AZERBAIJAN FINANCIAL AND BANKING SYSTEM DURING THE GLOBAL CRISIS: SHIFT OF EMPHASIS IN INTERNATIONAL COMPARATIVE ASSESSMENTS

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Introduction

The creation of a robust, innovative financial and banking system capable of meeting the needs of society is among the strategic tasks of the republic's economic policy aimed at ensuring the national sovereignty of this system as the country integrates into the global market. A sound financial system and increasing competitiveness of the banking sector are effective factors of sustainable economic growth making it possible to survive the global financial and economic collapse with relatively insignificant losses. International comparative assessments are among the main instruments for analyzing the financial and credit strength and vulnerability of individual countries. At the same time, the realities of the global crisis show that the techniques, principles, emphasis and focus of these assessments in current conditions should change radically. Otherwise their objectivity and validity will be called into question, and this will in turn have a negative impact on the decision making process.

Azerbaijan Financial and Banking System during Global Turmoil

At the turn of the century, Azerbaijan entered a stage of active reform in all areas of social life, characterized by significant improvements in economic indicators and rising living standards. Today the country has one of the most dynamic economies in the world. In the last five years, the country's economy grew 2.6-fold. And in 2008, faced with the challenges of the global crisis, our national economy demonstrated high stability and dynamism: in terms of GDP growth (10.8%), Azerbaijan ranked first among the CIS countries. It is interesting to note that non-oil GDP increased even faster: by 15.7%.[1] According to the International Monetary Fund (IMF), GDP (PPP) per capita increased 3.9-fold in 2000-2008 and reached a sufficiently high level for transition economies: $8.6 thousand.[2]

The positive trend caused by the general economic recovery and rising household incomes in Azerbaijan in recent years has **strengthened the positive trends in the financial and banking sector**.[3] Statistical data show that undeniable progress has by now been achieved in this sector in terms of its main quantitative and qualitative parameters.

In 2008, the republic's state budget revenues increased 1.8-fold, and their share in GDP rose by 4.5 percentage points. The consolidated budget surplus was 11% of GDP. In investment policy, priority is given to the use of domestic financial resources, whose share is now close to 75%. Moreover, Azerbaijan itself is gradually turning into an exporter of capital. In 2008, the current account of the balance of payments recorded a surplus of $16.5 billion (35.6% of GDP). Total foreign assets, as a rule, far exceed foreign liabilities (at the beginning of 2009, 1.8 times). The country's net international investment position was positive at around $11.9 billion.[4] The manat exchange rate against the world's major currencies is strong and stable. Capital flows have been completely liberalized.

Total bank asses have grown, their structure and quality have improved, and the total amount of corporate and retail deposits has increased. The capital base of credit institutions has been strengthened, the supply of innovative banking products and services has increased, and the bank branch network has expanded significantly. The external liabilities of banks remain at a controllable level (as of the end of 2008, 23% of total bank liabilities). Due to the constructive activities of the Central Bank of Azerbaijan, significant successes have been achieved in arranging bank regulation and supervision and in bringing them into conformity with advanced international practice.[5] In order to encourage recapitalization of the banking sector, since the beginning of 2009 retained earnings are exempt from tax. The legal and institutional frameworks for this sector of the economy have been improved, and its infrastructure has strengthened rapidly. More attention is being paid to the use of progressive technologies and the latest management information systems.

Azerbaijan's strategic international reserves—tangible evidence of the financial health of any state—have increased more than 12-fold in the last five years. In 2008 alone they increased by $11 billion to a total of $18.2 billion, which is almost 6 times in excess of the external public debt. In months of imports, foreign exchange reserves rose to 27 months, which is 3.4 times the figure for 2005.

Thus, despite the global liquidity crisis, **Azerbaijan's financial and banking system demonstrates sufficient stability in the face of economic upheaval in world markets thanks to ef-**

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[1] See: *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, Baku, No. 5, 2009, p. 4.

[2] See: *IMF World Economic Outlook Database*, April 2009.

[3] Current trends in Azerbaijan's financial and banking system are examined in greater detail in the scientific works of J. Hajiev, Chairman of the Board of the International Bank of Azerbaijan (see: (J. Hajiev, *The Monetary System and the International Bank of Azerbaijan*, CA&CC® Press AB, Stockholm, 2009, pp. 104-153); J. Hajiev, "Vremia—dumat o budushchem," *BDM. Banki i delovoi mir*, Moscow, No. 4, 2009, pp. 52-53), E. Ismailov, President of the Azerbaijan Banks Association (E. Ismailov, "National Currencies of the Central Eurasian Countries in the Context of Financial Globalization," in: *Central Eurasia: National Currencies*, CA&CC® Press AB, Stockholm, 2008, pp. 23-31) and Z. Mamedov, doctor of economics, professor at the Azerbaijan State Economic University (Z. Mamedov, "Denezhno-kreditnaia sistema Azerbaidzhana," *Obshchestvo i ekonomika*, No. 3, 2009, pp. 82-106).

[4] See: *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, pp. 7-9.

[5] This is indicated in a report by Standard & Poor's (see: *Bank Industry Risk Analysis*, S&P, 1 June, 2009).

fective measures implemented in recent years by the Ministry of Economic Development, Ministry of Finance and Central Bank of Azerbaijan. It is no accident that in contrast to similar systems in some other CIS countries it has avoided a heavy withdrawal of deposits and a large-scale outflow of foreign investments caused by panic after the outbreak of the world crisis.[6] This is exactly why the republic today is not faced with the problem of overcoming the risks associated with such processes.

International Assessments of the Financial and Banking System: the Need for a New Paradigm

The process of integration and globalization of financial markets dictated the need for international assessments allowing a comparative analysis of certain sectors of the economy. The use of assessments (instead of precise measurements or calculations) of both individual parameters and integral characteristics of the objects under study is a generally accepted and time-tested method for creating and using scientific knowledge in economic research. In recent years, extensive use has been made of so-called ratings and rankings, which have proved to be a convenient and reliable instrument for reasoned economic decision making.

