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## Financial Integration in a Transition Economy: Evidence from Azerbaijan Using ARDL and VAR Approaches

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**Abstract:** This study examines the degree and dynamics of Azerbaijan's financial integration with global financial markets within a comprehensive theoretical and empirical framework. Building on classical theories of economic integration and contemporary literature on financial market integration, the paper conceptualizes integration as a gradual, multidimensional, and institutionally conditioned process rather than a binary outcome. Using time-series data from official national and international sources, the analysis employs a combined autoregressive distributed lag (ARDL) and vector autoregression (VAR) approach to capture both long-run equilibrium relationships and short-run dynamic interactions among key macro-financial variables. The empirical results provide robust evidence of long-run cointegration between Azerbaijan's domestic financial indicators and global financial variables, indicating the existence of structural financial linkages. However, the magnitude of estimated coefficients and the speed of adjustment reveal a moderate and partial level of integration. Exchange rate dynamics emerge as the primary transmission channel of global financial conditions, while interest rate linkages remain comparatively weak. Short-run dynamics further show that external financial shocks propagate through the system in a controlled and non-disruptive manner. The study contributes empirical evidence from a transition economy and offers policy-relevant insights on balancing financial openness, stability, and market development.

**Keywords:** financial integration; emerging markets; ARDL; VAR; global financial markets

### 1. Introduction

Over the last few decades, the rapid expansion of global financial linkages has profoundly transformed the way national financial systems operate and interact with one another. Advances in information technologies, the liberalization of capital accounts, and the gradual dismantling of regulatory barriers have enabled financial markets to transcend national borders, creating an increasingly interconnected global financial environment. In this context, financial integration has emerged not merely as a

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technical outcome of globalization, but as a central structural feature shaping capital allocation, risk transmission, and macroeconomic performance across countries (Machlup, 1975; Kindleberger, 1987).

At its core, financial integration reflects the degree to which domestic financial markets are connected to international markets, allowing capital to move with fewer frictions and financial assets to be priced in a more uniform manner across borders. In highly integrated systems, investors benefit from broader diversification opportunities, reduced transaction costs, and improved access to global financial instruments. A substantial body of literature suggests that such integration can contribute positively to economic growth and welfare by enhancing risk-sharing mechanisms and lowering the cost of capital (Evans & Hnatkovska, 2007; Kim et al., 2006). Nevertheless, financial integration also carries inherent risks. Increased exposure to global financial cycles may amplify external shocks, transmit financial crises more rapidly, and limit the effectiveness of domestic monetary and regulatory policies—concerns that are particularly salient for emerging and transition economies (Lesmond et al., 1999; Waelti, 2011).

The concept of financial integration is rooted in broader theories of economic integration, which emphasize the gradual removal of discrimination between national markets and the formation of unified economic spaces. Early theoretical contributions by Tinbergen (1954) and Balassa (1961) conceptualized integration as a process driven by policy coordination and the elimination of artificial barriers to economic interaction. Subsequent work expanded this framework by highlighting the institutional, regulatory, and financial dimensions of integration, underscoring the role of financial markets as both drivers and outcomes of economic integration (Machlup, 1975). Over time, empirical research has complemented these theoretical perspectives by developing quantitative methods to measure integration, including cointegration analysis, dynamic correlation models, and vector autoregressive approaches applied to equity, bond, and banking markets (Worthington & Higgs, 2007; Lindman et al., 2020).

Much of the empirical literature on financial integration has focused on advanced economies, particularly within the European Union, where monetary unification and regulatory harmonization have provided a natural laboratory for studying deep financial integration. Evidence from the European Monetary Union indicates that shared monetary frameworks and coordinated policies significantly strengthen market integration and increase the synchronization of financial cycles (Kim et al., 2006; Waelti, 2011). By contrast, considerably less attention has been paid to emerging and post-transition economies, where integration processes tend to be partial, uneven, and strongly conditioned by institutional capacity and structural characteristics.

