The Economy of Azerbaijan in 2017 - Brief Overview

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Introduction

The year 2017 posed severe challenges for the economy of Azerbaijan, as it experienced a 3.1% decline in 2016, its first negative GDP growth since 1995. According to initial estimations of EBRD, the economy was expected to experience another negative GDP growth equal to 0.5% in 2017.1 However, The State Committee of Azerbaijan Republic has announced 0.1 % positive growth in GDP in 2017.2

The recessionary environment coupled with the continuing fall in oil prices in early 2017 made matters look grim for the country, whose economy is massively dependent on the oil sector. Inflation, according to the State Statistical Committee, is still as high as 12.9%.3 In the meantime, growth in wages is lagging far behind the inflation rate, which decreases the purchasing power of the population. The trend of declining state budget expenditures stopped this year, with a new amendment in July, after oil prices surged. According to the Ministry of Finance, the deficit of the executed state budget has reached 1,141 million manat or, in terms of dollars, 671.4 million US dollars.3 As a result, high government spending continues to be a potential obstacle that can hinder the development of the private sector.

Ongoing problems in the financial sector and the population’s loss of confidence in commercial banks resulted in further bank failures and, together with high interest rates, led to a sizeable contraction of credit. The default of the International Bank of Azerbaijan (IBA) due to long-term administrative problems added to the liabilities of the government. Not only the IBA, but also the financial losses of other State Owned Enterprises (SOEs) are another factor contributing to the indebtedness of the government. The credit rating of the government was downgraded from Ba2 to Ba1 by Moody’s in August, after a sharp decline in economic strength. According to Moody’s, the new credit rating “reflects the vulnerability of the economy, government finances and banking system to oil price volatility”.4

2.49 billion manat ($1.46 billion US dollars) have been transferred directly from the State Oil Fund of Azerbaijan (SOFAZ) to the Central Bank for the purpose of “providing macroeconomic stability”.5

On the other hand, the manat has been more or less stable during 2017, hovering around 1 USD = 1.7002 AZN. This is most likely due to the intervention of the Central Bank in the foreign exchange market to keep the rate stable, despite the fact that the official exchange policy is currently stated as a floating exchange regime.

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1European Bank for Reconstruction and Development, Regional Economic Prospects Updates, November 2017
http://www.ebrd.com/cs/Satellite?c=Content&cid=1395236497710&d=Mobile&pagename=EBRD%2FContent%2FContentLayout
2State Statistical Committee of Azerbaijan, Inflation
3President of Azerbaijan, legislation on amendment on the 2017 state budget, July 2017
http://president.az/articles/24674
4Moody’s, Global Credit Research, September 2017
https://www.moodys.com/research/Moodys-Azerbaijans-credit-profile-reflects-countrys-vulnerability-to-volatile-oil--PR_372002
5State Oil Fund of Azerbaijan, revenue and expenditure statement for January – September 2017
New legislation aimed at making customs and tax collection more transparent and efficient are starting to show their effects in a positive way. Employers are required to pay employees through their bank accounts, thus decreasing the potential for tax evasion. The Strategic Road Map of 2016, which identified 11 key sectors in Azerbaijan, has been implemented to some extent in 2017.\(^6\)

A Credit Guarantee Fund has been created in September in order to foster loans and help small business owners in strategically important sectors, particularly the agricultural sector, to take credit for financing their projects.\(^7\) Without the Fund, banks are reluctant to provide small business owners with loans. The aim of the Fund is to intervene in such cases and help entrepreneurs to get loans.

Azerbaijan’s ‘Ease of Doing Business’ ranking was set at 57\(^{th}\) in the world, up 8 places from 2016’s ranking of 65\(^{th}\). According to World Bank reports, this positive change is due to “improved access to credit information”, the protection of minority investors, easing contract enforcement by paying fees electronically and better insolvency resolution.\(^8\)

On the ‘Global Competitiveness Index’ of the World Economic Forum, Azerbaijan’s ranking moved from 37\(^{th}\) in 2016-2017 to 35\(^{th}\) 2017-2018. According to the ‘Global Competitiveness Report 2017-2018’, the biggest obstacles for doing business are access to financing, foreign currency regulations, tax regulations and inflation.\(^9\)

