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### **THE IMPACT OF THE FALLING OIL PRICES ON THE BANKING SECTOR AND THE BANKING CRISIS IN AZERBAIJAN**

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#### **Abstract**

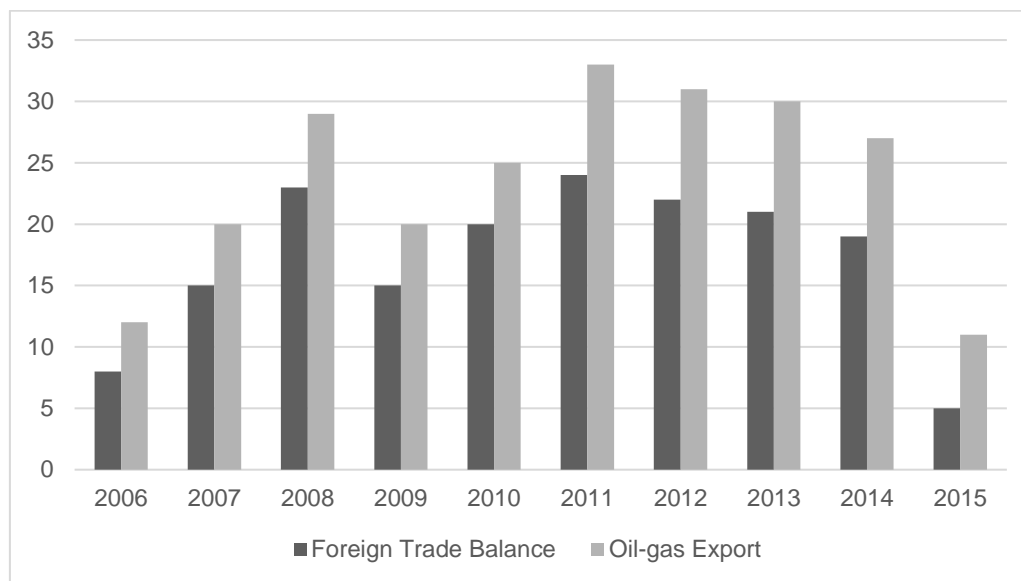
The Banking sector in Azerbaijan has been one of the most affected sectors and volatile due to the falling oil prices. In the recent years, the government's approach to the banking sector has changed significantly. The national currency has depreciated against the foreign currencies. The main goal of this paper is to clarify the current situation and key challenges in the Azerbaijan Banking sector including assessing the role of the Central Bank of Azerbaijan Republic (CBA). In this paper, the crucial problems in the financial sector are also indicated and some key points for the future actions are recommended.

**Keywords:** Banking Sector, Central Bank, Currency, Exchange Rate, Devaluation

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#### **1. Introduction**

The Azerbaijan Banking System has been organized mainly as commercial banks, non-bank credit organizations and the Central Bank of Azerbaijan (CBA). The CBA is the key organization to ensure the monetary policy and financial stability in the economy. However, the macroeconomic situation is the crucial factor during the application of this policy. Hasanov and Huseynov (2013) conclude that non-oil economic growth has positive relationship with the financial sector in Azerbaijan. By contrast, there has been negative relationship between this growth and real exchange rate. The oil-gas products have played important role in the export and organizing the foreign exchange reserves of the CBA. Because of the falling oil prices, the foreign trade balance has decreased recently (Figure 1).



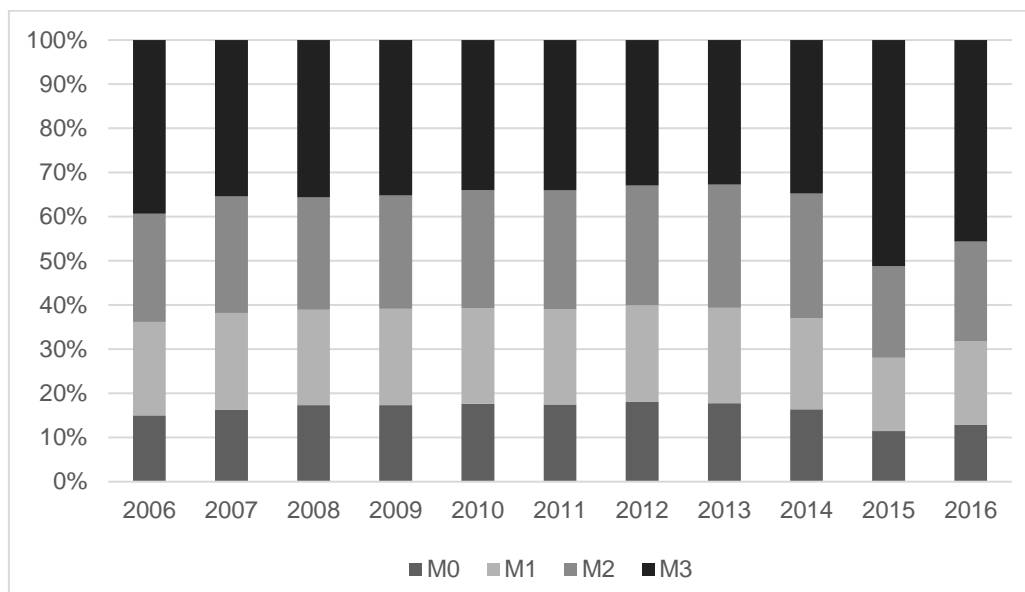
**Figure 1. The Foreign Trade Balance and Oil-gas Export, Billions of USD**

