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Inflation Targeting in Uzbekistan: Background and First Results

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ABSTRACT

This article describes the measures taken to introduce a new regime for the implementation of monetary policy in Uzbekistan and the economic results achieved. Specific and adequate scientific proposals and recommendations for the further implementation of inflation targeting (IT) are given.

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Introduction

According to the statistics of the International Monetary Fund, the number of countries applying the inflation targeting regime as of April 30, 2021 is 45, of which more than 30 are developing countries[1].

[1] International Monetary Fund. 2021. Annual Report on Exchange Arrangements and Exchange Restrictions: Overview 2021. Washington,

In order to achieve the inflation target, monetary policy mechanisms will be gradually transferred to this mode, which will be used as an effective tool for reducing inflation. In turn, the application of this regime can create additional conditions for strong and sustainable economic growth in the medium term by ensuring price stability. At the same time, the Central Bank determines the most appropriate inflation target and achieves it through the use of monetary policy instruments, regular analysis of economic developments, and a broad coverage of monetary policy plans.

The essence of inflation targeting lies in reducing the inflation rate and keeping it in a certain range of values, through which central banks achieve economic stability.

The inflation targeting regime allows achieving several macroeconomic goals, such as: preventing a sharp rise in prices and high inflation, forming a money market, eliminating the causes of money market segmentation, supporting the solvency of the population and entrepreneurs, taking into account internal and external factors, ensuring the stability of the financial sector.

According to IMF experts, two conditions are necessary for using inflation targeting as an indicator of monetary policy. First, the Central Bank must be able to pursue an independent monetary policy. The central bank should be free to choose monetary instruments to achieve an inflation rate that the government deems acceptable. The requirements of the country's fiscal policy should not be taken into account as a priority in the development of monetary policy. Second, for an inflation target to be chosen as an indicator, it is not necessary to set targets for wage growth, employment rates, and the exchange rate.

Inflation targeting has several important advantages. It differs from currency targeting, but like monetary targeting, inflation targeting allows monetary policy to focus on domestic conditions and respond to shocks to the domestic economy. Inflation targeting also has the advantage that the rate of occurrence of shocks is misplaced, since the monetary policy strategy no longer depends on a stable money-inflation relationship. In fact, inflation targeting allows the monetary authorities to use all existing information, rather than relying on just one variable, to determine the most appropriate monetary policy environment. Just like exchange rate targeting, inflation targeting is easily understood by the public and therefore highly transparent.

Literature review

Due to the relevance, there are many different kinds of scientific research devoted to the study of the main necessary conditions for the introduction of the IT regime, as well as the effectiveness of the application of inflation targeting. Often their results contradict each other to some extent. But in general, the vast majority of scientists agree on the conclusion that this regime is quite effective in terms of its impact on the ultimate goal of monetary policy, both in relation to developed and developing countries. So, in the work of Laurens et al. (2015) highlights the importance of meeting the necessary preconditions to be able to adopt a full IT regime in order to avoid adverse effects. In their research, Roger and Stone (2005), Walsh (2009), and Freedman and Otker-Robe (2009 and 2010) stress that the creation of an efficient and clear monetary policy instrument is a prerequisite for IT success. The need for a clear understanding of the transmission mechanism and the creation of economic data bases is studied in the work of Batini and Laxton (2005).

Hyvonen (2004), Vega and Winkelried (2005), and Mollik, Torres and Carneiro (2008) have studied the impact of IT on the volatility of inflation and economic growth. In their research, they obtain positive

DC: IMF., p.10.

results from the reduction in inflation, its volatility, as well as the volatility of economic growth rates during the transition of developed countries to the inflation targeting regime. Mishkin and Schmidt-Hebbel (2007) also obtain approximately the same result: functioning under the inflation targeting regime allows developed countries to maintain a low level of inflation in the long term.

Goncalves and Salles (2008) and Batini, Breuer, Kochhar and Roger (2006) concluded that inflation targeting in developing economies also helps to reduce inflation its volatility, as well as the volatility of economic growth rates. Moreover, Batini et al note that the effect of inflation targeting is stronger on average than other monetary policy regimes.

