

**REPUBLIC OF AZERBAIJAN**

*On the right of the manuscript*

**ABSTRACT**

of the dissertation for the degree of Doctor of Philosophy

**THE SPECIFICS OF FOREIGN BANKING CAPITAL  
INVOLVEMENT IN AZERBAIJAN'S ECONOMY**

Speciality: 5310.01 – The world economy

Field of science: Economic sciences

Applicant: **Erkin Kamil oghlu Dilbazi**

**Baku – 2025**

The dissertation was performed at the Azerbaijan State University of Economics

Scientific supervisor: Professor, Doctor of Economic Sciences  
**Rasim Tapdig Hasanov**

Official opponents: Professor, Doctor of Economic Sciences  
**Fuad Alinaghi Ganbarov**

Doctor of Philosophy in Economics  
**Jabir Jabrayil Mirzai**

Doctor of Philosophy in Economics  
**Ummuhabiba Mahamadtaghi Galandarova**

FD 1.11 Dissertation Council operating at the Scientific Research Institute of Economic Research under the Azerbaijan State University of Economics of the Higher Attestation Commission under the President of the Republic of Azerbaijan

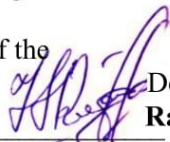
Chairman of the  
Dissertation council:



Doctor of economic sciences, Professor  
**Yadulla Hamdulla oghlu Hasanli**

*signature*

Scientific secretary of the  
Dissertation council:



Doctor of philosophy in economics  
**Rashad Aktiv oghlu Huseynov**

*signature*

Chairman of the  
scientific seminar:



Doctor of economic sciences, professor  
**Mushfiq Yelmar oghlu Guliyev**

*signature*



## INTRODUCTION

**The significance of a topic and the level of knowledge and understanding.** Since the late 20th century, the acceleration of financial globalization and transformations in the global economy, particularly the growing influence of foreign bank capital on national economic development, also new risks and opportunities have necessitated a more precise understanding of the role of foreign capital flows. Amid increasing international financial regulation and deepening economic polarization, foreign bank capital has assumed a significant role in shaping national economies.

Different schools of economic thought offer varying interpretations of the drivers behind foreign capital flows. The neoclassical economists emphasize yield differentials, Keynesians focus on macroeconomic regulation, while Post-Keynesians highlight monetary factors. Contemporary approaches, however, increasingly underscore micro-level determinants. Flows of foreign banking capital are influenced by factors such as profitability, liquidity, interest rates, and regulatory frameworks. Nevertheless, the volatility of global financial cycles continues to complicate the dynamics of these flows.

The role of foreign banking capital in Azerbaijan's economy is shaped by the theoretical framework through which it is analyzed. Since gaining independence, developments within the country's banking system have been marked by contradictions, with the involvement of foreign capital influenced by factors such as the sector's structural characteristics, conservative policy orientations and the impact of the oil boom. High concentration levels and institutional shortcomings within the banking sector constrained the allocation of financial resources to the real economy. Furthermore, the economic downturn of 2014–2016 disrupted the stability of the banking system, exacerbating existing vulnerabilities.

In this regard, the Strategic Roadmaps on National Economic Perspective and for the Development of Financial Services, adopted in 2016, identified structural reform of the banking system as a key priority. However, an experience indicates that enhancing the quality of capital alone is insufficient to address systemic challenges. In an environment characterized by high market concentration, unequal access to financial resources and limited service availability, increased capitalization does

not fully overcome the deficiencies in channeling resources to the real sector. Therefore, the effectiveness of foreign banking capital shouldn't be evaluated only by capital adequacy indicators, but also by its capacity to create the growth-oriented infrastructure.

Considering the rapid mobilization potential of banking capital, the national economy should benefit from such opportunities. However, due to the relatively weak development and specific structural characteristics of Azerbaijan's economy and banking sector, large-scale inflows of foreign capital, particularly in the form of short-term debt, may pose risks to financial stability, as evidenced by the experiences of countries such as Kazakhstan and Russia during the 2008 global financial crisis. Nevertheless, in light of current development trends, enhancing both the participation and effectiveness of foreign banking capital remains essential. Accordingly, the aforementioned considerations underscore the scientific and practical relevance of the research topic.

It is appropriate to approach this research from multiple perspectives. These include the role of foreign economic relations and financial resources in national economic development, the characteristics of international capital movements and the influence of banking mechanisms that derive advantages from integration into the global financial market.

The concept of "capital" as an economic category was developed by various schools of economic thought even prior to the emergence of capitalism. In subsequent periods, the classical economists such as A. Smith, D. Ricardo and J. Stuart Mill examined the forms and dynamics of international capital movement. Theories related to capital mobility are generally categorized into two main groups: (1) traditional theories which include neoclassical perspectives (R. Nurkse, R. Lucas, M. Gertler, R. King, S. Rebelo, A. Razin, P. Atlas, R. Caballero and others), neo-Keynesian approaches (R. Harrod, L. Metzler, A. Biancarelli, A. Kaltenbrunner, R. Andrade, D. Prates, etc.), and Marxist interpretations.

The second group of capital flows consists of modern theories: the TNC concept (R. Vernon, R. Coase, S. Hamer, J. Dunning), the international mobility of portfolio investments (H. Markovic, J. Tobin, N. Kaldor, W. Brainard, etc.). The international flow of bank capital and its impact on the national economy was analysed by J. M. Milesi-Ferretti, E.

Levi-Yeyaty, V. Bruno, S. Avtsiev, H. S.Shin, F. Lane, F. Nipman, K. Cornelia, R. Correa, etc. Research on foreign bank capital is conducted mainly within the framework of general capital flows. Borrowed capital, as a key component of these flows, is mainly considered at the macro level and in the context of the borrowing stability of the financial system.

Numerous Azerbaijani scholars—A. Aleskerov, Sh. Hajiyev, R. Hasanov, A. Muradov, E. Rustamov, A. Bayramov, M. Guliyev, M. Hasanli, A. Alekperov, F. Murshudlu, M. Bagirov, Z. Mammadov, E. Sadigov, R. Aliyev, N. Khudiyev and others—have conducted studies on different fields concerning Azerbaijan’s national economic system formation and development strategies in the post-independence period. This studies mainly cover areas such as the role of external resources, international capital flows and banking sector development. However, in the context of globalization, production internationalization and growing economic openness, an inclusive economic development and economic security provision should be the top priority. This is particularly vital for Azerbaijan, a newly independent “small economy,” to have an approach of mutual response to these tendencies.

**The object and subject matter of the study.** The Azerbaijan economy and the development features of national banking sector constitute the study object, while the subject matter of the study is evaluating the effectiveness and prospects of the involvement of foreign banking capital in the development of the national economy.

**The goals and objectives of the study.** The main objective of this study is to identify the functional and institutional characteristics of foreign banking capital’s participation in Azerbaijan’s economy and to develop policy recommendations aimed at enhancing its contribution to national economic development.

