

EXCHANGE RATE STABILITY AND THE DEVELOPMENT OF FINANCIAL SYSTEM IN AZERBAIJAN

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ABSTRACT:

The research paper shows how exchange rate and stability in financial markets can revive economy, entrepreneurship. Azerbaijan used to have a fixed exchange rate policy and Azeri manat was pegged to US dollar. During low oil returns, The Central Bank of Azerbaijan (CBAR) tried to ensure financial stability and started to use reserves as it did in 2008. In 2008 low prices for oil lasted for 6 months but starting from 2014 low oil prices continues for almost 4 years. This study also identifies fundamental and temporary factors which determine the exchange rates, also evaluates how and in which ways state regulate the exchange rates. As an exchange rate of Azerbaijan mostly depends on oil prices the drop in oil prices caused devaluation in the country. The research paper will identify and discuss monetary policies that state used to respond the devaluation and to see how these policies were successful. The final part of the research evaluates the transferring to floating exchange rate and reveals the current situation in the market. The transferring process is not over and CBAR has a lot of problems to solve till 2020. Although CBAR tried to establish free-floating exchange system, the economy was not ready for such sharp changes.

Key words: Exchange rate of manat, Financial system in Azerbaijan, Exchange rate regulation, Devaluation, Low oil prices.

Jel classification: E43, G12

FUNDAMENTAL FACTORS AFFECTING EXCHANGE RATE

There is an existing assumption that the effects of both temporary and fundamental factors over the following global and domestic economic developments will formulate the manat's exchange rate in the next years.

1. The price of oil - According to the research done by the global energy markets, the price of oil will be more than what level the Azerbaijan government predicted in further year's state budget (45\$ USD/barrel) Global oil prices will be formulated based on the results of important world trends, events:

OPEC and non-OPEC countries' decision to regulate the production and therefore made an agreement over it and the second one global oil reserves have decreased and at the same time there's an increasing demand because of large economic activities. All of these factors will decrease the demand and supply difference. Lots of global financial institutions projected these improvements in their financial reports. OPEC shows that by 2021, average oil prices will rise by \$5/bbl per year.(OPEC, World Oil Outlook 2016, accessed: 26.12.2017, p.60). The World Bank predicts \$60/bbl (World Bank, "World Bank Commodities Price Forecast",2017) whereas the IMF is \$50.2/bbl. (IMF, "World Economic Outlook, October 2017"). So, we can realize from these assumptions of financial institutions that the oil price will increase and thus this insures financial stability of the Republic Azerbaijan economy from any possible, sudden fluctuation.

2. Balance of Payment-This is not a surprising fact that the export of oil and oil products take a huge place in Azerbaijan exports. The rise of oil prices in the next year will lead to oil revenues, which will offset 8% reduction in foreign trade exports. Because of the decrease in production of oil, a decline in exports is assumed. At the same time, the level of inflation in Azerbaijan is predicted to be high. Due to weakening purchasing power of the population, there is a high possibility that the current import decline will go on. We believe that Azerbaijan government will regulate financial flows and thus leading to reduction on the national currency fluctuations.

3. Strategic currency reserves-The Azerbaijan Republic's strategic currency reserves are based on two sources:

- 1.Reserves of the Central Bank of the Republic of Azerbaijan and
2. Assets of the State Oil Fund of the Republic of Azerbaijan.

In 2017 growth in both sources has occurred. Reserves of the Central Bank went up by 32.3% (CBAR, Official available currency, 2017) by the beginning of December in contrast to the beginning of the year and reserves of the State Oil Fund increased by 8.7% in the beginning of October.

TEMPORARY FACTORS

I. Fiscal policy – If expenditures of the state budget for the any year have been expanded, it will lead to increase the demand for currency to some degree. In parallel, if the volume of exchanges from the State Oil Fund to the state budget increased – accomplished through the conversion of assets to manat in order to meet budget commitments – proposing that the Oil Fund will offer around \$1.8 billion USD in extra funds to foreign exchange markets in 2018, contrasted with the current year. The restructuring of the foreign debts of the International Bank of Azerbaijan (IBA) can increase the government's foreign debt commitments. The increased foreign debt

obligations will lead to an increased demand for foreign currencies on the part of the government. However, this increased demand on the part of the government will be neutralized by the decreased demand of the reduced exercises of the IBA. In other words, the foreign exchange demand emerging from budget spending will be compensated by the Oil Fund's supply and will not be a serious source of risk.