Analysis and results

Countries that have successfully used inflation targeting include New Zealand, Canada, the UK, Finland, Sweden, Australia, and Spain. In Australia, Finland and Sweden, the central bank announced inflation targets without the government's consent to support them. In Canada and New Zealand, an 18-month period is set to achieve the goal. At the end of this period, a new 12-month period is established in New Zealand and an 18-month period in Canada with the aim of gradually reducing inflation. At the expiration of the new deadlines, both countries managed to meet their inflation targets, and both countries set inflation targets for another five years. In Australia, Finland, the target inflation rate is taken as the exact level. In Canada, New Zealand, Sweden and the United Kingdom, the inflation target is set as a band.

The inflation-targeting regime applied by the Central Bank of Russia set the goal of bringing the annual inflation rate to 4% by the end of 2017. The measures taken in 2016 made it possible to achieve this goal. That is, at the end of 2016, the annual inflation rate in Russia was 5.4%. However, as of December 31, 2015, the annual inflation rate in Russia was 12.9%. By June 2016, a significant reduction in inflation allowed the Central Bank of Russia to lower the refinancing rate. The factors that ensured the effectiveness of inflation targeting in Russia in 2016 are:

1. Ensuring low growth rates of prices for products and services of natural monopolies. In 2016, the growth rate of these prices was 1.3%.

2. Stability of the nominal exchange rate of the national currency (during 2016, 1 US dollar was provided at the level of 64-67 rubles).

3. Ensuring low growth rates of the money supply. In 2016, the growth rate of the money supply (calculated on the M2 monetary aggregate) was 9.2%. In 2015, the growth rate was 11.5 percent.

4. It is not allowed to increase the monetary base by financing the state budget deficit from the Reserve Fund (allowed in 2015).

In Uzbekistan, until 2017, monetary policy was subject to a fixed exchange rate regime. However, starting from September 2017, the Central Bank of the Republic of Uzbekistan adopted a new approach, and the main focus of monetary policy was to achieve price stability. This was facilitated by the adoption of the Decree of the President of the Republic of Uzbekistan dated September 13, 2017 No. PP-3272 “On measures to further improve monetary policy”, Decree of the President of the Republic of Uzbekistan dated November 18, 2019 UP-5877 “On improving monetary policy through a phased transition to inflation targeting. The Central Bank of the Republic of Uzbekistan has been removed from the list of state bodies under government control, paving the way for greater operational independence of the Central Bank. In addition, restrictions on access to foreign exchange were lifted, resulting in a 50 per cent depreciation of the official exchange rate and its unification. In October 2019, a new law on the central bank was adopted, which clearly defined price stability as the main goal of monetary policy, and the Central Bank began the transition to an inflation targeting (IT) regime[2].

According to the Decree, in order to expand the use of market mechanisms and economic regulation tools to ensure macroeconomic stability, as well as to radically improve the efficiency of monetary policy, the Central Bank of Uzbekistan set a goal to reduce inflation to 10% in 2021. and 5% in 2023), to ensure a phased transition of monetary policy mechanisms to the inflation targeting regime from January 1, 2020.

The Resolution also approved the Concept of Joint Actions of the Cabinet of Ministers and the Central Bank of the Republic of Uzbekistan and approved the Roadmap to reduce inflation and ensure price stability in 2020. As follows from the report of IMF experts, progress in the implementation of this strategy has been uneven. While the Central Bank is successfully implementing the strategy in areas under its control, progress has not yet been made in some areas requiring government action - such as credit policy or utility tariffs[3].

Starting from 2018, the Central Bank began to use bank reserves as an operational target. Somewhat later, this function was performed by the main rate and interbank interest rates. In addition, the Central Bank has also begun to prepare liquidity forecasts despite shortcomings in data availability and has reformed its standing-access operations by consolidating lending operations and introducing an overnight deposit facility, in line with recommendations from IMF technical assistance. In early 2020, the Central Bank introduced a new system of open market operations, which has since been used to provide liquidity (currency swaps and repo auctions) and absorb liquidity (deposits and securities auctions of the Central Bank).

As a result of the monetary policy pursued in accordance with the Decree of the President of the Republic of Uzbekistan “On improving monetary policy through a phased transition to inflation targeting”, inflation was formed at an intermediate target level of 10% in 2021, but growth was noted during 2022 prices for a wide range of consumer goods, which was reflected in the acceleration of the overall annual inflation rate to 12.3%.

Core inflation over the last half of the year also showed a steadily growing trend, reaching 13.8% by the end of the year, which, together with the relatively high dynamics of the producer price index, is a signal for a further increase in inflationary pressure.

