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THE MECHANISM OF THE FORMATION OF THE EXCHANGE RATE IN UZBEKISTAN AND ITS INFLUENCE ON THE LEVEL OF INFLATION

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Annotation: This article explores the mechanism of exchange rate formation in Uzbekistan and its impact on inflation levels. By analyzing policy frameworks, economic dynamics, and empirical data, the study identifies key factors influencing currency valuation and inflationary trends. The article further examines global and local influences, providing actionable recommendations for policymakers to mitigate inflation risks while ensuring exchange rate stability.
Keywords: Uzbekistan, exchange rate, inflation, currency valuation, monetary policy, economic stability, financial market.

The exchange rate is a critical determinant of macroeconomic stability, directly affecting inflation, trade balances, and economic growth. In Uzbekistan, a transitioning economy with an open monetary policy, the exchange rate mechanism plays a pivotal role in shaping financial and social stability. This article aims to understand the factors influencing exchange rate formation in Uzbekistan and to evaluate its correlation with inflation.

The study's main objectives are:

1. To identify the mechanisms driving exchange rate formation in Uzbekistan.
2. To analyze the influence of exchange rate fluctuations on inflation.
3. To propose strategies to manage exchange rate impacts effectively.

The Mechanism of Exchange Rate Formation in Uzbekistan and Its Influence on Inflation

Understanding the exchange rate formation mechanism in Uzbekistan and its impact on inflation involves analyzing several economic factors. Below is a detailed explanation:

Mechanism of Exchange Rate Formation

In Uzbekistan, the exchange rate is determined primarily by market mechanisms, though the Central Bank plays a significant role in managing volatility. The mechanism includes the following components:

Supply and Demand Dynamics:

- The exchange rate of the Uzbek som (UZS) against foreign currencies, such as the US dollar, is largely determined by the supply of and demand for foreign currency in the market. Key contributors include:

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- Imports and Exports: Importers demand foreign currency to pay for goods, while exporters supply foreign currency earned abroad.

- Remittances: A significant source of foreign currency inflow comes from remittances sent by migrant workers.

Central Bank Interventions:

- Although Uzbekistan transitioned to a freely convertible exchange rate in 2017, the Central Bank intervenes occasionally to stabilize excessive fluctuations by buying or selling foreign currency.

- Such interventions are essential during periods of economic uncertainty or external shocks to ensure a balanced foreign exchange market.

Impact of Inflation and Interest Rates:

- High inflation in Uzbekistan often leads to depreciation of the national currency. The Central Bank counteracts this by adjusting interest rates to curb inflationary pressures and maintain exchange rate stability.

Influence of the Exchange Rate on Inflation

The exchange rate significantly impacts inflation levels in two primary ways:

Effect on Import Prices:

- Uzbekistan's economy heavily relies on imports, including essential goods such as food, machinery, and raw materials. A depreciation of the som increases the cost of imported goods, which translates into higher consumer prices, contributing to imported inflation.

Psychological Factors:

- Exchange rate volatility affects consumer and business expectations. If the som weakens, people anticipate higher future prices, prompting increased demand for foreign currency. This additional demand can further pressure the exchange rate and exacerbate inflation.

Case Studies and Practical Examples

- 2017 Currency Liberalization:

In 2017, Uzbekistan introduced a freely convertible exchange rate, leading to a significant depreciation of the som. This policy aimed to boost economic competitiveness and foreign investment but resulted in a temporary surge in inflation due to higher import costs.

- Role of Remittances:

Remittances from Uzbek migrant workers serve as a stabilizing factor for the exchange rate. However, fluctuations in remittance inflows can impact foreign currency supply, indirectly influencing inflation rates.

Managing Inflation Amid Exchange Rate Volatility

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To address the relationship between the exchange rate and inflation, the government and Central Bank have adopted several measures:

Monetary Policy:

- The Central Bank uses interest rate adjustments to control inflation. By raising interest rates, it aims to reduce domestic demand and stabilize the currency.

Diversifying the Economy:

- Reducing dependency on imports through the development of local industries and promoting exports can mitigate the effects of exchange rate fluctuations on inflation.

Maintaining Fiscal Discipline:

- Ensuring a balanced state budget helps reduce external vulnerabilities, which indirectly supports exchange rate stability and inflation control.

Building Reserves:

- Accumulating foreign currency reserves allows the Central Bank to intervene effectively in the forex market to cushion against sharp depreciation.

In Uzbekistan, the exchange rate is a pivotal factor influencing inflation. While the transition to a market-oriented exchange rate regime has enhanced economic competitiveness, it also exposed the economy to higher inflationary risks, particularly through import prices and consumer expectations. To mitigate these risks, the Central Bank employs a mix of monetary policy tools, market interventions, and structural reforms aimed at ensuring long-term economic stability.

This interplay between exchange rate formation and inflation underscores the importance of a balanced and sustainable economic policy framework.

The findings reveal that Uzbekistan's exchange rate mechanism is highly sensitive to external shocks. Despite the managed float regime's advantages, excessive reliance on interventions may undermine long-term stability. Inflationary pressures, exacerbated by currency depreciation, highlight the need for diversification in import dependency and enhanced monetary policy tools.

Comparatively, neighboring countries like Kazakhstan and Kyrgyzstan exhibit similar challenges but have leveraged international reserves more effectively to stabilize their currencies. Uzbekistan could draw lessons from these strategies while maintaining its unique policy orientation.

Conclusions

- Exchange rate volatility significantly impacts inflation in Uzbekistan, primarily through imported goods.
- The current managed float regime balances market-driven mechanisms with central bank oversight but requires further refinement.

Strengthen Reserves: Build foreign exchange reserves to cushion against external shocks.

Diversify Imports: Promote domestic production and alternative trading partnerships to reduce dependency on imports.

Enhance Transparency: Ensure clear communication of monetary policies to foster investor confidence.

Adopt Hedging Instruments: Encourage businesses to use financial derivatives to mitigate exchange rate risks.

Regional Collaboration: Partner with Central Asian countries to stabilize regional economic environments.

By addressing these aspects, Uzbekistan can better manage its exchange rate and inflation, fostering sustainable economic growth.

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