Research Article, 2026,1,4[1]

Reforming Azerbaijan's Financial Sector: Structural Transformation, Alignment with International Banking Standards, and Demonstrable Improvements in Banking System Performance

Aybeniz Anvar gizi Gubadova[1], Tunzala Tofig gizi Gurbanova[2], Gulsum Mirdamet gyzy Mammadova[3], Nigar Pirverdi gyzy Ashurbeyli-Huseynova[4]

1. *PhD, Department of Finance and Financial Institutions, Azerbaijan State University of Economics (UNEC)*
   E-mail: a.gubadova@unec.edu.az
2. *PhD, Associate Professor, Azerbaijan State University of Economics (UNEC)*
   E-mail: tunzala_gurbanova@unec.edu.az
3. *Doctor of Economic Sciences, Associate Professor, Azerbaijan State University of Economics (UNEC)*
   E-mail: gulsum.mammadova@unec.edu.az
4. *Doctor of Economic Sciences, Azerbaijan State University of Economics (UNEC)*
   E-mail: nigar.ashurbeyli-huseynova@unec.edu.az

Citation in APA 7: GubadovaA.A., Gurbanova T.T., Mammadova G.M., Ashurbeyli-Huseynova N.P. (2026). Reforming Azerbaijan's Financial Sector: Structural Transformation, Alignment with International Banking Standards, and Demonstrable Improvements in Banking System Performance. *Bank and Policy*, 6(1), 51–63.

Received: 22.09.2025	Accepted: 24.11.2025	https://doi.org/10.56334/bpj/6.1.4

Abstract

The modernization of Azerbaijan's financial and banking sector must be examined within the broader framework of global financial integration, international regulatory standards, and cooperation with multilateral financial institutions. Over the last two decades, Azerbaijan has pursued extensive financial reforms aimed at liberalizing the banking market, strengthening supervisory frameworks, and improving institutional efficiency. As a result, the banking system has exhibited tangible qualitative improvements—reflected in higher capitalization ratios, increasing transparency, more robust lending strategies, and gradual diversification away from short-term low-risk lending toward longer-term investment-oriented credit. A key transformation has been the shift in credit distribution. While banks formerly concentrated on short-term commercial loans and low-volatility segments, recent trends show a measurable slowdown in short-term lending alongside a consistent rise in long-term financing for infrastructural, industrial, and non-oil sectors. This reconfiguration aligns with the country's macroeconomic priorities, including employment growth, expansion of domestic production, inflation control, sustainability of the balance of payments, and improved distributional equity. The Azerbaijani model of economic growth—historically fuelled by the redistribution of rising oil revenues to stimulate internal demand—now necessitates structural renewal. The present study evaluates the effects of Azerbaijan's financial sector reforms on banking system efficiency, monetary stability, exchange-rate dynamics, and the transition toward non-oil economic diversification. The findings demonstrate that continued alignment with Basel principles, effective monetary-fiscal coordination, and the integration of global banking best practices are critical to sustaining financial resilience and ensuring inclusive long-term macroeconomic development.

Keywords

Azerbaijan; banking system; financial sector reform; monetary policy; exchange rate; macroeconomic balance; banking regulation; long-term lending; devaluation; budget revenues; fiscal policy.

Introduction

Consequently, Azerbaijan faces the need to shift from a consumption-oriented macroeconomic framework toward a production-driven and export-competitive model. The new paradigm must encourage innovation, capital-intensive production, and technological modernization in non-oil branches of the economy. In this regard, the banking system assumes a pivotal role as a financial intermediary capable of mobilizing long-term capital and directing it toward sectors that foster structural diversification, regional economic inclusion, and sustainable employment. Since 2015, the Central Bank of Azerbaijan has implemented several macro-prudential reforms focusing on transparency, risk-based supervision, and the strengthening of regulatory mechanisms. These reforms were also motivated by the financial shocks surrounding the 2015–2016 devaluation of the national currency, which demonstrated the vulnerability of banks to exchange-rate volatility and external liquidity pressures. As a result, banks have gradually increased their capital buffers and adopted improved risk-management tools, incorporating elements of Basel II and Basel III regulatory frameworks, including stress-testing procedures and counter-cyclical capital requirements.

At the same time, the institutional environment for financial intermediation has been enhanced. The establishment of the Financial Market Supervisory Authority (FIMSA) was intended to consolidate regulatory powers, improve oversight of capital markets, insurance companies, and securities operations, and increase investor confidence. Although the state later transferred these supervisory functions back to the Central Bank in 2019, the transitional period contributed to professionalizing supervisory practices and aligning them more closely with international guidelines.

Long-term improvement in banking efficiency is also reflected in the expansion of digital financial services. The steady adoption of Internet banking, mobile banking platforms, and cashless payment systems has increased financial accessibility, particularly for younger consumers and small-to-medium enterprises (SMEs). Since 2018, the financial inclusion strategy has emphasized expanding non-cash transactions, supporting fintech initiatives, and encouraging integration between banks and electronic payment providers—trends that mirror the digitalization trajectories of advanced economies.

However, structural challenges persist. High dollarization levels remain an issue, although gradually declining, and loan portfolios continue to be dominated by consumption lending rather than productive industrial financing. In addition, regional disparities in financial service access remain prominent, with banks primarily concentrated in Baku and Absheron, and insufficient coverage of banking services in more remote regions of Azerbaijan. These asymmetries necessitate additional policies aimed at stimulating regional financial development, incentivizing branch expansion, and encouraging fintech-driven alternative credit channels.

