in September, 2016 and the conclusion about not holding new election in the middle of October forced the Central Bank and the government to reconsider the exchange rate policy. Thus, the last depreciation rally of manat in 2016 started. This process continued until the end of the year and the national currency lost its value by 12%.

Internal and external factors affecting to the exchange rate of manat during 2016

Global economic factors

First of all, it should be stated that, 2016 is characterised by higher volatility in world financial and goods markets. These factors include: failure to realise global economic growth expectations; BREXIT, which is considered a threat to the expansion of the EU and its future, as well as depreciation of both euro and pound sterling; despite tight monetary policy by the FED, USD appreciation did not meet expectations regarding to appreciation in the first half of the year; disagreements among the oil producers, in parallel with hesitation concerning energy forecasts led to enlarged fluctuation level in goods market; the sharp appreciation of the Japanese yen during the first three quarters of the year; the unexpected results of the US presidential election and the business sector being sceptical about the economic viewpoints of the new president; the agreement of the OPEC and non-OPEC members about reducing production; increased interest rate by FED.

Note that, other factors such as coup attempt in Turkey in 2016, the deterioration of Turkey-Russia relations and the following economic and political reconciliation, the uplifting of embargo on Iran and its accelerating economic growth also affected the economic indicators of the region.

The price of oil – has considerably more impact on the economy of Azerbaijan and the exchange rate of manat compared with aforementioned factors. That is to say, since the predominate portion of foreign currency reserves of the country is formed by oil exports, a decrease in the price of oil leads to lower currency inflows and negatively affects the position of
manat in the BOP. It should be noted that, in 2016 the price of oil decreased to 1 Barrel=26 USD, the lowest level during the last decade.

**Figure 1: Price dynamics of a barrel of oil**


*Source: NASDAQ*

As can be observed, the oil price dynamics has demonstrated considerably sharp fluctuations in 2016. While during the first days of the year the price of oil declined to 26 USD, it hit over 50 USD during the last months of the year. In general, lower demand due to weakening economic growth rate and on the other hand, higher supply brought about, on average, 16% decline in oil prices compared with 2015. The decreasing oil prices, which are considered a major element for exports, formed negative global conditions for manat. Consequently, the annual deficit of BOP increased to 5 billion USD. The Vienna agreement reached in November among OPEC and non-OPEC members following the long-term discussions, enabled to address supply-demand imbalance. Currently, the oil price is likely to stabilize around 1 barrel=55 USD, which is 37.5%.

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2 NASDAQ, Latest Price & Chart for Crude Oil Brent, 13.01.2017

higher than the price (1 barrel=40 USD) 4 considered in consolidated state budget. Taking into account this specific factor, it should be noted that, the tendency of oil price in global markets will increase manoeuvre potential for monetary and exchange rate policies of government.

Internal economic factors

The monetary policy of Central Bank

The statements of “Central Bank, in collaboration with the government, will work to balance the currency market and smooth the currency XXX in 2016” and “the currency level of manat will be shaped by fundamental factors that form the demand and supply in the currency market (thus, under floating regime)” released in 2016 on monetary and financial stability policy report of Central Bank indicated that the situation is not under full control. That is, the Central Bank could not send unambiguous message to currency markets and signalled that any step taken will largely be resulted from desperation. Indeed, the currency markets experienced a range of administrative interventions over financial year. First of all, the principle of limited manat supply was maintained [see: graph 2].

Graph 2: The dynamics of monetary base (millions of manat)

Source: Central Bank of Azerbaijan Republic, 2017

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Although the monetary base has increased by 13.9% in relation 2015, it is 31.8% (3.68 billion manat) less in comparison with respective date of 2014. Limited manat supply may act as one of the factors reducing the pressure in currency markets, but it has an adverse effect on economic activity too. Consequently, the disinterested attitude of banks towards issuing credits in manat and the austerity measures adopted in budget expenditures can be interpreted as the outcomes of strict fiscal policy pursued by Central Bank. As of November 2016, the credit investments had decreased by 25.1% (16.27 billion manat) in comparison to the last period of 2015.5

The significant increase of interest rate
Parallel to other activities, the Central Bank also pursues the policy of preventing the depreciation of the value of manat by raising interest rate. As a result, the participants of financial markets ended up the year of 2016 at 15% interest rate, despite the fact that it stood at 3% in the beginning of the year. In other words, interest rate was increased by 5 times during financial year.