Source: The Central Bank of the Republic of Azerbaijan (2016a)

In this situation, the Azerbaijani government needs to promote foreign and local investments, implement the monetary reforms in order to stabilize the financial sector (Mammadov, 2016). Hasanov (2016) claims that with the exceptions of the two devaluations of the national currency in 2015, the oil prices will be one of the key factors when determining of the future exchange rate of Manat. In the light of the falling oil prices, the third devaluation of the national currency will be inevitable. Consequently, without the economic and structural reforms, the Azerbaijan economy may experience many challenges. For this reason, the expansionary policies could be more efficient in the protection of Manat, ensuring the better economic environment, enhancing the share of the non-oil GDP, the minimizing participation of the government in the economy, creating new work places (Bayramov, 2016).

## 2. The Banking Sector In Figures

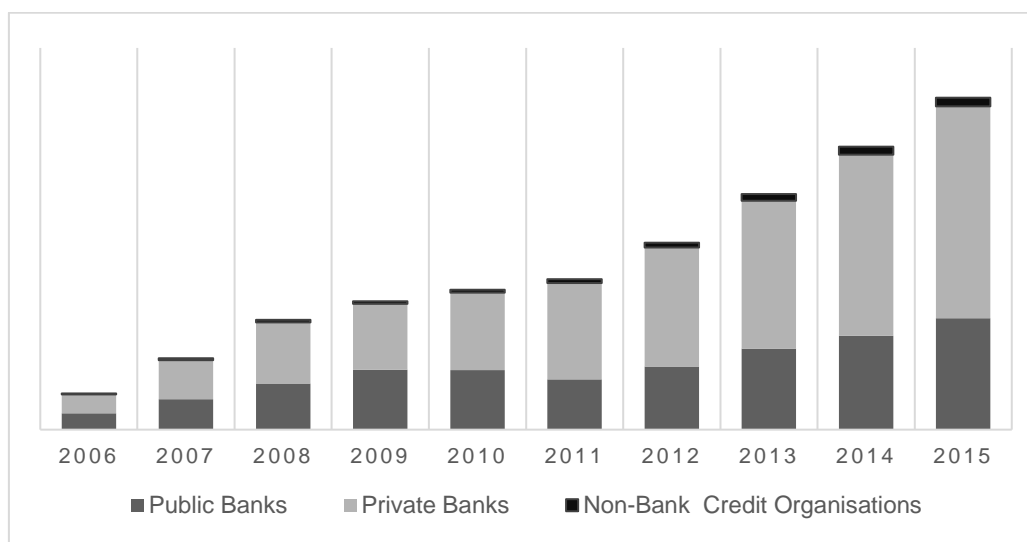
The Azerbaijan Banking Sector has been volatile to the economic situation, particularly in 2015 and 2016. The amount of the monetary aggregates M0 (Base money, banknotes and coins), M1 (M0+demand deposits and savings in Manat), M2 (M1+ deposits with term in Manat), M3 (M2+ freely converted currency deposits and savings) increase from 2006 to 2014. The foreign currency, denominated savings and deposits (M3) have not changed sharply since 2014. However, M0, M1, M2 have fallen dramatically, almost to the same level of 2009-2010 (Figure 2).



**Figure 2. The Monetary Aggregates, Billions of Manat, (in 2016 by September)**

Source: The Central Bank of the Republic of Azerbaijan (2016a)

By the same token, the total amount of the loans have been went up. The commercial banks are the main player in this process with 64% share of the total credits in 2015 (Figure 3).



**Figure 3. The Structure of the Loans by Credit Institutions, Billions of Manat**

Source: The Central Bank of the Republic of Azerbaijan (2016a)