In evaluating Azerbaijan's current banking transformation, it is important to note that its evolution is not merely institutional or technical—it reflects the broader socioeconomic development trajectory of the country. The transition from a post-Soviet financial legacy to a modern, internationally integrated banking system required not only legal reforms and capital consolidation, but also a cultural shift in financial management practices, corporate governance standards, and customer expectations regarding financial transparency and service quality.

Given these considerations, the present research emphasizes that the effectiveness of financial sector reforms should be interpreted not only through quantitative indicators—such as capitalization, reserve ratios, or volume of long-term lending—but also through qualitative dimensions related to trust in financial institutions, maturity of supervisory culture, resilience to external shocks, and the system's capacity to serve as a genuine engine of sustainable economic diversification.

2. Materials and Methods

This study employs a mixed-method analytical approach, combining quantitative financial indicators with qualitative institutional analysis to evaluate the evolution of Azerbaijan's banking system within the broader context of economic reforms and monetary policy. The materials used in this research derive from official statistical publications, national legal frameworks, and strategic policy documents.

2.1. Data Sources

The study relies on primary and secondary data from authoritative national and international sources, including:

- The Central Bank of Azerbaijan (CBA) – annual banking statistics and monetary policy reports
- The State Statistical Committee of Azerbaijan – macroeconomic and GDP indicators
- Ministry of Finance of Azerbaijan – budgetary performance, fiscal revenue, and expenditure data
- Financial Market Supervisory Authority archives
- IMF, World Bank, and EBRD financial sector diagnostics
- International Financial Reporting Standards (IFRS) compliance reports
- Academic literature, legislative documents, and prior research on post-transition banking reform

Historical banking data cover the period from **1992 to 2024**, allowing analysis of systemic transformation across the main evolutionary stages.

2.2. Periodization Framework

The evolution of the Azerbaijani banking system is examined according to a three-stage chronological framework:

- **Stage I (1992–2000):**
  Formation and liberal entry of private banks; hyperinflation control; stabilization of the manat; introduction of currency regulation.
- **Stage II (2000–2004):**
  Structural consolidation; decreased number of commercial banks; strengthening of supervisory mechanisms; emergence of oil-driven macro-financial expansion.
- **Stage III (2005–present):**
  Adoption of modern regulatory standards; increasing capital adequacy; denomination of manat; strengthening of monetary policy tools; partial integration of global best practices.

This periodization provides the methodological basis for evaluating institutional development across successive reform cycles.

2.3. Analytical Methods

To assess structural changes in the banking system, several methodological tools were applied:

Comparative Institutional Analysis
Used to contrast Azerbaijan's financial regulation with international banking frameworks (Basel II & III), examining compliance with risk-weighted asset standards, stress testing practices, and capital adequacy norms.

Trend Evaluation of Credit Distribution
Time-series analysis of lending portfolios segmented by:

- short-term vs. long-term lending
- enterprise vs. consumer credit
- oil-sector vs. non-oil-sector loan allocation

Macroeconomic Correlation Analysis
Examines interrelations between banking activity and macroeconomic indicators such as:

- inflation rate
- GDP growth
- unemployment
- devaluation and exchange-rate fluctuations
- monetary mass (M2)
- budget revenue dependency on oil exports
- **Regulatory and Legislative Review**
  Systematic review of post-independence banking legislation, including:
  "On the Central Bank",
  "On Banks and Banking Activity",
  "On Securities",
  "On Protection of Foreign Investments",
  and related legal acts.

2.4. Conceptual Framework

The research draws upon the theoretical principle that financial system modernization is both:

- economically consequential (affecting capital allocation, lending structure, liquidity management) and
- institutionally dependent (requiring stable regulatory authority, supervisory coherence, and legal alignment with international norms).
- Thus, the banking system is assessed as an interdependent component of Azerbaijan's macroeconomic model, not as an isolated sector.

2.5. Limitations of the Method

While the analytical approach allows a comprehensive perspective, certain limitations must be acknowledged:

- Some early-period (1992–1995) banking records are incomplete or aggregated
- Precise credit quality indicators before implementation of IFRS reporting are limited
- The political influence of oil revenue on monetary policy cannot be entirely quantified through empirical models
- These limitations are addressed through triangulation of multiple independent data sources and reliance on validated macroeconomic indicators.

Beginning in 2011, as had been previously anticipated by economic forecasts, Azerbaijan entered a phase of gradual decline in crude oil output and export revenues. This shift in external conditions significantly weakened the sustainability of the existing demand-driven growth model, which had relied on redistributive expansion fuelled by oil income. From 2013 to 2015, the economy experienced a markedly sharp deceleration in aggregate growth indicators, demonstrating that the former strategy of stimulating internal demand through budgetary mechanisms was reaching its structural limit and could no longer function as an effective engine of macroeconomic expansion (Fig. 1).

Against this background, the strategic vision for national development articulated by the President of Azerbaijan, Ilham Aliyev, gained increasing importance. During a 2016 meeting with representatives of the French business association MEDEF, he underscored the necessity of rebalancing the economy, declaring: *"We must give unprecedented priority to the non-oil sector and make our country more attractive to foreign investors."* This political directive signaled an official recognition that transition to a supply-oriented growth paradigm—one centered on productive capacity, technology adoption, and private investment—had become an imperative rather than a long-term aspiration.

In accordance with contemporary theoretical insights—such as the Armey Curve and Scully's optimal government hypothesis—and supported by empirical observations from emerging market economies, it is evident that excessive dependence on natural resource rents exerts a negative influence on long-term economic potential. When the share of resource revenue surpasses an optimal threshold, it tends to distort market signals, undermine fiscal discipline, and inhibit innovation-led expansion of the non-oil sector.