Output of the agricultural sector has improved as a result of increased state aid, particularly to the cotton industry. According to the State Statistical Committee, non-oil sector exports have increased by 23\% during January – November of 2017, when compared to the same period of 2016, mostly due to the agricultural sector.\(^10\)

The opening of the Baku – Tbilisi – Kars railway, which connects China with Europe, has yielded positive results to some extent, as the country is becoming a corridor for the East – West trade route. The ‘Contract of the Century’, originally signed in 1994, allowing foreign companies to invest and extract oil from the Azeri – Chiraqli – Guneshli cluster field, has been extended until 2050, according to the document signed by the heads of 9 oil companies.\(^11\) It should be noted that according to the new agreement, shares of the State Oil Company of Azerbaijan Republic (SOCAR) increased from 11.65\% to 25\%. The government will receive a onetime bonus of 3.6 billion US dollars in an eight year time period.

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\(^6\) Decree of the President of Azerbaijan, Strategic Road Map on National Economy, 2017 http://www.e-qanun.az/framework/34254
\(^7\) President of Azerbaijan, decree on charter of the Credit Guarantee Fund, November 2017 http://www.president.az/articles/26086
1. Main Macroeconomic Indicators for 2017

The macroeconomic environment of Azerbaijan experienced numerous problems in 2017, most of them arising from the previous plunge of oil prices and resulting negative effects associated with the Dutch disease.

1.1. Gross Domestic Product

The GDP of Azerbaijan has experienced stagnation in 2017. According to the Asian Development Bank, the economy contracted by 1.3% during the first half of the year.\(^2\) The main reason behind this decline, without a doubt, is the fall in oil prices coupled with a gradual decrease in oil production. The relationship between these two variables can be seen plainly from Diagram 1.

Diagram 1: Relationship between GDP Growth and Oil Rent in Azerbaijan

It is clear that following oil price drops, alternative sectors have not been able to recover from the dominance of the oil sector. However, when compared to the GDP contraction of 2016, which was -3.1%, this year’s indicator looks less severe. Yet, it must be noted that it is mainly due to a slight increase in oil prices, which led to increased government expenditures. In January – November of 2017, budget expenditures have been 11% higher than the expenditures of the same period in 2016.\(^3\) The sharp decrease in the oil industry was only partially offset by increased non-oil GDP, non-oil exports and a reduction in imports.

\(^2\)Asian Development Bank, Azerbaijan: Economy  
https://www.adb.org/countries/azerbaijan/economy  
\(^3\)State Statistical Committee of Azerbaijan, Macro-economic indicators, January – November 2017  
1.2. State Budget

State budget expenditures for 2017 have declined by approximately 0.9% and reached 17.59 billion manat, or 10.35 billion US dollars.\footnote{Ministry of Finance, Information on the execution of the state budget for 2017 \url{http://www.maliyye.gov.az/en/node/2119}} As we can easily see from the graph below, except for a brief decrease in 2009 due to the ongoing global financial crisis, the role of the government in the overall economy was rising steadily until recent oil price plunges in 2014. State budget expenditures for 2014, 2015 and 2016 experienced a decline, giving a potential push for the gradual shift of the Azerbaijani economy away from its heavy dependence on the public sector to an economy based on the private sector. Such a development would make the economy much more balanced and secure, since the private sector, unlike the public sector, would not be so dependent on the price of oil. According to initial budget legislation dated December 2016, budget expenditures were expected to reach 16.9 billion manat (9.9 billion US dollars).\footnote{Ministry of Finance, law on State budget of 2017 of Azerbaijan Republic \url{http://www.maliyye.gov.az/sites/default/files/Qanun_budce_2017_.pdf}} However, with the amendment of July of 2017, expenditures were changed to 17.9 billion manat (10.5 billion US Dollars).\footnote{President of Azerbaijan, decree on amendment of 2017 state budget \url{http://president.az/articles/24674}}

![Diagram 2: Budget Expenditures (Million manat)](image)

