Curbing inflation: Uzbekistan's Approach

Inflation in Uzbekistan was historically relatively high, and in recent years there has been a further **acceleration of inflation** in effect of structural reforms in the economy, liberalization of regulated prices, changes in tax policy and rising incomes. This raised the issue of reducing inflation in order to ensure macroeconomic stability.

As a solution to this issue, the Central Bank demanded to improve its monetary policy, in particular, the revision of its directions and principles. In order to achieve long-term sustainable economic growth and increase the welfare of the population, the Central Bank was tasked to **ensure a stable low inflation rate**.

First of all, the main goal of the Central Bank was confirmed as to ensure price stability in the economy, and in accordance with the relevant Presidential decree, Central Bank should gradually adjust its monetary policy to the **inflation targeting regime** based on international experience.

Transition of monetary policy to inflation targeting has been on the agenda since 2017, and the first steps of the Central Bank were to implement structural changes in the direction of monetary policy and improve staff capacity.

One of the peculiarities of the inflation targeting regime is a decision-making process based on an enhanced **macroeconomic analysis and forecasts**, and the forecasting skills of Central bank's staff was developed with the assistance of the European Bank for Reconstruction and Development and the Swiss National Bank.

In particular, the Quarterly Forecast Model (QPM) is used in the implementation of medium-term macroeconomic forecasts, and models such as ARIMA, BVAR and FAVAR are used in the short-term forecasting of inflation. The forecasts obtained from the results of the model are effectively used in making decisions on monetary policy guidelines and, in particular, on the policy rate.

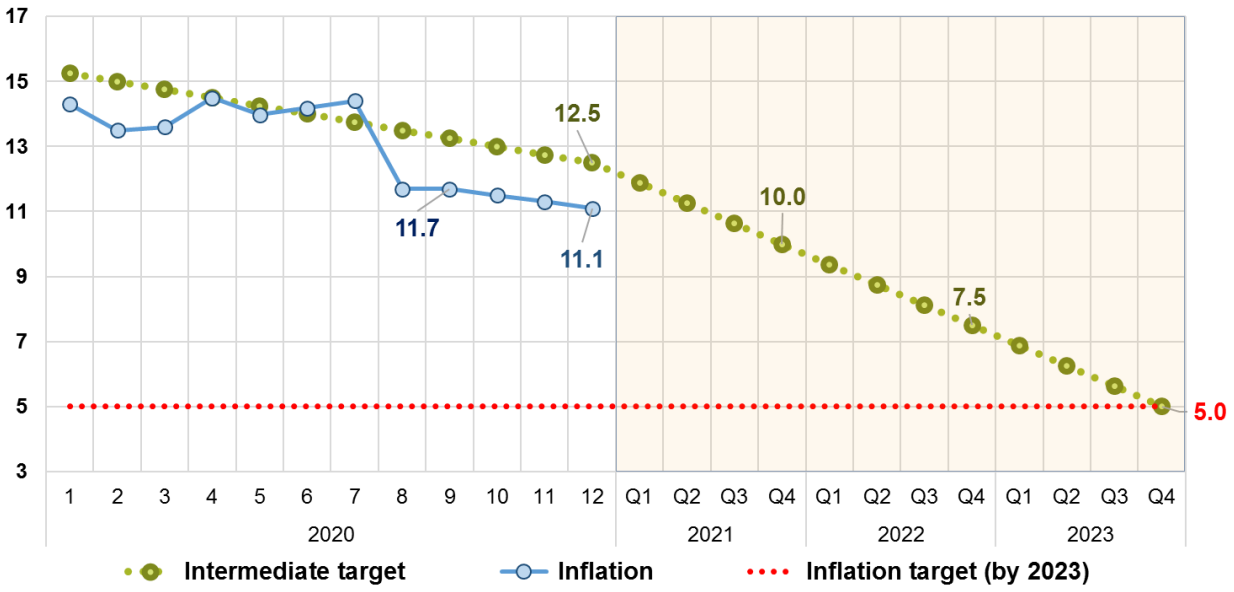
Also, due to the importance of the role of communication policy in the inflation targeting regime, the need for the Central Bank to ensure transparency in its activities, including monetary policy decisions, relevant departments have been established.

From 2020, the practice of reviewing the policy rate of the Central Bank **8 times a year** has been introduced, a press-release is issued on the results of each board meeting, and a press conference is held with the

participation of the Chairman of the Central Bank. The Monetary Policy Review, which is published quarterly, is also one of the main means of communication with public.

According to the Presidential Decree of November 2019, the Central Bank will gradually harmonize monetary policy mechanisms with the standards of the inflation targeting regime from 2020, ensuring that the intermediate target for inflation will not exceed **10% in 2021** and **5% from 2023** as a permanent target.