Ratings are universal: based on the construction of a composite indicator which makes it possible to assess both the quantitative and qualitative parameters of a given object, they have such properties as dynamism, predictability and adjustability. They are used by researchers and experts in conducting international comparative studies and in selecting "the only true" option from among numerous alternatives.[7] In the modern sense, **ratings/rankings** are a comprehensive assessment of the state of the entity being analyzed, which makes it possible to classify it based on concrete parameters. In other words, the results of a study of the activities of economic entities are expressed by a combination of symbols used as a basis for clustering, which provides an opportunity for making current and comparative assessments.

Information obtained by means of ratings can be used by investors in operations with financial instruments and securities, in developing investment policy and in practical decision making.[8] The

[6] This circumstance is noted, in particular, by Standard & Poor's (see: *Bank Industry Risk Analysis*).

[7] See: B.G. Litvak, *Ekspertnye otsenki i priniatie resheni*, Moscow, Patent, 1996; idem, "Bankovskie reitingi," *Biznes. Pribyl. Pravo*, No. 3, 1997, pp. 5-14; idem, *Ekspertnye tekhnologiii v upravlenii*, Delo, Moscow, 2004, 398 pp.; N. Muzaffarli (Imanov), *Reiting Azerbaidzhana v mezhdunarodnykh sravnitelnykh issledovaniakh*, Kavkaz, Baku, 2006, pp. V-VIII, 1-9; A. Melville, "Rossia v mirovykh reitingakh," *Ekspert*, No. 43, 20 November, 2006; V.T. Sevruk, "Znachenie reitingov dlia sravnitelnogo analiza finansovykh pokazatelei stran SNG," in: *Formirovanie integratsionnykh ob'edineni stran SNG: finansovyi, valiutnyi, bankovski aspekty. Nauchnyi almanakh fundamentalnykh i prikladnykh issledovani*, Finansy i statistika, Moscow, 2006, pp, 73-87; idem, "Mezhdunarodnye reitingi—indikator konkurentosposobnosti rosiiskikh uchastnikov mirovogo finansovogo rynka," in: *Deiatelnost bankov na finansovom rynke: rossiiskaia praktika i mirovoi opyt. Nauchnyi almanakh fundamentalnykh i prikladnykh issledovani*, Finansy i statistika, Moscow, 2007, pp. 138-152; M.G. Mironyuk, I.N. Timofeyev, Ya.I. Vaslavsky, "Universalnye sravnenia s ispolzovaniem kolichestvennykh metodov analiza: obzor pretsedentov," *Politicheskie nauki. Sbornik nauchnykh trudov*, Issue 3, No. 5, 2007, pp. 43-76; A.A. Chaikovskiy, "Primenenie otsenok v ekonomike," *Vestnik universiteta* (State University of Management), GUU, Moscow, No. 5, 2007; M.A. Sidorenkov, *Bankovskie reitingi*, available at [http://www.cfin.ru/finanalysis/banks/bank_ratings.shtml], 24 April, 2008.

[8] For more detail, see: V.T. Sevruk, "Mezhdunarodnye reitingi—indikator konkurentosposobnosti rosiiskikh uchastnikov mirovogo finansovogo rynka," pp. 139-147.

assignment of a rating offers a number of advantages to both the investor and the financial institution to which this rating is assigned. The main advantages are reflected in Table 1.

Table 1

Advantages of Having a Rating

ADVANTAGES	
For financial intermediaries	**For investors**
Broad access to capital markets. **A rated participant in the financial and banking sector in practice often enjoys better conditions of access to money and financial markets due to greater confidence in its debt instruments among investors and creditors. This can lead to a reduction in financing costs. Many institutional investors do not acquire debt instruments from unrated entities. Under growing financial globalization, international ratings have become guideposts helping issuers to offer their securities in world stock markets, thereby expanding the market for raising capital.** ***Management of credit costs.*** **A wider choice in capital markets results in a wider range of alternative sources of financing than for unrated banks. This enables financial and banking institutions to select more effective forms of borrowing and to optimize its cost.** ***Structural significance.*** **Greater customer confidence, expansion of niches occupied in the financial and banking markets, enhanced competitiveness and increasing returns on financial and banking activities make is possible to identify the strengths and weaknesses of the financial intermediary, and this in turn helps to determine where to focus attention in the near and distant future.**	***Opportunities for making a conscious investment decision.*** **The rating assigned to a banking or other financial institution enables investors to assess whether the risk/return ratio is acceptable for investment and to compare it with alternative options. It is obvious that given equal risk/return ratios investors will choose a financial intermediary with a rating assigned by a leading international rating agency.** ***Issuer's greater openness.*** **As a rule, a rated bank has a higher level of information transparency. This is because during the preparation of a rating report and in its efforts to maintain the assigned rating the bank provides a larger amount of information to the rating agency than other companies, and this information is usually open to all potential investors.**

In this context, it is appropriate to examine the international assessments characterizing the development of Azerbaijan's economy and primarily its financial and banking system as one of the pillars of the country's sustainable socioeconomic development. For objective reasons, in recent years these assessments have been positive.

According to a joint study by the **Swiss Economic Institute and the Swiss Federal Institute of Technology**, in terms of the index of economic globalization Azerbaijan is in 76th place (with a score of 62.16 points out of a maximum possible 100 points) among 139 countries included in the rankings, and in the CIS it ranks fifth ahead of Ukraine, Russia, Belarus, and also of the Central Asian countries (except Kazakhstan).[9] Azerbaijan has fairly high sovereign ratings from **Fitch Ratings** (BB+), **Moody's** (Ba1) and **Standard & Poor's** (BB+). The list of domestic banks rated by these top three rating agencies is expanding steadily.

