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Devaluation of manat: expectations and realities

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Abstract

This article will examine eight factors and evaluate the probability of Azerbaijan's manat devaluation in the post-oil period. However, there is no proportionality between the degree of influence of the listed factors and their ranking.

Key words: devaluation, inflation, PPP, manat, foreign trade, current account balance, REEM, bank, HHI

Introduction

Against the background of the decrease in oil revenues in Azerbaijan, the increase in regulated and market prices increases expectations regarding the manat's devaluation. The decline in foreign exchange earnings due to lower oil production and cheaper gas prices further increases consumer and business expectations that the closely related exchange rate will change. The fact that the current exchange rate policy has become one of the factors hindering the growth of non-oil exports, the high import component in the formation of consumer prices, the decrease in the purchasing power of the national currency due to high inflation, the sharp decline in the positive balance of the foreign trade balance and the current account compared to last year, and the increase in nominal and real effective exchange rates increased the arguments of supporters of devaluation in the government. At the same time, the fact that banks are more prepared for this process than in 2015, with their increased capital reserves and risk management strategies, strengthens their position. For many years, they have treated the devaluation as a necessary step to convert the manat, which has remained unchanged as the oil manat, into a real currency, and they do not see any other alternative for future risk management.

Thus, despite the psychological impact of the wave of devaluation in the countries that are Azerbaijan's main trading partners, even if the stability of the manat exchange rate is maintained, the fear of devaluation again increases the demand for the currency, accelerates the flow of investments abroad, and causes capital to remain outside the country.

Therefore, in this article, we look at the following factors that shape devaluation expectations.

Factor 1: Revenues from the sale of mineral fuel in foreign markets decrease, and the growth rate of non-oil exports that will replace it also decreases.

According to information as of July 1, in the first six months of 2024, the State Oil Fund of the Republic of Azerbaijan (SOFAZ) received¹ \$ 3,005.3 million in oil revenue from the Azeri Chirag Guneshli (ACG) field, which is \$ 342.7 million less than in the same period² last year. During the reporting period, revenues from the sale of gas and condensate on the Shah Deniz field amounted to \$ 244.069 million, which is \$ 757.931 million less than in the corresponding period of last year. Thus, in the first half of 2024, compared to the first half of 2023, the income of SOFAZ from oil-gas and condensate revenues decreased by 1 billion 100 million 631 thousand US dollars, which was mainly due to a more than 4-fold decrease in gas revenues during that period.

The decrease in oil revenues is related to the decrease in production. During the 20-year reporting period of the ACG field, the highest production was 300 million barrels in 2010; furthermore, there was a sharp decrease in oil production of the ACG in 2011 - 38 million barrels, in 2017 - 16 million barrels, in 2020 - 20 million barrels, and in 2023 - 19 million barrels. In 2023, the ACG oil production indicator was 44.5 percent of the peak production in 2010, and compared to 2014, production decreased by 100 million barrels or 43 percent. A sharp decrease in production in the ACG field has been observed since 2018, and

¹ <https://oilfund.az/fund/press-room/news-archive/1648>

² <https://oilfund.az/fund/press-room/news-archive/1595>

according to forecasts, this trend will continue until 2025, and production is expected to stabilize at the level of 119 million tons per year between 2025 and 2027. This leads to the conclusion that the decline of mineral fuel revenues is becoming a settled trend.

Moreover, let's note that according to the State Statistics Committee (SSC), in January-April 2024, the export of non-oil and gas products decreased by 22.5 percent in actual prices and by 30.2 percent in real terms compared to January-April 2023 and amounted to 920 million dollars³.

Factor 2: The surplus in the foreign trade and current account balance decreases.