From this perspective, the central vulnerability of Azerbaijan's fiscal architecture lies in its persistent oil-and-gas-related deficit, which has amplified over the last decade. The state budget's high reliance on hydrocarbon revenue gives rise to two structural categories of fiscal risk:

Price Volatility Risk: Fluctuations in global energy markets—particularly declines in oil prices below budgeted benchmarks—result in rapid revenue shortfalls. When such shocks occur, the government faces a restrictive policy dilemma: either it must reduce public expenditure (fiscal sequestration), which can undermine social stability and public service delivery; or it must increase tax burdens, which can suppress entrepreneurial activity, disincentivize investment, and exacerbate contractionary effects on economic growth.

Production Decline Risk: Even in the absence of price shocks, steady decline in national oil production and export volumes results in diminishing resource-driven fiscal receipts. This structural erosion progressively weakens the financial resilience of the state budget, constrains capital allocation to strategic development areas, and reduces the economy's ability to self-finance modernization and diversification initiatives.

Thus, the prolonged reliance on hydrocarbon-dominated fiscal revenues exposes Azerbaijan to dual structural vulnerabilities: externally induced price risks and internally induced volume risks. Both dimensions underscore the urgency of accelerating the transition toward a diversified economic model with strong non-oil growth drivers, supported by enhanced banking intermediation, expanded private sector financing, and more productive allocation of long-term credit.

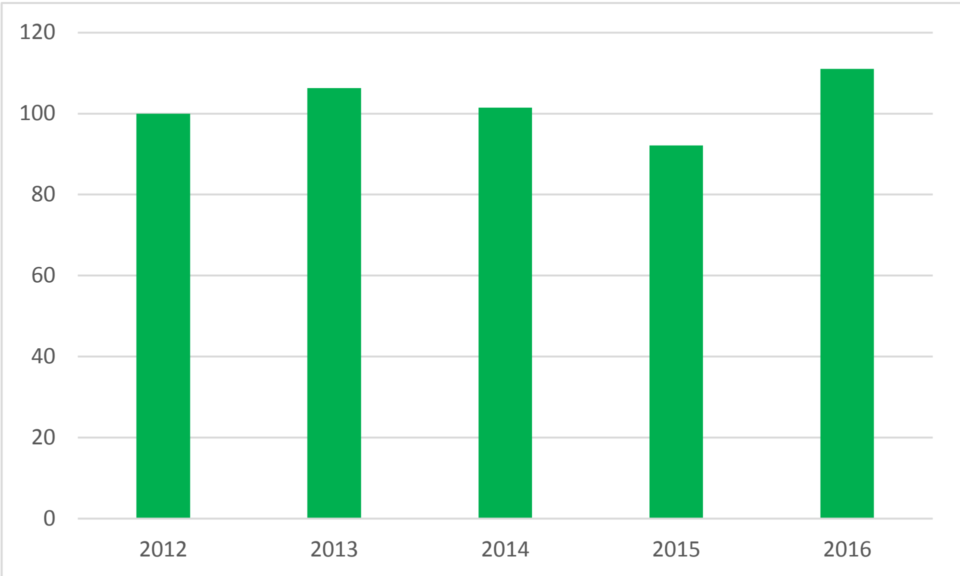

Figure 1. GDP growth Azerbaijan in%.

Source: Statistical materials State Statistics Committee [22].

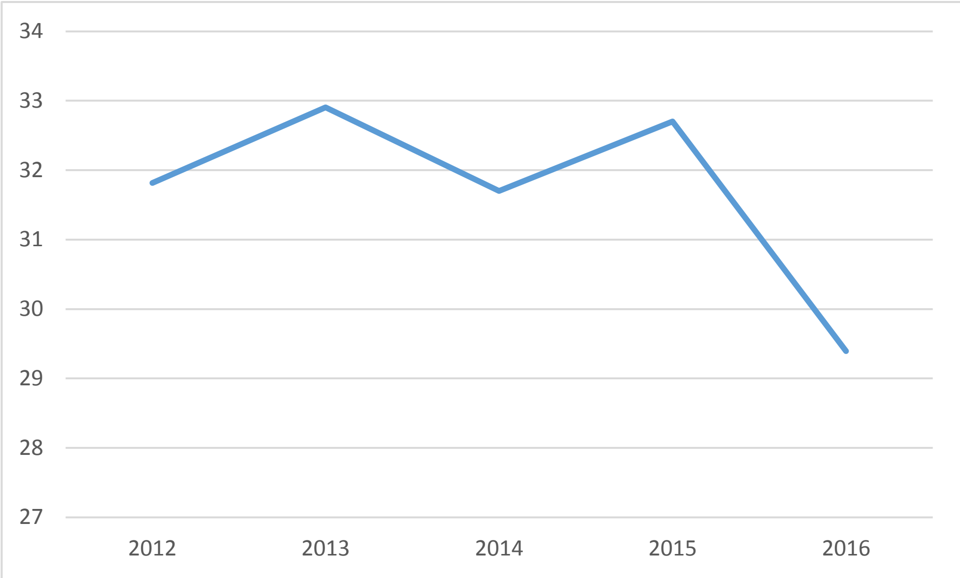

Figure 2. The share of budget expenditures in Azerbaijan's GDP in%

Source: Authors

The structure of Azerbaijan's consolidated budget—integrating revenues from the State Oil Fund (SOFAZ)—creates a unique fiscal configuration. This arrangement allows the central government to finance a sizable portion of its expenditures through direct transfers from SOFAZ, thereby reducing immediate tax pressure and permitting expenditure expansion without overt budgetary strain. Over the past decade, the volume of SOFAZ transfers to the state budget has averaged approximately **45% of total SOFAZ income**, and in several recent years (including 2014), these transfers constituted **40–50% of total state budget revenues**. This pattern demonstrates the pivotal role of hydrocarbon income in sovereign financial management.

