CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

MONETARY POLICY: OPERATIONAL FRAMEWORK

EXPLANATORY DOCUMENT

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This document has been prepared in relation to the new monetary policy operational framework and is intended for the public and will be updated regularly.

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1. GLOSSARY OF TERMS

Open market operations	Operations initiated by the Central Bank (as securities trading). Money supply decreases when the Central Bank sells securities and increases when it buys securities. Securities can be traded either directly or as Repo and reverse-Repo as part of open market operations.
Standing facilities	Operations initiated by banks at pre-set interest rates. The Central Bank sets overnight deposit (attraction of funds) and overnight reverse Repo (placement of funds) as standing facilities.
Dollarization	Migration of cash, savings, and deposits in the national currency to a convertible currency.
Cash in circulation	Cash in cash offices of the Central Bank and commercial banks along with the cash outside the banking system.
Interest rate corridor	System of indicators aimed at converging interest rates, in particular short-term interest rates in the money market to the Central Bank target. The interest rate corridor used in Azerbaijan consists of the floor, the ceiling, and the refinancing rate.
Repo and reverse Repo operations	Repo is the sale and future repurchase of securities at the pre-agreed specific date. The aim of this operation is to reduce money supply in a short-term by the Central Bank. Reverse Repo is the purchase and future sale of securities at the pre-agreed specific date. The aim of Central Bank's reverse Repo operations is to increase money supply for a short term.
Consumer price index	The index that characterizes the change in a general level of prices for goods and services consumed by the population for non-production purposes within a certain timeframe.

Excess liquidity	All funds of banks available in their correspondent accounts and cash offices that exceed the norms.
List of collateral	A list of securities accepted as collateral in monetary policy operations.
Required reserves	A portion of deposits accepted by commercial banks kept with the Central Bank mandatorily.
Monetary policy transmission	Pass-through of monetary policy decisions of the Central Bank to the economy. Nowadays, monetary policy transmission channels include interest rate, lending, the exchange rate, expectations etc. Monetary policy decisions translate to the real economy not instantly, but with a time lag.
Liquidity absorbing operations	Operations aimed at withdrawing excessive liquidity that potentially may cause inflationary pressure. However, the term 'sterilization (liquidity absorbing)' is used to characterize operations on purchase of excess currency that potentially may pose appreciation pressure in the FX market.
Net foreign assets	The balance of asset and liability operations of the Central Bank with non-residents in foreign currency and precious metals.

2. INTRODUCTION

The Central Bank of the Republic of Azerbaijan (the Central Bank) continues efforts to improve the monetary policy's strategic and operational framework considering best practices and the features of Azerbaijan economy. These actions contribute to the formation of short-term interest rates as an alternative operational target of the monetary policy in the interbank market, and improving various channels, in particular the interest rate channel in the monetary policy transmission.

In general, a new operational framework will allow managing inflation developments through interest rates and broadening opportunities to safeguard macroeconomic stability in the country, as well as strengthen financial sector resilience to possible shocks in the long term.

3. THE MAIN GOAL AND TARGETS OF THE MONETARY POLICY OF THE CENTRAL BANK

The main goal of the monetary policy of the Central Bank is to maintain price stability, in other words, a low inflation rate.

Low and stable inflation means a favorable environment for consumers and businesses. Price stability enables businesses and households to make their plans with certainty for a longer term. Low and stable inflation provides a stable purchasing power of the national currency. Low and stable inflation prevents depreciation of income and savings and stimulates long-term savings in the national currency, reduces dollarization and interest rates that positively translate to economic growth and financial stability.

A consumer price index is used to measure inflation, an ultimate target of the monetary policy. The State Statistic Committee of Azerbaijan calculates and publishes this indicator based on the consumer basket that includes all necessary consumer goods and services. The goods and services in the consumer basket are reviewed continuously in response to the welfare of the population and tendencies in the consumer market.

The Bank determines and makes public quantitative parameters of the inflation target for upcoming year. The annual target is set on the recent twelve-month change in the CPI (or twelve-month inflation).

Intermediate and operational targets of the monetary policy are set based on the ultimate target. It is planned to use short-term interest rates in the interbank money market as the main operational target with the transition to inflation targeting in the long term.

4. MONETARY POLICY RELATED DECISION MAKING

4.1. Decision-making procedures

The Management Board makes monetary policy decisions at the Central Bank. The Board is also authorized to make decisions on interest rate corridor parameters.

