PECULIARITIES OF THE STABILIZATION POLICY
IN AZERBAIJAN UNDER THE FINANCIAL CRISIS

Isa H. Aliyev
Institute of Economics
Azerbaijan Academy of Sciences, Baku, Azerbaijan
Phone: +994 050 211 82 88
E-mail: a.h.haciyev@gmail.com

Agha-Karim H. Haciyev
Institute of Economics
Azerbaijan Academy of Sciences, Baku, Azerbaijan

Rahim A. Haciyev
Institute of Economics
Azerbaijan Academy of Sciences, Baku, Azerbaijan
Phone: +994 050 211 82 88
E-mail: Rahim.hajiyev@gmail.com

Abstract

General characteristic of Azerbaijani economy is its high sensitiveness to external shocks. This is mostly due to high share of oil and gas sector in the economy, which reached at different times approximately 55-60% of GDP. In this connection the dynamics of energy resources prices in the world market is the main channel of impact of the financial crisis on economic situation in the country.

As in many countries with developing financial markets and specific structural characteristics of the economy, exchange rate of Azerbaijan manat to USD dollar is an important "nominal anchor" for ensuring the macroeconomic stability. In other words, among all possible interim monetary indices manat's exchange rate is the most under control and predictable orientator for achieving ultimate aims of monetary policy – stabilization of price and financial system.

As a whole it is considered that in the capacity of a conductor for the monetary and fiscal policy one of the following indices could be chosen – the exchange rate, money supply and the interest rate. It is not possible to target all those three indices at the same time. Fixation of exchange rate in this case does not allow the central bank to operate with interest rate. With intensification and complication of the capital market the demand for money becomes unstable and the interest rate comes out as a main orientator for the participants of economy.

The article analyses the peculiarities of the stabilization policy in Azerbaijan.

Macroeconomic situation in Azerbaijan depends significantly on prices and plans of the main point of the country's oil and gas export [1]. So:

- in high prices and rates conditions in the world market of energy resources proficit of current account on balance of payments of the country which is becoming a pressuring factor on the nominal rate of national currency. The attempts of Central Bank (CB) of Azerbaijan to slow down the rates of national currencies consolidations within active mechanisms of monetary-credit regulations, more specially, within either targeting of the amount of money in circulations (according to M2), or targeting of the nominal rates of the national currency makes it purchase redundant currency masses on the market. This leads to the increase, on one hand of gold and foreign exchange reserves of CB, on the other hand to the increase of the amount of money in the circulation which boosts inflation processes and specifies the growth of the real effective rates of national currency.

  Moreover, with the growth of prices and rates in the world energy resources market, takes place the growth of inflation imported into the country. This forces CB which provides constant monitoring of the inflation rates in the country to take more measures about its' reduction – more specifically provides further consolidation of the national currency rates;

- in the years of adverse extra economic conjuncture – slump in level of prices and rates in the world markets of energy resources becomes a necessity:
  - appropriate corrections and reduction of budget expenditures;
  - extra injections on currency market with the purpose of elimination of devaluation of national currency;
  - reduction of level of gold and foreign exchange reserves of the country.

In the tables 1 and 2 it is given the dynamics of basic macroeconomic indices of Azerbaijan in the years of favorable (2005-2008) and adverse (2008-2009) situations in the world markets of energy resources. As it is seen from submitted data:

- it is a big correlation between the dynamics of GDP of the country and average annual level of prices for oil in the world markets of energy resources and according to this the years of favorable and adverse situation are noted;
- the growth of M3 (because of incoming "petrodollars") specifies intensive currency buying-up by CB, the growth of M2 and gold and foreign reserves of CB from one side and inflation level from other side (the most characterized in this case were the years 2007-2008, when inflation levels were approximately 16.7 and 20.8%);
- the necessity of reduction of inflation level in the conditions of targeting of M2 specifies the strengthening of national currency rate. The national currency rate has been strengthened on 15% in 2008 compared to 2005.
- in the years of adverse conjuncture (2008-2009) price shocks in the world markets required serious adjustments on correction of budget policy of the country (table 2). In these years reductions of some articles of budget expenditures, injections from State Oil Fund (SOF) were necessary for maintenance of social guarantees of the government, additional expenses of gold and foreign reserves of CB that became slump in its' level and etc.