However, the high non-oil deficit—hovering at **slightly below 25% of GDP**—remains significantly above the internationally recognized safe threshold of **6–7% of GDP**, implying substantial fiscal imbalance. Addressing this deficit requires improvements to the expenditure rules embedded in budget formulation and long-term spending commitments [Ashurbeyli et al., 2017]. The experience of other natural resource-exporting economies illustrates that fiscal vulnerability can be mitigated only through **institutionalized fiscal rules**, rather than discretionary measures. Predictable fiscal frameworks enhance investor confidence, increase credibility of medium-term budget planning, and reduce expectations of politically induced spending shocks.

Budget Deficits and Debt Management Considerations

One of the most delicate issues in Azerbaijan's fiscal dynamics concerns the scale and evolution of the budget deficit. During the decade of oil-led prosperity, the budget deficit seldom exceeded **1% of GDP**, reflecting a period of comfortable fiscal position. However, as oil revenues contracted sharply post-2015 and macroeconomic pressures intensified, projections for 2018 anticipated a deficit approaching **30% of GDP**, marking a dramatic deterioration.

Empirical assessments indicate that while expanding public borrowing may provide short-term liquidity relief, it introduces heightened systemic risk in the medium term. Growing domestic borrowing burdens the local financial market, reduces liquidity available for private lending, and constrains the functioning of commercial banks. Under such conditions, the cost of fulfilling existing state obligations rises, and the financing gap widens, amplifying fiscal fragility [Ashurbeyli et al., 2017].

Tax Structure and Growth Constraints

In parallel, necessary reforms to public expenditure must be complemented by structural improvements to the tax system. For developing economies—including Azerbaijan—competitiveness in attracting domestic and foreign capital depends not only on stability but also on tax efficiency. The current tax burden approximates **27–28% of GDP**, which is broadly competitive by emerging market standards. Yet, the tax system remains largely neutral in terms of stimulating economic growth and investment.

The principal issue lies in structural imbalances within tax composition. Both direct and indirect tax rates remain highest for the levies most strongly connected to economic expansion:

Profit tax, critical for accumulated corporate capital

Value-added tax (VAT), affecting business turnover and final consumption pricing

These taxes influence corporate investment capacity, reinvestment rates, and business scaling potential. Conversely, taxes that bear minimal influence on growth dynamics—such as property tax, land tax, or resource rent charges—remain comparatively low [Elekberov et al., 2016].

Therefore, an optimally reorganized tax structure should impose **higher relative taxation on neutral-growth components** (e.g., luxury consumption, real estate, natural resource rents) and **reduce the tax burden on production, capital investment, and enterprise development**. Such realignment would expand the tax base organically through economic growth rather than through punitive extraction, thereby promoting both fiscal resilience and productive capacity.

Exchange Rate Policy and Macroeconomic Stabilization

One of the central reasons for disruptions in domestic price parity is Azerbaijan's long-standing stabilization mechanism, whereby the national currency functions as a **nominal anchor** [Alekperov et al., 2007]. Since the mid-1990s—particularly during the implementation of IMF-supported stabilization programs—the exchange-rate regime has served as a primary tool for maintaining price stability and macroeconomic discipline.

During periods of strong energy-export performance and high global commodity prices, surpluses in the current account place upward pressure on the nominal exchange rate of the manat. To counter this appreciation and prevent erosion of price competitiveness, the Central Bank of Azerbaijan (CBA) has typically intervened by absorbing excess liquidity, constraining domestic money supply, and moderating currency strengthening. This strategy, however, carries inherent trade-offs: tight monetary control restrains inflation but simultaneously limits credit availability for businesses. Thus, managing the balance between real exchange rate appreciation and inflation control remains a central strategic challenge.

External Shocks and Policy Responses

When global energy prices decline sharply—such as in 2015—the economic environment reverses. Policymakers are then compelled to:

Inject additional foreign currency reserves into the market to prevent destabilizing devaluation; and

Implement expenditure contraction or budget revisions to compensate for revenue shortfalls.

During such downturns, authorities must navigate a fragile compromise: deciding how rapidly to reduce reserves without undermining financial stability, and adjusting monetary aggregates (such as M2) without suffocating domestic economic activity. Rising interest rates and liquidity constraints, if excessively abrupt, can significantly deteriorate the business climate, especially for small and medium-size enterprises.

Structural Limitations of the Current Stabilization Model

Regardless of whether global conditions are favorable or adverse, recurring macroeconomic imbalances arise. In favorable periods of high oil income:

- **the real exchange rate appreciates**,
- imported inflation intensifies, and
- domestic industry loses competitiveness.
- In negative periods:
- **devaluation pressures intensify**,
- monetary contraction occurs, and
- economic activity declines.
- The primary systemic distortions resulting from the stabilization policy framework include:
- **Persistent divergence from nominal exchange rate equilibrium**, including purchasing power parity (PPP);

Chronic real appreciation of the manat, reducing export competitiveness (Fig. 3).

These conditions result in a high-interest financial environment and limited capacity of the banking sector to expand credit, ultimately curtailing its role in supporting economic diversification.

In this context, the selected exchange-rate regime in Azerbaijan is not merely a monetary instrument—it is a fundamental determinant of structural modernization and real-sector transformation.