Graph #1. CPI inflation dynamics and its medium-term forecast



Source: *State Statistics Committee, Central Bank of Uzbekistan*

The constant inflation target of 5% was determined on the basis of comprehensive analysis, forecasts of the macroeconomic situation in the country, the inflation rate in our major trading partners, the experience of developing countries in setting inflation targets.

At the same time, the Central Bank will take measures **together with the Government** to reduce inflation and ensure its stable low level. Inflation factors are divided into monetary and non-monetary factors, and the Central Bank minimizes the impact of monetary factors on inflation through the active use of monetary policy instruments.

However, since monetary policy has no effect on **non-monetary factors**, it is important that other ministries and agencies within their competence eliminate inflationary factors, thereby ensuring a single common goal - macroeconomic stability in the country.

Today, the Central Bank is constantly monitoring changes in prices in the economy, conducting an in-depth study of a group of goods and

services with relatively higher price hike, and submits proposals to the Government to address the negative impact of these factors on inflation. The availability of **government support and political will** to reduce inflation and ensure price stability in the economy will certainly serve to increase the effectiveness of the reforms.

Achieving the inflation target requires not only tightening monetary policy, but also effective **fiscal policy** and **structural reforms**.

In this regard, a plan of measures to be implemented in the field of **fiscal policy** has been developed, which includes the gradual reduction of the budget deficit and fiscal consolidation, the application of a limited approach to borrowing, introduction of a mechanism for legislating the annual parameters of the use of state budget funds, extra-budgetary funds, including Fund for Reconstruction and Development, effective control over budgetary execution.

In turn, government plans to implement **structural reforms** such as regulatory price liberalization, creation of modern production and transport infrastructure, uninterrupted supply of energy throughout the country, improving the competitive environment and creating equal business opportunities, growth of private investment and financial market development and increasing efficiency of production factors.

From the beginning of 2020, the Central Bank entered an **active phase** of transition to the inflation targeting regime, initially introducing the Central Bank's **policy rate** and **interest rate corridor**. This is due to the fact that in the inflation targeting regime, the main transmission channel for the transfer of monetary policy decisions to the economy is the **interest rate channel**.

Central bank notes have also been issued to effectively regulate the liquidity surplus in the banking system, to replace non-profit highly liquid assets of banks with alternative income-generating instruments and thereby reduce the price pressure on other active operations (especially loans).

Starting from February 2020, **short-term monetary operations** were introduced in order to effectively regulate the interbank money market interest rates and ensure that they are formed within the interest rate corridor close to the Central Bank policy rate.

In the second half of March 2020, against the background of the spread of the pandemic and the introduction of quarantine measures in Uzbekistan, there was a need to make some changes in monetary policy.

First of all, taking into account the high weight of the factors that reduce the dynamics of inflation in the conditions of a decrease in economic activity, the Central bank **reduced the policy rate** of the central bank twice: in April and September from 1 percent point (from 16 percent to 14 percent), due to the tasks of supporting economic activity.

Graph #2. Monetary Policy Operational Framework

Purpose	***Instruments***	***Term***	***Interest rate***
Providing liquidity	*REPO auctions*	*up to 14 days (every Monday) (11:00 – 11:30)*	*Policy rate (floor)*
	SWAP auctions	*up to 14 days (every Monday) (11:30 – 12:00)*	*Policy rate (floor)*
	Overnight REPO operations	*1 day (10:00 - 16:00)*	*Policy rate + 1%*
	Overnight SWAP operations	*1 day (10:00 - 16:00)*	*Policy rate + 1%*
Absorbing liquidity	*Overnight deposits*	*1 day (10:00 - 16:00)*	*Policy rate - 1%*
	Deposit auctions	*up to 14 days (every Tuesday & Thursday) (11:00 - 11:30)*	*Policy rate (cap)*
	Central bank notes	*Up to 12 months (based on schedule) (11:00 - 11:30)*	*Policy rate (cap)*

Source: *Central Bank of Uzbekistan*

During the quarantine period, commercial banks extended the terms of loan payments to individuals and businesses, while the full fulfillment of all obligations to customers by banks contributed to the decline in liquidity in the banking system. Given the current situation, from April 2020, the Central Bank's liquidity regulation operations was prioritized to provide the necessary liquidity to commercial banks.

In addition, in order to provide banks with liquidity in the event of a pandemic and increase their flexibility to current conditions, the **averaging coefficient** of required reserves was increased from 25% in April 2020. Increased to 35 percent and in June 2020 to 75 percent. Thus, a total of 2.8 trln. sum liquidity was returned to commercial banks.

It should be noted that the operations introduced by the Central Bank to regulate liquidity and easing of mandatory reserve procedures have served to provide banks with the necessary liquidity and ensure the payment system stability during the pandemic.