The Central Bank's Monetary Policy and Financial Stability Committee (MPFSC) may issue proposals to make decisions at the Management Board. The MPFSC is a collegial body that regulates, and coordinates business activities of Central Bank's structural units involved in the development and implementation of the monetary and exchange rate policy, the regulation and supervision of financial markets. Committee meetings issue recommendations to the Management Board on the operational framework of the monetary and exchange rate policy, parameters of monetary policy tools, financial stability risks, and the macro- and micro prudential policies, and take relevant decisions except for the issues related to the competence of the Management Board. The Governor of the Central Bank chairs the Committee. Committee members include heads of the structures directly engaged in the development and implementation of the Central Bank's monetary, exchange rate and financial stability policies.

4.2. A forecasting and policy analysis system

Monetary policy decisions of the Central Bank of Azerbaijan are based upon analysis and forecasts made as part of the forecasting and policy analysis system (FPAS).

Monetary policy related decisions are made 8 times a year under a schedule. The process involves the staff of structural units of the Central Bank engaged in analytics. The process is completed with the presentation titled 'Recent macroeconomic trends, forecast and policy recommendations.'

In general, the FPAS consists of five stages covering five weeks, and it is provided in the following sequence:

I. Stage One determines a structure of the presentation for a final meeting where monetary policy decisions will be discussed. The presentation mainly covers macroeconomic developments in the country economy, in particular inflation and forecasts, the situation in the external sector, economic activity, and trends in the FX and money markets occurred since the last meeting.
II. Stage Two determines assumptions related to main parameters of economic models (oil price, oil extraction, budget parameters, inflation in partner countries, money base etc.). In parallel, the database of forecast models is updated based on statistical data.
III. Stage Three issues forecasts of main macroeconomic indicators for current and upcoming years under various scenarios using a relevant model portfolio.
IV. An initial version of the presentation is discussed by experts from relevant structural units of the Central Bank at Stage Four. Appropriate corrections are made to the presentation depending on results of discussions. Proposals related to policy decisions based on common feedback of the specialists involved to the FPAS are formulated at this stage.
V. The presentation is discussed at internal collegial bodies of the Central Bank at Stage Five. As a result of the discussion, a monetary policy decision is taken in accordance with a voting among the members of the Management Board. The decision is made public either at the press conference participated by the Governor of the Central Bank or with a press release.

In general, the Central Bank considers all factors and risks that influence inflation as part of the monetary policy decision-making. These downward and upward factors relate to aggregate demand and supply. Aggregate supply factors include global food and non-food prices, import prices, domestic producer prices etc. Aggregate demand factors mainly include private consumption and private investments and public spending. Experience suggests that the impact of the monetary policy on aggregate supply related factors is limited. The monetary policy passes to inflation mainly through aggregate demand.

5. CENTRAL BANK'S INTEREST RATE CORRIDOR AND ITS PARAMETERS

One of the crucial elements of the monetary policy operational framework is the interest rate corridor. The aim of the interest rate corridor is to ensure movement of short-term interest rates of the interbank market within the interest rate corridor. The interest rate corridor also determines the hierarchy of interest rates on Central Bank's liquidity operations.

The Central Bank's interest rate corridor includes three parameters – the refinancing rate, the ceiling rate, and the floor rate. The floor of the interest rate corridor is the interest rate of an overnight deposit operation as standing deposit facility. While the ceiling of the interest rate corridor is the interest rate of the Reverse Repo on overnight liquidity providing standing facility. The refinancing rate is the central element of the interest rate corridor. By announcing the refinancing rate, the Central Bank strives to converge short-term interest rates in the interbank market to this parameter.

Short-term open market operations for absorption are conducted at interest rates between the floor of the interest rate corridor and the refinancing rate. Open market operations for liquidity provision are conducted at interest rates between the refinancing rate and the ceiling of the interest rate corridor.

The Central Bank strives to manage the interest rates in the interbank money market within the interest rate corridor using the tools in its arsenal. This process is the first stage of the transmission of monetary policy decisions. When short-term interest rates change in the interbank market, other interest rates, including deposit and lending interest rates change too. This process is the second stage of the transmission of monetary policy decisions.

6. THE FACTORS AFFECTING THE IMPLEMENTATION OF MONETARY POLICY

Attaining monetary policy targets mostly depend on the liquidity position of the banking system, affected by several factors.

The main autonomous (i.e., not depending on the Central Bank) factor to influence liquidity is the change in government accounts, in particular the change in a balance of treasury account. This factor depends on state budget revenues and spending. Decrease in the treasury account may have an upward effect, while its increase may have a downward effect on correspondent accounts in manat. The Central Bank cooperates with the Ministry of Finance to estimate the effect of the change in government accounts on liquidity.

