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TITLE OF WORK PROJECT

Microfinance and the Socioeconomic Empowerment of Azerbaijan

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## Abstract

This paper delves into the complex socioeconomic problems that Azerbaijan faces and how microfinance could help the nation achieve its goals, particularly the financial inclusion challenges. In an authoritarian country with out-of-control corruption, a poorly diversified economy, and an underway war, microfinance stands as the most transparent and powerful tool to lead economic metamorphosis while improving the social welfare of the financially deprived, who live in the shadow of Baku's oil mansions. My internship experience and passion for double-bottom-line institutions led me to this field in which I aim to work in the future.

Keywords: Microfinance, poverty, socioeconomic, sustainability, banking, Azerbaijan.

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## **Introduction**

In the Azerbaijan Republic, official reports such as the “Azerbaijan 2030: National Priorities for Socio-Economic Development” outline primarily three goals to be achieved this decade: economic diversification, business opening, and economic inclusion.

In this paper, I present to the reader the concept of microfinance as the highest potential solution to enhance economic inclusion and help deprived individuals break out of the poverty chain, with a positive secondary effect on economic diversification and the business environment.

We will focus our analysis on its past relationship with Azeri people, how microfinance institutions, frequently referred to as MFIs, can complement (not compete with) the banking sector outreach, two success stories and the one most worth following, and why this ever-changing nation is a fertile ground for further microservices growth.

Considering that the microcredit literature has hardly gone beyond Southeast Asia, reports from the State associations are biased, and most organizations provided old reports or refused to share data, this was a challenging paper to write. However, I pursued this topic as a matter of respect for the Azeri people’s will to change, deeply believing that, as Jonathan Morduch stated, “Microfinance stands as one of the most promising and cost-effective tools against global poverty”.

## **The Azerbaijani Economic Landscape**

Azerbaijan, strategically located between Eastern Europe and Western Asia, has experienced significant economic transformations since gaining independence from the Union of Soviet Socialist Republic (USSR) in 1991, displaying the characteristics of an emerging market.

Between 2013 and 2022, oil production gradually slowed down, depressing the economy. In 2015, the national currency (Azerbaijani Manat – AZN) devalued 34% and 48% in February and December, respectively, eroding the public trust in the financial sector. Inflation within and out

of borders, lingering difficulties in the global value chain, and conflicts worldwide are recent undefeated complications.

Despite substantial efforts that include fiscal, monetary, and industrial policies, progress remains slow on structural reforms in support of long-term economic sustainability. Its unhealthy dependence on oil and gas output accounts for roughly 88% of export revenue and over 50% of the state budget, leaving people oscillating between poverty and extreme poverty just like in Venezuela and Nigeria. On top of that, the State must retain a 51% stake in companies operating in the mining, oil, gas, satellite communication, and military sectors. The fact that a small group of government-connected holding companies dominates the economy, intellectual property rights enforcement is improving but still insufficient, judicial transparency is lacking, and corruption rates are exorbitant does not amend its international image.

### **Monetary policy**

Against the backdrop of uncertainties triggered by the previously mentioned risks, the Central Bank of the Azerbaijan Republic (CBAR) prioritized macroeconomic stability above the rest, as it is stated in its Financial Stability Report of 2022. The inflation rate increased from 6.7% in December 2021 to 13.9% in December 2022. Its orientation towards easing this inflationary pressure was successful as the banking sector was in general resilient against exogenous shocks. The refinancing rate shifted from 7.25% to 8.25%. The interest rate corridor ceiling also suffered changes, going from 8.25% to 9.25%. The floor went from 6.25% to 4% in September but ended the year at 6.25%. Other measures included strengthening the pass-through of the refinancing rate, introducing new monetary policy tools, and improving the money market infrastructure.

### **Gross Domestic Product (GDP)**

As of 2022, Azerbaijan's Gross Domestic Product in nominal terms was worth 78.72 billion US dollars, which corresponds to 0.04% of the global economy, according to the World Bank

(Figure 1). The GDP per capita in the same period, also in current terms, was 5,571.73 dollars. Economic growth and increased government expenditure on social services resulted in higher income per capita, job creation, and lower poverty levels. After having a GDP of 54.83 billion in 2021, the nation expects to reach 80.14 billion US dollars by the end of 2023.

### **Energy sector**

The oil and gas industry has traditionally been the cornerstone of Azerbaijan's economy. In December 2022, (as per CEIC Data), Azerbaijan produced 558,356 barrels of oil per day (Figure 2) and 46.7 billion cubic meters of natural gas in the whole year (as per the Ministry of Energy). Oil exports, primarily through the Baku-Tbilisi-Ceyhan (BTC) pipeline and the South Caucasus Pipeline (SCP), have been instrumental in generating revenue.

### **Non-energy sectors**

Efforts to diversify the economy have finally gained momentum in recent years with growing agriculture, manufacturing, and services sectors (Figure 3). Agriculture contributes roughly 5% to the total GDP, with essential products like cotton, fruits, vegetables, and grains, manufacturing is centered on machinery, chemicals, and textiles, and services encompass tourism and finance with increasingly important roles.

### **Foreign Direct Investment (FDI)**

In accordance with Macrotrends for 2022, the total FDI in the country was -4.47 billion US dollars, with a focus on sectors such as energy, telecommunications, and infrastructure.

### **Trade**

In recent years, Azerbaijan has signed 51 Bilateral Investment Treaties (BIT), besides the free trade agreements (FTAs) with Russia, Ukraine, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Uzbekistan, Moldova, and Belarus, which allow importing free of customs duties. As specified

by Macrotrends, in 2022, exports of goods and services hit 47.27 billion dollars (Figure 4), an 85.48% increase from 2021, with oil and gas products accounting for a significant portion. The imports registered a 30.22% increase in one year, reaching 21.27 billion US dollars (Figure 5).