Graph 3: The dynamics of interest rate

Source: Central Bank of Azerbaijan Republic, 2017

As seen on Graph 3, the first rise of interest rate took place in February 2016. The decision of the bank was expressed in the statement of “To increase the confidence in national currency, to incentivise the growth of manat deposits, as well as to create suitable conditions for the

sophistication of fiscal policy tools in line with the conjuncture formed in currency markets, the Executive Board of Central Bank has decided to set interest at 5%, the lower band of the interest rate corridor on liquidity transactions at 2%, the higher band at 10%\textsuperscript{6}. With the next rise in interest rate that took place in the early phase of March, the rate stood at 7%, which played an important role in strengthening manat in between March and May. However, the national currency started to experience gradual devaluation since May 2016, which created panic among public from August onwards, being the second panic moment after January 2016. One of the main causes of panic was the observation of exchange rate of 1 USD = 1.9 manat in black market. Subsequently, the Central Bank decided to raise interest rate by another 2.5%. The last decision to raise interest rate in 2016 took place on the 14th of September in 2016. Largely under political influences and motivated by the need of strengthening manat, the government decided to offer currencies at total value of $300 million (6 times higher than usual amount) to currency auctions on the 8th of September. This act was successful in meeting the needs of markets in short-term. Few days later, interest rate was raised by another 5.5% (leading to 15%\textsuperscript{7}), which was further support to national currency.

Deposit auctions of Central Bank in manats

One of the objectives in raising interest rate was to increase the rates applied to deposits and bonds in manats, and to enhance confidence in national currency. Simultaneously, the conditions and terms applied to deposits and bonds in manat were softened. It is worth noting that it was on 13th of June 2016 when the Central Bank decided to hold first auction\textsuperscript{8}.

\textbf{Figure 2: The announcement on deposit auction}

\textsuperscript{6} Central Bank of the Republic of Azerbaijan, “About the parameters of interest rates”, 15.02.2015
\url{http://www.cbar.az/releases/2016/02/15/on-parameters-of-interest-rate-corridor/}

\textsuperscript{7} Central Bank of the Republic of Azerbaijan, “Interest rates”, 17.01.2017
\url{http://www.cbar.az/infoblocks/corridor_percent}

\url{http://www.cbar.az/releases/2016/06/13/on-cba-deposit-auction-to-raise-funds/}
Deposit auctions are held to attract deposits in manat. Thus, the Central Bank has these following objectives to achieve through deposit auctions:

i) to reduce the volume of manat in circulation

ii) to increase the confidence in manat by ensuring the profitability of manat

iii) to regain the control over deposits withdrawn from banks due to decreased confidence in the banking sector

The dynamics of deposit auctions held over last 6 months show that although attracting deposits in manat did create positive impacts, it also caused many credit organisations to deposit financial resources into banks, which led to the reduction of interest in issuing credits. The factor that caused the banks to act in this manner was the instability and uneasiness observed in credit market and the recession in real sector. That is, banks decided to deposit its manat resources in the Central Bank whereby there was lower risk and return. In total, the Central Bank held 26 deposit auctions in 2016.

About currency exchange
Due to the decision taken on 21st December in 2015 that caused second devaluation, the volatility level increased to maximum level in the early days of 2016. Especially important to note is the tendency that on the days when the Central Bank (the only supplier of currency in markets) did not work, the accessibility of currencies worsened due to objective and subjective reasons. Exchange bureaus, in their turn, adopted as high profit margins as possible.

