

## **Reforms of the financial sector and the main results of the development of the banking system of the Republic of Azerbaijan**

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### **Abstract**

The purpose of this article is to characterize the main orientations of the development of the financial and credit system in Azerbaijan. Financial sector reforms in Azerbaijan have been under way for a long time, but they have now become a clearly visible qualitative result of the development of the banking system. The main objective of the country's economic policy is to guarantee the macroeconomic balance and the general economic balance. . It should be noted that the economic growth model of Azerbaijan of the last decade requires, in our opinion, our own updates. We would like to highlight the main results obtained in the conclusions of modern financial sector reforms in the banking system of the Republic of Azerbaijan.

**Keywords:** banking system, monetary policy, devaluation, market price, interest rate.

### **Introduction**

To achieve these objectives based on the complementary principle, the State uses fiscal, monetary, foreign trade and economic regulation policies as economic policy instruments. It is possible to note that each of these economic policy instruments can be used in a general sense to achieve these objectives. At the same time, each of the economic policy instruments has a particular purpose.

In recent years, Azerbaijan's banks have made significant progress, including reducing their exposure to risk. However, the Azerbaijani economy needs a more active participation of banks, their current share being about 22% (capital / GDP ratio). The banking system, overcoming many training problems, entered the qualitative reforms. Key benchmarks - capitalization, competition and reduction in the number of inert banks. Economic problems are affecting the banking sector, with inflation control leading to a

disproportionate increase in the central bank's refinancing rate. Economy adjusted to the nominal value and the devaluation of the currency. To date, Azerbaijan has a market-based two-tier banking system: the first tier - the Central Bank of Azerbaijan and the supervisory authority of the Chamber of Financial Markets; second level - commercial banks and other non-bank credit institutions.

### **Materials and methods.**

The evolution of the banking system of Azerbaijan can be divided into 3 stages:

According to the basic orientations of Azerbaijan's monetary policy in the coming years to ensure the stability of the manat (price stability), this is the main objective of the Central Bank of Azerbaijan. The system, used in the banking systems of Western countries and in the market, includes: reserve requirements of commercial bank deposits with the central bank (reserve requirements); central bank operations with government securities; refinancing interest rate of commercial banks; open market operations; Trade control; comparative analysis of monetary growth; direct quantitative restrictions - is the main tool of the country's monetary policy.

Central Bank of Azerbaijan (CBA) It was established February 11, 1992 on the basis of the Azerbaijani office of the State Bank of the USSR, ICB USSR and Agro-Industrial. In 1992 he was the laws "On the Central Bank" and "On banks and banking activity", with the entry into force of that decision of the Parliament of 7 August 1992 and ICB agroprombank were withdrawn from the NBA's submission. In 1992-1994, the country operated about 230 banks. These structures, which the authorized capital on the average estimate was 10-12 thousand. Dollars, actually did not play any role for the economy, and most of them are engaged in financial speculation, which in general correspond to the economic situation of the period.

In 1994 there was a crisis, and the system became more and more to acquire a purely banking specifics. In the first place this was due to announcement of manat the only means of payment in the territory of Azerbaijan (since January 1, 1994). While one of the main problems was the suppression of hyperinflation (E.Elekberov, 2007, p. 90).

To achieve this objective the CBA led the sale of centralized credit resources in accordance with market demand and began to pursue a policy of real interest rates. Speculative (artificial) demand for money and credit that created hyperinflation, was shot down. Plus in Azerbaijan was established "white" foreign exchange market, and an important stage of development was the holding of exchange control policies. For this was to raise funds for the International Monetary Fund and the World Bank.

### **Discussion.**

Formation of the foreign exchange market, the creation and operation of the Baku Interbank Currency Exchange, as well as the carrying out of currency trading by market rules marked the beginning of the creation of the foreign exchange market infrastructure. "Black," the foreign exchange market was broken. All this was carried out in parallel with the adoption of a number of important economic laws, in particular, "On Protection of Foreign Investments", "On Joint Stock Companies", "On Pledge", "On Securities", "On Land Reform", and others. Azerbaijan's banking system in the current format takes its real development, since 1996.