In this regard, Azerbaijan represents an underexplored but analytically important case. Existing studies on Azerbaijan's financial system have largely concentrated on institutional reforms, banking sector resilience, and regulatory alignment with international standards (Ağayev, 2010; Mamedov et al., 2021). While these contributions offer valuable descriptive insights, they rarely engage in systematic empirical analysis of Azerbaijan's financial integration with global markets. In particular, there is a noticeable lack of studies employing modern econometric techniques to examine the dynamic relationships between Azerbaijan's macroeconomic indicators and international financial variables. This gap limits our understanding of how deeply Azerbaijan is embedded in global financial networks and how external financial developments affect its domestic financial stability.

Addressing this gap is especially relevant in light of Azerbaijan's ongoing economic transformation. As a resource-rich economy seeking greater diversification and investment inflows, the integration of

its financial markets into the global system has become a strategic priority. Moreover, recent global developments—such as the rise of digital finance, FinTech innovations, and sustainable finance—have introduced new channels through which financial integration can occur, reshaping traditional patterns of cross-border financial interaction (Menkveld, 2013; Arslan & Berkman, 2022). These trends underscore the need for a comprehensive and empirically grounded assessment of Azerbaijan’s financial integration within the contemporary global context.

Against this background, the present study aims to analyze the degree and dynamics of Azerbaijan’s financial market integration with global financial markets using a robust econometric framework. By employing ARDL and VAR models, the study captures both short-term adjustments and long-term relationships among key macroeconomic and financial variables. In doing so, it contributes to the literature by extending empirical analysis beyond advanced economies and offering evidence from a transition economy with distinct institutional and structural features.

Overall, this research seeks to make three principal contributions. First, it applies established theories of financial integration to a relatively understudied national context, enriching the comparative literature. Second, it provides empirical evidence on the transmission mechanisms linking Azerbaijan’s financial system to global markets. Third, it offers policy-relevant insights into the opportunities and risks associated with deeper financial integration, thereby informing discussions on financial stability, regulatory reform, and long-term economic strategy in emerging economies.

## **2. Literature Review**

The literature on financial integration is deeply rooted in broader theories of economic integration, which conceptualize integration as a gradual process of reducing discrimination across national markets and enhancing cross-border coordination. Early theoretical contributions by Tinbergen (1954) and Balassa (1961) remain foundational, as they frame integration not merely as a market-driven phenomenon but as an outcome of deliberate policy alignment and institutional design. Tinbergen’s definition emphasizes the removal of artificial barriers and the conscious coordination of economic activities, while Balassa highlights the elimination of discrimination within a defined economic area (Tinbergen, 1954; Balassa, 1961). These perspectives provide the conceptual baseline for understanding financial integration as part of a wider economic transformation rather than an isolated financial outcome.

Machlup (1975) further systematizes this view by tracing the intellectual evolution of integration theory and underscoring the importance of institutional convergence. Within this framework, financial integration emerges as a functional extension of economic integration, reflecting the increasing interdependence of national financial systems. The dissertation explicitly builds on this theoretical lineage, treating financial integration as a multidimensional process shaped by regulatory harmonization, market infrastructure, and institutional capacity rather than capital mobility alone (Machlup, 1975).

A central strand of literature examines the macroeconomic consequences of financial integration, particularly its implications for welfare, consumption smoothing, and macroeconomic volatility. Among the most frequently cited core contributions is the study by Evans and Hnatkovska (2007), which provides a nuanced assessment of the welfare effects of financial integration. Their findings suggest that while integration enhances international risk-sharing and can stabilize consumption in the

short run, its long-term welfare gains are neither automatic nor uniformly distributed across countries (Evans & Hnatkowska, 2007). This insight is particularly relevant for emerging economies, where structural vulnerabilities may offset some of the expected benefits of integration.

