

STATEMENT OF THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN ON MAIN DIRECTIONS OF THE MONETARY POLICY FOR 2025

As a result of the successful implementation of the economic strategy determined by Honorable President Ilham Aliyev, macroeconomic stability was maintained, and economic growth continued in 2024. Economic outcomes of the current year have laid a solid foundation for optimistic forecasts regarding macroeconomic stability indicators for 2025.

In 2024, the Central Bank of the Republic of Azerbaijan implemented the monetary policy aimed at price stability. Monetary policy decisions were made considering the dynamics of inflation and changes in the balance of inflationary risks for the medium term. Inflation returned to the target band ($4\pm 2\%$) this year. Reforms continued to improve the monetary policy operational framework, thereby enhancing the transmission of the interest rate channel.

The main directions of the monetary policy for 2025 are developed and made public in accordance with Article 28 of the Law of the Republic of Azerbaijan 'on the Central Bank of the Republic of Azerbaijan'.

In 2025, the Central Bank's monetary policy will be aimed at maintaining inflation at a low and stable rate. Monetary policy decisions will be based upon updated macroeconomic forecasts and changes in the balance of inflationary risks from external and internal factors over the medium term.

As in previous years, reforms to improve the monetary policy framework will continue.

I. Monetary policy implemented in 2024 and its outcomes

In 2024, the monetary policy was oriented towards maintaining inflation within the target band through the monetary condition (financial market indicators – interest rate, exchange rate, etc.). Monetary policy tools served to neutralize the effects of the factors beyond the monetary policy (autonomous) on the monetary condition.

According to the State Statistics Committee, in November 2024 12-month inflation stood at 4.4%, food inflation at 4.4%, non-food inflation at 2.2% and services at 6%. Annual core inflation calculated by excluding changes in regulated prices and prices for seasonally volatile agricultural products was 3.9% in November 2024.

Several external and internal factors weighed on annual inflation this year. The drop in weighted average annual inflation in trade partners compared to historical highs and appreciation of the nominal effective exchange rate (NEER) of the manat had a downward effect on inflation. Over 11 months of 2024 the non-oil trade weighted NEER of manat appreciated by 7.1%. In the recent years, policy implemented by the government and the Central Bank to maintain price stability has also contributed to the drop in inflation.

The foreign exchange (FX) market was stable in 2024. Over 11 months, the Central Bank held 87 currency auctions to sell foreign currency of the State Oil Fund of the Republic of Azerbaijan (SOFAZ). Demand of the market for foreign currency was fully covered at these auctions. In 2024 the Central Bank's FX sales were

primarily conducted to support the implementation of strategically important government spending arising from public projects and the reduction of liabilities in foreign currency.

In 2024, monetary policy decisions were made considering comparison of actual and forecasted inflation with the target band ($4\pm 2\%$) and the changes in the balance of risks. During the period, the parameters of the interest rate corridor were discussed 8 times under the predefined schedule. The Management Board of the Central Bank decided to shift the refinancing rate from 8% to 7.25%, the ceiling of the interest rate corridor from 9% to 8.25%, and the floor of the corridor from 6.5% to 6.25% at the first three meetings dedicated to the monetary policy. The parameters were left unchanged at last five meetings. The changes led to the formation of a symmetric corridor with the refinancing rate being the center.

In 2024, monetary policy tools were applied considering financial market developments and the banking system's liquidity position. To achieve the monetary policy targets the Central Bank used open market operations, standing facilities and reserve requirements. Regular auctions continued the placement of 28, 84, 168 and 252-day notes for liquidity absorbing purposes as open market operations. Decisions regarding quantitative parameters of the open market operations were based upon liquidity monitoring and forecasting. Taking into consideration the downside effect of the change in government accounts under the condition of state budget surplus on the banking system liquidity, the Central Bank decreased the amount of liquidity absorbing operations. As of end-November, the portfolio of funds absorbed through notes amounted AZN300M, 4.4 times down compared with the amount of the portfolio as of end-2023 (AZN1320M). There has been no change in reserve requirements over the reporting period. However, clarifications have been made in relevant regulations regarding the explanations of the definitions and their calculation related to the new differentiation criteria introduced at the end of last year.

