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EXCHANGE RATE POLICY LIBERALIZATION AND DE-DOLLARIZATION STRATEGY: EVIDENCE FROM UZBEKISTAN

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Abstract

The current developments in the foreign exchange policy of Uzbekistan is causing some distress as devaluation of national currency and increase in the foreign debt has led to the strong dollarization of Uzbek economy overall. It is evident that it negatively affects the transmission mechanisms of monetary policy. The Central bank of Uzbekistan is aiming to resolve this by employing de-dollarization to mitigate the risks in implementation of inflation targeting regime. Thus, this article is devoted to the analysis of the most advanced practices in reducing high levels of dollarization in the economy. It is proposed to ensure macroeconomic stability, to implement prudential measures against dollarization and to undertake measures to develop the national capital market in order to deteriorate the level dollarization in the economy of Uzbekistan.

Keywords: Exchange rate policy, de-dollarization, currency mismatch, intervention, inflation targeting

INTRODUCTION

It is well-known that in developing countries the problem of dollarization of the economy is expanding within the framework of high inflation and the national currency devaluation. This fact requires the central banks to undertake efficient measures to strengthen public confidence in the national currency, reduce the negative impact of dollarization on the transmission mechanism of monetary policy and enhance the monetary policy efficiency.

The Decree of the Republic of Uzbekistan PD-5992 “On the strategy of banking reforms of the Republic of Uzbekistan for 2020-2025” dated May 12, 2020, which states that the high level of dollarization of assets and liabilities remains among the important problems currently challenged by the banking system. In particular, at the beginning of 2020, loans denominated in foreign currency accounted for 48 percent of total loans, while foreign currency deposits and funds constituted 44 percent of total deposits.

Therefore, the “Roadmap” for the reform of the banking system of the Republic of Uzbekistan for 2020-2025, approved by this decree, until November 2020 implies development of comprehensive measures, including regulations and incentives, aimed at reducing the dollarization level in the economy and the dollarization level in the assets and liabilities, in particular: a) creation of macroeconomic conditions to reduce the share of assets and liabilities of banks denominated in foreign currency; b) it is scheduled to introduce restrictions on the types of loans in foreign currency.

LITERATURE REVIEW

Such concepts as currency mismatch, “original sin”, financial dollarization, dollarization of deposits, dollarization of loans are widely applied in the economic literary sources in the process of researching the problem of dollarization in the economy. Currency mismatch does not represent a serious problem in major and developed countries, but their role and importance in the emergence of financial crises in developing countries is still relatively high.

Empirical studies on currency mismatch have focused on the dollarization of deposits and loans in the banking sector. For example, the primary reasons for the dollarization of deposits are the historically emerging rates of inflation, volatility in inflation and the real exchange rate, reliability of macroeconomic policies and the quality of institutions. Essential drivers factors in the dollarization of loans are represented by the Central Bank’s intervention in the foreign exchange market, government support through the deposit insurance system, financial development and liberalization, exchange rate regimes, and differences in interest rates.

According to some economists, the costs associated with the performance as the lender of the last resort in foreign currency will be higher than in the national currency (*Broda, Levy-Yeyati, 2003*).

The inability of countries to borrow funds in their own currencies constitutes the core problem of the currency mismatch. This factor is referred to in the literary sources as the "original sin".

In some empirical studies, in terms of "original sin", the size of the country (whether it is big or small) is admitted as a statistically significant factor in developing countries (*Hausman, Panizza 2003*). However, in assessing the currency mismatch, it is restricted by liabilities in foreign currency and does not take into consideration the asset side of the balance sheet.

In response, an aggregate effective currency mismatch (AECM) approach has been developed. This approach takes into account foreign currency assets and liabilities in assessing aggregate currency mismatch (Goldstein, Turner, 2004). However, due to the lack of statistical data on this approach by country, the factors of currency mismatch have not been adequately revealed and assessed.

As the first attempt in this regard, the researchers have done an empirical study in reliance upon extensive data on currency risk in external balance (*Lane, Shambaugh, 2010*). The regression variables chosen by them proceed from the most optimal distribution of the portfolio to foreign currencies based on a simple model of an open economy.