Budget plans for 2009 were recognized as feasible by international financial institutions. According to **Standard & Poor's**, which believes Azerbaijan's response to the world financial crisis to be quite adequate (especially regarding measures in the area of monetary policy and the financial system), in 2009 Azerbaijan's strong balance sheet should distinguish it from peers in the same rating category.[10] In the **IMF**'s opinion, "in contrast to other countries in the region, the solid foreign asset position of Azerbaijan and the expected overall fiscal position provide sufficient room to withstand a possibly severe economic slowdown."[11] According to the **World Bank**'s cross-country report *Doing Business 2009*, which serves as a guide for influential investors throughout the world, in terms of such indicators of the business climate as "getting credit" and "protecting investors" Azerbaijan has the best position among CIS countries, ranking 12th and 18th, respectively, among 181 countries in the world.[12]

A study carried out by such an influential research agency as **The Economist Intelligence Unit jointly with Columbia University and the Columbia Law School (U.S.A.)** showed that in the near future Azerbaijan could be the region's leading destination for foreign direct investment due to its strong investment appeal.[13]

In 2007, the State Oil Fund of Azerbaijan (SOFAZ) won a **U.N.** award for ensuring transparency and accountability in the extractive industries, and at the **Extractive Industries Transparency Initiative** (EITI) Conference in Doha (Qatar) in February 2009 Azerbaijan became the first of 25 candidate countries to achieve EITI Compliant status.[14]

On the whole, according to the *Transition Report* of the **European Bank for Reconstruction and Development** for 2008, the world liquidity crisis has had little effect on Azerbaijan's financial system.[15] The same conclusion is drawn by the **IMF**, which believes that "the ongoing global financial turmoil has so far had limited impact on Azerbaijan's financial sector."[16]

Of course, despite the prevalence of positive processes in Azerbaijan's financial and banking system, there are still some unresolved problems and bottlenecks in this area.[17] Their existence either already has a negative effect or can eventually have such an effect on the stability of financial institutions and can slow down market transformation processes, which dictates the need for further reform.

These problem spots have become particularly evident during the current global financial crisis, which has gradually acquired clear, understandable contours: having started in the United States in August 2006, during 2007 and 2008 it gradually spread across the entire world economy. **This cri-**

[9] See: *KOF Index of Globalization 2009*, Zurich, Swiss Economic Institute / Swiss Federal Institute of Technology, 27 January, 2009. In our opinion, the set of nine indicators used to compile the index of economic globalization is insufficient and it would make sense to add a number of indicators reflecting banking globalization, which would generally make these rankings more objective.

[10] See: "How Azerbaijan Is Responding to the Global Economic Turmoil," *S&P*, 15 July, 2009.

[11] *Azerbaijan—Aide Mémoire for the 2008 IMF Staff Visit Discussions*, *10-17 December, 2008*, Baku, 16 December, 2008.

[12] See: *Doing Business 2009. Country Profile for Azerbaijan*, The International Bank for Reconstruction and Development / The World Bank, Washington, D.C., 2008, pp. 26, 30.

[13] See: *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk*, The Economist Intelligence Unit / Columbia Program on International Investment, London, New York, 2007, p. 159.

[14] See: Official website of the State Oil Fund of Azerbaijan [http://www.oilfund/az].

[15] See: *Transition Report 2008: Growth in Transition*, EBRD, London, October 2008, p. 100.

[16] *Azerbaijan—Aide Mémoire for the 2008 IMF Staff Visit Discussions*, *10-17 December 2008*.

[17] For a detailed SWOT analysis of the domestic banking sector see: F. Murshudli, "Azerbaijan Banking System: Challenges and Prospects of Globalization," *The Caucasus & Globalization*, Vol. 2, Issue 2, 2008, pp. 76-87.

sis has brought into sharp focus the need to change the philosophy of economic activity and to establish a new paradigm of economic thought; it has also clearly revealed the hidden defects of the methodology used to make international economic comparisons and assessments, which are in much greater demand since the turn of the century. In particular, the current global crisis has added urgency to the need to make significant changes in the criteria used to evaluate the soundness and stability of banking systems, and also the principles for measuring the success of their development.

In current conditions, these systems should break the spell of dubious international comparative studies and address the real challenges of our time. Indeed, the crisis had triggered the collapse of financial and industrial giants, major transnational banks and national banking systems only recently seen as models of economic success, and this provides convincing evidence that the existing methods for ranking them are no longer fully consistent with present conditions. That is why **the approaches to cross-country analytical comparisons for various sectors of the economy, including the banking sector, need a fundamental renewal**. In this context, it makes sense to examine the international assessments characterizing Azerbaijan's financial and banking sector as a mainstay of its sustainable socioeconomic development.

Indicators of Financial Market Sophistication: Hidden Defects, Contradictory Assessments

A detailed analysis of international assessments of the current state of Azerbaijan's banking system is made in the publications of one of the authors of this article.[18] For this reason, **we shall focus on new cross-country comparisons made against the background of financial market instability.** Meanwhile, a study of this question has shown the contradictory nature of the indicators used to assess the financial and economic welfare of different countries.

Take, for example, the Global Competitiveness Index (GCI) developed as part of a wide-ranging and authoritative international comparative study conducted by the World Economic Forum (WEF). This index is based on 12 factors ("pillars"), including **financial market sophistication,** a factor of particular importance to us in the context of the problem we are dealing with. In 2007-2008, it was singled out into a separate pillar, which in turn consists of nine indicators. In the rankings for this pillar, the WEF's *Global Competitiveness Report 2008-2009* ranked Azerbaijan only 92nd among 134 countries.[19] Although in this parameter the republic outranks most CIS countries, the assessment of its financial sector sophistication is obviously low.

As a notable competitive advantage of the republic's financial market, the report names only the legal rights index, whereas the list of its shortcomings and weak points includes eight items. Among these are financing through local equity market (rank 117), regulation of securities exchanges (115), restriction on capital flows and ease of access to loans (100), strength of investor protection (86), financial market sophistication (77) and venture capital availability (60). Among the most problematic

[18] See: F. Murshudli, "Mezhdunarodnye otsenki bankovskoi sistemy Azerbaidzhana—vazhnyi indikator ieio integratsii v mirovoi finansovyi rynok," *Banki & Biznes*, No. 2, 2008, pp. 46-53; "Azerbaijan Banking System: Challenges and Prospects of Globalization," pp. 79-87.

[19] See: *Global Competitiveness Report 2008-2009*, World Economic Forum, Geneva, 2008, pp. 16, 96.

factors for the country's financial market are access to financing and foreign currency regulations. It should also be noted that Azerbaijan has not been included among the top 100 countries with the soundest banking systems, occupying only 116th place in the WEF rankings for soundness of banks.[20] In this ranking, Azerbaijan was assigned a score of 4.7 points and was placed between Bangladesh and Taiwan.

