



## AZERBAIJAN'S BANKING SECTOR AFTER THE SWITCH TO FLOATING EXCHANGE RATE REGIME

In 2014, the Central Bank of Azerbaijan stated that the banking sector in Azerbaijan started to develop as a result of ongoing positive dynamics of macro indicators and regulations which were characterized by the role of banks in the economy. According to Financial Sector Assessment Paper (2012) prepared by the Asian Development Bank, there are 44 banks in Azerbaijan's banking sector 5 of which are majorly owned by foreigners and remaining 18 are established with some foreign shareholders mainly from Russia, Turkey and Middle Eastern countries.

In 2014, Manat was controlled by the Central Bank and it was very important for the Central Bank to hold the currency at a stable rate since the oil prices were continuously dropping which was the main cause of the decline in the Central Bank reserves. The foreign currency reserves started to decrease slowly in July 2014. At the time, the reserves were over 15 billion dollar. After December 2014, its volume started to decrease sharply due to the increase in demand for dollar supply in the market. Until the February 2015, it experienced around 30% decline. At the end of 2015, the reserves were only 5 billion dollar which meant around 65 % decrease since 2014 July.

This decline was one of the causes of a deterioration of the fiscal balance. Therefore, on February 21, 2015, the Central Bank of Azerbaijan made a decision to set the exchange rate against Dollar as 1.05 which was 0.78 before. This corresponded to a 34% devaluation. However, after this devaluation, banking sector faced enormous problems. Banks could not get back dollar credits, depositors started to get back their currencies from their savings accounts and converted these currencies dollars. Foreign-currency loans comprised 27% of total lending at the end of 2014. According to the Fitch Rating Agency this was about 33% after this devaluation.

As known, on December 16, 2015, FED raised interest rates by 25 basis points. This was the first rise since 2006. Following this decision, on December 21, 2015, the Central Bank of Azerbaijan switched to a floating rate regime caus-

ing Manat to loose half of its value against Dollar (1 Dollar=1.55 Manat). The Azerbaijani Central Bank officials explained the reason of this switch to floating exchange rate by "intensifying external economic shocks". In fact, this devaluation which was the result of shifting to floating exchange rate can be considered as the second major devaluation within the same year. This currency fall helped the government, which had drawn up its 2016 budget on the basis of a \$50 oil price, to balance its books. But, this decision had negative effects on the banking sector and Azerbaijani citizens whose salaries and pensions and depositors whose savings were in terms of Manat.

According to 2014 report of the Fitch Rating Agency, at the end of June 2014, 70% of Azerbaijani bank deposits were denominated in foreign currencies. Whereas for 31 December 2015, according to the Central Bank, 85% of the deposits were denominated in foreign currencies. In general, after devaluation, deposits in all banks decreased by 320 million Manat. Dmitry Vasilyev, the director for financial institutions at Fitch, told that Azerbaijan's banking sector is facing two risks. Firstly, the assets in terms of Manat will rise in price, and respectively the capital adequacy ratio, which is the ratio of bank's capital to its risks, of all the banks will fall. Secondly, some banks which have straight open foreign currency position will have to accept large non-recurring losses due to Manat's devaluation, which will also affect the capital adequacy ratio. Fitch officials also said that the dollarization of deposits will continue in the country.

These events caused the loss of trust to the Central Bank. The exchange offices in Baku were closed for several days. The majority of banks did not exchange any Dollars into Manat. Moreover, as a result of an order declared by the Central Bank on January 6, 2016, the currency exchange offices which were located in places like buildings, shopping areas, entertainment centers, fairs, hotels, railway stations, ports and post offices were to be closed until March 2016. The Central Bank also limited the currency exchange rate corridor within 4% of the

official rate by purchasing -4% of the official rate and selling +4% of the official rate with an instruction which was sent to the banks. Due to these changes a black market emerged in the country.

Critics declare that shifting to flexible exchange rate had to happen sooner or later because Azerbaijan's economy depends on oil. However, the main criticism is about the timing. The step should be taken long before, before the decline of reserves to \$14 billion. Before 21 December decision, only four banks were having problems about meeting capital requirements, but today many banks have been suffering from this problem. Three banks were closed and the situation of four banks are under question. Economists comment that, the number of these banks will increase to 23-24 in near future. Consolidation is the most effective way of meeting the capital requirement. That's why, the majority of banks have been discussing the possibility of consolidation. In fact, the Central Bank of Azerbaijan is suggesting the development options of capitalization, consolidation, or ultimately going out of business for the banks.

The current situation of the banking sector makes it once again clear that, dependence on oil prices does not predict future stable development for the country especially for the banking sector. Dependence on oil must be reduced to the lowest level. Foreign investments should be attracted to non oil sector and the business climate for these investments should be improved. Trade barriers should be reduced. Anti-corruption programs should be applied more effectively. In addition, capital and financial markets need to be expanded. Azerbaijan ranks 80th in the World Bank's ease of doing business survey. With the suggestions above and other measures that can be taken to improve the financial markets and business environment, the Azerbaijan economy can not only stabilize its financial markets and attract more investors to the domestic markets but also increase its ranking in international markets.