As a result, psychological concerns were intensifying. In order to strengthen control mechanisms over currency, the Central Bank took the decision to make amendments to “The Rules on organisation of exchange bureaus and the conduct of exchange operations”, which resulted in the revocation of licences of bureaus and reduction of upper limit for currency exchange without identification document by 10 times to 500 USD. Two days later, the limits for currency exchange for commercial banks were set at +/- 4%. The objective was to regain control over manat via administrative methods.

The closure of exchange bureaus and the adoption of +/- 4% profit margin quickly led to the emergence of “black market”. Although the actors involved in black market were largely small physical and legal entities, with the entry of much larger banks and other actors, an organised system emerged there eventually. Effectively, the currencies obtained by commercial banks from auctions held by Central Bank and via other means were diverted into black market. As a result, the accessibility of foreign currencies became increasingly difficult, and both ordinary citizens and businesses had to resort to black market to meet their currency needs. The black market became so “lucrative” that the banks ceased selling currencies by citing numerous excuses. The reason of the continuous growth of black market was the high demand for foreign currencies, which indicated that the real currency level is higher than official exchange rate. It was also an indication of the mismatch between +/- 4 profit margin set by Central Bank and real market conjuncture. However, the government decided to launch a fight against black market in December 2016.

Balance of payments

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http://www.cbar.az/assets/2035/mubadiil%C9%991.pdf
According to Central Bank, the forecast as to the deficit in balance of payments is $5 billion in 2016, which is 56% lower than the figure for 2015, but two times higher than the figure for 2014. In numbers, the figure for 2015 stood at -$11.3 billion, whereas it was +$4.2 billion in 2014.

Diagram 1: The balance of payments (BOP) of Azerbaijan Republic, million USD

Source: Central Bank of Azerbaijan Republic. 17.01.2017

As shown by Diagram 1, the significant deficit in BOP started to emerge from the last quarter of 2014 onwards – the time when the price of oil began to cheapen in world markets. The deficit rose to its maximum level in 2015, as a result of which the Central Bank had to adopt harsh devaluation policies – leading to the devaluation of manat by 49.6% in 2015.

In comparison to 2015, the dynamics of BOP in 2016 turned out to be more acceptable for Azerbaijan. Thus, despite the deficit at the value of $1.3 was recorded in the first quarter of 2016, there has been a more balanced dynamics. In fact, there eventually was registered a surplus. In general, the recent two years can be interpreted as the period of adaptation of national economy to new trends.

It is important to note that one of the important components of BOP – trade balance has experienced significant changes over recent years. Foreign trade balance, chiefly due to the reduction in oil prices, has seen 50% decline in comparison to the period of high oil prices. Despite the measures (the stimulation of non-oil sector goods, the support to areas that have potential for export and the imposition of limits to import of goods purchased by the state) adopted by the
government and the deterioration of purchasing power of local people, the reduction in foreign trade balance recorded further downfalls [see: diagram 2].

Diagram 2: The dynamics of foreign trade balance, in USD millions

Source: Central Bank of Azerbaijan Republic, 17.01.2017

As seen in the diagram, foreign trade balance has declined by 69,3% in between 2014 and 2015. The forecast is that there will be further decline in 2016. However, the figure for foreign trade balance does not correspond with other parameters of BOP. That is, for example, the deficit in the service balances of Azerbaijan Republic decreases at much slower rate. As of now, the major obstacle to reducing the deficit in service balances stems from oil sector. In terms of the composition of the deficit in service balance as to the first 9 months of 2016, 86% ($1,96 billion out of $2,27 billions) falls to the share of oil sector. In the non-oil sector, the overall trend is one of increasing regulation and control, as well as government attention paid to this sector. Although the main reason of this trend is the weakening purchasing power of private sector, government and ordinary citizens, the improvement in tourism sector has also played its role in this respect. As a result, for the first time in 2016, the profit in service balances ($71 million) was recorded in the 3rd quarter. To put it into prospect, this figure stood at $1,7 billion and $1,2 billion (both were deficit) in 2014 and 2015 respectively.11