RESEARCH METHODOLOGY

In the process of research, such methods as generalization, grouping, logical and comparative methods of analysis, abstract-logical thinking, comparative analysis, analysis of selected literature have been widely used.

ANALYSIS AND DISCUSSION

As the international practice shows, administrative or market-based measures to reduce dollarization have been widely applied by countries.

Empirical studies show that only 11 of the 42 dollarized countries have become successfully de-dollarized, while the remaining 31 countries failed to do it (*Mecagni et al., 2015*). The interesting fact is that initial average dollarization rate (67.4%) in countries that have successfully implemented de-dollarization has been higher than in countries that has not successfully de-dollarized (48.4%). However, in comparison with the rest of the countries with successful de-dollarization, the following indicators have been achieved: real GDP growth was higher (average 2.8%), current account balance improved (5.3%), fiscal deficit decreased significantly (even in small amounts), and even small amount of surplus was achieved as well. In addition, in these countries during the period of de-dollarization there was a steady increase in the national currency value.

In reliance upon foreign experience, the success of performing de-dollarization is based on a stable macroeconomic environment and prudential measures play a significant part in this process.

During the years of independence, the level of dollarization in Uzbekistan has remained stable for a long time. In particular, in 2001-2012, Uzbekistan was among the countries with an average dollarization level (more than 10% and less than 30%).

However, the adoption of the Decree of the President of the Republic of Uzbekistan PD №-5177 on September 2, 2017 “On priority measures to liberalize foreign exchange policy” marked a new era in foreign exchange policy in the country, in particular in the field of foreign exchange market liberalization.

Starting from September 5, 2017, the Central Bank of the Republic of Uzbekistan set the official exchange rate of the UZS against the USD at the rate 1 USD = 8100.0 UZS. This implies a devaluation of the UZS by 92.4%. As a result, their share in total deposits and loans has also increased significantly after the sharp growth in the value of deposits and loans in foreign currency (mainly the USD) in UZS. In other words, a high level of dollarization was noted in the economy and there has appeared the necessity to combat it.

In accordance with the Resolution of the President of the Republic of Uzbekistan № PR-3270 “On measures to further develop and enhance the stability of the banking system” as of September 12, 2017, since October 1, 2017 the minimum amount of the charter capital (charter fund) are fixed in the national currency: for newly established commercial banks (100.0 billion UZS), microcredit organizations (2.0 billion UZS) and lombards (500 million UZS).

Herewith the measures have been undertaken to convert the charter capital of the National Bank for Foreign Economic Activity of the Republic of Uzbekistan and JSCB “Asaka”, previously generated in the foreign currency, into the national currency through sale of foreign currency. It has been set that the income (profit) from the sale of foreign currency by these commercial banks will not be included in the tax base and will be used to raise the share of their stockholders.

In addition, the Law of the Republic of Uzbekistan “On currency regulation” was adopted in a new wording on October 22, 2019 (Law № 573 in the National Legislative Base).

In compliance with Article 9 of this law, tariffs for goods (works, services) within the territory of the Republic of Uzbekistan, including such tariffs, prices on national electronic trading platforms, as well as requirements for the amount of the charter funds (charter capital) of legal entities are established only in the legal tender of Uzbekistan. In addition, it is not allowed to link the prices of goods (works, services) sold within the territory of the Republic of Uzbekistan to foreign currency and equivalent units.