At the same time, the Central Bank's determination of the **operational goal** of monetary policy and the focus of monetary policy instruments on achieving this goal have increased the importance of the interest rate channel.

In most countries that have switched to inflation targeting, the operational goal is to bring interest rates on overnight deposits in the money market closer to the policy rate.

In our case, due to the small number of transactions in the interbank money market, insufficient liquidity management by banks, the operational goal is to ensure that interest rates on deposits in the money market up to 14 days are formed close to policy rate.

The Central Bank actively uses short-term monetary policy instruments to achieve its operational goals. In particular, an unlimited volume of overnight REPO, currency swap and deposit operations are carried out at the upper and lower limits of the interest rate corridor at a constant rate.

This ensures that interest rates on deposits in the interbank money market are within the Central Bank's interest rate corridor. That is, banks are able to receive liquidity from the Central Bank at any time at an unlimited amount at the rate of the upper limit of the interest rate corridor, which also affects interest rates in the money market.

Unlike the interbank deposit market, the Central Bank's currency swap and REPO operations require collateral (foreign currency or government securities). Therefore, the Central Bank, together with the Ministry of Finance, pays special attention to the formation of the collateral base in banks through the issuance of government securities.

While overnight transactions ensure that money market interest rates are within the interest rate corridor, currency swaps, REPOs and deposit auctions conducted to ensure that money market interest rates are formed close to the policy rate.

With the introduction of short-term monetary instruments, more efficient liquidity management by commercial banks is observed, and their activity in the money market is growing. Today, in Uzbekistan, only the market of unsecured deposits has developed among banks, and in the future it is planned to develop the **interbank repo market**.

Regulation of the liquidity of the banking system plays an important role in improving the efficiency of the interest rate channel. Therefore, the Central bank monitors and analyzes the overall liquidity level on a daily

basis and determines its short-term (daily, weekly, monthly and quarterly) forecast.

New methods have been introduced in the **analysis and forecasting of the liquidity** of the banking system for 2019-2020. An in-depth study of each factor affecting overall liquidity has made it possible to effectively forecast their expected impact through constant information exchange.

In the coming periods, it is planned to use **modern econometric models** in forecasting autonomous liquidity factors, strengthen the exchange of information on government operations with external entities, including the Ministry of Finance, and extend the forecast period.

At the same time, in 2020, fluctuations in the dynamics of liquidity of the banking system through monetary operations were reduced, the efficiency of liquidity distribution and redistribution was increased.

One of the important measures to be taken in the coming years will be to determine the one-sided direction of monetary operations by the Central Bank.

It is also planned to introduce **'fine-tuning'** operations from 2 to 13 days to increase the flexibility of instruments in liquidity management, given that only 2-week REPOs, currency swaps and deposit auctions are currently conducted.

In addition, in the coming period it is planned to reduce the maturity of Central Bank notes and issue mainly for **3-6 months**. At the same time, it is important to announce the **schedule of issuance** for the next quarter at the beginning of each quarter and change these volumes in advance based on the liquidity situation in the banking system, which will allow banks to effectively plan liquidity.

The introduction of new monetary policy instruments and more efficient liquidity management by banks have also contributed to the intensification of the interbank money market. In the coming years, the main focus will be on further increasing the activity of banks in the money market, encouraging each bank to manage liquidity using the money market and organizing an effective redistribution of liquidity, primarily among banks.

One of the important tasks in the transition of monetary policy to inflation targeting is the development of the domestic FX market, thereby pursuing a freely formed exchange rate policy based on market principles.

The exchange rate, which is freely floating on the basis of supply and demand, in turn, increases the **independence of monetary policy** and

expands the ability to influence the decisions of economic entities through its instruments.

One of the positive changes in this direction is the **liberalization of the foreign exchange market** from September 2017 and the introduction of the principle of **"neutrality of gold and foreign exchange reserves"** in the implementation of Central Bank interventions from 2018 and the formation of the exchange rate based on supply and demand in the domestic foreign exchange market.

At the same time, it is planned to implement a number of measures to further improve the domestic FX market. Effective implementation of measures in this direction will **increase the flexibility of the exchange rate to internal and external factors**.

As a result, in the face of external risks, the exchange rate absorbs the effects of these risks ("risk absorber") and increases its importance as a coordinator of the economy ("automatic stabilizer").

In general, the Central Bank has focused on the introduction of liquidity management instruments in 2020 and ensure the efficiency of the interest rate channel. In 2021, the main focus will be on further development of the interest rate channel, as well as the development of the exchange rate channel and the study of other channels of the transmission mechanism.

Also, together with the Government, it will be continued to implement structural reforms that will be the basis for reducing inflation in the economy and ensuring macroeconomic stability. The main goal is to achieve a stable inflation target of 5% from 2023 and ensure this stable level.