Table 1

The dynamics of basic macroeconomic parameters

	2000	2005	2006	2007	2008	2009	2010
GDP (in mln. manat)	4718.2	12522.5	18037.1	26815.1	40137.2	34578.7	41574.7
Share of oil-sector in GDP (in %)	35.2	51.6	60.8	64.4	62.1	54.6	55.6
Average annual value of AzeriLite type oil (in US $)	29.0	54.4	60.2	72.7	97.7	62.1	78.2
Average annual nominal national currency rate compared to US $	0.8948	0.9459	0.8714	0.8461	0.8046	0.8030	0.7989
Inflation	1.8	9.6	8.3	16.7	20.8	1.5	5.7
Monetary units (in mln. manat)							
M0	207.0	547.4	1853.6	2713.5	4145.7	4174.8	5455.8
M2	325.8	796.7	2137.7	4401.6	6081.0	6169.2	8297.5
M3	509.7	1841.8	3440.5	5897.3	8494.2	8469.2	10527.5
Rate of Central Bank's reserves (in mln. US $)	691.4	1112.2	1967.3	4015.3	6137.0	5175.6	5470.7

Because of this in accordance with estimation of some international financial institutes and mainly International Currency Fund (ICF) the quality of the conducted budget and macroeconomic policy is low in Azerbaijan today. In the period of 2005-2008 the macroeconomic balance in the country was upset – passing ahead of overall demand over overall supply speeded up inflation processes.

Peculiarities of stabilization policy under global financial crisis. The main channels of transmission of global crisis on Azerbaijan economy were:

- slump in prices for oil on world markets (besides reduction of liquidity in economy, world prices cut has its influence also on export of other spheres, in particular metallurgy, chemical industry);
- high level of financial liberalization (since 2007 limits on operations with currency have been taken in Azerbaijan);
- reduction of foreign refinancing of banks in the result of crisis.

In these conditions CB and Azerbaijan government had to accept not ordinary arrangements for stabilization in economy.

Table 2

The basic parameters of Azerbaijan state budget

	2000	2005	2006	2007	2008	2009	2010
Incomes in total (in mln. manat)	714.6	2 055.2	3 868.8	6 006.6	10 762.7	10 325.9	11505.0
Share of income from oil and gas sector (%)	28.6	33.7	58.4	58.2	63.9	64.9	66.2
Expenses in total (in mln. manat)	764.0	2 140.7	3 790.1	6 086.2	10 774.2	10 567.9	12275.0
Level of budget deficit (%)	7.0	4.2	-	1.3	0.1	2.3	6.7

The present model of CB's monetary policy had two-stage structure: the first stage with classical instruments of monetary policy was directed on maintenance of stability of consumer prices in economy; the second stage included the mechanisms of contrcyclic macroprudential regulation. The essence of the last mechanism is the regulation of capital adequacy norms by banks and compulsory reservation.

An effective use of this model let CB to neutralize some negative consequences of crisis on the economy of the country. The prudential norms were defined to maintain liquidity enough and create additional reserves on potentially problematic credits. The conditions of assets classification were tightened, price ratio of total credit guarantee was increased. The norms of risks were revised and toughen with the purpose of regulation of credit risks.

The main purposes of Azerbaijan Central Bank's policy in crisis period included provision of financial system with liquidity, maintenance of overall demand and stability of financial system.

For this purpose a wide range of measures have been used:

- CB (Central Bank) 6 times changed refinancing rate and collar limits on operations in open market towards decrease. In the result of this refinancing rate decreased from 15% to 2%, consequently high collar limit fallen from 20 to 7%. Standards of mandatory reservation on internal source of funds attraction were decreased from 12 to 0.5% and on external sources of funds attraction were abated at all. In the result *net volume of "liquidity injections"* to economy in the years of crisis amounted approximately 2 bln. USD. Banks received 730 mln. USD of this sum at the expenses of reduction of required reserves.
- Activation of discount window of Central Bank in general was oriented towards support of liquidity of backbone companies – State Oil Company and banks aiming at timely external debt service;
- Mortgage fund extended its operation, this is immediately showed itself on the price stabilization in immovable property market and increase of activity in this market (prices stabilization played important role in financial position of banking sector, because immovable property was a mortgage for the half of loan portfolio).

All of these measures strengthened financial stability of banking sector. So, liquidity of banking sector is very high today, quick liquidity consist of 80%, while accepted minimum standard is 30%. Long-term liquidity also is remaining favorable. Results of stress-testing conducted by Central Bank indicated that, even in case of the most unfavorable scenarios of macroeconomic situation developments banking system is able to survive after strong shocks and absorb arising losses.