1<sup>st</sup> stage of evolution the banking system we have characterized the country's measures to restructure and improve the state-owned banks to ensure the formation of an institutional private banking sector. In order to achieve these objectives have been established liberal conditions for entry into the system, in particular the low capital requirements and soft tools of regulation of the banking system [Durevall D., Henrekson M. 2010].

2nd stage - 2000-2004 years - start restructuring and fundamental reform.

The next stage of banking reform, beginning in 2000, was sent to the intensive recovery of private banks, the globalization of the banking sector, which created conditions for improving the stability of the banking system. The process of consolidation of the banking sector, which took place in 1996, which resulted in a reduction by the year 2000 the number of banks from 136 to 70, and continued in subsequent years. The consistent increase in the CBA requirements on minimum capital requirements led to an annual reduction in the number of banks in the market, total for the period of 2000-2004. - from 59 to 44 banks [Hajiyev A. 2012].

### **Discussion.**

Began the influx of oil revenues in the country identified the need for significant improvement in the country's financial system, particularly the banking sector. Given this fact, it has prepared a new strategy of development of the national banking system for the period from 2002 to 2005. The main objective of the strategy was to ensure effective transformation of oil revenues in the non-oil sector, increasing opportunities of access of the population and regions to banking services, the creation of a truly competitive environment in the banking sector [Elekberov, 2016].

To achieve the goals outlined in the strategy, the new doctrine of the CBA for the next period included: improvement of banking legislation and bringing it in line with international standards, in particular the final adoption of International Financial Reporting Standards (IFRS); increased transparency of the banking system; improving the quality of corporate governance of banks; organization of effective banking supervision [Elekberov E. 2007].

As a response to growing interest in the local banking system by foreign investors, January 1, 2004 decision of the Central Bank have been lifted restrictions on participation in the Azerbaijani banking market of foreign capital. In 2004, significant amendments have been made to the Law "On the Central Bank" relating to the specification of the CBA mission of macroeconomic regulation. In particular, as the main objectives of the Central Bank was designated "... to ensure price stability in the framework of, its existing monetary policy authority." [Durevall D., Henrekson M. 2010].

In 2004, Azerbaijan's strategic currency reserves increased from 1.4 to 1.8 billion. US dollars. The refinancing rate of the Central Bank remained at 7%. Inflation for 2004 was 10.4%. The main factors of inflation were the growth of the money supply, energy costs, which grew by 31.9% in 2004, the impact on the consumer market of natural monopolies and increasing the incomes of the population [Mamedov, Z. 2017]

3rd stage - 2005 - present - the first high-quality achievements, the denomination of the national currency, the policy of "expensive money".

To control inflation the Central Bank increased the monetary measures, in particular by lifting in 2005 the refinancing rate from 7% to 9% (before refinancing rate of 7% has remained unchanged since 2002), in 2006 - from 9% to 9.5% , brought it June 5 to 13%, three times increasing in 2007.

Central Bank of Azerbaijan with the decision of April 2, 2007 approved the maximum and minimum limits of "percentage corridor" and the new refinancing rate. The maximum corridor was set at 19%, minimum - 5%, and the discount rate - at 12% (in July 2006 acted 9.5% rate).

At the beginning of 2018 the discount rate on deposits in country's banks varies from 14% to 15%.

In the period from 2006 to 2007 resulted in a denomination of manat that changed during the process of its denomination in the ratio of 1: 5000. Currently in circulation banknotes of 1, 5, 10, 20, 50 and AZN 100, and the coin 1 to 50 gyapik. According to preliminary information, the CBA guide was considering the release (emission) of metal coins in denominations of 1 manat and printing of new banknotes in denominations of 200 and 500 manat. The evolution of the banking sector comes at the mercy of the economic realities of the country.