### **Infrastructure development**

Azerbaijan has invested heavily in infrastructure projects, including the construction of the Baku-Tbilisi-Kars railway, which facilitates trade with neighboring countries. The country's transport and logistics sector is well-developed and plays a pivotal role in regional connectivity.

### **Ethics of business**

Responsible business conduct (RBC) is a relatively new concept in Azerbaijan, as producers and consumers never prioritized it in the last years. Larger foreign entities tend to follow generally accepted RBC principles consistent with parent company guidelines and aim to educate their local partners.

### **The Three Pillars of Sustainable Socioeconomic Success**

According to my research, in official papers such as the “Sustainable Finance Roadmap (2023 – 2026)” and the “Azerbaijan 2030: National Priorities for Socio-Economic Development”, Azerbaijan has essentially defined three pillars considered crucial to change its social and economic paradigm. Unfortunately, the government has taken a very passive approach considering the urgent difficulties of the nation, so the majority of initiatives are recent and without results yet. One must analyze the underlying problems and the ways to attack them, according to the State and specialists. Microfinance, the centerpiece of this paper, would directly affect the financial inclusion pillar, having an indirect effect on the other two.

### **Promoting economic diversification**

The definite solution to the lack of diversification problem is on the Federal State’s podium of

priorities. Vulnerability to external shocks, insufficient development of the non-oil sector, and concentration of wealth and opportunities are other problems associated.

The solutions include continuing to invest energy profits in the non-energy area, approval of green economy initiatives that include eco-friendly practices in other areas, and the recent private-public partnerships to encourage research and development (R&D).

### **Improving the business environment**

Azerbaijan is not the first destination on an investor's mind. Corruption, weak legal framework, and complex regulation have been repelling foreign capital holders from the region for years.

According to experts in the area, promising solutions include updating the regulatory framework following developed nations, enhancing administrative services such as the Azerbaijani Service and Assessment Network (ASAN), and aligning corporate governance to best practices.

### **Stimulating financial inclusion**

Banks are unable to serve a considerable part of the Azeri population. Associated problems include reduced economic growth, barriers to health and education, and social exclusion.

The solutions include continuing to carry out programs like the National Financial Literacy Strategy (NFLS) and the summer school "Learn, Save and Earn", developed by the CBAR, investing in physical and digital infrastructure development, and assisting microfinance players (with grants and reforms) to fill the socioeconomic gaps that banks undervalue.

### **Financial Inclusion**

Despite past notable strides, Azerbaijan is behind the average level of financial inclusion compared to upper-middle-income economies, and many challenges remain ahead (Figure 6).

In 2022, as specified by Global Findex Database, only 46% of Azerbaijani adults (age 15+) had

an account in a financial institution (a bank, an MFI, or an e-money agent). For comparison purposes, it is less than half of the percentage for United States citizens – 94%.

Additionally, on a planetary level, 74% of women and 78% of men have a financial account, while in Azerbaijan only 39% of women and 55% of men possess one, reflecting the wide gender gap as the backdrop to the diminished participation of women in economic activity.

Also regarding 2022, only 19% of the adult Azeri population saved any part of its income and 13% came up with a financial emergency fund, while in Europe and Central Asia (ECA), these figures ascended to 33% and 26%, respectively. The population has one of the highest levels of reliance on family and friends in case of financial distress, increasing exposure to vulnerability.

Lastly, the substandard digitalization is reflected in the limited 43% of Azerbaijani adults who made or received digital payments, contrasting with 74% in Europe and Central Asia.

Among the many challenges obstructing further progress, four of them are worth underlining.

### **Reduced number of financial players**

According to the Financial Markets Supervision Authority, 506 bank branches operated in Azerbaijan as of December 2017, 63 less than in 2016. This prevents the blossoming of Azeri MSMEs (micro, small, and medium enterprises), especially in mountainous and isolated regions.

### **High interest rates on credits**

As specified by a Qabus Research & Consulting Company survey, 87.4% of entrepreneurs claim it is not a favorable business environment when interest hits 15% (a conventional rate for Azeri banks), while this percentage is already far from what MSME entrepreneurs can afford.

### **Low financial awareness**

The absence of financial literacy (concerning management, procedures, and instruments) where

banks have complicated loan application procedures and high financing costs is lethal for MSMEs. Education is marvelously powerful in long-term saving and investment opportunities.

### **Lost client assurance**

In line with the Global Findex Database, of the total adult population in Europe and Central Asia without a bank account, one-third mentioned doubt and concern (due to poorly performed services and role in past crises) as reasons, higher than the developing country average of 23%.

### **The Azeri Banking Sector**

The formal financial sector is dominated by banks, which constitute 95% of the total assets of the Azeri financial system, while non-bank credit institutions and insurance companies (still in their infancy) share the remaining 5%. There are 25 banks in the country, 11 of them with foreign capital, two are state-owned and one is a foreign bank local branch. The CBAR describes the non-banking sector (which includes microfinance) as underdeveloped but essential to micro, small, and medium-sized enterprises.

Banks, as the leaders of the financial system, should be prepared to solve most of the socioeconomic problems of the nation, but they may be even worsening some.

After the sizeable devaluation of the national currency, banks changed their lending policy, boosting the number of loans issued in dollars (only now decreasing) and refusing to give loans in the national currency, reducing the number of citizens who went to banks.

Nowadays, most Azerbaijani banking organizations offer costly lending terms, usually between 10% and 15%, in US dollars, with a maximum two-year term. Following the WBG Financial Capability Survey, approximately half of the population does not borrow money, and among those who do, informal credit is the preferred mechanism. Due to high inflation rates and the ongoing economic uncertainty, banks do not see benefits in providing long-term or grace period

loans, which are vital for new businesses (particularly those with seasonal cash flows, like agricultural ones). Furthermore, the exclusive supply of financial products to privileged individuals shows their unawareness of social costs, such as the disutility from economic imbalance (Janda & Turbat, 2013).

