

# MAINTENANCE OF THE MONETARY SYSTEM STABILITY IN UZBEKISTAN

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## ABSTRACT

During the years of independence, the Republic of Uzbekistan has succeeded in building the modern monetary system. The national currency was introduced, monetary and currency markets have been developed along with the provision of independence of the Central Bank. However, the stability of national monetary system has not been ensured yet. In particular, the monetization level of the economy remains low, while the GDP deflator is rather high. In addition, high level of national currency devaluation is observed in recent years.

Eventually all these urgent problems will negatively influence the stability of macroeconomic growth. The relatively high level of the GDP deflator (GDP deflator reflects a more realistic rate of inflation) has led to the significant growth of the money supply, which resulted in a strong devaluation of the national currency of Uzbekistan. For example, in 2012 the devaluation level of the national currency against the U.S. dollar was 10.5%. In addition, because of the low monetization coefficient, a crisis of defaulted payments among business entities has arisen.

The author proposes to increase the volume of foreign currency swap and Gold Swap operation of the Central Bank of Uzbekistan in order to decrease the devaluation of the national currency. The author also suggests increasing the flexibility of monetary policy instruments such as an open market policy and reserve requirements to ensure the stable growth of the money supply.

## JEL CLASSIFICATION & KEYWORDS

■ E50 ■ E51 ■ E52 ■ DEVALUATION ■ MONEY SUPPLY ■ SWAP

## INTRODUCTION

The stability of the monetary system is one of the required conditions for ensuring the stability of the national financial system as well as for ensuring the continual production process and the stability of macroeconomic growth.

This article reveals the important issues related to ensuring the stability of the monetary system of the Republic of Uzbekistan and develops scientific and practical proposals to address those issues.

Hereby, we explore and summarize the experience of some foreign countries in maintaining the stability of the national monetary system and analyze the practical materials published by the Central Bank of Uzbekistan.

### The current state of the monetary system of the Republic Uzbekistan

National monetary system – as a state-legal form of organizing the money circulation, consists of the following elements: monetary unit, money circulation structure, organization and regulation of money circulation; the money supply and its structure; the parity and the exchange rate of the national currency; the principles of organizing the monetary system.

The national currency of Uzbekistan is “sum”. It was introduced into circulation on July 1, 1994. All denominations of the national currency (1, 3, 5, 10, 25, 50, and 100) are the banknotes of the Central Bank of the Republic of

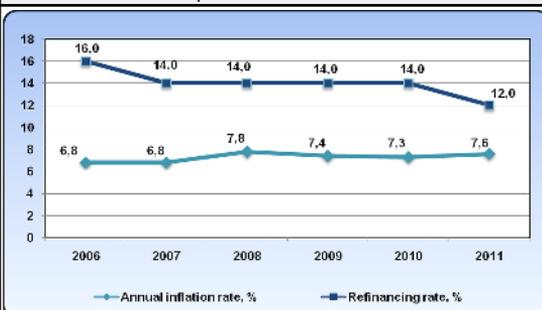
Uzbekistan. Therefore, they are backed by the assets of the Central Bank.

The national monetary system of the republic is regulated by the Central bank.

As a result of concrete measures undertaken by the Central bank within the framework of the monetary policy during 2006 – 2011, the balance between money supply and the GDP growth, taking into account the real demand of the economy to money resources, was ensured. The money supply control has been executed by regulating the dynamics of net domestic assets and international reserves as well as the liquidity of the banking system and the volumes of reserve currencies.

In order to regulate the money supply, the monetary policy instruments were widely used by the Central Bank of Uzbekistan, and also the measures were taken to attract new deposits of commercial banks with excess liquidity and to change the refinancing rate and the level of required reserves. Implementation of these measures has contributed to the decrease of the inflation rate, provided the stability of the national currency exchange rate as well as the high rates of real output growth.

Figure 1: Annual inflation rate and the refinancing rate of the Central bank of the Republic of Uzbekistan



Source: Annual report of the Central Bank of Uzbekistan 2011. Retrieved from [www.cbu.uz](http://www.cbu.uz)

Figure 1 shows that maintaining the refinancing rate of the Central Bank at a stable level facilitates a stable rate of inflation. However, the decline in the refinancing rate in 2011 by 2 percentage points has led to an increase in the money supply, causing inflation to rise by 0.3%.

During the years of 2000 – 2011, the monetization coefficient had a stable growing tendency. From 10.5% in 2000, it rose up to 21.7% in 2011.

Despite the increase in the monetization coefficient of the economy, inflation level is maintained within the established macroeconomic parameters. In 2011, the inflation rate was 7.6% and this is considered as one of the most stable among countries over the period of 2005 – 2011.

Results of researches by P.Graude and M.Polan (2001) show that there is a direct proportional relationship between money growth rate and inflation rate. Therefore, maintaining the stability of the monetary system is of great practical importance in controlling the inflation growth.