Characteristics exchange rate policy. As it is known in accordance with IMF methods, currency rate policy which is realized in various countries is classified as following:

- *rigid fixation* (national currency rate is fixing rigidly in ratio to one of the leading world currencies and CB of the country is bounded to support exchange rate of national currency by means of currency interventions);
- *flexible fixation* (the sense of this is in controlling national currency rate by CB without rigid fixation, but in the frame of certain "collar"). There are *usual flexible fixation, actual stabilization, horizontal collar, sliding linkage* types of flexible fixation;
- *floating currency rate* (it has types: *controlled floating* and *free floating*). When it is *controlled floating* the currency rate is defined mainly by the market, on the basis of demand and supply and CB impacted on the rate formation only when it is necessary, by conducting currency interventions in market. When it is regime of *free floating* national currency rate formed by the market and impact of CB on the market by currency intervention takes place in exclusive cases.
- *other regimes of rate controlling* (all types of currency rate policies which are not referred to other categories refer here).

In Azerbaijan, as it is in many countries with developing financial markets and specific structural characteristics of economy manat to dollar exchange rate is significant "nominal anchor" to support macroeconomic stability [2-4]. In other words, among all possible intermediate money indicators the rate of manat is the most controlled and predictable guideline for achievement of aims of money policy like price stability and financial system.

In the whole as guides of money-credit policy one of the following three indicators may be chosen – exchange rate, money volume and percent rate. It is impossible to target all these indicators simultaneously. In this case fixation of exchange rate does not allow central bank to operate percent rate. Besides, as per Mandella-Flemming model, while passing to floating currency rates system under condition of high mobility, international movement of capital efficiency of fiscal policy as macroeconomic regulator is falling significantly. In this case, money-credit policy became the most efficient tool to impact on issue and employment level in economy.

As more the growth of monetization of GDP, financial market deepening and complication, capital market developing and elimination of structural distortions in transition economy the demand for money became unstable and percent rate is going to be main bench mark for participants of economy activity. Fixation of exchange rate in this case does not allow central bank to operate by percent rate.

On the basis of above-mentioned, Central Bank of Azerbaijan basing on the principle of evolutionary modification of monetary policy regime de facto conducts rate policy in the regime of linkage to USD, although de jure currency basket consisting of USD and euro is serving as

operational bench mark. There are serious basis for this. The matter is that, the year of 2009 is appeared to be the period when excessive manat volatility could bring to destabilization of financial sector. But standard use of currency basket provides for synchronization manat rate movement in ration to USD and Euro with movement of cross-rate of USD to euro.

Such policy allows to central banks gradually refuse from one-sided fixation of rate to USD, to support flexibility of the rate and smoothly change over other monetary bench marks (in the first place percent rate on interbank market). However, this demands corresponding conditions in the economy. The decision of rate stability support was made on the basis of analysis of macroeconomic factors.

The following arguments showed the need in conducting devaluation of manat:

- This permits to improve foreign-trade balance in the conditions of price falling for exported goods.
- Defense de-facto of fixed rate brings to significant loss of gold currency reserves.
- Devaluation of monetary unit allows to exporters to get additional liquidity.
- From other side, there were serious arguments for keeping stability of exchange rate.
- Payment balance – basic monetary basis of rate stability – it remains stable and does not give basis for devaluation. Currency reserves in this case cover money volume in national currency fully. The countries, which faces growing deficit of payment balance and danger of complete loss of currency reserves resort to devaluation.
- In the condition of reduction of global demand and contraction of external markets, a positive effect of devaluation on export may be enough limited. As regards to the problem of import curb, its volume in non-oil sector decreased even without devaluation.
- Devaluation will not assist to quick import replacement because of limited unloaded producing capacity.
- Under conditions of high unit weight of imported packaging, materials and semi-manufactured articles in the production of local goods (as per some investigations from 40% to 60% depending on fields of industrial manufacture) devaluation of manat may disrupt its external competitiveness.
- The growth of inflation and consequently decrease of real assets and capital price, impoverishment of population could be the result of devaluation.
- While current scales of dollarization of the loans (46%) 2/3 dollar loans were issued to sectors of economy which did not receive income in foreign currency. Consequently, devaluation could influence to financial position of these sectors, causing acute impairment of the ability to pay on bank loans.
- Acute devaluation could bring to panic among population and sharp outflow of finds from the banks, intensifying liquidity problem. At the same time, floating devaluation would strengthen uncertainty, causing dollarization and further pressing on currency reserves.
- Devaluation could increase expenses on foreign debt servicing and debt burden of the banks.