II. Credit Policy – One of the components that temporarily affect currency demand in the markets is the lending policy of banks. Loans offered in manat can raise the demand for the currency and put pressure on it. However, alongside factors such as the weakening of the loan repayment capacity of the real sector, the increase in problem assets and the aggravation of the financial position of borrowers by increasing their debt burden due to the devaluation, a shrinking credit policy can be implemented by local banks. As a result, the credit investments of banks to the economy can decrease. As a result, excess liquidity can be observed in banks. Nevertheless, banks are not interested in credit, despite the existing risks; the Central Bank's manat deposit auctions enable them to manage funds without risk. Moreover, giving loans in manat with higher interest rates is another factor that declines demand. Thus, the likelihood of an increase in manat lending in 2018 is low. It weakens the probability of pressure on the manat's rate in the mentioned direction.

EXCHANGE RATE REGULATION

Central Bank of Azerbaijan tried to keep exchange rates fixed through foreign exchange reserves during almost a decade. In 2015, both the cash and non-cash segments of the foreign exchange market witnessed a big fall in foreign exchange supply, and a sharp rise in foreign exchange demand.

As a result of the oil price fall in world markets, transfers from State Oil Fund to budget decreased. Eventually, foreign exchange sales of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) fell by 33 percent relative to the previous year. Big rise in demand for foreign currency is explained by high level of dollarization. (CBAR, 2016).

Decreasing oil prices since 2014 have affected new market conditions and shaped national currency of Azerbaijan. During financial crisis in 2008 our country faced economic challenges that Central Bank attempted to protect the stability of exchange rate system with the expense of spending currency reserves. Although this operation just started in August 2014, during the third quarter only 0.2 billion dollars were used for intervention. After the end of 2014, intervention spending sharply increased like 1.68 billion dollars respectively and at the end currency reserves decreased about 26.6 % which was 11 billion dollars within 3 months. Main reasons for government

intervention currency to exchange market are society's prediction that devaluation is inevitable. (Center for Economic and Social Development (CESD), 2016)

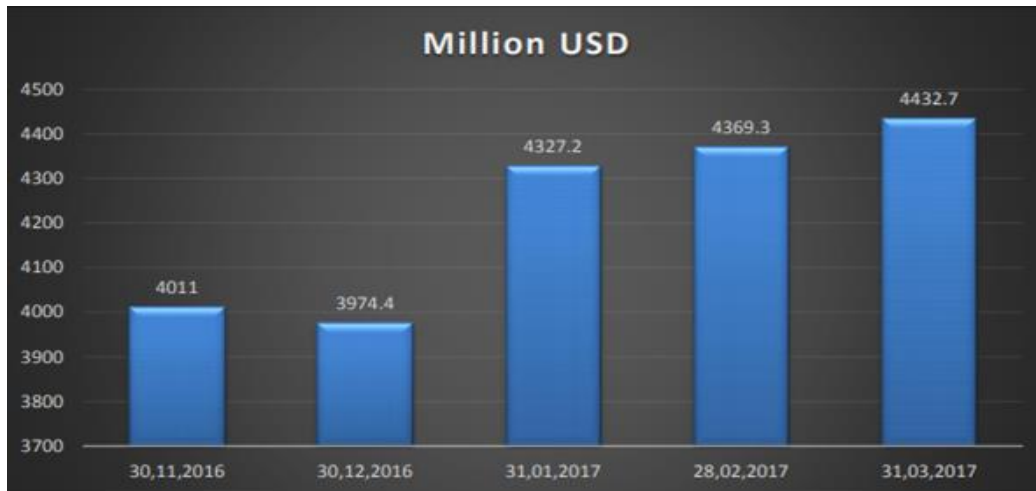
Changing floating exchange rate system end of the 2014, connection with second devaluation caused fluctuation in financial market. Central Bank's decision to accept devaluation aimed to complete the process of dollarization in a short term and reduced public anxiety with the lower costs. After that Central Bank forced limitations on currency exchange outflow, some currency exchange offices were briefly closed.