It is important to underline that the differentiated norms of required reserves in national and foreign currencies in 2006 were 15% and 8% respectively. In 2007, the Central bank unified them at the rate of 13%. Since 2008, the reserve requirement had been set at 15%. Starting from January 1, 2009, the differentiated rate of required reserves in national currency were set:

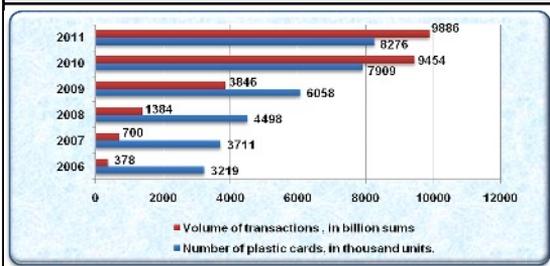
- on deposits with terms up to 1 year – 15%;
- on deposits with terms from 1 to 3 years – 12%;
- on deposits with terms over 3 years – 10.5%.

Some economists consider the policy of required reserves of the Central Bank as a reliable option to curb the growth of credit expansion by commercial banks. For example, the Nobel Prize winner, Professor Milton Friedman, University of Chicago, in 1959, suggested the idea of 100 percent required reserves (Moiseev S.R., Money-credit policy: theory and practice, 2011).

However, this idea of Milton Friedman did not receive the support of many economists. For example, the professor of the Rey Juan Carlos University, Madrid, J. Huerta de Soto believes that maintaining the 100 percent required reserve could lead to the collapse of the banking system (J. Huerta de Soto. Money, bank credit and economic cycle, 2008).

It is worth to note that, in recent years, the development of payment operations with the use of plastic cards has been observed and as a result the demand for cash has decreased.

Figure 2: Volume of transactions and quantity of plastic cards in Uzbekistan



Source: Calculations of the author on the basis of the statistical data of Central Bank Uzbekistan. Money-credit policy. Payment system. www.cbu.uz

Figure 2 shows that during the period of 2006 – 2011 the trend of growth in transactions with the use of plastic cards and a significant increase in the number of cards is observed in Uzbekistan. These facts indicate a high level of development in operations with the use of plastic cards.

**Problems related to the maintenance of monetary system stability**

Currently, in many transition economies, including in Uzbekistan, the instability of monetary system is observed. Thus, a high and unstable growth of money supply is an urgent issue to be addressed in maintaining the stability of monetary system (see Table 1).

The data show that in developed countries, the growth rate of the money supply is relatively low. This is mainly due to the development of the control system of money supply.

As it can be seen from the Table 1, the annual growth rate of money supply in Uzbekistan is rather high and unstable. We think, it is, first of all, explained by the price instability. In 2011, the GDP deflator in Uzbekistan was 16.0%. In turn, the relatively high level of the GDP deflator will lead to the increase of the real exchange rate of the national currency.

#		2008	2009	2010	2011
1	Euro zone	2.7	3.7	1.7	2.0
2	Japan	3.4	4.8	2.8	3.1
3	Russia	1.7	13.2	30.0	22.6
4	Uzbekistan	32.4	38.9	34.9	36.4

Source: Annual report of the Russian Federation Central Bank 2011. www.cbr.ru; Annual Report 2011. Bank of Japan. www.boj.or.jp; European Central Bank. Annual Report 2011. www.ecb.eu.

During the 2006 – 2011 the real exchange rate of the national currency of Uzbekistan – Sum against the U.S. dollar increased by 27.1%, against the Russian ruble – by 3.5%, against the Ukrainian grivna – by 29.8%<sup>1</sup>. Yet the rise in the real exchange rate negatively affects the country's exports.

Another problem lies in the fact that the Central Bank of Uzbekistan, as an object of open market operations, only recognizes the securities of the government of Uzbekistan, while the emission volumes of government securities are limited. This is explained by the fact that since 2005 the state budget of Uzbekistan is completed with surplus. Moreover, the enterprises in Uzbekistan do not have ratings of the international credit rating agencies, which prevent the use of corporate securities as objects of the open market operations of the Central Bank.

In the conditions of global financial and economic crisis of 2008, central banks have been forced to expand the list of securities, which could be used as objects of open market operations. Even the mortgage-backed securities have become an object of the open market operations by central banks in developed countries (Andryushin S., Burlachkov V., 2008).

Since 2001 a sequential policy devoted to the liberalization of foreign exchange market has been carried out in Uzbekistan. In 2001 – 2003, government and the Central bank of Uzbekistan implemented drastic measures to unify the exchange rates and create the necessary conditions to ensure the convertibility of the national currency on current account operations of the payments balance. However, the level of devaluation of the national currency remains high, leading to higher import costs and adversely affecting the effectiveness of financed investment projects.

