

The unexpected revenge of manat in Azerbaijan: what is going on in currency markets?

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Summary

The rapid appreciation of the national currency manat over recent days has created a shock effect across the local population. Everyone, including the participants of the currency markets are trying to understand the causes driving the existing developments in the value of currencies. The current situation has even left local economists puzzled, who are struggling to put forward any explanation. As it stands, the questions such as “to what extent can manat gain value?”, “what causes the existing developments?”, “what is the degree of administrative intervention to the processes?” and etc. remain unanswered. Even the officials in government and Central Bank have not provided any explanation. Thus, in the following chapters, we will attempt to answer a number of the pressing questions briefly.

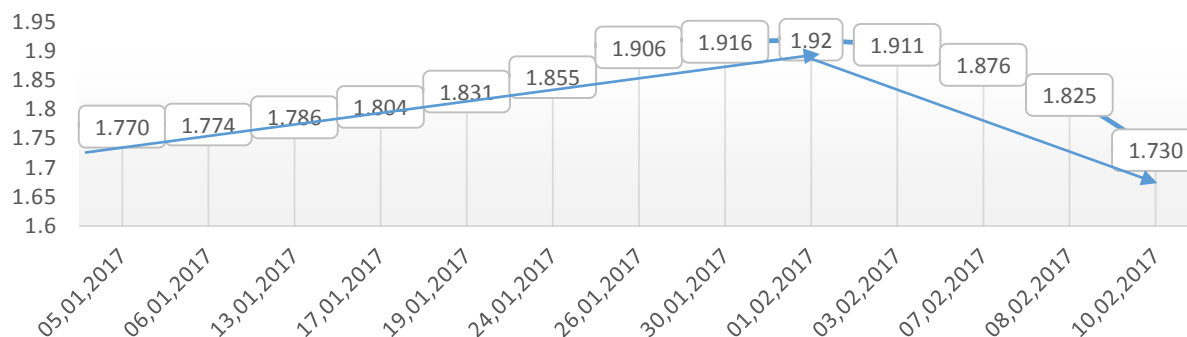
The environment stipulating currency panic

Although the gradual depreciation of manat since January 2017 onwards has not generated any notable public reaction, the appreciation from February onwards has led to serious panic. Thus, the depreciation of manat since 12th of January 2017 has been perceived by the public as a natural process due to the adoption of full floating regime. As a result of the depreciation by 7,6%, 1 USD became equal to 1,92 manat [see: graphic 1]. However, during the brief period in between 2-10 February, the national currency has gained value by 9,9% and 13,7% in official and black market rates respectively. To recall, our forecast for manat’s performance in 2017 was that the demand for the currency would not be sufficient to overcome the psychological barrier of 1 USD = 2 manat. [Generally, we hold the opinion that the current processes will not be sufficient to break the psychological barrier of 1 USD = 2 manat. That is, the information about the upcoming transfer of currency to Central Bank from the State Oil Fund is expected to bring some relief to the currency markets in the first half of 2017. It can also soften the impact of once expected severe impacts arising from existing developments.¹

¹ Center for Economic and Social Development, “Assessment on Real Effective Exchange Rate in Azerbaijan: 2017 Outlook”

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

Graphic 1: USD / Manat



Source: Central Bank of the Republic of Azerbaijan, 2017

The analysis of the graphic shows that the lack of information about many key issues increases the elasticity of both demand and supply in short term. The behaviour of market participants is a testimony to this argument. Thus, following the long period (2,5 months) of depreciation of manat, the local currency gained value against USD by 0,46% for the first time after the currency auction held on the 2nd of February. Understandably, this process quickly led the local people to wonder whether manat will appreciate further.

The dynamics of factors shaping the exchange rate of manat

We believe that it is worth looking at the statistical dynamics of factors shaping the rate of manat in order to understand the current situation in the currency markets. In this respect, we decided to classify the factors into two groups – *fundamental and temporary*.

The price of oil – no significant increase has been recorded in the price of oil over recent months. Even in the case of rapid increase in the price of oil would not raise the level of demand in the currency markets within such short period of time. It is because of the fact that the majority of the revenues obtained through the selling of oil enters into the budget of State Oil Fund. The Fund, in its turn, will then convert necessary amount of revenue (including the transfer to the state budget), of which the amount is known beforehand. That is, once the budget of the Fund for the next year is confirmed, the volume of manat required during the year is determined. In other words, the revenues obtained through the selling of oil enter directly into the currency markets.

