

Varazdin Development and Entrepreneurship Agency
in cooperation with
Azerbaijan State University of Economics (UNEC)
University North
Faculty of Management University of Warsaw
Faculty of Law, Economics and Social Sciences Sale - Mohammed V University in Rabat



Economic and Social Development

37th International Scientific Conference on Economic and Social Development –
"Socio Economic Problems of Sustainable Development"

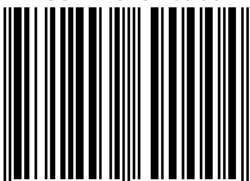
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CREATION OF ORDINARY MARKET INSTITUTIONS AND POTENTIAL OF AZERBAIJAN ECONOMY FOR SUSTAINABLE DEVELOPMENT

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ABSTRACT

The article deals with the Azerbaijan Republic' potential of developing with the support of financial intermediary institutions. There are many ordinary steps for realization of this goal. The aim is to analyze the mechanisms of stimulating creation of ordinary financial intermediaries and supplement public finance with private capital. Every country' sustainable development requires resting on long history proven basics-free entrepreneurship, banking industry, commodity and stock exchanges. Capital scarce emerging market countries need more market-oriented institutions for converting people' income into investment through saving. Low level of share of market capitalization in GDP, high share of prime working and mature working age population display potential of unused savings of people. Stock market, mutual funds, pension funds, mortgage associations may attract free disposable money into financial circle and resolve multi-purpose targets. The economy will get money resources requiring effective use, the people will have current and future rewards as dividends and growth in pensions. Development of financial institutions will contribute for restructuring of the economy into efficiently functioning mechanism and attract foreign direct and portfolio investments. The bank credit possibilities for economic development has exhausted itself. This explains the necessity of forming these institutions for future sustainable development at after-oil period of Azerbaijan. The creation of discussed mechanisms in the article in short period requires regulation and stimulation by strong tax and finance incentives. The coordinated strategy to improve and consolidate the work of legislative and executive power in Azerbaijan in the direction of creation and development of market-oriented financial intermediary institutions may change Azerbaijan' oil-dominated economy into a developed market economy.

Keywords: *financial intermediary institutions, market capitalization, stock market, pension funds, mutual funds, savings, tax and finance incentives, Azerbaijan economy*

1. INTRODUCTION

After collapse of the Soviet Union emerging independent republics switched from the way of planned economy into a free market economy road. The road required continual reforms of creating market economy elements and institutions from the old non-flexible system elements. In Azerbaijan within a short historical period in the result of the reforms, significant results were achieved in the fields of socio-economic development and integration into the world economic system. Joint exploitation of oil reserves with transnational companies involved foreign capital into the republic. High oil revenues had significant impact on large-scale investment in infrastructure along with rapid diversification of the economy. Oil and gas was central to Azerbaijan's economy. "During the oil price boom (2006-14) hydrocarbon (HC) activity accounted for three-quarters of GDP and government income, and 90 percent of exports." (IMF, p.4) However high dependence on the volatile oil sector adversely affected by price fluctuations. The downward trend of prices in 2014 had negative effects on Azerbaijan economy and banking sector. The Central Bank of Azerbaijan Republic for saving foreign currency reserves undertook a 25 percent first devaluation in February 2015 and a second 32 percent devaluation in December 2015, and choose a managed floating exchange rate regime.

The depreciation of manat against USD had decreased GDP in USD in overall and per capita terms. The same pattern is observed in GNI of Azerbaijan. The perspective of Azerbaijan rising to high end of the level of upper-middle income country (12055 USD) became more complicated.

Table 1: GDP and GNI of Azerbaijan ("Azerbaijan in figures 2018" p. 199; World Bank data)

	2013	2014	2015	2016	2017
<i>GDP mln. AZN</i>	58 182,0	59 014,1	54 380,0	60 425,2	70 135,1
<i>GDP mln. USD</i>	74 164,4	75 234,7	52 996,8	37 862,8	40 750,2
<i>Per capita AZN</i>	6 258,3	6 268,0	5 706,6	6 269,6	7 205,0
<i>Per capita USD</i>	7 977,4	7 990,8	5 561,5	3 928,6	4 186,3
<i>GNI per capita, Atlas method USD</i>	7450	7700	6550	4760	4080

The Central Bank of Azerbaijan through tightened monetary policy had addressed inflation and supported the currency. Though these adequate policies had helped to overcome the challenge, the lack of versatility in reforms for creating full set of financial infrastructure of market economy is a main hinder in the way for full utility of potential for the growth of the economy.