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Diagram 3: Services balance, in USD millions

<table>
<thead>
<tr>
<th>Year</th>
<th>I quarter</th>
<th>II quarter</th>
<th>III quarter</th>
<th>IV quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>-1,443</td>
<td>-1,595</td>
<td>-1,698</td>
<td>-1,831</td>
</tr>
<tr>
<td>2015</td>
<td>-1,377</td>
<td>-1,270</td>
<td>-1,030</td>
<td>-1,270</td>
</tr>
<tr>
<td>2016</td>
<td>-1,069</td>
<td>-1,097</td>
<td>-1,155</td>
<td></td>
</tr>
</tbody>
</table>

2014, services balance -6089.6
2015, services balance -4228.8
9 months of 2016, services balance -2271

Source: Central Bank of Azerbaijan Republic, 17.01.2017

As seen in diagram 3, despite the reduction in deficit in services balance in nominal terms, this area still remains as the main channel through which currency flows out of country. In the 9 months of 2016, the deficit of $2,3 billion has emerged in services balance, which is 32% and 51% lower in comparison to the figure from 2014 and 2015 respectively.

One of the important aspects to consider in the area of regulating currency balance in Azerbaijan is the changing dynamics observed in investments. In the time of decreasing oil revenues, the amount investments into and out of Azerbaijan plays an increasingly influential role on the exchange rate of national currency.

Diagram 4: The dynamics of FDI, in USD millions

http://www.cbar.az/assets/4056/BULLETEN-01-2016_AZERI_OK_.pdf
Another factor acting as a pressure on balance of payments is the increasing amount of investments made into foreign countries by people and entities in Azerbaijan. Thus, while this figure stood at $2.2 billion in 2014, it grew up to $3.3 billion by 2015. As of the first 9 months of 2016, the amount of investments made into foreign countries was $2.1 billion. However, parallel to that outflow, FDI into Azerbaijan has dropped, with being $5.4 billion in the first 9 months of 2016. The amount was, however, $5.7 billion and $5.8 billion in 2015 and 2014 respectively.

Supply in currency markets

The Central Bank ceased interventions

Just as it was the case in previous years, Central Bank and State Oil Fund were the major providers of currency to the currency markets in 2016. Through the currency auctions held by the Central Bank, state sector maintained its dominant position as the supplier of currency. Although the Central Bank took some active interventional operations in the first 2 months of 2016, it eventually started to minimize its role in this respect [see: diagram 5]. The main reason for such a change in interventional behaviour was the depletion of currency reserves of the Central Bank – down to $4

Source: Central Bank of Azerbaijan Republic, 17.01.2017
billion\textsuperscript{12}. The consequential situation intensified psychological effects on the level of national currency. State Oil Fund, on the other hand, continued conversion process over year.

**State Oil Fund’s assets in manat**
Throughout 2016, State Oil Fund sold $4.88 billion ($407 million on average per month), the currencies which acted as the major source of country’s foreign currency source. The amount sold, however, is 37.5\% smaller than for respective figure of 2015.\textsuperscript{13} The maximum amount of conversion conducted by State Oil Fund throughout its history was recorded in 2013 (3 times higher than 2016).

The conversion process has been conducted for the State Oil Fund to meet its liabilities in manat and providing further support to maintaining balance in currency markets.

**Diagram 5: The dynamics of currency supply, in US million**

\begin{center}
\includegraphics[width=\textwidth]{Diagram5.png}
\end{center}

*Source: Central Bank of Azerbaijan Republic, prepared by the author on the basis of the data by State Oil Fund*

http://www.cbar.az/infoblocks money_reserves_usd

http://www.cbar.az/assets/4254/2017-BEYANAT_-SON.pdf
The maximum amount of conversion conducted by State Oil Fund throughout 2016 was recorded in September ($631.1 million), whereas the minimum amount was $177.5 million. Generally, the maximum and minimum amount of currency sold in the auctions throughout 2016 by State Oil Fund and Central Bank was $911.8 million and $246 million respectively.