B o x 1. The world's soundest banking system is that of Canada with a score of 6.82 points. The top five countries also include Sweden (score 6.72), Luxembourg (6.71), Australia (6.70) and Denmark (6.68). The U.K. and U.S., which were among the top five in previous years, have lost their positions in the current rankings. For example, the U.K. has slipped to 44th place after a $87 billion pledge by the government to bolster bank balance sheets. The U.S. ranks 40th, partly due to the bankruptcy of investment banks Bear Stearns and Lehman Brothers and the sale of Merrill Lynch.

(Global Competitiveness Report 2008-2009)

At the same time, in our view, **the WEF's financial sector rankings are not always objective and should be seen as somewhat conjectural.** Of course, Azerbaijan's financial market cannot be classified as a developed one, and some of its components (like the insurance and stock market) are significantly below the standards of the world's leading countries. But in the context of a dynamically developing national economy this gap is steadily narrowing. In our opinion, Azerbaijan's position in this GCI pillar, like that of other countries, is influenced by the specific procedure of its calculation.[21] Doubts about the objectivity of the financial market sophistication pillar and its indicators arise after their comprehensive analysis. For example, according to the GCI rankings, Azerbaijan is ahead of such countries as China and Russia (even though they are BRIC countries with very dynamic growth of the equity market and strong investment appeal) and Argentina, and behind Zimbabwe, a country in the midst of a deep crisis with multi-digit inflation. Or take another example: the financial market of Italy (a G7 country with one of the world's strongest banking systems, a highly developed stock market and an S&P sovereign credit rating of A+) is only 91st in the WEF rankings, placed behind Bangladesh, The Gambia, Georgia, Costa Rica, Pakistan, El Salvador, Philippines, etc., whose financial institutions are little known on a global scale.

Apart from this, the inadequate positions of a number of countries can be explained by the specific composition of the indicators used to calculate this competitiveness pillar. The point is that only two of its component indicators—strength of investor protection and legal rights index—are based on generally accessible statistical data, while the other seven (including soundness of banks) are based on surveys of company executives and heads of financial and banking institutions. As we see it, possibly unreliable survey data may to some extent explain the very low positions of some countries (including Azerbaijan) and the overrated positions of other countries in these rankings; after all, in one indicator—the legal rights index, based on statistical data—Azerbaijan occupies a perfectly competitive position: rank 16.

[20] These rankings were compiled using data on bank accounts of different countries (hard data) and the results of a survey of top bank executives (survey data). As a result, banking systems were assigned scores of 1 to 7, where 7 means generally healthy banks with sound balance sheets, and 1, insolvent and may require a government bailout.

[21] This is noted by other economists as well (see: V.Yu. Dodonov, *Konkurentosposobnost investitsionno-finansovoi sfery Kazakhstana v otsenkakh mezhdunarodnykh organizatsi,* available at [http://www.iwep.kz], 21 May, 2008; K.V. Shvandar, "Mirovoi krizis skvoz prizmu platiozhnogo balansa i konkurentosposobnosti," *Bankovskoye delo*, No. 5, 2009, pp. 54-60).

It should be noted, however, that the *Global Competitiveness Report* in question is based on data collected at the initial stage of the financial crisis, when its attendant effects were still barely discernible. Hence a contradiction between the assessments it contains and the actual state of affairs. This determines the urgent need to review the characteristics assessing the quality and the competitive advantages of a country's financial system as a whole, because these characteristics have proved to be invalid in the present conditions and have become obsolete overnight.

For example, the top ten countries with the most competitive financial systems as listed in the global competitiveness rankings for 2008-2009 included the U.K. (rank 5), Ireland (7), Sweden (8) and the U.S. (9). But the consequences of the crisis make it clear that these assessments of their financial systems, as well as those of other countries from the upper half of the rankings, are unjustified, considering that the current turmoil has had a very painful effect on them. The point is that WEF experts focused on such indicators as openness to world financial markets and ease of access to capital. As it turns out, however, countries that failed to meet these criteria entered the current crisis later than other countries and with less destructive consequences. In addition, the technique for measuring the competitiveness of the financial system does not include such important indicators as external debt or an assessment of the opportunities for servicing this debt, whereas the realities of the current crisis situation clearly demonstrate that a large debt hinders competitiveness, leading to its partial or total loss. Thus, **logic suggests that it is advisable to change the method for assessing the competitiveness of national financial systems.** In particular, the "soundness of banks" indicator should be retained, but the entire system for assessing their soundness should be seriously corrected, because otherwise the objectivity of the rankings will be called into question.

2009 World Financial Health Index: Shift of Emphasis

In the context of the current financial meltdown, rankings in which assessment procedures have changed radically during the crisis and are now based on principles fully reflecting the specifics of the situation are of particular interest. In our opinion, this includes the **2009 World Financial Health Index** (WFHI) compiled by *The Banker*, one of the most authoritative economic publications. It rates the ability of countries to weather the current crisis.[22] It is surprising that this ranking, which is most instructive for transition countries, has escaped the attention of the country's economic agencies, Azerbaijani economists and usually meticulous journalists specializing in economics. Meanwhile, Azerbaijan's positions in this ranking (on both the overall index and its individual components) appear to be much better than in other international comparisons.

According to *The Banker*, **the financial crisis of 2008 has turned the world on its head, so that risks and the methods of their assessment have changed as well.** *The Banker*'s latest rankings, which focus on low leverage, reveal some amazing results. As the authors of the study point out, in this brave new world the most developed economies—and those most dependent on credit—have suddenly become the ones most exposed to potential economic disaster.[23] Statistical data that until recently were used as a measure of economic performance (such as levels of bank lending) are now seen as the main indicators of financial risk. Unlike previous country rankings, where the most devel-

[22] See: *The Banker*, London, Vol. 159, No. 995, January 2009, pp. 63-64, 66.
[23] See: C. Piggott, "Risers and Fallers," *The Banker*, January 2009, pp. 62-63.

oped financial markets were rewarded with high scores, *The Banker*'s 2009 World Financial Health Index penalizes countries that rely too heavily on financial leverage.[24]

An analysis of WFHI 2009 and its components has shown the following:

1. WFHI 2009 ranks 184 countries based on 25 indicators of financial and economic health grouped into four categories (economic stability, overall indebtedness, financial sector stability and government finances). With a score of 439.83 points (out of a maximum possible score of 1,000 points), **Azerbaijan is 39th in this ranking** (see Table 2).

