The Exchange Rate Policies of Azerbaijan’s Trading Partners, Part I: Imports

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Periodically in the international press, there are heated debates about international currency wars. Countries accuse one another of stimulating exports by artificially lowering the value of their national currencies. Not only exporting countries suffer damaging effects from policies lowering currency values, but so do countries dependent on imports. For the former, it is desirable that the currency of the country to which it exports should strengthen or at least remain stable. For the latter, the situation is somewhat different. Domestic devaluation makes imports more expensive and supports local production, while foreign devaluation makes imports cheaper and weakens the ability of local production to compete.

This article examines trends in the way the flow of goods coming into Azerbaijan from its main trading partners is affected by shifts in some of the macroeconomic indicators in those countries. From this perspective, this article will compare the volume of imports coming in from Azerbaijan’s primary trading partners, changes in the nominal exchange rates of their national currencies, and the level of inflation there with the same economic indicators for Azerbaijan over the last five years.

There is no doubt that changes in currency exchange rates affect domestic prices. The effects are of two kinds. Firstly, changes in exchange rates cause shifts in the price of imported consumer goods and services, as well as domestically produced goods and services with imported components. Not long ago, as a result of the 2015 devaluation in Azerbaijan, we witnessed a rise in prices on both imported and locally produced goods. This is because various components of local production, including raw materials, were imported. On the other hand, a change in the currency exchange rate can affect both the volume of exports and domestic prices. Reduction in supply, as a result of growth in exports, can cause a rise in prices. An onion shortage in Turkey, for example, brought about a sharp rise in exports from Azerbaijan and a rise in prices on the domestic market at the beginning of the year.

The tendencies noted above, however, are never confirmed in practice. For instance, the Financial Times investigated the effects of currency devaluation on exports and imports in 107 developing countries. The investigation covered the years 2013-2015 and was based on data from the IMF and Thomson Reuters Datastream. It was found that a fall in the national currency's exchange rate in developing countries did not result in a rise in exports. Instead, a decrease in imports was found.

Azerbaijan has still not recovered from the economic consequences of the 2015 devaluation, and the public's sensitivity to changes in the exchange rate has grown. When the Azerbaijani manat, which for a long time had been stable relative to the US dollar, lost up to 50% of its value in the course of a year, it caused difficulties in both domestic and foreign trade. The devaluation's effect on exports is still noticeable. According to the State Customs Committee (SCC), while Azerbaijan exported $1.9 billion of oil in 2012 when the dollar was worth 0.78 AZN, in 2017–2018 that indicator fell to about $1.5 to $1.6 billion, even though a dollar was now worth 1.70 AZN. Despite large-scale measures taken by the government in 2017-2018 to stimulate the non-oil sector, non-oil exports have still not reached the levels they were at before the devaluation. The overall drop in exports, of which oil and gas make up a large share, is due to a sharp decline in oil and gas prices on the world market.

As for imports, while in 2015 overall imports were $9.2 billion, in 2016 that figure fell 7.5% to $8.5 billion. In subsequent years, Azerbaijan's market once again became attractive for imports thanks to the manat's stable exchange rate and the devaluation of its trading partners' currencies. As a result, imports grew by 2.9% in 2017 to $8.8 billion, and by 30.6% in 2018 to $11.5 billion. This growth did not occur in imports from all countries. Despite growth from Russia, Turkey, China, and the eurozone, there was a decline from countries such as the USA, the UK, and Israel **(Table 1)**. While imports from the eurozone grew overall, imports from individual eurozone countries such as Belgium, Greece, and Lithuania decreased.

Table 1. Trends in imports among Azerbaijan's principle foreign trading partners, 2014-2018

(million USD)

Countries	**Years**				
2014	**2015**	**2016**	**2017**	**2018**	
Russian Federation	1314,48	1437,90	1641,81	1554,26	1885,17
Turkey	1286,64	1171,39	1181,58	1273,71	1576,87
Eurozone	1794,24	2037,64	1247,58	1327,15	1660,89
China	697,08	511,91	703,91	854,53	1196,67
USA	563,42	847,39	471,58	720,59	527,17
Ukraine	419,58	309,65	289,77	459,92	469,80
UK	978,34	553,33	495,22	239,86	263,72
Japan	240,51	558,10	282,65	170,37	383,89
Kazakhstan	221,01	98,93	98,12	107,83	174,15
South Korea	186,30	133,95	72,05	85,33	226,64
Iran	147,16	90,46	161,08	240,27	414,80
Sweden	94,36	99,21	63,11	56,87	512,95