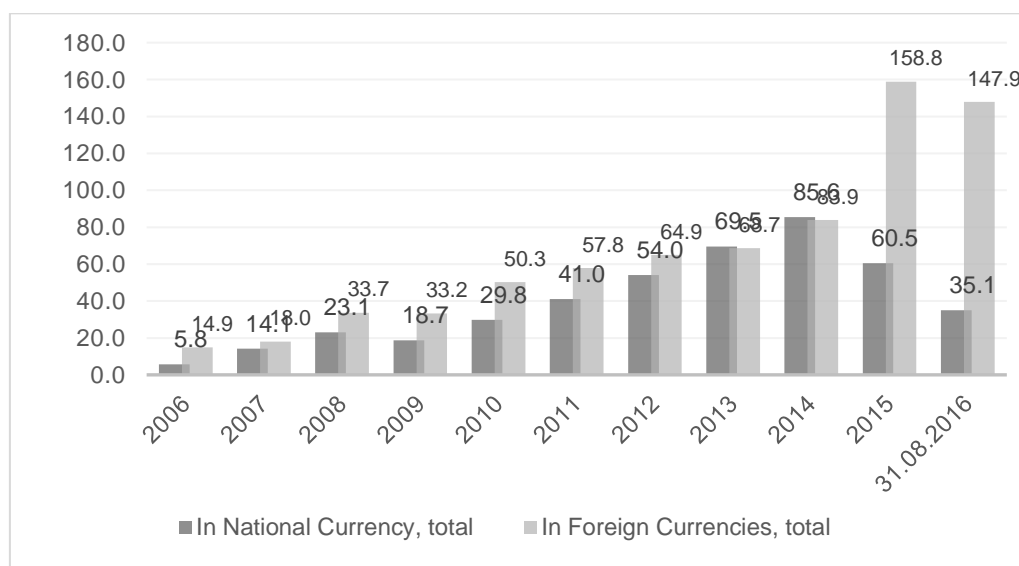
Furthermore, the distribution of the loans by the economic regions has been unequal since 2014. There are many factors to affect to this situation. To put it another way, the urbanization and centralized economic activities have caused this challenge. In fact, the regions need more investments and attract more loans for the regional economic development. Unfortunately, particularly, commercial banks have concentrated more on the capital region in issuing the loans (Table 1).

**Table 1. The Loans by the Economic Regions, % of total**

Economics Regions	2014	2015
Baku	83%	84%
All Regions	17%	16%

**Source:** The Central Bank of the Republic of Azerbaijan (2016a)

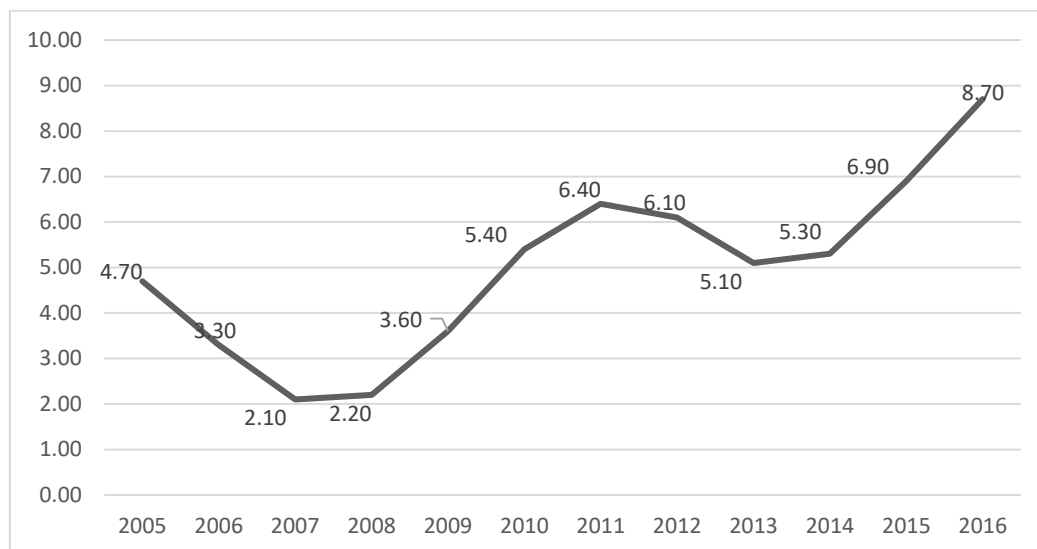
The structure of the deposits equally distributed till 2014. On the other hand, the recent depreciations of the national currency have caused the logical increase in the value of deposits in the foreign currencies with equivalent of Manat (Figure 4). However, we can also mention that after these devaluations of the national currency, people's confidence on Manat has been collapsed, they have started to save their money in the foreign currencies, especially USD.