Another crucial factor is the change in net foreign assets (NFAs). NFAs are the balance of asset and liability operations of the Central Bank conducted with non-residents in a foreign currency and precious metals. This balance depends on the change in foreign exchange reserves. When the Central Bank buys currency from the banking sector, NFAs and money base in manat, in particular correspondent accounts in manat increase. In contrast, when currency is sold to the banking sector, NFAs and money base in manat, in particular correspondent accounts in manat decrease.

The flow of cash in circulation also weighs on the liquidity position of the banking system. It includes cash in cash offices of banks along with the cash outside the banking system. Decrease in cash in circulation may increase the stock of correspondent accounts in manat, while its increase may decrease the stock of correspondent accounts in the manat. Digitalization of the economy is accompanied with the drop in the share of cash in the structure of the money base, and the rise in the share of correspondent accounts.

Apart from all, the Central Bank's monetary policy operations also affect banking system liquidity. With its open market operations, the Central Bank strives to neutralize the impact of the factors beyond the monetary policy on the liquidity position of the banking system.

7. MONETARY POLICY TOOLS

The tools employed by the Central Bank are divided into standing facilities (initiated by banks) and open market operations (liquidity providing and absorbing operations initiated by the Central Bank).

Table 1. Central Bank's standing facilities and open market operations

Aim	Types of tools	Tool	Collateral	Frequency	Maturity
Liquidity providing	standing facilities	Reverse Repo	list of collateral[1] (see Annex 1)	At banks' request	overnight
	open market operations	Reverse Repo auctions		If necessary	7-day
Liquidity absorbing		CBA's note auction	-	Under schedule	1,3,6,9-month
		Repo auction		Under schedule	7-day
	standing facilities	Deposits to CBA	Unsecured	At banks' request	overnight

[1] *Securities accepted as collateral on monetary policy operations approved at the decision of the Management Board of the Central Bank*

7.1. Standing facilities

Standing facilities may be liquidity providing and absorbing. Availability of standing facilities dramatically contains short-term interest rate fluctuations in the interbank market.

Standing deposit facilities (Liquidity absorbing). Banks may place overnight deposits with the Central Bank with the consideration of obligations on reserve requirements and funds required for uninterrupted payments at their own initiatives. As a result of these operations, funds are absorbed from correspondent accounts within overnight and recovered at the beginning of next business day. Overnight deposits are placed with the Central Bank at 16:45-17:00 every day. According to the decision of the Management Board of the Central Bank dated 28 January 2025, deposits must be refunded by 09:45 on the following business day, starting from 3 February 2025. Interest rates of overnight deposits equal to the floor of the interest rate corridor of the Central Bank.

Standing lending facilities (Liquidity providing). To conduct settlements and maintain required reserves banks may attract overnight liquidity with the Reverse Repo transaction in unlimited amount at their initiatives. Securities (lombard list) accepted as collateral on monetary policy operations approved at the decision of the Management Board of the Central Bank dated 30 November 2017 may act as collateral for overnight Reverse Repo operations. These operations are conducted at 16:45-17:00. According to the decision of the Management Board of the Central Bank, banks should return funds at the beginning of the following business day by 09:45, starting from 3 February 2025. Interest rates on overnight Reverse Repo operations equal to the ceiling of the interest rate corridor of the Central Bank.

7.2. *Open market operations*

The Central Bank initiates open market operations under the quantitative parameters it sets. One can differentiate liquidity absorbing and providing open market operations.

Liquidity absorbing open market operations. The Central Bank can hold auctions on 1, 3, 6 and 9-month notes at pre-set amounts for sterilization purposes. Note auctions are market interest rates based and held at fixed amounts. In other words, yield on notes will depend on supply and demand in the market.

In addition to the placement of notes, 7-day Repo auctions may be held at pre-set volumes, if necessary, to absorb liquidity. 7-day repo (reverse repo) auctions are held at 11:00-11:30 every Friday. Interest rates on auctions may range between the floor of the interest rate corridor (excluding the floor of the interest rate corridor) and the refinancing rate (excluding the refinancing rate).

Liquidity providing open market operations. 7-day Reverse REPO auctions to be held at pre-set volumes to provide liquidity, if necessary, also relate to open market operations. Banks can cover their seven-day liquidity needs. Auctions are held at 15:30-16:00 every Friday. Interest rates may range between the refinancing rate (excluding the refinancing rate) and the ceiling of the interest rate corridor (excluding the ceiling of the interest rate corridor).

Other open market operations also can be applied depending on the situation in the money market, in particular in the interbank market.