Monetary operations had a positive impact on effective management of liquidity by banks, the interbank market activity, and the formation of the yield curve. Over the reporting period, activity was observed in both secured and unsecured sectors of the interbank market. Over 11 months banks concluded 3365 transactions in the national currency (AZN94.4B) on the Bloomberg platform, 97% of which were 1–3-day transactions. AZN10.3B worth of 630 transactions were concluded in the interbank Repo market. The volume of transactions concluded on the Bloomberg platform increased by 3.4 times, and those concluded in the interbank Repo market increased by 2.3 times year-over year.

Interest rates in the unsecured money market reacted to the changes in interest rate corridor, and average interest rates were within the interest rate corridor of the Central Bank. In November 2024, the average interest rate (1D AZIR) on 1–3-day transactions in the unsecured interbank money market stood at 7.66%. Efforts were also made to strengthen the communication of interest rates in the interbank money market during the reporting period.

Analyses suggest that the transmission of monetary policy decisions through the interest rate channel is gradually improving. Interest rates on certain types of deposits are moving in the same direction as interbank rates. The interest rates in the interbank money market also influence the yields of securities with different maturities.

For 11 months of 2024, base money in manat decreased by 1.4%, and broad money supply in manat (M2) decreased by 2.1%. As in previous years, the change in balances of government accounts was one of the crucial factors to impact money supply this year. Over the period, the reduction in the volume of Central Bank's liquidity absorbing operations had an upward effect on money supply.

In 2024, efforts continued to enhance the analysis and forecasting in the Central Bank, the modelling toolkit expanded, more research was conducted compared to the previous years. The study of monetary policy's transmission channels has broadened.

The Central Bank still focused on effective communication of the monetary policy. Press-releases regarding monetary policy decisions were published with relevant analytic interpretations, in parallel with regular press conferences. The Central Bank disclosed forecasts of key macroeconomic indicators and the breakdown of actual inflation by factors in live-streamed press conferences. Starting from the last reporting period of 2024, several innovations have been introduced to the structure and content of the 'Monetary Policy Review,' aligned to best practices. The changes primarily include the addition of the macroeconomic forecasts section and a more detailed analysis of monetary developments. The yield curve is now assessed and published weekly. Quarterly reports on the analysis of inter-sectoral financial flows and research conducted in 2023 have been published on the official website. Monetary policy decisions and their substantiations have been shared not only on the Central Bank's official website, but also in infographic formats via social media platforms. Meetings with representatives of the financial sector and independent economic experts continued. Comprehensive materials in video format have been presented to a broad audience aided by numerous interviews on current issues. The public disclosure of certain Central Bank activities has a positive effect on the transmission of monetary policy messages. Educational events for media representatives also continued. Training sessions for journalists covered topics such as monetary policy decisions, the balance of payments, monetary policy tools, and monetary policy transmission.

II. The monetary policy in 2025

2.1. The objective and framework of the monetary policy in 2025

In 2025, the monetary policy will be aimed at maintaining price stability, the core mandate of the Central Bank, and stabilizing inflation within the established target band. Reforms will continue to improve the monetary policy framework.

According to the '2022-2026 Socio-economic development Strategy of the Republic of Azerbaijan', the monetary policy will target maintaining annual inflation within the $4\pm 2\%$ band in the next year. As in previous years the target indicator for the upcoming year will be recent twelve-month change of the consumer price index calculated by the State Statistic Committee.

According to recent (October 2024) forecasts by the Central Bank, annual inflation is expected to be around 5.8% in 2025, which is consistent with the target. The Central Bank will regularly update its inflation forecasts based on a comprehensive analysis of inflationary factors in 2025. The Central Bank will continuously analyze the dynamics of core inflation along with overall inflation and assess inflation expectations in parallel.

Several external and internal risks related to price stability remain relevant. Next year external factors – the dynamics of commodity prices in the global market, inflationary developments, and economic activity in partner countries – will continue to affect inflationary trends in the country. If geopolitical tensions persist, the external factors are expected to remain volatile. Potential overexpansion of aggregate demand, changes in the tariffs of goods and services regulated by the government, as well as rising inflation expectations, are internal risk factors for price stability.