2. FINANCIAL INFRASTRUCTURE IS AN ATTRIBUTE OF MARKET ECONOMY

It is common knowledge that every country' sustainable development requires resting on long history proven basics-free entrepreneurship, banking industry, commodity and stock exchanges. A market economy for efficient functioning requires along with free entrepreneurship a financial mechanism stimulating optimal ratio of consumption and saving, and converting private savings into productive investments. Without such financial mechanism, the efforts to diversify economy and boost sustainable economic growth are half-measures resulting in development of low productivity sectors. The economic reforms must account for all sides of economic development, mobilize labor and finance resources. Private capital scarce emerging market countries need more market-oriented institutions for converting people' income into investment through saving.

2.1. Income and savings of the people

Table 2: Income, expenditure, savings of population (million AZN) ("Azerbaijan in figures 2018" p. 172; p. 259)

	2013	2014	2015	2016	2017
<i>Income of the population</i>	37 562,0	39 472,2	41 744,8	45 395,1	49 162,9
<i>Expenditures</i>	28 021,2	30 799,6	34 963,4	39 775,0	45 152,5
<i>Saving</i>	9 540,8	8 672,6	6 781,4	5 620,1	4 010,4
<i>Bank savings of population</i>	6 395,8	7 188,4	9 473,9	7 448,7	7 561,2
<i>of which</i>					
<i>in national currency</i>	3 888,3	4 422,4	1 420,2	1 517,3	2 532,9
<i>in per cent to total</i>	60,8	61,5	15,0	20,4	33,5
<i>in foreign currency</i>	2 507,5	2 766,0	8 053,7	5 931,4	5 028,3
<i>in per cent to total</i>	39,2	38,5	85,0	79,6	66,5
<i>Ratio of savings to previous year, per cent</i>	125,1	112,4	131,8	78,6	101,5

Table 2 shows that, despite the growth in household incomes, a stronger increase in expenditures had decreased savings. However, there is an increase in bank savings (increase-decrease-increase shape) and the amount of bank savings is more than savings. This contradictory situation explains that public confidence in the financial sector is not exhausted and the people converted savings at hand into the bank savings.

2.2. Road of savings to investments

In the situation described above, the main task is to convert these savings into productive investments and increase income from the investments and savings of people. For the implementation of this task, a financial infrastructure with incumbent financial intermediaries is a necessary attribute of the economy. Ross Levine and Sara Zervos empirically had found “a strong, positive link between financial development and economic growth and the results suggest that financial factors are an integral part of the growth process.” (Levine, Zervos, p. 558). The financial factors imply existence and activity of financial intermediaries. Therefore, development of ordinary institutions of market economy, as stock markets, mutual funds, pension funds, mortgage associations in Azerbaijan has great importance.

2.2.1. Market capitalization

In Azerbaijan, the share of market capitalization in GDP is low. There are no on a regular basis published statistical figures about Azerbaijan’ stock market capitalization. According to data of IndexMundi market capitalization of Azerbaijan in 1999 was 3.22 mln. USD. (IndexMundi). Azerbaijan’ market capitalization reflected as 1.973 mln. USD (as of 07/2017) by the National depository center of the Azerbaijan Republic on the “AECSD profile 2017” prepared by The Association of Eurasian Central Securities Depositories (AECSD Profile 2017, p.6). GDP of Azerbaijan in 1999 was 4.477,5 mln. USD, in 2017 28.564,8 mln. USD. Accordingly, market capitalization to GDP ratio was 0.07% in 1999 and 6.9% in 2017. Despite this advancement during 18 years in the market capitalization, the level of it is not sufficient for the required scale of development.

2.2.2. Development of stock market

In “Azerbaijan 2020: Look into the future” Concept of development provides for “systemic measures in order to limit the disorganized market of securities and increase the attractiveness of the market for investors, and the legislation that regulates the activities of the market’s professional participants and mechanisms of overseeing them” (p.14). There is great need for increasing the rate of market capitalization in the country’s economy and extended use of investment institutions activities directed at the financing of viable economic projects through the stock market. For a stock market development is needed a stock market index. It is a measurement of a section of the stock market and used to compare the return on investments. For creating investing institutions, this index is an important element. The complex stock market institution functioning is based on supply and demand. For the liquidity of a stock market, either side must be in sufficient volume. For determining of demand side level, must be created the organized market of securities. However, for the formation of constructive demand for investments tools creation of mutual funds, pension funds, and mortgage associations is a necessary step. These funds may attract free disposable money into financial circle and resolve multi-purpose targets. The economy will have choice to get money resources requiring effective use; the people will have current and future rewards as dividends, interests and growth in pensions. Development of financial institutions will contribute for restructuring of the economy into efficiently functioning mechanism and attract foreign direct and portfolio investments.

2.2.3. The role of banks

Monopoly position of the banks in the credit market eliminated competition and their contribution possibilities for economic development has exhausted itself.