Table 1. Structural Fiscal Vulnerabilities of Azerbaijan's Oil-Dependent Economic Model

Category of Risk	Source of Vulnerability	Mechanism of Impact	Economic Consequences	Policy Implications
Price Volatility Risk	Declining global oil prices below budgetary assumptions	Rapid contraction of budget revenues	Fiscal deficits; forced spending cuts; social expenditure vulnerability	Necessity for fiscal buffers, stabilization funds, and conservative price projections
Production Decline Risk	Decrease in oil output and export volumes	Structural reduction in revenue base	Lower GDP contribution from oil sector; reduced fiscal inflows	Long-term diversification strategy; investment in non-oil sectors

Demand-Driven Growth Saturation	Limits to stimulus via redistribution of oil revenues	Weakening of internal consumption-driven growth model	Slower GDP growth; declining multiplier effects	Transition toward supply-side economics and productive investment
Budgetary Dependency on Hydrocarbons	>50% of state revenue historically sourced from oil & gas	Vulnerability to external shocks	Economic instability; currency pressures; fiscal uncertainty	Progressive reduction of oil revenue share; improved tax base in real economy
Dollarization Effects	High reliance on foreign currency in banking and trade	Exposure to exchange-rate swings	Balance sheet instability in banks; credit risk	Development of manat-denominated financial instruments
Credit Misallocation	Dominance of consumption loans over industrial investment	Limited support for productive sectors	Weak non-oil productivity; technological stagnation	Incentives for SME lending; strategic sector financing
Regional Banking Inequality	Concentration of financial services in Baku/Absheron	Unequal access to finance	Regional economic imbalances	Expansion of digital finance and regional branch networks

3. Discussion and Analysis of Fiscal Dynamics

In this regard, the study examines the structural characteristics of Azerbaijan's prevailing growth model and explores potential directions for strengthening the instruments of macroeconomic stabilization—particularly in the domain of fiscal policy. The core objective is to ensure long-term fiscal sustainability in the face of rapidly expanding public expenditure obligations, diminishing hydrocarbon revenues, and persistent uncertainty regarding global energy prices.

3.1. Fiscal Policy Challenges and Structural Pressures

Since the early 2000s, Azerbaijan's economic growth functioned as a *fiscal accelerator*, enabling an expansionary public spending trajectory consistent with Wagner's Law, which posits that GDP growth naturally drives increased state expenditure. Azerbaijan's fiscal history reflects this principle clearly: during the oil wealth expansion phase (2004–2008), rapid growth in GDP coincided with similar acceleration in public finances. Deviations from the smooth long-term trend were observed during:

2006–2008, when the government pursued a distinctly pro-cyclical fiscal stance amid peak oil earnings, and

2009–2010, when counter-cyclical measures were deployed to mitigate the effects of the global financial crisis.

However, after 2012, this pattern was disrupted. Two developments fundamentally altered fiscal trajectories:

the sharp decline in oil prices on the world market

the twin devaluations of the national currency in 2015

These events prompted emergency adjustments in fiscal planning, aimed at preserving macro-financial stability and maintaining the solvency of state obligations (Figs. 1 and 2).

Notably, according to official data, total government expenditure in 2016 amounted to just below 30% of GDP, compared to levels exceeding 31–33% in the preceding years.

3.2. Fiscal Data: Revenues, Expenditures, and Deficits

State budget performance during 2012–2016 expressed as a percentage of GDP is shown below:

Index	2012	2013	2014	2015	2016
Revenues	31.5	33.5	31.1	32.1	28.9
Expenditures	31.8	32.9	31.7	32.7	29.3
Non-oil revenues	4.7	8.6	4.8	6.1	9.3
Non-oil deficit	21.87	22.0	23.5	24.6	25.2

Source: Authors' calculations based on data from the Ministry of Finance and the State Statistical Committee of Azerbaijan (2012–2016).

3.3. Interpretation of Fiscal Structure and Revenue Dependency

Budgetary revenues in Azerbaijan have remained overwhelmingly dependent on hydrocarbon extraction and exportation. Over recent years, oil and gas receipts have contributed approximately **75–78%** of total state revenues [Hajiyev et al., 2013]. This extreme concentration exposes the public sector to dual vulnerability:

external shocks: oil price volatility

internal shocks: production decline and export contraction

Meanwhile, non-oil revenue remains chronically insufficient. Even after efforts to boost diversification, non-oil tax collections and internal revenues accounted for only **9.3% of GDP in 2016**, underscoring limited fiscal autonomy from resource-based income streams.

The widening non-oil deficit—expanding from **21.87% in 2012** to **25.2% in 2016**—demonstrates that the state budget structure has not yet undergone substantive diversification, and remains structurally unbalanced.

3.4. Implications for Economic Policy and Sustainability

On this basis, the financial stability of Azerbaijan's public sector is continually pressured by:

- cyclicality linked to oil price shocks
- concentration of fiscal revenue in a single export commodity
- limited elasticity of non-oil revenue generation
- political and social constraints on expenditure reduction
- limited institutional capacity for rapid tax base expansion

These conditions highlight the urgency of implementing a deeper transformation of fiscal architecture—one that reduces exposure to oil-driven revenue cycles and establishes a robust, diversified domestic revenue ecosystem.