According to the Customs Statistics of Foreign Trade Report⁴ of the State Customs Committee (SCC), the country's foreign trade turnover in January-May 2024 amounted to \$ 18 billion 439.27 million. \$ 11 billion 138.58 million (60.4 percent) of the trade turnover was the value of products exported from the country, and \$ 7 billion 300.69 million (39.6 percent) of the trade turnover was of the value of imported products, resulting in a positive balance of \$ 3,837.89 million. Compared to January-May 2023, foreign trade turnover decreased by 24.47 percent in actual prices, relatedly, exports decreased by 44.6 percent and imports increased by 10.67 percent. As can be seen, in the current year, as a result of the decrease of exports on the one hand and the increase of imports on the other hand, the foreign trade balance decreased by \$ 5 billion 437.7 million or 2.41 times in the first 5 months of 2024. This reduction had a negative impact on the balance of payments announced in the first quarter of 2024. So, in the current year, the positive balance of the current accounts of the balance of payments amounted to \$ 1 billion 730 million, which is 2 times or \$ 1 billion 648 million less than the same period last year.

Factor 3: Manat deposits decrease, foreign currency deposits increase.

So, in May 2024, compared to December 2023, manat deposits decreased 474 million manats or 2.43 percent from 19 billion 453.2 million manats to 18 billion 979.2 million

³ <https://www.stat.gov.az/news/macroeconomy.php?page=1&lang=az>

⁴ https://customs.gov.az/uploads/foreign/2024/2024_5.pdf?v=1718343859

manats. During the comparable period, foreign currency deposits increased 736.6 million manats or 7.59 percent from 9 billion 701.6 million manats to 10 billion 438.2 million manats.

Factor 4: The volume of transactions on the foreign exchange market increases, foreign currency purchases of banks exceed their sales.

According to the Summary of Monetary Policy⁵ of the Central Bank of Azerbaijan (CBAR) for the first quarter of 2024, the volume of operations conducted in the non-cash foreign exchange market during the reporting period was equivalent to \$ 8.9 billion. 81 percent of non-cash foreign exchange transactions were conducted in US dollars, and 19 percent in other currencies. 28 percent of foreign exchange transactions were carried out in the interbank foreign exchange market, and 72 percent in the intrabank foreign exchange market. During the reporting period, the volume of operations at the interbank foreign exchange market was equivalent to \$ 2.5 billion (including operations of SOFAZ and CBAR). 97.3 percent of transactions in this segment were conducted in US dollars. The volume of foreign exchange transactions at the intrabank foreign exchange market was equivalent to \$ 6.4 billion, of which 74 percent were transactions in US dollars.

Last year, the volume of foreign currency transactions conducted by banks was equivalent to \$ 1.4 billion, of which 91.6 percent were transactions in US dollars.

According to the Summary of Monetary Policy⁶ of the CBAR for 2023, the volume of transactions in the non-cash foreign exchange market in 2023 was equivalent to \$ 29.5 billion. 79 percent of non-cash foreign exchange operations were conducted in US dollars, and 21 percent in other currencies. 21 percent of currency operations were carried out in the interbank foreign exchange market, and 79 percent in the intrabank foreign exchange market. In the reporting year, the volume of operations at the interbank foreign exchange market was equivalent to \$ 6.2 billion (including the operations of SOFAZ and the CBAR).

⁵ <https://uploads.cbar.az/assets/09aa6a8f61b3daf4457115abc.pdf>

⁶ <https://uploads.cbar.az/assets/09aa6a8f61b3daf4457115abc.pdf>

98 percent of transactions in this segment were conducted in US dollars. The volume of foreign exchange transactions at the intrabank foreign exchange market was equivalent to \$ 23.3 billion, of which 74 percent were transactions in US dollars.

Last year, the volume of foreign currency transactions conducted by banks was equivalent to \$ 3.8 billion, of which 83.9 percent were transactions in US dollars.

As can be seen, in the first quarter of 2024, the volume of operations carried out in the non-cash currency market made up 30.16 percent of all operations carried out in this form in 2023, which was \$ 2.1 billion more than in the same period last year. In the first quarter of the current year, the volume of foreign currency transactions made 36.8 percent of the transactions in this form in 2023, which was \$ 429 million more than in the first quarter of last year⁷.