Inflation expectations over the past three months have also shown moderate growth due to the increased level of inflationary processes in the economy, rising prices for fuel and energy resources, basic food products and imported raw materials. Their orientation increases the likelihood of inflationary risks shifting upwards.

[2] Muayyad al Rasashi And Ezekiel Cabezon , 2022. "Uzbekistan's Transition to an Inflation-Targeting Regime," IMF Working Paper 2022/229, International Monetary Fund. Page 3.

[3] Mu'ayyad al Rasassi and Ezekiel Cabezon , 2022. "Uzbekistan's Transition to an Inflation-Targeting Regime," IMF Working Paper 2022/229, International Monetary Fund. Page 4.

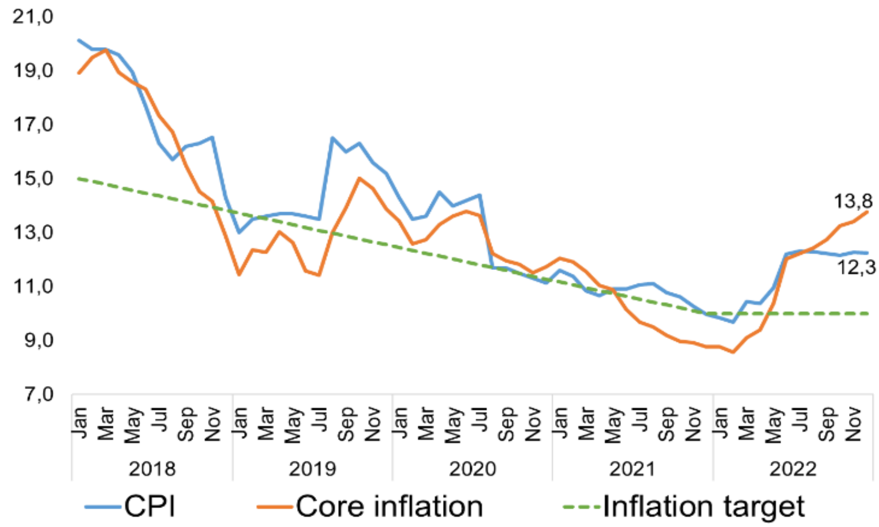

Fig.1. Headline and core inflation rates, annual (%)[4]

The strong growth in core inflation observed in recent months requires maintaining moderately tight monetary conditions. In this regard, despite the fact that the goal was to achieve a target inflation rate of 5% by 2023, the regulator had to change the forecast scenarios for the development of the economy.

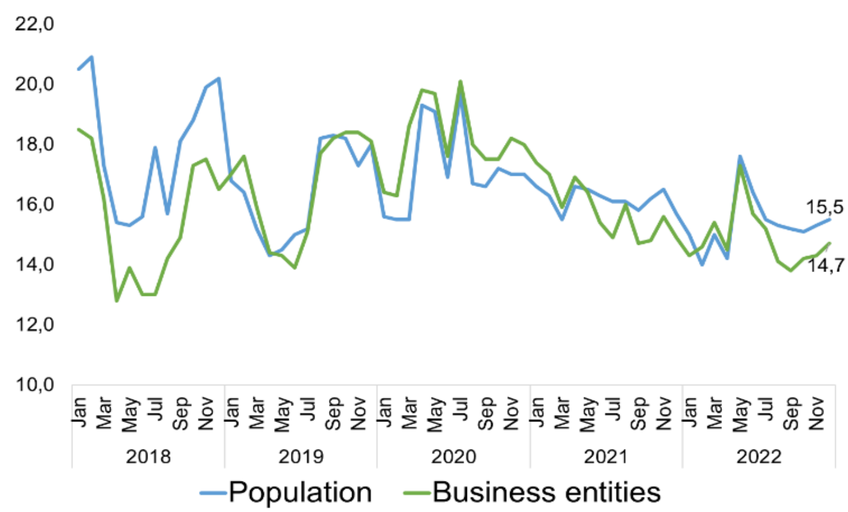

Fig.2. Inflation expectations for the next 12 months (%)[5]

According to these scenarios, further measures taken by the Central Bank together with the Government are aimed at reducing the inflation rate to the forecast level by the end of 2023 and achieving the 5% target in 2024.

As of the end of 2021, the situation in the money market was relatively stable, with the UZONIA rate averaging 14%. During the year, the dynamics of interest rates in the money market reflected an almost twofold volume of interbank transactions and a sharp increase in the activity of monetary instruments. Through the use of a set of monetary policy instruments, it is planned to ensure the formation of an

[4]Source: State Statistics Committee, Central Bank calculations

[5]Source: Central Bank surveys

interest rate in the interbank money market - UZONIA in 2023 within 3-4% in real terms (based on the inflation forecast for the next 6 months).