According to the Economist Intelligence Unit (EIU), the banking sector is uncompetitive, fragmented, poorly developed, and suffers from poor corporate governance. Lending is low as a share of GDP (banks only play an intermediation role), excessively focused on the capital city (Figure 8), and directed toward established medium and large enterprises, besides being highly influenced by the State and the society elite. Although the role of banks in the economic system is beyond doubt, their attributes cannot bring the country closer to its social and economic goals.

### **Traditional Finance for the Poor**

Before getting into detail about microfinance, one should be aware of the major options that impoverished households, rejected by the banks, rely on to improve their economic situation.

#### **Commercial money lenders**

This type of lending provides small loans with flexible terms (more relaxed application and eligibility criteria), but usually operate by charging excessively high interest rates and offer mostly short-term credit (not appropriate to create lasting change).

#### **Cooperative banks**

The second alternative consists of retail banking aiming to serve the poor. Even though they are typically rooted in local communities and have a deep understanding of their needs, they struggle to achieve economies of scale.

#### **Non-Governmental Organizations (NGOs)**

This notorious option is also considered a major resource, as they support underprivileged people

through subsidized loans, but this method has little outreach and growth capabilities, leaving most people behind.

### **Rotating Services and Credit Associations (ROSCAs)**

Lastly, ROSCAs, designed to help members save money and access credit, have an informal and unregulated environment that leads to high rates of fraud and default, disputes within the group, and limited scalability.

### **Traditional alternatives in Azerbaijan**

The commercial money lenders in Azerbaijan charge unreasonable rates, cooperative banks and Rotating Services and Credit Associations have an imperceptible presence, and Non-Governmental Organizations, even though available in the region (such as the Azerbaijan Women's Association for Rational Development - AWARD), do not have a sustainable and scalable plan of action. Therefore, microfinance emerges as a sizeable, sustainable, and efficient solution to provide financial services to those left out of the banking system.

### **The Microfinance Concept**

Microfinance refers to the provision of financial services, such as loans, savings, insurance, and other basic banking products to financially underprivileged individuals, usually excluded from the traditional banking system due to low income, lack of collateral, or insubstantial credit history. These services are provided by microfinance institutions, which tailor their approach according to the specific needs of the communities they are inserted in, allowing them to improve their quality of life. The loans are used to finance various income-generating activities, such as farming, handicrafts, trade, and services. Additionally, repayment terms are more flexible than those offered by traditional banks, and loans are usually provided to groups of borrowers who support and guarantee each other's repayment, strengthening social ties and fostering a sense of community and cohesion.

It all started with Muhammad Yunus, a Bangladeshi Economics professor who made small loans to local villagers in the 1970s. With the foundation of Grameen Bank in Bangladesh, Yunus officially institutionalized the approach of microfinance in 1976. While his vision and mission aimed at changing the way commercial banks operate, the main goal was always to improve the social welfare of the underprivileged class.

The microfinance evolution is remarkable. The humble idea of solely providing loans turned its attention to collecting savings from financially disadvantaged people (microsavings), providing insurance (microinsurance), facilitating money transfers, and even marketing and distributing clients' output. The diversification with microsavings and microinsurance is especially relevant, as the first one helps individuals build financial resilience and prepare for their future, while the second reduces vulnerability by providing a monetary safety net.

As with any other initiative, microfinance is associated with some challenges and criticisms, namely the high interest rates charged by some MFIs, their over-indebtedness, and concerns about excessive commercialization. That is why it is vital to analyze the past and learn from the mistakes committed, putting into practice responsible practices that truly benefit the poor.

In 2006, Mohammad Yunus was awarded the Nobel Peace Prize, further drawing attention to microfinance and its social welfare impact, such as poverty reduction, job creation, gender empowerment, economic growth, and social inclusion. International awards and recognition such as the Microfinance Excellence Awards and global partnerships with organizations like the World Bank have legitimized the sector in recent years. Microfinance has succeeded in delivering small loans to millions of people in emerging economies worldwide, especially in Latin America and South Asia, changing the paradigm for the better.

### **Microfinance Worldwide in Figures**

The global microfinance sector has shown signs of improved growth in 2021 compared to the

slowdown in 2020 due to the COVID-19 pandemic, as the Impact Finance Barometer 2022 shows. The Gross Loan Portfolio (GLP) at the level of MFIs went from 2% in 2020 to almost six times higher (11.8%) in the subsequent year (Figure 10). It was still below the year-on-year growth rates registered from 2017 to 2019, which ranged between 12.4% and 16.3%, but above the 3% rate of global inflation at the time. In end-2021, the top 100 MFIs managed about 69.4% of the total GLP of 187.3 billion USD.

In 2021, 156.1 million borrowers benefited from the services of microfinance organizations, an increase of 5% from 2020 and a whopping 59.3% growth when compared to the 98 million users in 2009. It is worth mentioning that of these 156.1 million customers, 53% are women and the vast majority reside in rural areas.

Portfolio quality in 2021 improved when compared to 2020. The median portfolio at risk over 30 days (PAR 30) dropped from 6.3% to 4.1%. At the MFI level, the average growth in PAR 30 reached its highest point at 33% in 2020, yet fell to -14% in the following year, reflecting the nosedive of credit risk on a planetary scale.

Besides, the sector's profitability has been improving steadily but remains below pre-pandemic levels. Portfolio yield became slightly better, evolving from 17.2% to 18.2%. The cost of risk has remained stable throughout this period, with the median provision expense ratio ranging between 1.5% to 1.7%.

The Asian microfinance market is the largest in terms of the number of people served, followed by the Latin American market, the bulkiest regarding outstanding loans. The emphasis is placed on the importance of promoting female empowerment, as data shows women have higher repayment rates and amplify more competently the social impact of credit for their families.

The South and Southeast Asia region is the leader with the top three markets in terms of borrowers – India, Bangladesh, and Vietnam. It served 72.5% of all borrowers in 2021, its GLP

market share went from 43.1% to 49.8% and the PAR 30 was stable at 3.7% by the end of 2021.