As can be seen, both non-cash and cash currency purchases and sales have increased compared to last year. For the first time in recent years, in 2023, foreign currency purchases of banks exceeded their sales. As a result, net sales settled in the negative zone.

Factor 5: Fiscal balance is disturbed, consolidated budget deficit increases.

The Opinion⁸ of the Chamber of Accounts of the Republic of Azerbaijan on the Draft Law of the Republic of Azerbaijan on Amending the Law of the Republic of Azerbaijan on the State Budget of the Republic of Azerbaijan for 2024 shows that the non-oil base deficit of the summary budget is increasing significantly. So, in 2024, against the background of a higher increase in the base expenditures of the summary budget (3 billion 891.8 million manats), the non-oil base deficit of the general budget is predicted to increase by 2 billion 50.2 million manats and amount to 20 billion 763.4 million manats compared to the approved indicator. As a result, the ratio of the non-oil base deficit of the summary budget to the non-oil gross domestic product is expected to be 24.5 percent during 2024, which suggests that the corresponding indicator is not within the budget rule.

⁷ <https://uploads.cbar.az/assets/c704f3600924427ccfe662d07.pdf>

⁸ https://sai.gov.az/files/db_rey_durustlesme-887515685.pdf

In the preliminary budget documentation of 2024, it was shown that the calculation of the price of oil with \$ 10 more will have an increasing effect on the summary budget by 2.2 billion manats. In the revised budget draft, the price of oil is increased by \$ 15 to \$ 75, and an increase of 4.5 billion manats (including 2.6 billion manats from oil revenues) is predicted for the revenues of the summary budget⁹.

As can be seen, the decrease of Azerbaijan's mineral fuel revenues against the background of the increase in budget expenditures has a negative impact on the sustainability of economic growth and the balancing of the fiscal balance. The determination of such a trend makes calls for fundamental reforms in the economy of Azerbaijan even more urgent. In this context, the devaluation of the manat exchange rate can also have a positive effect on the increase of summary budget revenues in terms of manat.

Factor 6: Inflation is not abating, the purchasing power of the manat is weakening.

After the devaluations of 2015, double-digit inflation from 2016-2017 was repeated in 2022. So, inflation increased significantly in late 2021 and 2022 compared to the target interval, stimulated by external shocks and the government's decision to raise tariffs for regulated goods. The exact process can be observed after the decision of the Tariff Council on June 30, 2024, regarding the increase in the regulated prices of gasoline, diesel fuel, public transport, and medicines. Even though it is the summer season, due to the shortage of agricultural products, especially fruits and vegetables, the prices of the goods have increased, especially for the food basket of consumers. Following 8.8 percent inflation in 2023, the factors that have an increasing effect on prices have become more active in the current year. Thus, due to continuous inflation, the purchasing power of the manat has weakened year by year, which ultimately increased the pressure on the devaluation of the manat exchange rate.

⁹ https://sai.gov.az/files/db_rey_durustlesme-887515685.pdf

According to the information released by the SSC, the inflation rate in Azerbaijan after the last devaluation was 12.4 percent in 2016, 12.9 percent in 2017, 2.3 percent in 2018, 2.6 percent in 2019, 2.8 percent in 2020, 6.7 percent in 2021, 13.9 percent in 2022, and 8.8 percent in 2023¹⁰. The author's calculations show that in 2015, 100 manats, the national currency of Azerbaijan, were accepted as a benchmark. Still, according to the Purchasing power parity (PPP) approach, as of July 1, 2024, 100 manats domestic purchasing power was 37 manats. That is, we are currently spending 100 manats for the goods we bought for 37 manats on January 1, 2016. It increases the need to devalue the manat. So, according to the PPP theory, the devaluation rate should be equal to the change in the domestic purchasing power of money.