8. REQUIRED RESERVES

The reserve requirement ratio is set in proportion to a certain percentage of banks' liabilities. Banks calculate and maintain required reserves in accordance with the 'Regulations on the ratio, calculation and maintaining required reserves.'

Required reserves are calculated based on an average daily balance on the calculation period (1 month) of bank's attracted liabilities according to the Regulations. The calculation period starts on the first and ends on the last calendar day of every month. Banks should deliver a report on required reserves to the Central Bank within 5 (five) business days after the calculation period. Required reserves for the next maintenance period are determined with the said report.

Required reserves are maintained in the bank's correspondent account with the Central Bank. The maintenance period begins on the 15th calendar day of the month following the end of the calculation period and lasts until the 14th calendar day of the following month.

A monthly averaging mechanism is used for maintaining required reserves. That is in case the required reserve amount falls below the requirement on certain days of the maintenance period, the bank can ensure that the monthly average corresponds to the required ratio by keeping more funds than required in the remaining days of the calculation period

Banks maintain required reserves depending on the currency of deposits in the calculation base. At that, the required reserve on national currency deposits is kept in the correspondent account in manat, while required reserves on all foreign currency liabilities are kept in the correspondent account in the USD.

9. INTERBANK MONEY MARKET INFRASTRUCTURE

Money market transactions between banks may be secured and unsecured. The interbank secured money market mainly includes Repo operations with pledged securities at the Baku Stock Exchange (Stock Exchange). When a Repo transaction is concluded, the securities that are the collateral of the Repo are frozen in the Repo buyer's account by the depository.

According to the amendments made to the 'Regulations on calculation and publication of indices on transactions concluded in the Repo market', the Stock Exchange calculates AINA (Azn Index Average) on 1-day, 1-week, 2-week, and 1-month Repo transactions after the last trading session of each working day. These indices act as a representative interest rate on secured money market transactions between banks. The information about indices is published on the Stock Exchange's website by 10.00 a.m. on the working day following the day of relevant transactions at the latest. Total nominal amount of repo opening transactions, the number of transactions, and the minimum and maximum interest rates are also published along with the indices.

The unsecured interbank money market mainly consists of interbank money market transactions concluded in the Bloomberg trading system. To activate this segment the Central Bank commissioned a new platform in the Bloomberg trading system. There is an effective mechanism in place to effectively control the execution of liabilities on unsecured money market transactions concluded between banks in the platform. Banks announce bids and ask prices through the platform and money market transactions are concluded by receiving requests from other participating banks. These interest rates act as a representative interest rate on unsecured money market transactions concluded between banks.

The Central Bank has been daily publishing various duration AZIR (Azerbaijan Interbank Rate) indices reflecting average interest rates of operations in the national currency between banks in the unsecured market on its official website since 2 May 2023. These indices are calculated based on the 'Regulations on calculation and publication of the benchmark rate (AZIR-Azerbaijan Interbank Rate) index at the unsecured money market', approved by the Management Board of the Central Bank. Transactions in national currency between commercial banks operating in the Republic of Azerbaijan on the Bloomberg platform are used when calculating indices. The amount and number of transactions that meet relevant requirements are also published on the Central Bank's website along with interest rate indices.

The Central Bank uses the AZİR indices as one of the indicators to measure the effectiveness of achieving the operational goals of the monetary policy. Market participants may use the AZIR index as a reference interest rate when concluding various transactions in the financial market.

In case the obligation on the transactions between the participating banks is not fulfilled, funds amounting to the liability is transferred from correspondent accounts of the borrowing bank to the correspondent account of the lending bank without acceptance based on a direct debit. In case the transaction is an overnight loan, the Central Bank automatically debits liabilities on the transaction from the correspondent account of the borrowing bank and credits the correspondent account of the lending bank without any direct debit until 10:00 on the next operation day.

Annex 1. List of securities accepted as collateral in monetary policy operations

- Government securities in manat issued by the Ministry of Finance of the Republic of Azerbaijan.
- Notes issued by the Central Bank of the Republic of Azerbaijan.
- Government guaranteed securities in manat.
- Mortgage bonds issued in manat by the Mortgage and Credit Guarantee Fund of the Republic of Azerbaijan.
- Bonds in manat issued by the following financial institutions:
    - The Asian Development Bank
    - The European Bank for Reconstruction and Development
    - The International Finance Corporation
    - The Black Sea Trade and Development Bank
- Corporate bonds in manat issued by resident issuers, whose ratings by international rating agencies (Standard & Poor's, Fitch, or Moody's) keep up with the credit rating of the Republic of Azerbaijan.