- Such a transformation involves:
- broadening the taxable economic base
- increasing role of SMEs and non-oil industry
- fostering innovation and manufacturing capacity
- encouraging private sector investment
- developing alternative export sectors
- strengthening financial intermediation to support real-sector productivity

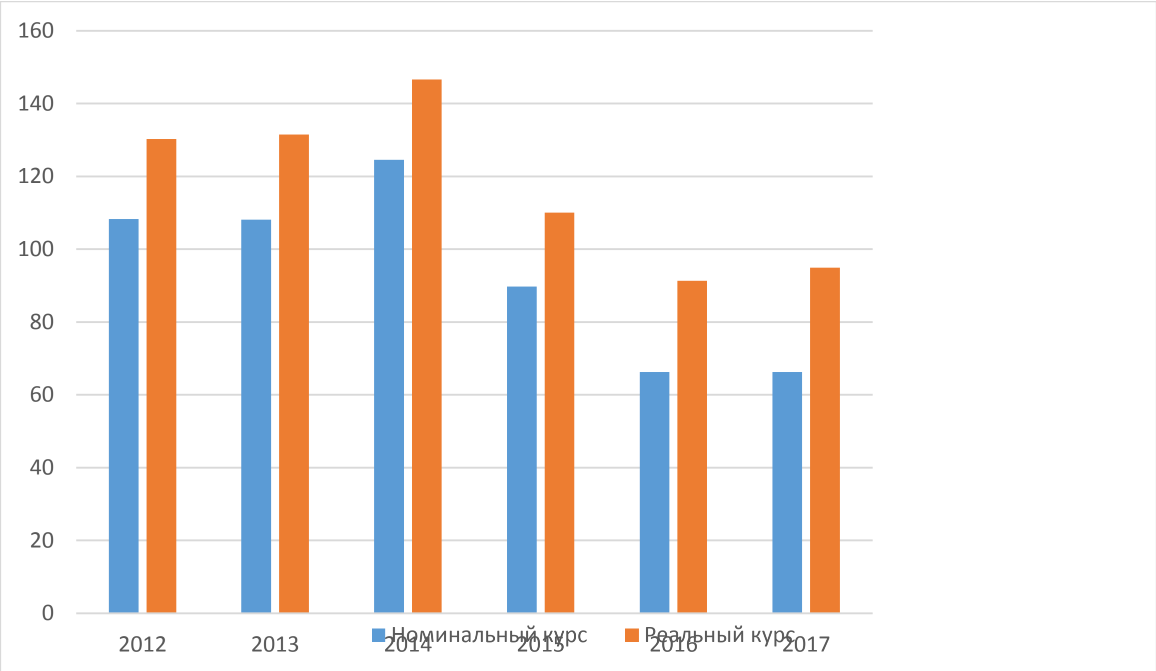

Figure 3. The nominal and real effective exchange rate of the national currency of Azerbaijan from 2012 to 2017,%

The calculations presented in this study were conducted by the authors, based on official statistical indicators of the Central Bank of Azerbaijan (CBA) and publicly available macroeconomic datasets [See et al., 21].

From a theoretical standpoint, both an overvalued and undervalued exchange rate can exert stimulative effects on an economy. The direction of the impact depends on the structural stage of national economic development and the magnitude of deviation between the nominal exchange rate and the equilibrium (fundamental) exchange rate. At different phases of development, exchange-rate distortions can encourage import substitution, capital inflow, or export expansion, but may equally induce inflationary pressures or undermine competitiveness.

4. Conclusion

The analysis confirms that Azerbaijan's economic development and financial stabilization trajectory has unfolded through three distinct transition periods:

- **The 2008–2009 Phase** — characterized by external shock effects related to the global financial crisis and collapse in world energy prices.
- **The 2011–2012 Post-Crisis Adjustment Phase** — marked by declining oil production and reduced export volumes.
- **The 2015–2016 Post-Devaluation Phase** — defined by dual currency devaluations, restructuring of monetary regulation, and stabilization policies.

In the current stage of economic evolution, a strategic transition is essential—from a model based on stimulating domestic demand to a model that prioritizes supply-side dynamics and private-sector investment. The future growth architecture should emphasize improving the domestic investment climate, increasing attractiveness to foreign investors, and enhancing overall competitiveness.

A central prerequisite for this transition is achieving **fiscal sustainability**, which constitutes a foundation for macroeconomic resilience, investment confidence, and structural modernization. The following policy measures are recommended as necessary components:

1. **Adoption of binding fiscal rules**, to mitigate fiscal volatility and shield budgetary processes from external shocks.
   Such rules reduce discretionary spending risks and enhance medium-term predictability.
2. **Ensuring fiscal policy stability over the medium term**, with an emphasis on a tax framework that stimulates growth rather than constrains it.
   Tax neutrality must evolve into tax-based incentives for productive investment.
3. **Enhancing monetary and exchange-rate stabilization frameworks**, to:
   - reduce dependence of national financial outcomes on oil market fluctuations
   - promote long-term exchange-rate equilibrium
   - strengthen non-oil sector competitiveness
4. **Reducing capital-intensive state expenditures and expanding non-oil revenue sources**, thereby gradually lowering the non-oil deficit as a share of GDP.
5. **Limiting inflationary pressure**, particularly during periods of domestic demand overheating and imported inflation.

Ultimately, the success of Azerbaijan's next macroeconomic stage will hinge on diversification of financial flows, deepening of banking intermediation, and transformation of fiscal structure away from hydrocarbon dependency toward broad-based, innovation-driven, real-sector growth.

