



ADB Working Paper Series

**PROBLEMS AND OPPORTUNITIES FOR
LEVERAGING SME FINANCE THROUGH
VALUE CHAINS IN AZERBAIJAN**

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Abstract

The paper outlines the contribution of small and medium-sized enterprises (SMEs) to Azerbaijan's economy, their access to finance, and the role of value chains in ensuring financing. The paper preparation process has shown that SMEs mainly benefit from bank loans, whereas there are some institutional, legislative, cultural and geographical factors limiting their access to finance.

The low financial literacy rate of SME owner/managers and higher interest rates offered by banks are among the factors restricting SME access to finance. The government has strengthened legislation—in particular relating to institutions—in recent years to improve SME access to finance, but the effectiveness of this move is insufficient.

This paper comprises eight sections: The contribution of SMEs to Azerbaijan's economy and the status of the financial sector; the financial inclusivity of SMEs; financial literacy levels; institutional, regulative, gender, cultural factors restricting SME finance; the structure of domestic value chain and Azerbaijan's role in global value chains; financial analysis of value chains; national strategies for SME finance; and key policy recommendations.

Keywords: Azerbaijan, SME, value chains, financial inclusion, financial literacy, loan, bank, financial institution

JEL Classification: G2, G3, G21, G28, O16

Contents

INTRODUCTION	1
1. THE ROLE OF SMES IN THE ECONOMY AND SME FINANCE.....	1
1.1 Breakdown of Azerbaijan’s Economy (Shares of GDP and Employment) and Growth Performance by Sector (Agriculture, Manufacturing, Services) ...	1
1.2 Role of SMEs in the Economy by Sector (GDP and Employment Shares).....	3
1.3 Country’s Sources of Finance for SMEs	5
1.4 Key Aspects of Country’s Financial Situation, Regulatory Framework, Tax Regimes and Financial Infrastructure.....	6
2. STATUS OF FINANCIAL INCLUSION FOR SMES	8
2.1 Financial Inclusion and Bank Accounts	8
2.2 Access to Credit	9
2.3 Financial Institutions Involved.....	14
2.4 Inclusion-related Financial Products and Services.....	15
2.5 Financial Technology Factors Driving Financial Sector Access by SMEs (P2P Lending or Crowdfunding)	15
3. FINANCIAL KNOWLEDGE AND SKILLS OF SME ENTREPRENEURS.....	16
3.1 Assessments of Financial Literacy	16
3.2 Existence of Financial Education Strategy	17
3.3 Institutions Involved (Both Public and Private)	18
3.4 Target Groups and Programs.....	18
3.5 Types of Programs	18
3.6 General Financial Education	19
3.7 Debt Management Programs	19
3.8 Assessment of Effectiveness.....	19
4. BARRIERS TO SME FINANCE.....	20
4.1 Supply Side	20
4.2 Demand Side.....	22
4.3 Institutional Aspects	22
4.4 Regulatory Factors	23
4.5 Cultural Aspects	24
4.6 Gender Issues	24
5. STATUS OF DOMESTIC AND GLOBAL VALUE CHAINS IN THE COUNTRY	25
5.1 Agricultural Sector: Primary and Intermediary Products Participating in Value Chains	26
5.2 The Potential of the Processing Industry for Establishing Value Chains.....	27
5.3 Opportunities to Participate in the Global Value Chains through the Services Sector	28
6. VALUE CHAIN FINANCING ANALYSIS	29

7.	POLICIES TO PROMOTE SME FINANCE	32
7.1	Relevant Contents of National Strategy	32
7.2	Level of Policy, National or Otherwise.....	34
7.3	Institutions Involved.....	34
7.4	Specific Strategies.....	34
7.5	Assessment of Effectiveness, Gaps, Issues.....	35
8.	CONCLUSIONS AND RECOMMENDATIONS	36
8.1	Conclusions.....	36
8.2	Recommendations	37
	REFERENCES	38

INTRODUCTION

Small and medium-sized enterprises (SMEs) have always played a marginal role in Azerbaijan's economy due to the economy's reliance on oil and this sector's being under the influence of large entrepreneurs. According to statistical data for 2016, the share of SMEs in value added in the economy was 6.4% while that in total production output in the economy and employment, respectively, was 9.2% and 18.5%.

The problem regarding SME access to finance in Azerbaijan is urgent. The devaluation of the Azerbaijan manat in 2015 has become one of the determining factors impacting the country's financial system. The deterioration of the currency exposure due to the sharp devaluation and a significant increase in problem loans have presented serious challenges to the banking sector. The reduced resource potential of the bank sector is one of the key factors curbing SME access to finance. At the same time, capital market in Azerbaijan does not serve as a source of funding for SMEs. Factors that hamper SMEs in accessing finance are high interest rates for all business, heavy lending terms, and lack of lending institutions' interest in providing finance to regions.

The importance of increasing financial inclusivity and financial literacy has recently become urgent in Azerbaijan. The levels of accessibility for the country's population and entrepreneurs, including SMEs, to services offered by financial institutions are not desirable. The existing strategies to enhance financial literacy and financial inclusivity are defined by the "Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy" adopted in 2016. Ensuring SMEs effective and favorable access to finance has been included in core strategic targets in the Roadmaps.

Since there is no official statistical database on SME finance, it is difficult to define the distribution of lending by value chains. The survey conducted among the banks holding 50% of the market share found that they are more interested in financing trade or the food service sector, which is the final stage of a product or service. A small proportion of lending institutions prefer agriculture financing. One of the key global value chain areas the Azerbaijani economy participates in is the agrarian sector. The non-oil sectors dominated by SMEs are trade and agriculture. The agricultural sector contributes to the creation of a value chain across the country through various crops and livestock products. The government's recent legislative and institutional initiatives are aimed at ensuring SME finance.

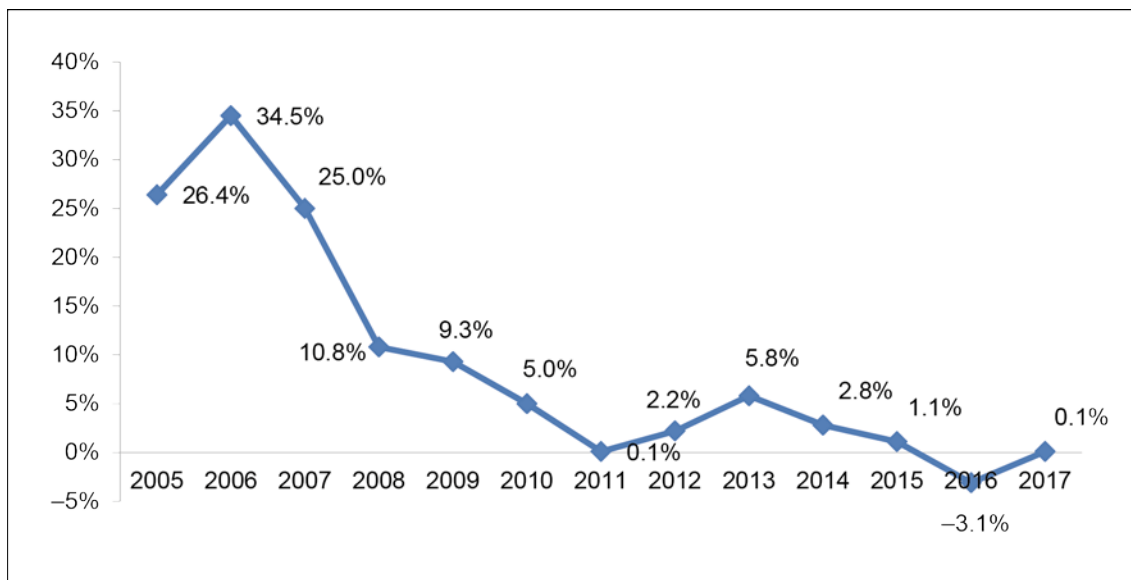
1. THE ROLE OF SMES IN THE ECONOMY AND SME FINANCE

1.1 Breakdown of Azerbaijan's Economy (Shares of GDP and Employment) and Growth Performance by Sector (Agriculture, Manufacturing, Services)

Azerbaijan has passed through different stages of economic development for the past 27 years, since it regained independence in 1991. Although the first post-Soviet decade (1991–2001) was marked by both crisis and stability situations, the country experienced rapid economic growth in subsequent years. From 2005 onwards in particular, an inflow of large oil revenues to the country under production sharing agreements (PSAs), signed with foreign oil majors in the previous 10 years, had served as a major catalyst for economic development.

Azerbaijan had an estimated gross domestic product (GDP) in 2017 of AZN70.1 billion (USD41 billion).

Figure 1: Azerbaijan GDP Growth Rate Over Previous Year (%)



Source: State Statistical Committee of the Azerbaijan Republic.

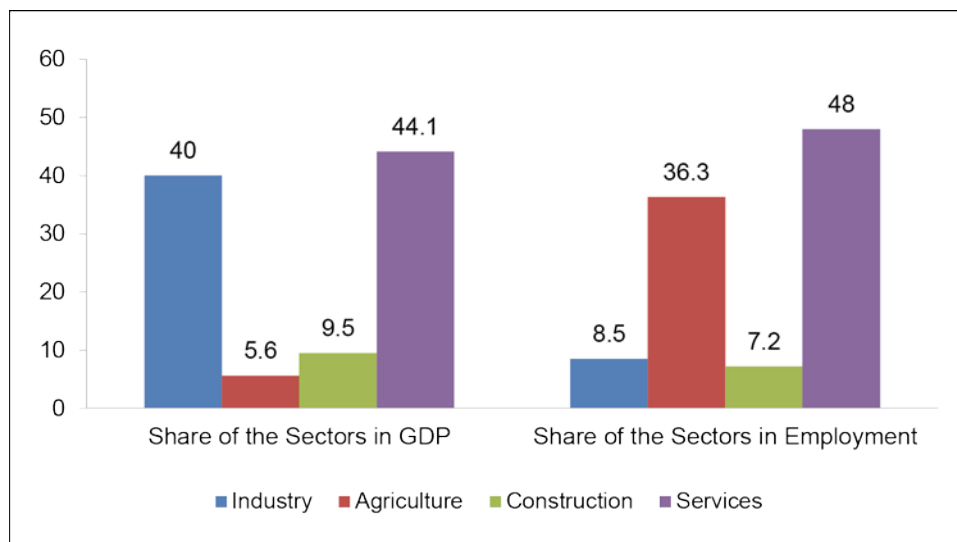
The first years, when the government generated much higher revenues, saw a more rapid growth rate, with GDP growth having ranged from 26.4% in 2005 to 34.5% in 2006 relative to the previous period. The economy, though at a lower rate, continued to grow during the period prior to the global oil price drop towards the end of 2014, with real GDP growth ranging from 0.1% in 2011 to 5.8% in 2013. However, the economic growth rate has declined significantly, driven by lower oil prices in the past three years.

Analysis of statistical data found that the share of the hydrocarbon sector in GDP formation now stands at roughly 35%. Although the industrial sector, as a whole, has the highest share in GDP formation in Azerbaijan’s economy (40% for 2017), the entire industry accounts for only 8.5% of total employment. Nevertheless, all service fields (trade, tourism and restaurant, all types of social and household services, transport and communication services, government services) in total account for the dominant share (about 44%) of GDP formation.

Although the agriculture sector has a very high specific weight (36.3%) in employment, only 5.6% of the economy’s GDP is generated through this sector.

As a whole, because of the severe imbalance between this sector’s employment and value added, overall labor productivity in the agriculture sector is extremely low. At present, agricultural value added per worker is about 25 times less than that in the non-agricultural sector. The construction sector accounts for 9.5% of GDP and 7.2% of employment. In 2017, about 4.8 million people (50%) were employed.

Figure 2: Share of the Main Sectors of the Economy in GDP Formation and Employment Generation (as percentage of total)¹



Source: State Statistical Committee of the Azerbaijan Republic.

1.2 Role of SMEs in the Economy by Sector (GDP and Employment Shares)

The role of SMEs in Azerbaijan's economy, notably in its expansion in recent years, is too insignificant. In 2016, SMEs, which numbered 191.7 thousand, accounted for 95% of all businesses. Of these SMEs, 20.9 thousand were legal entities and 170.8 thousand were individual entrepreneurs. Small entrepreneurs dominate in the overall number of SMEs in Azerbaijan, while the number of medium-sized entrepreneurs is moderate. Small entrepreneurs account for the bulk of SMEs—97.9% (187.6 thousand)—with medium entrepreneurs reaching 2.1% (4.1 thousand). According to the Cabinet of Ministers decision dated 5 June 2015, small enterprises in Azerbaijan are defined as those with less than 25 employees and annual revenue of less than 200 thousand manats, and medium enterprises as those with less than 125 employees and annual revenue of less than 1.250 million manats.²

However, the position of SMEs in the economy does not reflect the share of their business units.³

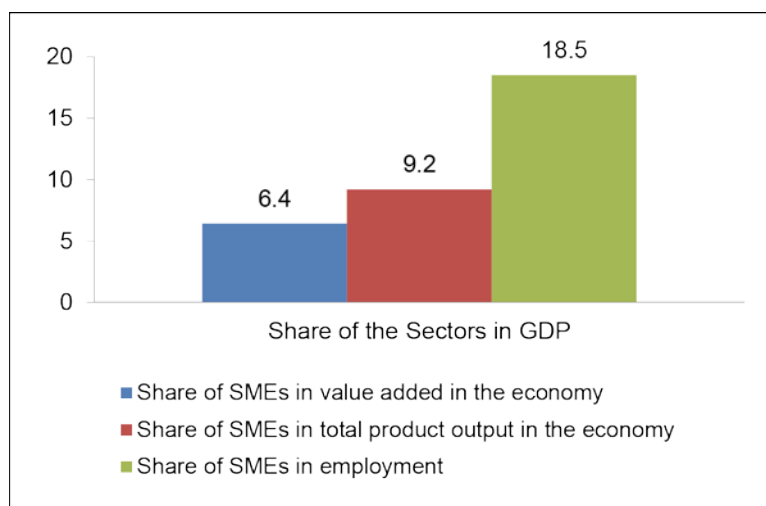
According to statistical data for 2016, the share of SMEs in value added in the economy was 6.4% while that in total production output in the economy and employment, respectively, was 9.2% and 18.5%. If we consider the data by sectors of the economy, SMEs primarily continue to provide the dominant share of the services sector.