In particular, the positive shock in oil prices since 2022 has caused the appreciation of the national currency in Azerbaijan in the long-term in relation to the leading currency units, except the dollar, as well as the currency of neighboring countries, Turkey and Russia, which are the main trading partners in imports. According to empirical studies, there is a positive and significant relationship between the oil price and the exchange rate. Furthermore, studies show that the real effective exchange rate has a common stochastic trend with oil prices. According to SOFAZ¹¹, the average export price of Azerbaijani oil for 1 barrel was 101.1 US dollars in 2022 and 86.1 US dollars in 2023. If we take into account that oil prices are high in the current year as well as in the last two years and the oil demand will reach its peak in 2025 according to BP's latest forecast¹² (oil demand will be 102 million barrels per day), then the real effective exchange rate of the manat will continue to trend upwards from the equilibrium point, which will increase the possibility of devaluation.

¹⁰ https://www.stat.gov.az/source/price_tarif/

¹¹ <https://oilfund.az/report-and-statistics/report-archive>

¹² <https://www.bp.com/content/dam/bp/business-sites/en/global/corporate/pdfs/energy-economics/energy-outlook/bp-energy-outlook-2024.pdf>

Factor 7: The real effective exchange rate (REER) of the manat is set above the equilibrium point.

For information, I should note that the REER index reflects the geometric mean of the change in the bilateral nominal exchange rates of the manat against the currencies of the trading partner countries, taking into account trade-specific weights and inflation in those countries. The value (inertia) of REER in the previous period, real oil prices, the difference in labor productivity with partner countries, and the difference in interest rates are considered the main indicators that shape the real rate.

The fact that inflation is higher than the average inflation in the partner countries has an increasing effect on REER, and its opposite has a decreasing effect on REER. The fact that the REER index is above the equilibrium level, i.e. the increase in the price of the REER, is considered one of the main factors determining devaluation. It was in 2015 that the devaluation of the manat corrected a large part of the increase in the price of the REER experienced during the previous oil boom. As a result, by 2016, REER was slightly above its 2005 level. As a result of higher inflation and the devaluation of the currencies of major trading partners, the real effective exchange rate has appreciated slightly over the past 3 years, and by 2023, it was more than 20 percent above the 2000 level. So, according to the CBAR's Monetary Policy Review Report¹³, the nominal and real bilateral exchange rates of the manat against the currencies of Azerbaijan's trading partners in 2023 strengthened by 19.3 percent and 5.1 percent, respectively, compared to December 2022. Compared to 2000, in May 2024, NEER was 104.3 percent, and REER was 120.1 percent. In other words, the real effective exchange rate of the manat was above the equilibrium point during the past year. However, against the backdrop of devaluations of our trade partners' currencies and rising inflation in Azerbaijan, the stability of the manat against the US dollar continues to increase the real effective exchange rate of the manat towards the

¹³ <https://uploads.cbar.az/assets/02013a6889281a5f272c2063b.pdf>

equilibrium point. This has become a settled trend since the beginning of 2021, and in the first 5 months of 2024, it is observed that it does not stand above the equilibrium point, that is, the price increases¹⁴.

Factor 8: Compared to 2015, the level of preparedness of the banking sector has increased.

As a result of the devaluations of 2015, the banking sector of Azerbaijan did not withstand the shocks of the deposit flow and rapid dollarization after the devaluation and the subsequent increase in problem loans, a credit and banking crisis occurred in the financial sector, and the consumer price index rose to a double-digit level. So, as a result of the double devaluation that took place in 2015, the banking sector experienced significant currency distortions on their balance sheets and an increase in non-performing loans from borrowers affected by devaluation. This led to the closure of several banks in 2015-2016, with the licenses of 13 banks revoked. The largest bank in the sector, the state-owned International Bank of Azerbaijan (IBA), has undergone a large-scale restructuring at high costs. As a result of this process, the bank's external debt in the amount of 3.3 billion USD was restructured, capital investment in the amount of 600 million manats and transfers in the amount of 14 billion manats to Agrarkredit (a state-owned non-bank credit organization authorized to manage IBA's toxic assets) have been carried out¹⁵.