**Figure 4. The Structure of the Deposits by Currencies, Billions of Manat**

**Source:** The Central Bank of the Republic of Azerbaijan (2016a)

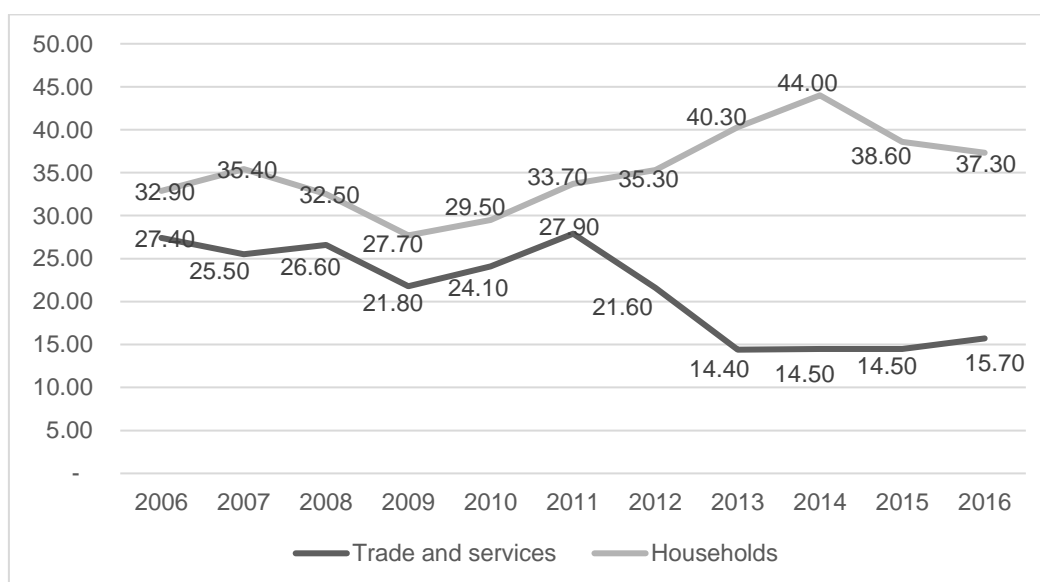
Another key feature of the banking sector, the overdue loans have changed significantly. This figure was the minimum level (2% of the total loans) in 2007-2008. However, it reached to 6.4% in 2011 and fall to 5.1 after the two years. In 2016, the amount of the overdue loans has climbed to the record level (8.7%) in the last decade (Figure 5). First thing to remember is the depreciation of the national currency. That is why, most of people have taken their loans in USD, and they have experienced difficulties to pay back the credit with almost doubled amount.



**Figure 5. The Overdue Loans of the total, as % (by 31<sup>st</sup> of Oct. in 2016)**

Source: The Central Bank of the Republic of Azerbaijan (2016c)

Moreover, the structure of the loans has some logical relations with the overdue loans. The percentage of the household loans has been around two thirds of the total in the most years in the last decade. This figure amounted 44% of the total in 2014. The main reason of this trend is the consumers' weak ability to pay back of the loans. They have no free cash reserves to meet their additional needs due to low average salaries. That is why consumers should give up some additional needs in 2015 and 2016. At the same time, the shares of the loans directed to the trade and service show a downward trend and have been 15% since 2013 (Figure 6).

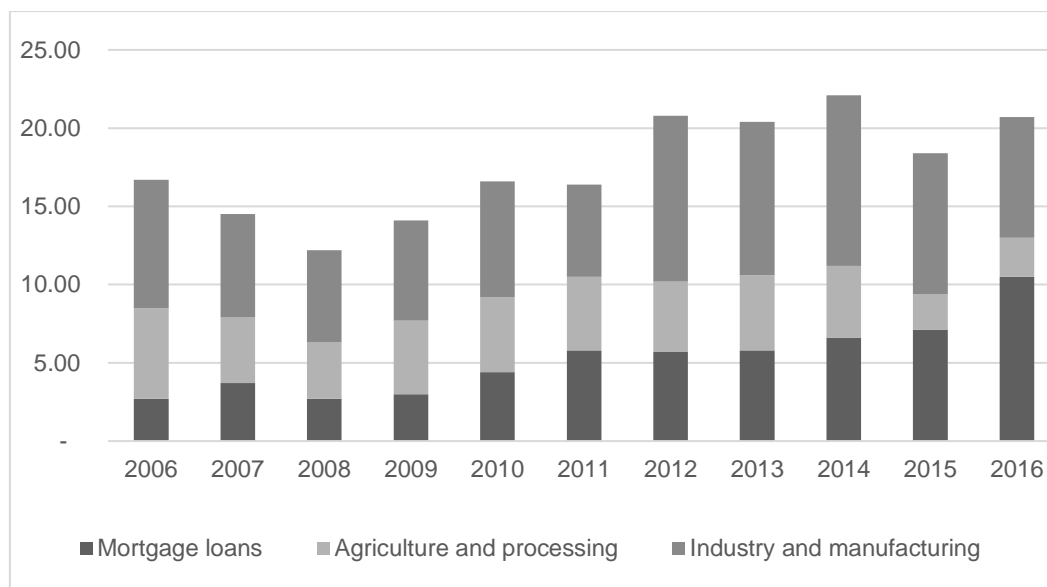


**Figure 6. The Sectorial breakdown of the loans, as % of the total (by Oct. 31, 2016)**

Source: The Central Bank of the Republic of Azerbaijan (2016c)

Similarly, the shares the loans directed to the agricultural and manufacturing activities have declined in the last decade. These activities are the traditional sectors for Azerbaijan in order to diversify and minimize the oil dependence of the economy. Unfortunately, the commercial banks have not been motivated to ensure the credits to these sectors. Nevertheless, in 2016 (by