Non-oil exports – According to the information by State Statistics Committee, the total volume of non-oil exports in 2016 was 16,4% lower in comparison to the volume in 2015². In other words, the trend has been one of downward movement until last month. Moreover, according to the data on last year, the total value of non-oil exports amount to \$100 million. The multiple increase of this volume would not be sufficient to trigger the current trend observed in currency markets.

The movement of investment– the close examination of the statistics dating to reveals that although there has been slight decrease in the amount of FDI since 2014, there has been significant increase in the amount of outgoing investment. In 2015 alone there has been a twofold (50%) increase in the amount of outgoing investment (2014- USD2,2 billion, 2015- USD3,3 billion) As a result, the amount of profit obtained through the movement of investment is heading in a decreasing direction.

Our analysis leads us to believe that the temporary factors play a more supportive role (in causing the appreciation of manat) than fundamental factors in the current situation. That is:

- The statements of US President's trade advisor Peter Navarro on "cheap euro" was interpreted by market participants as a sign of potential "cheap dollar" policy of the US government in the future, which eventually led to the depreciation of USD.
- The interest rate was not increased on the meeting of FED held on 1st of February 2017. The result of the meeting brought some psychological relief to Azerbaijani public (albeit the very weak impact of any change in interest rate on manat's rate) and resulted in the depreciation of USD against major currencies in the world.
- The currencies of major foreign trade partners (Georgia, Turkey, EU, Russia) of Azerbaijan are becoming stronger against USD
- Due to the reduction in the volume of budget expenditures over January, the volume of manat in circulation has shrank by 6,7% [01 January – 7,86 billion manat, 01 February – 7,33 billion manat³]
- The securities, bonds and stocks with manat base by state bodies (Central Bank, Ministry of Finance) are offered at high rate (up to 15%), which weakens the liquidity of manat.

Although temporary factors create conditions conducive for the appreciation of manat, the causes of the existing developments are of largely psychological origin. The exchange rate

² State Statistics Committee, "Foreign trade relations", 09.02.2017
<http://stat.gov.az/xeber/index.php?id=3469>

³ Central Bank of the Republic of Azerbaijan, "Monetary base", accessed at: 10.02.2017
http://www.cbar.az/infoblocks/money_base

policy pursued by the Central Bank since the adoption of floating regime in December 2015 has been stable for a ***very short period of time***. Since that time onwards, 5 turning points have been recorded during 14 months [see: table 1].

Table 1: The performance of manat under floating regime

Periods	USD/Manat	Official rate	Black market rate
11.03.2016-26.05.2016	↓	- 9.4%	- 22.9%
26.05.2016-09.09.2016	↑	+ 9.1%	+ 22.1%
09.09.2016-18.10.2016	↓	- 2.6%	- 17.3%
18.10.2016-02.02.2017	↑	+ 16.8%	+ 20.3%
02.02.2017 (starting from)	↓	- 9.9%	- 16.2%

Source: Central Bank of the Republic of Azerbaijan, 2017

Out of these periods, three of them have triggered the period of appreciation of manat, while other two time spells have seen depreciation. Each trend has continued for at least 1,5 month. These processes have made market participants try to benefit from, or at least survive with the least possible loss by switching to “buyer” or “seller” position [**note: the adoption of new currency regime has created new opportunities for many local citizens and businesses by incentivising commercial behaviours, as a result of which, the participation in currency market has relatively grown**]

Currency Markets: explanations and behaviours

Although, the authorities including the Central Bank have announced that the exchange rate of manat is formed by floating exchange rate regime-based on supply and demand principle, the society is still sceptical in this regard. Many local economists also consider that in practice, floating exchange rate cannot work in Azerbaijan. Based on the statement of the chairman of the ADP Movement, the economist Gubad Ibadoglu with respect to the transition to a new exchange rate regime “if there is no other seller in the currency market and the supply of currency is determined by administrative measures, this is not considered a transition to a floating exchange rate regime”⁴. Natig Jafarli, the economist, considers that, currency exchange and securities markets are essential for a floating exchange rate regime. “In our case, there are only two players: the Oil Fund and the Central Bank”⁵. According to Samir Aliyev, another economist, the

⁴ Azadlig Newspaper, “Gubad Ibadoglu: “The border between black market and banks disappears”, 13.01.2017 <https://www.azadliq.info/174167.html>

⁵ Azadliq Radiosu, “Tam üzən məzənnəyə keçid mümkün deyil”, 13.12.2016 <https://www.azadliq.org/a/uzen-mezenne/28173632.html>

transition to a floating exchange rate regime is impossible, unless the channels, which provide dollars, are established⁶.