The economy was provided with high real positive interest rates on deposits in the national currency due to the influence of decisions on the main rate on interest rates in the money market and in the banking system. Real interest rates were at a positive level of 4-5% even in comparison with inflationary expectations of the population. As a result, the savings activity of the population increased, and the volume of time deposits in the national currency increased by 1.6 times by the end of the year (in 2021 it increased by 1.7 times).

Thus, interest rates on term deposits of the population in the national currency rose from 20.2% at the beginning of the year to 21.8% in August. Due to somewhat accelerated inflationary processes in the economy, real interest rates on these deposits decreased from 9.5% at the beginning of the year to 7.8% in August. In August, interest rates on loans to individuals in the national currency were 22.7%, and on loans to legal entities in the national currency 21.9%.

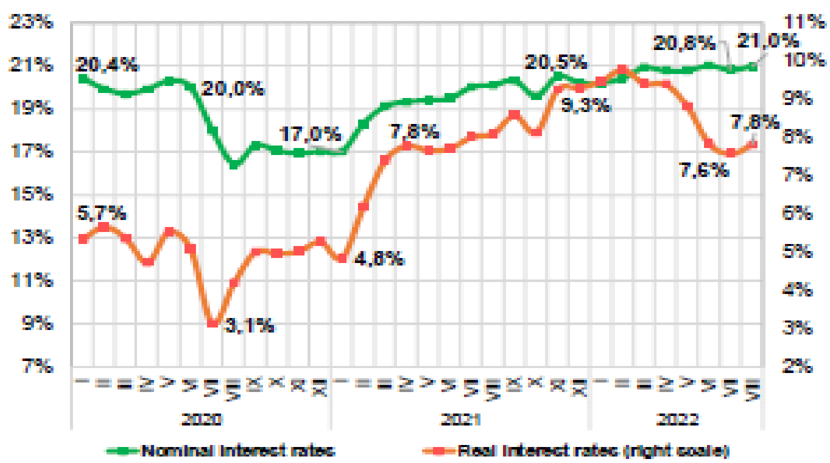

Fig.3. Interest rates on term deposits of the individuals in national currency [6]

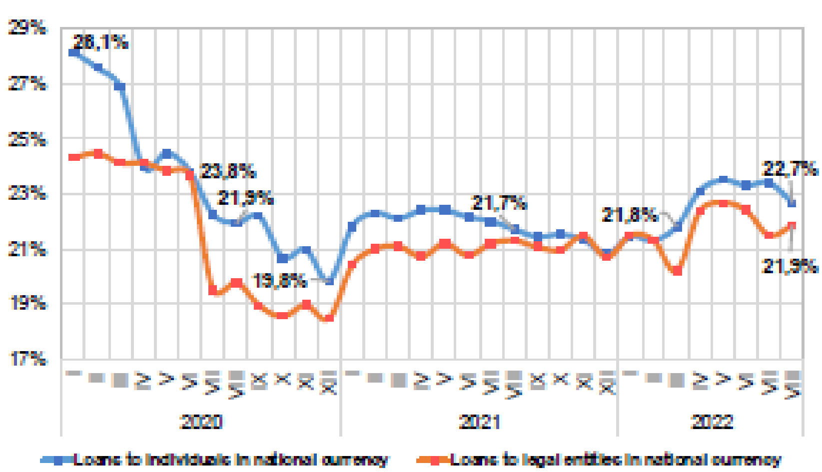

Fig.4. Interest rates on loans in national currency [7]

[6] Source: State Statistics Committee, Central Bank calculations

In turn, there was a balancing of interest rates on loans in the region of 21-23%, and the growth of loans to the economy was proportional to the growth of nominal GDP (growth by 21.4%). At the same time, loans to individuals increased by 45% and became one of the factors supporting aggregate consumption. The relatively low share of household loans in total loans (25%) indicates the possibility of continued high rates of their growth in the coming years.

In 2022, the impact of fiscal stimulus measures implemented in previous years on economic activity and investment processes continued. The deficit of the consolidated budget at the end of last year amounted to about 4% in relation to GDP. It is expected that the impact of fiscal stimulus on economic performance will continue in the first half of this year, and its further dynamics will depend on budget execution in 2023.