Central bank started its contractionary monetary policy to fight with demand to dollar and keep manat safe. This policy weakened the private sector as banks refused any credit in manats. Economic growth speeds up as financial depth grows. Until loan to GDP ratio reaches 86.5% (optimal point) this indicator positively impacts economic growth and afterwards negatively. However in our country loan to GDP ratio reached its peak of 38.5% in 2015 and afterwards decreased and then stabilized at 38.5% in 2017. (Gorkmaz Imanov 2019)

REVERSE SCENARIO FOR USD

The Monetary Authority of the Central Bank of the Republic of Azerbaijan used to intervention in the financial market and had a preference for a pegged currency rate. It followed this policy during times of high oil prices which meant larger oil windfalls. Since 2014, slightly decreasing of oil prices in world market have resulted oil producer countries, like Azerbaijan, faced unplanned and unexpected reduction in oil revenues and intensification of monetary and fiscal policies. Monetary Authority had to interfere in currency market with to use foreign reserves as request of pegged exchange rate policy and it reduced foreign exchange reserves of CBAR. Before diminishing oil prices started CBAR had foreign reserves were 15 billion US dollars, whereas at the end of 2016, it had 4 billion US dollars in reserves and lost their supplier position in auction.

After the implementation of the floating exchange rate policy through "The Strategic Roadmap of the Republic of Azerbaijan on National Economy Perspectives", the Monetary Authority followed an Expansion Quantitative Easing (henceforth QE) policy for foreign currencies because of obtain financial stability in the local economy and meet market requirements with the support of SOFAZ. Thus, SOFAZ provided foreign currency to commercial banks through auctions twice a week. In addition to this policy, SOFAZ transferred 4.2(Center for Economic and Social Development (CESD), 2016) billion dollars to the CBAR to complete the foreign exchange reserves of the Central Bank. As a consequence of the transfers and liberal exchange rate policy, the CBAR then possessed nearly 4.5 billion USD in reserves.

Figure 1: Foreign Exchange Reserves of the CBAR

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

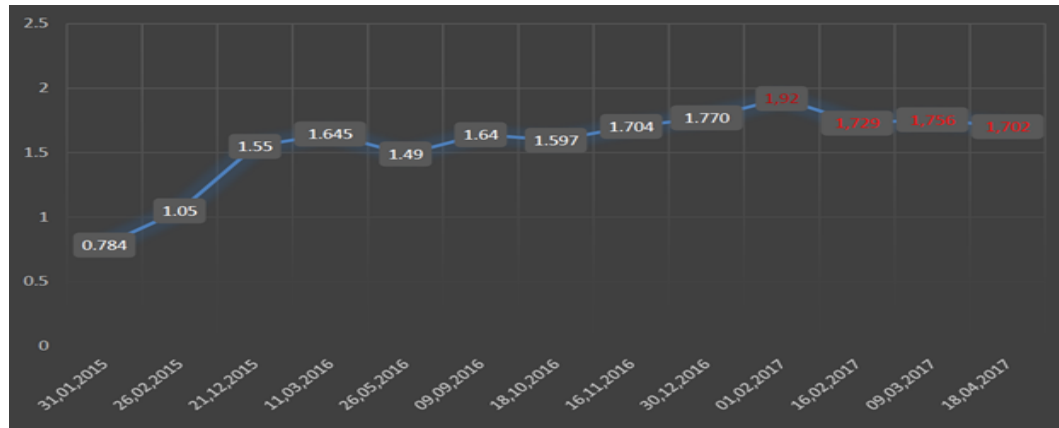
The exchange rate plays vital role in controlling inflation and inflationary expectations, maintain value of assets of population and real sector and financial stability of the banking sector.

ASSESSMENT OF MONETARY POLICY

Independent research shows that the annual real growth rate of GDP in Azerbaijan should be 11.7 % during the oil boom and 3.7 during the post-oil era in order to maintain long-term equilibrium between aggregate demand and aggregate supply. (TURAJ MUSAYEV 2019). The result of the prolonged slump in global oil prices was the significant negative effect to the financial system and generally the economy of Azerbaijan. In respond to this problem The Monetary Authority of Azerbaijan Republic started to pursue stricter monetary policy which resulted in a shrink of GDP to 0.9% between 2014-2017

Starting from 2016 The Monetary Authority of Azerbaijan Republic utilized the Taylor Rule, so that it raised the interest rate to prevent the value of manat from depreciation. As the result that year the interest rate of manat increased from 3% to 15%. This means that CBAR in order to carry the responsibility of maintaining the interest rate stable, five times raised the interest rate. The key purposes of the CBAR for which it increased interest rates were increasing deposit and bond rates (in order to extract manats from exchange markets and limit demand for dollars), increase the level of confidence in national currency, and decreasing inflation rate. (Ruslan Khankishiyev, 2017).