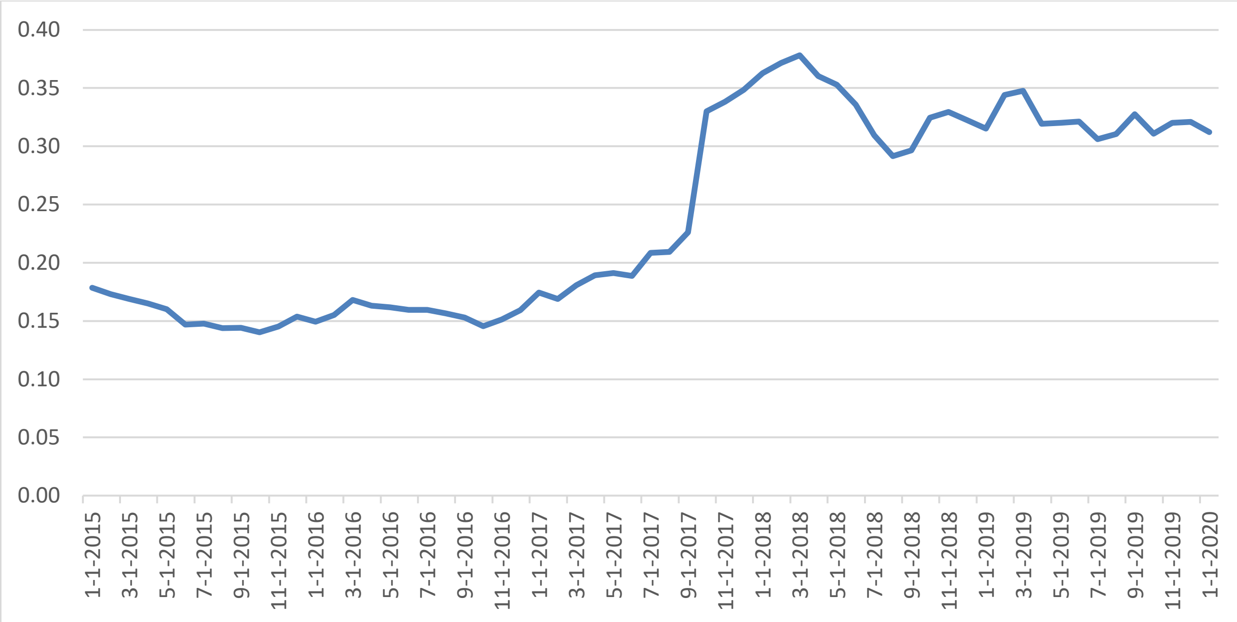

Figure 1. The Ratio of Foreign Exchange Deposits to the Money Supply (M2) in Uzbekistan

Source: Central Bank of the Republic of Uzbekistan

The ratio of foreign currency deposits to money supply (*broad money*) is a traditional way of measuring the dollarization level.

As a result of the monetary policy liberalization which has resulted in a sharp devaluation of the UZS against the USD in September 2017, the share of foreign currency deposits in the money supply increased from 23% on September 1, 2017 to 33% on October 1, 2017. However, this indicator continued to grow and reached its highest level (38%) as of March 1, 2018 (see Figure 1).

As of January 1, 2020, the share of foreign currency deposits in the money supply constituted 31%, which is almost average indicator and has remained relatively stable over the past year.

In addition, the dollarization level of loans and deposits in the country remains relatively high (Table 1). During the analyzed period, the dollarization of loans declined slightly, reaching almost 50 percent by the first half of 2020. Even though the dollarization of deposits is lower than the dollarization of loans, since the beginning of 2019, the dollarization of deposits has shown an upward trend.

The fight against dollarization is not only an essential element of monetary policy, but also the condition required for its efficiency.

Although economists do not come to the common point on the impact of dollarization on monetary policy, the general conclusion is that dollarization makes a negative impact on the transmission mechanism of monetary policy. Moreover, in countries with a high level of financial dollarization, the level of liquidity risk in foreign currency increases as central banks fail to fully perform their function of the lender of the last resort in terms of foreign currency.

Table 1 The Level of Dollarization of Bank Loans and Deposits in Uzbekistan

	01.01. 2018	01.07. 2018	01.01. 2019	01.07. 2019	01.01. 2020	01.07. 2020
The share of foreign currency loans in total loans, in%	62,3	56,8	55,9	56,9	47,7	49,8
The share of foreign currency deposits in total deposits attracted, in %	48,4	39,5	38,1	42,5	43,9	44,1

Source: Central Bank of the Republic of Uzbekistan

Therefore, the Central Bank of the Republic of Uzbekistan has recently been making attempts to reduce the attractiveness of the deposit dollarization environment by raising the reserve requirements for foreign currency deposits. In particular, the reserve requirements ratio for foreign exchange deposits attracted for a period of over 2 years in 2018 constituted 0%, and from July 1, 2019, the reserve requirement for foreign exchange deposits, regardless of the term, was set at 14% (Table 2).