The Europe and Central Asia region, where Azerbaijan is located, accounted for 4.9% of the GLP's global market share and 2.4% of the number of borrowers served. One interesting indicator to highlight is its median portfolio at risk over 30 days of 2.4%, the lowest worldwide.

### **The Azerbaijani Microfinance Ecosystem**

Microfinance emerged in Azerbaijan in the post-Nagorno-Karabakh inter-ethnic war period of the 1990s when there were suddenly 1 million refugees within the country with no employment or assets. Thus, emerging microfinance institutions put forward their social mission to help these people, whom commercial banks did not consider their target clients, turn their lives around.

However, the country experienced two substantial and unanticipated currency devaluations in 2015 so the Central Bank introduced a 21% interest rate cap for loans, a serious challenge for MFIs who had scarce access to lower-cost funding. It led to a slowdown of the market's steady growth, a decrease in the number of organizations, and weaker financial inclusion.

Nevertheless, Azeri MFIs came back stronger, matured, and grown in capacity, today among the most active financial institutions contributing to the nation's socioeconomic development. The products initially offered were mainly micro, small, and medium loans for business and agriculture activities. However, MFIs started to diversify their products and services (Figure 11), including loans for housing, travel, education, and medical purposes, as well as to upgrade the banks' *modus operandi* by designing different loan terms and conditions, offering grace periods and flexible payment dates, and providing express loans, increasing flexibility in an inelastic sector.

### **Regulatory framework for microfinance**

Legislation relevant to microfinance in Azerbaijan includes the Law of the Azerbaijan Republic

about the National Bank and the Law on Banks. MFIs are supervised by the National Central Bank after they apply for a non-bank financial institution license and their registration as legal entities is administered by the Ministry of Justice. In Azerbaijan, there are no minimum capital requirements for forming Non-Bank Credit Organizations (NBCO).

### **The role of the Azerbaijan Microfinance Association**

The Azerbaijan Microfinance Association (AMFA) was established in 2001 to be the voice of the sector, defending the interests of local MFIs, strengthening their capacity, supporting their needs, and providing assistance in non-financial services (such as financial education and entrepreneurship development training).

Its members have operated on a commercial basis without humanitarian or social donor funding since 2006 while keeping their commitment to social goals. Their diversified portfolio reflects different purpose loans, insurance, assisting clients' development, as well as launching new banking technology (that reduces costs and improves service delivery), such as charge cards, ATMs, and cell phones.

### **Outreach and scale**

Although Azerbaijani MFIs are still young, as of September 2007 these institutions had a total outstanding portfolio exceeding 316 million USD with 223,000 active borrowers, as indicated by AMFA on the 2006 Benchmarking Microfinance report. FINCA and Accessbank have been the leaders, accounting together for roughly 46% of the market.

In the last decade, many MFIs expanded upwards instead of outwards, meaning that loan balances are increasing faster than outreach. They also magnify outreach slower than their Central Asian peers but dilate balances faster. Hence, the focus is on increased efficiency of operations and productivity and expansion of scale to even more rural areas.

The total Azeri MFI Gross Loan Portfolio (GLP) increased by 33% in 2006, largely as a result of newly attracted funding. The total amount of external funding stood at 75 million USD at end-2006, against a total loan portfolio of over 90 million.

Azerbaijani MFIs grew increasingly leveraged in 2006, as commercial and non-commercial investment levels increased. The climb in the median debt-to-equity ratio from 0.4 to 1.6 reflected the trust that international donors and investors have in the nation's microfinance sector (Figure 12). At the end of 2006, Azerbaijani MFIs had 73 million dollars in debt, with over 95% of funds from foreign sources including funds, development institutions, and NGOs. The rest was mainly from the government, focusing on support for Internally Displaced Persons (IDPs).

In 2006, operational and financial self-sufficiency levels improved by 14.7% and 4.4% respectively, while Return on Equity (ROE) and Return on Assets (ROA) grew by 152% and 50%, pinpointing the players' ability to carry on their operations as stable credit providers.

Operating expenses decreased 14% due to a depletion in administrative expenses, while the limited decrease in personnel expenses shows the increased attraction of qualified experts to this market. Loan officer productivity improved by an outstanding 49%.

Azerbaijan MFIs have lower nominal yields than their Caucasus and ECA median peers, demonstrating the competitive environment that forces organizations to price lower.

According to the World Bank, microfinance has not reached its full potential yet: "The non-bank credit sector is underdeveloped and offers limited opportunities for Azerbaijani SMEs". The combined microfinance loan portfolio is still only about 1% of GDP, but the problem is on the supply side, not on the demand.

Jala Hajiyeva, AMFA's executive director, has also stated that the economy is growing again and so is the microfinance sector, and the gradual expansion of the sector will have a positive impact on the quality of their loan portfolios.

Nevertheless, it is hard to demonstrate the Azeri MFIs' economic impact since most reports are old and unreliable and organizations do not invest in data collection and impact assessments.

### **Advantages of MFIs**

As we saw before, the banking system targets educated, employed, and asset-holding people, while microfinance's mission is to serve the “unbankable”, who need a helping hand to set progress in motion. Even though this ex-USSR Republic is dominated by banks, its characteristics, socioeconomic problems, and goals ask for MFIs and their advantages.

#### **Higher quality monitoring**

MF loans have very short maturities and this gives the lender monitoring power to check repayments and avoid new loans in case of delinquency.

#### **Fewer costs**

MFIs present smaller transaction fees and debt screening costs, particularly in group lending programs, where weekly meetings with the borrowers increase transparency within the group and foster internal monitoring (Deutsche Bank, 2007).

#### **Exploration of the unexplored**

Studies show that banks prefer to serve the Baku region and do not allocate financial resources to other regions, so secondary Azeri provinces represent an uncaptured market share.