In the context of evolving global financial conditions, this issue is relevant not only for the banking sector but also in terms of ensuring the sustainability and inclusiveness of overall national economic development. To support the formulation and implementation of effective economic development strategies, the following research objectives have been identified:

■ To conduct a comprehensive analysis of the factors shaping the international movement of capital, particularly the banking capital, at the

current stage of global economic development;

■ To assess the prospects for the participation of foreign banking capital from both functional and institutional perspectives, in the context of the structural characteristics of Azerbaijan's national banking system;

■ To analyze the organizational and legal frameworks governing the regulation of the banking sector in relation to foreign banking capital, with particular attention to prudential regulation and risk management;

■ To evaluate the effectiveness of foreign banking capital in meeting the financing needs of the national economy in alignment with development objectives;

■ To assess the future prospects for the participation of foreign banking capital and to identify effective mechanisms for its integration in accordance with national economic development goals and reform strategies.

**The research methods of the study.** The theoretical and methodological foundation of the study is based on theories concerning the international movement of capital, the dynamics of banking capital within the framework of financial globalization, expert analyses by economists, legislative acts governing the legal regulation of Azerbaijan's banking system, strategic development documents and relevant international practices.

The methodological approach emphasizes a comprehensive evaluation of foreign capital, considering not only its role as a source of financial resources but also its potential to contribute to sustainable and inclusive development.

The study employs a range of methods, including systematic and statistical analysis, analytical generalization, induction and deduction, comparative analysis, and other established techniques of economic research.

**Key provisions for the defense.** The key provisions presented for defense based on the analyses conducted in this dissertation are as follows:

- An analysis of national economic growth (particularly during the oil boom) indicates that the financial intermediation function of the banking sector has largely been cyclical in nature, primarily oriented towards financing aggregate consumer demand;

- The oil boom period shifted aside the internal concentration within the banking sector, weak risk management systems, the absence of sustainable business models and other similar problems. At the same time, shortcomings in macroprudential regulation hindered the correction of fundamental structural deficiencies in the banking system;

- The stance towards foreign banking capital throughout the post-independence period has been inconsistent. Although restrictions were lifted in the 2000s, a cautious approach has persisted. The small scale of national economy and the fiscal policy stance during the oil boom diminished the attractiveness of Azerbaijan's economy to foreign banking capital. As a result, banks with foreign capital operating in the country failed to emerge as systemically significant institutions;

- Since 2015, increased financing needs have heightened the role of the banking sector. Following consolidation efforts beginning in 2016, several banks including those with foreign capital had their licenses revoked. While foreign-owned banks currently account for approximately one-fifth of the sector's total assets, these are predominantly small and medium-sized institutions with limited capacity to meet broad-based financing demands;

- In the medium to long term, attracting foreign banking capital has the potential to accelerate sectoral capitalization and consolidation, enhance competition, improve service quality and facilitate the adoption of international best practices. However, increased capitalization must be accompanied by strengthened oversight and regulatory frameworks to ensure that it contributes effectively to sustainable economic development.

**The scientific novation of the study.** Based on the results obtained in studies conducted within the framework of dissertation, we consider it appropriate to evaluate the following conclusions as scientific novations:

- Various theoretical paradigms related to the international movement of capital flows and their differential impacts on national economies were critically assessed;

- The evolution of Azerbaijan's national banking system was analyzed through the lens of structural and cyclical factors, with a focus on identifying sources of systemic risk;

- The level of concentration in the banking sector was evaluated

using the Herfindahl-Hirschman Index, as well as by examining the distribution of assets, loans and deposits among banks. The results were assessed in the context of current and prospective development priorities;

- The legal and regulatory framework including prudential regulation governing foreign banking capital was comprehensively analyzed based on Basel standards and international best practices;

- Opportunities to enhance the efficiency and resource transferability of banking capital within the national economy were explored, with particular attention to increasing the functional role of foreign banking capital in economic development under existing constraints. Corresponding policy proposals were developed;

- Strategic recommendations were formulated for the prospective utilization of foreign banking capital to meet the growing financing needs of Azerbaijan's non-oil and innovation-driven sectors in the post-oil development phase;

- Key areas for reform aimed at encouraging the inflow of foreign banking capital at the macroeconomic level were examined and policy recommendations were presented in accordance with the methodologies of various international rating systems.

**Theoretical and practical significance of the study.** The research findings and proposed recommendations hold both practical and theoretical significance in the context of ongoing reforms in the national economy. The results can serve as a valuable academic resource in the teaching of disciplines such as international economics, international finance, banking, and financial policy. Additionally, they provide a useful foundation for analyzing the sustainability and inclusiveness of national development, as well as for enhancing the effectiveness of reforms in the financial and banking sectors. The study's reference to a range of international regulatory and methodological frameworks, global rankings and comparative experiences of other countries further strengthens its theoretical and practical relevance.

**Approval and implementation of the study.** The main theoretical and practical findings, as well as the results of the research, are presented both individually at the end of each paragraph and chapter and in a generalized, integrated form across twelve key points summarized at the conclusion of the dissertation. The core contributions of the dissertation

have been presented at seminars held by relevant departments of Azerbaijan State University of Economics as well as at national and international scientific conferences. Based on the dissertation materials, the author has published nine scientific articles and two conference abstracts.

**Name of the organization where the dissertation work was conducted.** The dissertation was completed at Azerbaijan State University of Economics.

**The total volume of the dissertation indicating the volume of the structural sections of the dissertation separately.** The total volume of the dissertation is 157 pages and comprises of an Introduction, three chapters, a Conclusion and a List of References. The dissertation includes 3 diagrams, 7 tables, 11 graphs and 16 charts, and references 157 sources of literature. The volume of each structural section, measured in characters, is as follows: the Introduction – 18,722 characters, Chapter I – 87,422 characters, Chapter II – 61,949 characters, Chapter III – 75,191 characters, and the Conclusion – 10,722 characters. The total character count of the dissertation amounts to 254,326 characters.

### **The structure of the dissertation**

Introduction

#### **Chapter 1. The Theoretical and Methodological Foundations of Foreign Capital Participation in Economic Development**

1.1 . The economic nature of capital and its international movement, reasons and conditions for the choice of forms

1.2. The need to regulate the penetration of foreign banking capital into the national economy and justification for the choice of instruments

1.3. The forms, methods and tasks of attracting foreign banking capital into the national economy

#### **Chapter 2. The Characteristics of Foreign Banking Capital Influence on the Banking System and Economic Development of Azerbaijan**

2.1. The characteristics of impact of foreign capital on the formation of national banking system and its competitiveness

2.2. The organizational-legislative foundations of foreign banking capital participation in national banking system and its characteristics

2.3. The assessment of the level of national economy's financial safety

and the participation of foreign banking capital

### **Chapter 3. The Integration of National Banking System into Global Financial Market and the Perspectives of its Influence on Economic Growth**

3.1. The methods of regulating foreign banking capital in Azerbaijan and the tasks of improving the control mechanism

3.2. The ways to enhance the effectiveness of foreign banking capital utilization amidst global financial environment changes

3.3. The Potential of foreign banking capital in modernizing the national economy and reinforcing the banking system

Conclusions and proposals

List of References

Appendixes

#### **Primary content of the dissertation**

**The first chapter of the dissertation is titled “The Theoretical and Methodological Foundations of Foreign Capital Participation in Economic Growth”.** Here, we study the economic essence of capital and the reasons for its global mobility, as well as conditions of selecting its forms.

Capital has long been a central focus of economic theory as a fundamental resource in economic activity. Adam Smith distinguished between fixed capital, assets not consumed during production and circulating capital which is used up in the process. In classical and neoclassical thought, capital is defined as one of the main production factors alongside labor and land. John Stuart Mill emphasized the difference between capital and money, arguing that money merely facilitates exchange rather than constituting capital. From a Marxist perspective, capital is seen as money invested to generate profit a notion that has evolved into the modern concept of financial capital.

