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DEVELOPING GOVERNMENT LOCAL CURRENCY BOND MARKET OF THE REPUBLIC OF UZBEKISTAN

Abstract. *This study analyzes how the development of the local currency bond market contributes to financial market stability. Local currency bond markets help to strengthen money and financial markets. An efficient debt market promotes economic growth and development by allowing capital to be transferred from savers to borrowers. It improves allocation efficiency of resources in the economy, in addition to helping financial stability by improving monetary policy transmission.*

Keywords: *local currency bond market, risk, liquidity, depth of the market, exchange rate volatility, currency mismatch, maturity mismatch, financial crisis.*

INTRODUCTION

Developed and effective domestic government debt markets also encourage financial stability during turbulent periods and offer multiple additional economic advantages. The last two decades of financial crises, including headlines about turmoil in financial markets driven by the COVID-19 pandemic, have also demonstrated how effective local currency bond markets reduce financial strain as they allow borrowing in a domestic currency and hedge against currency risk. According to the guidance note of the experts of the International Monetary Fund and the World Bank – “the development of local currency bond markets is a cornerstone of broader capital market development that helps risk to be priced appropriately, allows participants in financial markets to better manage their portfolios, and provides a more effective conduit for monetary policy. These factors then help boost a country’s long-term economic growth potential” [1].

Over the past ten years, emerging market and developing economies have seen an increase in the percentage of total government debt that is marketable in local currency. The circumstances for this increase were brought about by improved macroeconomic conditions and a heightened awareness of the significance of growing domestic debt markets.

Increased monetary tightening in the US in 2022 caused capital outflows from emerging economies and currency depreciation. This illustrates how vulnerable emerging markets are to shocks from around the world: when investors sell riskier

assets and move their money to safer, more liquid assets – a phenomenon referred to as flight-to-quality and flight-to-liquidity – market liquidity declines.

Systemic financial crisis could arise from a combination of structural flaws in the market and a lack of liquidity. For instance, maturity and currency mismatches were extensively documented in the late 1990s as a significant structural problem in the financial markets, which aided in the Asian financial crisis of 1997–1998. Emerging markets are exposed to shocks because they have trouble borrowing from outside in their own currency or borrowing for a longer period of time. To address the financial fragility caused by these flaws, many nations have worked to build local currency bond markets that channel local currency funding, particularly longer-term tenors, to borrowers. As previously stated, maturity and currency mismatches are recognized as major reasons that will be cause capital flight, significant currency devaluation, and the depletion of foreign reserves in emerging economies with underdeveloped local currency bond markets.

In emerging countries, businesses and non-bank financial organizations obtain short-term loans from foreign banks while investing in long-term assets and/or providing long-term loans. As a result, their balance sheets reflect both long-term assets and short-term liabilities. During the financial crisis, when international banks refuse to roll over short-term loans, local businesses will encounter cash flow problems due to the "maturity mismatch" issue. Furthermore, because these economies lack a strong local currency bond market, the vast bulk of these liabilities will be denominated in foreign currencies. This will cause the "currency mismatch" problem. Conversely, some contend that the emergence of a local currency bond market could potentially increase uncertainty due to the increased participation of foreign investors in this developing bond market. It is found that when the percentage of foreign holdings rises above a certain threshold, the effect of a global shock on the local currency bond market is amplified. A currency mismatch for foreign investors could arise from an increase in the supply of local currency bonds in an emerging economy. Foreign investors' balance sheets will be impacted by a decline in the value of local currency bonds, which may lead to fire sales as a way for them to safeguard their investments before further losses from currency depreciation occur.

LITERATURE REVIEW

Studies have looked into the criteria necessary for the establishment of a local currency bond market. Burger and Warnock (2007) stated that the establishment of a local bond market is dependent on the rule of law and effective macroeconomic policy. They discovered that nations with stable inflation and strong creditor rights are more likely to have well-established domestic currency markets and a lesser reliance on foreign currency bonds. They claimed that improving macroeconomic performance and the creditor protection system would enable the establishment of a local currency bond market while lowering the risk of a crisis [2].

According to Boukhatem (2021), macroeconomic and financial variables are more important than institutional factors in the short term development of a local currency bond market. However, he discovered that a huge economy, significantly increased government spending, low inflation, a broader and deeper financial system, and improved bureaucratic quality are all relevant [3].

Berensmann et al. (2015) shown that the expansion of a local currency bond market is related to the size of the economy, the involvement of the banking sector, trade openness, and an effective regulatory framework [4].

Eichengreen et al. (2005) noted that due to underdeveloped bond markets, local currency-denominated bonds provide minimal liquidity when many economies experience high inflation and currency instability. Because of this dilemma, many economies are forced to issue short-term bonds in a foreign currency with a consistent value. As a result, if the local currency bond market is expanded to provide liquidity, these economies may be able to overcome the so-called "original sin." The term "original sin" refers to some economies' incapacity to borrow abroad using their own currency [5].