#### **Innovative instruments**

Unorthodox strategies and instruments like public repayment have led to unthinkable results that banks are missing out on, putting the old-school approach to credit out of context.

#### **Personalized client approach**

MFIs' loan officers have a relatable poverty background and choose to go directly to the

customer's house, who would otherwise never leave their homes. This personal approach has proven to reduce information asymmetry and force compliance (Roodman & Qureshi, 2006).

### **Special attention to women**

MFIs choose to discriminate positively to increase gender equality, having products, services, and initiatives specially designed for women, the financially vulnerable gender.

### **Prioritization of the social mission**

Banks minimize costs as much as possible, while MFIs are more proactive in offering non-financial services such as enterprise development or business skills training to consumers. One example is AMFA's "Building women professionals and promoting women entrepreneurship development in rural regions of Azerbaijan", supported by the European Union.

### **Removal of the collateral obligation**

Banks prefer real estate as collateral, but approximately 60% of entrepreneurs conduct their businesses on leased premises. Microfinance, conversely, increases reimbursements without using "physical" collateral (Cassano et al. (2013) consider collateral more of a dedication proof than a security), making them much more attractive for MSME entrepreneurs.

### **Two Different Perspectives on Microfinance**

The 1990s were marked by a debate between two leading views on how to address microfinance: the poverty lending and the financial systems approach. Both perspectives aim at making finance available to the poor throughout the planet but differ on the way to get there.

The first one focuses on reducing poverty through credit and other services provided by institutions that are funded by donor and government subsidies and other funds. Apart from the mandatory savings indispensable as a condition to acquire a loan, savings are not usually a significant part of the poverty lending approach in this field. Many of these organizations provide

low-priced microcredit, yet not sustainable, firstly because their interest rates on loans are too low for full cost recovery (Robinson, 2001).

On the other hand, the financial systems approach emphasizes self-sufficiency, defending that an MFI, just like an enterprise, should be designed and managed as a means to cover all of its operating costs and generate a profit margin without subsidies or unaffordable lending rates while rewarding savings with a sufficiently high interest rate (Schmidt, 2018). Their loan portfolios are financed by savings, commercial debt, and investment in varying combinations (Robinson, 2001). Advocates of the commercial approach defend that this can be done without neglecting the social aspirations that define these enterprises.

It is appropriate to say that microfinance started with the poverty lending approach. However, MFIs concluded that controlled commercialization could bring several advantages, such as a larger level of investment (namely from ESG investors) and sustainability to plan for the long term. Nowadays, the poverty lending approach is still present in many countries, particularly in those whose economies and regulatory environments are very fragile and the majority of the population lives in precarious conditions, such as Bangladesh.

Conversely, we see the commercial approach growing steadily in Southeast Asian countries like Thailand, where microfinance allies the financial system privileges with its social mission.

Microfinance in Azerbaijan has been primarily commercial in nature, with many MFIs operating as dual-bottom entities, charging interest rates that cover their operational costs and generate unexceptional profits. The shift towards commercialization was influenced by factors such as the fast development of Azerbaijan's financial sector, its bank-centered financial infrastructure, and the desire for financial sustainability.

### **Two Contrasting Success Stories**

The Republic of Azerbaijan should examine two success stories (one from each perspective) that

serve as role models to guide the nation in the exploration of this powerful field.

The best-known example of adopting the poverty lending approach is the well-known Bangladesh's Grameen Bank (GB), which has changed conventional banking practices by removing the need for collateral assets. Professor Yunus reasoned that if financial resources can be made available to poor households on reasonable terms, "these millions of small people with their millions of small pursuits can add up to create the biggest development wonder".

As of end-2023, it had 10.38 million borrowers, 97% of whom were women, and with its 2,568 branches, GB provides services in more than 94% of the total Bangladeshi villages, being an inspiration for microcredit institutions in over 100 countries. Its loans are interest-free so that beggars do not beg ever again, as happened already with 21,383 members.

To Jonathan Morduch, its most impressive achievement is having a 98% repayment rate without requiring collateral. However, Grameen is not genuinely profitable like Bolivia's BancoSol or Bank Rakyat Indonesia, and its clients are poorer, face more risk, and borrow smaller amounts (Morduch, 1999). In addition, from Robinson's perspective, subsidized programs are constrained by their budgets and thus have little outreach, end up financing local elites at below-market rates, and dull the incentive for innovative new technologies, with counterproductive long-term repercussions for the poor. This inefficiency is many times reflected in the absence of savings and payment services, essential to participate in the modern market economy.

Even though this approach's tools are poorly suited for building microfinance on a global scale, its commitment to eradicating poverty and contributions to the microcredit methodologies are nothing less than admirable and show the Azeri State what a social enterprise really is.

Regarding the financial approach, the Bank Rakyat Indonesia (BRI) is a suitable example as this state-owned bank is the largest self-sufficient supplier of microfinance in emerging nations.

BRI microfinance division has been profitable since 1986 and independent of subsidy since

1987. In 1999, it had 802 million USD in 2.5 million outstanding loans, 2.3 billion USD in 24.1 million savings accounts, and a long-term repayment rate of 98%. In 1983, the country saw a serious financial deregulation happening, which put an end to credit ceilings. As a result, BRI's unit desa system changed from a channeling intermediary for subsidized government loans to a profitable and sustainable commercial organization (Robinson, 2001).

14 years later, an economic crisis affected East Asia, but BRI carried on with its wide outreach, elevated repayment rate, and profitability. Deposits in the unit desas went from 7.7 trillion rupiahs in June 1997 (the month before the crises began) to 17.1 trillion rupiahs at end-1999, and the number of savings accounts rose from 17 million to 24.2 million.

The World Bank defends its success derived from simple loan designing, interest at market rate, staff training, performance incentives, and savings instruments provision. Indonesian MFIs helped the country reduce poverty, from 40% of the population in the 1970s to 11% in 1996, constituting an example of socioeconomic change drivers to the Azeri State.