   According to *The Banker*'s new financial risk model, Azerbaijan (like other post-Soviet countries: Russia, Moldova, Kazakhstan, Armenia, Georgia, Estonia and Belarus) is less likely to be affected by the current financial crisis than the U.K., Italy, Japan, France or Germany. These FSU countries may be poorer, but with a far lower reliance on credit and just a

Table 2

The Banker:
2009 World Financial Health Index[25]

Rank	Country*	Indicators (maximum score)				
		Total score (1,000)	Economic stability (400)	Overall indebtedness (200)	Financial sector stability (200)	Government finances (200)
1	Norway	549.77	215.39	144.34	53.04	136.99
2	*Russia*	544.80	126.23	172.88	124.02	121.68
3	Kuwait	535.83	163.05	145.17	108.57	119.04
4	Singapore	516.63	159.20	126.62	98.37	132.44
5	*Moldova*	510.30	108.15	167.77	137.01	97.38
15	*Kazakhstan*	488.84	118.35	188.02	80.70	101.77
16	*Armenia*	487.25	122.99	120.55	145.91	97.80
20	*Georgia*	471.84	84.69	172.36	116.74	98.04
21	Switzerland	470.72	149.62	143.93	80.99	96.19
22	*Estonia*	468.89	94.86	160.62	106.67	106.74

[24] For a detailed discussion of the importance of a state's external debt as a criterion of its economic independence see: Sh. Hajiev, N. Muzaffarli (Imanov), *et al*., "Economic Reform in Azerbaijan: Achievements and Problems," *The Caucasus & Globalization*, Vol. 2, Issue 4, 2008, pp. 52-53.

[25] See: *The Banker*, January 2009, pp. 64, 66.

Table 2 (continued)

Rank	Country*	Indicators (maximum score)				
		Total score (1,000)	Economic stability (400)	Overall indebtedness (200)	Financial sector stability (200)	Government finances (200)
27	U.S.	456.17	124.62	171.36	82.42	77.77
29	*Belarus*	453.85	127.84	111.16	114.78	100.06
35	China	446.59	146.05	145.56	56.60	98.37
37	Turkey	444.29	96.28	169.37	109.89	68.76
39	*Azerbaijan*	439.83	202.75	148.57	84.86	3.66
42	France	435.69	127.72	145.95	72.84	86.18
47	Germany	430.84	127.15	152.01	64.47	87.20
54	*Ukraine*	421.28	89.66	157.14	77.74	96.74
56	Italy	419.61	115.71	157.50	71.26	75.14
58	U.K.	418.84	122.00	134.53	77.51	84.80
59	*Lithuania*	416.80	85.76	151.93	82.17	96.93
63	*Latvia*	413.22	67.42	154.03	93.85	97.92
93	Kyrgyzstan	367.03	100.66	139.61	32.75	94.01
111	Japan	319.34	122.11	136.55	50.21	10.48
112	*Tajikistan*	316.55	108.93	97.58	32.34	77.70
124	*Uzbekistan*	281.69	128.13	145.03	—	8.53
166	*Turkmenistan*	171.47	117.07	49.97	—	4.43
182	Iraq	119.79	20.84	92.07	—	6.88
183	Mauritania	110.09	110.09	—	—	—
184	Zimbabwe	75.39	1.50	49.95	27.35	0.20

* Italics indicate post-Soviet (FSU) countries.

fraction of the leverage of rich developed countries they are evidently more insulated from financial meltdown than any of the latter.

B o x 2. In fact, not a single Group of 10 country makes it into the top 20 in The Banker's ranking. The highest ranked G10 country is Switzerland at 21, while Japan's beleaguered economy ranks at 111. Despite the crash in oil prices, the top three countries in the ranking—Norway, Russia and Kuwait—all have large reserves of oil or gas. Singapore, which has high levels of savings, low levels of government debt and huge foreign exchange reserves, ranks fourth. Moldova, a country with GDP per capita of just $1,830, ranks fifth. Moldova has very low levels of debt ($763 per capita, compared with the UK's $171,000 per capita), and its banks have high capital-to-asset ratios (more than 17.0%) and low levels of lending (35.0% of GDP).

(The Banker, January 2009, p. 64)

2. **In the first, most weighty component of WFHI 2009—"economic stability"** (a maximum score of 400 points)**—Azerbaijan alone among the countries of Central and Eastern Europe and the CIS has made it into the top five, ranking fourth (202.75 points)** behind Qatar (342.52), Luxembourg (220.50) and Norway (215.39).

B o x 3. This category includes 11 indicators: GDP growth forecast, 2009 (150 points); GDP per capita forecast, 2008 and 2009 (75 each); unemployment, %, 2008 (25); net national savings rates, % of gross national income (GNI), 2006 (25); current account balance forecast, % of GDP, 2008 and 2009 (15 and 10, respectively); foreign direct investment (FDI) inflow, % of GDP, 2007 (10); FDI inflow per capita, 2007 (5); FDI stock, % of GDP, 2007 (5); FDI stock per capita, 2007 (5).

(The Banker, January 2009, p. 63)

It should be emphasized, in particular, that most developed economies have large trade deficits and suffer from faltering economic growth, while many developing countries enjoy trade surpluses and continued economic growth. For example, according to *The Banker*, **Azerbaijan ranks third in the world in terms of its current account surplus as a percentage of GDP**.[26]

3. **In the second WFHI 2009 parameter—"overall indebtedness"** (a maximum score of 200 points)**—Azerbaijan is in 51st position (148.57 points)**, outranking such European states as Austria, Belgium, U.K., Greece, Norway, Ireland, Luxembourg, Netherlands, Portugal, Finland, Sweden, Switzerland, and CIS countries: Armenia, Belarus, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

B o x 4. This component is based on 4 indicators: external debt, % of GDP, 2007; debt, per capita, 2007; public debt, % of GDP, 2007; gross external debt position, % increase Q2 2007 to Q2 2008 (50 points each).