Economic literature offers diverse perspectives on financial capital. Henry George argues that securities and similar instruments do not represent real capital but rather reflect one social class’s capacity to appropriate another’s income, contributing little to societal wealth. In contrast, Werner Sombart and Max Weber define capital as wealth

recorded through double-entry bookkeeping, primarily aimed at profit generation. Eugen Böhm-Bawerk views capital as a commodity used in producing consumer goods, emphasizing its assessment through production turnover.

The cross-border movement of capital developed later than the trade in goods and labor migration. This delay was primarily due to the limited utility of exporting capital before sufficient domestic accumulation had been achieved. It was not until the 17th and 18th centuries spurred by the Industrial Revolutions and the evolution of capitalist economic relations that the phase of primitive accumulation came to an end, paving the way for the expansion of international capital flows.

The acceleration of financial globalization in the late 20th century intensified capital flows, driven by liberalized foreign investment regimes and technological advances. According to the OECD, foreign capital includes direct investments, reinvested earnings, loans and various debt obligations to parent companies. This broad definition expands the concept of foreign capital, reducing the emphasis on its national origin, aligning with globalization perspectives.

According to the neoclassical approach, capital flows from low to high-income countries due to differences in investment returns. Peter Henry notes that financial liberalization has boosted profitability and strengthened capital inflows to developing countries. This view aligns with the neoclassical Solow growth model.

This position remains debatable. Capital flow liberalization seeks not only to grant foreign investors market access but also to stimulate growth and enhance capital mobility. However, liberalization especially in portfolio investment, FDI and external borrowing can produce adverse side effects. Although studies show securities investments tend to be more efficient than debt instruments, debt is often preferred due to concerns over losing control of national assets.

On the other hand, resource scarcity can no longer be considered the primary driver of capital flows under current global conditions. Evidence from countries such as China (savings consistently exceed investment, resulting in a current account surplus) and the United States (savings are chronically lower than investment) supports this view.

Similar trends are also observed in many developing countries.

The second half of the 20th century introduced new perspectives on international capital flows. K. Kojima and T. Ozawa argued that resource availability is not a necessary condition for achieving competitive advantage in international trade. They emphasized that foreign investment, particularly in the case of Japan, has a more sustainable and long-term impact in securing such advantages. According to T. Ozawa, the inflow of foreign capital can also mitigate an economy's dependence on external markets and reduce vulnerability to fluctuations in factor prices.

S. Hamer argues that foreign direct investment (FDI) often succeeds in conditions of market failure. The monopolistic advantage model suggests that such environments attract investors due to potential excess profits. Chamberlin and Robinson note that investors accept risks if returns often supported by government aid and imperfect competition are sufficient.

The internationalization model emphasizes strong internal structures and technological innovation, enabling firms to bypass market limitations and promote intra-firm trade. Coase further highlights that transnational corporations (TNCs) mitigate imperfect market effects by creating internal markets within their networks.

Since the 1970s, global economic shifts and liberal financial policies have contributed to a growing share of banking capital in international capital flows. Following the 2008 financial crisis, banking capital flows declined, particularly in developed countries (EEC), with banking flows accounting for 16% of inflows and 9% of outflows.

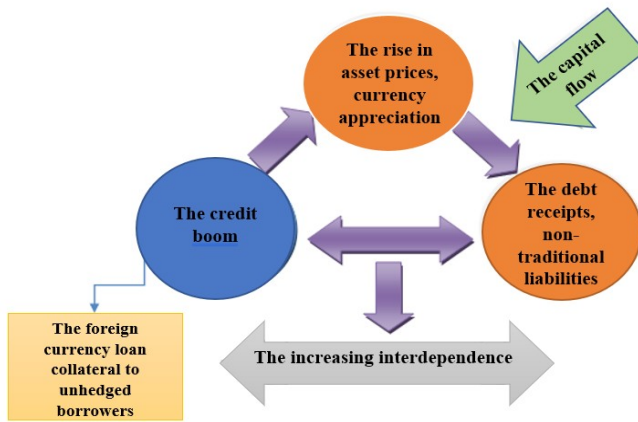
The dynamics of financial globalization and its influence on financing opportunities in both banking and non-banking sectors highlight the need to assess foreign bank capital within the broader context of international capital flows.

Foreign bank capital influences structural changes in the banking sector, shapes the macroeconomic and monetary environment and affects non-bank financial intermediaries, such as through access to foreign funding and the integration of foreign capital into the national banking system.

The next issue addressed in the first chapter is the regulation of

foreign bank capital's impact on the national economy and the rationale for selecting appropriate policy instruments. Poor management of capital inflows or the lack of adequate control mechanisms may pose three key risks: threats to macroeconomic stability, financial system vulnerability and increased capital outflows.

Foreign bank capital primarily affects national banking systems by expanding access to financing and increasing available resources through equity contributions from foreign entities. Consequently, the absorption of excess capital inflows should be regulated using targeted policy tools to mitigate potential risks and align foreign capital with national development priorities.



### Transmission channels of capital inflows

*Source: Compiled by the author based on materials from International Monetary Fund (IMF).*

Post-crisis policies seek to mitigate the adverse effects of bank capital flows by enhancing financial transparency, strengthening capitalization, reducing leverage and managing liquidity risks. Volatility in capital flows is addressed through monetary policy and capital regulation, as high volatility increases exchange rate risks and depletes foreign reserves. The policy response depends on the source and nature of flows; for example, cyclical inflows may not trigger inflation via exchange rate appreciation, but increased uncertainty can reduce short-term capital and stagnate the commercial sector. The need for capital regulation arises mainly from sharp exchange rate fluctuations,

speculative “hot money,” unchecked financial risks and the Mundell-Fleming trilemma. Macroprudential tools address volatility by (1) enhancing the financial system’s resilience to shocks and ensuring credit continuity and (2) dampening cyclical linkages between asset prices, exchange rates, and credit growth. Foreign banking capital inflows depend on macroeconomic conditions, external factors and the domestic institutional framework, analyzed through (1) national policies to attract capital and (2) determinants of foreign banks’ market entry. Thus, policy measures fall into institutional-structural reforms and prudential-financial regulations.

As a logical conclusion of the comprehensive study conducted in Chapter 1 of the dissertation, the assessment of the theoretical and methodological foundations regarding the participation of foreign capital in economic development, from both theoretical and practical perspectives, enables us to formulate the following conclusions:

1. Capital holds a dominant position among economic resources in the global system, owing to its mobility, scale and dynamic nature. The liberalization of capital flows extends beyond merely granting foreign investors access to domestic markets; rather, it reflects broader economic and strategic considerations. In contemporary conditions, resource scarcity is no longer the primary driver of capital mobility. Research indicates that under financial globalization, foreign banking capital functions as a critical transmission channel, significantly shaping the financial capacity and operational scope of national financial institutions.

2. Foreign bank capital influences the national economy across multiple dimensions, including structural, macroeconomic and monetary transformations within the banking sector. This impact extends beyond the banking system, affecting non-bank financial institutions as well. Among the key determinants of capital flows are risk aversion and information asymmetry. While these factors affect all forms of capital movement, their influence is particularly significant in the case of banking capital.