¹ All data taken from Azerbaijan's State Statistical Committee national accounts. https://www.stat.gov.az/source/system_nat_accounts/ and labor market <https://www.stat.gov.az/source/labour/databases>.

² <http://www.e-qanun.az/framework/30115>.

³ <https://www.stat.gov.az/source/entrepreneurship/>.

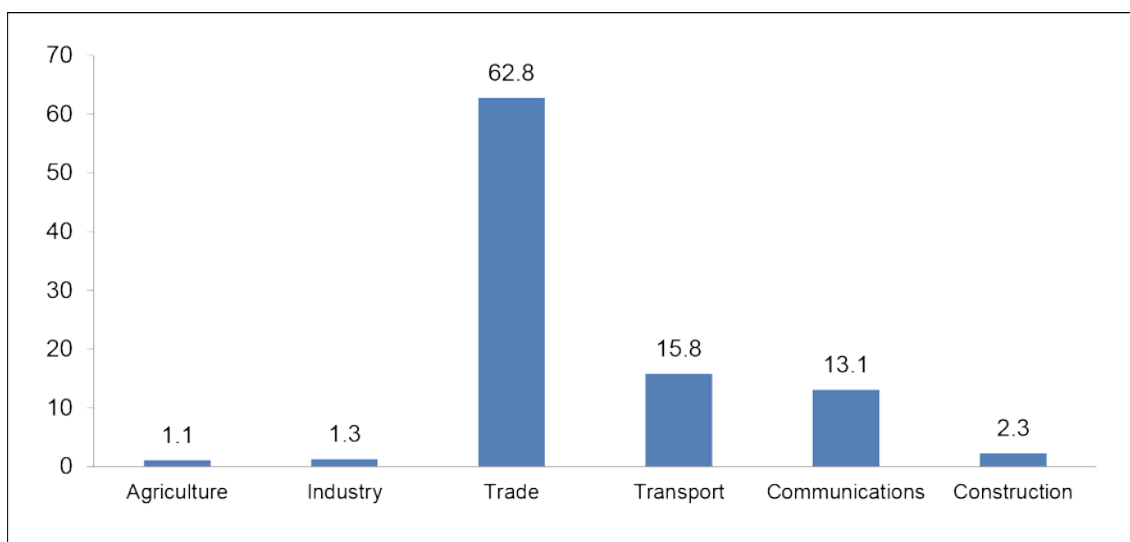
Figure 3: Number of SMEs in Major Economic Indicators (%)



Source: State Statistical Committee of the Azerbaijan Republic.

The share of SMEs in trade, transport, communications, construction, industry, and agriculture, respectively, comprises 62.8%, 15.8%, 13.1%, 2.3%, 1.3%, and 1.1%.

Figure 4: Share of SMEs in Product Output and Turnover of Services by Sector⁴



Source: State Statistical Committee of the Azerbaijan Republic.

There are no official data for the share of SMEs in the country’s total exports, which is one of the important economic indicators. However, our assessment based on the analysis of data on the export structure shows that the actual indicator does not exceed 5–6%. In 2017, Azerbaijan’s total exports stood at \$13.8 billion, of which 89%, or \$12.3 billion, came from the oil and gas sectors. SMEs are totally excluded from oil and gas exports. Therefore, the assessment was carried out on the basis of non-oil export indicators. According to the Center for Analysis of Economic Reforms and

⁴ Data taken from the Azerbaijan’s State Statistical Committee Business Division: <https://www.stat.gov.az/source/entrepreneurship/>.

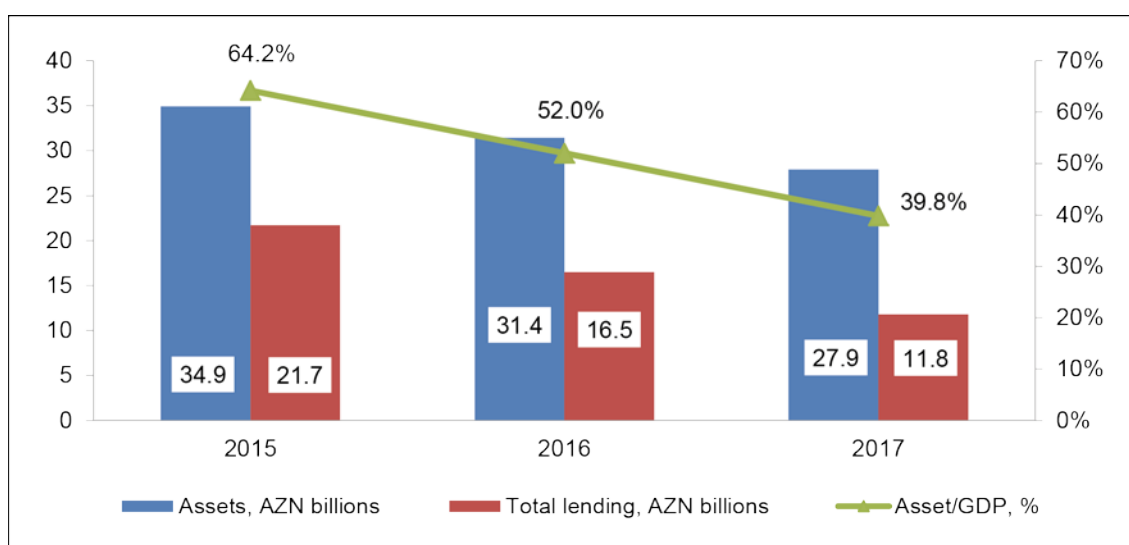
Communication (CAERC) under the President of Azerbaijan Republic, out of the total non-oil exports of \$1.54 billion in 2017, \$821.3 million, or 53%, fell to the share of 20 large state- or private-sector subjects of entrepreneurial activity. The remainder of exports worth \$712.7 million was provided by other SMEs, accounting for only 5% of the country's total exports.⁵

1.3 Country's Sources of Finance for SMEs

The impact of macro-economic conditions to ensure SMEs access to financial resources is conditioned by the quality of the financing structure. Preserving the stability of the national currency, the Azerbaijan manat exchange rate for more than a decade, and its devaluation by more than 50% in 2015, has become one of the determining factors impacting the country's financial system over the last three years. The deterioration of the currency exposure due to the sharp devaluation and a significant increase in problem loans presented serious challenges to the banking sector. This particularly contributed substantially to the decrease in the banking sector's assets and a worsening of the banks' financial performance.

Azerbaijan's bank assets decreased by about AZN7 billion (20%) during 2015–2017, while loans declined at a rate of 50% (AZN10 billion) due to write-offs of non-performing loans (NPLs) and the closure a third of the banks. At the same time, the ratio of bank assets to GDP in 2015 and 2017 decreased from 64.2 to 39.8%. The downward tendency of the share of loans in the structure of bank assets also remains dominant. This indicator stood at around 70% in 2013–2014, falling to 41.5% at the end of 2017. The reduced resource potential of the bank sector is one of the key factors curbing SMEs' access to financing. Since the debt and securities market in Azerbaijan do not serve as a source of funding for SMEs, the banking sector is a sole and indispensable resource for them. From this point of view, negative processes in the banking sector have a direct impact on SMEs (Figure 5.)

Figure 5: 2015–2017 Bank Assets (millions of manats)⁶



Source: Central Bank of the Republic of Azerbaijan.

⁵ http://iqtisadiislahat.org/store//media/documents/ixrac_icmali/2018/yanvar/Export_Review_2018-1.pdf.

⁶ Figure made on the basis of Central Bank and Financial Market Supervisory Authority data.

Although the securities market in Azerbaijan has expanded significantly in recent years, this segment of the financial market has no impact on SMEs, because their experience of attracting resources through various financial intermediaries and debt instruments has not yet arisen in practice. The securities market mainly trades government securities (short-term bonds issued by the Ministry of Finance and short-term notes issued by the Central Bank of the Republic of Azerbaijan (CBAR) and partly corporate securities issued by large state-owned companies or belonging to the banking sector. In 2017, for example, the market grew 12%, compared to 2016, to 15.7 billion manats. The government securities market increased from 836.2 million to 6.1 billion manats (+7.3 times), and the derivative financial instruments market was 33.8% up to 5.9 billion manats. The corporate securities market amounted to 3.7 billion manats. The corporate securities market accounted for 44% of shares and 56% of the bond segment.

1.4 Key Aspects of Country's Financial Situation, Regulatory Framework, Tax Regimes and Financial Infrastructure

The heavy reliance of the economy on oil money is a key factor affecting the country's financial system. This dependence is crucial in ensuring both the stability-oriented fiscal policy and balance of payments equilibrium. One of the lessons learned from the years 2015–2016 is that due to its dependence on oil revenues, it is becoming difficult to balance the budget with the sharp decline in oil prices on the world markets, and alongside the growth of the budget deficit. And due to the dependence of Azerbaijan exports on oil, it is also a challenge to ensure the balance of payments equilibrium with the sharp decline in oil prices on the world markets. A decrease in currency revenues increases the risk of macroeconomic instability in the country by creating a deficit in the overall balance of payments.

Steps have been taken in recent years towards the establishment of a legal basis for SMEs and the provision of an institutional environment in Azerbaijan. The key related laws governing their activities are the Law on Entrepreneurship and the Law on State Support for Small Business. The latter states that the state assists small entrepreneurship support, the development of small entrepreneurship programs and implementation of these programs, creating favorable conditions for small business to acquire financial, material, scientific, and technical information resources.⁷

The Law on Entrepreneurship will establish principles for entrepreneurship activities envisaging common rights and obligations, licenses and special permits for all entrepreneurship subjects.⁸

In addition, tax and customs laws will establish legal provisions that regulate the tax regime and financial reporting for SMEs. The Tax Code of the Azerbaijan Republic⁹ creates legal opportunities for SMEs to become simplified taxpayers. First, according to the Tax Code, agricultural producers and industrial agricultural producers are exempt from all taxes, except for land tax. According to official statistics, more than 90% of agricultural products is provided by natural entrepreneurs, small enterprises and family farms whose turnovers are insignificant. So, it is SMEs that take advantage of large-scale tax privileges in the agrarian sector, while non-agrarian SMEs are entitled to pay simplified tax, which is a combination of several taxes.

⁷ <http://www.e-qanun.az/framework/3849>.

⁸ <http://www.e-qanun.az/framework/7920>.

⁹ <http://www.e-qanun.az/code/12>.

Under Article 219.5 of the Tax Code, SMEs as legal entities paying simplified tax shall not pay VAT, profit tax and property tax, and as individuals involved in entrepreneurial activity without the creation of a legal entity, profit tax or VAT on subject activity. Individual entrepreneurs who have received investment promotion documents and other SMEs also obtain tax privileges according to the Tax Code. According to the privileges, these entities are fully exempt from land and property taxes, from taxes for imports of machinery, technological equipment and facilities for seven years from the date of receipt of the Investment Promotion Certificate, while legal entities are exempt from profit tax and individual entrepreneurs are exempt from 50% of profit tax.

Under Decision No. 401 of the Cabinet of Ministers, 6 October 2016,¹⁰ SMEs, capable of exporting non-oil products, have the opportunity to access export promotion financing based on the value of the products they sell abroad.

Steps have been taken in recent years to create important mechanisms in Azerbaijan such as important elements of the financial infrastructure and to support SMEs' access to financial resources. Since March 2018, for example, SMEs can obtain extracts of data from the real estate registry through the State Agency for Public Service and Social Innovations under the President of the Republic of Azerbaijan (ASAN) service centers, thus enhancing the ability to receive loans using real estate as collateral. In March 2017, 'the process was simplified for SMEs willing to take out a loan against their real estate. Thus, according to the new rules, the owner can obtain a certificate for the registered rights on the property and their restriction on the state register via the Electronic Notary Information System in real time.

Finally, with the entry into force, in October 2016, of the law regulating the activities of credit bureaus, an important financial institution, which is essential for SMEs, began to operate. Under Article 1 of this law, "the purposes are improvement of opportunities of access to financial services for individual entrepreneurs and legal entities by the forming of a long-term information base about the accomplishment of the financial liabilities, strengthening of financial discipline in debt relations and support to ensuring stability of the financial system in the country."¹¹ It is the institutions that play a crucial role as a database in giving an objective and comprehensive idea of SMEs involved in resource allocation, as well as providing funding to resource applicants as soon as possible. After the adoption of the law, in December 2017 the first credit bureau was established in Azerbaijan by eight commercial banks. Since May 2018, the Bureau has been exchanging information with 120 organizations, including the Central Bank, 30 banks and 14 banks under liquidation, 47 non-bank credit organizations, 22 insurance companies, 3 mobile operators and 3 communal service operators. Azerbaijan Credit Bureau LLC offers three types of services: 1) credit report; 2) issuance of personal credit rating; 3) issuance of credit histories.¹²

¹⁰ <http://www.e-qanun.az/framework/33870>.