Related research emphasizes that financial integration may simultaneously reduce idiosyncratic risk and increase exposure to global shocks. Lesmond et al. (1999) demonstrate that integrated markets tend to exhibit lower transaction costs, thereby improving market efficiency, but also facilitating faster transmission of financial disturbances. Similarly, Waelti (2011) shows that increased synchronization of financial markets—often associated with monetary and financial integration—can intensify spillover effects across countries. These studies collectively frame financial integration as a double-edged process, reinforcing the need for careful empirical assessment rather than normative assumptions of universally positive outcomes.

Beyond theoretical debates, a substantial body of literature focuses on how financial integration can be empirically measured. This line of research distinguishes between quantity-based measures (such as cross-border capital flows) and price-based measures, which examine the convergence of asset prices, interest rates, or returns across markets. In practice, price-based indicators have become dominant due to their ability to capture market expectations and dynamic adjustments.

Within this methodological tradition, the European Union has served as a primary empirical reference point. Baele et al. (2004) provide one of the most influential frameworks for measuring financial integration in Europe, proposing a set of indicators that capture integration across money, bond, equity, and banking markets. Their work is widely regarded as a core reference because it operationalizes integration in a way that is both theoretically grounded and empirically tractable (Baele et al., 2004). Complementing this approach, Arouri and Foulquier (2012) synthesize theoretical and empirical findings on financial market integration, highlighting the strengths and limitations of various econometric techniques used in the literature.

Studies focusing on capital markets frequently employ correlation, cointegration, and volatility-based methods to assess integration. Bekaert and Harvey (1997) offer an early and influential analysis of emerging equity markets, demonstrating how volatility dynamics change as markets become more integrated with global financial systems. Subsequent research by Croci (2004) and Bentes (2015) refines these approaches by emphasizing time-varying correlations and long-run equilibrium relationships, thereby capturing both short-term market reactions and deeper structural integration. This methodological evolution directly informs the empirical strategy adopted in the dissertation, particularly the use of ARDL and VAR models to distinguish between short-run dynamics and long-run relationships.

*Financial integration in emerging and transition economies:* While advanced economies dominate the empirical literature, a growing number of studies highlight the importance of country-specific institutional and structural factors in shaping integration outcomes in emerging and transition economies. These studies argue that incomplete financial development, regulatory gaps, and limited market depth can significantly alter the effects of integration. As a result, findings from advanced economies cannot be mechanically transferred to developing contexts.

In post-Soviet and resource-rich economies, financial integration often proceeds unevenly, with banking sectors integrating more rapidly than capital markets. The literature suggests that such asymmetries may increase systemic risk if regulatory capacity does not evolve in parallel with market

openness. This perspective reinforces the relevance of examining integration through a country-specific lens, as done in the present study.

*Azerbaijan's financial system in the context of the literature:* Within this broader academic landscape, Azerbaijan remains a relatively underexplored case. Existing studies primarily focus on institutional reforms and regulatory compliance, particularly in the banking sector. Ağayev (2010) evaluates Azerbaijan's banking system within the Basel II framework, emphasizing the importance of risk management and capital adequacy in the context of increasing financial openness. More recent work by Mamedov, Namazov and Valiev (2021) discusses emerging challenges and opportunities facing Azerbaijan's financial markets, noting that deeper integration with global markets requires enhanced transparency, stronger institutions, and more diversified financial instruments.

Structurally, Azerbaijan's financial system is dominated by the banking sector, while capital markets remain relatively shallow. The Baku Stock Exchange plays a growing but still limited role in mobilizing long-term finance, and non-bank financial institutions contribute mainly through microfinance and leasing activities. From the perspective of financial integration theory, this structure implies that Azerbaijan's integration is likely to be partial and uneven, underscoring the need for empirical analysis that captures both external linkages and domestic constraints.

Against this backdrop, the present study positions itself at the intersection of three strands of the literature: (I) classical theories of economic and financial integration, (II) empirical methodologies for measuring financial integration, and (III) country-specific analyses of emerging and transition economies. By applying established econometric techniques to Azerbaijan's financial system, the study seeks to bridge a clear gap in the literature and contribute empirically grounded insights to ongoing debates on the benefits, risks, and policy implications of financial integration in emerging markets.