3. Regulation of foreign banking capital is primarily aimed at promoting sustainable development and maintaining macroeconomic equilibrium. Effective oversight of capital flows is essential for ensuring economic stability, particularly in light of exchange rate volatility, the

expansion of non-tradable sectors and heightened risks to financial stability. In the absence of appropriate regulatory mechanisms, such flows may pose significant threats to both macroeconomic and financial stability.

4. To mitigate risks associated with capital flows, policymakers may employ tools such as lowering interest rates, allowing currency appreciation and conducting open market operations, particularly when asset price inflation remains moderate. The necessity of regulatory intervention arises from factors such as exchange rate volatility, speculative short-term capital ("hot money"), capital flight and the challenges posed by the Mundell-Fleming trilemma.

5. Stimulating capital flows is especially crucial for developing countries. The policy framework for attracting foreign capital depends on domestic economic conditions, external factors, political priorities and institutional capacity. For an economically resilient Azerbaijan, the policy must both mitigate external volatility and align capital flows with macroeconomic and strategic development goals. This approach is vital for enhancing competitiveness and fostering inclusive growth.

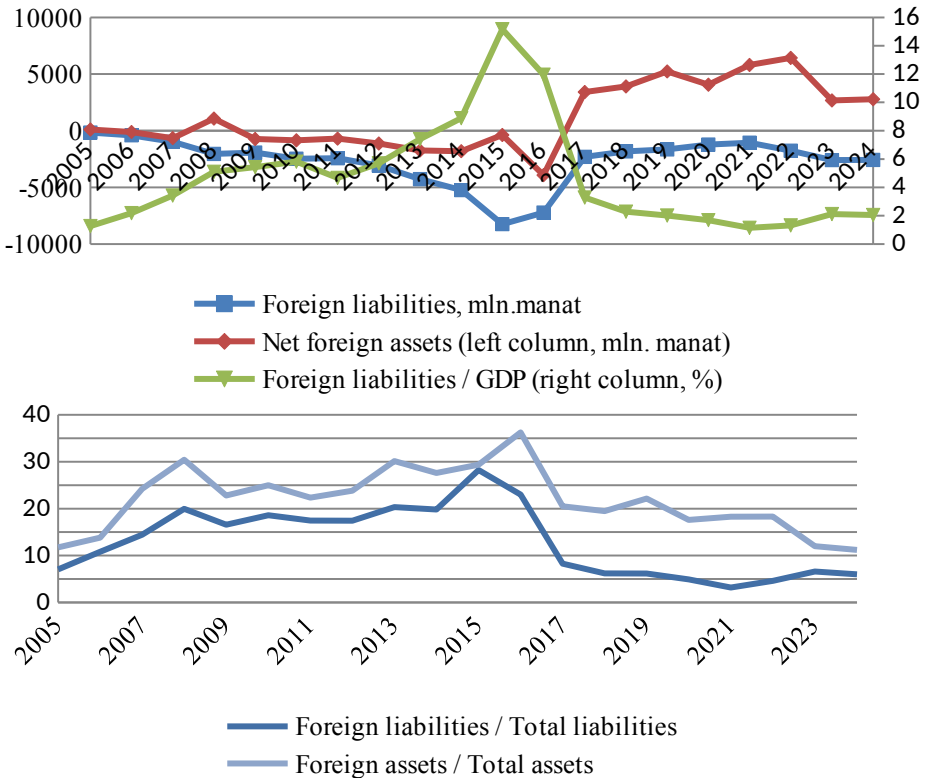
**The second chapter of the dissertation is titled "The Characteristics of Foreign Banking Capital Influence on the Banking System and Economic Development of Azerbaijan".** The first issue addressed is "The characteristics of impact of foreign capital on the formation of national banking system and its competitiveness". Following the restoration of independence, Azerbaijan established a financial and banking system aligned with market principles. Banks have played a vital role in meeting the financial needs of economic agents and facilitating integration into the global economy. In the early stages of development, foreign capital emerged as a key structural factor, particularly in operational portfolios, currency exchange and access to international financial markets. Between 1995 and 2015, a total of \$106.2 billion was directed into the country. Of the \$26.2 billion in foreign investment, a portion consisted of financial loans, and over the past 17–18 years 25–35% of total foreign investment comprised loans issued through banks by international financial institutions.

With the exception of a brief period characterized by an ultra-liberal approach, attitudes towards foreign capital in the banking sector have

generally been more cautious. The reforms implemented between 1995 and 2003 focused on enhancing financial sustainability and expanding access to funding. The inflow of foreign capital which began with the signing of the “Contract of the Century” continued dynamically, gradually extending to broader sectors. While 86% of capital inflows before 1994 were in the form of direct investment, a significant portion was channeled as cash through the banking system.

In parallel with the inflow of foreign investment into the national economy, the new phase of economic growth that began in 2005 was marked by a notable increase in the capitalization of the banking sector and the continued attraction of external financial resources.

### Analytical balance dynamics of commercial banks



Source: Made by the author based on Central Bank of Azerbaijan (CBA) and other sources.

Although rapid economic growth led to higher incomes and consumption, the banking sector's financing needs did not reach a level sufficient to attract substantial foreign banking capital. This can be attributed to the structure of the banking sector, levels of capitalization, market concentration and limited economic diversification.

The expansion of high-yield investments in the oil sector and the budget's investment orientation reduced reliance on banking resources. Rather than promoting foreign capital inflows into the banking sector, policy priorities focused on supporting cyclical economic growth. These constraints were rooted in economic, structural and political factors. In the early years of independence, the crisis conditions and transitional nature of the economy made the banking sector unattractive to foreign investors.

Since the early 2015, a new economic cycle in Azerbaijan has posed fresh sustainability challenges for the banking sector. The economic growth observed during the oil boom was predominantly consumption-driven, accompanied by a cyclical credit expansion rather than structural reforms within the banking system. Despite these developments, the role of foreign capital in the local banking sector has remained relatively limited.

The Strategic Road Maps (SRMs) adopted in 2016 identified the development of the financial sector as a key long-term objective. In this context, the participation of foreign banking capital and the advancement of financial technologies have the potential to produce positive outcomes.

For Azerbaijan's banking sector which continues to face structural constraints, the significance of foreign capital should be evaluated not only by the volume of financial inflows but also by the potential for transferring global banking standards and practices.