Comparing the two microfinance giants for 1995 (Figure 15), we can make some important remarks. Both began their activity in the 1980s and have a comparable number of borrowers (2.3 million for BRI's unit desas and 2.1 million for Grameen). The value of outstanding loans was 1.4 billion USD at BRI and 289 million USD at Grameen, while savings reached 2.6 billion at BRI (obtained voluntarily) and 133 million dollars for GB (mandatory for loans). BRI's unit desas also had a 6.5% return on assets before taxes, contrasting with the 0.14% of Grameen Bank.

### **Instruments for Organizational Success**

Experience shows that a borrower's repayment willingness depends essentially on two aspects (Schmidt & Tschach, 2001). The first is the borrower's relationship with the loan officer, since his performance may be unsatisfactory if he does not have the right incentives, leading to higher

default rates. The second factor is the borrower's likelihood of receiving a future loan. This aspect strongly depends on the business model sustainability of the MFI and thus the probability of continuing to exist in the long run. Concerning the instruments, some can mitigate governance problems like adverse selection, moral hazard, and strategic default.

### **Loan size increase**

Gradually increasing loan sizes as customers demonstrate their ability to borrow and repay is proven to reduce default rates. The client interprets this incentive as a vote of confidence and tries to act responsibly, hence improving the chances of repayment.

### **More frequent repayments**

Increasing the frequency of payments is also of use, once it imposes financial discipline on the borrower. For lenders, this translates into a steady and predictable cash flow, that helps to cover operational costs, reduces the need for external financing, and simplifies delinquency detection.

### **Joint-liability system**

The joint-liability system should also be invoked. It consists of forming a group of borrowers whose permission to borrow depends on each and every element. Morduch affirms that this strategy enables peer monitoring and segregation of risky borrowers.

Other innovative techniques include public repayment (increasing social pressure and stigma threat), forced savings (keeping a fraction of the credit as a deposit), notional collateral (increasing leverage), and women targeting (who opt for more conservative investments).

### **Strategies adopted in Azerbaijan**

Regarding MFIs in the Azerbaijani Republic, a number of these strategies are used but the most adopted are credit scoring, Government support, and financial literacy training.

Credit scoring is similar in definition to the standard banking one, although with different criteria and assessment methods, such as personal references of other community members.

Government support in the context of Azeri microfinance encourages providers to extend credit to riskier populations. It involves establishing funding programs that give guarantees to MFIs that cover a percentage of the outstanding loan in case of default.

Lastly, MFIs, often in partnership with the public sector, offer financial education programs to improve their financial management skills and ensure a better understanding of loan terms and responsibilities. Many of these projects are directed at women and rural inhabitants.

### **The Potential Success of Microfinance in Azerbaijan**

Microfinance has proven to be an efficient poverty-alleviating approach in developing countries and this post-Soviet state has one of the youngest and most rapidly growing microcredit sectors worldwide, but what makes it the perfect environment for further development?

#### **Unmet financial needs**

The socioeconomic costs of transitioning from communism to capitalism were severe. With the drop of more than 40% in the GDP came acute poverty levels and an alarming income gap. Its underprivileged and isolated people are the demographic characteristics of MFIs' target clientele, which historically have and will continue to fill an important void in this economy.

#### **Economic diversification**

Microfinance supports a range of economic activities that differ from those financed by traditional bank credit. Thus, microcredit can contribute to the State's diversification goals.

#### **International support**

In recent years, multiple international organizations provided support and funding to the Azeri

microfinance area, such as the U.S. Agency for International Development (USAID), the United Nations Development Program (UNDP), and the World Bank. The International Finance Corporation has inclusively invested in the paramount MFI AccessBank, while in 2020 it was signed a Memorandum of Understanding with the Italian National Microcredit Agency.

### **Transparency paragon**

The Azeri microfinance industry remains the single beacon of honesty and goodwill in a nation where corruption is deeply ingrained. Bribing is at times needed for obtaining banking capital but MFIs are genuinely motivated by national pride and concern for their citizens.

### **Economic resilience**

Although the country has had its fair share of economic crises, its microfinance sector always recovered faster than others across Central Asia, which shows growing structure and credibility.

### **Current armed conflict**

The Nagorno-Karabakh dispute with Armenia will likely lead to an increase in the number of refugees in the years to come. Once again, these internally displaced persons will be denied by the traditional banks and MFIs will help them gain footing in the emerging market economy.

### **Recommendations for Future Enhancement**

From all my research, I was able to pinpoint some aspects that could project the Azeri microfinance market to new heights.

### **Sustainable scalability focus**

It is crucial to develop strategies to ensure the long-term sustainability of the market, with a focus on how to increase outreach without jeopardizing the portfolio's quality. Sustainability can be further supported with more green policies and processes.

## **Social Impact Assessment**

Microfinance players and national organizations do not make reports on the current status of the market. Besides, it is almost impossible to find recent and unbiased data and opinions. Reporting on the impact of the programs considering factors such as gender equality and community development is a must to achieve social goals.

## **Government funds**

The Sovereign State could provide grants (in the form of capital and equipment), particularly to businesses led by women, operating in remote locations or diversifying the economy.

## **Policy advocacy**

The Government should collaborate with enterprises when formulating new policies. This is the best way to address challenges and promote support at the organizational or national level.

## **Tax reform**

Structural reforms namely new regulatory requirements on responsible lending and managing foreign capital and currency loans are now being implemented in the banking sector. However, tax-level reforms are perhaps more urgent as MFIs are subject to a similar tax policy as for-profit enterprises and have a profit taxation of 22% (above the local VAT rate) which impedes growth.

## **Strategic Innovation**

Continuing to invest in unconventional strategies and instruments is crucial to maximizing outreach while preserving quality and ensuring sustainability. The development of new products designed for specific needs is of extreme importance in reaching excluded groups.