¹¹ <http://www.e-qanun.az/framework/34274>.

¹² <https://www.acb.az/>.

2. STATUS OF FINANCIAL INCLUSION FOR SMES

The importance of financial inclusion has recently become real in Azerbaijan. In general, access of the business sectors, including SMEs, to the services offered by financial institutions is not at a desirable level, which is also confirmed by the results of studies carried out by both international financial institutions (e.g., World Bank) and local research organizations (e.g., Center for Support for Economic Initiatives).¹³

2.1 Financial Inclusion and Bank Accounts

In Azerbaijan, it is mainly bank and non-bank credit organizations and insurance companies that provide services that serve financial inclusion. Focusing on micro small enterprises and households in urban and rural areas, these services cover such sectors as trade, service, industry, and agriculture. One of the key elements of financial inclusion is the creation of necessary service infrastructure, including the equal distribution of credit institutions across the regions of the country. The closer businesses are to financial services, the greater the accessibility of such services will be. Although there were once a number of credit organizations and branches, the devaluation in 2015 had a negative impact on the country's financial sector. In 2014, there were 45 banks, 752 branches, and 162 departments. There were also 157 non-banking credit organizations with their 287 branches and 999 departments in that period.¹⁴ As a result of the devaluation, their number has dropped significantly over the past three years. According to the Financial Market Supervision Authority,¹⁵ by the end of 2017, the number of banks in Azerbaijan decreased to 30, the number of branches to 509, and the number of departments to 142. There are 223 branches and 1,112 divisions of 123 non-bank credit organizations. In general, the significant decline in the number of credit institutions has worsened the SMEs' access to financial services.

Table 1: Number of Active Azerbaijani Banks

Banks	2014	2017	Change (+ Increase, – Decrease)
Number of banks	45	30	–15
Banks with foreign capital, including:	23	15	–8
<i>with the share of foreign capital ranging from 50 to 100%</i>	8	8	0
<i>with the share of foreign capital not exceeding 50%</i>	13	7	–6
<i>local branches of foreign banks</i>	2	2	0
Local bank branches	752	509	–243

Source: Central Bank of the Republic of Azerbaijan, Financial Markets Supervisory Authority of the Republic of Azerbaijan.

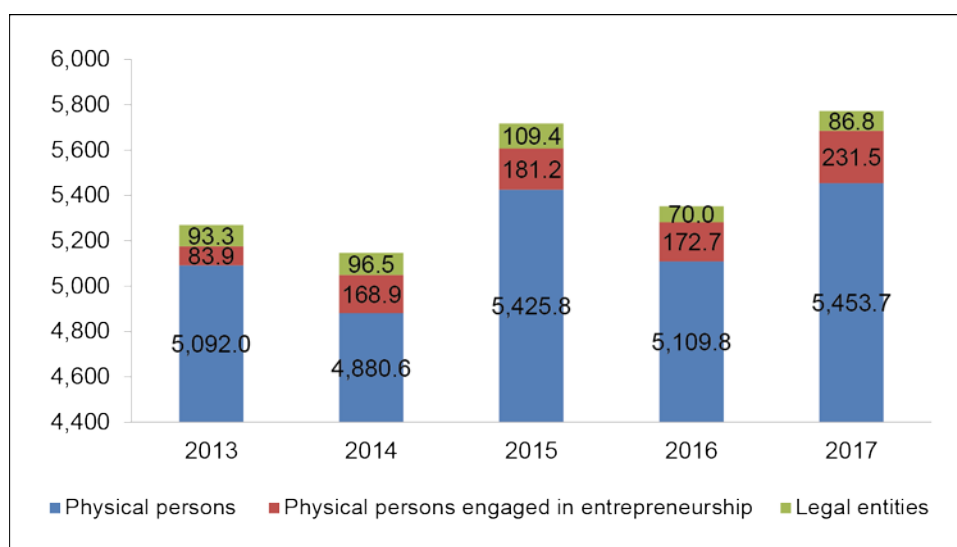
¹³ http://edf.az/ts_general/azl/ksid/downloads/maliyye_elchatanligi_aliyev_samir.pdf.

¹⁴ Azerbaijan Republic Central Bank Statistical bulletin, №12 (178), 12/2014, 2017, Baku. https://www.cbar.az/assets/3687/-_BULLETEN_12_-_2014_AZERI_OK.pdf.

¹⁵ <https://www.fimsa.az/en/2017-ci%20il>.

The increasing number of bank customers on the background of the declining number of credit institutions has negatively affected the quality of banking services. While the number of customers per bank was 114 thousand in 2014,¹⁶ with a total of 311.8 thousand bank accounts, this figure was 192 thousand people and 537 thousand accounts in 2017. In 2017, a customer had an average of 2.3 accounts (2.8 in 2014). According to the official information¹⁷ of the CBAR, by the end of 2017, of the total number of the bank clients, 231.5 thousand (168.9 thousand in 2014) were individual entrepreneurs engaged in entrepreneurship, and 86.8 thousand legal entities (96.5 thousand in 2014).

Figure 6: Number of Bank Accounts (2013–2017) (in thousands)



Source: Central Bank of the Republic of Azerbaijan.

Of all these accounts, 13.3 million (10.5 million in 2014) were current and 345.8 thousand (in 2014, 658.2 thousand) deposit accounts. Individuals with entrepreneurship activities accounted for 244.4 thousand (184.4 thousand), legal entities for 169.4 thousand (175.6 thousand) of the current accounts. Unfortunately, there are almost no statistical databases regarding small and medium-sized businesses in Azerbaijan, which prevents the identification of the share of SMEs in these accounts. Assuming that Individuals engaged in entrepreneurship represent SMEs, we can think of 231,500 as SME accounts. However, it is difficult to determine the share of SMEs in relation to bank accounts and deposit accounts of legal entities.

2.2 Access to Credit

As per the survey findings of the World Bank (WB) with small and medium-sized enterprises in 2014, high interest rates coupled with complicated procedures are among the key factors limiting their access to credit, which is one of the key elements of financial inclusion. In addition, the high level of collateral for bank loans, which is the main source of financing for SMEs, limits access to finance.

¹⁶ https://www.cbar.az/assets/3687/-_BULLETEN_12_-_2014_AZERI_OK.pdf.

¹⁷ Azerbaijan Republic Central Bank Statistical bulletin, №07 (220), 07/2018, 2017, Baku. https://www.cbar.az/assets/4715/Statistik_b%C3%BClleten_2018_iyul_PDF.pdf.

In the annual Doing Business report, prepared jointly by the WB and the International Finance Corporation (IFC), which reflects the business environment affordability assessment, entrepreneurs' access to credit has been dwindling in recent years. In the "Doing Business 2018" report, Azerbaijan was ranked low in terms of the ease of borrowing. In general, in the last 10 years, the level of access to credit has steadily been deteriorating. While Azerbaijan was ranked 15th out of 183 countries in 2010, this figure has fallen to 122nd place among 190 countries in 2018. Getting Credit explores two sets of issues—the strength of credit reporting systems and the effectiveness of collateral and bankruptcy laws in facilitating lending. The lack of private credit bureaus in Azerbaijan also significantly worsens its position in the credit obtaining index.

According to the results of the Business Environment and Enterprise Performance Survey (BEEPS), conducted by the European Bank for Reconstruction and Development (EBRD) in cooperation with the WB, the access to finance is one of the major obstacles to business development. The results of the survey, in which 390 enterprises, including SMEs, were also surveyed, reflect the year 2013. Of the surveyed local enterprises, 21.7% of small businesses operating in the country and 21.6% of medium businesses raised access to finance as the main problem.

SMEs in Azerbaijan are mainly looking at banks and non-bank credit institutions for loans. Entrepreneurs mainly use loans as sources of external funding.

The result of the BEEPS survey shows that about half of the SMEs do not need credit. According to the survey, bank loans are the dominant source of external funding for the SMEs, and alternative external sources of financing have not yet been developed. Of the businesses surveyed, 14.7% small businesses and 14.6% medium businesses reported having a credit line (Table 2).

As can be seen from Table 2, more than 85% of small and medium-sized entrepreneurship loans (small 85.7%, medium 97.2%) are collateral based, the value of which is more than twice as much as the value of the loan. This makes up 258.5% and 262.3% of collateral in the loan portfolio for small and medium enterprises, respectively. For comparison, these figures for Europe and Central Asia, respectively, are 197.9% and 189.8%, on average, while the world average is 217.5% and 198%.¹⁸

At least three quarters of SMEs are financed through their internal funds. In the absence of internal funding, a quarter of SMEs attract bank funds for investment financing. SMEs almost never finance themselves through equity financing.

"The SME Policy Index: Eastern Partners Countries 2016" Report¹⁹ by the Organisation for Economic Co-operation and Development (OECD) says that as in other Eastern Partnership (EaP) countries, the issue of access to finance is a problem for SMEs in Azerbaijan. According to the report, Azerbaijan's position on the SMEs' access to finance was 2.70 out of 5 points, which is the worst indicator among the EaP countries. According to the methodology of the organization, this level indicates that there are good bases for implementing policies in the field, but they are not put into practice.

¹⁸ Enterprise Surveys (<http://www.enterprisesurveys.org>), The World Bank.

¹⁹ SME Policy Index: Eastern Partner Countries 2016. Assessing the Implementation of the Small Business Act for Europe. <http://www.oecd.org/countries/belarus/sme-policy-index-eastern-partner-countries-2016-9789264246249-en.htm>.

Table 2: Businesses' Access to Finance (2013)

Indicators	Business Size	Specific Weight%
Share of enterprises with bank credits/credit line	Small	14.7
	Medium	14.6
Share of loans requiring collateral (%)	Small	85.7
	Medium	97.2
Share of collateral required for loan repayment (as % of loan amount)	Small	258.5
	Medium	262.3
Share of enterprises with no need for credit	Small	54.1
	Medium	49.3
Share of enterprises with a final loan application refused	Small	23.6
	Medium	23.6
Share of enterprises benefiting from a bank for investment financing	Small	25.3
	Medium	25.1
Share of funds financed from internal funds	Small	74.0
	Medium	82.8
Share of investments financed by banks (%)	Small	25.3
	Medium	16.3
Share of investments financed through the Ownership Loans (%)	Small	0.0
	Medium	0.9
Share of equity investments or equity financing (%)	Small	0.2
	Medium	0.0
Share of operating capital funded through banks (%)	Small	3.6
	Medium	6.3
Share of operating capital funded by the sender's loan (%)	Small	0.9
	Medium	1.7
Share of enterprises raising access to finance as the main problem	Small	21.7
	Medium	21.6

Source: <http://www.enterprisesurveys.org/data/exploretopics/finance>.

The results of the surveys conducted both by international and local organizations show that SMEs prefer to solve their financial problems more through internal resources. With limited resources, they prefer only less risky, less profitable, but more reliable spheres, the reason for which is the difficulty of attracting funds from external sources. Both the high cost of resources and the enterprises' transparency problems limit their ability to attract financial resources externally. It is only those businesses that want to expand that are interested in external sources.

The results of the BEEPS survey show that approximately 51.4% of SMEs do not need credit. Qabus Research and Consulting Company (QRCC), together with the Centre for Media and Public Initiatives (CMPI), conducted a survey among 200 SMEs in order to study their access to credit in Azerbaijan and the results suggest that when financial resources are needed, it is credit institutions that entrepreneurs go to the most. Forty-five percent of SMEs use bank and 5% non-bank loans. The share of entrepreneurs who approach their friends or acquaintances trying to get interest-free

funds is 42.5%. Only a small percentage of respondents (2.5%) were forced to seek funding through pawnshops, which have the highest interest rates in the country.²⁰

Although monthly, quarterly and annual statistical bulletins of entrepreneurship subjects are prepared in Azerbaijan, there is no statistical database on the share of SMEs in this lending. In response to the official inquiry addressed to the CBAR and the FIMSA, they said that no such statistics were recorded.

The following instruments of external funding sources for small and medium businesses, which are applied in world practice, are used in Azerbaijan in one form or another:

Financial resources (loans) attracted from credit institutions. SMEs in Azerbaijan are mostly focused on banks and non-bank credit institutions for financial resources. SMEs in Azerbaijan mainly use loans as sources of external funding.

No official information on SME lending is available in official statistical reports released by the banking sector. And neither is such information provided in the quarterly and annual financial statements disclosed by commercial banks in accordance with the legislation. For this reason, it is impossible to obtain reliable information on the level of lending to SMEs and on the specific weight of loans granted to SMEs from certain types of economic activity in aggregate loans used across sectors of the economy. With this in view, as part of the research, inquiries were sent to banks to evaluate SMEs' access to lending resources. The inquiries were submitted to the banks holding almost 70% market share.

In 2017, the banks holding 55% of the total assets and 42% of the aggregate loan portfolio in the banking sector responded to the inquiries. The analysis of the results reveals that the loans the banks allocated to SMEs amounted to AZN433.8 million (10.2%).

The statistical analysis of credit investments for the years 2013–2017 shows that the deterioration of banks' assets as a result of the devaluation in 2015 resulted in restricted lending to them. According to the WB, private sector crediting (domestic credit to private sector) dropped to 16.4% in 2017,²¹ while it had a 25.2% share in GDP. This restriction led to a decrease in lending and, thus a difficulty for SME financing.

Lending to small and medium businesses (trade and services, agriculture and processing, transport and communications, construction and property) has diminished over time. While the credit investments demonstrated growth before the devaluation, this began to decline after it (Figure 7).