ANALYSIS AND RESULTS

Recently, Uzbekistan is advancing the development of local currency debt markets in order to stimulate investment in infrastructure. First, the government's ability to successfully increase reliance on the bond market as a substitute source of funding for bank loans; and second, their capacity to impose fiscal contraction as a way to curtail bank lending and lower interest rates. Uzbekistan will need to grow quickly in the domestic debt market in order to reach this goal. Realistic policy sequences should be followed in the long-term planning and implementation of Uzbekistan's domestic debt market development. To reduce systemic risk, it must adhere to banking industry regulations.

In 2021 the experts of the International Monetary Fund and the World Bank developed local currency bond markets guidance notes for countries as a recommendatory nature. According to the notes there should be enabling conditions and 6 building blocks in order to develop the local currency bond markets.

Since enabling conditions essentially define a nation's economic potential, they are essential to the success of agreed-upon local currency bond market reform efforts. In order to produce a more precise evaluation of the foundational elements for the growth of the local currency bond market, it is imperative to assess the type of enabling conditions present in the subject nation. The goals and order of reforms in policy can also be influenced by the status of enabling factors. However, even in the face of inadequate enabling conditions, bolstering the fundamental features of the local currency bond market building blocks can support a positive feedback loop since they will enhance macroeconomic discipline, which in turn can enhance the enabling conditions themselves. There is an inherent limit to the growth of domestic markets in nations with structural constraints, such as those pertaining to the size of the financial sector or the economy; instead, the main objective may need to be securing consistent, ongoing funding from the domestic market.

The enabling conditions consist of macroeconomic conditions, financing needs of the government, fiscal and debt position, monetary and exchange rate conditions, structure of the economy, financial sector soundness, debt management capacity and operating procedures. Each enabling conditions assess one to four according to the development of them.

- Macroeconomic Conditions - Overall stable macroeconomic conditions and a good past track record to broaden potential demand and enable primary dealer intermediating role with a broader universe of potential investors;
- Financing needs of the government - The government's financing needs must form the basis of debt issuance. Local currency bond market development may be impaired in some lower income countries in which the availability of concessional borrowing makes the issuance of local debt more expensive;
- Fiscal and Debt position - High financing needs, and unsustainable debt trajectory may encourage debt management office to recur to interest rate controls and financial repression that undermine investors' appetite;

- Monetary and exchange rate conditions - Stable inflation, interest rates and exchange rates reduce uncertainty for investors and enhance demand for government marketable debt;
- Structure of the economy - Small economies may struggle to build liquid markets, low saving rates may limit demand, high level of dollarization equally constraint local currency assets' demand;
- Financial sector soundness - The financial sector needs to be well-capitalized and liquid. Any risks of financial sector instability would hamper the capacity of the banking sector to play its role effectively;
- Debt management capacity and operating procedures – debt management office should have trained staff, resources, and an adequate organization structure.

Figure 1 below shows today's analysis of the enabling conditions necessary for the development of the local currency bond market of the Republic of Uzbekistan. According to the data of the picture, 3.5 points were given to the current state of Fiscal and debt positions in our country, and this is almost an excellent situation. The lowest indicator was given to the state of debt management capacity and operating procedures and was evaluated with 2 points. The main problems with debt management capacity and operating procedures are not having sound governance arrangements and qualified staff in a responsible entity for debt management and problems with the preparation and publishing of a medium-term debt management strategy by an entity.