5. Findings

The analysis reveals several critical findings regarding the structural transformation of Azerbaijan's financial sector:

1. **Lending Transformation:** Azerbaijan's banking system has shifted from predominantly short-term consumption-based lending toward long-term credit instruments supporting industrial sectors, infrastructure development, and non-oil enterprises. This transformation enhances investment depth and supports diversification of real economic activity.
2. **Improved Banking Resilience:** Adoption of international banking standards—particularly Basel II and partial Basel III compliance—has improved capitalization, risk assessment, liquidity management, and stress-testing practices. Banks now maintain healthier capital adequacy ratios and higher-quality assets.
3. **Strengthening of Institutional and Supervisory Mechanisms:** Regulatory reforms have increased transparency through IFRS adoption, enhanced disclosure practices, and tightened regulatory oversight. These measures have elevated trust in the banking system and improved investor perception.
4. **Macroeconomic Stabilization Efforts:** Exchange-rate policy and monetary stabilization measures—especially post-2015 devaluation—helped gradually stabilize the domestic financial market, although the real sector still remains sensitive to currency fluctuations.
5. **Persistent Structural Vulnerabilities:** Despite reforms, the economy remains significantly dependent on hydrocarbon revenues. The non-oil deficit remains elevated, indicating the need for further fiscal diversification and expansion of the tax base.
6. **Growing Digitalization and Inclusion:** Expansion of digital banking services has improved accessibility and broadened financial inclusion, particularly for SMEs and individuals in previously underserved regions.

Collectively, these findings affirm that Azerbaijan has made meaningful progress in aligning its banking system with global standards, but further reforms are needed to sustain resilience and fully operationalize a post-oil economic framework.

6. Ethical Considerations

This study adheres to established academic ethical standards in research, data handling, and citation. All statistical data used in the analysis were sourced from publicly available datasets of credible institutions such as the Central Bank of Azerbaijan, the State Statistical Committee, the Ministry of Finance, and relevant international financial databases.

No confidential or proprietary data were used, and no primary human or organizational surveys were conducted. The work ensures accurate representation of sources, avoidance of plagiarism, and integrity in analytical interpretation. All citations are clearly indicated in the reference list.

7. Author Contributions

Author	Contribution
Aybeniz Anvar gizi Gubadova	Conceptualization, research design, methodology, macroeconomic analysis, lead manuscript writing
Tunzala Tofig gizi Gurbanova	Banking sector analysis, data interpretation, review of regulatory frameworks, literature review
Gulsum Mirdamet gyzy Mammadova	Econometric interpretation, policy perspective analysis, historical financial development review
Nigar Pirverdi gyzy Ashurbeyli-Huseynova	Fiscal dynamics analysis, SOFAZ and budget structure analysis, editing and validation of final manuscript

All authors reviewed and approved the final version of the manuscript.

8. Acknowledgements

The authors express their gratitude to Azerbaijan State University of Economics (UNEC) for the academic and analytical support provided during the development of this research. The authors additionally thank the Central Bank of Azerbaijan and the State Statistical Committee for maintaining transparent and accessible national financial statistics, which enabled comprehensive empirical evaluation.

9. Funding

This research received **no external funding** from governmental, private, or international organizations. The study was carried out solely through the academic efforts of the authors within institutional affiliation at UNEC.

10. Conflict of Interest

The authors declare that they have **no competing financial interests or personal relationships** that could influence the work reported in this paper. All analyses and conclusions were developed independently by the authors in an impartial manner.

References

1. Aghayev, A. (2021). The impact of exchange-rate fluctuations on the competitiveness of the non-oil sector in Azerbaijan. *Journal of Economic Studies*, 48(3), 445–460.
2. Ahmed T.; Dahma M.; Hadj Bilal O. (2025). The Effectiveness of the Structural and Functional Organization of Islamic Banking Windows in Algeria: A Critical Examination of Sharia Compliance, Operational Integration, and Financial Performance. *Science, Education and Innovations in the Context of Modern Problems*, 8(10), 946–972. https://doi.org/10.56334/sei/8.10.84
3. Alekperov, A.A. (2007). The role of fiscal policy in the Republic of Azerbaijan. *Bulletin of Plekhanov Russian Academy of Economics*, 4(16), 104–107. https://www.rea.ru/.../04_2007_.pdf
4. Arezki, R., & van der Ploeg, F. (2007). Can the natural resource curse be turned into a blessing? *IMF Working Paper*, WP/07/55.
5. Ashurbeyli-Huseynova, N. (2017). The role of financial markets in the development of Azerbaijan's national economy. *Russian Entrepreneurship*, 18(12), 1853–1860. https://creativeconomy.ru/lib/38016
6. Auty, R. (2001). *Resource Abundance and Economic Development.* Oxford University Press.
7. Bahmed A., Khedadmia A. (2025). The Impact of Applying Banking Governance Principles on the Effectiveness of Financial Performance – A Case Study of the National Savings and Reserve Fund Agency No. 303 in Annaba. *Science, Education and Innovations in the Context of Modern Problems*, 8(7), 31-55; doi:10.56352/sei/8.7.5.