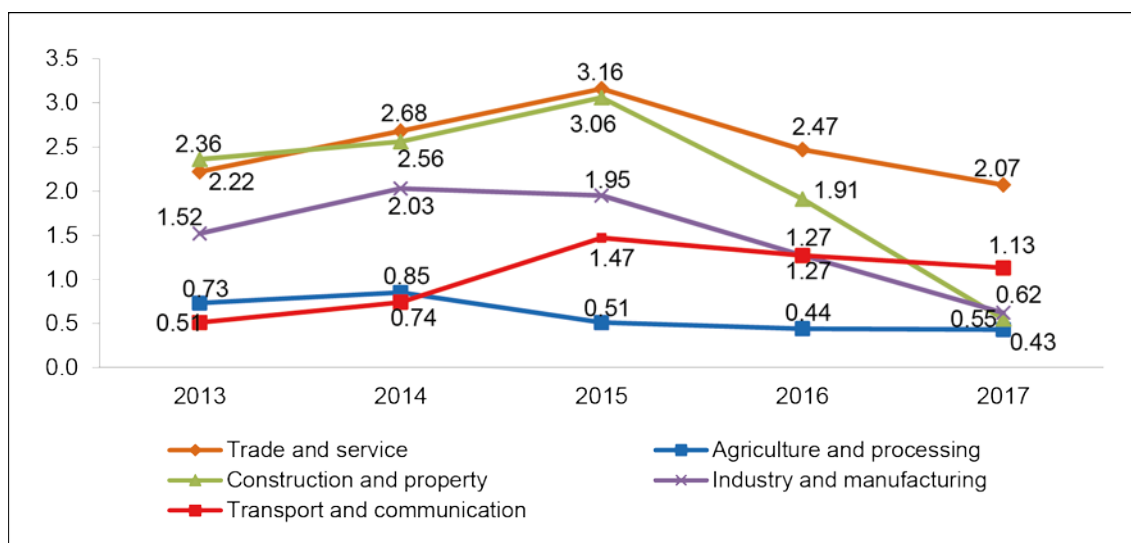
From 2013 to 2015, the total amount of credit lending in the country increased by 41% from 15.4 billion to 21.7 billion AZN. During this period, trade and service sector lending grew by 42.3%, the construction and property sector by 29.7%, industry and manufacturing by 28.3%, and the transportation and communication sector by 188.2%. Agriculture and processing sector lending decreased only by 30.1%. In the aftermath of the devaluation, falls were observed in the amount of credit lending both in the country and in separate sectors, with the total amount of lending decreasing by 46.3%. Thus, after the devaluation, credit investments in the trade and services sectors declined by 34.5%, agriculture and manufacturing by 15.7%, construction and property by 82%,

²⁰ Interest Rate Trends in Post-Soviet Economies: 2005–2011. Baku-2012. QABUS Research and Consulting Company and Center for Media and Public Initiatives.

²¹ <https://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS?end=2017&locations=AZ&start=2013>.

industry and manufacturing by 68.2%, and in the transport and communications sector by 23.1%.

Figure 7: Credit Investments by Sectors (million AZN) (2013–2017)



Source: Central Bank of the Republic of Azerbaijan.

There are no statistics recorded on SME lending in Azerbaijan and the amount of credit investments is annually disclosed by the CBAR. However, this disclosure shows only the total lending. Our research shows that nearly all of the trade and services in Azerbaijan, most of the agricultural and processing, construction and property, and a certain portion of transport and communications, belong to SMEs. The trend described in Figure 7 also includes the pattern of SME lending.

Factoring and forfeiting. These services are not a widely spread practice of financing in Azerbaijan’s financial system and play a minor role in the financing of SMEs. **Venture capital**, which is the main source for start-ups, has recently become an interesting source of funding in Azerbaijan.

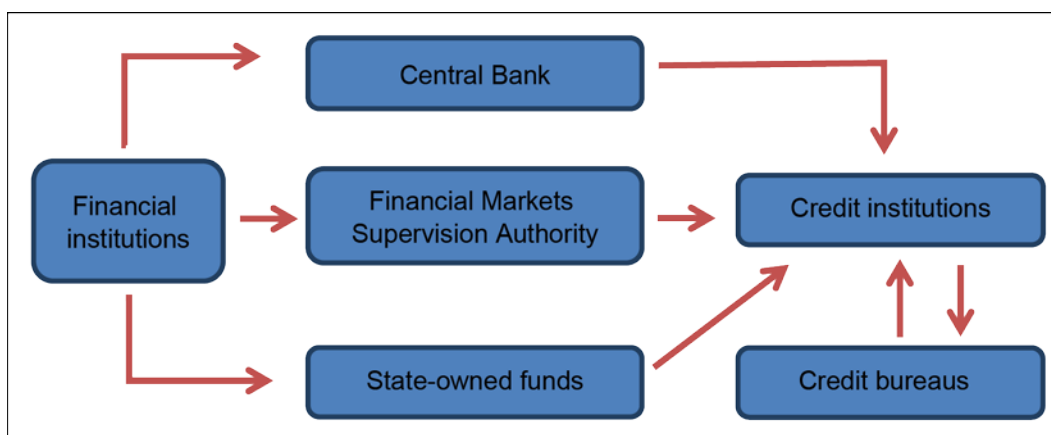
Leasing. The challenges of long-term investment financing for SMEs remains problematic in our country, especially now when bank loans are difficult to obtain. While there are a few leasing companies operating in Azerbaijan, this service has not yet been developed. In Azerbaijan, leasing services are regulated by special legislation, and there is no control over their activities.

Capital market financing. In Azerbaijan, there is little experience in terms of attracting alternative financial resources to credits for SMEs in the form of the issuance of shares and bonds. These sources are usually used by large companies. The volume of the securities market in 2017 amounted to about 15.7 billion manat, 3.7 billion manat of which is accounted for by the corporate securities market. Large enterprises are the major shareholders of corporate securities market and corporate bonds. Except for arbitrary cases, SMEs are not interested in attracting funds from this market.

2.3 Financial Institutions Involved

Financial institutions involved in the financing and financial inclusion of SMEs include regulatory and supervisory agencies (CBAR, FIMSA), state-owned funds providing government financial support, and credit institutions and bureaus providing financial support to business entities (**Scheme 1**).

Scheme 1: Financial institutions



The CBAR and FIMSA mainly regulate, control, and coordinate the financial market.

The experience of the Credit Bureau is new in Azerbaijan. The first credit bureau was established in December 2017 by eight banks together.²² The office has not yet started to operate. At present, the functions of the Credit Bureau are operated by the Centralized Credit Registry Service, which had initially been established within the CBAR and later transferred to the FIMSA.

The other market participants are state funds. Just as in international practice, there are a number of institutions in Azerbaijan providing state support, including funding for the development of SMEs. These institutions are as follows:

- Entrepreneurship Development Fund of the Republic of Azerbaijan²³
- State Agency for Agricultural Credits²⁴
- State Fund for Development of Information Technology²⁵
- Azerbaijan Mortgage and Credit Guarantee Fund²⁶

The main feature of these funds is that their credit resources that they give out are secured at the expense of funds allocated from the state budget. At the same time, the loans provided by these institutions are concessional and are a lot less expensive than the other loans on the market.

²² <https://www.azernews.az/business/124329.html>.

²³ No 222 Presidential decree of 31.07.2018, **National Fund for Entrepreneurship Support** was revoked and public legal entity called **Entrepreneurship Development Fund** was established in its place.

²⁴ Regulations on the State Agency on Agricultural Credits under the Ministry of Agriculture of the Republic of Azerbaijan. Approved by the Presidential Decree No. 226 of 20 April 2005.

²⁵ Official website of the Fund – <http://ictfund.gov.az>.

²⁶ <http://mcf.gov.az/?en/mainpage//>.

2.4 Inclusion-related Financial Products and Services

One of the mechanisms promoting financial inclusion is the expansion of cashless transactions. The government has created an appropriate legislative framework for the expansion of non-cash operations and has taken steps to create an appropriate infrastructure. Within this framework, the number of Point of Sale (POS) terminals has been increased for non-cash operations, with the payments for state services made electronically available. The development of Internet and mobile banking by banks improved the access of SMEs to banking services. According to the official information of the CBAR,²⁷ the number of bank payment cards increased from 5.67 million to 5.8 million during 2013–2017 years, with the volume of transactions on bank cards rising from AZN1,149 million to AZN1,546 million and the number of POS terminals increasing from 33.3 to 65.5 thousand during this period.

However, despite the purpose of the Law of the Republic of Azerbaijan “On Non-Cash Payments,” adopted on 16 December 2016, to promote non-cash payments in the country, it has been hampered by several restrictions. According to the law, the total amount of taxable transactions by the taxpayers engaged in trading or public catering activities exceeding 200,000 manat during the calendar year is 30,000 manats, and activities of the other taxpayers exceeding a total amount of 15,000 thousand manats are only to be paid non-cash. A 1% simplified tax charged for the cashback transactions created difficulties for SMEs, thereby restricting their access to banking services.

2.5 Financial Technology Factors Driving Financial Sector Access by SMEs (P2P Lending or Crowdfunding)

Financial technologies that allow customers to access financial services have just begun to develop in Azerbaijan. Over the past five years, Azerbaijani banks have spent about 300 million manat on financial technologies, 49.8% of which was spent on purchasing new programs.²⁸ The so-called “regulatory sandboxes” mechanism is not used in Azerbaijan, and this significantly limits the possibility of the appearance of fintech companies on the market. Innovative and prospective start-ups are forced to leave Azerbaijan due to the lack of legislation. For example, Maliyya start-up²⁹ allowing p2p-lending without participation of financial institutions was forced to move to the UAE, where it was granted Innovative Technology License, a special license for fintech companies.³⁰

P2P lending or crowdfunding, which has become a popular means of funding for SMEs throughout the world in recent years, is limited in Azerbaijan. Companies working in this field are newly entering the market. Still, these mechanisms do not play a role in the financing of SMEs.

EnterpriseAzerbaijan.com launched by the CAERC,³¹ a state-run entity, provides services to bankable investment projects, playing the role of crowdfunding to finance business ideas of SMEs as well as start-ups.

²⁷ Azerbaijan Republic Central Bank Statistical bulletin, №07 (220), 07/2018, 2017, Baku. https://www.cbar.az/assets/4715/Statistik_b%C3%BClleten_2018_iyul_PDF.pdf

²⁸ <http://banco.az/az/news/duneni-bugunu-sabahi-fintech-maliyye-texnologiyalari-nedir>.

²⁹ <http://maliyya.com/#about>.

³⁰ <https://en.trend.az/other/commentary/2889171.html>.

³¹ <http://ereforms.org/>.

3. FINANCIAL KNOWLEDGE AND SKILLS OF SME ENTREPRENEURS

3.1 Assessments of Financial Literacy

As per the approach of the Organisation for Economic Co-operation and Development (OECD), financial literacy is a set of skills of financial consumers to understand financial products and concepts to improve their well-being, evaluate their financial risks and opportunities, make informed choices and take other effective steps. In many countries, there are state programs or strategies for financial literacy, and at the same time, work is being done to add financial literacy to the training program. Central banks and commercial banks are conducting campaigns for different target groups. In some countries, there are even financial literacy advisory centers.

Financial literacy of the population of consumers of financial services, including entrepreneurs, is not yet at the desirable level. Although there are no fundamental assessments conducted in this area, the results of surveys conducted by international organizations reveal the necessity of continuing financial literacy initiatives.

Unlike the local organization, the assessments done by foreign institutions capture the current reality with regard to financial literacy.

In 2014, *S&P's Ratings Services and the World Bank Development Research Group* produced the Global Financial Literacy Ranking as a result of the survey conducted with 150,000 people (over the age of 15) in 140 countries. Azerbaijan was ranked 65th out of 144 countries, implying that 36% of the population in Azerbaijan are financially literate. For comparison, according to the said report, the financial literacy levels in Kazakhstan are 40% (ranked 49th), in Uzbekistan 21% (ranked 126th), in Kirgizia 19% (ranked 134th), and Tajikistan 17% (ranked 139th).³²

In order to assess the financial literacy of the population, the WB surveyed the population over 18 years in Azerbaijan as part of the Financial Capability and Consumer Protection survey.³³ Since the survey was conducted in 2009 and 2016, it was possible to compare the levels of financial literacy of the population. The answers show that although there was an upward trend in a range of financial knowledge (inflation and computing knowledge), a backward-trending knowledge (compound interest rate) has also been observed. According to the assessment, the lowest score is about the ordinary interest rate (35.4) and the highest score in the correct distribution of ordinary shares (89.8). According to the methodology of the assessment, the lowest score is 0, the highest score is 100.

³² <https://www.theatlas.com/charts/VJDhtA8Xe>.

³³ <http://responsiblefinance.worldbank.org/surveys/demand/exploreconomies/azerbaijan/2016#financial-knowledge>.

Table 3: Key Financial Knowledge Indicators

Indicators	Azerbaijan		World	East Asia and Pacific
	2009	2016		
Percent of adults with understanding of inflation	45.8	67	51.5	38.9
Percent of adults with understanding of simple interest		35.4	42.3	69.2
Percent of adults with understanding of compound interest	46.2	45.7	35	58.7
Percent of adults who can think in real monetary values (money illusion)	61.7		50.5	
Percent of adults correctly calculating a simple division		89.8	88.2	96.8
Percent of adults with basic numeracy skills (to identify better bargains)	78.1	78.6	70.1	86
Percent of adults with basic numeracy skills (APRs)	52.3		41.2	
Percent of adults with deposit insurance awareness	5.8		11.3	

Source: World Bank.