Despite the fact that the share of financial sector assets in Azerbaijan's GDP is still low, the closing of banks and the restructuring of IBA have had a positive effect on the development of the financial sector. So, according to the Financial Stability Report¹⁶ of the CBAR for 2023, the ratio of bank assets to GDP, which is one of the main indicators characterizing the financial depth of the banking sector, increased by 4.8 percentage

¹⁴ <https://cbar.az/page-41/macroeconomic-indicators>

¹⁵

<https://documents1.worldbank.org/curated/en/09910010922241014/pdf/P175326058504d07d0b6df0510aeb761254.pdf>

¹⁶ <https://uploads.cbar.az/assets/1db1173040cd0364af5d7f0d2.pdf>

points compared to the end of 2022 and amounted to 40 percent. At the same time, the ratio of loan portfolio to GDP, which is another indicator of financial depth, increased by 4.2 percentage points compared to last year and reached 18.8 percent. For comparison, let's note that the sector is significantly smaller compared to similar countries in the region. For example, the ratio of Georgia's financial sector assets to GDP was 111 percent in 2019. The slow pace of recovery has been caused by the prolonged process of bank consolidation and recapitalization. However, the Financial Stability Report¹⁷ of the CBAR states that the low level of financial depth indicators of the Azerbaijani banking sector compared to benchmark countries indicates that the sector has a high development potential.

According to CBAR's statements, 19 banks have been liquidated by 2024, and 23 banks are currently operating in the country. 2 of these banks are state banks. The number of banks with foreign capital is 9, and one of these banks is a local branch of a foreign bank. The service network of the sector consists of 475 branches, 96 departments, 3,040 ATMs, and 23.6 thousand employees. These indicators show that the level of concentration in the banking sector is increasing. So, the dynamics of the Herfindahl-Hirshman Index (HHI) based on the share of the loan portfolio, deposit portfolio, assets, and net profit in the system represent negative changes in 2018-2022¹⁸. All this leads to the conclusion that although the banking sector is more prepared for devaluation shocks compared to 2015, reforms in this sector should be continuous and fundamental changes should be implemented in order to increase competitiveness. This goes through the depoliticization of the banking sector.

¹⁷ <https://uploads.cbar.az/assets/1db1173040cd0364af5d7f0d2.pdf>

¹⁸ Ibadoghlu, Gubad and Bayramli, Emin, Analysis and Evaluation of HHI and Beneficiary Ownerships of the Banking System of Azerbaijan (June 11, 2023). Available at SSRN: <https://ssrn.com/abstract=4475680> or <http://dx.doi.org/10.2139/ssrn.4475680>

Conclusion

Regarding the facts, firstly, there is no proportionality between the degree of influence of the listed factors and their ranking. Measuring the degree of influence of each factor requires more profound studies, which can create the basis for their ranking. However, if the number of factors is at least 8, the probability of devaluation is high.

Secondly, it is essential to examine the effect of the exchange rate on aggregate indicators of the real sector in Azerbaijan. This includes GDP, inflation, employment level, import, export, etc. Such an examination allows for the measurement of the impact of the post-devaluation fixed exchange rate policy on individual indicators and sectors. These impacts are undoubtedly different, and the transmission channel and duration of this impact are not the same for all sectors. Furthermore, the reactions of commercial and non-commercial sectors to devaluation are different. A key issue that needs to be addressed is the prevention of future price increases in areas and sectors following devaluation, as this can have significant economic implications.

Finally, let us mention that the government's adoption of a devaluation decision in fixed exchange rate systems means the failure of the applied economic and financial policy. Therefore, governments should avoid making devaluation decisions until the last moment. Instead, it tries to promote exports and restrict imports indirectly. This also leads to the expansion of bureaucratic barriers and a move away from the market mechanism.

It's crucial to note that the impact on the REER is significant in countries with high exports of mineral fuels like Azerbaijan (oil and gas exports accounted for 88.68 percent of the exports of the first five months of 2024). A decrease in oil production and gas prices can reduce the state's foreign exchange income and increase demand for imported goods, pushing the REER above the equilibrium point. The continuous decline in the national currency's purchasing power increases the possibility of

devaluation yearly; the state's political leadership, not the governments and banks, decides about it.