Source: State Statistical Committee, 2017

The recent amendment showed that the Azerbaijani government has no intention of decreasing its large spending, as long as oil prices are above a certain level. The abovementioned overspending – originating from oil revenues – has the potential of slowing the growth of the private sector and making tax revenues less essential for the budget, leading to massive levels of tax evasion. When the budget is not filled with tax revenues, but rather with the help of oil windfalls, control over the effectiveness of spending becomes vastly doubtful.
According to the Ministry of Finance, state budget revenues equaled 16,447 million manat (9,674 million US dollars), which is equal to 98.1% of expected revenues. The main reason behind this gap is the lower than planned amount collected from actual tax revenues. That is, tax revenues have been 8.8% less than expected. One of the potential reasons behind the miscalculation is that the government overestimated economic growth for 2017. When we look at the budget projections for 2017, the estimated GDP growth was given as 1.0%, which does not reflect reality. Another factor is that the enlargement of the tax base has not been as fruitful as initially predicted, since the underground economy still possesses a significant part of the overall economy. According to the Association of Chartered Certified Accountants (ACCA), Shadow economy makes up 66.12% of the overall economy.

1.3. Inflation

Double digit inflation continued throughout 2017. According to the State Statistical Committee, annual inflation was equal to 12.9%. The rate has been particularly high for food products, with a 16.4% increase in overall prices. It must be noted that, according to our estimates, the real inflation is much higher than the reports of the Committee.

We can identify multiple potential reasons behind the double digit inflation:

- The first reason is the double devaluation of manat in February and December 2015. Imports play a crucial role in the economy, as a large portion of local production depends on goods from abroad. Naturally, when the manat was devaluated, imported goods become more costly for producers. To offset the increase in the cost of production, producers raised the price of their final product, which lead to an overall increase of prices in the economy. The government took multiple actions to manipulate the free market during 2015 and 2016, preventing producers from increasing their prices immediately. However, the effects of the devaluations are continuing to be felt in 2017 in the form of inflation, as producers are still adapting to current exchange rates.

- Secondly, despite the fact that manat has been stable against the dollar for most of 2017, the national currency has actually lost value against other foreign currencies. In the table below, you can see the currencies of countries from which Azerbaijan imports the most.

| Table 1: Exchange Rates of different currencies against the manat |
|-------------|-------|-----|-------|-------|-------|-------|
|             | USD   | EUR | RUB   | TRY   | CNY   | GBP   |
| 5.01.2017   | 1.7707| 1.8638| 0.0293| 0.4967| 0.2558| 2.1841|
| 29.12.2017  | 1.7001| 2.0307| 0.0295| 0.4499| 0.2608| 2.2881|
| Change during 2017 | -4.15%| 8.22%| 0.68%| -10.4%| 1.92%| 4.55% |

17 Ministry of Finance, Budget project for 2017
18 Association of Chartered Certified Accountants, Emerging from the shadows
19 State Statistical Committee of Azerbaijan, Inflation
20 Center for Economic and Social Development, Azerbaijan Economy in the first nine months of 2017; brief overview
Unlike Turkish and American currencies, the euro, Russian ruble, Chinese yuan and British pound have all appreciated against the manat. Appreciation is especially noticeable in the case of the euro. This means, despite a stable exchange rate against the American dollar, the manat has depreciated against currencies of other major import partners, making their goods more expensive in the local market for both consumers and producers, leading to a positive contribution to ongoing inflation.

- Next must be mentioned the effect of new legislation, such as those requiring employers to pay their employees through bank accounts, increasing transparency of the businesses operating inside the country. As a result, tax evasion and other illegal activities have been on the decline, which increased the cost of production for domestic firms.

- Lastly, in July 2017, the Tariffs Council announced the rise of prices of AI – 92 type fuel by 28.6%, from 0.70 manat per liter to 0.90 manat. The increase in prices of both natural gas and electricity affected the overall price of the consumer basket in a positive way.

The minimum cost of living, on the other hand, has increased from 155 to 173 manat, according to new legislation of the Milli Majlis dated 1 December 2017. Despite the raise, the actual cost of living is expected to be much higher than the abovementioned amount, meaning the 11.6% increase is likely still not enough to meet the 12.9% inflation, especially the 16.4% increase in food prices.