Belarus	83,94	83,63	76,30	130,21	180,76
Israel	23,96	24,87	15,62	32,67	23,91
Georgia	93,89	67,99	51,47	74,15	94,09
Total share of import	**88,7%**	**87,0%**	**80,3%**	**83,4%**	**83,7%**

Source: State Customes Committee

The period from the beginning of 2015 to the first quarter of 2017 was a time of instability for the manat's exchange rate. On December 21, 2015, at the time of the second sharp devaluation, the manat's official exchange rate rose to 1.55 AZN to the dollar, and in February 2017 it reached a peak of 1.92 AZN to the dollar. That same month, with oil prices on the rise on world markets, a growth in fiscal transfers from the State Oil Fund (SOFAZ) and funds allocated by the Central Bank to promote macroeconomic stability gave support to the national currency and the manat began to strengthen, quickly reaching an exchange rate of 1.70 AZN to the dollar. The devaluation also raised the consumer price index. Following the devaluation, the inflation rate remained at over 12% for 2 years. In 2018, however, it fell to 2.3%.

It is now two years that the manat's exchange rate has remained at 1.70 AZN to the dollar. From the cross rates of the manat with other currencies it can be seen that the dollar is an exception, and the manat's value in relation to other currencies fluctuates very often. This fluctuation in exchange rates, however, has not put the domestic market under serious inflationary pressure.

Let us turn to imports from the Russian Federation, which is currently facing economic difficulties due to sanctions and is the biggest importer to Azerbaijan, and to the nominal exchange rate between the ruble and the manat. From official data it is clear that, in the period 2014-2018, a fall in the ruble's exchange rate has leads to a rise in imports from Russia, while a rise in the rate has led to a fall in imports.

Only in 2016, despite a strengthening of the ruble against the manat by 29%, imports grew by 14.2%. That same year, the fact that the inflation rate in Azerbaijan (12.4%) exceeded the corresponding indicator for its northern neighbor (5.4%) could not obstruct the growth in imports. Nevertheless, in 2017 both factors (the strengthening of the ruble and the fall in the inflation rate) had the effect of reducing imports, while in 2018, the weakening of the ruble and the rise in the inflation rate increased imports. In recent years Russia's share of import has fluctuated within the range of 16-19%. **(Figure 1)**

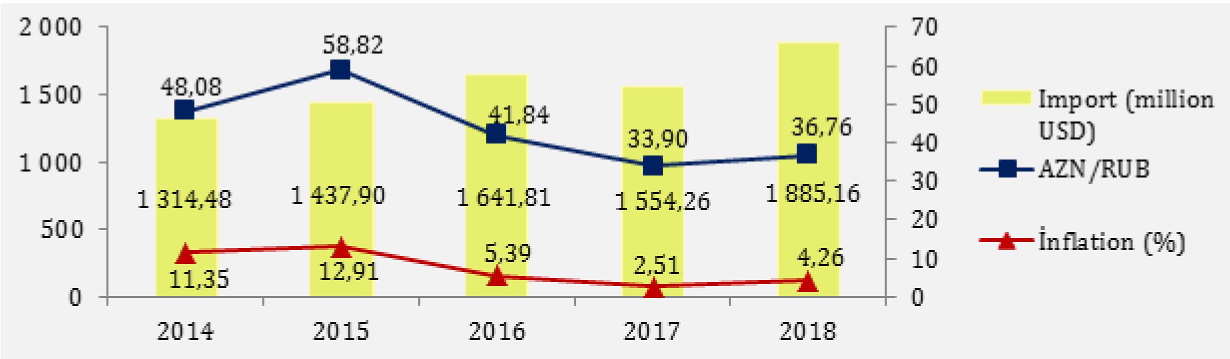

Figure 1. Imports from Russia in relation to the currency exchange rate and the level of inflation, 2014-2018

With a share of 13-14% of total imports, Turkey is Azerbaijan's second biggest importing partner. Imports from Turkey fell by 8% in 2014-2016, while in 2016-2018 they grew by 33.5%. When imports were decreasing the Turkish lira strengthened against the manat by 32%, while the lira's rate fell by 45.6% when imports were growing. Inflation indicators played a role in the fluctuation in import indicators in both countries. In 2016, Turkey's inflation rate was 8.5% against Azerbaijan's rate of 12.6%, while it subsequently rose, reaching 20.3% in 2018. In that same year, however, Azerbaijan was able to reduce the growth rate in consumer prices to single digits (2.3%). **(Figure 2)**