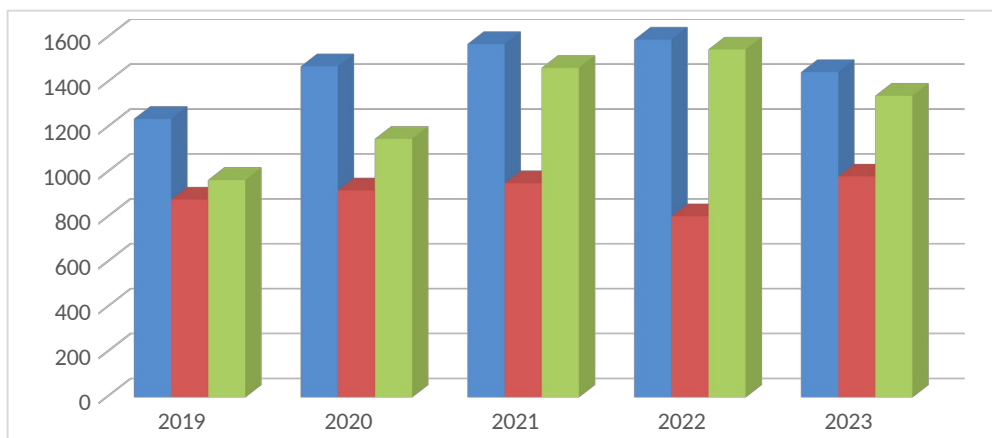
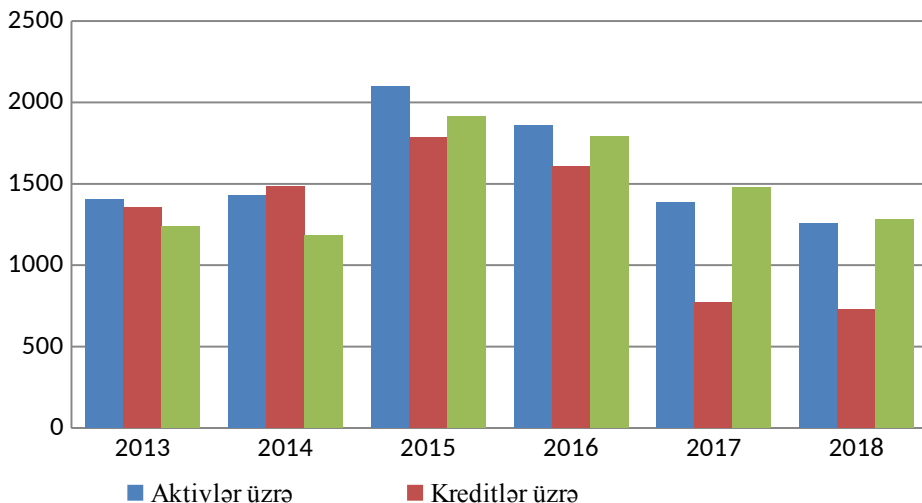
Moreover, the involvement of foreign capital should be aligned with the country's medium and long-term macroeconomic objectives.

Foreign bank participation can enhance competition, improve the quality of financial intermediation and expand the range of financial services offered.

Empirical estimates based on the Herfindahl-Hirschman Index indicate a moderate level of concentration in Azerbaijan's banking sector during the years 2013–2018. Over this period, the share of the top five banks by total assets increased from 55% to 65.6% while the share of

banks with foreign capital declined from 27.8% in 2015 to 22.4% in 2018. Despite this decline, in 2015-2018 the share of foreign-capital banks in total deposit mobilization rose from 18.7% to 21.3%. However, their share in the total loan portfolio fell from 28.3% to 25.4% over the same period.

## Concentration dynamics in the Azerbaijani banking sector



*Source:* Compiled by the author based on data from the CBA and Azerbaijan Banking Association (ABA).

One of the main challenges facing Azerbaijan's banking system is the limited access to financial resources. High interest rates, combined with concentration dynamics within the sector, further exacerbate these constraints. Fundamental reforms are needed to enhance access to alternative funding sources, including foreign bank capital. Strengthening the sector's capacity to attract such capital would also support small and

medium-sized enterprises (SMEs) in meeting their financial needs more effectively through domestic resources.

Thus, the analysis indicates that the national banking system continues to face significant constraints in attracting foreign banking capital which may hinder the achievement of Azerbaijan's medium and long-term strategic economic objectives.

This chapter explores the organizational and legal framework governing the participation of foreign banking capital in the national banking system. The legal foundation of Azerbaijan's banking and financial system is established by the Constitution, national laws, presidential decrees and regulatory acts issued by supervisory authorities. Additionally, international conventions and standards play a critical role in shaping the legal and regulatory environment.

The current version of the Law on Banks does not impose restrictions on the participation of foreign capital. Since January 1, 2004 the financial market of Azerbaijan has been open to foreign banks. Based on our analysis, there are no explicit limitations regarding foreign capital in key banking regulations including licensing procedures, participation in authorized capital, prudential norms and regulatory recommendations.

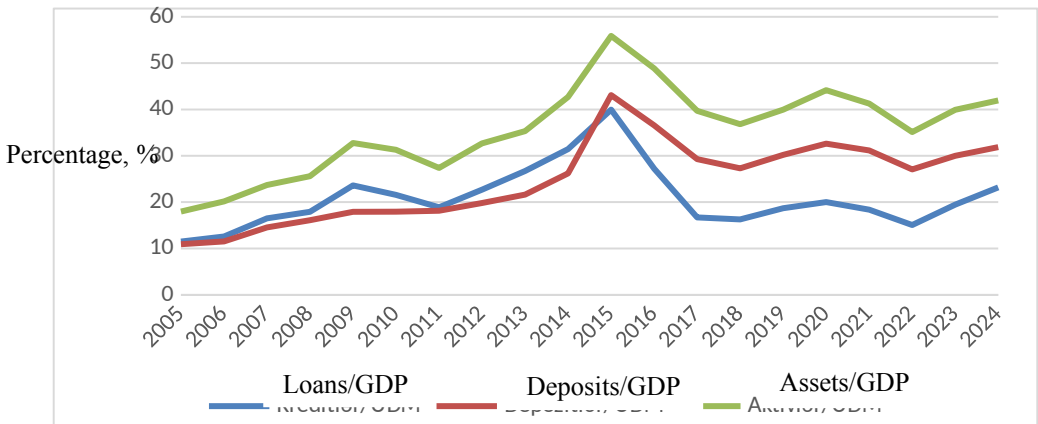
Overall, the participation of foreign capital in Azerbaijan's banking sector is assessed positively from both legal and institutional perspectives. The regular updating of the legislative framework has contributed to strengthening regulatory mechanisms and enhancing the institutional foundation of the supervisory system. However, challenges in regulatory oversight and supervision observed in recent years highlight the need to improve the effectiveness of legislative implementation. In this regard, ensuring coordination among relevant supervisory authorities and maintaining the coherence of policy measures is essential.

The final focus of the second chapter is the assessment of the national economy's financial security and the extent of foreign banking capital participation. The analysis indicates that fiscal policy was the primary driver of economic growth during the oil boom period. From 2004 to 2014, state budget expenditures grew 12.5 times reaching 32% of GDP. Alongside this expansive fiscal stance, monetary policy also experienced significant growth: the monetary base increased eighteenfold, the money supply in circulation grew twenty-onefold and liquid assets in

correspondent bank accounts rose by a factor of 3.3.

Amidst the rising financial depth of the national economy, the financial intermediary capacity of banks developed largely in line with cyclical economic growth. Although the overall financial depth reflects the systemic characteristics of the economy, banks did not provide equitable financing across different segments of the real sector.

### Indicators of financial depth



*Source: Compiled by the author based on data from the CBA and Chamber of Financial Markets Control.*

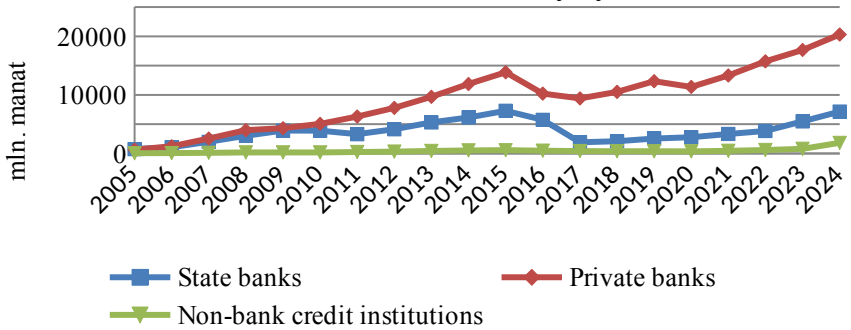
Investment financing for small and medium enterprises (SMEs) remains uneven. A World Bank study covering 2007–2014 found that SME financing was predominantly sourced from domestic funds (71%), with banks providing only 28% of the total financial resources.