3.2 Existence of Financial Education Strategy

The government has never had a long-term strategy in the field of financial literacy. At present, the existing strategies to increase financial literacy are reflected in the “National Road Map and Strategic Road Map on major sectors of the economy” approved by the Presidential Decree of 6 December 2016. The three components of the Strategic Road Map are highlighted in the development of financial literacy.

- Enhancing financial literacy has been identified as one of the five strategic goals in the ***Strategic Road Map on the development of financial services in the Republic of Azerbaijan***. The country’s financial services sector has been analyzed in the form of SWOT analysis in the Road Map, with the low financial literacy indicated as one of the weak sides of the sector. Therefore, enhancing the financial literacy of consumers and strengthening the protection of their rights is considered as one of the priority steps to be taken.
- ***The Strategic Road Map on the production and processing of agricultural products in the Republic of Azerbaijan*** argues that the low level of financial literacy of agricultural producers has led to the smaller share of loans provided to the agricultural sector in the total economy. Financial literacy is included among one of the priority activities “Improving financing mechanisms in the agricultural sector” to serve the strategic goal of “facilitating access to finance.” According to the map, the financial literacy of agricultural producers, including SMEs, will have increased and their access to finance on favorable terms will be provided.
- ***The Strategic Road Map on the production of consumer goods at the level of small and medium entrepreneurship in the Republic of Azerbaijan*** has included activities related to the improved financial literacy of SMEs under the Strategic Objective of “ensuring the effective and efficient access to financial resources of SME subjects.” The map indicates that as a result of the increased financial literacy of SMEs, they will be more competitive, which, in turn, will have a positive impact on the proper use of financial resources.

3.3 Institutions Involved (Both Public and Private)

CBAR was the first to subscribe to the initiative of financial literacy, implementing various financial literacy projects since 2010. The Ministry of Education and the Azerbaijan Library Confederation are the partners of the CBAR in Financial Literacy. On the other hand, the external organizations joining the process include the OECD, International Federation of Library Associations (IFLA), American Resource Centre (ARC), Germany International Cooperation Society (GIZ), PricewaterhouseCoopers Global (PWC), WB, German Savings Banks Foundation for International Cooperation (SBFIC).³⁴

Different public authorities and public legal entities are responsible for implementing activities to increase financial literacy envisaged in the “National Road Map and Strategic Road Map for Major Sectors of the Economy.” *The Strategic Road Map for production of consumer goods at the level of small and medium entrepreneurship in the Republic of Azerbaijan* shows the Ministry of Economy, the Ministry of Education, the FIMSA, and the Small and Medium Business Development Agency as the main implementers of the financial literacy of SMEs in the years 2017–2020. The CBAR and the FIMSA are responsible for the implementation of the “Identification of Directions to Strengthen Financial Literacy” envisaged in *the Strategic Road Map on the development of financial services in the Republic of Azerbaijan*. The main implementer of “Increasing the Financial Literacy of Agricultural Producers” envisaged in *the Strategic Road Map for the production and processing of agricultural products in the Republic of Azerbaijan*, which is to be implemented during 2017–2020, is the Ministry of Agriculture, as well as the Ministry of Economy, FIMSA and Local Authorities.

Along with public bodies, there are banks, higher education institutions, and public unions involved in this process. Azerbaijan Banks Association (ABA), Azerbaijan Micro-Finance Association (AMFA), together with the CBAR, implement projects on “Financial Literacy” now and then.

3.4 Target Groups and Programs

The main target groups of the Financial Literacy project, initiated by the CBAR, are students, the broader population, journalists specializing in economics, employees of the CBAR, bank employees and students studying banking. In addition, the target groups of events held by banks and associations are housewives, entrepreneurs who have started their business, young scholars, and teachers. Currently, there are no special programs to promote financial literacy among SMEs.

3.5 Types of Programs

Seminars, trainings, round tables, printed materials, video clips, and competitions are used as the tools for increasing financial literacy. For instance, e-learning materials were developed and a total of 25 events were held in 2012 under the framework of increasing financial literacy. A “Banks for Schools, Schools Banks” week was organized in cooperation with commercial banks, and trainings were held for commercial banks and teachers with varying approaches.³⁵ In 2013, the second International Savings Day in Azerbaijan and later, the Financial Literacy Month in November were held as the continuation of this. Issues such as central banking, credits, savings, credit cards, and others were discussed with necessary explanations in those events, covering

³⁴ <https://en.cbar.az/lpages/finance-edu/about-the-project/>.

³⁵ Central Bank of the Republic of Azerbaijan 2012 Annual Report. www.cbar.az.

about 10,000 schoolchildren, young families, and the broader public. In addition, the “Actual Annual Interest Rate” calculator was prepared and posted on play.google.com in partnership with the SBFIC.³⁶

3.6 General Financial Education

In recent years, various educational events (trainings, seminars, etc.) have been held in Azerbaijan to increase financial literacy. Secondary and higher education institutions are also involved in this process. Activities related to increasing financial literacy in educational institutions are limited to project activities. Except for economics-specific universities, subjects that focus on increasing the level of financial literacy are not taught in other higher and secondary education institutions.

3.7 Debt Management Programs

In Azerbaijan, SMEs have both payable and receivable debts. However, unlike payables, official statistics on the receivables are not disclosed. More than 90% of SMEs are individual entrepreneurs and family businesses without an accounting system in place and, therefore, no accurate accounting of enterprises' receivables is done. The receivables of SMEs arise from the non-payment for the products and services that SMEs sell. A number of entities are unable to meet their obligations to other institutions, including credit institutions, because they cannot obtain their receivables, and thus face the risk of default. Such a conclusion is made on the basis of the discussions with entrepreneurs within the framework of the study.

Unlike receivable debts, there are statistics on payable debts of SMEs. Due to the devaluation of the country in 2015, the volume of loans received from the financial institutions of the SMEs has increased up to double, which has created difficulties in repaying them. No program on the repayment of such loans has been made. To repay debts, credit institutions have to set up individual programs with their SME clients.

There is no single strategy in the country to manage either payables or receivables.

3.8 Assessment of Effectiveness

It is important to conduct an appropriate assessment to measure the level of financial literacy. Unfortunately, there are no such exams held in Azerbaijan except for a few cases. While the results of the “Financial Literacy Survey”³⁷ conducted with 1,200 respondents in the eight economic regions of the country in 2009 allowed for the basis of comparisons, no second survey was carried out later, which would have allowed an evaluation of the situation.

Not only the implemented projects, but also the economic hardships experienced in the financial sector of the country in 2014–2016 also played an important role in enhancing the financial literacy of SMEs. The devaluation of the national currency, the closure of banks, the increased risk of non-repayment of deposits, the bank's preference for foreign currency loans, and other threats raised entrepreneurs' interest in economic issues, with a growing readership of economic news in the mass-media, and the number of

³⁶ Central Bank of the Republic of Azerbaijan 2013 Annual Report. www.cbar.az.

³⁷ FINAL REPORT Results of the Financial Literacy Survey December 30, 2009 Baku, Azerbaijan. file:///D:/Rakurs/Sorgu/Financial_Literacy_Survey_Report_ENG.pdf.

economically active portals (fins.az, finans.az, fed.az. kommersant.az) starting to increase.

4. BARRIERS TO SME FINANCE

4.1 Supply Side

Factors hindering SMEs' access of to finance can be summarized as follows:

High interest rates. A high interest rate on credits is among the factors which enfeebls the access to credit resources for SMEs. According to the CBAR, the annual interest rate for loans up to one year is 17.75% in national currency, 7.75% in foreign currencies, 19.5% and 11% between 1 and 3 years, and 14.31% and 11.65%, respectively, on loans between 3 to 5 years.³⁸ In fact, interest rates for bank loans are higher than the official ones.

The main reason for higher annual interest rates on credit is due to higher rates for resources, in particular deposits, drawn by the banks. The share of deposits in total bank liabilities ranged from 75% to 78% between 2015 and 2018.³⁹ Therefore, a higher annual interest rate for deposits gives rise to higher interest rate on credit. According to the CBAR,⁴⁰ the annual interest rate for deposits in AZN is 11%–12%, while hitting 14%–15% at some banks, thus causing higher lending interests.

Qabus Research and Consulting Company (QRCC) and Centre for Media and Public Initiatives (CMPI) held a survey⁴¹ on **SMEs' access to loans**, with 38% of respondents citing a high interest rate as the reason why they had not applied to credit institutions. Up to 85% of the entrepreneurs surveyed had an average annual interest rate of over 20% for their loans.

Credit institutions not interested in financing the region. The official data suggest that in 2017 Baku had the highest concentration of the country's credit resources (83%). Overall, in 2010–2013, Baku's share in total credits was 87%. Annual interest rates on loans continue to grow, despite the slowdown in the capital from region to region. In Baku, annual interest rates (10.3%) are lower than the national average (11.8%). However, in some regions, such as the Lankaran and Aran economic regions, the annual interest rate is even higher than 22%.⁴²

Harsh terms of credit. Failure to get credit within the required amount and time is one of the common problems facing SMEs. In QRCC's and CMPI's survey,⁴³ entrepreneurs have raised this problem. The analysis of the survey results showed that 31.5% of the respondents were able to take as much credit as required, while the others complained about the small-size (29.6%), short-term (10.2%), and high interest rates (25%) of loans.

³⁸ https://www.cbar.az/assets/4495/STATISTIK_BULLETEN_2017_DEKABR.pdf.

³⁹ Azerbaijani Banks in 2018. Analytic bulletin. Baku Research Institute. <https://bakuresearchinstitute.org/azerbaijani-2018-ci-ild%C9%99-az%C9%99rbaycanin-bank-sektoru/>.

⁴⁰ Central Bank annual statistical bulletins. www.cbar.az.

⁴¹ Interest Rate Trends in Post-Soviet Economies: 2005–2011. Baku-2012. QRCC and CMPI.

⁴² Central Bank annual statistical bulletins. www.cbar.az.

⁴³ Interest Rate Trends in Post-Soviet Economies: 2005–2011. Baku-2012 QRCC and CMPI.

In addition, SMEs are not encouraged to deal with financial institutions due to the excessively high level of collateral requirements and much higher loan rates proposed by banks. It is also clear from the responses of banks surveyed that 94% of loans issued to SMEs in 2017 were secured by collateral and 6% were unsecured.

High risk in the economy. The analysis of the CBAR and FIMSA shows that the share of loans in the structure of bank sector assets has been decreasing in recent years; despite reaching a peak of 73.5% in 2013 the ratio of bank loans to assets started to decline in the following years, dropping to 41.1% in 2017.

The sharp decline in the ratio of loans to assets demonstrates the increasingly limited participation of the banking sector in the economic and real sector development. High risk in the economy leads banks to invest up to 60% of their assets in securities or the CBAR's depositary auctions. The increased share of troubled loans to 14% points to a high risk in the economy.

Preference toward loans in foreign currency. The expectations of devaluation accelerated the dollarization of the banking sector as of the end of 2014, with the banks squeezing their loans in national currency and preferring loans in foreign currency. As a result, the share of foreign currency in total lending increased from 27% in 2014 to 49.4% by the end of 2015 when the devaluation occurred. In the following years, this figure dropped slightly to 40.9% by the end of 2017 due to the relative stability of the national currency. Currently, the dollarization level in trade and the service sector is 43.8%, in the industrial and manufacturing sector 52.1%, in the Construction and property sector 24.4%, in transport and the communications sector 85.8%, and 19.4% in agriculture. The low level of dollarization in agriculture is due to the recent increase in the preferential loans provided by the state to this sector.

Lack of interest in leasing. Leasing services are poorly developed, and SMEs still rely on state-run "Agroleasing" Open Joint-stock Company,⁴⁴ working on more favorable terms. Private leasing companies operating in Azerbaijan chiefly lease out consumer goods (automobiles, domestic appliances, furniture, etc.). Current leasing interest rates are higher than bank loans and they are not profitable for entrepreneurs.

SMEs access to finance in Azerbaijan is limited and the "Strategic Road Map for manufacture of consumer goods by small and medium enterprises" adopted by the Government in December 2016 provides detailed explanations on the problem.⁴⁵ The document notes that 51% of SMEs operating in Azerbaijan point to the issue of access to finance as the most serious obstacle to business development. The Road Map also emphasizes that the low level of cash management capabilities in SMEs and weak corporate governance make banks less attractive to provide lending to SMEs. As a result, there is a high rate of denial of loans for SMEs in Azerbaijan. The government acknowledges in its Road Map that in 2016, one quarter of the loan applications in the agricultural sector, and 36% of micro-business lending applications were refused by banks.

Analysis of the surveys as part of the study also shows that banks restrictedly use loan financing mechanisms, such as letters of credit and guarantees (about 10–15% of all loans). The banks' responses show that about 90% of loans to SMEs are ordinary loans secured by collateral. As external security mechanisms do not work effectively, SMEs' personal assets (more than 30% of all loans are provided on these terms), or machinery and mechanisms at their disposal (about 27%), or their real estate (23%) are used as a

⁴⁴ <http://agrolizing.gov.az/en>.

⁴⁵ https://azertag.az/store/files/Strateji_yol_xeritesi/Ki%C3%A7ik_v%C9%99_orta_sahibkarl%C4%B1q_s%C9%99viyy%C9%99sind%C9%99_istehlak_mallar%C4%B1n%C4%B1n_istehsal%C4%B1na_dair.pdf

guarantee for collateral. In other words, according to a third-party warranty, SMEs at best can obtain about 10% of the loan available.