Figure 2. Imports in relation to the currency exchange rate and the level of inflation, 2014-2018

The eurozone area, which includes 19 countries in total, accounts for about 14-15% of total imports. In 2015, the eurozone countries' share of imports actually exceeded 22%. Unlike with Russia and Turkey, there was an asymmetric dependence between the volume of goods flowing from eurozone countries and the euro's exchange rate. In 2014-2018, the manat consistently decreased in value against the euro. At the same time, in relation to the manat, the euro strengthened from 96 cents to 50 cents. In this period, however, apart from 2016, imports continued to increase. The strengthening of the euro had no negative impact on the growth in imports, which came mainly from Germany, the Netherlands, France, Estonia, and Spain. Even Azerbaijan's consumer price index, which exceeded the eurozone's index several times over, could not reduce imports. After a sharp decrease in 2016, in the following years there has been a growth trend. **(Figure 3)**

Figure 3. Imports from eurozone countries in relation to the currency exchange rate and the level of inflation, 2014-2018

In recent years, the People’s Republic of China has become Azerbaijan’s fourth biggest importer. In 2014-2018, the Middle Kingdom’s share of imports rose from 7.6% to 10.4%. The Chinese yuan grew in value against the manat from 7.85 to 3.89. The strengthening of the yuan could not obstruct the growth in imports. In this period, except for 2015, imports showed a tendency to growth, increasing from $697 million to $1.2 billion. [China’s inflation rate](), which is lower than Azerbaijan’s, could not decrease imports, either. **(Figure 4)**

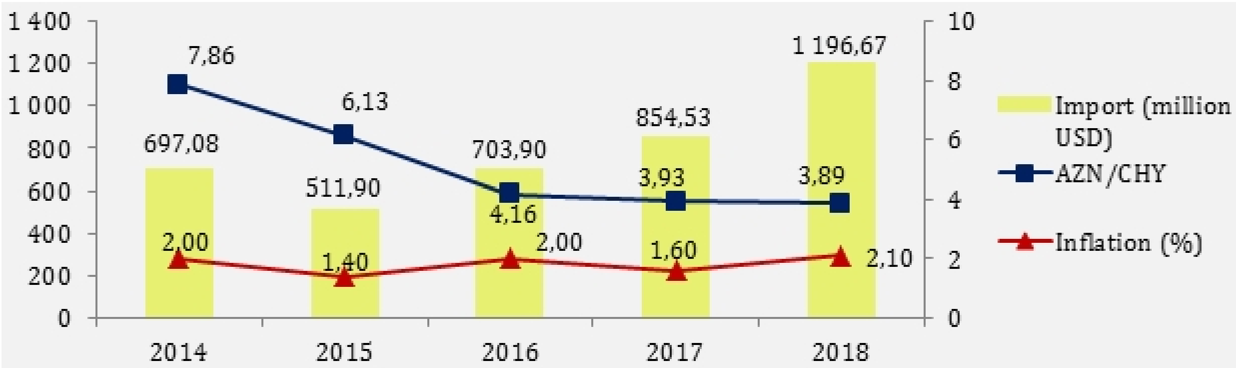

Figure 4.Imports from the People’s Republic of China in relation to the currency exchange rate and the level of inflation, 2014-2018

The situation with UK imports is similar. Unlike China, the UK’s share of imports has fallen over the last five years from 10.7% to 2.3%. While the volume of import trade form the UK was $978.3 million in 2014, in 2018 that indicator had dropped to $263.7 million. In that period, the pound’s official exchange rate rose from £0.77 to £0.44 to the manat. While the UK’s consumer [price index rose from 0.04% to 2.68%,]() it did not reach the level of Azerbaijan’s CPI. **(Figure 5)**