Although the loan portfolio share of foreign-owned banks nearly doubled between 2003 and 2014, this trend reversed in subsequent years. By 2015, the combined share of state-owned and foreign banks in the loan portfolio had declined to 63%, falling further to 41.8% by 2018. Since 2017, the primary growth in lending has been driven by local private banks.

Between 2005 and 2014, rising household income and expenditure fueled increased consumption amid growing demand. Financial resources were primarily directed towards meeting household needs, reflecting the

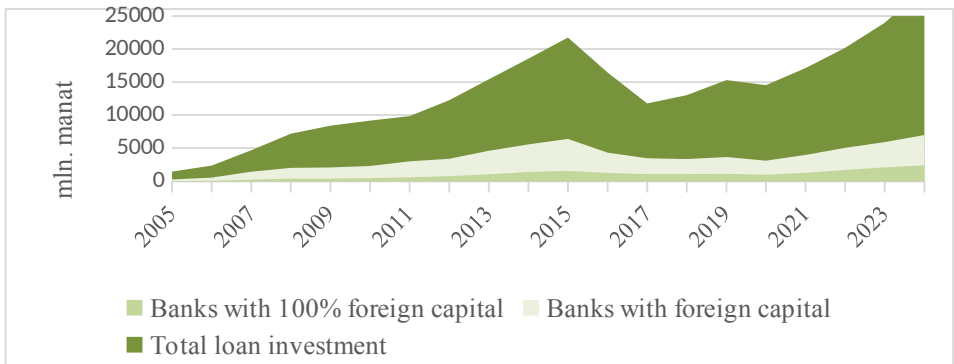
structural characteristics of the national economy as well as fiscal and monetary policies. During the oil boom, budget expenditures prioritized construction and service sectors while the consumer sector experienced significant growth.

### Structure of credit investments in the economy by credit institutions



Source: Compiled by the author based on data from the CBA.

### Share of banks with foreign capital in lending to the economy



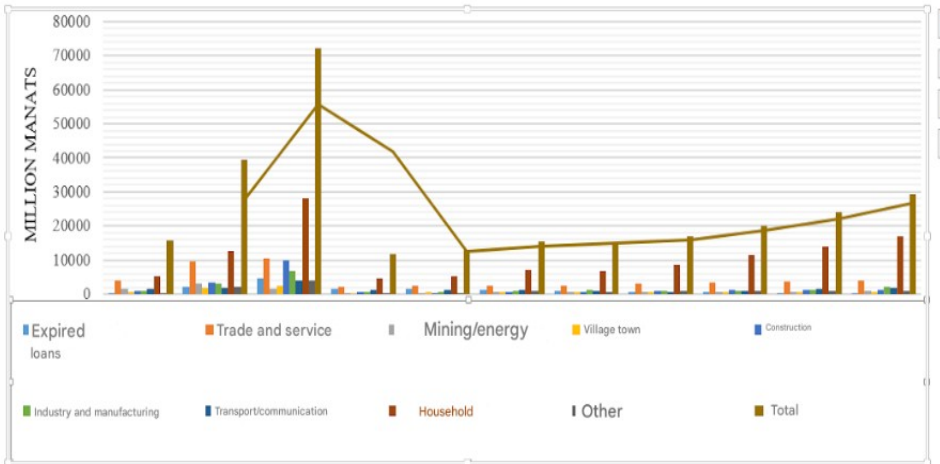
Source: Compiled by the author based on data from the CBA.

However, the rapid expansion period saw a decline in loan quality, heightening risks to banking sector stability. This was largely due to structural weaknesses within banks and inadequate risk management with loans issued without thorough risk assessment. The subsequent rise in non-performing loans after 2015 posed a serious threat. Concurrently, during peak foreign currency inflows the CBA’s sterilization operations

led to an appreciation of the manat exchange rate above market levels, contributing to a reduction in dollarization.

The financing of the national economy and the involvement of foreign bank capital have followed cyclical patterns. These cycles have hindered the banking sector’s structural adaptation, resulting in financing largely sourced from unstable channels. After 2015, these constraints led to asset quality issues and threats to financial stability. Although capitalization levels increased quantitatively during the oil boom, risks related to asset quality and instability became more pronounced post-2015.

**Credit investments by sectors, mln. AZN**



*Source: Compiled by the author based on data from the CBA.*

A cautious stance towards foreign bank capital along with restrictions on the national banking system limited the attraction of foreign equity. Instead, borrowed capital grew during the boom while subsequent devaluation and economic phases weakened bank balance sheets and adversely impacted economic growth. Given shifts in the global financial landscape, there is a need to revisit foreign capital policies, enhance prudential regulation and diversify financing sources.

**The third Chapter of the dissertation is titled "The Integration of National Banking System into Global Financial Market and the**

**Perspectives of its Influence on Economic Growth".** The key issues examined in this section include the experience of regulating foreign banking capital in Azerbaijan, the need to improve control mechanisms and strategies to enhance the effective use of foreign capital in light of changes in the global financial environment. The study also explores the prospects for the involvement of foreign banking capital in the modernization of the national economy and the strengthening of the banking system.

In the development of Azerbaijan's banking system, changes in the minimum authorized capital requirements introduced by the CBA have contributed to greater consolidation and stability, reinforcing the capital base of private banks. The increase in total capital has supported the solvency of banks and enhanced public confidence in the sector. As of the first quarter of 2019, three out of 30 banks, each with foreign capital, did not meet the minimum capital requirements. Since 2014, the licenses of seven foreign-capital banks have been revoked. However, restructuring efforts implemented between 2017 and 2019 have led to improved compliance with capital requirements among banks with foreign ownership.

The “Criteria for Assessing a Bank as Systemically Important” which came into effect in April 2019 introduced stricter capital adequacy requirements for banks designated as systemically important. This classification is intended to mitigate potential risks such as fiscal burdens and market discipline failures that may arise when government support programs are implemented during financial crises.

The banking sector developments of 2015–2016 demonstrated that existing prudential requirements were insufficient to adequately assess and manage the risks associated with large banks. Consequently, the application of tailored prudential instruments became necessary to promptly identify concentration trends and systemic vulnerabilities within the sector.

Prudential regulation in Azerbaijan is primarily based on the Basel I framework, adapted to local conditions. The full transition to Basel III standards is planned to be completed by 2025, with ongoing technical cooperation between the CBA and the Basel Committee. A key challenge in this process is the instability of capital and liquidity ratios across the

banking sector. Many banks prioritize loan-based liquidity over capital strengthening, thereby increasing their risk appetite. An International Monetary Fund (IMF) assessment in 2015 highlighted persistent difficulties in closing capital and liquidity gaps within the sector.