The reviewed literature highlights two interrelated gaps that motivate the empirical strategy of the present study. First, while theoretical and empirical research has extensively examined financial integration in advanced economies, particularly within the European context, evidence from emerging and transition economies remains limited and fragmented. Second, even in studies focusing on such economies, short-term market co-movements are often analyzed separately from long-run structural relationships, leading to an incomplete understanding of integration dynamics.

The dominance of price-based and time-series approaches in the core literature suggests that financial integration is inherently dynamic, evolving through both short-run adjustments and long-run equilibrium relationships (Bekaert & Harvey, 1997; Baele et al., 2004). This methodological insight is especially relevant for countries like Azerbaijan, where financial markets are still developing and integration processes are unlikely to be instantaneous or linear. As emphasized in prior studies, capturing only contemporaneous correlations risks overstating integration, while ignoring short-run dynamics may obscure important transmission mechanisms (Arouri & Foulquier, 2012).

In response to these methodological challenges, recent empirical work increasingly favors econometric frameworks that allow for the simultaneous examination of short-term dynamics and long-term relationships. The autoregressive distributed lag (ARDL) approach and vector autoregression (VAR) models have emerged as particularly suitable tools in this regard, as they accommodate mixed orders of integration, capture dynamic interactions among variables, and provide a coherent structure for analyzing macro-financial linkages over time. These features align closely with the objectives of the

present study, which seeks to assess not only whether Azerbaijan’s financial markets are integrated with global markets, but also how this integration unfolds across different time horizons.

Accordingly, building on the theoretical foundations and empirical insights identified in the literature, the next section outlines the data sources, model specifications, and econometric methodology employed to analyze the degree and dynamics of Azerbaijan’s financial integration with global financial markets.

### 3. Methodology

The empirical analysis relies on a time-series dataset constructed from officially published macroeconomic and financial indicators. The primary data source is the Central Bank of Azerbaijan, complemented by internationally harmonized databases to ensure consistency and comparability. The sample period is defined by data availability and is sufficiently long to capture both internal financial reforms and exposure to global financial shocks.

Variable selection follows the core literature on financial integration and reflects both price-based and quantity-based dimensions. Exchange rate indicators are included to capture external price transmission and competitiveness effects; interest rate variables represent domestic monetary conditions and potential capital mobility; balance-of-payments indicators proxy cross-border financial interactions. Together, these variables allow financial integration to be analyzed as a multidimensional and dynamic process rather than a single-channel phenomenon.

#### 3.1. Time-Series Properties and Integration Structure

Before estimating the models, unit root tests are conducted to examine the stochastic properties of the variables. The results are summarized in Table 1.

**Table 1. Unit root test results**

Variable	Level	First difference	Integration order
Exchange rate	Non-stationary	Stationary ( $p < 0.05$ )	I(1)
Interest rate	Weakly stationary	Stationary ( $p < 0.05$ )	I(0)/I(1)
Balance of payments	Non-stationary	Stationary ( $p < 0.01$ )	I(1)
External financial indicator	Non-stationary	Stationary ( $p < 0.05$ )	I(1)

The variables exhibit mixed orders of integration, with most becoming stationary after first differencing. This pattern is typical for emerging and transition economies, where external-sector variables adjust gradually, while monetary indicators respond more directly to policy actions. Crucially, none of the variables are integrated of order two, which confirms the appropriateness of the ARDL framework and rules out spurious regression concerns.

#### 3.2. Long-Run Integration Analysis: ARDL Bounds Testing

To test for the existence of a long-run relationship among the variables, the ARDL bounds testing approach is applied. The results are reported in Table 2.

**Table 2. ARDL bounds test for cointegration**

Statistic	Value
F-statistic	Above upper bound (5%)
Cointegration	Confirmed

The bounds test clearly indicates cointegration, implying that Azerbaijan's domestic financial indicators and external financial variables are linked by a stable long-run equilibrium relationship. From an integration perspective, this result constitutes the core empirical evidence that Azerbaijan's financial system is structurally connected to global financial markets, even if short-run deviations occur.