It should be noted that, one of the underlying causes of the initial elasticity observed in supply and demand in currency markets, is the high degree of volatility with respect to exchange rate [see: table 1]. Especially, in black market the extent of this volatility is even deeper which triggers anxiety in the period of new trends. As a result, the volume of supply and demand changes sharply during short period. That is to say, based on the outcomes of the auctions held during the first 10 days of February, demand has declined sharply.

Table 2: The dynamics of demand and supply in currency auctions

Date	Supply	Demand	Demand/supply, in percentages
02.02.2017	35 million	24 million	69%
07.02.2017	35 million	12 million	34%
09.02.2017	35 million	6.5 million	19%

Source: Report Information Agency⁷, 2017

It is clear from the data by Report Information Agency that, during the last 3 auctions only 42.5 million USD (40.5%) was sold despite supply amounted to 105 million USD [see: table 2]. As a result of the auction held on February 9, demand declined to 6.5 million USD, equivalent to 19%. As can be observed, during the first days of a new trend, the elasticity of supply and demand is at high level.

By the way, it should be stated that, the impact of the transfer to be made by the State Oil Fund to the Central Bank amounted to 7.5 billion manat is significant on currency markets. That is to say, some market participants believed that the abovementioned transfer is to be supplied to the currency markets during upcoming months. The first revaluation attempt prompted market participants.

The appreciation period of manat since the beginning of February is the first cycle of panic, following the transition to a free floating exchange rate regime and the cancellation of margin applied to currency exchange. This results in expansion of speculative behaviours leading to higher anxiety. Several banks reduced their currency purchases at 1 USD=1.58 manat, while others applied limits.

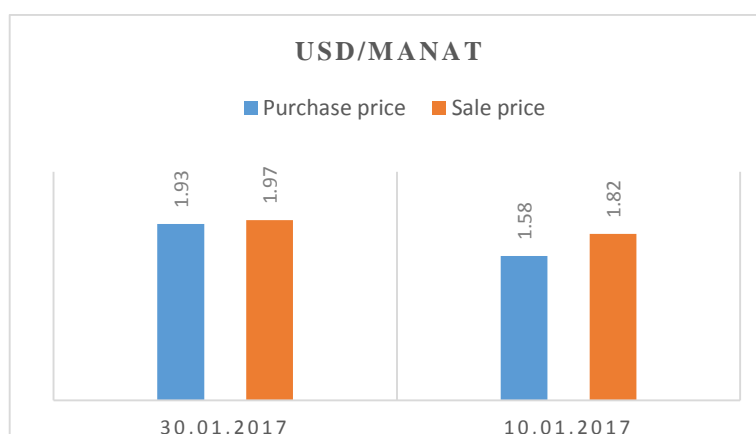
⁶ Azadlig Radio, "The transition to a free floating exchange rate regime is impossible", 13.12.2016
<https://www.azadliq.org/a/uzen-mezenne/28173632.html>

⁷ Report Information Agency, "Supply exceeded demand by more than 5 times on today's currency auction", 09.02.2017
<https://report.az/maliyye/bugunki-valyuta-herracinda-teklif-telebati-5-defeden-cox-usteleyib/>

One of the important issues is that, inadequate behaviour in currency markets increased in the background of recent events. That is to say, some banks are applying limits to currency sales in presence of rapidly increasing currency supply and decreasing exchange rate, notwithstanding the underlying causes. According to information on the website Fins.az, the number of banks selling dollar without limit was 14 on the last working day of the previous week (February 10)⁸. It should be noted that, there are 33 banks constantly participating in currency markets including Azerpocht. The application of limits to currency sales by some banks increases the concerns of general public. Why do banks apply limits to currency sales in case of de-dollarization and decreasing exchange rate?