Through this policy, the Central Bank intends to reduce the volume of foreign currency resources of commercial banks, thereby reducing the volume of foreign currency lending in the economy.

Table 2 Changes in Mandatory Reserve Requirements for Foreign Exchange and National Currency Deposits

<table>
<tr><th rowspan="2">Reserve currency</th><th rowspan="2">Term</th><th colspan="2">As of January 1, 2018</th><th rowspan="2">Since October 1, 2018</th><th rowspan="2">Since July 1, 2019</th></tr>
<tr><th>For individuals</th><th>For legal entities</th></tr>
<tr><td rowspan="3">National currency</td><td>Over 2 years</td><td>0%</td><td>0%</td><td>0%</td><td rowspan="3">4%</td></tr>
<tr><td>From 1 year up to 2 years</td><td>2%</td><td>7%</td><td>2%</td></tr>
<tr><td>Other deposits</td><td>4%</td><td>14%</td><td>4%</td></tr>
<tr><td rowspan="3">Foreign currency</td><td>Over 2 years</td><td>0%</td><td>0%</td><td>0%</td><td rowspan="3">14%</td></tr>
<tr><td>From 1 year up to 2 years</td><td>3%</td><td>8%</td><td>7%</td></tr>
<tr><td>Other deposits</td><td>6%</td><td>16%</td><td>14%</td></tr>
</table>

Source: Central Bank of the Republic of Uzbekistan

One of the key sources of financial dollarization in developing countries is attracting foreign currency loans from international financial institutions. In this regard, it should be noted that Uzbekistan lays emphasis on attracting loans from international financial institutions as well. In particular, the lenders of the country's external debt include the Asian Development Bank (3.9 billion USD), the World Bank (3.0 billion USD), the Eximbank of China (2 billion USD), the Islamic Development Bank (0.8 billion USD).

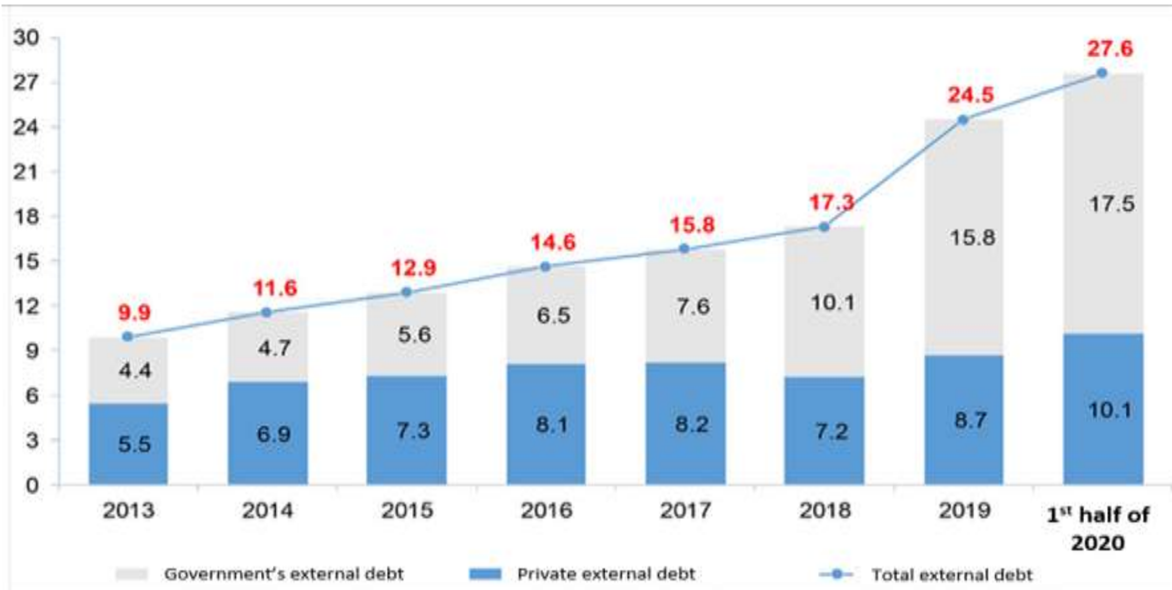

Figure 2. Dynamics of External Debt of the Republic of Uzbekistan
Source: Central Bank of the Republic of Uzbekistan

Over the past three years, the growth dynamics of Uzbekistan external debt has accelerated (Figure 2). 74 percent of the total external debt was issued for a period of over 10 years. The share of the USD in the currency structure of Uzbekistan external debt constitutes 71 percent. 45 percent of private external debt belongs to the banking sector and 44 percent are possessed by the oil and gas and energy sectors.