The exchange rate channel is expected to continue playing a crucial role in monetary policy transmission. The NEER of the manat will remain one of the significant factors influencing imported inflation. According to the latest calculations based on forecasts of bilateral exchange rates by international analytical centers, the NEER of the manat is projected to appreciate in 2025.

Next year the Central Bank's interest rate corridor will be used as one of the main facilities affecting monetary conditions in the economy. Decisions regarding the interest rate corridor will be based on changes in the balance of risks of external and internal factors of inflation, as well as updated macroeconomic forecasts. As in previous years, in 2025, the interest rate corridor is expected to be discussed by the Central Bank's Management Board according to a pre-established schedule.

The Central Bank will focus on elevating its analytical and forecasting capacity. As part of the forecasting and policy analysis system, the modelling toolkit will be regularly aligned to best practices, with the scope and depth of research being expanded. Cooperation with public and private institutions will continue to broaden the coverage of alternative statistical data sources.

Efforts to strengthen institutional foundations of monetary policy communication will continue. Clarity, consistency, transparency, and predictability will be the core principles of monetary policy communication. The primary target groups for communication will include financial market participants, the media, academic circles, economic experts, entrepreneurs, the government, and the broad public. Reports on the implemented monetary policy will provide comprehensive and timely information on the Central Bank's assessments of the macroeconomic stance and its outlook. In 2025, in line with the disclosed schedule, press releases on the Central Bank's policy decisions will be published with relevant analytical comments, and regular press conferences will be held. Analytical reviews will continue to be

published quarterly. The Central Bank's activities will be regularly covered through its official website, as well as social media platforms such as YouTube, X, Instagram, LinkedIn, and Facebook. Meetings with various target groups and educational events will continue. Recommendations of international organizations will also be used to enhance the communication.

Aligning monetary policy with the Central Bank's other areas of activity, including financial stability policies, will remain a priority next year. Increasing financial depth, maintaining financial stability, and expanding digital payments will continue to be factors positively influencing the effectiveness of monetary policy. Analyses of effects of inflation stemming from climate change and the green transition will also continue within monetary policy. The Green Taxonomy, approved by the Central Bank's Management Board on the eve of COP29 provides a foundation for supporting the green transition through monetary policy, if necessary, in the future.

In 2025, the effective coordination between fiscal and monetary policies will still be crucial to ensure that aggregate demand grows in line with the country's production potential. Considering this, the Central Bank will continue strengthening the coordination of monetary policy with various directions of economic policy. The Economic Council will play a key role in ensuring interorganizational macroeconomic coordination.

2.2. Monetary policy's operational targets and tools for 2025

In 2025, the Central Bank will actively use the tools in its arsenal to achieve the monetary policy targets. Reforms will proceed to strengthen an alternative monetary policy anchor.

The exchange rate of the manat against the US dollar, the main anchor of price stability, will base on the average exchange rate of interbank (both auction and off-auction) transactions. The Central Bank will continue holding auctions for the sale of foreign exchange of the SOFAZ. In line with the experience of previous years, in response to changes in government's demand and supply for foreign exchange, the Central Bank may also buy and sell foreign currency in the FX market in 2025.

Short-term interest rates in the money market will be used as an alternative operational target for monetary policy. The dynamics of the AZIR index, the weighted average interest rate of transactions in the unsecured market, will be on focus. The methodology for calculating benchmark interest rate indices will be aligned considering the recommendations of the international organizations. To ensure that interest rates in the interbank money market move within the Central Bank's interest rate corridor, the Central Bank will use all the tools in its arsenal adequately and promptly. The Central Bank will select the tools based on the inflation environment and financial market developments. The flexible use of monetary policy tools will contribute to the efficient functioning of the transmission mechanism, as well as to macroeconomic and financial stability.

Standing facilities and open market operations will be used to manage banking system liquidity. Due to expected structural surplus (excess liquidity) in the banking

sector, the probability is high that there will be demand for Central Bank's liquidity absorbing facilities. However, if structural surplus is replaced by structural deficit, the liquidity providing tools in the Central Bank's arsenal will be activated as part of open market operations.