It should be noted that the number of banks operating in Azerbaijan in 2017 is 31 [Carling R., Kirchner S. 2009]. Dominant role in the banking sector with the private sector, including 29 banks. private banking sector is more diverse. Since 2005 the first year was marked tendency to weaken the monopoly state banks, the private sector on the basic parameters approached the 50% market share, and was 80.74% for the 2017 year. Number of non-bank credit institutions licensed by the Central Bank of Azerbaijan at the end of 2017 was 78. Of these, 47 - non-bank credit institutions [17], 31 - banks [Tanzi V., Schuknecht L. 1997].

The total number of non-bank credit institutions decreased in 2017 compared to 2012 from 101 to 47 and remained at January 1, 2018.

Since the beginning of 2000, the possibility of serial production growth and energy exports from the country, as well as the favorable situation on the world markets. We determined the policies of economic growth of Azerbaijan, which is to promote the expansion of domestic demand through the channels in consumer spending and government investment. This model contemplates the realization of the classical scheme: through the distribution of oil revenues through the state budget system to ensure the growth of effective demand in the economy and on this basis, to encourage the growth of production in non-oil sector of the economy [Durevall D., Henrekson M. 2010]. However, (as experience has shown) in an open economy and violated as a result of macroeconomic stabilization mechanism adopted by the model of price parity is not able to adequately ensure the development of non-oil industrial sector. In the structure of GDP were generated significant imbalances in relation to the accelerated pace of import growth and development of services. Therefore, creation of conditions for their development requires a transition to new principles of functioning of the national markets [Khudiyev et.al. 2016].

Since 2011, as has been predicted, in Azerbaijan began a consistent decrease in the volume of oil production and exports. Formed a new situation has limited the possibility of the continuation of the policy of economic growth based on the expansion of demand model. During the 2013-2015 GG the country experienced a sharp slowdown in economic growth (Fig. 1.)

#### Research methods.

Although, on the basis of this economic situation, the President of Azerbaijan Ilham Aliyev put forward the thesis: "We must pay attention to the unprecedented first non-oil sector should make our country more attractive to foreign investors" in a meeting with a delegation from the organization "Movement of the French enterprises» (MEDEF) in 2016 [Durevall D., Henrekson M. 2010]. This situation requires the improvement of the current model of economic growth, and in particular the creation of new mechanisms for the transition from model to model demand for supply-side economics economy [Khudiyev N. 2013 ]. in accordance with the results of theoretical studies (curve Army Rana and Scully dot) [12] and empirical observations (and Tapas Zskikpes M) [A.A.Gubadova, 2016] above acceptable threshold for developing economy (in terms of the positive effect on growth).

The main problem of Azerbaijan's fiscal policy, in our opinion, is the level of oil and gas deficit, which has grown rapidly over the last decade. High level of dependence of the state budget revenues from oil and gas generates two types of problems:

problems due to price fluctuations on the world markets (drop in energy prices lower than planned in the state budget level and the reduction of budget revenues each time put the government to choose between spending cuts (sequestration) and an increase in the tax burden. Both directions of the situation in the economy countries are highly undesirable (reducing government spending - in socio-political terms, a tax increase - in terms of stimulating economic growth and rising levels of show jumping abilities);

problems due to the fall in oil production and exports and, as a consequence, with a consistent decline in income of the economy and the state budget provided by the oil and gas sector.

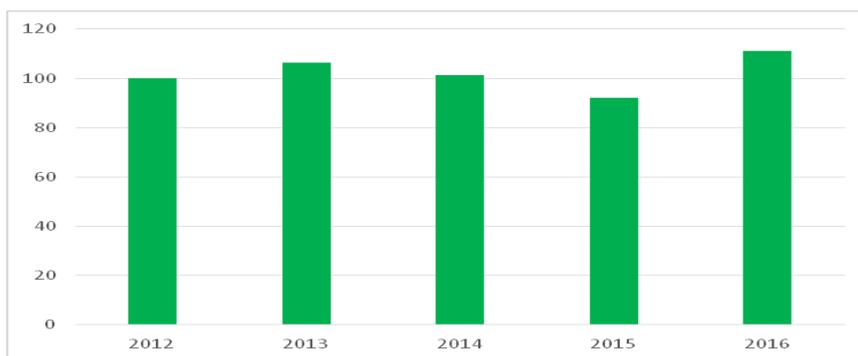


Figure 1. GDP growth Azerbaijan in%.