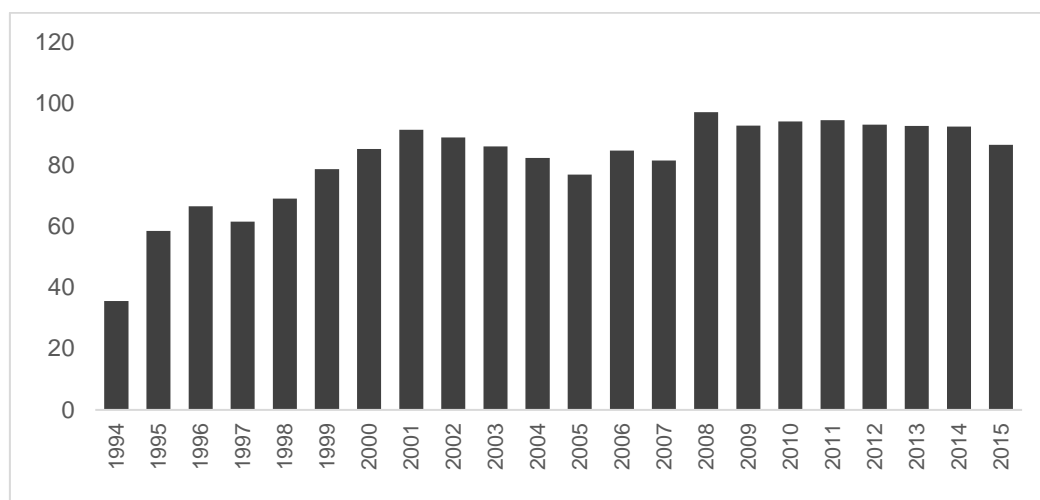
the end of October), there is positive signs for the mortgage loans. So, the percentage of these loans hit the highest point: 10.50% in the decade (Figure 7). In this context, people, particularly young generation experience some challenges to buy a flat. That is why the amount of the mortgage loans should be increased and the regulations should be simplified.



**Figure 7. The Sectorial breakdown of the loans, as % of the total (by 31<sup>st</sup> of Oct. in 2016)**

Source: The Central Bank of the Republic of Azerbaijan (2016c)

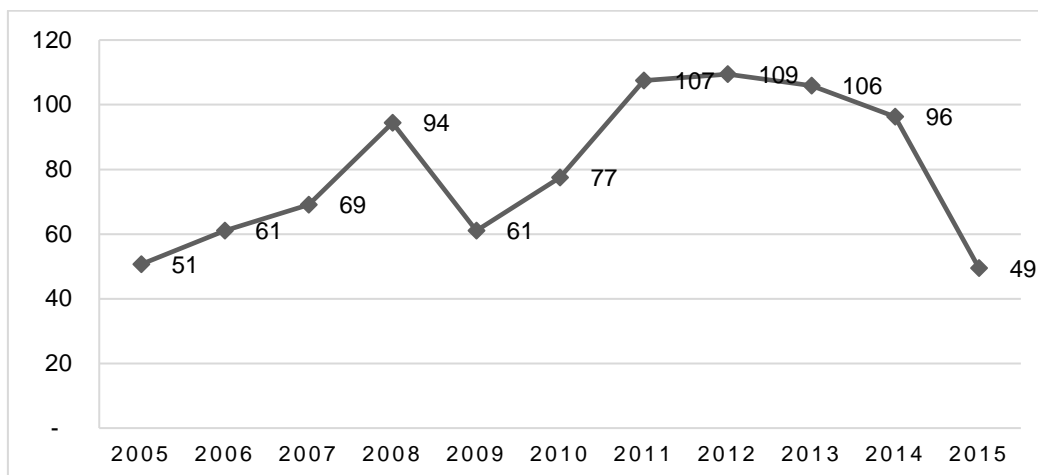
The Azerbaijan economy has been more dependent on the oil-gas exports in comparison with the previous decades (Figure 8). Therefore, the share of the oil-gas products in the total export has been more than 90% (97% in 2008).



**Figure 8. The Structure of exports by product: Mineral fuels, Minerals oils and related products, share in export, in percent**

Source: The State Statistical Committee of the Republic of Azerbaijan (2016b)