The other issue for concern is the serious difference between purchase and sale. That is to say, as already mentioned, the margin of exchange is cancelled in January following the amendments made to currency exchange rules. Of course, in case of transition to a floating exchange rate regime (note: currently, the implementation of a free floating exchange rate regime is disputable) the cancellation of exchange margin and the application of similar measures should be considered acceptable by market subjects. On the other hand, the country is characterised with a poor competitiveness of domestic banking sector; several banks are managed by their shareholders; and there are misuses of rules stipulating market hegemony. These factors undermine the implementation of abovementioned policy. In consequence, households and business have faced with serious losses. This is undesirable in the current situation of declining income level.

Diagram 1: Difference between currency purchase and currency sale



Source: Prepared by author based on the information by Fins.az, 2017

⁸ Fins.az, “How much dollar can be purchased by each bank? – AMOUNTS”, 10.02.2017 <http://fins.az/bank/915829/hansi-bankdan-ne-qeder-dollar-almaq-olar-mablaglar.html>

Economist scholar Vugar Bayramov suggests that, in order to weaken speculative attacks, and to prevent the potential loss of citizens and businesses, the margin of 4% should be restored. But, the connection to the official rate of the Central Bank should be eliminated. Instead, this margin is to be applied to the maximum difference of exchange rate between purchases and sales. Based on his statement, in the presence of current conditions, this margin level will not trigger black market⁹. According to Gubad Ibadoglu, in the absence of competitive environment, the Central Bank should lift its decision with regard to margin¹⁰. Based on his opinion, some banks conduct misuses in terms of increasing the difference of exchange rate between purchases and sales after the cancellation of margin.

Conclusions

The appreciation of manat is short-lived in current situation, and this revaluation is the result of temporary economic factors and administrative measures. The elasticity of supply and demand in currency markets in the short-term facilitates the policy-making of the Central Bank. At the same time, the cancellation of the margin under the transition to the free floating exchange rate regime resulted in an expansion of speculative behaviours. This led to a sharp decline in currency purchases and increased the loss of market participants (excluding banks).

Although the Central Bank announced the transition to a floating exchange rate almost a month ago, many economists agree that it is practically impossible as the key source of currency in circulation is public sector. Notwithstanding, the impact of floating exchange rate regime factor is observed in the behaviours of currency market participants.

By analysing the recent events in currency markets, it can be concluded that, despite the appreciation of manat is desirable within the framework of natural economic conditions in the long-term, appreciation in the short-term increases the risks for citizens, business and the banking sector. That is to say, the uncertainty regarding the projections or periodic adjustments between expenditures and exchange rate cycles leads to a cheaper sale of foreign currency. As a result, the revenues in millions of manats gained from previous economic activities are turned into loss.

⁹ New Musavat Newspaper, "Dollar in turmoil, manat in uncertainty...", 02.10.2017
http://musavat.com/news/iqtisadiyyat/dollar-telashda-manat-muemmada_414638.html

¹⁰ Sonxəbər.az, "The decision of the Central Bank on manat should be lifted immediately, otherwise...", 12.02.2017
<http://sonxeber.az/36686/tecili-merkezi-bankin-manatla-bagli-qerari-tecili-legv-olunmalidir-yoxsa>

At the same time, observations show that, the behaviour of some currency market participants (banks) is not in line with the current situation. In other words, it does not make sense to apply limits to foreign currency sale given the sharply declining demand, sharply increasing supply for currency and the rapidly declining exchange rate. The period after the year 2014 is considered a recession period for the banking sector; therefore, their attempts to seize the maximum profit from the present situation are natural. This specific factor enables to conclude that the current revaluation period can be short-lived.

Manat during next months

The appreciation of manat is not going to be long-lasting, unless the fundamental factors change. After several days, supply will lose its initial elasticity, which will lower the excess currency in markets. Moreover, monetary expansion will be conducted during next weeks in the background of budget planning and fiscal regulation, leading to higher foreign exchange demand and depreciation of manat. The rise of imports targeting domestic consumption in March is also among the factors increasing the demand for foreign currency. Thus, it can be concluded that, current events in currency markets will ultimately result in new losses. Because, the foreign currency sold cheaper today, is to be purchased expensively after several weeks.

As has been predicted before, the exchange rate will not exceed 1 USD=2 AZN¹¹ in the first half of the year. The reasons include: significantly shrinking currency market; high degree of dollarization; contraction in business activity; decreasing purchasing power; decline in imports; limiting imports owing to state funds and so on.

In general, the volatility in currency markets will remain high during the course of 2017.

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