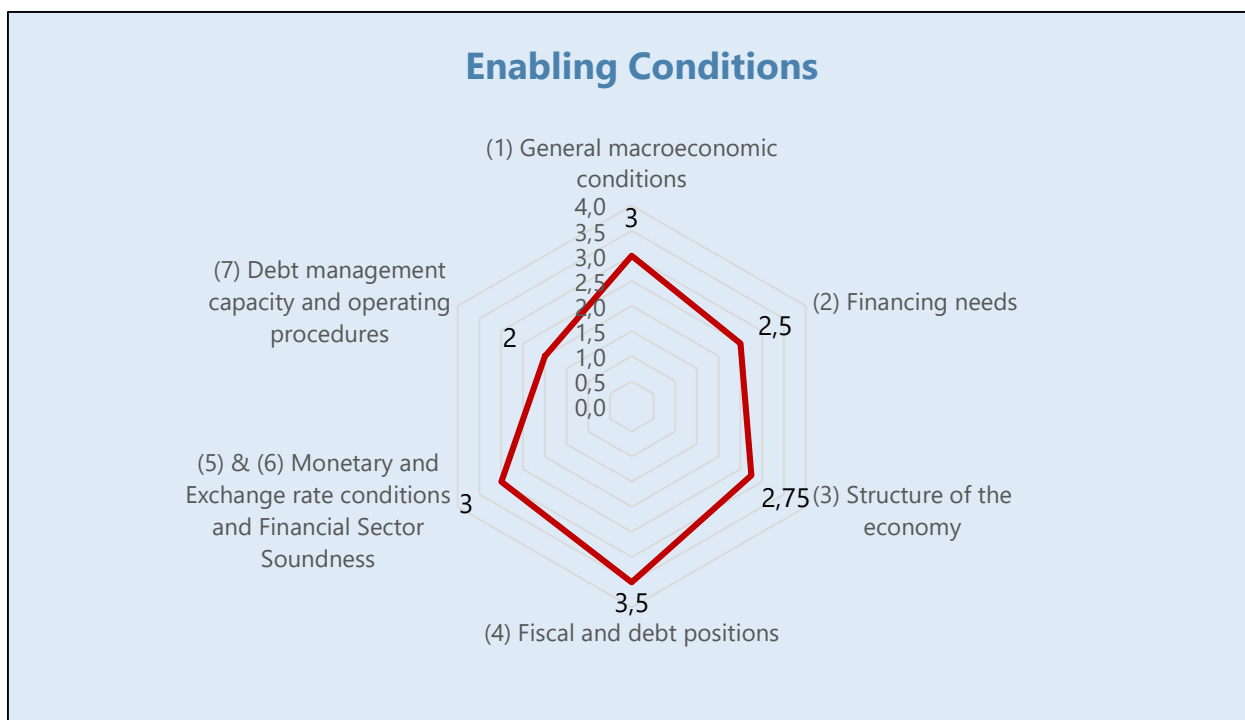


Figure 1. The assessment of the enabling conditions of the Republic of Uzbekistan [1]

The local currency bond market in Uzbekistan has made remarkable strides in recent years as a result of several initiatives by the central bank, government, and other stakeholders. Nonetheless, while activity in the corporate bond market has increased, the Uzbekistan bond market remains dominated by the government bond market.

In Figure 1 below analyses government securities issued and placed by the Ministry of Economy and Finance from December 2018 to September 2024. According to the analyzed data, the issuance of state securities worth 400 billion soums was announced in December 2018, of which almost 404.9 billion soums were placed. The number of bidders in this number was only 5, and almost all of them were state-owned banks. Since 2019, the volume of trade in government securities has increased significantly, in particular, in this year, 1 582 billion soums were placed, almost 32 billion soums more than the announced volume.

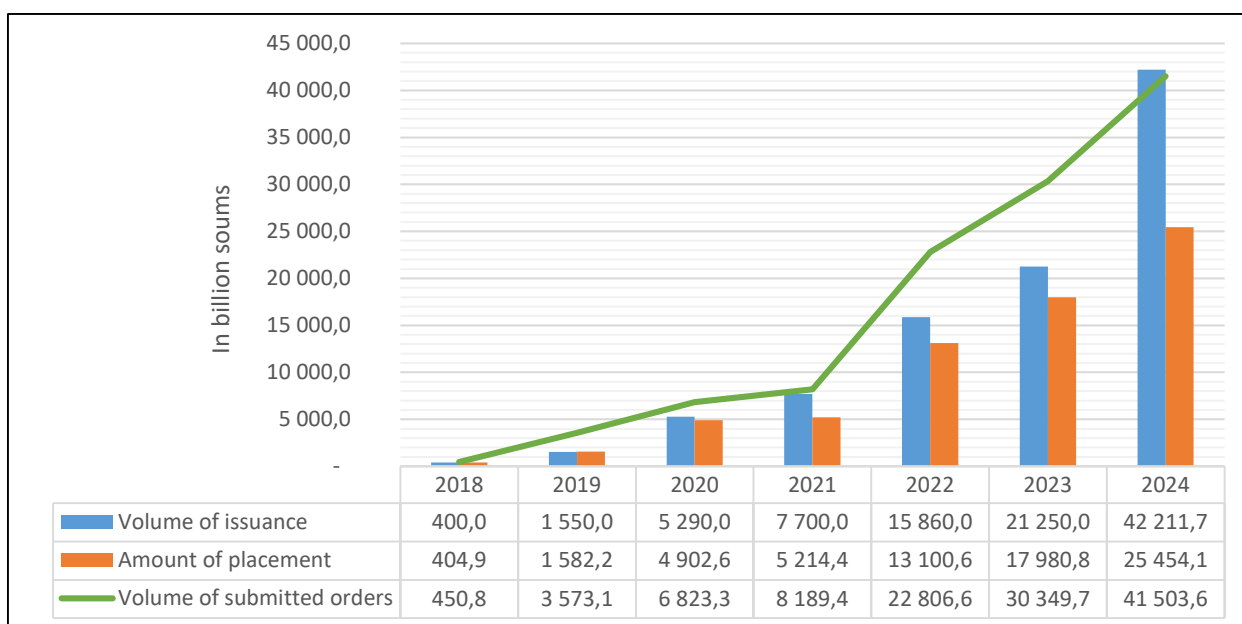


Figure 2. Volume of government securities issued and placed by the Ministry of Economy and Finance of the Republic of Uzbekistan during 2018-2024 [6]