Insolvency. The devaluation that took place in 2015 worsened the solvency of SMEs borrowing in foreign currency. A more than twofold increase in monthly payments in foreign currency due to the devaluation, on the one hand, and the deteriorating turnover due to the slowing sales, on the other, restricted the ability of SMEs to repay their debts. Banks restructured the debt repayments by prolonging the repayment periods and reducing the annual interest rates of loans. However, this did not solve the problem, and the volume of troubled loans kept increasing. The insolvency to repay the incumbent loans and the prolonged periods of the old loans limited entrepreneurs' ability to receive new loans.

4.2 Demand Side

Low financial literacy of entrepreneurs. The low level of awareness of entrepreneurs about the range of financial services, coupled with their inaccurate and untimely loan applications ultimately reduce their access to credit resources. The results of our in-depth interviews with entrepreneurs in the research process indicate that many of them are unaware of the state funds providing preferential loans. For example, the QRCC and CMPI survey⁴⁶ shows that 73.1% of entrepreneurs reported that they had not applied for the state's preferential loans, with 53.9% of them explaining that they had had no information on preferential loans. Our interviews also show that entrepreneurs do not have the basic knowledge of the capital market, and only see bank loans as a source of finance.

Low financial transparency. Low financial transparency in the activities of SMEs complicates their access to finance. For example, in Azerbaijan, there is no experience in attracting financial resources from bonds. These sources are usually used by large companies. While the minimum annual interest rate of 16%–17% of the country's loans is low, attracting funds is even cheaper than that. The inability of SMEs to comply with the financial standards, or the lack of accountability in some cases, deprives them of being a participant in the equity market and it is because of the lack of transparency in financial accountability that SMEs cannot attract resources from abroad.

4.3 Institutional Aspects

Although there is a certain institutional environment providing for SMEs' access to finance, some institutional mechanisms do not function properly or exist at all. One such mechanism is the real estate registration and its participation in lending by acting as a guarantee mechanism.

According to the Civil Code and other legislation, the rights acquired through the agreements over land plots and other real estate are subject to state registration. The registration of rights over immovable property is carried out by the State Register of Real Estate Property. The certificate of state registration of real estate rights and their restrictions shall be provided to the right holder in writing or electronic form upon their written or electronic requests. At the request of the right holder, the extract, which is placed on the portal "Electronic government," is obtained by the notary public in the real-time mode via the electronic information system. After the approval of the contract by the

⁴⁶ Interest Rate Trends in Post-Soviet Economies: 2005–2011. Baku-2012. QABUS Research and Consulting Company and Center for Media and Public Initiatives.

notary, it is submitted along with other documents of the land to the State Real Estate Register Service for legal registration.

Banks often require collaterals for their business loans to SMEs. As a rule, real estate is required as a credit guarantee. It is mostly cars and gold products that are required as collateral. The practice of movable property as collateral is not a widespread practice in Azerbaijan.

Currently, there are difficulties in obtaining guaranteed credits in Azerbaijan. As part of the study and in-depth interviews, focus-group discussions held with entrepreneurs and professionals in the banking sector show that the collateral requirements of credit institutions are quite tough. These requirements mainly include the following:

- Real estate (house, premise, land) is accepted as collateral
- Real estate has to be based in the capital city of the country
- The amount of loan offered to a customer cannot exceed 50% of the market value of the collateral
- Real estate must be state-registered and included in the state registry

The complexity of the current collateral mechanisms leads the bank to apply harsh conditions to their customers to insure themselves. Our research suggests that the process of obtaining the right to sell the collateral for a non-repaid loan takes between 6 months to 2 years, which is due to the uncertainty in the relationship between the banks and the customer caused by law and the unfair judicial system.

The adoption of the *Law of the Republic of Azerbaijan "Encumbrance of Movable Property"* on 2 May 2017 created the possibility of movable property obtaining collateral status. According to the law, operated by the FIMSA, the state registry of the Encumbrance of Movable Property was established. Under the bill, along with cars as collateral, equipment, goods and cattle, goods in circulation, as well as movable assets such as receivables, will be accepted as collateral. The mechanism has just been created and is not used in lending yet.

4.4 Regulatory Factors

Insolvency issues in Azerbaijan are regulated by the law on *Insolvency and bankruptcy* adopted on 13 June 1997. Under the law, the debtor becomes insolvent when he or she can't repay the loans. The debtor is considered to be insolvent only when it is announced either by him/herself, the court, or lenders.

Under the law, the bankruptcy process may be initiated by the enterprise through an appropriate decision without the court's involvement. As soon as bankruptcy is announced, the debtor loses their right to dispose of any of the property as part of carrying out business activities or for the purpose of fulfilling their obligations. The debtor can issue such orders only with the permission from the court, property administrator and temporary property administrator.

The amendments made to the law created more opportunities for the debtor to recover from bankruptcy. According to the change, the lender or debtor can appeal to the court at any time to suspend the bankruptcy process in order to look at the possibility of recovery. The debtor's recovery should be carried out in accordance with the plan of recovery within the maximum duration of 24 months, as determined by law.

The law applies to all legal entities (*excluding banks and public entities*) and to all profit and non-profit organizations. At present, there is no legal basis for individuals to declare their insolvency. The Law of the Azerbaijan Republic on *Insolvency and Bankruptcy* does not prevent entrepreneurs from obtaining finance, yet it is incapable of addressing existing problems.

According to the *Doing Business 2018* report, Azerbaijan ranks 47th out of 190 on the Resolving Insolvency Indicator.⁴⁷ According to the report, lenders can get only 40.2 cents of each 1 dollar from an insolvent entity.

4.5 Cultural Aspects

The complicated access of SMEs to financial resources is also explained by the deep-rooted mentality and attitudes of people. First of all, the requirements arising from the religious narratives limit financial sources for entrepreneurs. As an Islamic country, a group of entrepreneurs in Azerbaijan may refuse to take loans from banks by referring to Sharia law, which states that interest is forbidden. The existing banking legislation does not support Islamic banking in the country, as a result of which entrepreneurs susceptible to religious demands are left without bank loans. Although Azerbaijan is a Moslem country, the financial legislation, and statements by government officials, exclude any initiatives or intentions regarding the implementation of the Islamic financial system.

Another cultural aspect with a negative impact on business financing is the lack of an unambiguous attitude of the society towards women's engagement in entrepreneurship. In surveys conducted,⁴⁸ the *negative attitudes (of their family and people around them, etc.) towards women in business* is raised as an obstacle.

4.6 Gender Issues

Gender disparity in financing the SMEs is blatantly prevalent. Since women's entrepreneurship is part of the overall entrepreneurship, women are faced with the same financial problems as SMEs are. The survey results held with women show that the problem of access to finance is reported to be the main factor hindering businesses.⁴⁹

There is no gender analysis of access to credit resources available in the official statistical data, including statistical bulletins of the CBAR and the FIMSA. According to the results of the representative statistical survey "*Gender issues in the production and sale of agricultural products*" conducted by the State Statistical Committee of the Azerbaijan Republic (SSCAR) in 2012,⁵⁰ women account for only 25.8% of the households receiving loans from financial institutions, while Global Findex argues that the share of women receiving loans from financial institutions was 15%.⁵¹

⁴⁷ http://www.doingbusiness.org/en/data/exploreeconomies/azerbaijan#DB_ri.

⁴⁸ The Current Situation on Women's Socio-economic Empowerment – Baseline Analysis. Democracy Monitoring Center. Baku 2017.

⁴⁹ The Current Situation on Women's Socio-economic Empowerment – Baseline Analysis. Democracy Monitoring Center. Baku 2017.

⁵⁰ Women and men in Azerbaijan – 2017. Statistical review. State Statistics Committee. www.stat.gov.az.

⁵¹ <http://datatopics.worldbank.org/financialinclusion/country/azerbaijan>.

The Entrepreneurship Development Fund of the Republic of Azerbaijan (EDF) granting preferential loans to entrepreneurs at the expense of public funds, provides gender analysis of loans. The Fund gave out a total of 2090.1 million manat to entrepreneurs in the country during 2012–2017, of which 61.3 million or 2.9% was accounted for by woman entrepreneurs.⁵²

5. STATUS OF DOMESTIC AND GLOBAL VALUE CHAINS IN THE COUNTRY

For Azerbaijan, whose economy is dependent on resources, it is key to develop value chains on the basis of non-resource spheres in accordance with the diversification strategy. The government has precisely targeted the economic diversification in its road map for the prospective development of the economy adopted in late 2016, and identified areas, such as the agrarian sector, food industry, tourism, financial services, and information technologies, as key sectors.

A value chain is a set of activities that an organization in a specific industry carries out to deliver a valuable product or service for its customers. The value chain of a finished product (service) sometimes runs through a full range of activities—including design, production, transportation, marketing, distribution, storage, etc., which are separate links in this chain.

The concept of a “global value chain” is used in relation to commodities and services that are the object of international trade. Countries contribute to the process of creating a global value chain in a different way. The participation of countries in the creation of a global value chain occurs either through the import of some components of products or services they export, or the export of various raw materials and components for goods and services produced in different countries.

The service sector plays an important role in ensuring the Azerbaijan economy’s participation in the global value chain. In 2017, the services sector (including construction) accounted for 55% of value added in the economy. However, according to the Government’s Road Map, only 3% of Azerbaijan’s SMEs are able to earn export revenues. Given that all SMEs are concentrated in the non-oil sector and non-oil exports account for only 2% of GDP, it is clear that export revenues from SMEs are very small in the tourism sector. It should also be taken into account that the activities of SMEs in Azerbaijan are mostly focused on manufacturing products of low and medium technological levels of the value chain. This includes primarily agrarian products, the food industry and construction industry, which do not require high technological processes.

The level of participation of any country in global value chains is directly dependent on the potential for the national economy’s diversification. The more the economy is diversified, the more sectors are involved in the creation of added value; the economy produces more products and services; to release products and services in the same sector, raw materials and materials of other sectors are consumed in the form of intermediate products. In this respect, the priority area for economic diversification should play the role of locomotive for the development of other sectors and form a new demand for their products. Diversification of the economy can take place on the basis of product development, which replaces imports on the basis of large domestic demand,

⁵² National Entrepreneurship Support Fund – 2012–2016 years annual reports. www.anfes.az.

and diversification of exports on the basis of areas where the country has comparative advantages.

Azerbaijan's non-oil exports for 2017 totaled US\$1.538 billion, accounting for 11% of total exports. Below is the product structure of non-oil exports:⁵³

Table 4: Product Structure and Value of Azerbaijan Non-oil Exports

Description of Goods	Value, in Million US\$	Share in Non-oil Exports, %
Live animals and edible products of animal origin	12.6	0.82
Edible vegetables and certain roots and tubers	210.0	13.65
Edible fruits and edible nuts: peel of citrus fruits	292.8	19.04
Animal and vegetable fats and oils	17.0	1.11
Sugars and sugar confectionery	40.2	2.61
Products of processing of vegetables, fruits, nuts, and other parts of plants	15.5	1.01
Miscellaneous food products	3.3	0.21
Alcoholic and non-alcoholic beverages and vinegar	21.9	1.42
Tobacco and manufactured tobacco substitutes	15.3	0.99
Products of the chemical industry	79.5	5.17
Organic chemicals	67.3	4.38
Plastics and articles thereof	101.1	6.57
Raw hides and skins (other than fur skins) and leather	14.9	0.97
Cotton	51.9	3.37
Other made up textile articles; worn clothing	20.5	1.33
Precious metals and articles thereof	141.5	9.20
Products of the ferrous and non-ferrous metal industry	245.0	15.93
Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	36.0	2.34
Electrical machinery and equipment and parts thereof	14.4	0.94
Other non-oil products	138	8.97

Source: State Statistical Committee of the Azerbaijan Republic.

As can be seen, the bulk of non-oil exports—about 44%—are agricultural and food products, while the metallurgy industry accounts for 25% of total non-oil exports.

5.1 Agricultural Sector: Primary and Intermediary Products Participating in Value Chains

The agricultural sector is one of the leading areas enabling the Azerbaijan economy's participation in global value chains. This is due to exports of various agricultural and agro-industrial products. The total volume of agricultural and agrarian-industrial production exported from Azerbaijan constituted \$658.9 million – \$502 million, or 76% of exports, consisted of fresh fruit and vegetables.⁵⁴

⁵³ Database on Azerbaijan's foreign trade structure: <https://www.stat.gov.az/source/trade/>.

⁵⁴ Data obtained from the State Statistical Committee publication on "Foreign Trade Relations of Azerbaijan – 2018." Source: <https://www.stat.gov.az/source/trade/>.

The agricultural sector participates in the formation of value chain across the country through both the production of various crops and livestock production. According to the results of 2017, the aggregate output of the agricultural sector at the actual prices is AZN6.580 billion. AZN3.561 billion or 54.1% of this amount is due to of cattle-breeding, and AZN3.019 billion or 45.9% is due to plant-growing production.

Based on official statistics, the bulk of agricultural products is provided by small farms. Thus, AZN5.935 billion, or 90%, of the AZN6.580 billion worth of agricultural production was provided by family-farmer and households of individual entrepreneurship subjects in 2017. There is no information in official sources on the exact portion and distribution of aggregate loans made available to the agricultural sector among the small, medium-sized, and large entrepreneurs. Only information on the total volume of loans allocated to agriculture is disclosed. According to the information provided by the CB, only 3.7%, or AZN29.2 million, of the loans for the whole economy was assigned to agricultural producers.

There is clearly currently some concern regarding the development level of these sectors and what they can contribute to the economy in the future. What remain serious problems in particular are the extensive growth of the agrarian sector, the smaller size of the agricultural area per capita (about 0.45 hectares), the non-use of cooperative models and the fragmented distribution of land plots among 800,000 farmers, the weak development of the processing industry that would purchase the crops of local farmers at the right time and at affordable prices, and exporting the bulk of their value chain as raw materials and intermediate products at lower prices without entering the stage of processing.

