

Improving the Practice of Using Monetary and Credit Policy Instruments in the Republic of Uzbekistan

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Abstract

The article analyzes the practical situation of the Central Bank of the Republic of Uzbekistan's use of monetary credit policy instruments and identifies its problems. In the Republic of Uzbekistan, practical suggestions and recommendations are given for improving the practice of using monetary and credit policy instruments.

Keywords: *central bank, monetary policy, instruments, deposit, devaluation reserve, loan, regulatory capital, required reserve, financial stability, liquidity, liquid assets, refinancing rate.*

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Introduction

The fact that the mandatory reserve rates of the Central Bank of the Republic of Uzbekistan are relatively high and the amount of reserve allocations are withdrawn from the representative accounts of banks has a negative impact on their financial stability.

The lack of stability of the composition of regulatory capital of commercial banks is one of the urgent problems in this regard. The essence of the problem is that the devaluation reserve is included in the first-tier capital of commercial banks of our republic. However, according to the Basel standard, it is not at all possible to include the devaluation reserve in the regulatory capital of commercial banks.

In countries with a relatively high rate of depreciation of the national currency, including Uzbekistan, a large amount of devaluation reserve is observed in the balance sheets of banks. In such conditions, the inclusion of devaluation reserves in the capital of commercial banks leads to a qualitative deterioration of their capitalization level. Therefore, an increase in its regulatory capital structure leads to a decrease in the level of financial stability of the bank.

One of the main favorable aspects of the monetary policy reserve requirement operation is that the Central Bank knows exactly how much it affects the money supply when applying the reserve policy. The remaining instruments at the disposal of the Central Bank do not provide such an opportunity. Along with the many positive aspects of mandatory reserve policy, it also has negative aspects. In particular, the Central Bank cannot apply the mandatory reserve policy to a small change in the money supply. Also, mandatory reserve policies affect all banks in the country equally, further worsening the situation of small banks with low liquidity or distress.

Article 30 of the newly revised law "On the Central Bank of the Republic of Uzbekistan" No. 582 stipulates that the Central Bank, within the framework of the implementation of the monetary policy, determines the norms of the mandatory reserves transferred by the banks to the depositors in the Central Bank under the obligations of the banks. Also, the Central Bank approves the amount of mandatory reserve requirements, the composition of banks' obligations to transfer reserves to depositors, the procedure for calculation and reserve, and the averaging coefficient of mandatory reserves. The norms of mandatory reserves are the same for all banks. Mandatory reserves are kept by transferring the funds of banks in special accounts at the Central Bank to the depositor, or by maintaining the average amount of mandatory reserves calculated based on the amount of the averaging coefficient of mandatory reserves in the representative account opened at the Central Bank. Averaging reserve ratio is a multiplier whose value is between 0 and 1.

As we mentioned above, the mandatory reserve policy is used by the central banks of developing countries to influence the money supply and market interest rates, in particular, the interest rate in the money market, deposit and loan interest rates of commercial banks. The basis of this scientific work is the situation of the above hypothesis in the practice of Uzbekistan. In this scientific research, we focus on the impact of the mandatory national currency reserve ratio on the deposits of legal entities on the percentage of deposits in the national currency attracted from corporate clients and the percentage of loans in the national currency allocated to them.

Review of literature on the subject

Many scientists have conducted scientific research on the reserve policy as part of the monetary

policy instruments of the Central Bank. In particular, there are quite controversial scientific debates about the effect of the required reserve ratio on the percentage of deposits and loans in commercial banks. It is appropriate to get acquainted with some of them.

Ma Guonan, Xiandong Yan and Xi Liu (2013) conducted research on the importance of mandatory reserve policy in the Chinese economy. Since 2007, the People's Bank of China has widely used a low-cost mandatory reserve instrument as an alternative to open market policy in order to prevent the accumulation of large amounts of foreign currency in the economy. It also uses reserve requirement policy to address many issues, including influencing credit policies of commercial banks, financial market fluctuations, and macroeconomic issues. But the extensive use of reserve requirements by central banks imposes excessive costs on commercial banks. In order to get out of this situation, commercial banks are charging the costs of mandatory reserves on the responsibility of clients consisting of individuals or representatives of medium and small businesses.

China's economy is very different from other economies. The role of the state in the Chinese economy remains high. The People's Bank of China frequently changes the reserve requirement ratio to ensure macroeconomic stability. S. Chang et al. (2019) analyzed the impact of frequent changes in China's reserve requirement on macroeconomic stability through a two-sector DSGE model. The heavy industrial sector, called state-owned enterprises, is financed by bank loans guaranteed by the state and subject to mandatory reserves. The highly profitable private sector, on the other hand, relies on unstructured off-balance sheet financing. High reserve requirements lead to redistribution of financial resources to private firms, which increases their productivity and, conversely, increases the probability of bankruptcy of state-owned enterprises. Adjustment of optimal reserve requirements complements adjustment of money supply, among other instruments, to ensure macroeconomic stability. In our opinion, frequent changes in mandatory reserve requirements are an effective instrument for mitigating the effects of sector-specific «shocks» that require reallocation of financial resources. But we do not think that it should be used to prevent «shocks» that spread to the entire economy by changing reserve requirements frequently.