## Politics, Foreign Affairs and Security

- During the 13th Conference of Shanghai Cooperation Organization (SCO) Defense Ministers held in Astana, the parties summed up the results of cooperation stressing that as the threat of international terrorism activities continue to rise, the defense departments and armed forces of the SCO countries should further enhance cooperation to protect regional security and stability. The Defense Ministers of the SCO Countries Joint Communique and other documents were signed at the Conference.
- During the meeting of the Council of Heads of Governments of the Commonwealth of Independent States (CIS) held in Bishkek, the parties approved a protocol decision on the elaboration of proposals aimed at improving the activity of the executive bodies of the CIS and increasing the efficiency of the organization. These proposals will be submitted to the Council of CIS Heads of State, which will be held in September 16 in Bishkek.
- During his official visit to Moscow, the Prime Minister of Israel, Benjamin Netanyahu, and the President of Russia, Vladimir Putin, signed a number of agreements on social support, customs regulation and cooperation in energy. The parties paid special attention to the issue of pension provision for Russian pensions to Israelis who did not keep the previous citizenship after immigration from the Soviet Union and Russia.
- During his official visit to Astana, the Deputy Prime Minister, the Minister of Economy and Sustainable Development of Georgia, Dimitry Kumsishvili, and the Prime Minister of Kazakhstan, Karim Massimov, discussed prospects of deepening trade-economic relations, increasing mutual trade turnover as well as intensification of business contacts between the two countries.
- During his official visit to Ashgabat, the Minister of Defense of Russia, Sergei Shoigu, and the President of Turkmenistan, Gurbanguly Berdimuhamedov, discussed the ongoing military operation carried out by Russia's forces in Syria and current situation on the Turkmen – Afghan border.
- Ukrainian aircraft manufacturer, Antonov, signed contract for the sale of 10 military transport planes AN-178 to Azerbaijan. According to the deal, the first batch of two aircraft and then the final batch eight aircraft will be delivered to Azerbaijan with-

in two years. An aircraft is capable of carrying 18 tons of cargo.

- During the meeting held in accordance with the Individual Partnership Action Plan between Azerbaijan's Defense Ministry and NATO for 2016, the parties exchanged views on the activities and the standards applied to Naval Forces of Azerbaijan and NATO in the training process of deck-search units for tracking sea.

## Economy, Finance and Energy

- During his visit to Minsk, the President of Russia, Vladimir Putin, noted that Russian state-owned company Gazprom plans to invest \$2.5 billion in the development of the Belarusian gas pipeline system by 2020. It was also noted that Gazprom plans to invest \$1.1 billion in boosting the capacity of underground gas storage facilities in Belarus by 2020. Gazprom supplied 18.8 billion cubic meters of natural gas to Belarus in 2015. Furthermore, 45.4 million cubic meters of natural gas were supplied via Belarus to CIS and non-CIS countries and the Kaliningrad region of Russia.
- According to Azerbaijan's state-owned oil and gas company, Azneft, the company produced 2.619 million tons of oil in January-May 2016. Current company's production of gas amounted to 2,386.1 million cubic meters in the same period of 2016, which exceed the planned amount by 2.7%.
- According to the U.S. Energy Information Administration's (EIA) forecasts, Kazakhstan's oil production will drop from 1.73 million barrels per day (bpd) in 2015 to 1.68 million bpd in 2016 and reach 1.7 million bpd in 2017.
- The Russian gas company Yamal LNG announced about receiving the first \$1.2 billion tranche within the framework of the loan agreement signed with Sberbank and Gazprombank. It is planned that total project financing will amount to \$18.4 billion. The Yamal LNG project involves the construction of a gas liquefying plant near the Yuzhno Tambeiskoye field in the Arctic Russia. The designed capacity is 16.5 million tons of LNG per year. The project is scheduled to be launched in 2017.
- Turkmenenergo State Corporation signed a contract with Da Afghanistan Breshna Sherkat (DABS) on the electric-power transmission over the route Atamurat (Turkmenistan) – Andhoy (Afghanistan). The sides have also come to an agreement on the extension of previously signed contracts on the electric-power

transmission from Turkmenistan to Afghanistan. The construction is planned to start in January 2018 and finish in December 2027.

- The World Bank (WB), in its new analytical report, changed its GDP growth forecasts for Russia and the Central Asian countries. According to the report, the WB expects that Russia's GDP growth slightly improves from -1.9% to -1.2% in 2016 and will grow by 1.4% in 2017. It was also reported that the economies of Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan would grow by 0.1%, 3.4%, 4%, 5% and 7.3% respectively. Overall, the economic growth in Central Asia would reach 2.1% and 3.4% in 2016 and 2017 respectively.
- According to the Minister of Economy of Azerbaijan, Shahin Mustafayev, the country allocated \$106 million worth of preferential loans for financing 52 logistics centers with a total capacity of 330,000 tons. Currently, 42 out of 52 logistics centers operate in the country with total capacity of 241,000 tons.
- According to the National Statistics Office of Georgia, Azerbaijan invested \$137 million in Georgia's economy in the first quarter of 2016. It was also noted that, following Azerbaijan, Turkey and the UK made \$57 million and \$44 million of investment respectively in Georgia's economy.

## Society and Culture

- The International Union of Pure and Applied Chemistry (IUPAC) announced its plans to name two recently discovered elements after Moscow City and the Russian academician. The Mendeleev periodic table will be appended with four new elements. The element with the index 115 will have the symbol Mc and the name moscovium after the city of Moscow while the element with the index 118 will get the symbol Og and will be named after Yuri Oganessian.
- The Spiritual Administration of Muslims of Uzbekistan (SAM) announced that during the Ramadan period the customary of breaking fast at sundown is being banned in mosques and restaurants. The SAM suggests people to gather at home in small groups instead of gathering in large groups in public places.
- According to Russia's Roscosmos space agency, The Proton-M carrier rocket with Briz-M rocket orbit insertion upper stage and US communications satellite Intelsat 31 (Intelsat DLA2) was launched from the Baikonur spaceport.