2. State Oil Fund of Azerbaijan

On January 10th 2017, the budget of the State Oil Fund (SOFAZ) was approved. It showed that anticipated revenues were 8,371 million manat (4,923 million US dollars). However, due to the slight increase of crude oil prices, the budget was amended in October and revenues were increased to 10,813.9 million manat (6,360.4 million US dollars). At the same time, expenditures were set at 15,242.9 million manat (8,965.9 million US dollars), which lead to a budget deficit of 4,429 million manat (2605.1 million US dollars). As a result, SOFAZ’s deficit equaled 4,399.1 million manat (2,587.3 million US dollars). When compared to the deficit of 2016, this year’s number is significantly larger. Considering that the fundamental purpose of the Fund is to transfer oil revenues to future generations, the current high deficit is out of place. On a side note,
we need to mention that these numbers are from the approved budget, meaning that the actually executed budget (which is not yet announced) may be slightly different.

As of October 2017, the reserves of the Fund equaled 36 billion US dollars. Compared to the beginning of 2017, this number was 8.67% higher, certainly because of the recent hike in oil prices.25

Transfers to the state budget from the Fund have totaled 6,100 million manat (3,587 million US dollars), which is lower than 2016 levels by 1,515 million manat (891.1 million US dollars). This can be considered a positive development because it decreases the dependence of the state budget on transfers from the Oil Fund. On the other hand, the upper limit of transfers for 2018 has been set at 9,216 million manat (5,420 million US dollars), making it highly likely that actual 2018 transfers from SOFAZ to the state budget will be higher than previous years.26

3. Financial Problems

Problems associated with the financial sector continued during the course of 2017. When we look at a graphical representation of Azerbaijan’s foreign debt to GDP ratio below, the two 2015 devaluations are easy to observe.

Diagram 3: Foreign Debt of Azerbaijan as share of GDP

Because GDP is calculated using the local currency, the manat, and foreign debts are in dollar or other foreign currencies, the 2015 devaluations affected the ratio severely. Apart from the devaluations, the inefficient administration of State Owned Enterprises (SOEs), particularly the default of the International Bank of Azerbaijan – the largest SOE – also contributed to the

25 SOFAZ, Latest Figures as of 1 October 2017
http://www.oilfund.az/az_AZ/ hesabatlar-ve-statistika/son-reqemler.asp
26 SOFAZ, 2018 approved budget
increase in overall government indebtedness. According to the Ministry of Finance, the foreign debt of Azerbaijan, as of July 2017, is equal to 12,208.5 million manat (7,172.6 million US dollars), which accounts for 18.9% of GDP.\(^2^7\)

Despite these observations, the foreign debt of Azerbaijan has not increased as rapidly as was initially expected during 2017. The expected amount of additional foreign debt for this period was 4.5 billion manat (2.65 billion US dollars). Instead, the actual amount was 1.15 billion manat (0.67 billion US dollars) less.\(^2^8\) Unfortunately, the last available data from the Ministry of Finance is for July 2017; however, when we take into account the restructuring of the debts of the International Bank of Azerbaijan, which according to Moody’s is expected to increase the foreign debt of the country by 2.45 billion US dollars, as well as the inability of many State Owned Enterprises (SOEs) to pay their obligations, it is estimated that the foreign debt of Azerbaijan will grow exponentially over the next periods.

The difference between the deposit interest rates of manat and foreign currencies has become even wider in 2017, as we can observe from the graph below. The main incentive for the increasing gap is that by offering a higher rate of return for deposits made in manat, the Central Bank aims to decrease the dependency of commercial banks on dollars, thus, making them less vulnerable to exchange rate fluctuations.

![Diagram 4: Interest Rates for Deposits](http://www.maliyye.gov.az/en/node/2074)

Source: Central Bank of Azerbaijan, 2017

On the other hand, the amount of deposits in financial institutions has surpassed the amount of credits in 2017 (see Diagram 5 below). The fundamental laws of economics tell us that in this case, interest rates should fall. However, according to data from the Central Bank, interest rates for credits in manat have increased from 12.05% to 13.14% (and for the dollar, the increase has been from 8.60% to 10.53%). By pursuing such a policy, the Central Bank aims to shrink the

\(^{27}\)Ministry of Finance, Information on external public debt as of July 1\(^{st}\), 2017

\(^{28}\)Marja, “Azerbaijan increases limit of foreign debt”
http://marja.az/news/17005
consumption of the population, which will ultimately curb down inflation, as well as to decrease pressure on the manat in exchange markets.