Source: Statistical materials State Statistics Committee.

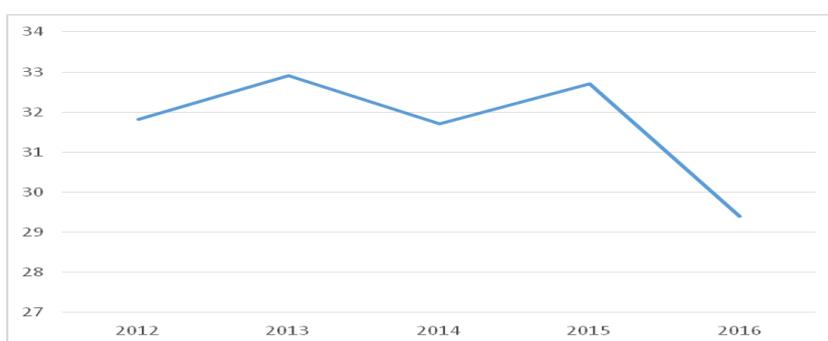


Figure 2. The share of budget expenditures in Azerbaijan's GDP in%. Source: State Statistics Committee Statistical materials [www.stat.gov.az ].

In this regard, the study discusses the features of the current model of economic growth of Azerbaijan, as well as possible ways of improving the basic tools of macroeconomic stabilization in the area of fiscal policy - to ensure long-term fiscal sustainability in a rapidly grown over the last decade, the volume of budget commitments, falling oil revenues and price uncertainty on global energy markets.

#### Problems of fiscal policy.

Since 2000, economic growth in Azerbaijan acted as an accelerator of growth in government spending, the dynamics of which is fully consistent with the law of Wagner (GDP growth was accompanied by a rapid increase in government spending (deviations from trend in 2006-2008. Related to the country's government pursued a pro-cyclical, and in 2009-2010, -. counter-cyclical fiscal policy), however, since 2012 this trend was interrupted in the first place on this influenced the decline in oil prices and as a result -. two-time devaluation of the national currency s in 2015, with the aim of stabilizing the national financial market and maintain the level of solvency of the state budget. (Figs. 1 and 2).

It can be observed that the latter according to statistics the current level of public spending in 2016 (slightly less than 30% of GDP) [Durevall D., Henrekson M. 2010].

The income of the state budget are formed exclusively by the oil and gas revenues over the past few years, the share of which rose to the level of 75-78% of budget revenues [Hajiyev, et.al. 2013].

The peculiarity of the budget system of Azerbaijan, which takes into account the resources of the State Oil Fund (SOFAZ) in the consolidated budget enables the government of the country with little or no restriction to finance government spending from the fund resources. Thus, the amount of transfers from SOFAZ to the state budget of the country for the past 10 years was about 45% of its income (and in the structure of the state budget the last three years, including 2014, the share of SOFAZ transfers 40-50% of budget revenues). Therefore, to reduce the high level of oil and gas not deficiency (is slightly less than 25% of GDP) to a safe level (6-7% of the GDP) necessary to improve the operating cost rules.

The experience of oil-exporting countries indicates that the problem is primarily due to the application of statutory fiscal rules (only in these conditions it is possible to get rid of the risk in the medium term). Such rules are essential to improve the investment climate in the country, as are the guarantee of the stability of the budget parameters.