In long term perspective Central Bank of Azerbaijan is orienting towards gradual transmission to regime of flexible exchange rate. In post crisis period the flow of foreign capital and exported oil incomes have grown. This may bring to overheating of the economy because of

increase of money emissions in the condition of fixed currency rate. Therefore, flexibility of rate policy is very significant in the long-term plan for concentration of monetary policy on achievements of target indicators of inflation.

Peculiarities of structural policy. Workable model of economic growth is oriented to achievement of high level of diversification and step-by-step growth of the share of non-oil sector of economy in aggregate volume of country export. The model structure is based on the fact that quantity of country population (9 mln.) does not provide sufficient level of internal demand, but while by 2025-2030 years growth of GDP level in 2-2.5 times, the strategy goal – provision may be archived only on the basis of external demand and under strong diversification of non-oil sector of economy.

Stated goal requires from one side, the achievement of high competitiveness in the economy, which is impossible without formation of high effectively national innovation system and realization of correspondent structural policy, and from other side – the solution of problems of macroeconomic stability. In other words, there are two mutually complementary control loops in the developing model: the first is influence on aggregate demand, as more dynamic component of macroeconomic balance (this direction is realized by means of tools of money-credit and budget-taxation policy); the second is influence on aggregate supply (in this loop the decisive role belongs to structural policy, which impacts first of all on aggregate supply).

Stabilization policy in the model of economic growth is directed to creation and support of macroeconomic balance (to maximum apply of factors of production in the condition of stable prices level). As per data of 2010, the level GDP per head in the country, on purchasing-power parity (PPP) amounted about 9.0 thousand USD. In the new strategy of economic development of Azerbaijan, in medium term perspective, the goal is to provide GDP per head on the level of 15-17 thousand USD. For this variant the volume of private investments on the level no less that 50% of the achieved non-oil GDP is required. As per experts' estimations Central Bank of the country is able to sterilize the volume of investment funds no more that 5 bln. USD yearly and only in case of such volume of money supply growth to ensure preservation of macroeconomic stability (as it is known, the last one demands balance of temps of money supply growth and economic growth).

The concept of structural adjustment in Azerbaijan is necessary for formation of industrial diverse of national economy. According to this there are three groups of branches in the structure of economy:

- *branches of fuel and energy complex, metallurgy* which keep its competitiveness and attractiveness for foreign investments*;*
- *branches capable of supplying product for export,* some branches of manufacturing industry (branches of chemical industry, construction materials producing industry, food-processing industry), agriculture and etc.
- *branches that can be competitive on internal market* (some branches of light industry, food industry and etc.).

State participation in the model supposes:

- <u>*direct effects*</u> as subsidies, soft investment loans with purpose of creation, maintenance or development of some enterprises, branches and conducting of fundamental and applied research works. In accordance with this there is National Fund for the support

of enterprise of Azerbaijan and Azerbaijan Investment Fund realizing preferential crediting of priority directions of small and medium enterprise and strategic investment projects;

- *indirect effects* which are realized mainly by tax allowance with purpose of increase of quantities of output and encouragement of investments. At the present all branches of agriculture production are included (after land reform farm enterprises of the country were released of all types of direct and indirect taxes except tax on land and tax on importation of seeds for production); financial sector and etc. In the model the future development of this direction supposes the involvement of processing industries having export orientation. This direction is ensured due to structural change taxing.

In the model stabilization and structural policy are closely connected because macroeconomic stabilization as a factor of improvement of investment climate creates conditions for investments in competitive industries of real sector and for economic growth. And vice versa effective structural policy is an important factor of keeping of stable macroeconomic environment.

References

1. Aliyev I., Haciyev A., Haciyev R., Economic growth and features of macroeconomic regulation in Azerbaijan, *Journal of International Scientific Publication: Economy&Business,* Vol. 5, Part 4, 2011, pp. 16-24, Published at: *http://www.science-journals.eu.*
2. Aliyev I., Haciyev R. Actual problems of the theory of exchange rate, *Transaction of the National Academy of Sciences of Azerbaijan, Economical series*, No. 1, 2010, pp. 3-12.
3. Haciyev R. IMF continues reforms in Azerbaijan, *Azerbaijan to day*, No. 2, 2002, pp. 20-22.
4. Haciyev R. Dollar or Euro – what are the options for Azerbaijan, *Azerbaijan to day*, No. 4, 2002, pp. 10-14.