3.1. Bank Failures

The licenses of 11 banks were rescinded by the government in 2016 alone, because they did not meet the minimum requirements. The number of banks in operation by the end of 2017 has been decreased from the pre-devaluation number of 45 banks to 30.29

Banks are faced more and more with problematic credit due to the inability of the population to pay back their loans, as a result of their long-term, incompetent risk management policy. Many borrowers have significantly lost their purchasing power and some are unemployed as a result of the economic downturn starting in 2015. Learning from past mistakes, commercial banks are now more reluctant and careful when giving credit, which makes it hard for banks to raise revenues from loans. Keeping in mind that credit is supposed to be a major source of revenue for banks, this poses an ongoing threat to the financial sector.

The latest bank to lose its license in 2017 was DamirBank. The Financial Market Supervisory Authority stated that the reason behind the cancellation of the license was that the bank did not meet the minimum requirements determined by the law.30

Diagram 5: Timeline of Credits and Deposits in Azerbaijan

Source: Central Bank of Azerbaijan, 2017

Continuing failures in the banking sector undermine the population’s confidence in commercial banks, especially towards smaller banks. As we can see from the graph above, the

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amount of deposits has surpassed the amount of credits during 2017. Fewer credits make it harder for banks to raise revenues, leading to a continuous cycle of problems. Deposits are also equally important for the operations of the bank; therefore, in order to make the population confident in banks again, a new law was introduced in March of 2016 guaranteeing the total amount of deposits in banks.\textsuperscript{31} It must be noted that this law is signed for 3 years and elapses until 2019.

If the number of banks in operation continues to shrink during the next years, Azerbaijan might end up with only 10-15 large banks, which would create a potential environment where they work together to manipulate the interest rates. Such a development, without a doubt, would hinder the free market and hurt consumers.

3.2. Default of the International Bank of Azerbaijan (IBA)

Azerbaijan’s largest bank, the International Bank of Azerbaijan, had stopped paying its foreign debts and filed for bankruptcy in May 2017. Long-term, inefficient management, an inadequate investment policy, low liquidity and widespread corruption forced the bank to restructure 3.3 billion USD of its foreign debt.\textsuperscript{32} It is estimated that as a result of the restructuring of IBA – which is the largest state owned bank in Azerbaijan – external debt of the government will increase by $2.45 billion US dollars.\textsuperscript{33}

Given the ties of IBA to the Government and to SOCAR, the default hurts the credibility of the country. In August, Moody’s decreased the credit rating of Azerbaijan from Ba1 to Ba2. The downgrade comes as a result of the sharp indebtedness of the economy.

The restructuring plan had 93.9% of votes in favor and the plan was finished by September. The positive side of the restructuring is that it creates a better environment for the privatization of the bank, which is planned for 2018.

4. Exchange Rate Policy

It did not come as a surprise that the Azerbaijani manat started the year of 2017 by losing value against the American dollar. The last devaluations lead to a loss of confidence of the population in the manat. Since the announcement of the Central Bank regarding the shift to a floating exchange rate in December 2015, the manat started to lose value sharply. The drop was such that, on February 2\textsuperscript{nd} 2017, the USD/AZN rate reached its peak of 1.92. However, during the next 2 weeks, the exchange rate unexpectedly rebounded and the manat appreciated by 9.9%.

\textsuperscript{31} President of Azerbaijan, the law on insurance of deposits
http://www.president.az/articles/17946
\textsuperscript{32}Center for Economic and Social Development (CESD), “International Bank of Azerbaijan: Why the South Caucasus’s largest bank has requested restructuring?”
\textsuperscript{33}Moody’s downgrades Azerbaijan’s rating to Ba2, with a stable outlook, concluding review for downgrade, August 2017
This sharp fall can be attributed to a number of temporary factors which affect the exchange rate:

- The single most decisive variable, without a doubt, is the price of oil. When prices are higher, Azerbaijan gains more dollars from trade, which increases the overall supply of foreign reserves in exchange markets. Under a floating exchange regime, this higher supply translates into a lower “price” for foreign currencies.