Although State Oil Fund had the liability of transferring 7,615 billion manat to the state budget in 2016, the amount of funds transferred to the budget as of the first 9 months of 2016 stood at 3,26 billion manats, meaning that the liability has not been paid to its fullest extent. To the question placed to State Oil Fund by Center for Economic and Social Development, the following reply has been provided: “For the Fund to pay its liabilities in a timely manner the existence of sufficient manat reserves is a prerequisite. In terms of the transfers to the state budget, they are paid upon the request of the Ministry of Finance. If requested to State Oil Fund, the full amount of transfer will be realised”. In other words, the absence of request by the Ministry of Finance for transfer by State Oil Fund has been the chief reason behind the non-fulfilment of the aforementioned liability. As of the end of 2016 financial year, State Oil Fund has deposited its manat reserves in Central Bank at the annual interest rate of 4.99%.

Alongside participating in currency auctions for the first time in its history, State Oil Fund deposited $1 billion in its account at International Bank of Azerbaijan at the interest rate of 4% for 12 months. The main objective of this act was to reduce volatility in financial markets and play a certain role in meeting the currency demands of private sector.

The reduction in the sale of currencies in cash

The volume of sale of currencies in cash has gone down significantly in 2016 [see; diagram 6]. As the chief reasons of the decrease in consumption levels, weakened level of confidence in manat and uncertainty regarding future economic circumstances decline are shown. Despite the limited participation of Central Bank and State Oil Fund in currency markets, the decline in sale of currencies in cash was not prevented.

Diagram 6: The sale dynamic of USD in exchange operations carried out in cash

Source: Central Bank of Azerbaijan Republic, 2017

As seen from the graph, the sale of USD in cash in exchange operations was down by 56.3% ($221.3 million) in November in comparison to January figure, ending up in $171.6 millions. In general, in the first 11 months of 2016 the total volume of exchange operations in USD amounted to $2.9 billion, which is 64% and 73.4% lower than it was in 2014 and 2015 respectively. This situation has two adverse consequences; 1) it increases the uneasiness and uncertainty among the participants of currency markets, and 2) it maintains pressure on floating level of manat.

The foreign liabilities of commercial banks is rapidly growing

One of the reasons behind the reduction in the volume of sales of currencies in cash throughout 2016 has been the steady growth of liabilities (observed since May 2016, see: diagram 7) commercial banks have against foreign financial institutions. That is, at the period when commercial banks saw 5.1 billion manat reduction in their foreign assets, their foreign liabilities increased by 0.3 billion manat. As a result, while the volume of assets was 2 billion manat higher
than their foreign liabilities in April 2016, the situation changed dramatically by November, with foreign liabilities being 3.7 billion manats higher than the value of assets.

**Diagram 7: The net foreign liabilities of commercial banks, in Manat millions**

![Diagram showing net foreign liabilities of commercial banks, in Manat millions]

*Source: Central Bank of Azerbaijan Republic, 2017*

As seen from the graph, the volume of foreign liabilities held by commercial banks has registered steady increase in 7 consecutive months, which in its turn, raises costs associated with liability-repayment services and increases banks’ demand for foreign currency.

**The performance of Azerbaijani Manat in comparison with other oil-rich countries**

Similar to Azerbaijan, many oil exporters have experienced macroeconomic volatility and deterioration of major economic indicators due to plummeting oil prices. Fall in oil prices have reduced foreign exchange inflow to these countries and increased pressures on their currencies.

**Figure 4: Performance of some oil exporter currencies**
As the biggest oil producer, Saudi Arabia has experienced a serious decrease in revenues. Nevertheless, the country hasn’t allowed the devaluation of its currency and the population is largely unaffected by the developments in oil market. Foreign exchange reserves of the country allow a long-term intervention in Saudi riyal market.