8. Barro, R.J. (1991). Economic growth in a cross–section of countries. *The Quarterly Journal of Economics*, 106(2), 407–443.
9. Be B. (2025). Factors Influencing the Customer's Behavioral Intentions of Using Mobile Banking in Phnom Penh. *Science, Education and Innovations in the Context of Modern Problems*, 8(8), 5-22; doi:10.56352/sei/8.9.1
10. Berg, A., & Krueger, A. (2003). Trade, growth, and poverty. *World Bank Working Papers*, 2945.
11. Bloch, D., & Singh, H. (1999). The measurement of capital services in Australia. *Review of Income and Wealth*, 45(3), 353–372.
12. Carling, R., & Kirchner, S. (2009). Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation. *CIS Policy Monograph*, 98.
13. CBA macroeconomic statistical tables. https://www.cbar.az/assets/3570/1.6.pdf
14. CBA Monetary Policy Releases (2018). https://www.cbar.az/releases/2018/01/
15. Dornbusch, R. (1976). Expectations and exchange-rate dynamics. *Journal of Political Economy*, 84(6), 1161–1176.
16. Durevall, D., & Henrekson, M. (2010). The futile quest for a grand explanation of long-run government expenditure. *IFN Working Paper*, 818.
17. Edwards, S. (1988). Real and monetary determinants of real exchange-rate behavior: Theory and evidence from developing countries. *Journal of Economic Development*, 32(3), 31–42.
18. Elekberov, E.E. (2016). Opportunities for optimization of tax structure in Azerbaijan for economic adjustment benchmarks. *Azerbaijan Tax Journal*, 3(129), 108. http://vergijurnali.az/upload/File/N3-2016.Elekberov%20E..pdf
19. El-Katiri, L., & Fattouh, B. (2017). A brief political economy of energy subsidies in the Middle East and North Africa. *Energy Policy*, 101, 451–464.
20. European Bank for Reconstruction and Development (EBRD). (2020). *Transition Report 2020-21: Azerbaijan Chapter.*
21. Financial Market Supervisory Authority Reports (2017). https://www.fimsa.az/assets/upload/files/Bank...
22. Frenkel, J.A. (1981). Flexible exchange rates, prices, and the role of 'news': lessons from the 1970s. *Journal of Political Economy*, 89(4), 665–705.
23. Gelb, A.H. (1988). *Oil Windfalls: Blessing or Curse?* Oxford University Press.
24. Gubadova, A.A. (2017). The impact of the non-oil sector of Azerbaijan's economy. *Russian Entrepreneurship*, 18(12), 1861–1866.
25. Gylfason, T. (2001). Natural resources, education, and economic development. *European Economic Review*, 45(4–6), 847–859.
26. Hajiyev, A. (2012). Macroeconomic aspects of innovative growth in Azerbaijan. Institute of Control Sciences, Moscow.
27. Hajiyev, A. (2012). Macroeconomic stabilization in developing financial markets. In *Global World: Anti-Crisis Modernization Imperatives*, Moscow: Higher School Press.
28. Hajiyev, A. (2013). Equilibrium level of exchange rate in Azerbaijan. In *Proceedings of the II International Scientific and Practical Conference "Statistics XXI Century"*. Kiev.
29. Hasanov, F. (2013). Dutch disease and the Azerbaijan economy: International evidence. *Communist and Post-Communist Studies*, 46(4), 463–480.
30. Hasanov, F., Mikayilov, J., & Bulut, C. (2018). Monetary policy rules in resource-rich countries: The case of Azerbaijan. *Resources Policy*, 55, 258–269.
31. Hunter, L. (2008). The Leviathan Project. *Institute for Social Choice and Individual Values.* http://www.socialsecurityinstitute.com/...
32. IMF. (2014). *Sovereign Wealth Funds: Generally Accepted Principles and Practices (Santiago Principles).*
33. IMF. (2022). *Republic of Azerbaijan: Article IV Consultation Report.* IMF Country Report No. 22/113.
34. International Monetary Fund. (2017). *Republic of Azerbaijan: Selected Issues Paper.* IMF Country Report No. 17/50.
35. Ismayilov, E. (2020). Financial inclusion and digital banking in Azerbaijan: Trends and prospects. *Caucasus Economic Review*, 12(2), 118–136.
36. James, A. (2015). The resource curse: A statistical mirage? *Journal of Development Economics*, 114, 55–63.
37. Khudiyev, N.N. (2013). Perspectives and methods of reforming oligopolistic insurance markets in CIS countries. *Finance*, 3, 49–50. http://www.finance-journal.ru
38. Khudiyev, N.N. (2015). Priorities of financial and taxation adjustment in the national insurance market. *Azerbaijan Tax Journal*, 1(121), 109–116. http://vergijurnali.az/.../2015-1.%20N.Xudiyev.pdf
39. Lane, P.R., & Tornell, A. (1996). Power, growth, and the voracity effect. *Journal of Economic Growth*, 1(2), 213–241.
40. List of non-bank credit institutions licensed in Azerbaijan (2017). https://www.fimsa.az/az/List...
41. Mamedov, Z.F. (2010). The banking system amid the global financial crisis. *Finance and Credit*, 48(432), 8–14.
42. Mehdiyev, A. (2018). Strengthening macroeconomic stability in Azerbaijan: Key policy trends and reforms. *Central Asian Economic Journal*, 6(1), 22–35.

43. Novoye Vremya – Economic analysis archives.
    http://www.novoye-vremya.com/...
44. OECD. (2018). *Improving Public Financial Management in Resource-Rich Countries.* OECD Guidelines.
45. OECD. (2019). *Tax Policy Reforms 2019: OECD and Selected Partner Economies.*
46. Omes, N., & Mineshima, A. (2010). A further increase in exchange rate flexibility in Azerbaijan: Pros and cons. *IMF Country Working Paper*.
    http://www.imf.org/.../022610r.pdf
47. Sachs, J.D., & Warner, A.M. (2001). The curse of natural resources. *European Economic Review*, 45(4), 827–838.
48. Sala-i-Martin, X., & Subramanian, A. (2003). Addressing the natural resource curse: An illustration from Nigeria. *NBER Working Paper 9804.*
49. SOFAZ Annual Reports and Income Data.
    http://www.oilfund.az/...
50. State Statistics Committee – Financial sector indicators.
    https://www.stat.gov.az/source/finance/az/006az.xls
51. State Statistics Committee – National accounts datasets.
    https://www.stat.gov.az/source/system_nat_accounts/az/010.xls
52. Tanzi, V., & Schuknecht, L. (1997). Reconsidering the fiscal role of government: An international perspective. *American Economic Review*, 87, 164–168.
53. World Bank. (2019). *Azerbaijan: Country Economic Memorandum.* Washington, DC.