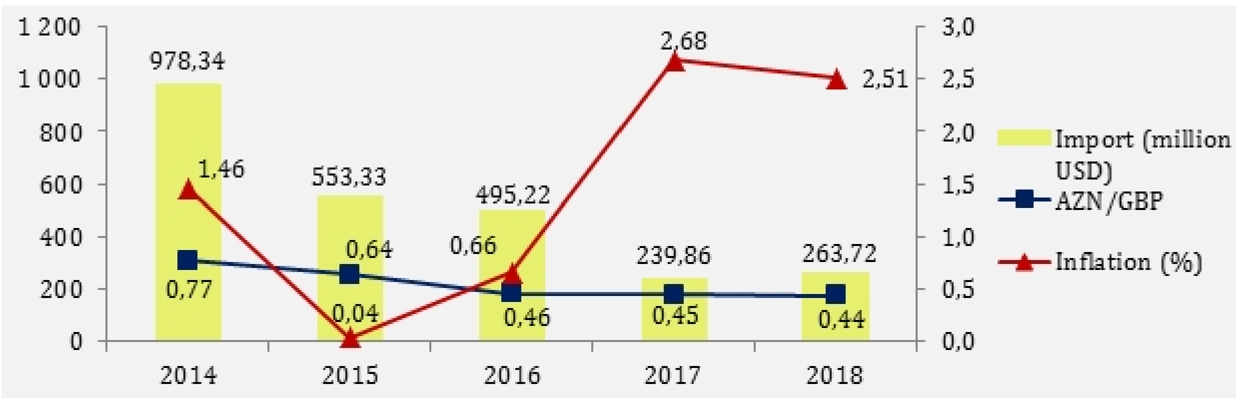

Figure 5. Imports from the UK in relation to the currency exchange rate and the level of inflation, 2014-2018

The strengthening of the dollar up to 2017 in its direct exchange rate with the manat had various impacts on the volume of import trade from the USA. In 2015 and 2017 imports increased byt in 2016 and 2018 they decreased. In 2018, with the nominal exchange rate stable and the same inflation rate, imports decreased. **(Figure 6)**

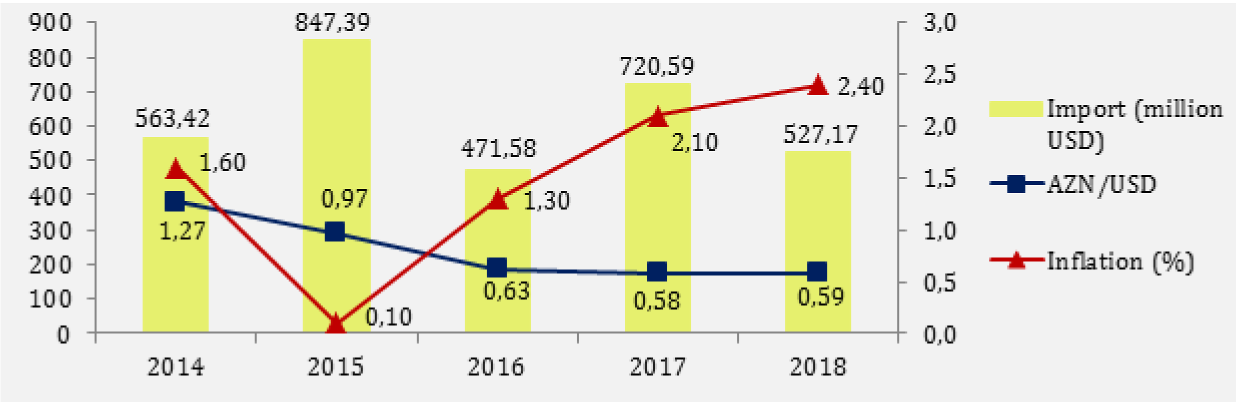

Figure 6. Imports from the USA in relation to the currency exchange rate and the level of inflation, 2014-2018

2014-2018 was an unstable period for Ukraine'e economy. In 2015, despite the devaluation in Azerbaijan, the manat strengthened against the hryvnia to 21.23 AZN/UAH. In subsequent years, the hryvnia strengthened. Faced with high inflation, Ukraine was able to slow down the rise in prices, lowering it from 43.3% in 2018 to single digits in 2018. Nevertheless, Ukraine's consumer price index remained high compared to Azerbaijan's. Despite the artificial strengthening of the exchange rate, the high inflation rate created favorable conditions for imports from Ukraine and they nearly doubled in the past three years. **(Figure 7)**