### 3.3. Long-Run Coefficients and Adjustment Mechanism

The estimated long-run coefficients and the error correction term are summarized in Table 3.

**Table 3. Long-run ARDL estimates**

Variable	Coefficient	Significance
Exchange rate	0.35–0.45	Significant
Interest rate	0.20–0.25	Significant
Error correction term	–0.30	Significant

The long-run coefficients indicate that exchange rate movements are the dominant channel of financial integration. A one-percent change in the exchange rate leads to an approximately 0.35–0.45 percent long-run adjustment in balance-of-payments-related indicators, suggesting a moderate but meaningful degree of price-based integration. Interest rates also display a significant relationship, though with smaller elasticity, reflecting partial monetary integration constrained by domestic policy instruments.

The error correction term is negative and statistically significant, with a magnitude close to –0.30. This implies that about 30 percent of short-run disequilibrium is corrected within one period. Economically, this adjustment speed points to gradual integration: deviations from the long-run path are neither persistent nor immediately eliminated, reflecting a balance between external pressures and domestic stabilization mechanisms.

Short-run ARDL estimates reveal that exchange rate shocks exert an immediate effect on external financial indicators, with coefficients in the range of 0.15–0.20. These effects are statistically significant but smaller than the long-run coefficients, indicating that integration intensifies over time rather than materializing instantaneously. Short-run interest rate effects are weaker and often insignificant, suggesting that short-term monetary adjustments remain largely domestically driven.

### 3.4. Dynamic Interactions: VAR Framework

To capture endogenous interactions among variables, a VAR model is estimated. The key results are summarized in Table 4.

**Table 4. Variance decomposition results (medium term)**

Shock source	Share of variance explained
Exchange rate	20–25%
Interest rate	<10%
Own dynamics	Remainder

The variance decomposition shows that exchange rate shocks account for a substantial share of the forecast error variance in external financial indicators, while interest rate shocks play a more limited role. The dominance of own dynamics highlights the importance of domestic structural factors. Together with impulse response analysis (not tabulated), these results indicate that external shocks propagate through Azerbaijan's financial system but do not dominate it.

Integrating the evidence from all tables, the methodology reveals a partial, asymmetric, and gradual pattern of financial integration. Long-run cointegration confirms structural linkage with global markets, while short-run dynamics and VAR results demonstrate differentiated transmission channels. Exchange rates serve as the primary conduit of external financial influence, whereas interest rates reflect a more domestically anchored adjustment process.

By embedding the key empirical tables directly within the methodological framework, this section demonstrates not only how the analysis is conducted, but also why the chosen econometric strategy is appropriate for capturing the specific characteristics of Azerbaijan's financial integration.

#### **4. Results and Discussion**

The empirical findings provide consistent evidence that Azerbaijan's financial system exhibits a partial, asymmetric, and gradual form of integration with global financial markets. Rather than indicating full convergence or isolation, the results point to a nuanced integration pattern shaped by structural characteristics, policy frameworks, and market depth. This section discusses the findings in light of the theoretical expectations and empirical evidence reviewed earlier.

The confirmation of cointegration among domestic financial variables and external financial indicators constitutes the central empirical result of the study. The existence of a stable long-run relationship suggests that Azerbaijan's financial system is structurally linked to global financial markets, even though short-term deviations occur. From a theoretical standpoint, this finding aligns with the classical integration framework proposed by Tinbergen and Balassa, which conceptualizes integration as a gradual and policy-mediated process rather than an instantaneous outcome of liberalization.

The magnitude of the long-run coefficients indicates that exchange rate dynamics are the dominant channel through which global financial conditions influence Azerbaijan's external financial position. The estimated elasticity—lying in a moderate range—implies that external price signals are transmitted into the domestic system, but not in a fully proportional manner. This outcome reflects Azerbaijan's managed exchange rate practices and the presence of policy buffers that moderate external pressures. In contrast, interest rate linkages are weaker, pointing to limited monetary integration. This asymmetry suggests that while Azerbaijan is exposed to global financial movements, domestic monetary policy retains a degree of autonomy.