The second key aspect of prudential regulation concerning foreign capital is the maintenance of bank liquidity stability. These regulatory standards are designed to protect banks' balance sheets and operational capacity from both internal and external shocks. Liquidity requirements within this framework aim to ensure banks' ability to meet their balance sheet and off-balance sheet obligations, manage funding risks particularly those stemming from external sources and preserve financial resilience.

In Azerbaijan, liquidity regulation is governed by the "Rules for Managing Bank Liquidity," adopted by the CBA in 2009. While these rules address lending, portfolio quality and fund monitoring, the economic downturn in recent years suggests that compliance has often been formal rather than substantive. Additionally, the sharp rise in foreign liabilities during the oil boom period further complicated adherence to prudential standards.

Basel III standards impose constraints on the mismatch between banks' liquid assets and liabilities, as well as on the proportion of highly liquid assets in total holdings. In Azerbaijan, prudential norms classify assets using multiple criteria; however, the underdeveloped nature of the financial system continues to constrain overall liquidity. Inadequate transparency and accountability in some banks further impede effective risk and liquidity classification, leaving practices well below international standards. Therefore, accelerating the adoption of Basel standards is critical for enhancing the regulation of foreign bank capital and ensuring the long-term sustainability of the banking sector.

Despite recent improvements in the legislative framework, the regulation of foreign bank capital and the effectiveness of prudential supervision remain pressing issues in Azerbaijan. Prudential oversight must go beyond quantitative financial restrictions and also aim to secure the functional resilience of banking institutions. The full implementation of Basel III principles, particularly those related to capital adequacy and liquidity management, will be instrumental in shaping the future trajectory of the national banking system. Azerbaijan's experience suggests that the

domestic economic environment poses structural limitations to the development of the banking sector. Therefore, strengthening the role of banks in supporting economic growth should be prioritized as a medium and long-term strategic objective.

An evaluation of bank capital utilization within the Azerbaijani economy underscores several key observations. Primarily, it is evident that the infusion of banking capital into both the real and financial sectors of Azerbaijan remains relatively modest. This shortfall persists across periods of high oil prices and into the new economic phase. Such constrained mobilization can be attributed to several factors: (1) the underdeveloped state of the banking sector and broader financial system, (2) the peculiarities of economic activity, (3) superficial approaches to financial intermediation by both banks and their clientele, and (4) nuances within the country's monetary policy framework.

Bank capital is primarily transmitted into the economy through lending. In Azerbaijan, this channel plays a key role not only in the functioning of the banking sector but also in the implementation of monetary policy. However, the structure of the national economy and the specific characteristics of the lending process constrain the ability of this channel to support the real sector on a long-term and sustainable basis.

Several factors contribute to these limitations. First, during the oil boom period the effectiveness of the credit channel was largely shaped by cyclical dynamics while an unstable macroeconomic environment undermined the efficient deployment of capital resources. Second, the transmission of credit was adversely affected by exchange rate volatility as fluctuations in the national currency significantly weakened the stability and predictability of lending activity. Empirical research by Mukhtarov and Mikailov further confirms that the credit demand of enterprises is closely linked to national income levels and aggregate demand conditions. These findings highlight the sensitivity of the credit channel to broader economic trends and underscore the need for a more structurally resilient financial intermediation system.

Secondly, high interest rates hinder long-term lending and limit the effective participation of bank capital in this process. Elevated interest rates in Azerbaijan are influenced by several interrelated factors, including the monetary policy stance of the Central Bank of Azerbaijan (CBA), the

currency and sectoral composition of loan portfolios, inflationary pressures and overall credit risk levels.

The effectiveness of the CBA's interest rate channel remains relatively weak. Adjustments to the discount rate during the oil boom and in the post-2014 period had a limited and unstable impact on commercial bank lending rates. This inefficacy is largely attributable to the relatively small share of the CBA in the total pool of credit resources, as well as the high reliance of commercial banks on deposits and household savings. During the oil boom, deposit interest rates ranged between 8% and 12% further entrenching the high cost of funding and discouraging long-term lending.

One of the key challenges in channeling bank capital to the real sector lies in the structure of lending. Analysis indicates that a significant portion of loans has been directed towards consumer purposes. The share of household loans increased from 27% in 2005 to 39.2% in 2017 and reached 58.2% in 2024. This growing concentration in consumer lending reduces the interest rate elasticity of loan demand and restricts access to credit for entrepreneurs. Interest rates for both SMEs and households remain high, ranging between 22% and 30%. This leads to a structural mismatch between the credit needs of the real sector and the actual allocation of bank capital, perpetuating elevated interest rates.

While the expansion of bank lending in Azerbaijan has positively influenced the non-oil sector, its overall impact on the real economy remains constrained. The high perceived risk and limited financial literacy of SMEs further discourage banks from issuing loans to this segment. Additionally, the restrictive monetary policy of recent years has curtailed credit availability. Currency devaluations and the rise in non-performing assets have also negatively affected banks' balance sheets. Although banks actively adjusted their currency positions in 2018 in response to market conditions, the stabilization of the exchange rate has since reduced the scope for such adjustments.

Thus, our analysis indicates that enhancing the efficiency of banking capital utilization within the national economy requires a combined approach involving both macroeconomic and structural policies. In particular, addressing the challenges associated with the transmission channels of banking capital to the real economy is of critical

importance.

Increasing the share of foreign capital remains a priority for strengthening the national banking system. At present, 9 of the 22 banks in Azerbaijan have foreign capital participation though the extent of this involvement varies. The recent economic downturn underscores that addressing capital participation solely based on residency is insufficient. Many challenges within Azerbaijan's banking system stem from structural deficiencies. Therefore, the role of foreign banking capital in addressing these systemic issues is significant for the following reasons:

- Facilitating the development of financial intermediation services.
- Revitalizing competition within the banking sector.
- Broadening banks' access to alternative financial resources.

Attracting foreign banking capital to the national economy promotes increased competition and more efficient resource allocation. However, disparities in access to foreign borrowing and existing weaknesses in Azerbaijan's banking system adversely affect competitive dynamics. The banking sector currently falls short of modernization objectives, hindered by gaps in both resource transfer mechanisms, the organizational and legal framework. Loan availability remains relatively low compared to neighboring countries, largely due to the recent economic downturn. Although recent reforms have contributed to improvements, significant challenges persist.

Therefore, the analysis suggests that the new strategic objectives of the national economy demand comprehensive, high-quality reforms across all sectors. In this context, foreign banking capital holds substantial potential as a key driver of transformative change within the banking system.

## **CONCLUSIONS AND PROPOSALS**

1. The research presented in this dissertation emphasizes the importance of analyzing the causes and forms of international capital flows in the contemporary context through the lens of post-Keynesian monetary theory. In particular, the dynamics of international banking capital flows, financial integration and the linkage between the national financial system and its position in the global financial landscape are highlighted as critical factors.

2. Although various national policy strategies can mitigate the macroeconomic risks associated with the inflow of bank capital into the national economy, they do not offer a sustainable guarantee of long-term financial stability.

3. Attracting foreign banking capital beyond the national economy's absorption capacity poses sustainability challenges in the medium and long term. Enhancing the ability to channel capital into the real sector is crucial for strengthening its contribution to economic development. Although the banking sector in Azerbaijan expanded during the independence period, this growth did not translate into qualitative economic transformation. Moreover, high concentration within the sector exacerbated systemic issues and constrained the effective utilization of foreign capital.