Analysis and main results

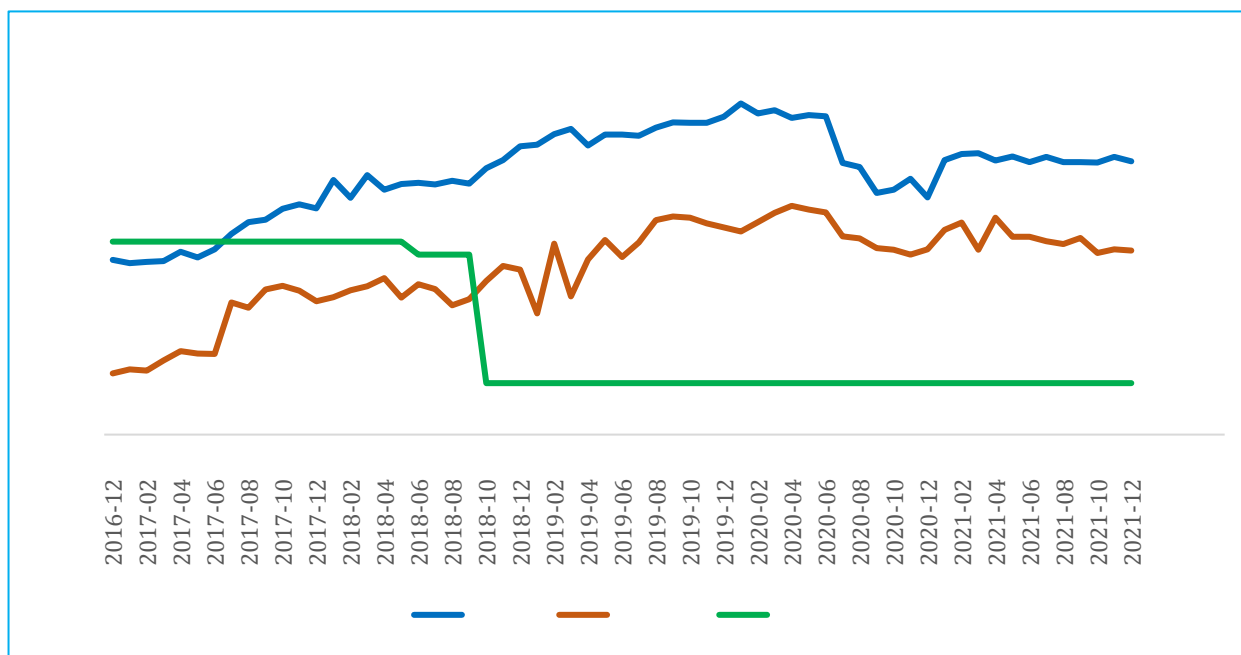
Increasing the level of capitalization and strengthening the financial stability of commercial banks is a necessary condition for ensuring the stability of the country's banking system. Therefore, in the Decree No. PF-60 of the President of the Republic of Uzbekistan dated January 28, 2022 «On the development strategy of the new Uzbekistan for 2022-2026», deepening the reform of the banking system and ensuring its stability, increasing the level of capitalization of banks and strengthening the financial stability of the country's banking system recognized as priorities.

Also, the adoption of the decision of the President of the Republic of Uzbekistan dated May 6, 2015 No. PQ-2344 «On measures to further increase the financial stability of commercial banks and develop their resource base» played an important role in increasing the level of capitalization and ensuring financial stability of the country's banks. Because, in this Decision, specific tasks were set to increase the level of capitalization of commercial banks based on the new requirements of the Basel Committee and to strengthen their financial stability.

Table 1 Mandatory reserve regulations (from July 1, 2019 to the present day)

Obligation type	Mandatory reserve regulations (from July 1, 2019 to August 4, 2021)	Mandatory reserve regulations (from August 5, 2021)
Deposits of legal entities in national currency*	4	4
Deposits of legal entities in foreign currency	14	18
Deposits of legal entities in foreign currency	4	4
Deposits of individuals in foreign currency	14	18
Deposits of legal entities in national currency* Deposits of legal entities in foreign currency Deposits of individuals in national currency* Deposits of individuals in foreign currency Application of averaging coefficient to bank liabilities	for deposits in national currency for the period 01.07.2019 - 31.03.2020 (0.25) for the period 01.04.2020 - 14.06.2020 (0.35) For the period 15.06.2020 - 04.08.2021 (0.75) averaging coefficient was applied	* averaging coefficient (0.8) for deposits in national currency enti is used

In order to fulfill the task of introducing the new requirements of the Basel Committee on banking supervision into the banking practice of the country, as defined in the decision of the President of the Republic of Uzbekistan No. PQ-2344 of May 6, 2015 «On measures to further increase the financial stability of commercial banks and develop their resource base», the Central Bank of the Republic of Uzbekistan bank's instruction No. 14/3 dated June 13, 2015 (registered by the Ministry of Justice of the Republic of Uzbekistan with No. 2693 dated July 6, 2015) «On approval of the Regulation on the requirements for the capital adequacy of commercial banks» was adopted. In this guideline, the requirement to gradually increase the minimum requirements for the adequacy of the regulatory capital of commercial banks of our republic was reflected.