Figure 2: USD/AZN Exchange Rate



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

The next attempt of CBAR was the organization of deposit auctions in order to attract deposits in national currency and consequently extract more of national currency from circulation. The deposit auctions helped the Central Bank to achieve the following purposes:

1. Reduction of the volume of manat that is in circulation.
2. Increasing the profitability of manat, so by this way enhancing the level of confidence in national currency.

Bringing back the control over deposits, that were withdrawn because of reduced confidence in national currency.

Beginning from January of 2017, monthly auctions were offered by SOFAZ, at the amount of 250 million US dollars. This amount has met the market requirement, so caused the stabilization of manat. Also, global oil prices have risen (more than 50\$ for each barrel). Both of these reasons caused the appreciation of manat.

However, the stabilizing policy of country can't always be efficient. The policy of government to close many exchange places lead to the illiquidity of foreign greenbacks. This situation lead that the illegal black currency market confronted to the foreign exchange currency market of Azerbaijan.

SWITCHING TO FLOATING EXCHANGE RATE AND CURRENT SITUATION:

We can surely say that the reason for devaluation and changing the exchange rate system is low oil prices and enormous cash outflow from Azerbaijan to neighbor countries as neighbor countries devalued their currencies earlier. Decline of oil price had a negative impact on SOFAZ's 2015 revenues, oil revenue fall from \$15707,00

to \$7299,10. SOFAZ transfers as a percentage of state budget revenue was less than previous year in 2015, and form 46,4% of the budget. (F.Mammadov 2017)

Even if Azerbaijan has officially switched to floating rate, in reality there are some hindrances that prevent the effectiveness of floating rate. That's why still certain level of regulation of exchange rates exists.

The following facts can be highlighted:

- After two devaluations the population stopped believing to official statements of the Monetary Authority about predictions of the manat. The result is that people always prefer exchanging manat to US Dollars.
- The confidence in national currency is also weakens because of limited access to real and publicly available data.
- Financial instability that emerged because of shutting down banks, increase in foreign debt of banks, higher inflation rate and negative trade balance.
- The negative effect of illegal black currency market.

The deficiencies listed above cause the intervention of government to the exchange rate in following ways:

During auctions SOFAZ is the only supplier of foreign currency, which means that it dictates the market, which in turn implies the administrative power of the government over the financial markets.

In order to decrease demand in dollar auctions the CBAR prevented the International Bank of Azerbaijan (IBAR) from participation in auctions as it was the main player among commercial banks.. So IBAR itself would get foreign currency directly from CBAR.

CBAR started deposit auctions offering banks between 12-15% annual rate which was aimed to collect extra manat from market which in result will decrease money supply for a short term.

CONCLUSION

The monetary policy has successful and unsuccessful results for creating stabilization in the exchange rate. What did country get as a result of successful policy? Reduction of volume of manat that was in the circulation, increasing the profitability of national currency, enhancing of confidence in national currency, bringing back all the deposits that was withdrawn because of reduce in the confidence level in the AZN. Generally, it caused the appreciation of manat. However, there are negative sides. When foreign illiquidity is observed, illegal black market emerges. Population started to trade there and as a conclusion the government policy is damaged. Government after the devaluation passed

from fixed exchange rate to the floating exchange rate as a response. But, government can't follow this floating exchange rate system because of the regulations. There are also other reasons such as, population does not believe monetary authority official statements. Limited access to the real and publicly available data, financial instability, and illegal black market currency market are negative effects. They coupled with the ineffectiveness of the implemented monetary and fiscal policies. In a long run market will determine high exchange rate for US dollar as result of high discount rates. Currently exchange rate and interest rate parity doesn't hold almost for 2 years. Although CBAR pays high rates in deposit auctions the current situation can't prolong for a long term as with high deposit rates CBAR should increase money supply in a long run. This will cause in 20-30% rise in US dollar. In order to stop negative effects of this exchange rate system the CBAR should gradually change the exchange rates. In a long terms government should increase private sector and decrease the public sector participation in economy. This will lead to collection of high taxes and reduction of government spending. As private sector is more flexible to changes in economy, government will suffer less from exchange rates and will decrease dependence from oil revenue.

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