(The Banker, January 2009, p. 63)

Let us note that developed countries' overall indebtedness relative to GDP (including private sector borrowing) is several times the levels of many developing countries. The high-

[26] See: *The Banker*, January 2009, p. 67 (according to IMF *World Economic Outlook Forecast*, November 2008).

est level of government debt compared to any other developed country is recorded in Japan: 170.4% of GDP. Other highly leveraged countries in the ranking include Ireland and the U.K.: they have the highest external debt-to-GDP ratio of any country: 646% and 375% of GDP, respectively. In most developing and transition countries this indicator is several times lower. Even though household incomes remain lower in developing countries, they can take comfort from the fact that they were not part of the post-millennium credit boom. For example, Azerbaijan's external debt at the beginning of 2009 was 6.4% of GDP. It spent less than 1.1% of state budget revenue on debt service (interest payments), while Italy spent 11.9% for these purposes.[27] Low dependence on external borrowings and speculative operations is also characteristic of Azerbaijan banks, as confirmed, in particular, by Standard & Poor's ratings.[28] Such post-Soviet countries as Belarus, Ukraine, Georgia, Armenia, Russia and the Baltic states, on the contrary, have rapidly growing external debts, and in terms of this indicator (June 2007 to June 2008) they are among the world's top 20 countries.[29]

4. **In the third WFHI 2009 parameter—"financial sector stability"** (a maximum score of 200 points)**—Azerbaijan is in 54th place (84.86 points)**, significantly ahead of the G10 countries (Switzerland, Canada, U.S., Sweden, Netherlands, France, Germany, Italy, U.K. and Belgium), the countries of Central Asia, and also such countries as Norway, Denmark, Austria, China, Argentina, Czech Republic, India, Lithuania, Latvia, Greece, Portugal, Ireland, Luxembourg and Japan.

B o x 5. This parameter is based on 5 indicators: bank regulatory capital to risk weighted assets, 2008 (100 points); bank capital to assets, 2008; non-performing bank loans, 2008; bank provisions to non-performing loans, %, 2008; domestic credit provided by the bank sector, 2006 (25 points each).

(The Banker, January 2000, p. 63)

In Azerbaijan, one of the indicators constituting this parameter—domestic credit provided by banks—was only 18.4% of GDP in 2008.[30] Japan tops the ranking in this indicator: its banks have extended domestic credit equal to 308% of GDP, far higher than any other country in the world. In the U.S., domestic bank lending has exceeded 230% of GDP, nearly four times the world average.[31] Until recently such high figures were regarded as a positive phenomenon, but an analysis of crisis realities has made it clear that credit resources three or four times in excess of GDP cannot be seen as a positive factor.

At the same time, strangely enough, in this segment of the ranking Azerbaijan is significantly behind its neighbors in the region: Georgia and especially Armenia. This is all the more surprising given that *The Banker* has included them among the world's 20 countries with the lowest level of bank stability (ranks 17 and 16, respectively):[32] the percentage of non-performing bank loans in these countries was 54.4% and 53.8%, respectively.[33] In Azerbaijan,

[27] See: *The Banker*, January 2009, p. 63.
[28] See: *Bank Industry Risk Analysis*, p. 1.
[29] See: *The Banker*, January 2009, p. 68.
[30] Calculated based on data from: *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, Baku, No. 12, 2008, pp. 4, 19.
[31] See: *The Banker*, January 2009, p. 63.
[32] Ibid., p. 68.
[33] See: *IMF Global Financial Stability Report*, July 2008.

this indicator stood at 3.8%, and despite its insignificant growth from the previous year, the situation in this area has stabilized.[34]

5. **In the last of the four basic parameters of WFHI 2009—"government finances"** (a maximum score of 200 points)—Azerbaijan is in the worst position: rank 141[35] with an incredibly low score of 3.66 points.

Box 6. This parameter is based on 5 indicators: central government cash surplus or deficit, 2006 (80 points); central government debt interest, % of revenue, 2006 (80); reserves of foreign exchange and gold, % of imports, 2008 (20); reserves of foreign exchange and gold, % of GDP, 2008 (10); reserves of foreign exchange and gold, per capita, 2008 (10).

(The Banker, January 2009, p. 63)

Azerbaijan's position in this ranking is questionable for several reasons.

- **First,** the initial indicator for the country's reserves of foreign exchange and gold was taken from the *CIA World Factbook 2008*: $8.5 billion (as of 31 December, 2008), whereas in actual fact, as noted above, with due regard for the resources of the Oil Fund of Azerbaijan the figure was $18.2 billion.
- **Second,** government debt interest is insignificant because both government debt itself and the percentage of debt service (interest payments) are low, which has found its reflection in the second WFHI 2009 parameter ("overall indebtedness"). Consequently, in ranking Azerbaijan so low in this indicator the WFHI authors are contradicting themselves.
- **Third**, in recent years Azerbaijan has had a cash surplus, which should be generally seen as a positive factor, whereas Armenia and Moldova, for example, have recorded a cash deficit. But in this case the statistical source for WFHI 2009 was the World Bank's database, *World Development Indicators 2008*, where the said indicator for Azerbaijan, in contrast to other countries, is absent for some obscure reason. And according to *The Banker*'s methodology, in the absence of data a country receives a score of zero.

Thus, despite the significantly better position in each indicator of government finances, Azerbaijan in this ranking is far behind (about 26 times) Georgia (whose score is 98.04 points), Armenia (97.80) and Moldova (97.38). This assessment can hardly be regarded as objective. Assuming a slightly higher score for the state of government finances in Azerbaijan than those of the above-listed countries (even if at least 100.00 points, a figure close to what it should be), **the republic would have been among the top three countries in the WFHI 2009 rankings** behind Norway and Russia.

Addressing the Crisis: Arguments for Financial Health

The latest reports of international financial institutions and rating agencies support our arguments for Azerbaijan's financial health.

[34] In this context, we believe that Standard & Poor's estimate of gross problematic assets in Azerbaijan's banking system in the 35-50% range (see: *Bank Industry Risk Analysis*) is totally unjustified.