Table 3: Provision with credit of economy (end of year, Million AZN) ("Azerbaijan in figures 2018" p. 259)

	2013	2014	2015	2016	2017
Total credit to economy	15 423,0	18 542,6	21 730,4	16 444,6	11 757,8
of which					
short-term	3 335,5	3 931,3	5 297,3	3 478,0	2 101,3
in per cent to total	21,6	21,2	24,4	21,1	17,9
long-term	12 087,5	14 611,3	16 433,1	12 966,6	9 656,5
in per cent to total	78,4	78,8	75,6	78,9	82,1

This explains the necessity of forming new for Azerbaijan but old for free market economy countries financial intermediary institutions for future sustainable development at a post-oil period of Azerbaijan.

2.2.4. Financial intermediaries

Historically emerged financial intermediaries are being perfected with the development of market economy and changing economic environment. However, Azerbaijan lacks long period of development for traditional market institutions. Therefore, the government has to play leading role in the creation and stimulation of these institutes by tax breaks and financial injection where they are necessary.

2.2.4.1. Pension funds

Life-cycle hypothesis, developed by Franco Modigliani and Richard Brumberg states that individuals seek to smooth consumption over the course of a lifetime – borrowing in times of low-income and saving during periods of high income. The population tend to save for future periods. The pension funds may be very attractive vehicle for savings. Azerbaijan implements pension system reform aimed at linking benefits almost entirely to individual retirement accounts. Retirement ages and contribution periods are gradually being increased. Annual pension fund deficits (some 3 percent of GDP) should gradually be eliminated. (IMF, p.14). Creation of private pension funds may render pensions before formal retirement age. Now in Azerbaijan about 1.3 million person receive pensions and annual amount of these payments is about 3.3 billion AZN. At least the private savings for pension age may be about the same amount. In 1917 share of the prime working age population (25 to 54 years old) and mature working age population (55 to 64 years old) were 45.6% and 10.6% accordingly. As a determinant of savings it is normal figure for the potential of saving growth. And financial incentives as tax breaks can stimulate savings of these people to the fund. Tax exemption of savings to the pension fund and future benefits may attract population' interest to savings. The economy will have free finance resource for investments. The Tax Code of Azerbaijan provides for "insurance premiums paid by employer to insurers of the Republic of Azerbaijan on accumulative life insurance and pension insurance under contract concluded for not less than 3 years, any amounts paid to the insured and beneficiary after 3 years term from the moment of entering the accumulative life insurance and pension insurance contract into effect shall not be subject to income tax" (The Tax Code article102.1.8). However, tax breaks for the pension funds activities must be clear-cut for attracting savings and investing. For preventing misuse of fund resources must be determined by legislation the management rewards as percentage of revenues from investments.

2.2.4.2. *Investment funds*

An open-end investment company-a mutual fund pools money together from a large number of investors and uses that money to buy stocks, bonds and other securities. The creation of mutual funds may attract the population' free financial resources and direct them into viable projects. For the beginning, the government may temporarily participate as a partner in mutual funds activities to supply a source capital. As far as the mutual fund will begin to operate self-dependent, the government takes away its share and the mutual fund becomes a private one. For the stimulation of creation and development of mutual funds the government may temporarily grant tax breaks for the profit of a fund and the dividends of investors. According to the Tax Code of Azerbaijan "the annual interest income paid on deposits of individuals by local banks and branches of foreign banks in Azerbaijan, as well as dividends on investment securities, discounting (difference caused by lower placement of bonds than its nominal value) and interest income paid by issuer - within 7 -year period beginning from 1 February 2016 shall not be subject to income tax"(The Tax Code article 102.1.22). However, the profit of investment funds need exemption from taxes during a certain period, too. The profits by the enterprises using the investment fund resources are being taxed for tax on profit and the investment funds receive dividends after profit tax. Therefore, the income taxed once may be exempted from second time tax.

3. CONCLUSIONS

The coordinated strategy to improve and consolidate the work of legislative and executive power in Azerbaijan in the direction of creation and development of market-oriented financial intermediary institutions may change Azerbaijan' oil-dominated economy into a developed market economy. The creation of discussed here financial mechanisms in a short period requires regulation and stimulation by strong tax and finance incentives. At first, must be created the demand side for the financial resources. This includes creation of organized stock market and a stock market index. The growth of listed companies will contribute to the market capitalization. The development of stock market will require and attract the free private capital. This private capital may be organized as pension funds and investment funds. For the formation of demand side for financial resources, the government may effect tax stimulation and financial participation:

- Temporarily exemption from profit tax the pension and investment funds revenues;
- Temporarily participation of the government as a partner in the activity of pension and investment funds;
- Legislatively determination of the managers rewards of funds as percentage of revenues.
- The pensions from the pension funds may be received earlier the retirement age.

At second, for stimulating of supply side for the financial resources the tax exemption may be of great importance:

- Allocations from wage and salaries into a pension fund may be exempted from income tax;
- Received pensions from a pension fund may be exempted from income tax.

Proof of this article' claims is the history of free market economy countries.

After creating full set of free market institutions in Azerbaijan next step will be assuring of their more efficient functioning.

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