Unlike other oil producers, Russian ruble has experienced a pressure from two different fronts. Annexation of Crimea by Russia in the beginning of 2014 resulted in international sanctions on Russian economy and outflow of foreign investments. Oil price decline in the second part of the year, on the other hand, caused a significant decline in foreign exchange revenues of the country and rapid devaluation of the ruble, which led to transition to floating exchange rate regime.

**Figure 5. Russian ruble**
As is seen from the figure, Ruble lost 41.9% and 22.8% of its value in 2014 and 2015 respectively. However, it began to appreciate in 2016. So that, ruble hit its historic minimum (1 USD=83.6 RUB\(^\text{18}\)) at the beginning of 2016, as the oil prices were at record low of 26.3 USD/barrel, but it appreciated by 16% during 2016. It should be noted, that as of now the value of ruble is determined in the market by demand and supply. Ruble has depreciated by 45% since 2014.

Kazakh tenge, the currency of the country with economic structure similar to Azerbaijan, had responded to oil price decline more rapidly than manat. Kazakhstan adopted floating exchange rate regime in August of 2015. Continuing decline in oil prices and psychological effect of transition to floating regime resulted in depreciation of tenge down to 1 USD=384.81 KZT level in January 2016. Later, with the help of monetary policy decisions of central bank, relative rise in oil prices, development of liberal investment environment for foreign investments tenge started to appreciate. Thus, after its record minimum, tenge has appreciated by 13% in 2016 and 2% relative to the end of 2015. Tenge has depreciated by 43.4% during this period.

Norway, as an oil producer, has also experienced a depreciation of krone. In a 17 month period from May of 2014 to January of 2016 krone has depreciated by 33.4%. However, upward trend in oil prices led to a 5.3% appreciation to krone. As a result, overall depreciation of krone this period have been 29.7%.

https://www.cbr.ru/eng/currency_base/dynamics.aspx?VAL_NM_RQ=R01235&date_req1=01.01.2014&date_req2=21.01.2017&rt=1&mode=1
93% of exports of Azerbaijan are comprised of oil, gas and oil products, thus Azerbaijan was forced to devalue manat five months after the start of oil price decline, by 25.7% in February of 2015, then by 32.2% in December of 2015, resulting in overall 49.6% depreciation. As a result, manat was the worst performer in the world in 2015. Furthermore, manat couldn’t hold its value in 2016 either. The depreciation by the end of 2016 have been 12.2%, thus raising overall loss to 57%.

As seen from statistical analysis of currencies of four abovementioned countries, manat was the least resilient among them.

Figure 6: Trend comparisons of currencies


As seen from the figure, upward trend in oil prices resulted in a more optimistic outlook in currency markets of Russia, Norway and Kazakhstan. As a result, Norwegian krone, Russian ruble and Kazakh tenge have depreciated by 5.3%, 16%, and 2% respectively. While Azerbaijani manat is still depreciating and the lowest point was reached on the last day of 2016 (1.7707). Moreover, manat is the most depreciated currency among the ones discussed here.

2017, the exchange rate of manat

The expression about switch to a freely floating exchange rate regime in “The Strategic Roadmap of the Republic of Azerbaijan on national economy perspectives” increased the

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Concerns of the general public, as well as currency market participants. That is to say, taking into account that, manat has not found its real value and demand for foreign currency overwhelmingly exceeds supply, it is hard to predict the outcomes of a switch to a freely floating exchange rate regime.

It should be noted that, in parallel, the government started to fight against illegal currency circulation, which further reduced the access to currency. This, in turn, ignited concerns of market participants, especially of businesses. What is more, currency supply reduced to minimum level in December, 2016 [246 million USD, State Oil Fund]. The statement about major directions of monetary and financial stability by the Central Bank made on the last working day of the year, once again confirmed the expectations about the switch to a freely floating exchange rate regime, and thereby, conclusions about 2017 being a difficult year for manat.