These results resonate with the broader literature on emerging and transition economies, where financial integration tends to be incomplete and uneven across market segments. Similar to the findings of Evans and Hnatkowska (2007), integration enhances cross-border linkages without eliminating domestic frictions or policy influence. Thus, the Azerbaijani case reinforces the view that integration should be understood as a conditional and context-dependent process.

The statistically significant and negative error correction term indicates that deviations from the long-run equilibrium are systematically corrected over time. However, the estimated speed of adjustment—around one-third of disequilibrium per period—points to gradual rather than rapid convergence.

Economically, this suggests that Azerbaijan's financial system absorbs external shocks without abrupt realignments, reflecting a balance between openness and stabilization mechanisms.

This gradual adjustment dynamic is consistent with institutional and structural realities. Financial markets with limited depth and liquidity typically adjust more slowly to external shocks, as information transmission and arbitrage mechanisms are less developed. In this sense, the observed adjustment speed can be interpreted not as a weakness, but as a reflection of controlled integration, where excessive volatility is avoided at the cost of slower convergence.

Short-run dynamics further underline the asymmetric nature of financial integration. Exchange rate shocks exert immediate and statistically significant effects on external financial indicators, whereas interest rate effects remain weak or insignificant in the short term. This pattern suggests that currency markets serve as the primary conduit for short-term financial transmission, while credit and interest rate channels are more insulated.

From a policy perspective, this finding is particularly relevant. It implies that external financial disturbances are most likely to affect Azerbaijan through exchange rate movements rather than through sudden shifts in domestic borrowing costs. Such insulation may reduce vulnerability to global monetary tightening cycles but also limits the responsiveness of domestic financial markets to international capital flows.

The VAR-based analysis reinforces the conclusions drawn from the ARDL framework. Impulse response functions reveal that exchange rate shocks generate persistent, but not destabilizing, responses in balance-of-payments indicators. The effects peak within a few periods and gradually fade, indicating that external shocks trigger adjustment cycles rather than permanent disruptions.

Variance decomposition results further demonstrate that while global financial variables play a meaningful role, domestic dynamics remain dominant. Exchange rate shocks explain a sizable but not overwhelming share of forecast error variance, whereas interest rate shocks account for a relatively small portion. This reinforces the interpretation that Azerbaijan's financial system is externally connected yet internally anchored.

Such findings are consistent with empirical evidence from other emerging economies, where integration enhances exposure to global conditions without fully displacing domestic determinants of financial outcomes. In this regard, Azerbaijan resembles economies that occupy an intermediate position between financial autarky and full liberalization.

#### **4.1. Implications for Financial Integration Theory**

Taken together, the results contribute to the literature by illustrating how financial integration manifests in a resource-rich, transition economy with evolving institutions. The findings challenge simplistic notions of integration as a binary state and instead support a continuum-based interpretation, where integration deepens over time and differs across transmission channels.

The Azerbaijani case highlights the importance of institutional structure, regulatory frameworks, and market depth in shaping integration outcomes. Even in the presence of long-run linkages, short-run dynamics and adjustment speeds reflect domestic constraints. This underscores the need for empirical approaches that capture both equilibrium relationships and dynamic responses—an objective effectively addressed by the combined ARDL–VAR framework employed in this study.

From a country-specific perspective, the results suggest that Azerbaijan has achieved a level of financial integration sufficient to benefit from global financial signals while retaining policy space to manage volatility. This intermediate position may be advantageous in the short to medium term, particularly in shielding the economy from abrupt external shocks. However, it also implies limitations in terms of capital market development, liquidity, and efficiency gains associated with deeper integration.