## **Technology Integration**

According to Moro Visconti (2015), IT applications disrupt and re-engineer business models

and their impact on microfinance is astonishing but underexploited. MFIs should make use of this field to ameliorate services such as mobile banking and online financial management tools. Additionally, training concerning the use of technology could be provided to the customer.

## **Conclusion**

In closing, the study delved into the social and economic variables that Microfinance can affect positively in Azerbaijan, namely financial inclusion, business diversification, poverty alleviation, and entrepreneurial development, with several dissimilar nations serving as proof.

By collecting data from national agencies, such as the National Central Bank and AMFA, as well as international ones, including the OECD and Convergences, we found out that it is more than a suitable solution given the specific Azeri dynamics.

We analyzed qualitatively and quantitatively the complex socioeconomic landscape of this South Caucasus Republic while alerting for its difficulties, and how its past spotlight on the traditional banking system cannot bring it closer to achieving the goals set for this decade.

Microfinance and its innovative *modus operandi*, on the other hand, have proven to be a catalytic force in unlocking the potential of the economically marginalized and contributing to other success cornerstones.

That is the rationale behind the examination of the two perspectives: one followed by Grameen Bank, a pioneering selfless organization that puts its clients' needs before everything else, and Bank Rakyat, a microbank that helped socially and economically its customers and country during their darkest years, making it a true dual-bottom organization.

Policymakers and institutions must collaborate to ensure a better future for all, not just the few. In essence, the journey towards socioeconomic empowerment through microfinance in Azerbaijan is full of obstacles, but it is in the hands of people who care.

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## Appendix

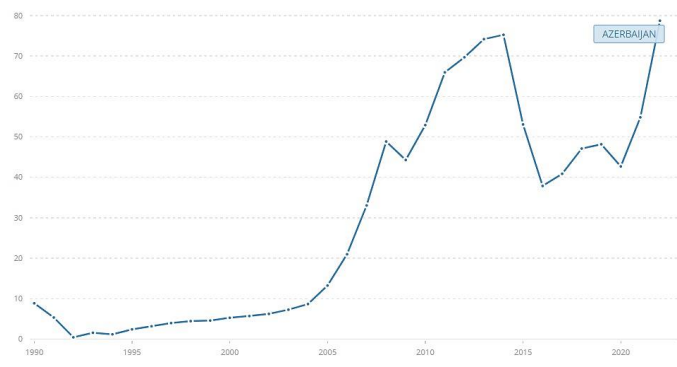


Figure 1 – Evolution of Azerbaijan GDP (1990 – 2022)  
Source: World Bank

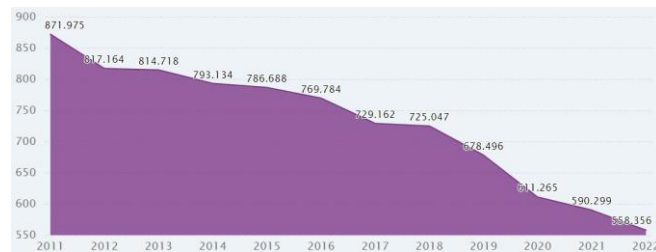


Figure 2 – Crude oil production (2011 – 2022)  
Source: CEIC Data

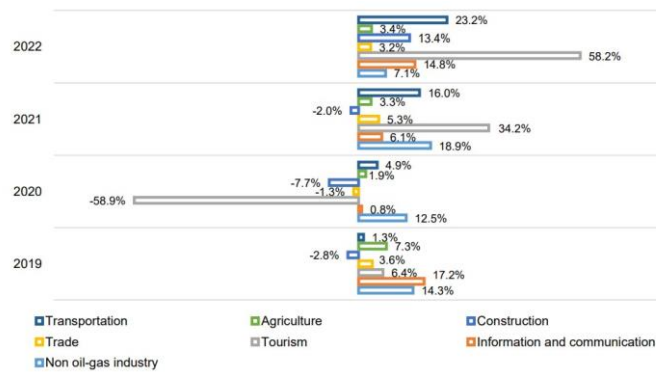


Figure 3 – Non-oil economic growth  
Source: Central Bank of Azerbaijan

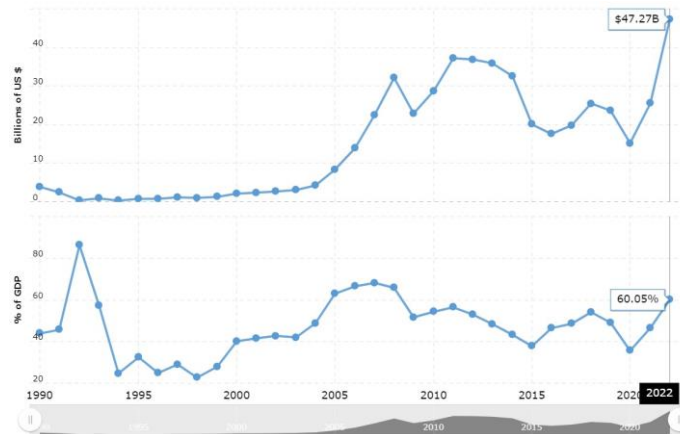


Figure 4 – Exports in billions of dollars and as a % of GDP (1990 – 2022)  
Source: *Macrotrends*

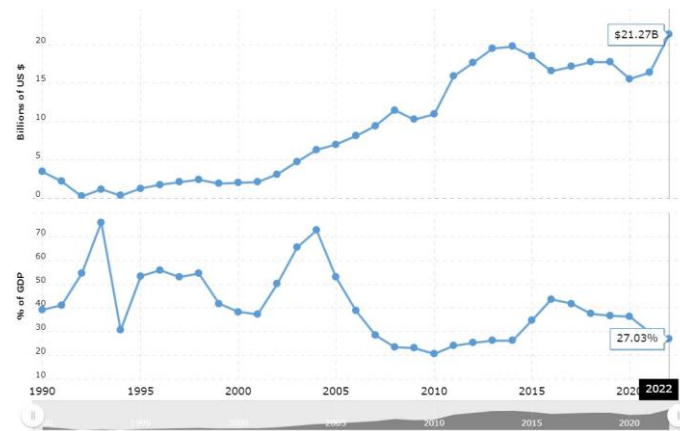


Figure 5 – Imports in billions of dollars and as a % of GDP (1990 – 2022)  
Source: *Macrotrends*