[35] This rank could have been even lower because the necessary data for many countries were unavailable.

For example, the **IMF** has included Azerbaijan in the group of countries whose economy is most immune to the crisis and least vulnerable to external factors.[36] Special note is taken of the banking system: according to IMF experts, serious steps have been taken in the republic in recent months to strengthen this system.[37] Somewhat earlier, an IMF mission that visited the republic in mid-December 2008 came to the conclusion that "Azerbaijan is expected to weather the short-term impact of the crisis relatively well under the current policy plans."[38] That is why the IMF expects Azerbaijan in 2010 to show the highest real GDP growth among the countries of the Caucasus and Central Asia: 12.3% against a regional average of 5.0%.[39]

The **World Bank**'s Country Economic Memorandum of March 2009 emphasizes that Azerbaijan (and its financial sector) is more immune than other countries to the effects of the global crisis.[40] In its *Global Economic Prospects 2009* report, the World Bank projected GDP growth in Azerbaijan at 10.4% in 2009 and 7.8% in 2010, the highest growth rates in the Europe and Central Asia region (19 developing countries).[41] And although its annual report on the financial aspects of global development (*Global Development Finance: Charting a Global Recovery*) makes a less optimistic forecast (including for Azerbaijan), its experts say that in 2009-2011 Azerbaijan will be one of the countries in Europe and Central Asia with accelerating annual economic growth (3.3% in 2009, 5.2% in 2010, and 9.0% in 2011) and a double-digit current account surplus (10.3%, 15.5% and 19.0% of GDP, respectively).[42] Real GDP growth in Azerbaijan is also projected by the **Asian Development Bank** at 8.0% in 2009 and 6.7% in 2010,[43] and by **Standard & Poor**'s at 4.0% and 5.4%, respectively.[44] **At a meeting of CIS finance and economy ministers and heads of national banks on 31 March, 2009, Russian Vice Premier and Finance Minister A. Kudrin** emphasized that Azerbaijan is least affected by the global crisis, sustaining high investment volume and economic growth.[45] According to **Standard & Poor's**, "Azerbaijan is set in the medium term to take advantage of major opportunities that should support its sovereign credit ratings."[46]

The results of Azerbaijan's socioeconomic development in the first five months of 2009 with positive dynamics in all economic sectors without exception support the conclusions of influential international rating agencies and financial institutions on the minimal impact of the world crisis.[47] This is also evident from a study conducted by FBK, one of the leaders of the Russian professional services market, according to which Azerbaijan has the best socioeconomic indicators of all CIS countries for January-April 2009 (together with Uzbekistan) and is addressing the world economic crisis quite effectively.[48]

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[36] See: *World Economic Outlook: Crisis and Recovery*, IMF, Washington, D.C., April 2009, p. 84.

[37] See: *Regional Economic Outlook: Middle East and Central Asia*, IMF, Washington, D.C., May 2009, p. 30.

[38] *Azerbaijan—Aide Mémoire for the 2008 IMF Staff Visit Discussions*, *10-17 December 2008*.

[39] See: *Regional Economic Outlook: Middle East and Central Asia*, pp. 25, 36.

[40] See: Statement by Azerbaijan Minister of Economic Development Sh. Mustafayev at a Cabinet meeting on the results of the country's socioeconomic development in the first quarter of 2009 (*Bakinski rabochi*, 24 April, 2009, p. 2).

[41] See: *Global Economic Prospects 2009: Commodities at the Crossroads*, The International Bank for Reconstruction and Development / The World Bank, Washington, D.C., 20 November, 2008, pp. 151-152.

[42] See: *Global Development Finance: Charting a Global Recovery*, The International Bank for Reconstruction and Development / The World Bank, Washington, June 2009, pp. 115, 117.

[43] See: *Asian Development Outlook 2009*, Manila, Asian Development Bank, March 2009, pp. 134, 296.

[44] See: *Azerbaidzhanskaia respublika—kreditnyi reiting*, Standard & Poor's, 24 February, 2009; *Bank Industry Risk Analysis*.

[45] See: Official website of the Russian Ministry of Finance [http://www.minfin.ru/ru/press/speech/index.php?id4=7229].

[46] "How Azerbaijan Is Responding to the Global Economic Turmoil," *S&P*, 15 July, 2009.

[47] For more detail, see: F. Akhundov, "Rost ekonomiki Azerbaidzhana nagliadno demonstriruet minimal'noie vozdeistvie mirovogo krizisa," available at [http://www.day.az/news/economy/161888.html].

[48] See: I.A. Nikolayev, T.Ye. Marchenko, M.V. Titova, *Strany SNG i mirovoi krizis: obshchie problemy i raznye podkhody. Analiticheski doklad*, FBK, Moscow, June 2009, pp. 8, 27.

One of the most visible expressions of a country's financial health is the existence of successful financial institutions. In Azerbaijan this includes, in the first place, the **International Bank of Azerbaijan** (IBA), the system core of the country's banking sector with a dominant position in the key segments of the domestic financial market. IBA plays the leading role in the development of the national banking system, in enhancing its competitiveness and stability. As a National Development Bank,[49] IBA also has a stabilizing effect on the state of the Azerbaijan economy as a whole. Well-established in the Caucasus region as one of its largest and soundest brand-name financial holding groups, IBA has the most advanced position in the republic in key banking indicators.

IBA's long positive experience and active involvement in innovation processes are the main factors behind its steadily growing reputation even during the active phase of the global financial crisis. For example, its main performance indicators in this contradictory period full of the worst expectations continued their positive dynamics. In April 2009, the Board of Directors of the European Economic Chamber of Trade, Commerce and Industry declared IBA the most stable credit institution in Europe at the time of the global financial crisis. That same month the Bank received awards from two leading global analytical magazines: from *Global Finance* (New York) as the best Azerbaijan bank in the Best Emerging Markets Bank category and from *Emeafinance* (London) as the best local bank in the Best Bank in CIS, Central and Eastern Europe category. In addition, at the 3rd Vienna Banking Forum (23-25 April, 2009) IBA Board Chairman Jahangir Hajiyev was named the best crisis manager of 2009 for the CIS, Central and Eastern Europe and was awarded the Platinum Key (the first international banking prize awarded by the Banking Association of Central and Eastern Europe) for his important contribution to the development of the national banking system.[50] Finally, in June 2009 Fitch Ratings affirmed IBA's long-term issuer default rating at "BB+" with a stable outlook.[51]

Overall, it should be noted that **timely preventive measures taken by the country's authorities have made it possible to minimize the negative impact of the crisis on its economy, particularly on its financial and banking sector, where this impact was barely noticeable, thereby promoting a further improvement in the state's financial health.** World practice in fighting the crisis shows that countries with significant gold and foreign exchange reserves coupled with a low level of external and internal debt—and Azerbaijan has a rightful place among these countries—can overcome the effects of global turmoil less painfully.