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Figure 1. The effect of the mandatory reserve norm on the average deposit and loan percentage of legal entities in the banking system.

Also, developing countries are characterized by high mandatory reserve norms. This can be explained by central banks' insurance of the banking system. The Central Bank of the Republic of Uzbekistan has maintained high reserve requirements for many years. Only since 2018, the mandatory reserve norms in national currency have been reduced, but the mandatory reserve norms in foreign currency remain high. This is necessary to curb the demand for foreign currency deposits by banks.

Also, with the opening of the deposit guarantee fund in the banking system of Uzbekistan in 2003, deposits of individuals in banks were exempted from mandatory reserve requirements, and only deposits of legal entities are subject to mandatory reserves. However, starting from 2018, the obligations of commercial banks from individuals were also taken into reserve by the Central Bank. Today, we can see the mandatory reserve norms from the data of Table 1.

We think that the mandatory reserve policy of the Central Bank has found its logical basis since July 1, 2022. In particular, from this period, the method of stratification by maturity was abandoned in determining the mandatory reserve norm. One of the main reasons for this was that most of the deposits of legal entities in commercial banks were transactional deposits, and the deposits of legal entities corresponded to a high percentage of the reserve requirement. At the same time, the mandatory reserve norm for deposits of legal entities and individuals in foreign currency is set much higher than the norm for deposits in national currency. This is expected to increase the demand for the national currency and slow down the rate of devaluation of the national currency against the foreign currency. For this purpose, starting from August 5, 2022, the Central Bank increased the mandatory reserve ratio for foreign currency deposits from 14% to 18%.

In Uzbekistan, there is a strong correlation between the percentage of deposits that commercial

banks attract from legal entities and the percentage of loans allocated to them. But the logical connection between the Central Bank reserve requirement and the above two indicators is not noticeable. In particular, in order to eliminate the short-term liquidity shortage in the money market, the reduction of the mandatory reserve ratio by the Central Bank should also reduce the percentage of loans.

But we can see from the practice of Uzbekistan that the reduction of mandatory reserve norms from 2018 did not reduce the percentage of loans, on the contrary, the percentage of loans is increasing. This, in turn, means that other factors have a strong influence on the percentage of short-term loans of commercial banks.

The initial impact of the monetary policy of the Central Bank is seen in the money market. The influence of the monetary policy on the state of the money market of Uzbekistan was imperceptible until the beginning of 2022. Of course, we can give a number of reasons for this, but this is not the object of our scientific research. From 2022, the Central Bank of Uzbekistan started using the instruments and tools used in the experiences of the central banks of developed countries. In particular, instruments such as overnight deposit operations, which set the lower limit of the interest rate in the money market, and overnight REPO operations, which set the upper limit of the interest rate in the money market, were introduced. As a result, the Central Bank's monetary policy began to bear fruit.

Conclusions and suggestions

In order to solve the problems mentioned above, it is necessary to implement the following proposals and conclusions:

In order to eliminate the negative impact of the Central Bank's mandatory reserve requirements on the financial stability of commercial banks, first of all, the amount of mandatory reserve allocations should be kept in the "Nostro" representative account of commercial banks; secondly, it is necessary to unify mandatory reserve rates, taking into account the expected level of inflation.

Keeping the amount of mandatory reserve allocations in the "Nostro" representative account of banks serves to increase their liquidity level, while the unification of mandatory reserve rates in line with the inflation rate allows to increase the resource potential of banks.

- it is necessary to exclude the devaluation reserve from the composition of the first-tier capital of commercial banks and to stop the devaluation of the national currency in order to prevent the accumulation of the amount of the devaluation reserve in the banks' balance sheets.

Taking into account the presence of undistributed profit in the amount necessary to remove the devaluation reserve from the banks' balance sheets in the commercial banks of our republic, in our opinion, it is necessary to introduce the formation of the devaluation reserve from the net profit of the current year.

Removing the devaluation reserve from the regulatory capital of commercial banks allows to qualitatively increase the level of capitalization of commercial banks with foreign currency funds in their authorized capital.

- in order to ensure the adequacy of the regulatory capital of commercial banks at the macro level, first of all, it is necessary to ensure the proportionality between the growth rate of the regulatory capital and the growth rate of the nominal gross domestic product; secondly, it is

necessary to increase the amount of regulatory capital of commercial banks both by issuing new shares and by directing undistributed profit to the authorized capital; thirdly, in order to ensure the investment attractiveness of the new ordinary shares issued by commercial banks, the income received by investors from their investments in the banks' shares should be exempted from the profit tax.

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