



Better financial literacy and inclusion would strengthen Azerbaijan's financial sector

The drop from peak oil prices is testing Azerbaijan's economy and its people's ability to adjust to a more modern financial system.

For the decade from 2006 to 2016, few economies were as dynamic as Azerbaijan's. Petroleum reserves brought boom times and the economy grew by 35% in the year 2006 alone.

But the prosperity concealed a troubling undercurrent.

When oil prices began dropping beginning in 2014, Azerbaijan's economic resilience was tested.

By 2015, the industrial sector had slowed, confidence in financial institutions had dropped, and the currency was devalued by 48%. Increasingly, the most obvious features of Azerbaijan's economy were its long-term problems rather than its short-term promise. Chief among those is the financial literacy of its people and their place in the economy and financial system.

Consumer protection is inadequate and financial inclusion rates are low. Small and medium-sized enterprises find it hard to obtain credit and applying is expensive and complex. Banks also provide incomplete information, leading to distrust in the financial system.

The government has taken some steps.

The Central Bank of Azerbaijan has instituted procedures for mediating between financial institutions and consumers and established a deposit insurance fund. Government subsidy funds are also promoting small and medium-sized enterprises. Further, the Central Bank has developed a national financial literacy strategy.

But the list of institutional obstacles that Azerbaijan's financial sector has chronically faced is long.

The Economist Intelligence Unit says the banking sector is uncompetitive, fragmented, poorly developed, and suffers from poor corporate governance. Lending is low as a share of GDP, and banking plays only a marginal role in the economy. State and elite influence over the sector is high. Lending is overwhelmingly focused on Baku, the capital, and is largely directed toward established medium-sized and large enterprises. The banking system remains small relative to the size of the economy. Total banking assets were about 52.4% of GDP, with individual deposits counting for only 12.4% at the end of 2016, much lower than in advanced transitional economies of Central and Southeastern Europe.

The insurance sector is highly segmented, reducing competition and impeding expansion. The securities market is small with only 12 brokerages, 13 dealers, 3 securities managers, and 1 clearing house. The World Bank says the non-bank credit sector is underdeveloped and offers limited opportunities for small and medium-sized enterprises. The combined microfinance loan portfolio is still only about 1% of GDP, despite considerable demand.

An example of the kind of long-term problems that impede recovery is consumer credit cards. Like other sectors, the market for consumer credit cards contracted following the boom. Eleven banks closed in 2 years and the number of cards plunged by 37.5% from 2015 to 2016.

The result of this contraction has been a fear of formal credit. Many depositors have left formal banking altogether. Although the rich and the poor generally have different attitudes toward credit, Azerbaijanis by and large prefer informal credit, which outpaces formal borrowing by 15%. Since informal lending exists outside government and institutional oversight, it contributes to a financial setback that will be difficult to surmount.

While small and medium-sized enterprises are specifically responses to difficult economic issues, in Azerbaijan, dollarization, over-indebtedness, parallel borrowing, and savings withdrawals have increased, reducing the likelihood that debts will be repaid.

The government took steps to set up financial safeguards before oil prices dropped.

In 2010, the Central Bank launched the Financial Literacy Project. The project found that the many adults had a high rate of basic financial awareness, but few could understand and calculate interest. Given the high stakes surrounding Azerbaijan's ability to institutionalize its prosperity, outreach from banking institutions to bolster long-term financial strategies is essential.

While efforts to improve the financial sector and regulatory framework will continue, a more inclusive financial regime is essential. Women, the poor, the disabled, pensioners, and other vulnerable groups must be targeted. Without more financial literacy, they could revert to informal lending.

Although oil prices will likely continue to drive Azerbaijan's economic development, the country can anticipate that an extractive-based economy is less likely to be as dynamic in the future.

This episode is based on the [research](#) of Gubad Ibadoghlu, senior policy analyst at the Scientific-Research Institute at Azerbaijan State University of Economics, Baku.

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