Also, during this period, the volume of aggregate demand in the economy remained at a high level, and at the end of the year, the real growth of gross domestic product amounted to 5.7%. As the main factors of high economic growth, a significant increase in spending on consumption by the population and the state is highlighted. A significant increase in the volume of remittances coming to our country in 2022 (by 2.1 times compared to 2021) was one of the important factors supporting the demand of the population. This, in turn, was reflected in a significant increase in revenue from trade and paid services, as well as an increase in the production of consumer goods.

The Central Bank has updated its forecasts based on the results of 2022, based on the situation in the domestic and foreign economic environment, statistical indicators, future risks and their possible impact on our economy. The main assumptions in the development of these forecasts are the expected slowdown in global economic growth, a possible recession, the balancing of inflationary processes, the persistence of a tense geopolitical situation and the continuation of current trends in external activity indicators.

Given that inflationary pressures of various nature will persist in the economy in 2023, as well as taking into account the effect of the external conjuncture pass-through, monetary conditions will remain at a “moderately tight” level.

According to the basic scenario of macroeconomic development, in the first quarter of this year, real GDP growth is expected to slow down and by the end of the year it will be about 4.5-5%. In turn, the likelihood of a slowdown in global economic growth and the start of a recession in some countries increases. Based on this, in order to generate high rates of economic growth this year, it is important to increase the volume and efficiency of private and foreign investments, expand production potential and provide the economy with the necessary resources.

In 2023-2024, it will be important to complete the transformation of enterprises and banks with a state share in the main sectors of the economy, to raise capital through IPOs and SPOs, to move to setting prices for electricity and network gas in market conditions based on supply and demand. The results of these reforms will begin to be reflected in macroeconomic indicators from 2024 and will serve to improve the quality of economic growth indicators.

Given the reduction in 2023 of the inertial effects of the fiscal stimulus implemented in previous years, the limitation of public resources and the beginning of fiscal consolidation, stimulating the investment opportunities of the private sector is the most important criterion for ensuring real economic growth. In general, according to the updated forecasts, the GDP gap (the difference between actual and potential

[7] Source: State Statistics Committee, Central Bank calculations

GDP) will increase in the negative direction this year and will decrease in the coming years. This negative gap can have a depressing effect on inflation, with aggregate supply and demand conditions in the economy playing an important role.

However, the strong fiscal stimulus seen in previous years is helping to maintain upward pressure on inflation this year through support for domestic consumption.

Under the main scenario, real growth in final consumption expenditure is projected at around 5-6% in 2023 and around 7-9% in 2024-2025, which will serve to positively shape aggregate demand in the economy. Another important component of aggregate demand is the volume of investment in fixed assets, which is projected to grow by 9-10% in 2023, 12- 13% in 2024 and 10-11% in 2025.

Based on the above, the inflation rate at the end of 2023 is expected to be around 8.5-9.5%. The current dynamics of inflation and the forecast for the nearest period require maintaining moderately tight monetary conditions in the economy. At the same time, by making the necessary decisions on the main rate within positive real interest rates of at least 2-3% will be ensured in the money market. In addition, the strengthening of the real effective exchange rate, which occurs with the current trend of foreign exchange flows into the country, will also have a downward effect on inflation.

Based on the above analysis and considerations, the following recommendations can be made. To implement the inflation targeting regime, first of all, the following conditions must be met:

- setting a permanent target inflation rate and bringing it to the attention of the general public (regular informing the population about inflation, its factors and the expected target level of inflation);
- it is necessary to ensure the implementation of structural transformations and the development of the financial market, which in itself is a rather complex and lengthy process.
- for the effective implementation of any monetary policy measures and the transition to the IT regime, it is necessary to strengthen the operation of the transmission mechanism, or rather, the functioning of the exchange rate and interest rate channels.
- widespread use of monetary policy instruments (REPO auctions and currency swaps, deposit auctions, auctions on Central Bank bonds) to control inflation and regulate interest rates in the money market;
- detailed macroeconomic analysis for making objective decisions in the field of monetary policy (analysis of the state of business entities: households, entrepreneurship, government and the outside world) and forecasting based on open data available in the domestic and foreign markets;
- improving communication policy to communicate to the general public the goals of monetary policy (price stability, popularity of credit, low inflation, increasing public confidence in the national currency, etc.), the ability to predict the macroeconomic situation and strengthen market confidence.

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