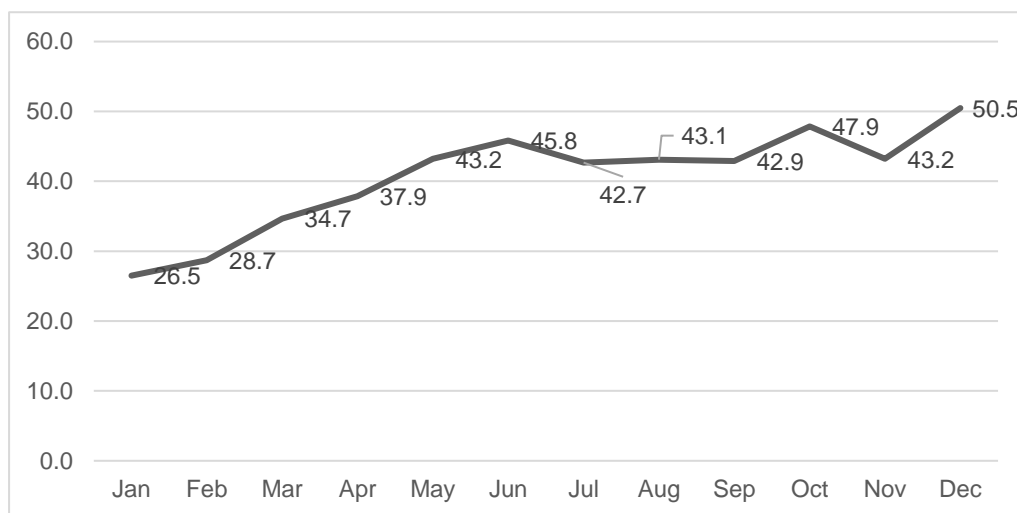
The trend in the world oil market shows some fluctuation from 2005 to 2015. Particularly, in 2008 and 2011-2014 years the prices peaked. Nevertheless, in 2015, the average of the crude oil prices has declined to the same level in 2005 (Figure 9).



**Figure 9. The World average crude oil price, per barrel, USD**

Source: OPEC (2016)

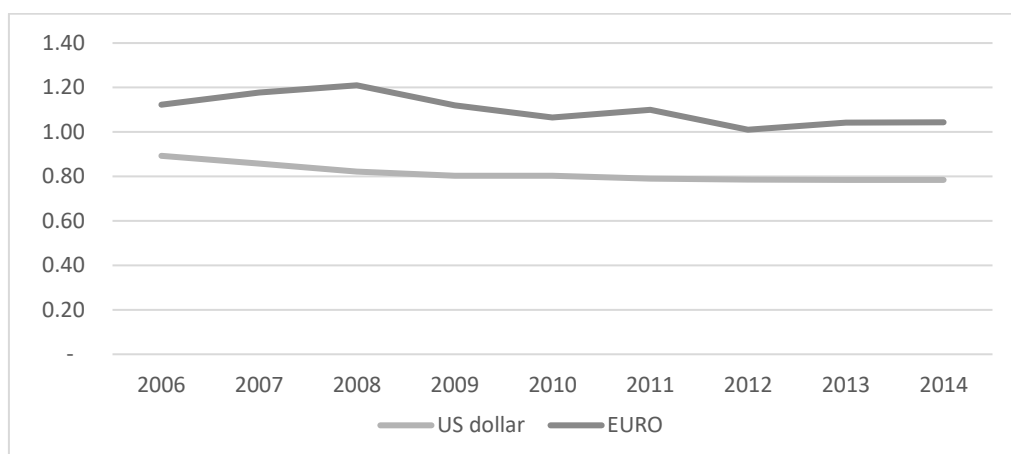
In the beginning of 2016, the average crude oil prices have been the lowest in the decade (Figure 10). There are many factors that affect these prices. The key factor to remember is the level of the world oil production. Likewise, the oil producing countries' decisions on the productions level have played more important role.



**Figure 10. The World average crude oil price, per barrel, USD, 2016**

Source: OPEC (2016)

Furthermore, the Azerbaijan government applied the fixed exchange rate regime until 2014. The official exchange rates of the national currency against USD and Euro have been maintained with the administrative tools by the CBA (Figure 11).

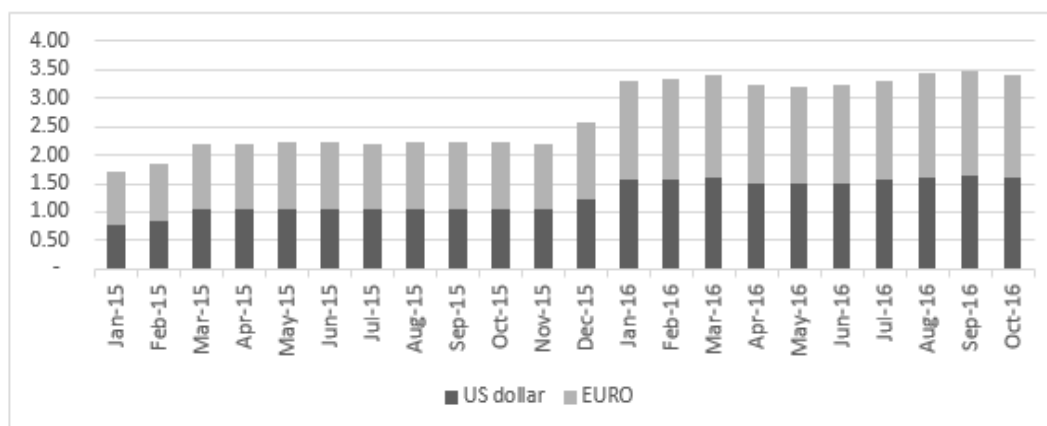


**Figure 11. Official average exchange rates of Manat, 2006-2014**

Source: Central Bank of the Republic of Azerbaijan (2016e)

In the middle of February 2015, the CBA announced that the fixed exchange rate policy (USD/AZN) will be substituted with targeting the currency basket. From that day, the CBA have started to apply the new exchange rate policy focused on the basket of the currencies (EUR and USD) in order to achieve the efficient macroeconomic policy and suppleness of the national currency exchange rate (Figure 12).