The extensive expansion of the agrarian sector manifests itself primarily in low productivity. Azerbaijan now lags behind developed countries, producing around four times less in both cattle breeding and crop production.

The number of food industry enterprises in the country is extremely limited and their processing capacity is insignificant. Most of them fail to contribute to the formation of a global value chain because they lack the capacity to export. For comparison, it is worth mentioning that the number of enterprises specialized in meat processing in Azerbaijan is less than 50 and the number of wine factories is less than 20. However, in Moldova, whose economy is 4–5 times smaller than Azerbaijan, the number of specialized meat-processing enterprises and wine plants is 200 and 50, respectively.

5.2 The Potential of the Processing Industry for Establishing Value Chains

The extractive industry constitutes a significant part of Azerbaijan's industry. According to official statistics, only 27.5%, or AZN8.9 billion, of industrial production with a value of AZN32.3 billion was generated in the processing industry. And 66% of the processing industry was provided by two areas—food products (including beverage production) and oil products processing. The food industry in Azerbaijan has no potential to create a large value chain; intermediate products formed mainly in the agricultural sector and raw materials are directly converted to end-products through the processing industry.

Table 5: 2017 Industry Structure in Azerbaijan⁵⁵

Fields and Sectors	Share of Industries, %
All industries	100
Extractive industries	70.3
Food industry (including tobacco)	8.2
Petroleum products processing	6.4
Chemical industry	1.3
Metallurgy industry	1.2
Energy power sector	4.6
Production of building materials	1.7
Other	6.3

Source: State Statistical Committee of the Azerbaijan Republic.

Other sectors of the processing industry hold very little portion in overall industry. The share of textiles, apparel and leather products (including footwear production) manufacturing in the total industrial output is slightly above 0.5%. The share of construction materials in the total industrial production is 1.3%, that of the chemical industry 1.2% and the metallurgy industry 1%.

In 2017 exports of processing industry products amounted to \$3.1 billion.

The share of small entrepreneurs is insignificant in the processing industry. In 2016, only 3% out of the products of the processing industry, which totals AZN8.9 billion in actual prices, was provided by small enterprises. In turn, small entrepreneurs produced 3.4% of food processing industry products and 16% of construction materials. However, small entrepreneurs dominate in terms of the number of enterprises. Thus, out of 1,777 enterprises operating in the processing industry, 1,058 were small and 719 large and medium-sized enterprises.

5.3 Opportunities to Participate in the Global Value Chains through the Services Sector

There has been a steady increase in the tourism sector in Azerbaijan in recent years. This growth was particularly strong between 2010 and 2015. The number of tourism enterprises in Azerbaijan increased by 4.5%, while employment within the tourism sector rose by 6% a year. The number of tourists rose by 8.5% during the period. According to the World Tourism and Travel Council, the tourism sector in Azerbaijan accounts for 2.8% of direct GDP and 2.6% of employment, which is slightly different from the average 3% of GDP in the world and 3.6% of direct employment. This means there is potential for further development.⁵⁶

Only the tourism sector has the potential to develop the value chain both domestically and globally. According to official statistics, the total turnover of the country's export of tourism services as of 2017 stood at around \$2.5 billion. However, this figure was 1.3 billion in 2013.

⁵⁵ Azerbaijan's industry statistical database: <https://www.stat.gov.az/source/industry/>.

⁵⁶ "Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy" <http://www.e-qanun.az/framework/34254>.

The development of the tourism sector, in particular improving its export potential, is among the government's main targets. Nevertheless, this sector should first be able to compete with the fastest-growing tourist destinations in the region, in particular, Turkey and Georgia. Natural conditions in these two countries are perfect for tourism activities. In particular, Georgia's tourist arrivals have grown by three times, with tourist numbers being over twice as large as that country's population over the past five years. But Azerbaijani tourism grew only by 22%. Azerbaijan in this situation will be able to shape the competitive tourism sector by improving the quality of its tourism infrastructure, creating favorable prices and applying simplified visa procedures under the same conditions for all countries.

In 2017, there were 16,795 SMEs in the tourism sector, accounting for 10% of the total number of SMEs. Their total turnover stood at 817 million manats, accounting for 15% of SMEs total product and service turnover. According to official data, SMEs accounted for 48.5% of the tourism sector.⁵⁷

6. VALUE CHAIN FINANCING ANALYSIS

The share of SMEs in lending is appropriate to their role in the economy. Thus, the share of SMEs in the economy is slightly above 6%, and about 10% of all loans are provided to them. This picture is similar across sectors of the economy. Trade is the sector with the highest share of SMEs and 63% of total turnover in this area is provided by SMEs. In turn, 42.4% of the loans provided to SMEs are used by the trade sector.

In agricultural production, SMEs account for 1.1%, and 3.6% of SME loans had been used by this sector. Although the share of the said sector in value added is less than 5%, nearly 25% of all loans provided to SMEs went to that sector. But the exports from this sector significantly exceed those from other areas. In 2017, the tourism sector generated \$3 billion in export revenues for the country, while the total export revenue of SMEs across all sectors of the economy is substantially less than that. According to the Government's road map, only 3% of Azerbaijan's SMEs are able to earn export revenues. Given that all SMEs are concentrated in the non-oil sector and non-oil exports account for only 2% of GDP, it is clear that export revenues from SMEs are very small in the tourism sector. It should also be taken into account that the activities of SMEs in Azerbaijan are mostly focused on manufacturing products of low and medium technological levels of the value chain. This includes primarily agrarian products, the food industry, and the construction industry, which do not require high technological processes. According to the banks surveyed, the services sector accounts for 77% of all loans issued to SMEs, while the agrarian sector accounts for 3.6%, construction materials for 2.2%, the construction sector for 1.1%, and the food industry for 0.6%.

The statistical data available to evaluate the level of SME financing through the value chain in Azerbaijan need sharpening in order to conduct in-depth research. Now let's look at how the information on the value chain financing scheme is disclosed in the context of agriculture.

First, and most typical in agriculture, the actors and especially farmers *self-finance* their operations through savings. The analysis of interviews with 270 farmers from across all regions of the country between 2015 and 2016 as part of the project, *Azerbaijan*

⁵⁷ <https://www.stat.gov.az/source/entrepreneurship/> "Small and Medium Entrepreneurship in Azerbaijan."

Agricultural Finance Facility (AAFF),⁵⁸ showed that 40.4% of respondents self-finance their operations. *One of the mechanisms for self-financing is the establishment of credit unions.* Under the Law of the Republic of Azerbaijan on Credit Unions, the Credit Union can be constituted by not less than 11 individual and (or) juridical persons in the statutory order. According to official figures, 54 credit unions are functioning in Azerbaijan.⁵⁹ There is no database on the volume of resources required for credit unions.

Since cooperatives as well as the network of credit cooperatives created jointly by farmers have not been formed in rural areas across Azerbaijan, self-financing has still to be developed. The reason for this was reported to be the lack of a legal framework to establish agrarian cooperatives until recently. The law on agriculture cooperation was adopted only in 2017, but the government's action plan on the development of cooperation in 2018. As the result of this policy it should be expected some improvement on this sector next years

Second, value chain financing is informal. Of the farmers interviewed within the AAFF project,⁶⁰ 19.3% said they had borrowed money from family members, 4.3% from friends and 0.2% from pawnbrokers. Examples also include input suppliers who sell fertilizer to farmers on credit, or commodity traders who supply cash advances so rural storekeepers can acquire commodities from farmers.

Third, it is a formal financing mechanism in the form of credit and technical support from state, international, and private financial institutions. With financial support from the World Bank (IBRD), the government of Azerbaijan implemented the *Agricultural Competitiveness Improvement Project (ACIP)*⁶¹ to facilitate the access of agricultural producers to markets by enhancing selected value chains, which is one of its targets. In the process of implementing the project with the total cost of \$53.25 million, an information-propaganda campaign was conducted for potential participants in 30 districts, and conceptual documents for agribusiness value chains for various manufacturing enterprises (engaged in dried fruits, meat processing, etc.) operating in several districts (Barda, Samukh) were prepared and submitted to the World Bank for approval. The banks, as part of the project, offered to finance the same value chain through authorized banks. Another project, the AAFF, is a joint project of the European Union and EBRD. Within the project, up to US\$40 million had been allocated to partner financial institutions to provide lending to entrepreneurs or individuals in the agrarian sector.

The above-mentioned funding mechanisms in the agrarian sector are present in any form at each stage of the value chain from field to table. Farmers mostly seek to self-finance their operations – or, if that is not possible, go to financial institutions. At the same time, they seek to benefit from the state's favourable financial and technical support.

At the *input supply* stage, technical support is provided by processing enterprises and the state (through Aqrolizing ASC). For example, a sugar-producing company supplies farmers with seeds, fertilizers and pesticides, and the costs incurred are deducted from the value of the product to be sold in the future. The state-owned Agroleasing company

⁵⁸ Azerbaijan Agricultural Finance Facility –AZAFF, Baku, 6 October 2016. http://amfa.az/uploads/6_october_2016_Az%C9%99rbaycan_k%C9%99nd_T%C9%99ssrufat%C4%B1_maliyy%C9%99_Erda_l_Kocoglu_AZE.pdf.

⁵⁹ <https://www.fimsa.az/en/List%20of%20Credit%20Unions>.

⁶⁰ Azerbaijan Agricultural Finance Facility – AZAFF, Baku, 6 October 2016. http://amfa.az/uploads/6_october_2016_Az%C9%99rbaycan_k%C9%99nd_T%C9%99ssrufat%C4%B1_maliyy%C9%99_Erda_l_Kocoglu_AZE.pdf.

⁶¹ <http://akia.gov.az/en/projects/view/3>.

provides farmers with seeds, fertilizers and pesticides, subject to a market price of 70%.⁶² Animal husbandry Agroleasing is leased to farmers by applying a 50% discount on animal value.⁶³ Similar support is also provided by *private processing* and state companies during the service process (Table 6).

In the *production process*, processing companies provide technical support to farmers to collect, harvest or market their products. For example, cotton processing plants supply to farmers harvesters and transportation means during the cotton harvest. The costs of machinery and equipment are then deducted from the value of the cotton they receive from the farmer. At the processing stage of the product, manufacturers will make a prepayment to the producers for the future product under futures contracts (Table 6).

Table 6: Value Chain Financing Scheme

Value Chain Level	Within Chain Finance	Source of Finance
Input supply	<ul style="list-style-type: none"> • Supplying seeds, fertilizers and pesticides • Supplying breeding animals (bloodstock) 	<ul style="list-style-type: none"> • In-kind support from processing companies (with a condition of subsequent repayment) • State's in-kind support on concessionary terms
Service providing	<ul style="list-style-type: none"> • Provision of technical means for cultivation, irrigation and spraying • Provision of essential equipment and medicines for animal housing (raising), survey and feeds 	<ul style="list-style-type: none"> • In kind support from processing companies (with a condition of subsequent repayment) • State's in-kind support on concessionary terms
Production	<ul style="list-style-type: none"> • Technical support for harvesting, transporting it to warehouses or sales points (e.g., delivery of harvesters for the cotton harvest) • Technical support for the processing of dairy and meat products, transportation to warehouses or sales points (e.g., milking equipment and dairy products' quality control devices) 	<ul style="list-style-type: none"> • In-kind support from processing companies (with a condition of subsequent repayment) • State's in-kind support on concessionary terms
Processing	<ul style="list-style-type: none"> • Making a prepayment for a future product under futures contracts 	<ul style="list-style-type: none"> • Financial support from wholesale companies / exporters (in the form of initial payment) • Favorable financial support from the state • Financing by credit institutions
Wholesale/Export	<ul style="list-style-type: none"> • Providing loans to exporters and wholesale sellers • Certification, logistics and sales organization on a 'single window' principle 	<ul style="list-style-type: none"> • Financial support from international and local financial institutions • Technical support by the government Support to Family Business (ABAD) public legal entity, AZPROMO) • Financial support from export-oriented companies and individual entrepreneurs
Retail	<ul style="list-style-type: none"> • Prepayment to producers or wholesalers by retailers 	<ul style="list-style-type: none"> • Financial institutions • Companies • Large supermarket chains

⁶² <http://agrolizing.gov.az/az/menu/213>.

⁶³ <http://agrolizing.gov.az/az/menu/229>.

At the *Wholesale/Export* stage of the value chain, loans are provided to exporters and wholesalers by financial institutions. The certification, logistics and sales organization of products are carried out on the “one-stop shop” principle by the state-run ABAD public-legal entity.⁶⁴ At the same time, the manufacturer brand is put on the product, with a relevant trademark indicating that it is manufactured under the supervision of ABAD. Retailers make initial payment to wholesalers for the products to be purchased (Table 6).

Recently, farmers have been provided with technical and financial assistance at all stages of the value chain thanks to the state’s increasing attention to the agrarian sector. At the same time, banks within the framework of programs of international financial institutions (WB, EBRD, ADB, among others) channel a certain amount of funding into the agrarian sector. Despite all this, banks are not particularly interested in attracting their funds to the agrarian sector. Banks prefer to allocate loans for the wholesale, export, and retail, which are the final stages of the value chain.