In our view, the worsening of public debt service in foreign exchange could result in the increased fiscal risks and ultimately cause systemic risk problems. In addition, within the framework of high financial dollarization, exchange rate fluctuations (devaluation of the national currency) can result in the systemic banking crises due to the inability to meet foreign exchange obligations.

Meanwhile, it should be kept in mind that the constant downward trend in the exchange rate causes a decrease in public confidence in the potential of the Central Bank and thus in the national currency.

Due to high inflation rates in developing countries, it will be complicated for the national currency to function as a store of value, and stable leading currencies (mainly the USD and the EURO) will start to perform this function as a substitute. The population prefers to place their savings on deposits in the national banking system in foreign currency. As a result, the dollarization of banking sector liabilities has an upward trend.

In addition, under conditions of the digital economy, countries with weak financial institutions and unstable national currencies are more likely to prefer virtual currency over other countries' hard currencies, such as the USD. This situation is admitted by economists as the concept of "Dollarization 2.0" (*Peprah et al., 2018*).

CONCLUSION AND RECOMMENDATIONS

It should be noted that in developing countries, dollarization also reflects a specific hedging strategy aimed at protecting against inflation. Therefore, the formation of the market for currency risk hedging instruments in the country is crucially important as well. In our opinion, it is necessary to undertake measures to prevent the dollarization level in the economy from exceeding 30% in the medium term in Uzbekistan. To pursue this aim, in reliance upon foreign experience, it is recommended to arrange the process of combatting dollarization in our country in three areas.

First, taking into consideration, that the first condition for de-dollarization is to ensure macroeconomic stability, we believe that the implementation of the following proposals will be appropriate.

1) To prevent a sharp rise in public debt. Consequently, the aggravation of debt service conditions reduces the possibility of fiscal flexibility. The high share of external debt in the structure of public debt promotes the demand for USD to service it.

2) Achieving a single-digit inflation rate. For this purpose it is recommended to demonstrate stiffness in the introduction of inflation targeting, to provide conditions required for the market mechanism to play a decisive role in price formation by sharply reducing the share of monopoly enterprises in the economy.

In general, hyperinflation encourages the population to keep their assets and liabilities in a stable foreign currency. As a result, the level of financial dollarization in the country will increase and the efficiency of monetary policy channels will decline.

3) To prevent a significant increase in the state budget deficit. This is because covering the budget deficit can result in the borrowings in foreign currency.

4) Ensuring the fact that current account is executed with a surplus.

5) Ensuring the adequacy of the country's gold and foreign exchange reserves and preventing its sharp decline.

Second, as prudential measures against dollarization, it is advisable to implement the following measures:

1) strengthening reserve requirements for foreign currency deposits;

2) increase the requirements for reserves created for loss loan provisions on foreign currency loans;

3) If commercial banks lend to non-exporting enterprises in foreign currency, they should hedge currency risk or require more sufficient collateral than loans in the national currency;

4) tightening restrictions on open currency positions;

5) raising liquidity requirements: commercial banks must have liquid assets in foreign currency in the amount of minimum 20% of foreign currency liabilities to be repaid within 12 months;

6) introduction of the insurance system of foreign currency deposits at a higher premium.

Third, in order to attract debt and increase investment opportunities, it is necessary to undertake measures to develop the national capital market. In particular:

- development of the long-term government and corporate bond market;
- issuance of securities adjusted to the consumer price index;
- raise the volume of investments of commercial banks in long-term government bonds.

In our opinion, it is not advisable to undertake drastic measures in the fight against dollarization in our country, which is consistently implementing reforms to liberalize foreign exchange policy, such as introduction of quantitative restrictions or bans on foreign currency loans and deposits.

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