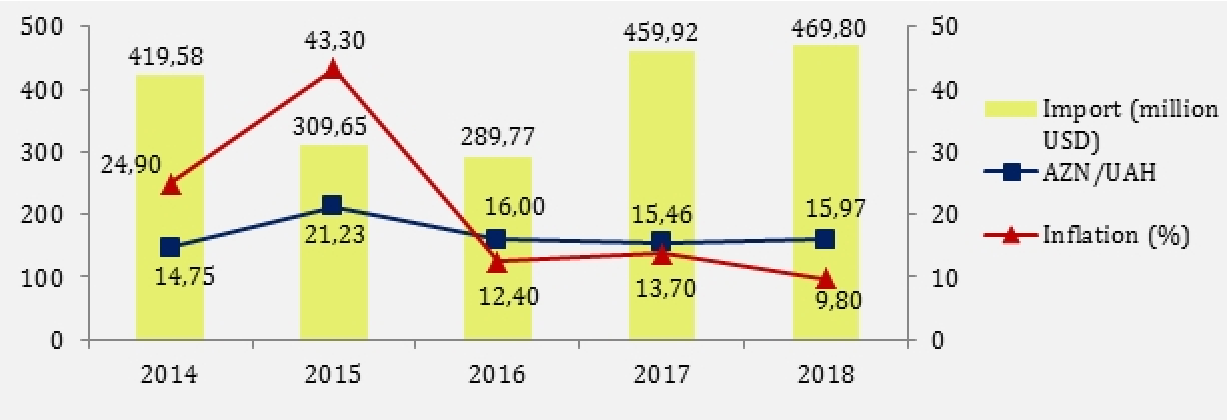

Figure 7. Imports from Ukraine in relation to the currency exchange rate and the level of inflation, 2014-2018

Imports increased from Azerbaijan's other main trading partners (Japan, Kazakhstan, Korea, Iran) as well. In some of the countries the national currencies strengthened against the manat, and in some the rate of inflation exceeded the rate in Azerbaijan.

While this article focused mainly on the currencies' nominal exchange rates, the revenues and expenditures of exporters and importers are not dependent only on the nominal exchange rate, but also on the inflation rate in the country. Naturally, we are referring to the real effective exchange rate and the trends in its fluctuation. The main thing here is to ensure the competitiveness of local production not only in foreign markets, but in domestic markets as well.

The real effective exchange rate (REER) reflects the trade-weighted average exchange rate against a basket of the currencies of Azerbaijan's trading partners, taking into account inflation rates in the relevant countries. Based on data from the Central Bank, the manat's REER is compiled as a unified index taking into account the relevant indicators of Azerbaijan's 15 main trading partners (USA, eurozone, UK, Belarus, South Korea, Georgia, China, Iran, Israel, Sweden, Kazakhstan, Russia, Turkey, Ukraine, Japan).

Table 2. The manat's real effective exchange rate against foreign currencies (%) (December 2010 = 100)

Years	Real Effective Exchange Rate	
Overall	Non-oil sector	
2014	114.9	122.0
2015	86.2	93.3
2016	71.5	74.8
2017	73.8	77.9
2018	77.9	82.6

Source: Central Bank

As **Table 2** shows, as a result of the devaluation, the manat's real effective exchange rate fell from 114.9% to 86.2% in 2015, and to 71.5% in 2016. Only in the last three years has the REER begun to rise, reaching 77.9%. In the non-oil sector the situation was worse.In 2016-2018, the REER rose from 74.8% to 82.6% due to the stability of the national currency and the lower inflation rate than that of Azerbaijan's trading partners.

While, as a rule, the devaluation of the national currency causes inflation, the rise in domestic prices lessens somewhat the impact of the devaluation, because the real effective exchange rate fluctuates less than the nominal exchange rate. That is why, if the nominal exchange rate is used as a macroeconomic policy instrument, you must try in the end to change the real currency exchange rate to have a real impact on economic indicators.

A fall in the real effective exchange rate theoretically stimulates exports and decreases imports. In this article, we have seen that changes in the nominal exchange rate and the inflation rate have a serious impact on imports from primary trading partners. For instance, even though the real effective exchange rate is favorable, we see a rise in the flow of goods coming from the eurozone countries and China, because if a policy of replacing imports is not implemented or if it is not

successful, a devaluation of the national currency can, at best, give local production short-term support. Therefore, in countries like Azerbaijan, dependent on imports, a decrease in the real effective exchange rate cannot always have the effect of reducing imports. The same thing can be said about exports. If there are no opportunities for export, then no devaluation can stimulate it, because as a result of a devaluation, exports based on imported components can become more expensive and less competitive.