Reserve requirements will be applied using the monthly averaging mechanism. Banks will hold required reserves in manat and foreign currency, depending on the currency of the deposits included in the calculation base. Reserve requirements will support demand in the interbank money market and reduce dollarization, in addition to the sterilization of excess liquidity.

Standing facilities will ensure that interest rates in the interbank money market are formed within the interest rate corridor. The liquidity absorbing standing facility will be conducted at an interest rate equal to the lower bound, while the liquidity-providing standing facility will be conducted at an interest rate equal to the upper bound of the Central Bank's interest rate corridor. For operations involving the provision of one-day liquidity, securities accepted as collateral for monetary policy operations (the lombard list), approved by the Central Bank's Management Board on 30 November 2017 will serve as securitization.

As part of open market operations, Central Bank notes, as well as auctions for 7-day operations will be held for sterilization purposes. Interest rates for these instruments will be formed in accordance with the rules set by the Central Bank's Management Board and announced in advance to financial market participants. Other open market operations may also be applied depending on the situation in the interbank money market.

Decisions regarding the quantitative parameters and durations of open market operations will be made weekly, depending on the liquidity position of the banking system, and communicated to relevant market participants prior to auctions. Banking system's liquidity position will be regularly assessed, the liquidity monitoring and forecasting will be further improved.

The Central Bank will continue its efforts to enhance monetary policy tools and develop the technical infrastructure of the money market.

2.3. The monetary policy environment in 2025

The main directions of monetary policy for 2025 will be implemented considering the forecasts for the global economy, the country's external balance, fiscal policy, and real sectors.

Forecasts for global economic growth in 2025 are shaped amid uncertainties stemming from geopolitical tensions and gradual easing of inflation.

According to the IMF's WEO October 2024, global economic growth in 2025 is expected to be 3.2%, which is 0.1 basis points lower than the previous forecast. It is predicted that economic growth in advanced economies (AEs) will be 1.8%, and 4.2% in emerging market economies (EMEs).

According to IMF's recent forecasts, global inflation is expected to decrease to 4.3% in 2025 (it was 6.7% in 2023 and is expected to be 5.8% in 2024).

Overall, by the end of 2025, inflation in most AEs is expected to return to the target. In this context, the likelihood increases that central banks of AEs will gradually ease policy rates. However, if geopolitical tensions rise, trade disruptions may increase short-term inflation risks.

According to the latest forecasts, global trade is expected to grow by 3.4% in 2025, which remains below the 4.9% - the average of 2000-2019. After the stagnation in 2023, global trade growth dynamics is projected to align with global GDP growth.

Prices for energy will continue to respond to global economic activity, geopolitical factors, and decisions made within the OPEC+ framework. According to the IMF's October report, the price of oil in 2025 is expected to be \$72.8/b, year-over-year down by 10.4%. However, most international analytical centers have more optimistic forecasts. For instance, the US Energy Information Administration predicts oil prices to be around \$78/b.

Given high volatility of the Azerbaijan's economic environment, the Central Bank will regularly update macroeconomic forecasts under various scenarios.

Current account of the balance of payments is estimated to remain in surplus in 2025. According to baseline scenario forecasts (with oil prices at \$79.2/b and gas prices at \$340 per thousand m³) in 2025 current account surplus is expected to be \$5.5B (7.2% of GDP). During this period, the geopolitical situation, global prices for key export products, macroeconomic conditions in trade partners, and export potential of the non-oil and gas sector will be the main factors to affect the balance of payments.

Economic growth in Azerbaijan's real sector is expected to continue. According to the Central Bank's October 2024 forecast, real economic growth rate is projected to be 3.3% in 2025, with the non-oil and gas sector growing by 5.1%. The government, international financial and credit organizations, and leading rating agencies also have optimistic expectations regarding Azerbaijan's economic growth prospects.

Schedule of disclosure of monetary policy decisions to the public

In 2025, decisions related to the parameters of the interest rate corridor will be announced 8 times under the schedule below:

22 January

12 March

23 April

11 June

23 July

10 September

22 October

10 December

Disclosure of decisions will be accompanied with press conferences on 22 January, 23 April, 23 July, and 22 October. Decisions will come into force on the next working day following their announcement.