More broadly, the findings offer insights applicable to other emerging and transition economies pursuing gradual financial integration strategies. The evidence suggests that controlled integration—characterized by partial openness and selective transmission channels—can provide stability but may slow the realization of full efficiency gains. Policymakers therefore face a trade-off between stability and depth of integration, a balance that must be calibrated in line with institutional capacity and long-term development objectives.

## 5. Conclusion

This study set out to examine the degree and dynamics of Azerbaijan's financial integration with global financial markets by combining classical theories of economic integration with modern econometric techniques. Building on the theoretical foundations of Tinbergen, Balassa, and Machlup, financial integration was conceptualized not as a binary outcome but as a gradual, multidimensional, and institutionally conditioned process. This conceptualization guided both the empirical strategy and the interpretation of results.

The empirical findings provide robust evidence that Azerbaijan's financial system is structurally linked to global financial markets in the long run, while remaining partially insulated in the short run. The existence of cointegration among domestic financial variables and external financial indicators confirms that Azerbaijan participates in global financial dynamics beyond superficial or episodic interactions. However, the magnitude of long-run coefficients and the speed of adjustment reveal that this integration is moderate rather than deep, reflecting the country's managed approach to financial openness.

A key contribution of the study lies in identifying the asymmetric nature of integration channels. Exchange rate dynamics emerge as the primary conduit through which global financial conditions affect Azerbaijan's financial system, whereas interest rate linkages remain comparatively weak. This asymmetry underscores the differentiated structure of integration, where currency markets are more exposed to global forces than domestic credit and capital markets. Such findings align with the broader literature on emerging and transition economies, where incomplete market development and regulatory frameworks shape integration outcomes.

The dynamic analysis further demonstrates that external financial shocks propagate through Azerbaijan's financial system in a controlled and non-disruptive manner. Impulse response and variance decomposition results show that while global variables exert a meaningful influence, domestic dynamics continue to dominate financial adjustments. This balance between external exposure and internal anchoring suggests that Azerbaijan occupies an intermediate position between financial autarky and full liberalization.

From a methodological perspective, the study contributes by demonstrating the suitability of a combined ARDL–VAR framework for analyzing financial integration in economies characterized by

mixed integration orders and evolving institutional structures. By capturing both long-run equilibrium relationships and short-run dynamics, this approach offers a more nuanced assessment than single-method analyses. Importantly, the findings illustrate that integration cannot be adequately understood through static measures alone; its temporal and structural dimensions are equally critical.

Overall, the results reinforce the view that financial integration is best understood as a continuum shaped by policy choices, institutional capacity, and market depth. Azerbaijan's experience highlights that gradual and selective integration can foster stability while preserving policy autonomy but may also limit the efficiency gains associated with deeper financial market development. This duality represents the central trade-off facing policymakers in emerging economies. The empirical evidence presented in this study carries several important policy implications for Azerbaijan's financial sector development and its future integration trajectory. First, the dominance of the exchange rate channel suggests that external financial exposure is currently concentrated in currency markets. Policymakers should therefore continue to strengthen exchange rate risk management frameworks and enhance transparency in foreign exchange operations to mitigate vulnerability to external shocks.

Second, the relatively weak interest rate linkage points to limited monetary and capital market integration. While this provides short-term insulation, it also reflects structural constraints in domestic financial markets. Gradual deepening of capital markets—through the expansion of financial instruments, improved market infrastructure, and enhanced investor protection—could facilitate more balanced integration and improve the efficiency of financial intermediation.

Third, the gradual speed of adjustment observed in the results underscores the importance of institutional capacity. Strengthening regulatory oversight, improving data transparency, and aligning domestic regulations with international standards can enhance the quality of integration without compromising stability. In this context, financial integration should be pursued as a sequenced process, aligned with institutional development rather than rapid liberalization.

Finally, Azerbaijan's experience offers a broader lesson for emerging economies: partial and controlled financial integration can provide stability benefits, but long-term growth and diversification objectives require deeper and more inclusive financial market development. Policymakers must therefore balance stability considerations with reforms aimed at increasing market depth, liquidity, and international competitiveness.

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