Post-Crisis Transformation Prospects: New Trends and Models

It should be noted that international experts **are expecting serious transformations in the post-crisis financial services market.** For example, a PwC publication entitled *The Day After Tomorrow*[52] analyzes the new trends and models developing in the wake of the credit crisis and against the background of attempts by financial sector companies to adapt to the new business environment. The inevitability of transformations in the world banking system was also predicted by the top executives of

[49] For more detail, see: J. Hajiyev, "MBA—Bank Obshchenatsional'nogo Razvitia," *Zerkalo*, 9 May, 2003; J. Hajiyev, "MBA—iadro bankovskoi sistemy Azerbaidzhana," *Zerkalo*, 12 November, 2005.

[50] Official website of the CIS Financial and Banking Council [http://www.fbc-cis.ru/nws/news10.php].

[51] See: *Fitch Affirms International Bank of Azerbaijan at "BB+"; Outlook Stable*, 11 June, 2009.

[52] See: *The Day After Tomorrow: A PricewaterhouseCoopers Perspective on the Global Financial Crisis*, PwC, February 2009, 24 pp.

a number of major Western banks who took part in a debate at the editorial office of *The Banker*.[53] In their opinion, this system will shortly undergo drastic changes: it should have a totally new face and be filled with new content.

A similar position is also clearly evident in the documents of authoritative and sufficiently effective world forums: the **G20 Leaders Summit on Financial Markets and the World Economy** (London, 1-2 April, 2009) and the **U.N. Conference on the World Financial and Economic Crisis and Its Impact on Development** (New York, 24-26 June, 2009). In particular, the G20 adopted a new concept (binding on all) of regulatory reform and financial recovery. It is important that this relates not only to banks, but also to financial companies. From now on, all financial institutions, instruments and markets systemically important to the world economy will be tightly regulated and controlled by a Financial Stability Board (FSB). In addition, the EU is insisting on the creation in 2010 of a new board to assess systemic risk headed by the European Central Bank, and the U.S. is urging the establishment of a new body to monitor systemic risk.[54] Progressive solutions for reform in the international financial system are contained in a speech by U.N. Secretary General Ban Ki-moon[55] at the above-mentioned U.N. Conference, and in the Report[56] and Recommendations[57] of the Commission of Experts.

Under the new rules of the game introduced in the world financial market, it is planned, in the first place, to change the behavior model of financial institutions: they will be responsible for performing financial analysis required to ensure loan portfolio quality, with tighter internal and government control. The main features of the new banking landscape will be a downsizing of the banking system with a simultaneous tightening of regulation and focus on a universal banking model. The banking model of the post-crisis world will be simpler, sounder, more transparent and geared to avert risk. Profit will fall, but risk-adjusted return will decline less sharply, because the level of business risk will decline as well.

One of the main conclusions is that financial institutions should not concentrate on current problems alone at the expense of long-term development. Most of the institutions now operating in the survival mode should already take decisions on how business will develop within two or three years. At the same time, they should adapt themselves to the realities of doing business in the world, where the interests of numerous stakeholders—the government and society as a whole—are increasingly important. This unquestionably competent opinion of leading international experts deserves close attention and study.

Consistent improvement in the indicators measuring the country's financial health will bring Azerbaijan closer to implementing the idea of its financial sovereignty, of turning its capital, Baku, into a powerful financial center of the Caucasus and achieving global competitiveness of national financial institutions. Compared to its neighbors, Azerbaijan is highly competitive in the struggle for the role of a regional financial center due to its undeniable advantage as the holder of significant gold and foreign exchange reserves coupled with a large energy potential. In the conditions of the current financial and economic crisis, Azerbaijan has every reason to be satisfied with its relatively stable monetary and banking system, which helps the economy to weather this global storm with relatively insignificant losses.

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[53] See: C. Piggott, "FIG Chiefs Survey New Financial Landscape," *The Banker*, April 2009.

[54] See: *Declaration on Strengthening the Financial System*, London, 2 April, 2009, available at [http://www.g20.org]; *Global Plan for Recovery and Reform: the Communiqué from the London Summit*, London, 2 April, 2009, available at [http://www.londonsummit.gov.uk].

[55] See: *The World Financial and Economic Crisis and its Impact on Development*, available at [http://www.un.org/ga/econcrisissummit/ docs.shtml].

[56] See: *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System*, available at [http://www.un.org/ga/ econcrisissummit/docs.shtml].

[57] See: *Recommendations of the Commission of Experts of the President of the General Assembly on Reforms of the International Monetary and Financial System*, available at [http://www.un.org/ga/ econcrisissummit/docs.shtml].

Nevertheless, if Azerbaijan wants to aspire to the role of financial leader in the region, its economic agencies and financial institutions will have to do a great deal to create the necessary conditions for this purpose. Namely, **to anticipate the threats to the state's financial health and reputation, establish their sources, analyze the "anatomy" of each threat, try to understand their mechanics, nature and evolution, and most important of all, find appropriate mechanisms for blocking these threats and map the way to upgrade the entire financial and banking system, its institutional and staffing support in full accordance with current requirements.** In our opinion, it is only through such a consolidated effort that the domestic financial and banking markets can achieve quantitative optimization and make a qualitative breakthrough in the next 5 to 10 years, supply resources for the growing economy and for the development of the country's productive forces, ensure the necessary social stability and minimum social guarantees for the population, and provide the state with an effective tool for implementing macroeconomic decisions and strengthening Azerbaijan's geopolitical and geo-economic positions.