Figure 6 – Use of Financial Services  
Source: *FinDev Gateway*



Figure 7 – Lending and Deposit portfolios  
Source: Central Bank of Azerbaijan

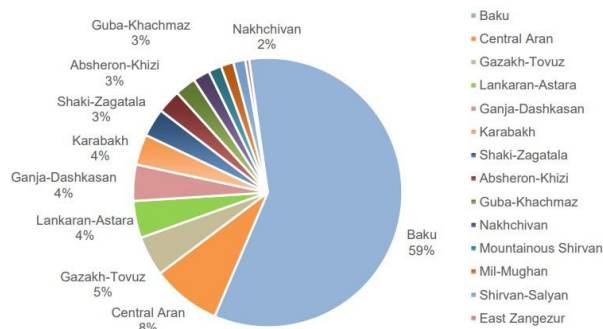


Figure 8 – Bank loans geographical distribution  
Source: Central Bank of Azerbaijan

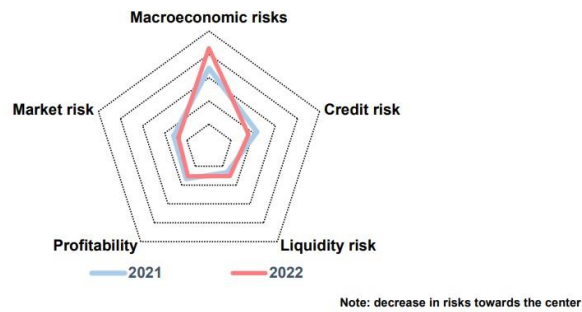


Figure 9 – Risk mapping of the banking sector  
Source: Central Bank of Azerbaijan



Figure 10 – Gross Loan Portfolio and number of female borrowers  
Source: Impact Finance Barometer 2022

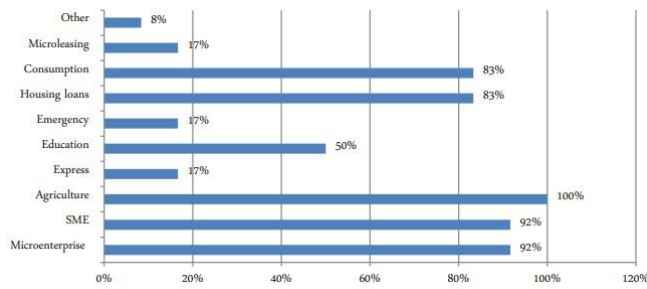


Figure 11 – Loans on offer in Azerbaijan, percentage of reporting institutions  
Source: *Azerbaijan Microfinance Association*

Lender Type	Foreign			Local		
	Outstanding Amt.	Term (months)	Interest Rate	Outstanding Amt.	Term (months)	Interest Rate
Commercial Bank				320,010	12.00	14.78%
DFI	23,419,051	61.77	8.89%			
Fund	39,966,553	41.82	9.31%	219,753	24.02	11.02%
Government				1,339,469	55.23	10.89%
NGO/Foundation	8,233,146	32.16	8.86%	130,702	4.00	14.19%
Grand Total	71,620,750	48.41	9.12%	2,009,935	40.42	12.66%

Figure 12 – Characteristics of External Debt for Azeri MFIs  
Source: *MicroBanking Bulletin 2006*

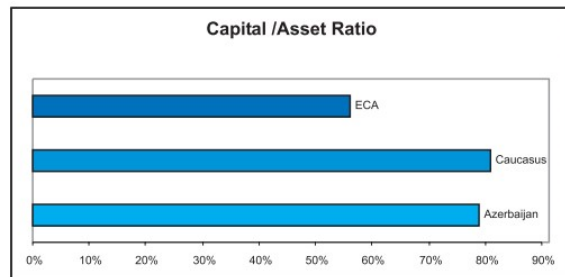


Figure 13 – Capital-to-Assets Ratio  
Source: *Azerbaijan Benchmarking Report 2004*

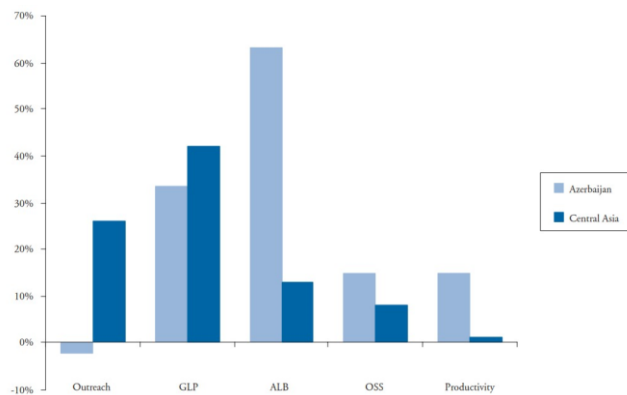


Figure 14 – year-to-year changes in median indicators  
Source: *MicroBanking Bulletin 2006*

Indicator	BRI's unit desas	Grameen Bank
Number of branches	3 512	1 056
Real effective interest rate for loans (%)	15.6 – 22	13.4
Average loan balance as a share of GNP per capita (%)	61	58
Number of outstanding loans (millions)	2.3	2.1
Value of outstanding loans (millions of USD)	1 383	289
Value of savings (millions of USD)	2 606	133.3
Number of savings accounts (millions)	14.5	2.1
Average savings account (USD)	180	65
Return on Assets (%)	6.5	0.14

Figure 15 – BRI's unit desas and Grameen Bank compared for 1995

Source: *Microfinance Revolution*