In 2023, a total of 17.9 trillion soums, more nearly 5 trillion soums compared to the previous year, were placed in the government securities of the Ministry of Economy and Finance. In the last year 2024 the issuance of state securities worth 42.2 trillion soums was announced which almost 25.5 trillion soums were placed until September 1, 2024. According to the analytical data, the demand for government securities denominated in the domestic currency has an increasing tendency. In particular, in 2019, 1,550 billion soums worth of state bonds were announced, but 3,573 billion soums of state bonds were requested for this year, and this shows that there were twice as many requests for the issuance. Also, it can be seen that the demand for state bonds in domestic currency was much higher than the announced volume during the remaining years (Figure 2).

Starting from 2021, the laws on the state budget, which are approved every year, have confirmed the limited net volume of the issuance of government securities (Table 1).

In table 1 below provides an analysis of the limited net volume of state securities issuance and the limited amount of public debt in each year's State Budget Laws. According to the table, the limited amount of state securities in 2021 is set at 5 trillion soums, and the limited amount of state debt is set at 5.5 billion US dollars.

Table 1.

Analysis of the determination of the limited net volume of Government securities for 2021-2024 [7]

Years	Limited amount of public debt	Limited net volume of government securities	Legal basis
2024 year	5 billion US dollars	25.0 trillion soums	Law "On the State Budget of the Republic of Uzbekistan for 2024", 25.12.2023/No 886
2023 year	4.5 billion US dollars	17.0 trillion soums	Law "On the State Budget of the Republic of Uzbekistan for 2023", 30.12.2022/No 813
2022 year	4.5 billion US dollars	6.0 trillion soums (12.0 trillion soums)*	Law "On the State Budget of the Republic of Uzbekistan for 2022", 30.12.2021/No 742 /29.12.2022/No 811
2021 year	5.5 billion US dollars	5.0 trillion soums	Law "On the State Budget of the Republic of Uzbekistan for 2021", 25.12.2020/No 657

In 2022, although the limited amount of state securities was set at 6 trillion soums at the beginning of the year, it was changed to 12 trillion soums by the end of the year. For 2024, the limited amount of state debt was set at 5 billion US dollars, and the limited amount of state securities was set at 25 trillion soums. However, in 2024, the limited amount of state securities was set so far that the volume of issuance was 42.2 trillion soums and nearly 17 trillion soums above the limited net volume of the issuance of government securities. In our opinion, the limited net volume of the issuance of government securities defined by the law will change until the end of this year.

CONCLUSIONS

In boosting local currency bond markets, the government should try to provide a welcoming environment for foreign investors while also improving macroeconomic stability. To address the original sin problem, the Republic of Uzbekistan should issue long-term bonds of various maturities to the market and strive to lessen its reliance on short-term foreign borrowing. The goal will be to better absorb external shocks and avoid exchange rate increases caused by unexpected halt and short-term reversals of international capital flows.

Some theoretical studies link the growth of local currency bond markets to financial stability. The creation of a local currency bond market may contribute to an economy's financial stability by reducing foreign borrowing and boosting the diversity of bonds with varying maturities.

If developing economies maintain the majority of their liabilities in local currency denominated bonds, a fall in the local currency's value may not raise the likelihood of foreign capital outflows. As the local bond market grows, bank liquidity will improve. Furthermore, the availability of bonds with varying maturities and long-term maturity will address the maturity mismatch issue and eventually contribute to financial stability. Many emerging economies are significantly reliant on bank finance. They say that local currency bond markets help to deepen capital markets and balance financial systems by lowering reliance on bank financing.

A well-developed local currency bond market also delivers significant economic benefits:

It offers a yield curve, which is a market-determined term structure for interior rates. The yield curve is used primarily as a benchmark for pricing credit risk, bank loans, and equities. The shape of the yield curve provides useful information regarding market expectations of future interest rates and inflation rates for macroeconomic policymakers. The bond market serves as the foundation for the development of efficient derivatives markets (forwards, futures, swaps, and options) for low-cost financial risk management.

It allows for the transfer of risks through security. The bond market is an essential instrument for banks to bundle and sell loans. This decreases banks' liquidity risk and mitigates maturity mismatches.

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