4. Under the new economic conditions, the banking sector is tasked with several critical objectives such as actively participating in revitalizing economic activity as financial intermediaries, enhancing the development of robust risk management systems within banks and improving the variety and quality of financial services offered to customers.

5. Equally crucial is the attraction of foreign banking capital to bolster the non-oil sector in alignment with the strategic objectives outlined for the national economy. Moreover, augmenting banks' access to both domestic and foreign financial resources will strengthen their capacity to fulfill capitalization needs. Furthermore, there's a growing imperative to enhance the institutional and legislative framework to ensure the banking sector's adaptability to evolving conditions in recent years.

6. The analysis indicates that banking sector instability cannot be resolved through restrictions on foreign capital alone; such measures may, in fact, exacerbate long-term structural challenges. Key priorities include enhancing the effectiveness of prudential policy, particularly through clearer separation of supervisory powers, improved accountability and full implementation of Basel III standards. Additionally, adopting a counter-cyclical regulatory approach and strengthening flexibility in managing systemic risks remain essential.

7. In the short and medium term, key areas of involvement for foreign banking capital in the country's economy include:

- Given the current level of capitalization and the maturity of financial services, the banking system's capacity to meet the goals of the Strategic Road Maps remains limited. Under these conditions, foreign capital appears better positioned to address existing shortcomings;

- The predominantly systemic nature of weaknesses in the banking sector significantly undermines its sustainability and macroeconomic performance. Issues such as insufficient capitalization, limited access to financial resources and high concentration in specific segments further exacerbate these challenges;

- Trends in global capital flows and the emergence of new, profitable financial instruments present both opportunities and risks for Azerbaijan's economy and banking sector. In this context, the presence of experienced foreign banks offers a valuable means to address existing structural gaps;

- The analysis indicates that comprehensive restructuring of the national economy requires qualitative renewal across all sectors. In this context, foreign banking capital holds strong potential to drive fundamental reforms in the banking system. However, its effectiveness depends on substantial structural improvements, including robust macroprudential regulation and better coordination of macroeconomic policy channels.

**The results obtained in the dissertation were published in the following scientific papers:**

1. "Foreign banking capital in the economy of Azerbaijan", Global world: multipolarity, anti-crisis imperatives, institutions: materials of the 5th International Scientific and Practical Conference (Rostov-on-Don, May 22–24, 2014 ): in 3 volumes / ed. by M. A. Borovskoy, Yu. M. Osipov, A. Yu. Arkhipov. – Rostov-on-Don: Publishing House of the Southern Federal University. – 570 p., 2014, Vol. 2, pp. 341-345

2. "Examining the Genesis of Foreign Capital Flows: A Comparative Analysis through Neoclassical and Keynesian Perspectives". "Research Publications" of the Institute of Economics, Azerbaijan National Academy of Sciences, Volume 5, 2017, pp. 67-75.

3. "Factors Influencing the Appeal of National Economies for Foreign Direct Investment: A Comprehensive Review within the Framework of Structural and Economic Policies". News of Azerbaijan

National Academy of Sciences. Economy Series, No. 1, 2018, pp. 102-107.

4. "Examining Capital Flow Regulation: A Comparative Analysis through the Lens of Macroprudential Control and Capital Control". "Research Proceedings" of the Institute of Economics, National Academy of Sciences of Azerbaijan, Volume 3, 2018, pp. 88-95.

5. "Foreign Capital in the Banking Sector of Azerbaijan: Economic and Legal Perspectives" in "Investments: Practice and Evidence" (Kiev, Ukraine) DOI: 10.32702/2306-6814.2018.20.44, 2018, Issue 20, pp. 44-49.

6. "Foreign capital in the banking sector of Azerbaijan: regulatory issues", Development of banking systems in the minds of the globalization of financial markets: materials of the 12th International Scientific and Practical Conference (9 November 2018, Cherkasy) / Cherkasy Institute DVNZ "University of Banking Certificate" " – Cherkassy (Ukraine). – 371 p., [https://cibs.ubs.edu.ua/wp-content/uploads/2018/12/materialy\\_09112018.pdf](https://cibs.ubs.edu.ua/wp-content/uploads/2018/12/materialy_09112018.pdf), 2018, pp. 272-275

7. "Foreign Banks in Transition Economies: Trends and Impact on Systemic Stability", Economic and Social Development (Book of Proceedings). 37<sup>th</sup> International Scientific Conference on Economic and Social Development – "Socio Economic Problems of Sustainable Development" (Baku, 14-15 February 2019). Baku: VDEA – UNEC. – 1609 p. (WoS), [https://apps.webofknowledge.com/full\\_record.do?product=WOS&search\\_mode=GeneralSearch&qid=7&SID=E3O2GLRranTdINIBi6g&page=1&doc=2](https://apps.webofknowledge.com/full_record.do?product=WOS&search_mode=GeneralSearch&qid=7&SID=E3O2GLRranTdINIBi6g&page=1&doc=2), 2019, pp. 795-806

8. "Foreign Banks in Transition Economies in the Context of the Global Crisis: Current Trends, Risk Profiles and Impact Specificity on Systemic Stability", J. Ponte (Italy, Florence), [doi: 10.21506/j.ponte.2019.6.9], [URL:http://www.pontejournal.net/mainpanel/abstract.php?TOKEN=gRkgF5411G&PID=PJ-H7A4L](http://www.pontejournal.net/mainpanel/abstract.php?TOKEN=gRkgF5411G&PID=PJ-H7A4L), 2019, Volume 75, Issue 6/1, pp. 2-11

9. "Banking Business Internationalization in Developing Countries (Evidence from Azerbaijan and Ukraine)", Financial and credit activity: problems of theory and practice (Xarkov, Ukraina),

<https://doi.org/10.18371/fcaptive.v2i33.206405>, 2020, Vol. 2, No. 33, pp. 48-57

10. “International banking business and bank strategy: global trends and benchmarks for post-soviet states”, The Economic Annals-XXI (Kiyev, Ukraina), <https://doi.org/10.21003/ea.V185-03>, 2020, № 9-10, pp. 27-38

11. “Multinational banks and the formation of debt-type economy in the countries of Central and Eastern Europe”, Globalization and its Socio-Economic Consequences. 21st International Scientific Conference (Zilina, Slovak Republic, 13rd-14th October, 2021). Zilina: University of Zilina,

<https://www.shs-conferences.org/articles/shsconf/abs/2021/40/contents/contents.html>, 2021, pp. 2-10.

The dissertation defense will be held on June 30, 2025 at 15:00 at a meeting of the FD 1.11 Dissertation Council operating at the Scientific Research Institute of Economic Studies under the Azerbaijan State University of Economics.

Address: AZ 1001, Baku, Istiglaliyat street 6

The dissertation is accessible at the Azerbaijan State University of Economics Library.

Electron versions its abstract are available on the official website of the Azerbaijan State University of Economics.

Abstract was sent to the required addresses on 19 June 2025



Çapa imzalanıb: 23.05.2025  
Kağızın formatı: 60x84 <sup>1</sup>/<sub>16</sub>.  
Həcmi 1 ç.v. (46739 işarə)  
Tiraj 30.

*“AA – Poliqraf” istehsalat-kommersiya birliyində  
hazır diopozitivlərdən istifadə olunmaqla çap edilmişdir.  
Əlaqə üçün: [capevi@internet.ru](mailto:capevi@internet.ru) Tel.: +994552012809*