After 5 days from this statement, the CBA announced that Azerbaijan national currency depreciates and the official exchange rate of Manat to USD will be 1.05 due to the economic challenges and depreciation of the national currencies in the partner countries. By all means, the Management of Board of the CBA justified their decision with the aim of the economic diversification and ensuring of the higher foreign competitiveness, balance of payments and credibility of the Azerbaijan economy. This decision had been in power by the end of 2015 (The Central Bank of the Republic of Azerbaijan, 2016f).



**Figure 12. The Official average exchange rates of Manat, 2015-2016**

Source: The Central Bank of the Republic of Azerbaijan (2016e)

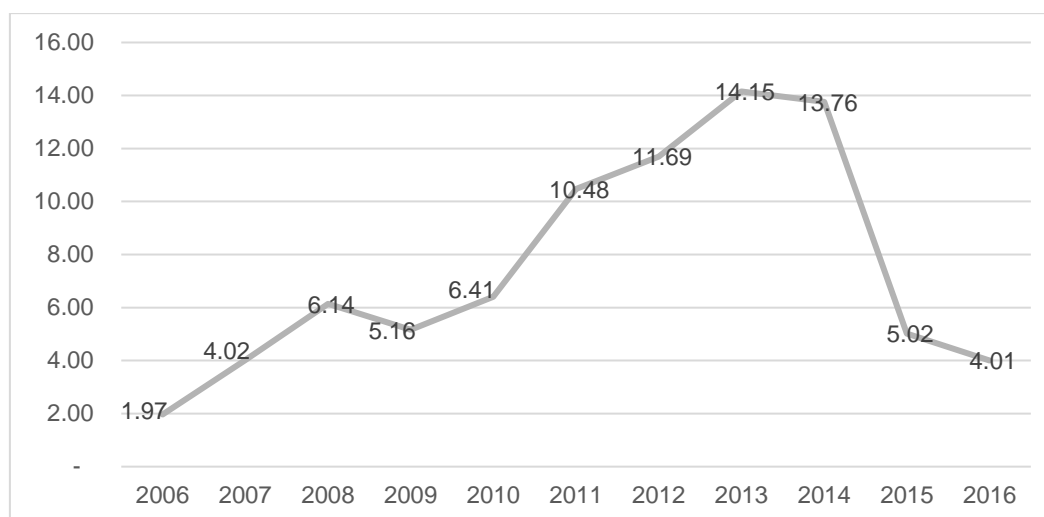
Finally, in December 2015, the Azerbaijan Government admitted that the national economy had been dependent on the oil export. That is why the CBA declared the second depreciation of the national currency and decided to move to floating exchange rate regime due to pressures caused by the falling oil prices, economic shocks and collapses in other countries. Not surprisingly, the main motivation of this decision had been the same: to enhance the balance of payments, to protect critical level of the reserves, promote economic competitiveness (The Central Bank of the Republic of Azerbaijan, 2016f).



However, it has been mentioned in the decision, the exchange rate of Manat will depend on the financial market conditions and the participation of the CBA in this process will be different. All in all, this decision has caused shock effect in the country since the beginning of 2016. The exchange rate of Manat to USD, Euro has been hitting the highest points 1.6 and 1.8 starting from the beginning of the year (Figure 12).

### 3. The Banking Crisis and Economic Actions by the Government

Under those circumstances, in addition to the mentioned decisions, the CBA has adopted the several policies rules in order to stabilize the financial stability. In fact, if we would like to understand in which level, the Azerbaijan economy has been dependent on the oil revenue, Figure 13 can clarify the situation. Particularly, in the higher world crude oil prices: more than 100 USD per barrel (Figure 10) between 2011 and 2014 the foreign currency reserves of CBA were more than 10 billions of dollar. Unfortunately, these reserves have been used inefficiently to stabilize the financial stability, support the currency regime in 2015 and 2016 fallen to the same level in 2007.



**Figure 13. Official foreign reserves, billions of US dollars (by 31<sup>st</sup> of Oct. in 2016)**

Source: The Central Bank of the Republic of Azerbaijan (2016b)

Moreover, after long time, the CBA changed its policy on foreign investments to the national banking sector. In the end of 2014, CBA had positive decision on the licensing application of Ziraat Bank of Turkey. In all cases, this decision could be green light for the recovery in the banking sector (The Central Bank of the Republic of Azerbaijan, 2016f).