- Exchange rate fluctuations in 2015 and 2016 left many people, especially businesses, with a number of financial problems. As a result, people became extremely responsive to the exchange rate, so that when there is a small decrease in USD/AZN rate, a large number of people start exchanging their dollars into manat, leading to an even further decrease of the exchange rate.

- Fearing the further depreciation of the manat, the population converted their manat into dollars in large numbers back in 2016. However, since the only legal tender in the country is the manat, these people had to convert their currencies back to manat if they wanted to buy something, causing higher demand for the national currency after some time.

After a short period of fair volatility, the exchange rate has been more or less the same since the beginning of April, hovering just above the 1.7 line. It is quite clear that this stability has been achieved with the intervention of the Central Bank in the market. Higher oil revenues allowed the State Oil Fund to transfer 2,279 million manat (1,340 million US dollars) directly to the Central Bank during the January – March period, ostensibly for the purpose of “macroeconomic stability”.  

A further 169.3 million manat (99.6 million US dollars) was transferred to the Central Bank in May. 

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34SOFAZ, Revenue and Expenditure Statement for January – March 2017
http://www.oilfund.az/en_US/hesabat-arxivi/rubluqb/2017_1/2017_1_1/
transferred throughout the second quarter of 2017.\textsuperscript{35} It is intelligible that the stability of the exchange rate has been achieved thanks to these large transfers, which have been the first transfers directly from SOFAZ to the Central Bank.

It must be noted that the ongoing stable exchange rate created a better environment for businesses, especially for the much troubled banking sector. However, when we think of the medium- to long-term, the manipulation of exchange markets by the Central Bank not only discourages foreign investments but also creates mistrust in the population, revealing itself as the Saturday Syndrome, when the population thinks that another devaluation is coming and starts to panic.\textsuperscript{36} At the same time, the threat of draining the reserves of the Central Bank while trying to keep the exchange rate stable should not be completely crossed out.

\textbf{Conclusion/Recommendations}

As can be seen, the economy has more or less stagnated during 2017. Despite some positive signs, such as the increase in the output of the non-oil sector, the stabilization of the national currency, as well as the slowed-down pace of the economy’s contraction, overall, the position of the economy continues to look troubled. The financial sector, particularly the banking sector, is still unstable with more banks expected to fail throughout 2018 on account of the fact that no serious steps, except for the restructuring of the International Bank of Azerbaijan, have been taken for the improvement of the sector. The potential case of fiscal consolidation has been abandoned by the government following the elevation in oil prices and government expenditures are expected to be even larger next year. The Central Bank still manipulates exchange markets, even though the officially stated regime is a floating exchange rate. High levels of inflation undermine the purchasing power of the population, as the growth in wages is not sufficient to counter inflation.

For solving the abovementioned problems, Center for Economic and Social Development recommends the following steps:

- The tremendous need for fiscal consolidation must be addressed in government expenditures. The cuts should particularly focus on capital expenditures, which are well-known for being notoriously corrupt. On the contrary, spending towards social expenditures, which serve the interest of the population – especially the most marginalized ones – should not be subject to a reduction.

- The law on deposit insurance must be extended beyond 2019, if necessary, as the confidence of the population in banks is still not sufficiently high. If the continuing trend of decreasing credits and stagnant deposits continues, more bank failures are inevitable.

\textsuperscript{35}SOFAZ, Revenue and Expenditure Statement for January – June 2017

\textsuperscript{36}Center for Economic and Social Development, “The Saturday Syndrome: Roots of mistrust toward the exchange rates in Azerbaijan”
• Keeping the exchange rate of the manat stable with the intervention of Central Bank might looks like a good policy in the short run; however, in the medium and long run, it has many drawbacks. For that reason, the Central Bank must let the manat find its real value.

• There is no single tool for solving high inflation in the short run. The appreciation of the manat, in order to combat the import-originated inflation, can cause severe problems for the economy. The only potential solution in the medium to long run is to incentivize businesses to get their input products from the domestic market and make local production less dependent on goods from abroad.
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