Another important issue the country's fiscal policy is the level of government deficits. Over the last decade, the level of the budget deficit in Azerbaijan does not exceed 1% of GDP. However, due to falling oil revenue deficit of Azerbaijan State Budget 2018 is planned at the level of about 30% of GDP. Analysis and the calculations of researchers on the opportunities for growth of the budget deficit in Azerbaijan indicate that this earlier approach increases the cost of execution of obligations the risks in the medium term, and creates additional difficulties to address the financing gap. This is due to the fact that in terms of growth of loans to the domestic market would be a reduction of liquidity of financial institutions (and especially the commercial banks)

One of the main causes of violations of the domestic market price parity of the country considered to be a valid mechanism of stabilization in the economy [E.Elekberov, 2007]. Azerbaijan (as in many countries with developing financial markets and poorly diversified economies), the exchange rate acts as a "nominal anchor". Using the exchange rate regime has begun to stabilize the country still in the framework of the first IMF loan programs (1995-1999.). Therefore, changes in the energy export levels, as well as in prices and tariffs on the world market level have a decisive influence on the macroeconomic situation. So, growth of the surplus in the current account of balance of payments in the context of high prices and tariffs in the global energy markets forces in order to stabilize the situation the Central Bank of Azerbaijan (CBA) in the domestic market as well as to reduce the pressure on the nominal exchange rate of the national currency to carry out reduction of excessive levels money supply on the market. Under the current mechanism of monetary policy, this approach to the stabilization of the foreign exchange market determines the growth of the money supply and inflation. Therefore, it is the establishment of an optimal balance between growth and inflation growth of real effective exchange rate of the national currency (with the latter figure, known to be associated level of competitiveness of the economy) to CBA in the period of high prices and tariffs in the global energy markets, the main task.

The main task of the government and the Central Bank in this period is to choose a balance between the level of international reserves reduction and the money supply, between inflation and economic activity in the economy (the sharp reduction in the rate of growth and decline in monetary aggregate level M2 worsen the business environment for domestic producers (interest rate rise, the lack of money in circulation, etc.). Thus, regardless of the direction of "shock" worsening of the macroeconomic situation in the country occur in favorable years conditions (when the prices and tariffs in the world energy markets are soaring), and in bad years (when prices and rates tend to decrease).

The main problems in the market, which are used due to a stabilization mode are:

deviations from the nominal exchange rate equilibrium level (and in particular the level of PPP - purchasing power parity);

The steady appreciation of the real exchange rate (Fig. 3).

Such situation is characterized by high interest rates and low capacity of the banking system to expand the money supply. Level and the chosen exchange rate regime in the country are essential for the structural modernization of the economy.

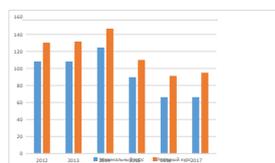


Figure 3. The nominal and real effective exchange rate of the national currency of Azerbaijan from 2012 to 2017,%. Note. Calculations performed by the authors on the basis of statistical data CBA [N.Omes, 2010].

From a theoretical point of view, a stimulating effect on the economy can have both an overvalued exchange rate, and understated. It all depends on what stage of development is the country, and there are some deviations between the nominal and the equilibrium exchange rate.

Conclusion.

Analysis has shown that economic development took place during three periods:

- in the period from 2008 to 2009 (in connection with the global financial crisis and the decline in prices on world energy markets);
- in the post-crisis period in 2011-2012. (In connection with a reduction in oil production and export);
- post-devaluation in the period 2015-2016 years.

To date, in our view, is a necessary transition from model to stimulate domestic demand to stimulate growth model offers (private investment). In other words, the new model should be focused on achieving a significant improvement of the investment climate in the country, an attractive environment for private investment and economic growth competitiveness (A.Hajiyev, 2012).

An important issue in this regard is to achieve fiscal sustainability, which is the foundation of macroeconomic stability, investment attractiveness and competitiveness of the economy. In order to increase the competitiveness of the economy of Azerbaijan are necessary:

fiscal rules - to avoid the negative impact of the external economic environment changes. Without such rules exist as increased costs risks and reduce the risks of revenue in the budget system of the country;

stable fiscal policy over the medium term, which primarily involves a stable tax policy with a stimulating effect on the character of the processes of economic growth;

improving the existing mechanism of stabilization regimes of monetary policy and exchange rate policy, which will allow:

eliminate the dependence of the country's financial policy on the situation in world energy markets, implement opportunities to reduce capital expenditure from the budget and increase non-oil revenues in the medium term;

limit inflation growth in the event of pressure on the demand side.

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