On the other hand, after the recent depreciations of the national currency, the CBA should reconsidered the number of the several commercial banks and the status of their licenses in order to ensure the mobilization and support the financial stability in the country with improving the quality of access to the financial resources. That is why the Management of Board of the CBA made decision to withdraw the banking licenses of Evrobank OJSC (July, 2015), Azerbaijan Kredit Bank OJSC (July, 2015), Bank of Azerbaijan OJSC (January, 2016), Ganjabank (January, 2016), United Credit Bank OJSC (January, 2016), NBC Bank OJSC (January, 2016), Caucasus Development Bank OJSC (January, 2016), Atrabank OJSC (January, 2016), Texnikabank OJSC (February, 2016). In all decisions, there have been common features. These banks could not meet their minimum capital requirements, liabilities to the creditors, manage their operations (The Central Bank of the Republic of Azerbaijan, 2016f).

The CBA applies reserve requirements to the commercial banks from every attracted deposits in order to manage the money supply, the liquidity and to guarantee in the returning the deposits to the costumers. The reserve requirements show a downward trend from 2006 to 2011. However, during 2011-2015 this figure fluctuated between 2% and 3%. Interestingly, the reserve

requirements were decreased from 2% to 0.5% (2015-2016). After the decisions on the withdrawal of the licenses, the CBA has decided to increase the percentage by 100% (to 1%) in 2016 (Table 2).

**Table 2. The Reserve requirements of the CBA, %**

Effective period	On deposits of legal entities and households
01.02.2006 - 15.07.2008	10.00
16.07.2008 - 14.10.2008	12.00
14.10.2008 - 01.12.2008	9.00
01.12.2008 - 31.01.2009	6.00
01.02.2009 - 01.03.2009	3.00
01.03.2009 - 01.01.2011	0.50
01.01.2011 - 01.05.2011	0.50
01.05.2011 - 01.07.2011	2.00
01.07.2011 - 31.01.2012	3.00
01.02.2012 - 31.07.2014	3.00
01.08.2014 - 01.03.2015	2.00
01.03.2015 - 02.03.2016	0.50
from 03.03.2016 up to date	1.00

**Source:** The Central Bank of the Republic of Azerbaijan (2016d)

In the beginning of 2016, the CBA changed some regulations in order to ensure better environment for the new currency regime. So, most of the independent exchange offices have been closed, some limitations have been applied: if the converted amount is more than 500 USD, ID card will be required. All in all, people cannot exchange their money to the other countries due to the restrictions and the expanding of the black currency market.

Another key thing to remember is the foundation of the "Chamber of Control on Financial Markets" Public Entity with the merging of the State Committee for Securities of the Republic of Azerbaijan, the State Insurance Control Service under the Ministry of Finance, the Financial Monitoring Service under the Central Bank by the President Decree. The main goal has been to ensure the sustainability of the financial sector and to improve the management of the financial market in Azerbaijan (Alivev, 2016).

Not only having the changes in the institutions but also, the transparency and efficiency of the Commercial Banks in Azerbaijan have been the main factors affecting the Banking Sector. The International Bank of Azerbaijan was founded in 1992 and has been one of the leading banks in Azerbaijan. Apart from that the government: the Ministry of Finance of Azerbaijan Republic is the main shareholder of the Bank with 54.96% (International Bank of the Azerbaijan Republic, 2016). In 2016, according to the decision of the Baku Grave Crimes Court, Chairman of the Board of the Bank has been sentenced 15 years in prison due to misappropriation, fraud and other illegal activities (Samir, 2017). For this reason, the reputation and reliability of the banking sector have been affected and depositors hesitate to invest their assets to these kind of banks.

#### 4. Conclusion and Recommendations

The Azerbaijan macroeconomic indicators have been volatile to the world oil market conditions due to the dependence on the oil-gas export (more than 90% of total). In fact, the Banking system is one of the most affected sectors in the Azerbaijan economy. As the result of these, the foreign trade balance has fallen dramatically due to the falling oil prices.

All in all, due to those factors, the national currency: Manat has been depreciated in two times since 2015, and the foreign currency reserves of the CBA has fallen to 4 billion of USD. On the other hand, the CBA has revoked the several licenses of the commercial banks in order to

ensure the mobilization and support the financial stability in the country with improving the quality of access to the financial resources.

Apart from that, the urbanization and centralized economic activities have caused the huge gap in the distribution of the loans in the economy. This gap has been related to the regional and sectorial distribution. Another key issue to remember is the increasing overdue loans due to the borrowers' poor ability to pay back. The Azerbaijan government has applied some changes and reforms in order to stabilize situation. It is hard to say that all these actions have been successful.

In the light all of these factors and the current economic situation in the Azerbaijan Banking sector, there are many problems waiting for their solutions:

- The Banking sector should be open for the foreign investors with implementing economic reforms;
- The independence and diversification in the financial activities of the commercial banks should be ensured with the changes in the regulations;
- The current financial market should be improved and available for the public;
- The operation of the independent currency exchange offices should be activated with new regulations in order to eliminate the black market;
- The regional and sectorial distribution of the loans should be promoted to the whole economy;
- The new support regulations should be adopted in order to support some special groups, who have challenges to pay back the loans;
- The transparency of the bank management and accessibility of the financial reports and performance of commercial banks to the public should be ensured.

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