Besides, the relatively high level of devaluation, at low level of monetization coefficient, negatively influences the efficiency of investment projects, brings to the increase of expenses of enterprises connected with import operations in Uzbekistan.

In Uzbekistan, provision level of the economy with money resources is relatively low, this in turn adversely affects the stability of macroeconomic growth. It is explained by the fact that the low level of monetization of the economy does not allow to solve the problem of defaulted payments among business entities.

Researches by A. Tihonov (2000) show that countries, where the monetization coefficient of the economy at the level of 30% to 40%, are characterized by a significant reduction of average inflation rate in comparison with the countries with monetization coefficient below 30% and where sharp increase in the real interest rate is observed. In countries where the monetization coefficient is above 50%, low inflation rate is observed.

<sup>1</sup> Author's calculations on the base of Uzbekistan's Central Bank statistical data.

Figure 3: Devaluation level of the national currency against the US dollar and monetization coefficient level in Uzbekistan (in percentage)



Source: Annual reports of the Central Bank of Uzbekistan for 2006-2011. Retrieved from www.cbu.uz

The Figure 3 shows that the devaluation level of the national currency against the US dollar still remains high.

It is important to emphasize that in 2009 – 2011 it became possible to ensure the balance between the volume of money supply and GDP growth taking into account the real demand of the economy to money resources. However, the provision level of the economy with money resources, in the meantime, does not meet the needs of the economy.

The results of Figure 3 show that provision level of the economy of Uzbekistan with money resources has considerably increased in 2011. However, the value of the given indicator remains at very low level. For comparison: the monetization levels in such countries as Japan, UK and USA were 162.4 %, 149.5 % and 60.1 % respectively (Abdullayev U.A. Monetary policy of the Central Bank and its impact on economic growth, 2011).

**Proposals on maintaining the stability of the national monetary system**

We think that in order to ensure sustainable growth of the money supply, it is essential to develop the use of monetary policy instruments of the Central Bank in practice. In particular, it is necessary to increase the number of objects of the open market operations of the Central bank of the Republic of Uzbekistan by issuing bonds with high ratings from international rating agencies - Standard & Poor's and Moody's.

In order to decrease the level of national currency devaluation, we propose the following measures:

- To increase the volume of foreign currency swaps of the Central bank;
- to introduce such operations as Gold Swap.

Under the foreign currency swap operations the Central bank of Uzbekistan should sell dollars to commercial banks on spot terms and buy their dollars on forward terms. Moreover, the Central bank of Uzbekistan can increase the supply of dollars by entering into swap transactions with foreign central banks.

In terms of gold reserves and production, Uzbekistan is among the top ten countries. Therefore, gold is considered as an important asset of the Central bank of the country. The central bank of Uzbekistan, using the Gold Swap operations, can increase the supply of foreign currencies in the domestic currency market.

In this case, the Central Bank of Uzbekistan must sell gold on the spot terms and buy it on the forward terms. Because, there is currently a high and unstable demand for U.S. dollars in Uzbekistan, as a result devaluation level of the national currency remains high. Therefore, in our opinion, swap and GOLD swap operations should facilitate the

demand for foreign currencies, primarily for U.S. dollars. Since, most of the official foreign reserves of Uzbekistan are in U.S. dollars.

We believe that it would be reasonable to raise the flexibility and efficiency of the required reserves policy of the Central bank of Uzbekistan by differentiating the rates of required reserves by types of foreign currencies. Rates of required reserves, on foreign currency deposits of commercial banks, should be determined on the basis of market prices of these deposits formed on the international markets of loan capital.

As international practice shows, high rates of required reserves are usually used by the central bank on foreign currency deposits of commercial banks in case when large inflow of foreign currency funds might lead to the revaluation of the national currency. But, currently in Uzbekistan this kind of operation is not observed.

**Conclusion**

Relatively high level of GDP deflator, low level of monetization coefficient, unstable and high level of money supply growth, the increase in real exchange rate of the national currency are the urgent issues related with the provision of monetary system stability of the Republic of Uzbekistan.

Proposals developed hereby on improving the use of monetary policy instruments, on increasing the volume of operations such as "foreign currency swap" and "GOLD swap" will assist to address the aforementioned problems.

Conclusion of swap transactions by the Central Bank of Uzbekistan with foreign central banks to buy U.S. dollar and Euro may increase the supply of foreign currency on the domestic market, which consequently leads to the strengthening of the national currency in the short run. Because, the liquidity shortage in the domestic market is observed in the short run.

Also, the flexibility of monetary policy instruments should be increased by increasing the targets of open market operations and differentiation of the required reserve rates of the Central Bank of Uzbekistan by the types of currencies. Finally, we think that the current rates of required reserves of the Central Bank of Uzbekistan is very high and therefore, the rates on these deposits should be set on the basis of market prices of these deposits formed on the international market of loan capital.

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