Taking into consideration the limited currency reserves of the Central Bank, the decrease in the volume of transfers from the State Oil Fund under the 2017 state budget, the statement by the FES on tight monetary policy for upcoming years, in currency markets, manat could only be supported by the Vienna agreement among OPEC and non-OPEC members on the regulation of oil production. Even a group of market participants switched to “sell” position, after the price of a barrel of oil exceeded 55 USD. Despite all these, currency market anxiety continued and manat depreciated day by day, as a result of currency auctions held by the Central Bank. It is not surprising that, the lowest exchange rate for manat was on the last day of the year [1 USD = 1.7707 manat]. In general, during the last days of December the access to currency fell to the minimum and, as a result, the exchange rate in black market was 1 USD = 1.95 manat. It should be noted that, the experts of the Center for Economic and Social Development (CESD) predicted the exchange rate to be 1 USD=1.93 manat. Thus, the Azerbaijani manat entered 2017 under the impact of aforementioned factors.

During the first days of 2017, the uncertainty continued. In fact, citizens of the country were unable to obtain currency to meet their basic needs (trip, education, healthcare and etc.), as banks were only conducting “purchase” exchanges and applied restrictions on currency sales.
Starting from the first days of January, the government commenced the implementation of exchange rate plan. The Decree of the Republic of Azerbaijan on January 10, 2017 on “the Budget of the State Oil Fund of the Republic of Azerbaijan” was the first important information for currency markets. That is to say, based on the Decree, for the first time, a transfer amounted to 7.5 manats [4.2 billion USD] is to be made to the Central Bank. The participants of currency market comprehended it as changes in current conditions, or “currency supply will increase during the year». During the urgent meeting held on January 11, 2017, bankers were informed to abandon a margin of +/- 4%.

Beginning from January 12, 2017, currency auctions were implemented based on new rules and during exchanges the requirement of a margin of +/- 4% was eliminated. It should be noted that, during the switch to a freely floating exchange rate regime, communication opportunities were used skilfully. News about the switch to a freely floating exchange rate regime led to considerably lower volatility in currency markets than expected.

**Figure 6: The performance of manat in a freely floating exchange rate regime**

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It should be noted that, manat lost its value only by 3.1% (0.7% on the first day) during January 12-19 [during the implementation of a freely floating exchange rate regime]. But, after the auction which are based on new rules, the dynamics of exchange rate demonstrate a higher percentage changes. Aftandil Babayev, the deputy chairman of the Board of Directors of the Central Bank stated that, the adaptation of currency markets to new conditions- freely floating exchange rate regime is smoother than expected²⁴.

The main reason for lower volatility during the switch to a freely floating exchange rate regime is the transfer of 4.2 billion USD to be made from SOFAZ to the Central Bank. The currency market participants consider this measure of government to strengthen manat by increasing foreign currency supply in currency markets.

The depreciation of manat will continue
Despite the attempt of the government to switching to a freely floating exchange rate regime, unconditional implementation does not seem feasible so far. Because, the key source of currency supply is still government (Central Bank, State Oil Fund) and institutional infrastructure in

²⁴ APA Information Agency, “CBA: The adaptation to the floating exchange rate regime is smoother than expected”, 19.01.2017
currency markets has not yet formed. This means, the influence of administrative measures will continue.

In general, the process observed currently is not enough to break the first psychological threshold ($1 \text{ USD}=2 \text{ manat}$). That is to say, the information about the transfer to the Central Bank will reduce the tension in currency markets and will mitigate the effects of previously predicted sharp fluctuations. On the other hand, the government may hesitate to make the aforementioned transfer for the purpose of defending currency reserves. As a result, pressures on national currency may increase, market participants may switch to “buy” position and manat may lose its value to the point $1 \text{ USD} = 2.2 - 2.5 \text{ manat}$ due to several external (the oil price, the decision of FES on interest rate, the discussions about BREXIT, the decisions of the US president) and internal factors (intervention policy of the Central Bank, foreign investment attraction, capital outflow, the dynamics of purchasing power).

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