7. POLICIES TO PROMOTE SME FINANCE

7.1 Relevant Contents of National Strategy

Financing entrepreneurs, including SME operations, has been reflected in *the Law on Entrepreneurship* of the Republic of Azerbaijan, dated 15 December 1992. The law also envisages the activity of the National Fund for Entrepreneurship Support (NFES) at the Ministry of Economic Development in order to provide financing to entrepreneurship activities. Under the Presidential Decree *on Improving the Mechanism of State Support for the Development of Entrepreneurship in Azerbaijan*, dated 31 July 2018, NFES was liquidated and the public legal entity Entrepreneurship Development Fund was established under the Ministry of Economy.

The *Law on State Support for Small Entrepreneurship* of the Republic of Azerbaijan, adopted 4 June 1999, stipulates small enterprises’ access to concessional financing as the main directions of state aid. The scope of this law is limited to small entrepreneurship.

“*Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy*” was endorsed under a Presidential Decree on 6 December, 2016. The roadmaps focus on 11 major sectors of the economy, three of which, mentioned below, envisage increasing SMEs’ access to financial sources and implementing mechanisms for state support to financing.

- 1) One of the five strategic targets in the “*Strategic Road Map for manufacture of consumer goods by SMEs*” is to grant SMEs effective and favorable access to financing. It identifies four priority areas to achieve strategic targets:
 - *Conduct reforms to solve winding-up and insolvency issues*
 - *Create SME Loan Guarantee Fund*
 - *Improve activities related to property issues and boost access to finance*

⁶⁴ <http://abad.gov.az/en/about>.

- 2) One of the five strategic targets in the “*Strategic Road Map for manufacture of agricultural products*” is to provide simplified access for SMEs to financing opportunities. It identifies three priority areas to achieve strategic targets:
 - *Improve mechanisms for financing agriculture*
 - *Boost agricultural insurance*
 - *Promote agricultural investments*
- 3) One of the five strategic targets in the “*Strategic Road Map for financial services*” is to develop the financial markets. It identifies three priority areas to achieve strategic targets:
 - *Create favorable environment for emitters and financial intermediaries;*
 - *Increase access of investors to financial markets;*
 - *Increase active participation in inter-bank exchange market*

The establishment of mechanisms and institutions to improve SME finance in Azerbaijan is currently carried out in accordance with the strategic targets of these Road Maps.

Financial inclusion is one of the priorities of the “*Strategic Road Map for the development of financial services in the Republic of Azerbaijan.*” The document notes that improving the access to finance for micro, small and medium enterprises (MSMEs) can help to increase productivity, increase employment opportunities and provide a more productive distribution of resources in separate companies and across the whole country.

Women’s entrepreneurship is one of the main targets of the development in the *Strategic Road Map for manufacture of consumer goods by SMEs.*” Creating incentive mechanisms for the development of women’s entrepreneurship, the development of information support, creation of business incubators, organizations, associations, and professional organizations are measures to be taken within the Road Map.

The development of financial services is also among the strategic goals of the Azerbaijan government. The financial services market plays an important role in economic development, both in terms of access to essential financial resources of the economy or the formation of corporate governance culture to ensure the economy’s efficiency, as well as ensuring its participation in the global value chain through the domestic service markets. The strategic targets defined by the government in the Road Map are largely associated with the prospects of the money market and partly the stock market. However, the formation of a financial market that supports sustainable economic development depends on the mutual activities and parallel development of the monetary and capital markets. The money market carries out the accumulation and distribution of free cash as a debt in the short term, and serves as an exchange of resources. In the capital market, resources serve as a capital that increases their value, which is a “long money” market. But, for example, no strategic objectives, priorities and relevant indicators have been reflected in the said Road Map for the development of private investment funds and private pension funds, which are very important capital market institutions. However, the number of investment funds and private pension funds to be formed potentially in the country for the next 20 years, as well as their possible capitalization level, could be defined as target indicators. The Law on Labor Pensions (adopted in 2006), which provides legal opportunities for the creation of private pension funds in the country, has been in effect for 11 years and the Law on Investment Funds (adopted in 2010) for 7 years. However, neither investment funds nor private pension funds have been created in the country over the past period. Despite the fact that there is a separate law governing the activities of investment funds, the lack of capital markets and the lack of interest in companies to become a stock company are the main reasons

for the creation of investment funds. The main reason for the absence of private pension funds is the low level of formal employment (33%). Records for employees of the public sector with a two-third share of official employment are maintained through the state-owned pension fund.

7.2 Level of Policy, National or Otherwise

The regulatory acts regulating the enhancement of SMEs' access to financial resources are part of the country's national legislation and their implementation is mandatory in line with the legislation. The Strategic Road Maps, which focus on the development of various sectors of the economy, including the financing of SMEs, cover the government's strategic outlook until 2020, long-term outlook by 2025 and target outlook for the period after 2025.

7.3 Institutions Involved

"The *Strategic Road Map for manufacture of consumer goods by SMEs*" specifies the institutions providing financial services for SMEs. They are: Entrepreneurship Development Fund of the Republic of Azerbaijan (EDF),⁶⁵ the Azerbaijan Export and Investment Promotion Foundation (AZPROMO), the State Agency for Agricultural Credits (SAAC), the State Fund for Development of Information Technologies under the Ministry of Communications and High Technologies of the Republic of Azerbaijan (**see: section "2.3. Financial Institutions Involved"** for more details).

In addition, the state bodies such as CBAR, FIMSA, the Ministry of Taxes, the State Customs Committee, and the Ministry of Finance have been involved in the process.

The Agency for Development of Small and Medium Enterprises of Azerbaijan was created under a Presidential Decree *on Further Improving the Management of Small- and Medium-sized Businesses*, dated 28 December 2017. According to the Decree, the Agency will support the development of small and medium-sized businesses in the country and provide a range of, in particular, financial, services to the SMEs. To that end, SME houses, State–Entrepreneur Partnership Development Centre as well as SME development funds will be created under the Agency.⁶⁶

7.4 Specific Strategies

Support for trade finance. Trade finance has developed in Azerbaijan in recent years, with its products offered by only a limited number of banks. There are no specific strategies that support trade finance in Azerbaijan.

Interest rate subsidies. One of the requirements in the "*Strategic Road Map for manufacture of consumer goods by SMEs*" is to establish the credit guarantee fund. In accordance with this, "Azerbaijan Republic Credit Guarantee Fund Open Joint Stock Company" was created under a Presidential Decree, dated 29 November 2017. The legislation was amended under another Presidential Decree dated 25 December 2017 and the Azerbaijan Mortgage and Credit Guarantee Fund CJSC was established through the merger of the Azerbaijan Mortgage Fund and the Credit Guarantee Fund.⁶⁷ The Fund's major objective is to provide guarantees to entrepreneurs for manat

⁶⁵ The public legal entity Entrepreneurship Development Fund was renamed from the National Fund for Entrepreneurship Support on 21 July 2018.

⁶⁶ <http://www.e-qanun.az/framework/37470>.

⁶⁷ <http://mccgf.az/?/en/mainpage//>.

loans taken from authorized banks, and grant subsidies for a part of the interest calculated on these loans. The Rules “*On Subsidizing interest rates on loans received by entrepreneurs in manats*” were approved under a Presidential Decree, dated 29 November 2017. According to the Rules, the amount of secured loans is AZN30,000 to AZN5,000,000. The interest subsidy term for loans of up to three years is 8% per year and 10% for loans of over three years. Notably, the interest subsidy is provided for loans with annual interest rates not exceeding 20%. The interest rate subsidy does not apply to concessional loans provided through the government’s financial resources.

Since its launch, entrepreneurs have received AZN17.5 million in loans thanks to the guarantees issued by the Fund. At present, a system of automation of guarantee and interest subsidy provision is created to simplify the access of entrepreneurs, including SMEs, to lending and to secure the transparency and efficiency during the appeal process. The electronic system will be put into operation in the second quarter of 2019.⁶⁸

Credit databases. Loans in Azerbaijan had been long governed by the Centralized Credit Registry (CCR), which was established under the CBAR in 2005. The nature of data submissions and submission procedures for the CCR are governed by the Law of Azerbaijan *On Banks* (Article 35.4) and the Law of Azerbaijan *On Non-bank Credit Institutions* (Article 22.1). Currently, the CCR is operating within the FIMSA.⁶⁹

On 28 October 2016, the Law on Credit Bureaus was adopted, paving the way for the creation of a legal base for private credit bureaus. In December 2017, eight banks decided to establish the first private bureau – the Azerbaijan Credit Bureau LLC (ACB),⁷⁰ which started functioning on 15 January 2018 and providing access to debt obligation details to data users from 6 March 2018. The CCR no longer provides users’ access to data, pursuant to Article 23.3 of the Law *On Credit Bureaus* of Azerbaijan from 1 April 2018.

7.5 Assessment of Effectiveness, Gaps, Issues

In Azerbaijan, SMEs have not been marked as target groups in legislative acts related to business financing until recent years. Although the objective of EDF at the Ministry of Economy is to finance SMEs, its major beneficiaries have been large and medium-sized enterprises. In addition, in particular, small enterprises have been unable to access the concessional lending source provided by the government. Moreover, the Fund has not given sufficient priority to attention to SME finance since it operates as a public legal entity endorsed under the Presidential Decree, dated 31 July 2018.

Small enterprises have been outside areas of special state concern in Azerbaijan. The Law *on State Support for Small Entrepreneurship* of the Republic of Azerbaijan, adopted 4 June 1999, stipulates small enterprises’ access to concessional financing as the main directions of state aid, yet its implementation has not been ensured.

The document “*Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy*,” endorsed under a Presidential Decree on 6 December 2016, as a legal framework, was geared to supporting some mechanisms. A number of legislative acts were adopted to ensure the creation of the lending base and guarantee mechanism in accordance with the Road Maps. The law on *Encumbrance of Movable Property* has been adopted to increase the accessibility of SMEs to secured loans, because a lack of a unified system for the registry of movable property had hindered

⁶⁸ <http://mccf.az/post/563>.

⁶⁹ <https://www.fimsa.az/en/centralized-credit-registry>.

⁷⁰ <https://www.azernews.az/business/124329.html>.

financial institutions in lending more funds to small enterprises secured by their movable assets. The World Bank ⁷¹ reports that of SME assets in Azerbaijan, only 22% are land and property, while 34 and 44% are accounts receivable, and plant and equipment, accordingly.

The State Registry of the Encumbrance [of Movable Property] has been operating since 15 March 2018, introduced by the law. The Registry was established to enhance SMEs' accessibility to financing and enable them to take loans through any movable property as collateral. The Registry's activity is still limited.

In general, the institutions – including the Credit Guarantee Fund, Azerbaijan Credit Bureau, the Registry of the Encumbrance of Movable Property—geared to increasing SME finance have been recently established and therefore the scope of their activities is limited. So, at this early stage, it is premature to assess the efficiency of their work.

8. CONCLUSIONS AND RECOMMENDATIONS

8.1 Conclusions

Although the number of SMEs in Azerbaijan is increasing, their contribution to the country's economy is insignificant. One of the factors that hampers the development of SMEs is their poor access to finance. While assessing the business environment in the country, both international and local organizations point to the difficulty SMEs face in attracting finance to enhance their business.

The SMEs in Azerbaijan mainly prefer bank loans as external funding sources. However, high loan rates, the severity of conditions, a shortage of the required amount, and reduced grace periods weaken SMEs' access to this kind of finance. The experience of securing finance from the alternative securities market is not at the level of small and medium enterprises. A lack of SME interest in transparency and accountability limits their ability to benefit from financial market sources.

State support mechanisms have been established in the country to ensure SME development and finance, resulting in the functioning of a number of institutions. However, these institutions are unable to fully support the finance required by the market. On the other hand, large enterprises are gradually driving SMEs out of state support.

One of the key areas of the Azerbaijan economy's participation in the global value chain is the agrarian sector. However, our surveys found that the banks are most interested in financing the trade or food service, which are the end stage in the value chain. Although the financial institutions established by the state prefer to issue preferential loans for the agricultural sector, the share of the agrarian sector in total lending is low because of the high risk in the sector.

A preference of banks for secured loans, the lack of full functioning of movable property's collateral mechanism, and shortcomings in this mechanism as a whole, reduce SMEs' access to secured loans.

⁷¹ <https://mpcr.fimsa.az/en/about>.

8.2 Recommendations

It would be appropriate to initiate the following steps to increase SMEs' access to finance:

- **Apply Islamic banking** through providing support to the development of Islamic financial mechanisms and institutions by amending the existing legislation. It should be approved by separate legislation, such as a *Law on Islamic Banking* or can be included in a special section of the *Law on Banking* to allow credit organizations to conduct Islamic banking;
- **Improve the collateral mechanism in the banking sector to facilitate SMEs' access to lending.** This involves improving the process of pledging property and decreasing its term, including the number of court procedures.
- **Implement a mechanism for venture financing to meet risks SME innovative start-ups may be exposed to.** The legislative framework is being improved to develop start-ups, and to stimulate innovative investment. To that end, it is anticipated that a bill on "Venture Funds" will be adopted, while the law on "Investment Funds" will be amended.
- **Support the application of financial technologies.** It is necessary to take stimulating measures under legislation for the application of P2P lending or crowdfunding, which are financial mechanisms for SMEs.
- **Task the Entrepreneurship Development Fund to lend to only micro, small, and medium-sized enterprises.** It is appropriate to seek to apply the government's concessional financial mechanisms to SMEs through amending the Fund's statute.
- **Expand financial services for international trade transactions carried out by SMEs and promote foreign direct investment (FDI)** through providing methodological support to increase the compliance of products exported by SMEs with relevant standards and requirements, and issuing grants and preferential loans to producers.
- **Prepare a state program for rural tourism development.** This could include a number of issues, such as increasing SMEs' knowledge to strengthen their role in the state program, developing financing mechanisms, simplifying visa regime, etc.

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